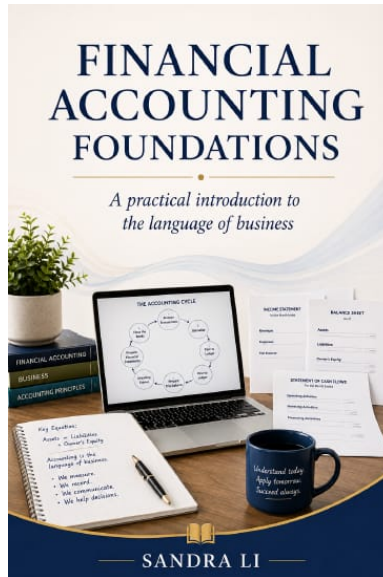


FINANCIAL ACCOUNTING FOUNDATIONS: A PRACTICAL INTRODUCTION TO THE LANGUAGE OF BUSINESS



Sandra Li
De Anza College



Financial Accounting Foundations

A Practical Introduction to the Language of Business

This text is disseminated via the Open Education Resource (OER) LibreTexts Project (<https://LibreTexts.org>) and like the thousands of other texts available within this powerful platform, it is freely available for reading, printing, and "consuming."

The LibreTexts mission is to bring together students, faculty, and scholars in a collaborative effort to provide an accessible, and comprehensive platform that empowers our community to develop, curate, adapt, and adopt openly licensed resources and technologies; through these efforts we can reduce the financial burden borne from traditional educational resource costs, ensuring education is more accessible for students and communities worldwide.

Most, but not all, pages in the library have licenses that may allow individuals to make changes, save, and print this book. Carefully consult the applicable license(s) before pursuing such effects. Instructors can adopt existing LibreTexts texts or Remix them to quickly build course-specific resources to meet the needs of their students. Unlike traditional textbooks, LibreTexts' web based origins allow powerful integration of advanced features and new technologies to support learning.



LibreTexts is the adaptable, user-friendly non-profit open education resource platform that educators trust for creating, customizing, and sharing accessible, interactive textbooks, adaptive homework, and ancillary materials. We collaborate with individuals and organizations to champion open education initiatives, support institutional publishing programs, drive curriculum development projects, and more.

The LibreTexts libraries are Powered by [NICE CXone Expert](#) and were supported by the Department of Education Open Textbook Pilot Project, the California Education Learning Lab, the UC Davis Office of the Provost, the UC Davis Library, the California State University Affordable Learning Solutions Program, and Merlot. This material is based upon work supported by the National Science Foundation under Grant No. 1246120, 1525057, and 1413739.

Any opinions, findings, and conclusions or recommendations expressed in this material are those of the author(s) and do not necessarily reflect the views of the National Science Foundation nor the US Department of Education.

Have questions or comments? For information about adoptions or adaptations contact info@LibreTexts.org or visit our main website at <https://LibreTexts.org>.

The LibreTexts name, logo, and book covers are trademarked by LibreTexts, Inc. (a 501(c)(3) not-for-profit organization) and protected against unauthorized use.

This text was compiled on 09/19/2026

TABLE OF CONTENTS

Licensing

Program Page

Accessibility Statement

AI Use

About the Book

About the Author

1: Introduction to Financial Accounting

- 1.1: Importance of Accounting
- 1.2: Users of Accounting Information
- 1.3: Financial vs Managerial Accounting
- 1.4: Types of Organizations
- 1.5: Accounting Career Pathways
- 1.6: Introduction to The Accounting Cycle
- 1.7: Summary
- 1.8: Key Terms
- 1.9: Practice Questions
- 1.10: Alternate Text Descriptions

2: Accounting Equation and Journal Rules

- 2.1: The Accounting Equation
- 2.2: The Expanded Accounting Equation
- 2.3: Transaction Analysis - Example
- 2.4: Debit and Credit Rules
- 2.5: Applying the Debit and Credit Rules
- 2.6: Summary
- 2.7: Key Terms
- 2.8: Practice Questions
- 2.9: Alternative Text Descriptions

3: Journalizing Transactions

- 3.1: Journal Entry
- 3.2: Journalizing Transactions
- 3.3: Summary
- 3.4: Key Terms
- 3.5: Practice Questions
- 3.6: Alternate Text Descriptions

4: Posting and the Trial Balance

- 4.1: Posting to the General Ledger

- 4.2: Finding each account's balance
- 4.3: Journaling and posting to account
- 4.4: Prepare a Trial Balance
- 4.5: The Unadjusted Trial Balance - Example
- 4.6: Summary
- 4.7: Key Terms
- 4.8: Practice Questions
- 4.9: Alternate Text Descriptions

5: Accrual Accounting and Adjusting Entries

- 5.1: Accrual Accounting Foundations
- 5.2: Cash vs Accrual comparison
- 5.3: Adjusting Entries
- 5.4: The Adjusted Trial Balance
- 5.5: Summary
- 5.6: Key Terms
- 5.7: Practice Questions
- 5.8: Alternate Text Descriptions

6: Completing the Accounting Cycle

- 6.1: Worksheet
- 6.2: The Financial Statements
- 6.3: Closing Entries
- 6.4: Post-Closing Trial Balance
- 6.5: Key Terms
- 6.6: Practice Questions
- 6.7: Alternate Text Description

7: Merchandising Transactions

- 7.1: The Perpetual Inventory System
- 7.2: The Periodic Inventory system
- 7.3: Comparing Inventory Systems
- 7.4: Accounting for Shipping Costs
- 7.5: Summary
- 7.6: Key Terms
- 7.7: Practice Questions
- 7.8: Alternate Text Description

8: Inventory Cost Flow Assumptions

- 8.1: Inventory Valuation Methods and Comparison
- 8.2: Calculate COGS and Ending Inventory
- 8.3: Summary
- 8.4: Practice Questions

Index

Glossary

Detailed Licensing

This page titled [Financial Accounting Foundations: A Practical Introduction to the Language of Business](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

Licensing

A detailed breakdown of this resource's licensing can be found in **Back Matter/Detailed Licensing**.

This page titled [Licensing](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

Program Page



De Anza College sits in the heart of Silicon Valley, where innovation and opportunity are part of daily life, and also has one of the highest costs of living in the country. For our students, that makes every dollar count, and the price of a textbook can be the difference between staying enrolled or dropping a class. Our Zero Textbook Cost (ZTC) program closes that gap by giving students full access to high-quality, faculty-created course materials at no cost from the first day of class.

De Anza is proud of its diverse student community, and we hold our ZTC materials to the same standard of excellence that defines the college. Faculty across departments write, adapt, and review these resources themselves, keeping them accurate, current, and grounded in the perspectives of the students who use them, with accessibility and inclusive design built in from the start.

This program reflects the time and care our faculty invest in their students. If you have questions, feedback, or come across any issues with a ZTC resource, contact De Anza College's ZTC Grants Coordinator, [Shagun Kaur](#).

Learn more about [De Anza ZTC Program](#) [www.deanza.edu/academic-services/oer/]

Note: The De Anza logo is a copyrighted trademark of De Anza College and may not be reproduced without permission.

Accessibility Statement

Accessibility

De Anza College is dedicated to creating learning materials that are accessible and benefit all students. Our materials follow the Web Content Accessibility Guidelines (WCAG) 2.1 Level AA. Our authors and contracted accessibility specialists checked all resources using this ASCCC OERI checklist, the accessibility tool in LibreTexts, WAVE, JAWS, and other more detailed checks for complex materials such as interactive components.

We selected LibreTexts as our preferred platform because of its [commitment to accessibility](#). In addition to the platform's inherent accessibility, we collaborated with the LibreTexts team to fix any accessibility issues we found.

Our Accessibility Review Process

Accessibility was built into the resource as it was written. This resource went through the following stages of review:

1. **Template check.** The project coordinator and instructional designers checked the first chapter for accessibility as a model to ensure later chapters meet accessibility standards.
2. **Progress checks.** The manuscript was checked at approximately 40%, 60%, and 80% completion to catch and correct accessibility issues in production.
3. **Specialist review.** Once the manuscript was complete, an accessibility expert conducted an accessibility check.
4. **Remediation.** The author and the project manager who conducted the earlier progress checks worked together to remediate the issues identified by the accessibility expert.
5. **Final check.** The resource underwent another full check by the accessibility expert before the book was deemed ready for publication.

This process combines ongoing checks during writing with a final specialist review, so issues are caught early and confirmed fixed before publication.

Report an Accessibility Problem

We are always looking for ways to make our resources more accessible. If you run into a barrier while using this resource, please let us know so we can look into it. When you [contact us](#), it helps to include:

- The name of the resource
- The location of the problem (a web address or page/chapter description)
- A description of the problem you encountered
- The device, browser, and any assistive technology you were using (e.g., Windows 11, Google Chrome, JAWS screen reader)

Contact us: [De Anza ZTC team](#)

This statement was last updated August 2026

This resource was project-managed by **Shagun Kaur**, overseeing scope, budget, and schedule; stakeholder coordination via monthly meetings; training and platform support (LibreTexts, troubleshooting, technical support); QA/accessibility check scheduling; and licensing and copyright governance.

A Note on Known Limitations

No accessibility check is perfect. We've made a genuine, sustained effort to catch and fix issues throughout the writing and review process described above, but some barriers may remain, especially in complex or interactive content. We'd rather be upfront about that than claim a standard of perfection we can't guarantee.

AI Use

AI Use in Course Development – Transparency & Standards

As part of the development process for this textbook and its accompanying course materials, we utilized artificial intelligence (AI) as a supportive educational technology to assist with idea generation, content organization, and early-stage drafting. Our use of AI was guided by principles of transparency, academic integrity, accessibility, and human oversight. At no point was AI used as a substitute for faculty expertise, scholarly judgment, or pedagogical decision-making.

The AI's role was limited to ideation and preliminary content generation. All AI-generated material underwent extensive review, revision, verification, and editing by the course authors. Faculty members evaluated content for accuracy, clarity, inclusivity, accessibility, relevance, and alignment with course learning outcomes. In many cases, AI-generated text served only as a starting point and was substantially modified, expanded, reorganized, or rewritten during the development process.

We also recognized that AI systems can reflect biases, inaccuracies, omissions, or outdated information. For this reason, no content was accepted without human review and independent verification. All factual claims, educational recommendations, examples, and references were evaluated against current evidence, professional standards, and the authors' subject matter expertise. Responsibility for the content ultimately rests with the human authors, not the technology used during development.

Our use of AI mirrors how many professionals increasingly use emerging technologies in education and the workplace: as tools that can enhance efficiency, creativity, and productivity while still requiring critical thinking, ethical judgment, and expert oversight. By incorporating AI transparently and responsibly, we sought not only to improve the development process but also to model thoughtful technology use for students navigating an increasingly digital and AI-assisted world.

Finally, we believe that innovation must be balanced with a commitment to equity and accessibility. Throughout the development process, all content was reviewed to ensure it met accessibility standards and supported diverse learners. AI-assisted drafting was only one component of a much larger process that included faculty collaboration, scholarly review, accessibility evaluation, and continuous revision. The result is a resource that reflects both the opportunities offered by emerging technologies and the enduring importance of human expertise in teaching and learning.

Copyright & Fair Use Considerations

We aligned with evolving IP policy frameworks, especially insights from the U.S. Copyright Office:

- The [Office's Part 3 report on AI model](#) training highlights the importance of fair use analysis and restricts reliance on generative AI when it could replicate copyrighted works—our use was limited to non-protected, openly licensed materials.
- This cautious approach is consistent with [guidance](#) that encourages transformative use, transparency, and limiting output that could inadvertently mirror protected content.

About the Book

Financial Accounting Foundations

Overview

Financial Accounting Foundations introduces students to the fundamental concepts and processes of financial accounting through clear explanations, practical examples, and step-by-step applications.

Designed for students who may be encountering accounting for the first time, the book emphasizes understanding the reasoning behind accounting procedures rather than simply memorizing rules.

Students learn how everyday business transactions move through the accounting system, from analyzing and recording transactions to preparing financial statements and interpreting financial information.

Throughout the book, realistic examples connect accounting concepts to business decisions and activities. Visual explanations, worked examples, practice activities, and review questions reinforce key concepts and give students opportunities to apply what they have learned.

The goal of this book is simple: to make accounting approachable, relevant, and practical while giving students a strong foundation for future coursework and the workplace.

Acknowledgments

The author would like to express appreciation to Shagun Kaur, Jyothsna Viswanadha, and Catherina Wong of De Anza College for their support and contributions in helping make this book possible.

About the Author

Sandra Li



Professional headshot of Sandra Li

Sandra Li is an accounting educator and accounting professional with over 30 years of combined experience in accounting, taxation, business, and education. She is a full-time accounting faculty member at De Anza College, where she teaches accounting courses. She also serves as an adjunct faculty member at the College of San Mateo, where she teaches QuickBooks Online courses.

In addition to teaching, Sandra works with small businesses on their accounting, bookkeeping, and taxation needs. This practical experience gives her firsthand insight into the accounting challenges business owners encounter in their day-to-day operations. It also helps her connect classroom concepts with real-world applications and demonstrate how accounting information is used to make business decisions.

Sandra holds a Bachelor of Science in Finance, a Master of Science in Taxation, and a Master of Science in Accounting. She is also an Enrolled Agent (EA). Her combination of professional practice and academic experience enables her to bring both technical knowledge and practical perspectives into the classroom.

Sandra understands firsthand that accounting does not always come easily at first. As a college student, she struggled with introductory accounting concepts and often found them difficult to understand. That experience shaped the way she approaches teaching today. She believes students learn best when complex concepts are broken into manageable steps, connected to practical situations, and explained in a way that answers not only how accounting works, but why.

Her goal as an educator and author is to make accounting approachable, relevant, and accessible—especially for students who may initially believe that accounting is simply “not for them.” Through clear explanations, practical examples, and opportunities to practice, she hopes to help students build confidence and discover that accounting is a skill that can be learned.

1: INTRODUCTION TO FINANCIAL ACCOUNTING

Overview

Every day, individuals and organizations make decisions that involve money. Whether purchasing supplies, paying employees, applying for a loan, or planning for the future, accounting provides the financial information needed to make informed decisions. Often called the "language of business," accounting helps transform financial data into meaningful information that can be used by managers, investors, creditors, government agencies, and other stakeholders. Understanding how this financial language works and who uses it is essential for anyone entering the business world.

In this chapter, you will learn the purpose of accounting, the users of accounting information, and the differences between financial and managerial accounting. You will also explore the various types of organizations that rely on accounting information and discover the many career opportunities available in the accounting profession. Finally, you will be introduced to the accounting cycle—the process accountants use to record, summarize and report financial information.

Learning Objectives

By the end of this chapter, you can:

1. Define accounting and explain its importance in business and personal decision making.
2. Identify the primary users of accounting information and explain how they use financial reports.
3. Differentiate between financial accounting and managerial accounting.
4. Describe the role of accounting in various types of organizations and identify career pathways within the accounting profession.
5. Identify the major steps in the accounting cycle and explain how accounting information supports organizational operations and decision-making.

1.1: Importance of Accounting

1.2: Users of Accounting Information

1.3: Financial vs Managerial Accounting

1.4: Types of Organizations

1.5: Accounting Career Pathways

1.6: Introduction to The Accounting Cycle

1.7: Summary

1.8: Key Terms

1.9: Practice Questions

1.10: Alternate Text Descriptions

This page titled [1: Introduction to Financial Accounting](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [1: Role of Accounting in Society](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://openstax.org/details/books/principles-financial-accounting>.

1.1: Importance of Accounting

Why Accounting Information Matters

Every swipe of a credit card, online purchase, paycheck, business decision, and investment creates financial data. **Accounting** transforms that data into meaningful information that people can use to make decisions. In a world increasingly driven by technology, data analytics, and artificial intelligence, understanding accounting is more valuable than ever because it helps people interpret the financial information that organizations rely on every day.

Accounting is the process of identifying, recording, analyzing and communicating financial information for decision making. Whether you plan to become an accountant, business owner, manager, or work in another profession, a basic understanding of accounting can help you better understand how organizations operate and make financial decisions.

Accounting is often called the "language of business" because it communicates the financial health and performance of an organization. Just as people use language to communicate ideas, businesses use accounting information to communicate financial results to owners, managers, investors, lenders, government agencies, and other stakeholders. Accounting information supports many everyday decisions, including:

- Creating a personal budget
- Purchasing a vehicle
- Evaluating a job offer
- Applying for a loan
- Determining whether a business activity is profitable

Throughout this course, you will learn how accounting information is collected, organized, and used to support effective decision making.

Think About It

Think about a financial decision you've made recently, such as buying a phone, choosing a bank account, or deciding whether to accept a job. What financial information helped you make that decision? Would having more information have changed your decision?

Meet Priya and Ledgerline

Throughout the first part of this book, you will follow Priya Nair, the owner of Ledgerline, a small business bookkeeping business. As you learn the fundamentals of accounting, you will record Priya's transactions and prepare her financial statements. Later in the course, when we begin studying merchandising businesses and inventory, we will introduce a different company whose operations better illustrate those topics.

Small Business Snapshot

These statistics demonstrate why accounting and bookkeeping skills are valuable. Regardless of size, businesses need reliable financial information to operate effectively.

Business Spotlight: Small Businesses Drive the Economy

Small businesses play a significant role in the U.S. economy. According to the U.S. Small Business Administration (SBA), small businesses account for 99.9% of all U.S. businesses and employ nearly half of all private-sector workers.

Whether operating a home bakery, dog grooming service, landscaping company, online retail store, or veterinary clinic, business owners rely on accounting information to track revenues, expenses, cash flow, and profitability. Accurate bookkeeping helps owners make informed decisions, obtain financing, and meet tax and reporting requirements.

To understand the contemporary landscape of entrepreneurship and small business economics, it is vital to examine empirical federal data. The U.S. Small Business Administration (SBA) Office of Advocacy publishes an annual data-driven brief titled [Frequently Asked Questions About Small Business](#). The 2026 edition compiles the most up-to-date statistics on American small firms, defining independent businesses with fewer than 500 employees. According to this report, small businesses make up 99.9% of all U.S. firms, employ 45.9% of the private sector workforce (62.3 million people), and generate 43.5% of the nation's Gross Domestic Product (GDP).

This resource provides foundational data regarding new business survival rates, financing methods, demographic ownership trends, and the regulatory or paperwork compliance burdens facing modern entrepreneurs. Reviewing this publication will help you connect core economic and management theories to current, real-world data.

Table 1.1.1 below summarizes the United States small business statistics of the number of businesses, share of U.S. businesses, employees, and the share of private-sector workforce.

Table 1.1.1: U.S. Small Business Statistics

Category	Value
Total Number of Businesses	36.2 million
Share of All U.S. Businesses	99.9%
Total Number of Employees	62.3 million
Share of Private-Sector Workforce	45.9%

1.2: Users of Accounting Information

Why Users Need Accounting Information

Accounting information is valuable because many different groups rely on it to make decisions. Whether managing a business, evaluating an investment, approving a loan, or ensuring compliance with laws and regulations, decision-makers need reliable financial information. Users of accounting information are generally classified into two categories:

- Internal users
- External users

Internal Users

Internal users are individuals within an organization who use accounting information to help manage day-to-day operations and make future plans. Examples of internal users include:

- Managers
- Department supervisors
- Executives
- Employees involved in planning and budgeting

Internal users may use accounting information to:

- Monitor performance
- Control costs
- Prepare budgets
- Evaluate profitability
- Make hiring and expansion decisions

Here are two examples of an internal user:

- A store manager reviewing monthly sales reports and expenses to determine whether additional employees should be hired during the holiday season.
- A home bakery owner comparing monthly sales revenue with ingredient and labor costs, and after noticing consistent profit growth, the owner decides to purchase a second commercial mixer to increase production capacity.

Think About It

If you currently work or have worked for a business, who were the internal users of accounting information? How might a manager have used accounting information to make decisions about staffing, scheduling, or purchasing?

External Users

External users are individuals or organizations outside the business who use accounting information to evaluate the organization's financial performance and make decisions. Examples of external users include:

- Investors
- Lenders and banks
- Government agencies
- Tax authorities
- Suppliers
- Potential business partners

External users may use accounting information to:

- Decide whether to invest in a company
- Determine whether to approve a loan
- Assess the company's ability to pay its debts
- Verify compliance with tax laws and regulations

Here are two examples of an external user:

- A bank reviews a company's financial statements before approving a business loan to determine whether the business can repay the debt.
- An investor examines a company's income statement and balance sheet before purchasing shares of stock to evaluate the company's profitability and financial stability.

Why Reliable Information Matters

Both internal and external users rely on accounting information to make important decisions. If the information is inaccurate or incomplete, poor decisions may result. Therefore, accountants play an important role in providing information that is relevant, reliable, and timely.

Figure 1.2.1 visually presents how accounting information flows to internal and external users. Internal users include managers, employees, supervisors, and executives, while external users include investors, lenders, government agencies, and suppliers.

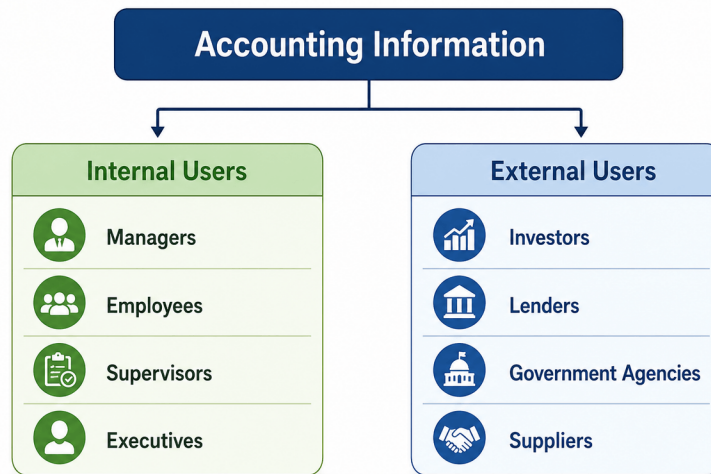


Figure 1.2.1: Comparison Internal Users vs External Users. (CC BY 4.0; Sandra Li via AI Generated image, 2026). [Detailed Description of Figure 1.2.1.](#)

Real-World Application 1.2.1

Maria owns a home bakery that sells cakes and pastries to local coffee shops. Although she enjoys baking, she must also track ingredient costs, sales revenue, and cash collections.

Internal users, such as Maria, use accounting information to determine whether the business is profitable and whether prices should be adjusted. External users, such as lenders, may review financial information when evaluating a loan application.

This example illustrates how accounting information supports decision-making for businesses of all sizes.

This page titled [1.2: Users of Accounting Information](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [1.2: Identify Users of Accounting Information and How They Apply Information](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

1.3: Financial vs Managerial Accounting

Overview

Different users have different information needs. Many decisions involve both financial and non-financial information. As a result, accountants prepare information in different forms to support those needs. For example, when deciding whether to purchase a vehicle, you may consider not only the price and monthly payment but also reliability, fuel efficiency, and maintenance costs. Businesses make similar decisions by considering both financial results and other factors that affect long-term success.

There are two primary branches of accounting: **financial accounting**, and **managerial accounting**. Financial accounting focuses on preparing financial information for external users such as investors, lenders, and government agencies. Managerial accounting focuses on providing financial and non-financial information to managers within an organization to support planning, decision-making, and operational improvement.

Whether working in a small business, nonprofit organization, or large corporation, accounting information helps individuals and organizations evaluate performance, make informed decisions, and plan for the future.

Table 1.3.1 below compares financial accounting and managerial accounting across key reporting characteristics, including users, report types, frequency, purpose, focus, information content, and verification requirements.

Table 1.3.1: *Financial vs. Managerial Accounting*

Communication of Reports	Financial Accounting	Managerial Accounting
Users	External users: stockholders, creditors, regulators.	Internal users: managers, officers, and other employees.
Types	Financial statements: balance sheet, income statement, cash-flow statement, etc.	Internal reports: job cost sheet, cost of goods manufactured, production cost report , actual vs budget reports
Frequency	Quarterly; annually	As frequently as needed
Purpose	Helps those external users make decisions: credit terms, investment, and other decisions	Assists the internal users in the planning and control decision-making process
Focus	Pertains to company as a whole. Uses GAAP structure composed from a multitude or combination of other more individual data.	Pertains to departments, sections of the business. Very detailed reporting. No GAAP constraints.
Nature	Monetary	Monetary and non-monetary information
Verification	Audited by CPA	No independent audits

Think About It

Imagine you own a small coffee shop. What accounting information would you want to see each day to help run your business? What information would a bank want to review before approving a business loan?

1.4: Types of Organizations

Types of Organizations and Their Accounting Needs

We can classify organizations into three categories: for profit, governmental, and not for profit. These organizations are similar in several aspects. For example, each of these organizations has inflows and outflows of cash and other resources, such as equipment, furniture, and land, that must be managed. In addition, all of these organizations are formed for a specific purpose or mission and want to use the available resources in an efficient manner—the organizations strive to be good stewards, with the underlying premise of being profitable. Finally, each of the organizations makes a unique and valuable contribution to society. Given the similarities, it is clear that all of these organizations have a need for accounting information and for accountants to provide that information.

There are also several differences. The main difference that distinguishes these organizations is the primary purpose or mission of the organization, discussed in the following sections.

For-Profit Businesses

As the name implies, the primary purpose or mission of a **for-profit business** is to earn a profit by selling goods and services. There are many reasons why a for-profit business seeks to earn a profit. The profits generated by these organizations might be used to create value for employees in the form of pay raises for existing employees as well as hiring additional workers. In addition, profits can be reinvested in the business to create value in the form of research and development, equipment upgrades, facilities expansions, and many other activities that make the business more competitive. Many companies also engage in charitable activities, such as donating money, donating products, or allowing employees to volunteer in the communities. Finally, profits can also be shared with employees in the form of either bonuses or commissions as well as with owners of the business as a reward for the owners' investment in the business. These issues, along with others, and the associated accounting conventions will be explored throughout this course.

In for-profit businesses, accounting information is used to measure the financial performance of the organization and to help ensure that resources are being used efficiently. Efficiently using existing resources allows the businesses to improve quality of the products and services offered, remain competitive in the marketplace, expand when appropriate, and ensure the long-term success of the business. In the United States, financial reporting for for-profit businesses is generally guided by accounting standards established by the **Financial Accounting Standards Board (FASB)**, the organization responsible for setting accounting standards for private-sector businesses and most nongovernmental nonprofit organizations.

For-profit businesses can be further categorized by the types of products or services the business provides. Let's examine three types of for-profit businesses: manufacturing, retail (or merchandising), and service.

Manufacturing Businesses

A **manufacturing business** is a for-profit business that is designed to make a specific product or products. Manufacturers specialize in procuring components in the most basic form (often called direct or raw materials) and transforming the components into a finished product that is often drastically different from the original components.

As you think about the products you use every day, you are probably already familiar with products made by manufacturing firms. Examples of products made by manufacturing firms include automobiles, clothes, cell phones, computers, and many other products that are used every day by millions of consumers.

Think about the items you have used today. Make a list of the products that were created by manufacturing firms. How many can you think of? Think of the many components that went into some of the items you use. Do you think the items were made by machines or by hand?

Retail Businesses

Manufacturing businesses and retail (or merchandising) businesses are similar in that both are for-profit businesses that sell products to consumers. In the case of manufacturing firms, by adding direct labor, manufacturing overhead (such as utilities, rent, and depreciation), and other direct materials, raw components are converted into a finished product that is sold to consumers. A **retail business** (or merchandising business), on the other hand, is a for-profit business that purchases products (called inventory) and then resells the products without altering them—that is, the products are sold directly to the consumer in the same condition (production state) as purchased.

Examples of retail firms are plentiful. Automobile dealerships, clothes, cell phones, and computers are all examples of everyday products that are purchased and sold by retail firms. What distinguishes a manufacturing firm from a retail firm is that in a retail firm, the products are sold in the same condition as when the products were purchased—no further alterations were made on the products.

Did you happen to notice that the product examples listed in the preceding paragraph (automobiles, clothes, cell phones, and computers) for manufacturing firms and retail firms are identical? If so, congratulations, because you are paying close attention to the details. These products are used as examples in two different contexts—that is, manufacturing firms *make* these products, and retail firms *sell* these products. These products are relevant to both manufacturing and retail because they are examples of goods that are both manufactured and sold directly to the consumer. While there are instances when a manufacturing firm also serves as the retail firm (Dell computers, for example), it is often the case that products will be manufactured and sold by separate firms.

Service Businesses

As the term implies, service businesses are businesses that provide services to customers. A major difference between manufacturing and retail firms and service firms is that service firms do not have a tangible product that is sold to customers. Instead, a **service business** does not sell tangible products to customers but rather provides intangible benefits (services) to customers.

Meet Priya and Ledgerline

Throughout the next several chapters, you'll follow **Priya Nair**, the owner of **Ledgerline**, a small bookkeeping business. Because Ledgerline provides bookkeeping services rather than selling products, it is classified as a **service business**.

As you learn the accounting cycle, you will record Priya's transactions and prepare her financial statements. Later in the book, when we study inventory accounting, we'll introduce a merchandising business whose operations better illustrate those concepts.

Examples of service-oriented businesses include hotels, cab services, entertainment, and tax preparers. Efficiency is one advantage service businesses offer to their customers. For example, while taxpayers can certainly read the tax code, read the instructions, and complete the forms necessary to file their annual tax returns, many choose to take their tax returns to a person who has specialized training and experience with preparing tax returns. Although it is more expensive to do so, many feel it is a worthwhile investment because the tax professional has invested the time and has the knowledge to prepare the forms properly and in a timely manner. Hiring a tax preparer is efficient for the taxpayer because it allows the taxpayer to file the required forms without having to invest numerous hours researching and preparing the forms.

The accounting conventions for service businesses are similar to the accounting conventions for manufacturing and retail businesses. In fact, the accounting for service businesses is easier in one respect. Because service businesses do not sell tangible products, there is no need to account for products that are being held for sale (inventory). Therefore, while we briefly discuss service businesses, we'll focus mostly on accounting for manufacturing and retail businesses.

Think About It

Think of a service business that you use regularly, such as a hair salon, auto repair shop, gym, or tax preparer. What accounting information do you think the owner needs to keep the business operating successfully?

Your Turn 1.4.1

So far, you've learned about three types of for-profit businesses: manufacturing, retail, and service. Previously, you saw how some firms such as Dell serve as both manufacturer and retailer. Now, think of the last restaurant where you ate. Of the three business types (manufacturer, retailer, or service provider), how would you categorize the restaurant? Is it a manufacturer? A retailer? A service provider? Can you think of examples of how a restaurant has characteristics of all three types of businesses?

Solution

Answers will vary. Responses may initially consider a restaurant to be only a service provider. Students may also recognize that a restaurant possesses aspects of a manufacturer (by preparing the meals), retailer (by selling merchandise and/or gift cards), and service provider (by waiting on customers).

Governmental Entities

A **governmental entity** provides services to the general public (taxpayers). Governmental agencies exist at the federal, state, and local levels. These entities are funded through the issuance of taxes and other fees.

Accountants working in governmental entities perform the same function as accountants working at for-profit businesses. Accountants help to serve the public interest by providing to the public an accounting for the receipts and disbursements of taxpayer dollars. Governmental leaders are accountable to taxpayers, and accountants help assure the public that tax dollars are being utilized in an efficient manner.

Examples of governmental entities that require financial reporting include federal agencies such as the Social Security Administration, state agencies such as the Department of Transportation, and local agencies such as county engineers.

Students continuing their study of accounting may take a specific course or courses related to governmental accounting. While the specific accounting used in governmental entities differs from traditional accounting conventions, the goal of providing accurate and unbiased financial information useful for decision-making remains the same, regardless of the type of entity. While FASB establishes accounting standards for for-profit businesses and most nongovernmental nonprofit organizations, **Governmental Accounting Standards Board (GASB)** establishes accounting standards for state and local governments.

Not-for-Profit Entities

To be fair, the name “not-for-profit” can be somewhat confusing. As with “for-profit” entities, the name refers to the primary purpose or mission of the organization. In the case of for-profit organizations, the primary purpose is to generate a profit. The profits, then, can be used to sustain and improve the business through investments in employees, research, and development, and other measures intended to help ensure the long-term success of the business.

But in the case of a **nonprofit (not-for-profit) organization** the primary purpose or mission is to serve a particular interest or need in the community. A not-for-profit entity tends to depend on financial longevity based on donations, grants, and revenues generated. It may be helpful to think of not-for-profit entities as “mission-based” entities. It is important to note that not-for-profit entities, while having a primary purpose of serving a particular interest, also have a need for financial sustainability. An adage in the not-for-profit sector states that “being a not-for-profit organization does not mean it is for-loss.” That is, not-for-profit entities must also ensure that resources are used efficiently, allowing for inflows of resources to be greater than (or, at a minimum, equal to) outflows of resources. This allows the organization to continue and perhaps expand its valuable mission.

Examples of not-for-profit entities are numerous. Food banks have as a primary purpose the collection, storage, and distribution

of food to those in need. Charitable foundations have as a primary purpose the provision of funding to local agencies that support specific community needs, such as reading and after-school programs. Many colleges and universities are structured as not-for-profit entities because the primary purpose is to provide education and research opportunities.

Similar to accounting for governmental entities, students continuing their study of accounting may take a specific course or courses related to not-for-profit accounting. While the specific accounting used in not-for-profit entities differs slightly from traditional accounting conventions, the goal of providing reliable and unbiased financial information useful for decision-making is vitally important.

Example 1.4.1



Figure 1.4.1: Sailors and Marines stock boxes at SF Marin Food Bank. (Public domain; via PICRYL).

What are some sources of revenue (inflows) of a food bank? What are some examples of its expenses (outflows) of a food bank?

Solution

A food bank may receive revenue and support through cash donations, grants, fundraising activities, and program service revenue. These inflows help fund operating expenses such as food distribution, salaries and benefits, rent and utilities, fundraising costs, and administrative expenses.

If revenues exceed expenses, the organization reports an increase in net assets. This increase can be used to support future programs and services to better fulfill the organization's mission.

Example 1.4.2

Types of Organizations

Think of the various organizations discussed so far. Now try to identify people in your personal and professional network who work for these types of agencies. Can you think of someone in a career at each of these types of organizations?

One way to explore career paths is to talk with professionals who work in the areas that interest you. You may consider reaching out to the individuals you identified and learning more about the work that they do. Find out about the positive and negative aspects of the work. Find out what advice they have relating to education. Try to gain as much information as you can to determine whether that is a career you can envision yourself pursuing. Also, ask about opportunities for job shadowing, co-ops, or internships

Solution

Answers will vary, but this should be an opportunity to learn about careers in a variety of organizations (for-profit including manufacturing, retail, and services; not-for-profit; and governmental agencies). You may have an assumption about a career that is based only on the positive aspects. Learning from experienced professionals may help you understand all aspects of the careers. In addition, this exercise may help you confirm or alter your potential career path, including the preparation required (based on advice given from those you talk with).

1.5: Accounting Career Pathways

More than Number Crunchers?

Many people think accountants spend their days working quietly with numbers and spreadsheets. In reality, accounting professionals work closely with managers, employees, customers, government agencies, and business owners. They help organizations solve problems, communicate financial information, and make informed decisions. Successful accounting professionals often possess skills such as:

- Attention to detail
- Analytical thinking
- Organization and time management
- Communication and interpersonal skills
- Problem-solving ability
- Professionalism and integrity

As technology continues to transform the profession, employers also value adaptability, data analysis skills, and the ability to work with cloud-based accounting systems and artificial intelligence tools.

Education and Career Opportunities

Accounting offers multiple entry points into the profession. Students may begin with bookkeeping or accounting support positions and later advance through additional education, certifications, and work experience.

Common entry-level positions include:

- Bookkeeper
- Accounts Payable Clerk
- Accounts Receivable Clerk
- Payroll Clerk
- Accounting Assistant

With additional education and experience, accountants may pursue careers such as:

- Staff Accountant
- Tax Accountant
- Auditor
- Accounting Manager
- Controller
- Certified Public Accountant (CPA)
- Chief Financial Officer (CFO)

Whether your goal is to enter the workforce quickly, earn a degree, pursue professional certifications, or eventually become a CPA, an accounting education provides a strong foundation for a wide range of career opportunities.

Career Connection: Bookkeeping in Small Businesses 1.5.1

Most bookkeepers do not begin their careers working for large multinational corporations. Instead, many work for small businesses such as medical offices, retail stores, construction companies, restaurants, nonprofit organizations, and professional service firms.

In these roles, bookkeepers may process payroll, record transactions, prepare invoices, reconcile bank accounts, maintain accounting records, and assist with financial reporting.

The bookkeeping skills introduced throughout this course provide a foundation for supporting organizations of all sizes and may serve as a pathway to advanced accounting careers.

Table 1.5.1: Career paths open to students of accounting

Entry-Level (No Degree Required)	Mid-Level (Experience + Education)	Advanced (Bachelor's Degree Typically)	Leadership (Advanced Education & Experience)
Bookkeeper	Full-Charge Bookkeeper	Senior Accountant	Controller
Accounts Payable Clerk	Accounts Payable Specialist	Accounting Manager	CPA (Certified Public Accountant)
Accounts Receivable Clerk	Accounts Receivable Specialist	Tax Accountant	Chief Financial Officer (CFO)
Payroll Clerk	Payroll Specialist	Auditor	Financial Consultant
Accounting Assistant	Staff Accountant	Controller (with experience)	Entrepreneur/Business Owner

Accounting Careers Across Organizations

Accounting professionals work in many different types of organizations:

Public Accounting Firms

Public accounting firms provide accounting services to individuals, businesses, nonprofit organizations, and government agencies. Common services include auditing, tax preparation and planning, consulting, bookkeeping, payroll support, business valuation, and forensic accounting.

Organizations often hire public accounting firms when they need specialized expertise or independent professional services. For example, a small business may engage a public accounting firm to prepare financial statements or process payroll, while larger organizations may hire external auditors to examine their financial statements.

Public accounting firms are often categorized based on the size (revenue). The largest firms are known as the Big Four: Deloitte, PwC, EY, and KPMG. Several large national and international firms, including RSM, BDO, Grant Thornton, and Forvis Mazars, are commonly considered the next tier of public accounting firms in the United States (Accounting Today, 2025).

Many accountants working in public accounting pursue the Certified Public Accountant (CPA) designation. Public accounting firms may specialize in particular industries, such as healthcare, technology, banking, or manufacturing, or focus on specific service areas such as auditing, taxation, or consulting.

For many organizations, hiring a public accounting firm provides access to professional expertise without the cost of maintaining specialized accounting staff on a full-time basis.

Corporate Accounting

Corporate accountants work within organizations to help managers and other internal users make informed business decisions. Their responsibilities include preparing financial reports, developing budgets, monitoring costs, analyzing financial performance, and helping ensure that company resources are used effectively.

Unlike public accountants, who provide services to multiple clients, corporate accountants work for a single organization and focus on its day-to-day financial operations. They help management evaluate performance, plan for the future, and maintain effective internal controls.

The responsibilities of corporate accountants vary depending on the size of the organization. In small businesses, accountants

may perform a wide range of duties, including bookkeeping, payroll, budgeting, and financial reporting. In larger organizations, accountants often specialize in areas such as cost accounting, financial reporting, budgeting, tax compliance, or internal auditing.

Many corporate accountants pursue professional certifications to enhance their knowledge and career opportunities. One of the most common certifications is the Certified Management Accountant (CMA), which focuses on financial planning, analysis, and decision-making. Corporations also employ Certified Public Accountants (CPAs) for financial reporting, compliance, and other specialized accounting functions.

Governmental Entities

Accountants in governmental entities perform many of the same functions as accountants in public accounting firms and corporations. The primary goal of **governmental accounting** is to ensure proper tracking of the inflows and outflows of taxpayer funds using the proscribed standards. Some governmental accountants also prepare and may also audit the work of other governmental agencies to ensure the funds are properly accounted for. The major difference between accountants in governmental entities and accountants working in public accounting firms and corporations relates to the specific rules by which the financial reporting must be prepared. Whereas as accountants in public accounting firms and corporations use GAAP, governmental accounting is prepared under a different set of rules that are specific to governmental agencies, as previously referred to as the Governmental Accounting Standards Board (GASB). Students continuing their study of accounting may take specific courses related to governmental accounting.

Accountants in the governmental sector may also work in specialized areas. For example, many accountants work for tax agencies at the federal, state, and local levels to ensure the tax returns prepared by businesses and individuals comply with the tax code appropriate for the particular jurisdiction.

Not-for-Profit Entities

Not-for-profit entities include charitable organizations, educational organizations, religious organizations, health care organizations, arts and cultural organizations, animal and environmental organizations, etc. These not-for-profit organizations have a primary focus of a particular mission. Therefore, **not-for-profit (NFP) accounting** helps ensure that donor funds are used for the intended mission. Much like accountants in governmental entities, accountants in not-for-profit entities use a slightly different type of accounting than other types of businesses, with the primary difference being that not-for-profit entities typically do not pay income taxes.

However, even if a not-for-profit organization is not subjected to income taxes in a particular year, it generally must file informational returns, such as a Form 990, with the Internal Revenue Service (IRS). Information, such as sources and amounts of funding and major types and amounts of expenditures, is documented by the not-for-profit entities to provide information for potential and current donors. Once filed with the IRS, Form 990 is available for public view so that the public can monitor how the specific charity uses proceeds as well as its operational efficiency.

Professional Certifications

Many accounting professionals pursue certifications to demonstrate specialized knowledge and advance their careers. Common certifications include:

- CPA (Certified Public Accountant)
- CMA (Certified Management Accountant)
- CIA (Certified Internal Auditor)
- CFE (Certified Fraud Examiner)
- EA (Enrolled Agent)

Professional certifications often require examinations, work experience, and continuing education.

Ethical Consideration: Why Ethics Matter

Accounting professionals are trusted to prepare and communicate financial information that others rely upon for decision-making. Because investors, lenders, government agencies, and business owners depend on accurate information, accountants are expected to act with integrity, objectivity, confidentiality, and professional competence. Ethical behavior helps maintain public trust and is a fundamental responsibility of all accounting professionals.

1.6: Introduction to The Accounting Cycle

Overview of the Accounting Cycle

Every business engages in financial activities, such as purchasing supplies, paying employees, and providing goods or services to customers. To ensure these activities are accurately recorded and reported, accountants follow a systematic process known as the accounting cycle. The accounting cycle consists of a series of steps used to identify, record, summarize, and communicate financial information. By following these steps, businesses can produce reliable financial statements that help owners, managers, investors, lenders, and other stakeholders make informed decisions. Figure 1.6.1 provides an overview of the ten steps in the accounting cycle. Throughout the rest of the book, you will learn each step in detail as you build your accounting knowledge one step at a time.



Figure 1.6.1: The accounting cycle follows ten steps used to record, adjust, summarize, and report financial information before beginning a new accounting period. AI Generated Image, 2026. [Detailed Description of Figure 1.6.1.](#)

The Accounting Cycle at a Glance

Figure 1.6.1 illustrates the accounting cycle for a period, usually a month. At quarter end cycles and year-end cycles, accountants will usually find themselves doing extra transactions to close out the period, including any entries in the General Ledger that need to be corrected. Let's go through the ten steps in the accounting cycle.

Step 1: Identify and Analyze Transactions. Before recording anything, accountants determine how a business transaction affects the accounting equation. They identify which accounts are involved and whether each account increases or decreases. Example: A business purchases supplies for cash. Supplies increase and Cash decreases.

Step 2: Record Transactions to Journal. The formal method accountants use to record the financial effects of business activities is through journal entries, using the debit and credit system. Journal entries create a chronological record of a company's transactions and events. Example: Debit Supplies and Credit Cash when supplies are purchased with cash.

Step 3: Post to the General Ledger. Information from journal entries is transferred to individual ledger accounts. The ledger helps track the balance of each account over time. Example: The Supplies account shows all increases and decreases in supplies during the period.

Step 4: Prepare an Unadjusted Trial Balance. An unadjusted trial balance lists all account balances prior to any adjusting entries and verifies the total debits equal total credits. This step helps identify recording or posting errors before financial statements

are prepared. Example: If total debits are \$10,000 and total credits are \$10,000, the books are mathematically in balance.

Step 5: Prepare Adjusting Entries. At the end of the accounting period, adjusting entries update account balances to reflect revenues earned and expenses incurred. These adjustments ensure financial statements are accurate. Example: Record one month's depreciation expense on equipment.

Step 6: Prepare an Adjusted Trial Balance. After all adjusting entries have been recorded and posted, an adjusted trial balance is prepared. This report lists all account balances after adjustments and verifies that total debits still equal total credits. The adjusted trial balance serves as the primary source for preparing financial statements. Example: After recording depreciation expense and accrued wages, the updated account balances are listed in the adjusted trial balance before preparing the financial statements.

Step 7: Prepare the Financial Statements. Financial statements communicate the company's financial performance and position to users. Common statements include the income statement, statement of owner's equity, and balance sheet. Example: The income statement reports revenues, expenses, and the net income for the period.

Step 8: Closing Entries. Closing entries transfer temporary account balances to owner's equity and reset temporary accounts to zero. This is usually done once a year. This prepares the accounts for the next accounting period. Example: Revenue, expense, and drawing account balances are closed to the owner's capital account.

Step 9: Prepare Post-Closing Trial Balance. A post-closing trial balance verifies that permanent accounts remain in balance after closing entries have been recorded. Only asset, liability, and equity accounts appear on this report. Example: Cash, Accounts Receivable, and Accounts Payable balances remain, while Revenue and Expense accounts have zero balances.

Step 10: Reversing entries. Reversing entries are optional journal entries made at the beginning of a new accounting period to simplify the recording of certain transactions. They reverse selected adjusting entries from the previous period, helping to prevent double-accounting of revenues or expenses. Example: If wages payable were accrued at year-end, a reversing entry can be made on the first day of the new period so that payroll can be recorded normally when employees are paid. Reversing entries are optional and are used primarily as a convenience to simplify bookkeeping procedures.

1.7: Summary

1.1 Importance of Accounting

- Accounting is the process of organizing, analyzing, and communicating financial information that is used for decision-making.
- Accounting is often called the “language of business.”
- Financial accounting measures performance using financial reports and communicates results to those outside of the organization who may have an interest in the company’s performance, such as investors and creditors.

1.2 Users of Accounting Information

- The primary goal of accounting is to provide accurate, timely information to decision makers.
- Accountants provide information to internal and external users.
- Financial accounting measures an organization’s performance in monetary terms.
- Accountants use common conventions to prepare and convey financial information.
- Financial accounting is historical in nature, but a series of historical events can be useful in establishing predictions.
- Financial accounting is intended for use by both internal and external users.
- Managerial accounting is primarily intended for internal users.

1.3 Financial Accounting vs Managerial Accounting

- Accounting information is prepared to meet the needs of different users.
- Financial accounting provides information to external users, while managerial accounting serves internal users.
- Financial accounting reports include financial statements prepared according to GAAP.
- Managerial accounting reports include budgets, cost analyses, and performance reports used for planning and decision-making.
- Financial accounting focuses on the organization as a whole, whereas managerial accounting focuses on specific departments, products, or activities.
- Financial accounting primarily reports historical financial information, while managerial accounting often emphasizes future planning and operational improvement.
- Both financial and managerial accounting support informed decision-making and help organizations achieve their goals.

1.4: Types of Organizations and Their Accounting Needs

- Accountants play a vital role in many types of organizations.
- Organizations can be placed into three categories: for profit, governmental, and not for profit.
- For-profit organizations have a primary purpose of earning a profit.
- Governmental entities provide services to the general public, both individuals and organizations.
- Governmental agencies exist at the federal, state, and local levels.
- Not-for-profit entities have the primary purpose of serving a particular interest or need in communities.
- For-profit businesses can be further categorized into manufacturing, retail (or merchandising), and service.
- Manufacturing businesses are for-profit businesses that are designed to make a specific product or products.
- Retail firms purchase products and resell the products without altering the products.
- Service-oriented businesses provide services to customers.

1.5 Accounting Career Pathways

- Accounting offers many career opportunities, ranging from entry-level to advanced roles.
- Successful accountant possess strong professional skills.
- It is important for accountants to be well versed in written and verbal communication and possess other non-accounting skill

sets.

- Common accounting specialties include auditing, taxation, financial accounting, managerial accounting, consulting, accounting information systems, and financial planning.
- Accountants have opportunities to work for many types of organizations, including public accounting firms, corporations, governmental entities, and not-for-profit entities.
- Technology continues to transform the profession.
- Professional certifications and continuing education can help advance careers. Examples are CPA, CMA, CIA.

1.6 The Accounting Cycle

- Accounting cycle is a structured process accountant use to collect, record, summarize, adjust, and report financial information during an accounting period.
- Each step builds on the previous step, helping ensure that financial data is accurate, complete, and organized before financial statements are prepared.
- The cycle begins by analyzing and recording business transactions and continues through posting, preparing trial balances, making adjustments, and creating financial statements.
- Adjusting entries ensure that revenues and expenses are recorded in the proper accounting period, providing a more accurate picture of a company's financial performance.
- Once financial statements are prepared, closing entries reset temporary accounts for the next accounting period, and optional reversing entries may be used to simplify future recordkeeping.
- The accounting cycle helps businesses maintain reliable financial records, comply with accounting principles, and provide useful information to managers, investors, creditors, and other stakeholders.
- By following the accounting cycle consistently, organizations can make informed decisions, evaluate performance, and plan for future operations.
- The accounting is a step-by-step process that transforms daily business transactions into meaningful financial statements that support decision-making and financial accountability.

This page titled [1.7: Summary](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [1.6: Summary](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

1.8: Key Terms

Definitions

accounting

process of organizing, analyzing, and communicating financial information that is used for decision-making

auditing

process of ensuring activities are carried out as intended or designed

consulting

process of giving advice or guidance on financial and nonfinancial impact of a course of action

cost of goods manufactured

The total cost of goods completed during a period and transferred from work in process inventory to finished goods inventory.

creditor

business that grants extended, but short-term, payment terms to other businesses

financial accounting

measures the financial performance of an organization using standard conventions to prepare financial reports

Financial Accounting Standards Board (FASB)

independent, nonprofit organization that sets financial accounting and reporting standards for both public and private sector businesses in the United States that use Generally Accepted Accounting Principles (GAAP)

for-profit business

has the primary purpose of earning a profit by selling goods and services

generally accepted accounting principles (GAAP)

common set of rules, standards, and procedures that publicly traded companies must follow when composing their financial statements

governmental accounting

process of tracking the inflows and outflows of taxpayer funds using prescribed standards

Governmental Accounting Standards Board (GASB)

source of generally accepted accounting principles (GAAP) used by state and local governments in the United States; is a private nongovernmental organization

governmental entity

provides services to the general public (taxpayers)

job order costing

A costing system that accumulates and assigns costs to individual jobs, batches, or customer orders.

lender

bank or other institution that has the primary purpose of lending money

managerial accounting

process that allows decision makers to set and evaluate business goals by determining what information they need to make a particular decision and how to analyze and communicate this information

manufacturing business

for-profit business that is designed to make a specific product or products

nonprofit (not-for-profit) organization

tax-exempt organization that serves its community in a variety of areas

not-for-profit (NFP) accounting

including charities, universities, and foundations, helps ensure that donor funds are used for the intended mission of the not-for-profit entity

privately held company

company whose stock is available only to employees or select individuals or groups

production cost report

A report used in process costing that summarizes production activity, equivalent units, and the assignment of costs to completed and partially completed units.

publicly traded company

company whose stock is traded (bought and sold) on an organized stock exchange

retail business

for-profit business that purchases products (called inventory) and resells the products without altering them

Securities and Exchange Commission (SEC)

federal regulatory agency that regulates corporations with shares listed and traded on security exchanges through required periodic filings

service business

business that does not sell tangible products to customers but rather sells intangible benefits (services) to customers; can be either a for-profit or a not-for-profit organization

stakeholder

someone affected by decisions made by a company; may include an investor, creditor, employee, manager, regulator, customer, supplier, and layperson

stockholder

owner of stock, or shares, in a business

transaction

business activity or event that has an effect on financial information presented on financial statements

1.9: Practice Questions

Multiple Choice Questions

Exercise 1.9.1

1. Accounting is sometimes called the “language of ____.”
 - a. Wall Street
 - b. business
 - c. Main Street
 - d. financial statements
2. Financial accounting information _____.
 - a. should be incomplete in order to confuse competitors
 - b. should be prepared differently by each company
 - c. provides investors guarantees about the future
 - d. summarizes what has already occurred
3. External users of financial accounting information include all of the following *except* _____.
 - a. lenders such as bankers
 - b. governmental agencies such as the IRS
 - c. employees of a business
 - d. potential investors
4. Which of the following is an internal user of accounting information?
 - a. Investor
 - b. Bank
 - c. Manager
 - d. IRS
5. Which of the following groups would have access to managerial accounting information?
 - a. bankers
 - b. investors
 - c. competitors of the business
 - d. managers
6. Which of the following is an example of financial accounting rather than managerial accounting?
 - a. Preparing a budget
 - b. Evaluating product costs
 - c. Preparing financial statements for external users
 - d. Making equipment replacement decisions
7. A bank reviewing a company's financial statements before approving a loan is an example of a(n):
 - a. Internal user
 - b. Employee
 - c. Manager
 - d. External user
8. The primary purpose of what type of business is to serve a particular need in the community?
 - a. for-profit
 - b. not-for-profit
 - c. manufacturing
 - d. retail
9. Which of the following is *not* an example of a retailer?
 - a. electronics store
 - b. grocery store
 - c. car dealership
 - d. computer manufacturer
 - e. jewelry store
10. A governmental agency can best be described by which of the following statements?

- a. has a primary purpose of making a profit
 - b. has a primary purpose of using taxpayer funds to provide services
 - c. produces goods for sale to the public
 - d. has regular shareholder meetings
11. Which of the following is likely *not* a type of not-for-profit entity?
- a. public library
 - b. community foundation
 - c. university
 - d. local movie theater
12. Which of the following skills is most important for accounting professionals?
- a. extensive computer programming background
 - b. analytical thinking
 - c. professional athletics experience
 - d. graphic design expertise
13. Typical accounting tasks include all of the following except:
- a. auditing
 - b. recording and tracking costs
 - c. tax compliance and planning
 - d. consulting
 - e. purchasing direct materials=
14. What type of organization commonly provides tax, audit, and consulting services?
- a. corporations
 - b. public accounting firms
 - c. governmental entities
 - d. universities
15. The accounting cycle is best described as:
- a. a process used to hire accountants
 - b. a step-by-step process used to record and report financial information
 - c. a type of accounting software
 - d. a government reporting requirement
16. What is the primary purpose of the accounting cycle?
- a. to prepare tax returns
 - b. to ensure financial information is accurate and organized
 - c. to increase profits
 - d. to hire employees
17. Which of the following best describes the outcome of the accounting cycle?
- a. Hiring new employees
 - b. Obtaining a bank loan
 - c. Preparing financial statements
 - d. Purchasing inventory

Answer available at the end of this section.

Answers

Exercise 1.9.1

Table 1.9.1: Answers to multiple choice questions

Question	Correct Answer
1	b. business
2	d. summarizes what has already occurred
3	c. employees of a business
4	c. Manager
5	d. managers

Question	Correct Answer
6	c. Preparing financial statements for external users
7	d. External user
8	b. not-for-profit
9	d. computer manufacturer
10	b. has a primary purpose of using taxpayer funds to provide services
11	d. local movie theater
12	b. analytical thinking
13	e. purchasing direct materials
14	b. public accounting firms
15	b. a step-by-step process used to record and report financial information
16	b. to ensure financial information is accurate and organized
17	c. Preparing financial statements

This page titled [1.9: Practice Questions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [1.7: Practice Questions](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

1.10: Alternate Text Descriptions

Figure 1.2.1: Comparison Internal Users vs External Users

This diagram shows how Accounting Information is used by two main groups of people: Internal Users and External Users.

At the top center of the diagram is a dark blue box labeled “Accounting Information.” From this box, two arrows point downward to two categories.

On the left is a green box labeled “Internal Users.” Internal users are people within the organization who use accounting information to help manage and operate the business. Four groups are listed inside this box:

- Managers
- Employees
- Supervisors
- Executives

On the right is a light blue box labeled “External Users.” External users are people or organizations outside the company who rely on accounting information to make decisions about the business. Four groups are listed inside this box:

- Investors
- Lenders
- Government Agencies
- Suppliers

The diagram emphasizes that Accounting Information serves both Internal Users and External Users. Internal users use the information for planning, managing, and operating the organization, while external users use it to evaluate the organization's financial condition and make economic or regulatory decisions. The arrows indicate that accounting information flows to and supports the needs of both groups.

Figure 1.6.1: The Accounting Cycle

This infographic illustrates the accounting cycle, a sequence of ten accounting steps arranged in a circular flow to show that the process repeats each accounting period.

The title in the center reads “The Accounting Cycle.” Below it reads “The cycle repeats in the next accounting period.”

The numbered steps, connected by arrows in a clockwise sequence, include:

1. Identify and Analyze Transactions
2. Record Transactions to Journal
3. Post Journal Information to Ledger
4. Prepare Unadjusted Trial Balance
5. Adjusting Entries
6. Prepare Adjusted Trial Balance
7. Prepare Financial Statements
8. Closing Entries
9. Prepare Post-Closing Trial Balance
10. Reversing Entries (optional)

An arrow from Step 10 returns to Step 1, indicating that the accounting cycle begins again for the next accounting period.

This page titled [1.10: Alternate Text Descriptions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

2: ACCOUNTING EQUATION AND JOURNAL RULES

Overview

Priya just quit her job to run her own bookkeeping and tax firm full-time. She calls it Ledgerline. In her first month she puts in her own savings, buys a laptop, lands two clients, pays her assistant, and takes a little cash out for herself.

Money moves in a dozen directions. By the end of the month, she has one nagging question: *Did the business actually make progress, and where did all the cash go?*

She can't answer that from her bank balance alone. A bank balance tells her how much cash remains-not what the business owns, what it owes, whether it earned a profit, or why the cash balance changed. To answer those questions, she needs a system that records every business transaction consistently and shows how each transactions affects the business.

That system begins with the **accounting equation**.

Every business transaction affects a company's financial position. To understand and communicate those changes, accountants use the accounting equation together with the financial statements. The accounting equation provides the framework for recording transactions, while the financial statements organize and summarize the results in a meaningful way.

In this chapter, you will learn about the five fundamentals elements of accounting: **assets, liabilities, owner's equity, revenues, and expenses**. You will see how these elements are reported in the financial statements and how business transactions affect the accounting equation. As you analyze a variety of transactions, you will begin developing the skills needed to interpret and record financial information accurately.

Learning Objectives

By the end of this chapter, you can:

1. Define assets, liabilities, equity, revenues, and expenses.
2. Explain the accounting equation and why it never goes out of balance.
3. Apply the rules of debits and credits.

2.1: The Accounting Equation

2.2: The Expanded Accounting Equation

2.3: Transaction Analysis - Example

2.4: Debit and Credit Rules

2.5: Applying the Debit and Credit Rules

2.6: Summary

2.7: Key Terms

2.8: Practice Questions

2.9: Alternative Text Descriptions

This page titled [2: Accounting Equation and Journal Rules](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

2.1: The Accounting Equation

Overview

Before you record anything, you need a rule that tells you when you've recorded it correctly. The accounting equation is that rule.

The accounting equation is the basis for all transactions in accounting. It provides the foundation for the rules of debit and credit in the journalizing process, where for each transaction total debits must equal total credits. As a result, the accounting equation must be in balance at all times for a business' financial records to be correct. It involves the three types of accounts that do not appear on the income statement.

Concept

Everything your business owns came from somewhere. Either the owner put it in, the business earned it, or someone lent it. That single idea is the whole equation:

Accounting Equation

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Assets are the resources your business controls. Common examples are cash, inventory, land, building equipment, and money customers owe you (accounts receivable). When you purchase an asset, there are two ways to pay for it—with your own money and with other people's money. This concept is a simple description of the accounting equation.

Liabilities are what your business owes to outsiders - a supplier's bill, a bank loan, and what you owe to suppliers (accounts payable).

Owner's equity is the owner's stake — what would be left for the owner if you sold every asset and paid off every debt. Other terms for owners is stockholders, if you're a public company.

The two sides always match. They have to. Every dollar of stuff your business owns is a dollar that belongs to someone — an outside creditor or the owner. So the moment you record a transaction and the equation still balances, that's your first signal you got it right.

Why it matters

The equation is your built-in error check. If a transaction ever leaves the two sides unequal, you know instantly that something is missing.

Example 2.1.1

Priya Nair starts Ledgerline by depositing \$12,000 of her own savings into a business bank account.

The business now has \$12,000 in cash (an asset). Where did it come from? Priya. Her stake, known as owner's equity is also \$12,000

Solution

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Cash \$12,000 = \$0 + Nair, Capital \$12,000

Example 2.1.2

Priya now buys a laptop and a printer for \$3,000 cash. No new money entered the business. She has traded one asset (cash) for another (equipment):

Solution

Assets = Liabilities + Owner's Equity

Cash \$9,000 + Equipment \$3,000 = \$0 + Nair, Capital \$12,000

Note

The total assets for Priya are still \$12,000. The mix changed; the balance didn't.

Caution

Watch out

A transaction never changes just one thing. If you think you've recorded a transaction by touching only a single account, you've missed half of it. Every transaction keeps both sides equal.

2.2: The Expanded Accounting Equation

Overview

The basic equation hides something a business owner desperately cares about - profit. Owner's equity grows and shrinks for four different reasons, and lumping them together hides *why* the owner's stake changed.

What Changes Owner's Equity?

Owner's equity is not one static number. It changes as the business operates. Four common activities increase or decrease owner's equity:

- **Revenue** — Income earned from providing goods or services. Revenue increases owner's equity.
- **Expenses** — Costs incurred to earn revenue, such as rent, wages, and utilities. Expenses decrease owner's equity.
- **Owner Investments** — Cash or other assets the owner contributes to the business. Owner investments increase owner's equity.
- **Owner Withdrawals (Drawings)** — Cash or other assets the owners takes out of the business for personal use. Owner withdrawals decrease owner's equity.

Spelling those out gives the **expanded accounting equation**:

Expanded Accounting Equation

$$\text{Asset} = \text{Liabilities} + \text{Owner's Capital} + \text{Revenue} - \text{Expenses} - \text{Drawings}$$

This is the same equation as mentioned in [2.1: The Accounting Equation](#), but this expanded equation has more detail. Revenue and expenses are just the pieces of equity that explain whether the business made money.

Activities That Increase Owner's Equity

- Revenue
- Owner investments

Activities That Decrease Owner's Equity

- Expenses
- Owner withdrawals (drawings)

Why it matters

"Net income" is simply revenue minus expenses. Because those live inside equity, earning a profit raises the owner's stake, and running a loss lowers it—automatically. The equation and the income statement are the same story told two ways.

Example 2.2.1

Ledgerline finishes a tax return for a client and bills them \$2,500. The client hasn't paid yet, but Priya earned the fee the moment the work was done. That \$2,500 is revenue, and revenue lifts equity.

Solution

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Accounts Receivable + \$2,500 = \$0 + Revenue + \$2,500

Example 2.2.2

Priya also pays her assistant \$1,100 in wages. That's an expense, and expenses shrink equity.

Solution

Assets = Liabilities + Owner's Equity

Cash - \$1,100 = \$0 + Expense - \$1,100

Note

Both transactions keep the equation balanced. One pushes equity up, the other pulls it down.

Caution

Watch out

Drawings are not an expense. When Priya takes cash out for herself, that's not a cost of running the firm. It is the owner helping herself to her own stake. Keep drawings and expenses in separate accounts, or your profit number will be wrong.

Recap

Owner's equity changes through revenue (up), expenses (down), investments (up) and drawings (down). Revenue minus expenses is net income.

2.3: Transaction Analysis - Example

Overview

You have learned the accounting equation and the expanded accounting equation by following Priya's new bookkeeping business, Ledgerline. You have seen how business activities affect assets, liabilities, owner's equity, revenues and expenses.

Now it is time to apply those same concepts to a different business. Printing Plus is organized as a corporation.

As discussed in [1.6: Introduction to The Accounting Cycle](#), the first step in the accounting cycle is to identify and analyze transactions. Each source document must first be evaluated to determine whether it has a financial impact on the business. If it does, the transaction is analyzed to determine how it affects the accounting equation and, ultimately, the financial statements.

Recall the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Every transaction must keep this equation in balance.

Although the accounting equation never changes, the names of some equity accounts depend on how a business is organized. As mentioned earlier, Printing Plus is a corporation rather than sole proprietorship, so you'll notice a few different account names.

Table 2.3.1: Comparison of Equity Terminology for a Sole Proprietorship and a Corporation

Sole Proprietorship (Ledgerline)	Corporation (Printing Plus)
Owner's Capital	Common Stock
Owner Drawings	Dividends
Owner	Stockholders
Owner's Equity	Stockholders' Equity

Do not let the different terminology distract you. The accounting equation and the process for analyzing transactions remain exactly the same.

Reviewing and Analyzing Transactions

The following transactions occurred during the current month for Printing Plus:

1. Issued common stock for \$20,000 cash.
2. Purchased equipment on account for \$3,500, payment due within the month.
3. Received \$4,000 cash in advance from a customer for services not yet rendered.
4. Provided \$5,500 in services to a customer who asked to be billed for the services.
5. Paid a \$300 utility bill with cash.
6. Distributed \$100 cash in dividends to stockholders.

Tip: Analyze every transaction using the same three questions:

1. "Which accounts are affected?"
2. "Does each account increase or decrease?"
3. "How does the transaction keep the accounting equation in balance?"

Let us analyze the following six transactions to see how it affects the accounting equation and the financial statements.

Transaction 1: Issued common stock for \$20,000 cash.

Table 2.3.2: Transaction for issuance of common stock for cash

Assets	Liabilities	Equity
Cash +\$20,000	No data available	Common Stock +\$20,000

Analysis: Looking at the accounting equation, we know cash is an asset and common stock is stockholder's equity. When a company collects cash, this will increase assets because cash is coming into the business. Issuing common stock increases stockholders' equity because owners are investing cash in the business.

Remember that the accounting equation must remain balanced, and assets need to equal liabilities plus equity. On the asset side of the equation, we show an increase of \$20,000. On the liabilities and equity side of the equation, there is also an increase of \$20,000, keeping the equation balanced. Cash increases assets on the balance sheet and is reported as a cash inflow on the statement of cash flows. Common stock increases stockholders' equity on the balance sheet.

Transaction 2: Purchased equipment on account for \$3,500, payment due within the month.

Table 2.3.3: Transaction for purchase of equipment on account

Assets	Liabilities	Equity
Equipment +\$3,500	Accounts Payable +\$3,500	No data available

Analysis: We know that the company purchased equipment, which is an asset. We also know that the company purchased the equipment on account, meaning payment will be made at a later date. Since the company owes money and has not yet paid, this is a liability, specifically labeled as *accounts payable*. There is an increase to assets because the company has equipment it did not have before. There is also an increase to liabilities because the company now owes money. Accounts payable increases because the company owes the supplier \$3,500.

The accounting equation remains balanced because there is a \$3,500 increase on the asset side, and a \$3,500 increase on the liability and equity side. This change to assets will increase assets on the balance sheet. The change to liabilities will increase liabilities on the balance sheet.

Transaction 3: Received \$4,000 cash in advance from a customer for services not yet rendered..

Table 2.3.4: Transaction of cash received in advance for services

Assets	Liabilities	Equity
Cash +\$4,000	Unearned Revenue +\$4,000	No data available

Analysis: We know that the company collected cash, which is an asset. This collection of \$4,000 increases assets because money is coming into the business.

The company has yet to provide the service. According to the revenue recognition principle, the company cannot recognize that revenue until it provides the service. Therefore, the company has a liability to the customer to provide the service and must record the liability as unearned revenue. Unearned revenue increases because the company now owes the customer \$4,000 of future services.

The equation remains balanced, as assets and liabilities increase. The balance sheet would experience an increase in assets and an increase in liabilities.

Transaction 4: Provided \$5,500 in services to a customer who asked to be billed for the services.

Table 2.3.5: Transaction of services provided to customer not yet billed

Assets	Liabilities	Equity
Accounts Receivable +\$5,500	No data available	Revenue +\$5,500

Analysis: The customer asked to be billed for the service, meaning the customer did not pay with cash immediately. The customer owes money and has not yet paid, creating an accounts receivable. Accounts receivable is an asset that is increasing in this case. This customer obligation of \$5,500 adds to the balance in accounts receivable.

The company did provide the services. As a result, the revenue recognition principle requires recognition as revenue, which increases stockholders' equity by \$5,500. The increase to assets would be reflected on the balance sheet. Revenue increases net income on the income statement. Net income increases retained earnings on the statement of retained earnings, which in turn increases stockholders' equity on the balance sheet.

Transaction 5: Paid a \$300 utility bill with cash.

Table 2.3.6: Transaction of utility bill paid

Assets	Liabilities	Equity
Cash -\$300	No data available	Utility Expense -\$300

Analysis: The company paid with cash, an asset. Assets are decreasing by \$300 since cash was used to pay for this utility bill. The company no longer has that money.

Utility services have already been received, so the cost is recognized immediately as Utility Expense. Expenses decrease stockholders' equity. The decrease to assets, specifically cash, affects the balance sheet and statement of cash flows. The income statement would see a change to expenses, changing net income (loss). Net income (loss) is computed into retained earnings on the statement of retained earnings. This change to retained earnings is shown on the balance sheet under stockholder's equity.

Transaction 6: Distributed \$100 cash in dividends to stockholders.

Table 2.3.7: Transaction of cash dividend distributed to stockholder

Assets	Liabilities	Equity
Cash -\$100	No data available	Dividends -\$100

Analysis: The company paid cash dividends to its stockholders. Assets decrease by \$100 as a result. Dividends affect equity and, in this case, decrease stockholders' equity by \$100. The decrease to assets, specifically cash, affects the balance sheet and statement of cash flows. The decrease to equity because of the dividend payout affects the statement of retained earnings by reducing ending retained earnings, and the balance sheet by reducing stockholder's equity.

The accounting equation remains in balance after recording all six transaction. Table 2.3.8 summarizes the effect of each transaction and shows that total asset equal total liabilities plus stockholders' equity. It shows the amount recorded in each account and demonstrates that total assets equal total liabilities plus equity after every transaction. It ends with the total of each account after recording the transactions and verifies that total assets equal total liabilities plus equity.

Table 2.3.8: Effects of Six Transactions on the Accounting Equation

Transactions	Cash	Accounts Receivable	Equipment	Accounts Payable	Unearned Revenue	Common Stock	Dividends	Revenues	Expenses
1	+20,000	No data available	No data available	No data available	No data available	+20,000	No data available	No data available	No data available
2		No data available	+3,500	+3,500	No data available	No data available	No data available	No data available	No data available

Transactions	Cash	Accounts Receivable	Equipment	Accounts Payable	Unearned Revenue	Common Stock	Dividends	Revenues	Expenses
3	+4,000	No data available	No data available	No data available	+4,000	No data available	No data available	No data available	No data available
4	No data available	+5,500	No data available	No data available	No data available	No data available	No data available	+5,500	No data available
5	-300	No data available	No data available	No data available	No data available	No data available	No data available	No data available	-300
6	-100	No data available	No data available	No data available	No data available	No data available	-100	No data available	No data available
Total	23,600	5,500	3,500	3,500	4,000	20,000	-100	5,500	-300

Accounting Equation Check

Assets:

Table 2.3.9: Summary of asset balances

Cash	\$23,600
Accounts Receivable	5,500
Equipment	3,500
Total Assets	\$32,600

Liabilities + Stockholders' Equity:

Table 2.3.10: Summary of Liabilities and Stockholders' Equity Balances

Accounts Payable	\$3,500
Unearned Revenue	4,000
Common Stock	20,000
Revenues	5,500
Less: Expenses	(300)
Less: Dividends	(100)
Total Liabilities and Stockholders' Equity	\$32,600

Note

Accounting Equation Check

Asset = Liability + Stockholders' Equity

\$32,600 = \$32,600

Exercise 2.3.1

Try It !

Debbie's Dairy Farm had the following transactions:

Debbie ordered shelving worth \$750. Debbie's selling price on a gallon of milk is \$3.00. She finds out that most local stores are charging \$3.50. Based on this information, she decides to increase her price to \$3.25. She has an employee put a new price sticker on each gallon. A customer buys a gallon of milk paying cash. The shelving is delivered with an invoice for \$750.

Which events will be recorded in the accounting system?

Answer available at the end of this section.

Answers

Exercise 2.3.1

- Debbie did not yet receive the shelving—it has only been ordered. As of now there is no new asset owned by the company. Since the shelving has not yet been delivered, Debbie does not owe any money to the other company. Debbie will not record the transaction.
- Changing prices does not have an impact on the company at the time the price is changed. All that happened was that a new price sticker was placed on the milk. Debbie still has all the milk and has not received any money. Debbie will not record the transaction.
- Debbie now has a transaction to record. She has received cash and the customer has taken some of her inventory of milk. She has an increase in one asset (cash) and a decrease in another asset (inventory.) She also has earned revenue.
- Debbie has taken possession of the shelving and is the legal owner. She also has an increase in her liabilities as she accepted delivery of the shelving but has not paid for it. Debbie will record this transaction.

This page titled [2.3: Transaction Analysis - Example](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by OpenStax via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [3.4: Analyze Business Transactions Using the Accounting Equation and Show the Impact of Business Transactions on Financial Statements](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

2.4: Debit and Credit Rules

Overview

One of the first steps in analyzing a business transaction is determining whether each affected account increases or decreases.

You now know every transaction moves at least two accounts and keeps the equation balanced. Debits and credits are just the shorthand accountants use to record those moves consistently.

Concept

Every account has two sides: a left side and a right side. **Debit (DR) simply means the left side of an account. Credit (CR) means the right side.** That's all the words mean - not "good" and "bad," not "up" and "down." Left and right.

Here's the key move. We decide, once, which side is the increase side for each type of account, and we base that decision on the accounting equation itself.

Remember the accounting equation? $ASSETS = LIABILITIES + OWNER'S EQUITY$. The accounting equation must always be in balance and the rules of debit and credit enforce this balance.

Assets sit on the left of the equation, so assets increase on the left (debit). Liabilities and equity sit on the right, so they increase on the right (credit). Everything else follows from those two facts:

Table 2.4.1: Rules for increases, decreases, and normal balances of account types

Account Type	Increases with a...	Decreases with a...	Normal Balance
Assets	Debit	Credit	Debit
Liabilities	Credit	Debit	Credit
Owner's Capital	Credit	Debit	Credit
Revenue	Credit	Debit	Credit
Expenses	Debit	Credit	Debit
Drawings	Debit	Credit	Debit

Notice the pattern. Revenue increases equity, so revenue behaves like equity - it goes up with a credit. Expenses and drawings decrease equity, so they flip - they go up with a debit. You never have to memorize the bottom three rows if you remember what they do to equity.

An account's **normal balance** is just the side it increases on - the side it usually lands on. Cash normally carries a debit balance; revenue normally carries a credit balance.

Example 2.4.1

Ledgerline collects \$2,000 cash for a month of bookkeeping work. Two accounts move:

- Cash (an asset) goes up \$2,000. (Assets increase with a **debit**)
- Service Revenue goes up \$2,000 (Revenue increases with a **credit**)

Solution

Shows as **T-accounts** - a T-account is just a quick sketch of one account, debits on the left, credits on the right:

Table 2.4.2: Cash T-account

Debit (Dr)	Credit (Cr)
\$2,000	No data available

Revenue

Table 2.4.3: T-account for Revenue

Debit (Dr)	Credit (Cr)
No data available	\$2,000

One debit, one credit, equal amounts. That balance of debit equals credits is the same balance the accounting equation demands, just expressed a different way.

Why it matters

In every business transaction, total debits always equal total credits. This is not a coincidence or something you must balance manually. Instead it is a direct consequence of keeping the accounting equation in balance. If the total debits and credits do not equal each other, the transaction has been recorded incorrectly.

The accounting requirement that every transaction be recorded with equal debits and credits is called the **double-entry bookkeeping**. This system ensures that the accounting equation remains in balance after every transaction.

Caution

Watch out

Don't attach feelings to the words. A credit to Cash means cash went down, which sounds backwards if you think "credit" = good." Forget good and bad. Ask only: what type of account is this, and is it going up or down?

Recap

Debit means left, credit means right. Assets, expenses, and drawings increase with debits; liabilities, equity, and revenue increase with credits. Every entry's debits equal its credits.

2.5: Applying the Debit and Credit Rules

A Four-Step Process for Determining Debits and Credits

Knowing the debit and credit rules is only half the job. Every business transaction is different, but you can analyze every transaction using the four-step process.

Step 1: Identify one account affected by the transaction.

Step 2: Does this transaction increase or decrease the account?

Step 3: What type of account is this?

CHOICES:

- **Assets** – Resources owned or controlled by the business that are expected to provide future economic benefit (e.g. Cash, Accounts Receivable, Inventory, Prepaid Insurance, Equipment, etc.)
- **Liabilities** – Obligations the business owes to creditors or other parties (e.g. Accounts Payable, Unearned Revenue, Notes Payable, Bonds Payable, Long-term Mortgage Payable).
- **Owner's Equity** – The owner's residual interest in the assets of the business after liabilities are deducted.
- **Revenues** – Amounts earned from providing goods or services to customers (e.g. Sales Revenue, Service Revenue).
- **Expenses** – Costs incurred to earn revenues (e.g. Salaries Expense, Rent Expense, Insurance Expense, Utilities Expense, Cost of Goods Sold)
- **Owner Drawings** – Withdrawals of cash or other assets by the owner for personal use. Drawings reduce owner's equity but are *not* business expenses.

Step 4: Apply rules—Use the debit and credit rules in the table below to determine whether the account is debited or credited.

Repeat Steps 1 through 4 for every other account affected by the transaction. Some transactions involve more than two accounts.

Refer to Table 2.5.1 in Section [2.4: Debit and Credit Rules](#) whenever you need to determine whether an account is debited or credited.

Remember

- Every journal entry must contain at least one debit and one credit.
- Total debits in a journal entry must equal total credits in that journal entry.
- Debits are recorded on the left; credits are recorded on the right.

Flowchart: Decision Process for Determining Debits and Credits

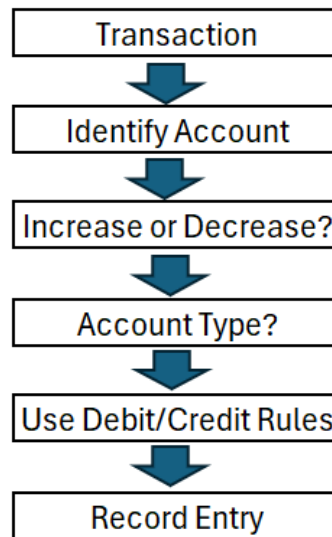


Figure 2.5.1: Decision Process for Determining Debits and Credits. (Illustration by Sandra Li; CC BY-NC-ND 4.0). Detailed description of the Figure 2.5.1.

Example 2.5.1

Transaction: Paid \$900 cash for rent.

Solution

First account:

Step 1: Rent Expense

Step 2: Increasing

Step 3: Expense

Step 4: Expenses increase with debits

Debit Rent Expense \$900

Second account:

Step 1: Cash

Step 2: Decreasing

Step 3: Asset

Step 4: Assets decrease with credit

Credit Cash \$900

Record the journal entry:

Table 2.5.2: Journal entry to record rent

Account	Debit	Credit
Rent Expense	900	No data available
Cash	No data available	900
Memo: Paid Rent for the month	No data available	No data available

Looking Ahead

You now know how to determine whether an account is debited or credited. In the next chapter, you will use the same four-step process to prepare complete journal entries, the first formal accounting record of every business transaction.

2.6: Summary

The Accounting Equation

- The accounting equation is the foundation of financial accounting.
- Every business transaction must keep the accounting equation in balance.
- The accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- Assets are financed by either creditors (liabilities) or the owner's investment and accumulated earnings (owner's equity).

The Expanded Accounting Equation

- Owner's equity changes as the business operates.
- The expanded accounting equation explains why owner's equity increases or decreases:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Capital} + \text{Revenue} - \text{Expenses} - \text{Drawings}$$

- Owner's equity increases through:
 - Owner investments
 - Revenue earned
- Owner's equity decreases through:
 - Expenses incurred
 - Owner withdrawals (drawings)
 - Net income is calculated as:

$$\text{Revenue} - \text{Expenses}$$

Transaction Analysis

- Every transaction affects at least two accounts.
- Each transaction must keep the accounting equation in balance.
- Transaction analysis requires you to:
 - Identify the accounts affected.
 - Determine whether each account increases or decreases.
 - Verify that the accounting equation remains balanced.
- Transaction analysis is the first step in the accounting cycle.

Debit and Credit Rules

- Debit means the left side of an account.
- Credit means the right side of an account.
- The rules for debits and credits come directly from the accounting equation.

Accounts that increase with debit

- Assets
- Expenses
- Drawings

Accounts that increase with a credit

- Liabilities
- Owner's Equity
- Revenue
- Every journal entry must contain:
 - At least one debit
 - At least one credit
 - Equal total debits and total credits

Determining Debits and Credits

Use this four-step process for every account affected by a transaction:

1. Identify the account.
2. Determine whether the account increases or decreases.
3. Identify the account type.
4. Apply the debit and credit rules.

Following the same process for every transaction reduces memorization and helps ensure journal entries are recorded correctly.

This page titled [2.6: Summary](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [2.4: Summary](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

2.7: Key Terms

Definition

accounting equation

Assets = Liabilities + Owner's Equity; it stays in balance after every transaction.

owner's equity

The owner's stake in the business: assets minus liabilities

expanded accounting equation

Assets = Liabilities + Owner's Capital + Revenue - Expenses - Drawings.

revenue

What a business earns by doing its work; it increases equity.

expense

The cost of doing business; it decreases equity.

net income

Revenue minus expenses

credit

The right side of an account

normal balance

The side - debit or credit - on which an account increases

T-account

A quick sketch of one account shaped like a "T", with the account title above, debits on the left and credits on the right.

transaction analysis

the process of identifying the accounts affected by a business transaction, determining whether each account increases or decreases, and verifying that the accounting equation remains in balance

liabilities

What a business owes to outsiders - cash, equipment, and money customers owe.

assets

The resources a business controls - cash, equipment, and money customers owe.

debit

The left side of an account

drawings

Cash or assets the owner takes out for personal use; it decreases equity.

2.8: Practice Questions

Multiple Choice Questions

Exercise 2.8.1

1. The accounting equation is expressed as _____.
 - a. $\text{Assets} + \text{Liabilities} = \text{Owner's Equity}$
 - b. $\text{Assets} - \text{Noncurrent Assets} = \text{Liabilities}$
 - c. $\text{Assets} = \text{Liabilities} + \text{Investments by Owners}$
 - d. $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$
2. Which of the following decreases owner's equity?
 - a. Investments by owners
 - b. Losses
 - c. Gains
 - d. Short-term loans
3. An exchange of one asset for another, such as purchasing equipment with cash, generally has what effect on owner's equity?
 - a. Increase owner's equity
 - b. Have no impact on owner's equity
 - c. Decrease owner's equity
 - d. There is no relationship between assets and owner's equity
4. All of the following increase owner's equity except which one?
 - a. Gains
 - b. Investments by owners
 - c. Revenues
 - d. Acquisitions of assets by incurring liabilities
5. Which of the following correctly identifies an account, its account type, and its normal balance?
 - a. Accounts Receivable – Liability – Credit
 - b. Service Revenue – Revenue – Credit
 - c. Wages Expense – Revenue – Credit
 - d. Accounts Payable – Asset – Debit
6. Which account is classified as an owner's equity account with a normal debit balance?
 - a. Service Revenue
 - b. Accounts Receivable
 - c. Dividends
 - d. Accounts Payable
7. A business has assets of \$20,000 and liabilities of \$7,500. What is the owner's equity?
 - a. \$12,500
 - b. \$20,000
 - c. \$27,500
 - d. \$7,500
8. Which of these accounts is an asset?
 - a. Common Stock
 - b. Supplies
 - c. Accounts Payable
 - d. Fees Earned
9. Which of these accounts is a liability?
 - a. Accounts Receivable
 - b. Supplies
 - c. Salaries Expense
 - d. Accounts Payable
10. If owner's equity equals \$100,000, which of the following is true?

- a. Assets exceed liabilities by \$100,000.
 - b. Liabilities exceed owner's equity by \$100,000.
 - c. Assets plus liabilities equal \$100,000.
 - d. None of the above is true.
11. What is the impact on the accounting equation when a current month's utility expense is paid in cash?
 - a. Both sides increase
 - b. Both sides decrease
 - c. Only the asset side changes
 - d. Neither side changes
 12. What is the impact on the accounting equation when cash is used to pay an account payable?
 - a. Both sides increase
 - b. Both sides decrease
 - c. Only the asset side changes
 - d. Neither side changes
 13. Which pair of accounts normally has a debit balance?
 - a. Cash and Supplies
 - b. Accounts Payable and Notes Payable
 - c. Service Revenue and Owner's Capital
 - d. Unearned Revenue and Accounts Payable
 14. Which of the following accounts is a liability?
 - a. Accounts Payable
 - b. Cash
 - c. Drawings
 - d. Service Revenue

Answer available at the end of this section.

Answers

Exercise 2.8.1

Table 2.8.1: Answers to multiple choice questions

Question	Correct Answer
1	d. Assets = Liabilities + Owner's Equity
2	b. Losses
3	b. Have no impact on owner's equity
4	d. Acquisitions of assets by incurring liabilities
5	b. Service Revenue – Revenue – Credit
6	c. Nair, Drawings
7	a. \$12,500
8	b. Supplies
9	d. Accounts Payable
10	a. Assets exceed liabilities by \$100,000.
11	b. Both sides decrease
12	b. Both sides decrease
13	a. Cash and Supplies
14	a. Accounts Payable

This page titled [2.8: Practice Questions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

2.9: Alternative Text Descriptions

Figure 2.5.1: Decision Process for Determining Debits and Credits

This vertical flowchart illustrates the decision process for recording a journal entry. The process begins with Transaction, followed by Identify Account, Increase or Decrease?, Account Type?, Use Debit/Credit Rules, and ends with Record Entry. Each step is connected by a downward-pointing arrow, showing the sequence to follow when determining whether an account should be debited or credited.

This page titled [2.9: Alternative Text Descriptions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

3: JOURNALIZING TRANSACTIONS

Overview

In the previous chapter, you learned the logic behind recording business transactions. The accounting equation showed that every transaction must keep the business in balance. Expanding the accounting equation revealed how revenues, expenses, and owner withdrawals affect owner's equity. Finally the rules of debits and credits provided a consistent method for determining which accounts increase and which decrease.

Knowing which accounts are affected and whether each account is debited or credited is only part of the process. The next step is to record those changes in a permanent accounting record.

Businesses record transactions using journal entries. A journal entry documents each transaction in chronological order and provides a complete record of what happened, when it happened, and which accounts were affected. Every journal entry follows the same rules: the accounts to be debited are listed first, the accounts to be credited are listed second, and the total debits must equal the total credits. This ensures that the accounting equation remains in balance after every transaction.

In this section, you will learn how to convert a business transaction into a properly formatted journal entry - the foundation of the accounting system and the second step in the accounting cycle.

Learning Objectives

By the of this chapter, you can:

- Explain the purpose of a journal and the process of journalizing business transactions
- Identify the parts and proper format of a journal entry, including dates, debits, credits, and descriptions.
- Prepare journal entries by applying the rules of debits and credits to common business transactions.
- Verify that each journal entry is balanced by ensuring total debits equal total credits.

3.1: Journal Entry

3.2: Journalizing Transactions

3.3: Summary

3.4: Key Terms

3.5: Practice Questions

3.6: Alternate Text Descriptions

This page titled [3: Journalizing Transactions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [3: Analyzing and Recording Transactions](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://openstax.org/details/books/principles-financial-accounting>.

3.1: Journal Entry

Why Do We Journal?

Businesses do not simply change account balances whenever a transaction occurs. Instead, accountants first record each transaction in a **journal**. The journal serves as the official record of what happened, when it happened, and which accounts were affected. Recording transactions in a journal creates an organized history of a business's financial activities and ensures that each transaction follows the rules of double-entry accounting.

Imagine changing the Cash account directly every time a transaction occurred. There would be no chronological history showing what happened first, second, or third. The journal creates a permanent chronological record before information is posted to the individual accounts in the general ledger.



Figure 3.1.1: The accounting cycle follows ten steps used to record, adjust, summarize, and report financial information before beginning a new accounting period. Arrow pointing to Step 2 (Record Journal Entries). AI Generated Image, 2026. [Detailed Description of Figure 3.1.1.](#)

A Four-Step Process for Preparing Journal Entries

Preparing journal entries becomes much easier when you follow the same four-step process every time. Rather than memorizing individual journal entries, use the following steps:

Step 1: Identify the Accounts Affected

Determine which accounts change because of the transaction.

Step 2: Determine Whether Each Account Increases or Decreases

Decide whether each affected account increases or decreases.

Step 3: Apply the **Debit and Credit Rules**

Using the [debit and credit rules](#) from the previous section, determine whether each increase or decrease is recorded as a debit

or a credit.

Step 4: Record the Journal Entry

Write the journal entry using the standard format. Record the date, list the debit account or accounts first, indent the credit account or accounts, enter the amounts, include a brief description, and verify that total debits equal total credits.

Concept

Recording a transaction in the journal is called **journalizing**. Regardless of the transaction, every journal entry follows the same standard format:

- The date of the transaction.
- The account or accounts debited, listed first at the left margin.
- The account or accounts credited, listed second and indented.
- The debit and credit amounts.
- A brief description of the transaction.

Debits always appear first and are aligned with the left margin. Credits are listed beneath the debits and indented. This standardized format allows accountants to identify the debit and credit accounts quickly and consistently.

The following examples demonstrate how the four-step process is used to prepare properly formatted journal entries.

Example 3.1.1

March 1: Priya invests \$12,000 cash to start the business.

Solution

Step 1: Identify the accounts affected.

The accounts affected are Cash and Nair, Capital.

Step 2: Determine whether each account increases or decreases.

Cash increases, and Nair, Capital increases.

Step 3: Apply the debit and credit rules.

Cash is an asset. An increase in an asset is recorded as a debit. Nair, Capital is an owner's equity account. An increase in owner's equity is recorded as a credit.

Step 4: Record the journal entry.

Table 3.1.1: Journal entry for the owner's cash investment

Date	Account	Debit	Credit
March 1	Cash	\$12,000	No data available
No data available	Nair, Capital	No data available	\$12,000
Memo: Owner invested cash to start the business.			

Example 3.1.2

March 3: The business purchases equipment for \$3,000 cash.

Solution

Step 1: Identify the accounts affected.

The accounts affected are Equipment and Cash.

Step 2: Determine whether each account increases or decreases.

Equipment increases, and Cash decreases.

Step 3: Apply the debit and credit rules.

Equipment and Cash are both assets. An increase in an asset is recorded as a debit, while a decrease in an asset is recorded as a credit.

Step 4: Record the journal entry.

Table 3.1.2: Journal entry for equipment purchased with cash

Date	Account	Debit	Credit
March 3	Equipment	\$3,000	No data available
No data available	Cash	No data available	\$3,000
Memo: Purchased equipment with cash.			

Example 3.1.3

March 4: The business purchases \$600 of office supplies on account. Purchasing on account means that the business will pay for the supplies later.

Solution
Step 1: Identify the accounts affected.

The accounts affected are Supplies and Accounts Payable.

Step 2: Determine whether each account increases or decreases.

Supplies increases, and Accounts Payable increases.

Step 3: Apply the debit and credit rules.

Supplies is an asset. An increase in an asset is recorded as a debit. Accounts Payable is a liability. An increase in a liability is recorded as a credit.

Step 4: Record the journal entry.

Table 3.1.3: Journal entry for office supplies purchased on account

Date	Account	Debit	Credit
March 4	Supplies	\$600	No data available
No data available	Accounts Payable	No data available	\$600
Memo: Purchased office supplies on account.			

Note

In the Real World

Software such as QuickBooks hides the debit-and-credit layout behind user-friendly buttons such as “Create Invoice” and “Enter Bill.” Underneath these buttons, the software records the same journal entries that you have learned to prepare by hand. Understanding the journal entry allows you to recognize and correct errors when the software records a transaction incorrectly.

Caution

Watch Out

A journal entry that does not balance cannot be left for later correction. Before moving on, add the debit amounts and the credit amounts. If the totals are not equal, you may have omitted an account, entered an incorrect amount, or recorded an amount in the wrong column. Find and correct the error before continuing.

Recap

A journal entry records a business transaction in chronological order. Every journal entry includes the date, the account or accounts debited, the account or accounts credited, the amounts, and a brief description. Debits are listed first, credits are indented beneath them, and total debits must always equal total credits.

After transactions are journalized, the information is transferred, or **posted**, to the individual accounts in the general ledger.

3.2: Journalizing Transactions

You Try It!

Exercise 3.2.1

On March 5, Priya paid \$900 to her landlord for office rent for March.

Answer available at the end of this section.

Exercise 3.2.2

On March 12, Priya billed her client, Ramos, \$2,500 for tax preparation services. Payment is due within 30 days.

Answer available at the end of this section.

Exercise 3.2.3

On March 22, Priya collected \$2,000 cash from client ABC Bakery for monthly bookkeeping services.

Answer available at the end of this section.

Exercise 3.2.4

On March 25, Priya paid the supplier for supplies purchased on Mar. 4. Recall this from [3.1: Journalizing Transactions](#).

Answer available at the end of this section.

Exercise 3.2.5

On March 28, Priya paid her part-time assistant \$1,100 for March wages.

Answer available at the end of this section.

Exercise 3.2.6

On March 30, Priya withdrew \$800 cash for her personal use.

Answer available at the end of this section.

The Completed General Journal

Until this point, each transaction has been presented as a separate journal entry. In practice, journal entries are recorded one after another in the **general journal** in chronological order. The following table brings together Priya's six March transactions from this section on one journal page.

Exercise 3.2.7

Expand the answer on the six March transactions from this section.

Answer available at the end of this section.

Answers

Exercise 3.2.1

Table 3.2.1: Journal entry to record payment of March office rent

Date	Account	
March 5	Rent	
No data available	Cash	No data available
<i>Memo: Paid March office rent.</i>	No data available	No data available

Exercise 3.2.2

Table 3.2.2: Journal entry to record tax preparation services provided on account

Date	Account	
March 12	Accounts Receivable	
No data available	Service Revenue	No data available
<i>Memo: Billed a client for tax preparation services.</i>	No data available	No data available

Exercise 3.2.3

Table 3.2.3: Journal entry to record cash received for monthly bookkeeping services

Date	Account	
March 22	Cash	
No data available	Service Revenue	No data available
<i>Memo: Received cash for monthly bookkeeping services from ABC Bakery.</i>	No data available	No data available

Exercise 3.2.4

Table 3.2.4: Journal entry to record payment to the supplier for supplies purchased on account

Date	Account	
March 25	Accounts Payable	
No data available	Cash	No data available
<i>Memo: Paid the supplier for supplies purchased on March 4.</i>	No data available	No data available

Exercise 3.2.5

Table 3.2.5: Journal entry to record payment of wages to a part-time assistant

Date	Account	
March 28	Wages Expense	
No data available	Cash	No data available

Date	Account	
<i>Memo: Paid wages to a part-time assistant.</i>	No data available	No data available

Exercise 3.2.6

Table 3.2.6: Journal entry to record the owner's withdrawal of cash for personal use

Date	Account	
March 30	Nair, Drawings	
No data available	Cash	No data available
<i>Memo: Owner withdrew cash for personal use.</i>	No data available	No data available

Exercise 3.2.7

Table 3.2.7: General journal for Priya's March transactions

Date	Account	Debit	Credit
March 5	Rent Expense	\$900	No data available
No data available	Cash	No data available	\$900
No data available	<i>Memo: Paid March office rent.</i>		
March 12	Accounts Receivable	\$2,500	No data available
No data available	Service Revenue	No data available	\$2,500
No data available	<i>Memo: Billed Ramos for tax preparation services.</i>		
March 22	Cash	\$2,000	No data available
No data available	Service Revenue	No data available	\$2,000
No data available	<i>Memo: Received cash from ABC Bakery for monthly bookkeeping services.</i>		
March 25	Accounts Payable	\$600	No data available
No data available	Cash	No data available	\$600
No data available	<i>Memo: Paid the supplier for supplies purchased on March 4.</i>		
March 28	Wages Expense	\$1,100	No data available
No data available	Cash	No data available	\$1,100
No data available	<i>Memo: Paid wages to a part-time assistant.</i>		
March 30	Nair, Drawings	\$800	No data available
No data available	Cash	No data available	\$800
No data available	<i>Memo: Owner withdrew cash for personal use.</i>		
Totals		\$7,900	\$7,900

The general journal preserves the transactions in the order in which they occurred. Notice that each journal entry is balanced individually and that the total debits of **\$7,900** equal the total credits of **\$7,900**.

Although the journal provides a complete chronological record, information about the same account appears in different places. For example, Cash appears in several journal entries throughout the month. To determine the balance of an individual account, the journal information must be transferred to the appropriate account in the general ledger. This transfer process is called **posting**.

Add up the debits and the credits across the whole month and they match to the penny because each individual entry matches. That balance is what makes the next step possible.

Right now these entries live in date order, scattered by time rather than gathered by account. To answer Priya's original question, where did all cash go? You need every cash line collected in one place, every revenue line in another. That's **posting to the ledger**, and it is where the next chapter begins.

This page titled [3.2: Journalizing Transactions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

3.3: Summary

Key Takeaways

- A **journal** is the book of original entry where business transactions are recorded in chronological order before they are transferred to the general ledger.
- **Journalizing** is the process of recording a business transaction using a standard journal entry format.
- Every journal entry follows the same **four-step process**:
 1. Identify the accounts affected.
 2. Determine whether each account increases or decreases.
 3. Apply the debit and credit rules.
 4. Record the journal entry using the proper format.
- Every journal entry includes:
 - the transaction date,
 - the account(s) debited,
 - the account(s) credited,
 - the debit and credit amounts, and
 - a brief description (memo).
- **Debits** are always recorded first at the left margin, while **credits** are listed beneath the debits and indented.
- The total **debits must always equal total credits**. Balanced journal entries ensure the accounting equation remains in balance.
- Journal entries document a complete history of a business's transactions and provide the information needed for the next step in the accounting cycle—**posting to the general ledger**.
- Accounting software records the same journal entries behind the scenes, making it important to understand how journal entries are prepared and interpreted.
- Before moving to the next transaction, always verify that the journal entry is complete and balanced to avoid errors in later accounting records.

3.4: Key Terms

Definitions

account title

official name of an account used to record business transactions

chart of accounts

list of all accounts used by a business to record financial transactions

compound journal entry

journal entry that affects more than two accounts

credit

entry recorded on the right side of an account; increases liabilities, owner's equity, and revenues, and decreases assets, expenses, and drawings

debit

entry recorded on the left side of an account; increases assets, expenses, and drawings, and decreases liabilities, owner's equity, and revenues

double-entry accounting

accounting system in which every transaction affects at least two accounts and total debits always equal total credits

general journal

book of original entry used to record business transactions in chronological order

journal

accounting record where business transactions are first recorded before they are posted to the general ledger

journal entry

record of a business transaction showing the accounts affected, debit and credit amounts, date, and, when appropriate, an explanation

journalizing

process of recording a business transaction in the journal

normal balance

side of an account, debit or credit, on which increases are normally recorded

simple journal entry

journal entry that contains one debit and one credit

source document

document that provides evidence a business transaction occurred, such as an invoice, receipt, check, or bank statement

transaction analysis

process of identifying the accounts affected by a transaction and determining whether each account increases or decreases

transaction date

date on which a business transaction occurs and is recorded in the accounting records

3.5: Practice Questions

Multiple Choice Questions

Exercise 3.5.1

- What is a journal?
 - A record that summarizes the balances of all accounts at the end of an accounting period
 - A chronological record of a business's financial transactions
 - A list of all accounts used by a business and their account numbers
 - A financial statement that reports a business's assets, liabilities, and owner's equity
- Recording a business transaction in the journal is called _____.
 - posting
 - journalizing
 - balancing
 - reconciling
- What is the first step in preparing a journal entry?
 - Record the journal entry
 - Identify the accounts affected
 - Determine whether total debits equal total credits
 - Write a description of the transaction
- After identifying the accounts affected, what is the next step in preparing a journal entry?
 - Post the transaction to the general ledger
 - Record the credit account first
 - Determine whether each account increases or decreases
 - Prepare a trial balance
- In the standard journal entry format, which account is listed first?
 - The account being credited
 - The account being debited
 - The account with the largest balance
 - The account listed first in the chart of accounts
- How is a credited account normally displayed in a journal entry?
 - It is listed above the debit account
 - It is written in parentheses
 - It is listed beneath the debit account and indented
 - It is entered without an account name
- Which statement about a properly prepared journal entry is correct?
 - It must contain only one debit and one credit
 - Its total debits must equal its total credits
 - It must increase both assets and owner's equity
 - Its credit amount must be greater than its debit amount
- Priya invests \$12,000 cash to start the business. Which journal entry correctly records the transaction?
 - Debit Cash \$12,000; Credit Nair, Capital \$12,000
 - Debit Nair, Capital \$12,000; Credit Cash \$12,000
 - Debit Cash \$12,000; Credit Service Revenue \$12,000
 - Debit Equipment \$12,000; Credit Cash \$12,000
- The business purchases \$600 of supplies on account. Which journal entry correctly records the transaction?
 - Debit Accounts Payable \$600; Credit Supplies \$600
 - Debit Supplies \$600; Credit Cash \$600
 - Debit Supplies \$600; Credit Accounts Payable \$600
 - Debit Supplies Expense \$600; Credit Nair, Capital \$600
- The business pays \$900 cash for rent. Which journal entry correctly records the transaction?
 - Debit Cash \$900; Credit Rent Expense \$900
 - Debit Rent Expense \$900; Credit Cash \$900
 - Debit Rent Expense \$900; Credit Accounts Payable \$900

- d. Debit Accounts Payable \$900; Credit Cash \$900
11. The business receives \$2,000 cash for services performed. Which journal entry correctly records the transaction?
- Debit Cash \$2,000; Credit Service Revenue \$2,000
 - Debit Service Revenue \$2,000; Credit Cash \$2,000
 - Debit Accounts Receivable \$2,000; Credit Cash \$2,000
 - Debit Cash \$2,000; Credit Accounts Payable \$2,000
12. After transactions have been journalized, what happens next in the accounting cycle?
- The journal entries are posted to the general ledger
 - The temporary accounts are closed
 - The financial statements are prepared
 - The transactions are deleted from the journal

Answer available at the end of this section.

Answers

Exercise 3.5.1

Table 3.5.1: Answers to multiple choice questions

Question	Answer	Explanation
1	b.	A journal is a chronological record of a business's financial transactions.
2	b.	Journalizing is the process of recording a business transaction in the journal.
3	b.	The first step is to identify the accounts affected by the transaction.
4	c.	After identifying the accounts, determine whether each account increases or decreases.
5	b.	The debit account is always listed first in a journal entry.
6	c.	The credit account is listed beneath the debit account and is indented.
7	b.	Every journal entry must have total debits equal total credits.
8	a.	An owner's investment increases Cash (debit) and Nair, Capital (credit).
9	c.	Purchasing supplies on account is recorded as Debit Supplies and Credit Accounts Payable.
10	b.	Paying rent is recorded as Debit Rent Expense and Credit Cash.
11	a.	Receiving cash for services performed is recorded as Debit Cash and Credit Service Revenue.
12	a.	After journalizing, transactions are posted to the general ledger.

This page titled [3.5: Practice Questions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

3.6: Alternate Text Descriptions

Figure 3.1.1: Accounting Cycle with Step 2 Highlighted

A circular diagram of the 10-step accounting cycle. An arrow labeled "We are Here!" points to Step 2, **Record Journal Entries**, indicating the current stage in the process. The accounting cycle proceeds through the following steps: Analyze Transactions, Record Journal Entries, Post to Ledger, Prepare Unadjusted Trial Balance, Record Adjusting Entries, Prepare Adjusted Trial Balance, Prepare Financial Statements, Record Closing Entries, Prepare Post-Closing Trial Balance, and optional Reversing Entries. The cycle repeats each accounting period.

This page titled [3.6: Alternate Text Descriptions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

4: POSTING AND THE TRIAL BALANCE

Overview

Priya has all ten of Ledgerline's March transactions written down as journal entries. They are neat, dated, and every one balances. But when her friend asks a simple question - "So how much cash do you actually have right now?" Priya froze.

The answer is somewhere in those entries. Cash shows up in seven of them, scattered across the month. To find the balance she would have to hunt down every line that touched Cash and add and subtract as she goes. Do that for a full year and you'd never finish.

The journal is organized by date. To run a business you need information organized by account. This chapter is about making that switch, and then proving, with a single quick check, that the whole month still holds together.

Learning Objectives

By the end of this chapter, you can:

- Post journal entries to accounts in the general ledger.
- Compute the balance of any account.
- Prepare an unadjusted trial balance.
- Explain what a trial balance proves, and what it does not.

4.1: Posting to the General Ledger

4.2: Finding each account's balance

4.3: Journaling and posting to account

4.4: Prepare a Trial Balance

4.5: The Unadjusted Trial Balance - Example

4.6: Summary

4.7: Key Terms

4.8: Practice Questions

4.9: Alternate Text Descriptions

This page titled [4: Posting and the Trial Balance](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by OpenStax via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [5: Completing the Accounting Cycle](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://openstax.org/details/books/principles-financial-accounting>.

4.1: Posting to the General Ledger

Overview

We now look at the next step in the [accounting cycle](#), step 3: post journal information to the ledger. To do this, we can use a T-account format. A company will take information from its journal and post to this general ledger. Posting refers to the process of transferring data from the journal to the general ledger. It is important to understand that T-accounts are only used for illustrative purposes in a textbook, classroom, or business discussion. They are not official accounting forms. Companies will use ledgers for their official books, not T-accounts.

The journal tells you what happened in order, but it is terrible at telling you where any one account stands. You need the same information regrouped by account, and that's what this chapter is about.

Concept

An account is a running record of everything that happens to one item. One for Cash, one for Service Revenue, and so on. The full set of accounts for a business is its **general ledger**. Moving each line of a journal entry into its matching account is called **posting**.

Nothing new gets decided when you post. The thinking already happened when you journalized. Posting is pure copying: every debit in the journal becomes a debit in that account's ledger, every credit becomes a credit. The journal and the ledger always tell the same story one—sorted by date, the other by account.

Example 4.1.1

Referencing the example that we followed in [3: Journalizing Transactions](#), we will now look at the Cash entries from Priya's March transactions.

Of the March transactions, three debited Cash and five credited Cash. Each journal entry is posted to the corresponding side of the Cash T-account.

Solution

The title of this T-Account is Cash.

Table 4.1.1: T-Account of cash transactions for March

Debit	Credit
12,000	3,000
1,500	900
2,000	600
No data available	1,100
No data available	800

Every amount on the left came from an entry that debited Cash: the owner's investment of \$12,000 on March 1, the customer payment of \$1,500 on March 18, and the cash received of \$2,000 on March 22.

Every amount on the right came from a journal entry that credited Cash: purchasing equipment for \$3,000 on March 3, paying rent of \$900 on March 5, paying the supplier \$600 on March 25, paying wages of \$1,100 on March 28, and the owner's withdrawal of \$800 on March 30.

Notice the amounts have not changed from the journal entries. Posting simply organizes all Cash transactions into one account, making it much easier to determine the account balance.

Note

In the real world

In Quickbooks or Xero you never post by hand. The moment you save an invoice or a bill, the software posts it to the ledger instantly. But it's posting to these exact accounts, on these exact sides, which is why a bookkeeper who understands posting can spot when an automated entry landed in the wrong account.

Caution

Watch out

A debit on the journal is always a debit in the ledger. Beginners sometimes "flip" an amount to the other side because it feels like it should reduce the account. Don't. Copy the side exactly as journalized; the balancing step below is what nets it out.

Recap

The ledger is your accounts regrouped from the journal. Posting copies each journal line to its account, keeping the same side - debits to debits, credits to credits.

This page titled [4.1: Posting to the General Ledger](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [3.5: Use Journal Entries to Record Transactions and Post to T-Accounts](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

4.2: Finding each account's balance

Why find the account's balance?

A posted account is still just a column of debits and a column of credits. You want a single number that shows the account's current balance. The ending account balance is then transferred to the trial balance, which is used to verify that total debits equal total credits.

Concept

To find the account's balance, total each side of the account. Accountants call this footing it; subtract the smaller total from the larger. The difference is the account's balance, and it sits on the side with the larger total.

Because assets, expenses, and drawings normally carry debit balances, their debit side usually wins. Liabilities, equity, and revenue normally land on the credit side. If an account ever balances to the "wrong" side, that's a signal to investigate.

For example, the Cash account is an asset. We know from the accounting equation that assets increase on the debit side and decrease on the credit side.

Example 4.2.1

Foot the Cash account. Add the debit (left) side and the credit (right) side, then subtract the smaller total from the larger total. The ending balance is entered on the side with the larger total. For Cash, this is normally the debit side because Cash is an asset account. What is the account's ending balance?

Solution

This is Ledgerline's Cash T-account for March, showing cash transactions with debits on the left and credits on the right. The debit side has a total of \$15,500, while the credit side has a total of \$6,400. To determine the account balance, subtract the smaller total from the larger total. The ending balance is recorded on the side with the larger total. In this example, \$15,500 minus \$6,400 equals \$9,100; therefore, the ending balance of the Cash account is a debit balance of \$9,100.

Table 4.2.2: Cash T-Account of Ledgerline's March transactions

Debit	Credit
12,000	3,000
1,500	900
2,000	600
No data available	1,100
No data available	800
Total: 15,500	Total: 6,400
9,100 (Ending Debit Balance)	No data available

The Cash account has an ending debit balance of \$9,100. That's the number Priya couldn't find at the start of the chapter — the actual cash on hand.

Every financial statement is ultimately built from the ending balances of the general ledger accounts. Before accountants can prepare the financial statements, they must first determine the ending balance of each account and summarize those balances

in a trial balance.

Of all the accounts a company maintains, the Cash account usually has the greatest number of transactions. Now, let us look at a simpler example.

Example 4.2.2

Accounts Payable was credited \$600 when Ledgerline bought supplies, then debited \$600 when it paid the bill. What is the ending balance for Accounts Payable?

Solution

This is Ledgerline's Accounts Payable T-account for March, showing Accounts Payable transactions with a debit on the left and a credit right. The debit side had a total of \$600, while the credit side has a total of \$600. Because the debit and credit totals are equal, the account has a zero ending balance. If the balance had not been fully paid during the month, the Accounts Payable account would typically have an ending credit balance.

Table 4.2.3: Accounts Payable T-account for Ledgerline's March transactions

Debit	Credit
600	600
Total: 600	Total: 600
No data available	0 (Ending Credit Balance)

In this example, we see that the two sides cancel. Accounts Payable has a zero balance. The firm owes nothing.

Caution

Watch out

The balance goes on the side with the larger total, not automatically on the account's normal balance side. Usually, the two are the same. If they are not, stop and investigate. An unusual balance may indicate an error, or it may reflect an unusual situation, such as an overdrawn Cash account.

Example:

Cash is an asset, and it usually has a debit balance. However, if you find that Cash has a credit balance, you may want to ask:

- Was cash receipt never recorded?
- Was a payment posted twice?
- Was a payment posted to the wrong account?
- Was the bank account actually overdrawn?

Recap

Foot both sides, subtract the smaller from the larger, and place the balance on the larger side. An account whose sides are equal has a zero balance.

This page titled [4.2: Finding each account's balance](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

- [3.5: Use Journal Entries to Record Transactions and Post to T-Accounts](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

4.3: Journaling and posting to account

You Try It !

- You have the following transactions the last few days of April.
- Instructions:
 - Prepare the necessary journal entries for each transaction, and post the entries to the general ledger.
 - After all entries are posted, what will be the new balance in each account used in these entries?

Exercise 4.3.1

Transaction: April 25 — You stop by your uncle's gas station to refill both gas cans for your company, Watson's Landscaping. Your uncle adds \$28 to your account.

Answer available at the end of this section.

Exercise 4.3.2

Transaction: April 26 — You record another week's revenue for the lawns mowed during the past week. You earned \$1,200 and received cash equal to 75% of the revenue.

Answer available at the end of this section.

Exercise 4.3.3

Transaction: April 26 — You pay your local newspaper \$35 to run an advertisement in this week's paper.

Answer available at the end of this section.

Exercise 4.3.4

Transaction: April 29 — You make a \$25 payment on account.

Answer available at the end of this section.

General Ledger Accounts After Posting All Entries for April

Exercise 4.3.5

What's the ending Cash Balance for April?

Answer available at the end of this section.

Exercise 4.3.6

What's the ending Accounts Receivable Balance for April?

Answer available at the end of this section.

Exercise 4.3.7

What's the ending Accounts Payable Balance for April?

Answer available at the end of this section.

Exercise 4.3.8

What's the ending Lawn-Mowing Revenue Balance?

Answer available at the end of this section.

Exercise 4.3.9

What's the ending Fuel Expense Balance?

Answer available at the end of this section.

Exercise 4.3.10

What's the ending Advertising Expense Balance?

Answer available at the end of this section.

Answers

Exercise 4.3.1

Table 4.3.1: Journal Entry for Fuel Purchase

Date	Account	Debit	Credit
April 25	Fuel Expense	\$28	No data available
No data available	Accounts Payable	No data available	\$28
Memo: Purchased gas on account.			

The April 25 transaction is recorded by debiting Fuel Expense for \$28 and crediting Accounts Payable for \$28. When the journal entry is posted to the general ledger, Fuel Expense receives a \$28 debit, and Accounts Payable receives a \$28 credit.

Table 4.3.2: Fuel Expense General Ledger

Date	Debit	Date	Credit
April 25	\$28	No data available	No data available

New Balance: Fuel Expense = \$28 debit balance

Table 4.3.3: Accounts Payable General Ledger

Date	Debit	Date	Credit
No data available	No data available	April 25	\$28

New Balance: Accounts Payable = \$28 credit balance

Exercise 4.3.2

Table 4.3.4: Journal Entry for Lawn-Mowing Revenue and Partial Cash Collection

Date	Account	Debit	Credit
April 26	Cash	\$900	No data available
No data available	Accounts Receivable	\$300	No data available
No data available	Lawn-Mowing Revenue	No data available	\$1,200
Memo: Earned \$1,200 of revenue and received 75% in cash.			

The April 26 transaction is recorded by debiting Cash for \$900, debiting Accounts Receivable for \$300, and crediting Lawn-Mowing Revenue for \$1,200. When the journal entry is posted to the general ledger, each account receives the corresponding debit or credit.

Table 4.3.5: Cash General Ledger

Date	Debit	Date	Credit
April 26	\$900	No data available	No data available

New Balance: Cash = \$900 debit balance

Table 4.3.6: Accounts Receivable General Ledger

Date	Debit	Date	Credit
April 26	\$300	No data available	No data available

New Balance:
Accounts Receivable = \$300 debit balance

Table 4.3.7: Lawn-Mowing Revenue General Ledger

Date	Debit	Date	Credit
No data available	No data available	April 26	\$1,200

New Balance: Lawn-Mowing Revenue = \$1,200 credit balance

Explanation: Cash increases because 75% of the revenue was collected immediately. Therefore, Cash is debited for \$900. The remaining 25%, or \$300, is owed by customers, so Accounts Receivable is debited. Because the lawn-mowing services have been performed, the business has earned \$1,200 of revenue. Revenue accounts increase with credits, so Lawn-Mowing Revenue is credited for \$1,200.

Exercise 4.3.3

Table 4.3.8: Journal Entry for Advertising Expense Paid with Cash

Date	Account	Debit	Credit
April 26	Advertising Expense	\$35	No data available
No data available	Cash	No data available	\$35
Memo: Paid cash to run an advertisement.			

The April 26 transaction is recorded by debiting Advertising Expense for \$35 and crediting Cash for \$35. When the journal entry is posted to the general ledger, Advertising Expense receives a \$35 debit and Cash receives a \$35 credit.

Table 4.3.9: Advertising Expense General Ledger

Date	Debit	Date	Credit
April 26	\$35	No data available	No data available

New Balance: Advertising Expense = \$35 debit balance

Table 4.3.10: Cash General Ledger

Date	Debit	Date	Credit
No data available	No data available	April 26	\$35

New Balance: Cash = \$35 credit balance

Explanation: Advertising is an operating expense of the business. Because expenses increase with debits, Advertising Expense is debited for \$35. The advertisement was paid for immediately with cash, so Cash decreases. Asset accounts decrease with credits; therefore, Cash is credited for \$35.

Exercise 4.3.4

Table 4.3.11: Journal Entry for Payment on Account

Date	Account	Debit	Credit
April 29	Accounts Payable	\$25	No data available
No data available	Cash	No data available	\$25
Memo: Made payment on account.			

The April 29 transaction is recorded by debiting Accounts Payable for \$25 and crediting Cash for \$25. When the journal entry is posted to the general ledger, Accounts Payable receives a \$25 debit and Cash receives a \$25 credit.

Table 4.3.12: Accounts Payable General Ledger

Date	Debit	Date	Credit
April 29	\$25	No data available	No data available

New Balance: Accounts Payable = \$25 debit (payment applied to the liability)

Table 4.3.13: Cash General Ledger

Date	Debit	Date	Credit
No data available	No data available	April 29	\$25

New Balance: Cash = \$25 credit (cash decreases)

Explanation: A payment on account reduces the amount owed to a creditor. Because liabilities decrease with debits, Accounts Payable is debited for \$25. Cash is paid to the creditor, so Cash decreases. Asset accounts decrease with credits; therefore, Cash is credited for \$25.

Exercise 4.3.5

Table 4.3.14: Cash General Ledger

Date	Debit	Date	Credit
April 26	\$900	April 26	\$35
No data available	No data available	April 29	\$25
No data available	Total Debits: \$900	No data available	Total Credits: \$60

New Balance: Cash = **\$840 debit balance**

Explanation: The Cash account received one debit of \$900 and two credits totaling \$60 (\$35 + \$25). Debits exceed credits by \$840 (\$900 – \$60), leaving a final debit balance of \$840.

Exercise 4.3.6

Table 4.3.15: Accounts Receivable General Ledger

Date	Debit	Date	Credit
April 26	\$300	No data available	No data available
No data available	Total Debits: \$300	No data available	No data available

New Balance: Accounts Receivable = **\$300 debit balance**

Explanation: The business earned \$1,200 of revenue and collected 75% in cash. The remaining 25%, or \$300, is still owed by customers. Because Accounts Receivable is an asset, it increases with debits. After posting the journal entry, the Accounts Receivable account has a debit balance of \$300.

Exercise 4.3.7

Table 4.3.16: Accounts Payable General Ledger

Date	Debit	Date	Credit
April 29	\$25	April 25	\$28
No data available	Total Debits: \$25	No data available	Total Credits: \$28

New Balance: Accounts Payable = **\$3 credit balance**

Explanation: The Accounts Payable account was credited \$28 when the business purchased fuel on account. Later, a \$25 payment reduced the liability with a debit. Credits exceed debits by \$3 (\$28 – \$25), leaving a final credit balance of \$3.

Exercise 4.3.8

Table 4.3.17: Lawn-Mowing Revenue General Ledger

Date	Debit	Date	Credit
No data available	No data available	April 26	\$1,200
No data available	Total Debits: \$0	No data available	Total Credits: \$1,200

New Balance: Lawn-Mowing Revenue = **\$1,200 credit balance**

Explanation: The business earned \$1,200 by providing lawn-mowing services. Because revenue accounts increase with credits, Lawn-Mowing Revenue is credited for \$1,200. After posting the journal entry, the Lawn-Mowing Revenue account has a credit balance of \$1,200.

Exercise 4.3.9

Table 4.3.18: Fuel Expense General Ledger

Date	Debit	Date	Credit
April 25	\$28	No data available	No data available
No data available	Total Debits: \$28	No data available	Total Credits: \$0

New Balance: Fuel Expense = **\$28 debit balance**

Explanation: Fuel was purchased for use in the business, creating a fuel expense of \$28. Because expense accounts increase with debits, Fuel Expense is debited for \$28. After posting the journal entry, the Fuel Expense account has a debit balance of \$28.

Exercise 4.3.10

Table 4.3.19: Advertising Expense General Ledger

Date	Debit	Date	Credit
April 26	\$35	No data available	No data available
No data available	Total Debits: \$35	No data available	Total Credits: \$0

New Balance: Advertising Expense = **\$35 debit balance**

Explanation: The business paid \$35 to advertise in the local newspaper. Because expense accounts increase with debits, Advertising Expense is debited for \$35. After posting the journal entry, the Advertising Expense account has a debit balance of \$35.

This page titled [4.3: Journaling and posting to account](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

- [3.5: Use Journal Entries to Record Transactions and Post to T-Accounts](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

4.4: Prepare a Trial Balance

Overview

After all transactions have been journalized and posted to the general ledger, the next step in the accounting cycle is to prepare an **unadjusted trial balance**. A trial balance is a report that lists each general ledger account with a nonzero ending balance in either the Debit or Credit column.

The primary purpose of the trial balance is to verify that **total debits equal total credits** before moving to the next step in the accounting cycle. If the two columns do not balance, an error has occurred and must be corrected.



Figure 4.4.1: The accounting cycle follows ten steps used to record, adjust, summarize, and report financial information before beginning a new accounting period. Arrow pointing to Step 4 (Prepare Unadjusted Trial Balance). AI Generated Image, 2026. [Detailed Description of Figure 4.4.1.](#)

What Is an Unadjusted Trial Balance?

An **unadjusted trial balance** is prepared after transactions have been posted to the general ledger but before adjusting entries are recorded. It summarizes the ending balance of each general ledger account and provides a quick check that the accounting records remain in balance.

Preparing an Unadjusted Trial Balance

Follow these steps to prepare an unadjusted trial balance:

1. List each general ledger account with a nonzero ending balance.
2. Arrange the accounts in the following order:
 - Assets
 - Liabilities
 - Owner's Equity
 - Revenues
 - Expenses
 - Owner's Drawings, if applicable
3. Enter each account's ending balance:

- Debit balances are entered in the Debit column.
 - Credit balances are entered in the Credit column.
4. Total the Debit and Credit columns.
 5. Verify that total debits equal total credits.

If the debit and credit totals are equal, the ledger is mathematically in balance and is ready for the next step in the accounting cycle.

Formatting Guidelines

A properly prepared trial balance should include:

- The company name
- The report title, **Unadjusted Trial Balance**
- The reporting date
- Accounts listed in the proper order
- Separate Debit and Credit columns
- Equal debit and credit totals

Caution

What a Trial Balance Cannot Prove

A balanced trial balance confirms only that total debits equal total credits. It does not guarantee that every transaction was recorded correctly.

A trial balance may still balance if:

- A transaction was omitted entirely.
- The wrong account was used (e.g. The correct entry is Rent expense debited for \$900, but the bookkeeper accidentally records as Utilities expense instead)
- The same incorrect amount was recorded for both the debit and the credit.

The trial balance is an important error-checking tool, but it cannot detect every type of accounting mistake.

Next Step

Now that you understand the purpose and format of an unadjusted trial balance, the next section demonstrates how to prepare one for Ledgerline using the ending balances from its general ledger accounts.

4.5: The Unadjusted Trial Balance - Example

T-Accounts of Ledgerline for March

In [4.4: Prepare a Trial Balance](#) you saw an example of Printing Plus company. Now, let us continue with our example of preparing the trial balance for Priya's business, Ledgerline.

Before preparing the trial balance, let us review the ending balance of each account in Ledgerline's general ledger. Notice that each ending balance appears on the account's normal balance side. Note: Some general ledgers include a Post Reference column that identifies where a transaction originated in the journal, making it easier to trace transactions between the journal and ledger. (E.g. a reference such as J1 in the general ledger indicates that the transaction can be found on page 1 of the General Journal.) We have omitted the Post Reference column in our examples below to keep our focus on posting and calculating account balances.

Table 4.5.1: Cash - General Ledger

Date	Debit	Date	Credit
March 1	12,000	March 3	3,000
March 18	1,500	March 5	900
March 22	2,000	March 25	600
No data available	No data available	March 28	1,100
No data available	No data available	March 30	800
March 31 Cash Ending Balance: 9,100	No data available	No data available	No data available

Table 4.5.2: Accounts Receivable - General Ledger

Date	Debit	Date	Credit
March 12	2,500	March 18	1,500
March 31 Accounts Receivable Ending Balance: 1,000	No data available	No data available	No data available

Table 4.5.3: Supplies - General Ledger

Date	Debit	Date	Credit
March 4	600	No data available	No data available
March 31 Supplies Ending Balance: 600	No data available	No data available	No data available

Table 4.5.4: Equipment - General Ledger

Date	Debit	Date	Credit
March 3	3,000	No data available	No data available
March 31 Equipment Ending Balance: 3,000	No data available	No data available	No data available

Table 4.5.5: Accounts Payable - General Ledger

Date	Debit	Date	Credit
March 25	600	March 4	600
No data available	No data available	No data available	March 31 Accounts Payable Ending Balance: 0

Table 4.5.6: *Nair, Capital - General Ledger*

Date	Debit	Date	Credit
No data available	No data available	March 1	12,000
No data available	No data available	No data available	March 31 Nair, Capital Ending Balance: 12,000

Table 4.5.7: *Nair, Drawings - General Ledger*

Date	Debit	Date	Credit
March 30	800	No data available	No data available
March 31 Nair, Drawings Ending Balance: 800	No data available	No data available	No data available

Table 4.5.8: *Service Revenue - General Ledger*

Date	Debit	Date	Credit
No data available	No data available	March 12	2,500
No data available	No data available	March 22	2,000
No data available	No data available	No data available	March 31 Service Revenue Ending Balance: 4,500

Table 4.5.9: *Rent Expense - General Ledger*

Date	Debit	Date	Credit
March 5	900	No data available	No data available
March 31 Rent Expense Ending Balance: 900	No data available	No data available	No data available

Table 4.5.10: *Wages Expense - General Ledger*

Date	Debit	Date	Credit
March 28	1,100	No data available	No data available
March 31 Wage Expense Ending Balance: 1,100	No data available	No data available	No data available

Note

The Ending Balances are the amounts that will be transferred directly to the unadjusted trial balance. The trial balance is simply a list of the ending balances from each ledger account's ending balances; accounts with debit balances are listed in the Debit column, while accounts with credit balances are listed in the Credit column.

Example 4.5.1

Here is Ledgerline's unadjusted trial balance at March 31, built from the balance of every account. Notice that Accounts Payable is not listed because its ending balance is zero. When an account whose balance is zero contributes nothing to either column, and is typically omitted from the trial balance.

Solution

This is a Balance Sheet headed up with three lines. The first line is the name of the company, called Ledgerline. The second line of the report is the name of the report, called Unadjusted Trial Balance. The third line of the report is the period name. Since this is for March transactions, the period name of the Unadjusted Trial Balance is March 31, 20XX.

Table 4.5.11: Ledgerline's Unadjusted Trial Balance.

Account	Debit	Credit
Cash	9,100	No data available
Accounts Receivable	1,000	No data available
Supplies	600	No data available
Equipment	3,000	No data available
Nair, Capital	No data available	12,000
Nair, Drawing	800	No data available
Service Revenue	No data available	4,500
Rent Expense	900	No data available
Wages Expense	1,100	No data available
Totals	16,500	16,500

In the above example of Ledgerline's Unadjusted Trial Balance, both columns total \$16,500. The ledger is internally consistent: for every dollar posted as a debit, an equal dollar was posted as a credit.

One important point to understand is what a trial balance can and cannot tell you. A balanced trial balance proves the two sides are equal. It does not prove they are right. Several mistakes slip through untouched:

- You forgot to record a transaction. Nothing to unbalance.
- You posted a correct amount to the wrong account.
- You recorded the wrong amount on both sides of the journal entry.

Think of the trial balance as a spell check, not a fact check. It catches arithmetic errors and unequal debits and credits, but it cannot detect mistakes that still keep total debits equal to total credits.

Caution

Watch out

Do not assume that because a trial balance balances, every transaction has been recorded correctly. A balanced trial balance passes one test, but transactions must still be reviewed for accuracy.

Recap

Equal totals confirm debits equal credits; however, they do not guarantee that every transaction was recorded correctly.

4.6: Summary

The General Ledger

- After transactions are recorded in the journal, they are **posted** to the **general ledger**.
- Posting transfers journal information into the individual accounts affected by each transaction.
- The general ledger organizes all account activity in one place and shows the balance of each account.
- Each account in the ledger may be presented in a T-account or general ledger format.

Posting Transactions

- Every journal entry is posted to the appropriate general ledger accounts.
- Debits are posted to the debit side of an account, and credits are posted to the credit side.
- Posting does not create new information. It reorganizes journal entries by account.
- Accurate posting ensures that account balances are complete and up to date.

Determining Account Balances

- The balance of an account is determined by comparing its total debits and total credits.
- Assets, expenses, and owner's drawings normally have debit balances.
- Liabilities, owner's capital, and revenues normally have credit balances.
- Knowing an account's normal balance can help identify possible journalizing or posting errors.

Journalizing and Posting

- Journalizing and posting are separate but connected steps in the accounting cycle.
- Transactions are recorded first in the journal and then transferred to the general ledger.
- Both steps must be completed before a trial balance can be prepared.
- Errors made during journalizing or posting can affect account balances and later accounting reports.

Preparing a Trial Balance

- A **trial balance** lists each general ledger account and its ending balance.
- Debit balances are listed in the debit column, and credit balances are listed in the credit column.
- The total of the debit column must equal the total of the credit column.
- The trial balance helps verify the mathematical accuracy of the general ledger before financial statements are prepared.

The Unadjusted Trial Balance

- The trial balance prepared after transactions have been journalized and posted is called the **unadjusted trial balance**.
- It is prepared before any adjusting entries are recorded.
- An equal trial balance does not guarantee that all accounting records are error-free.
- The unadjusted trial balance provides the starting point for recording adjusting entries in the next step of the accounting cycle.

Key Takeaways

- Posting transfers journal entries to the general ledger.
- The general ledger organizes transactions by account and shows each account's balance.
- Account balances are determined by comparing total debits and total credits.
- The trial balance verifies that total debit balances equal total credit balances.

- The unadjusted trial balance is prepared before adjusting entries are recorded.

4.7: Key Terms

Definitions

abnormal balance

account balance that is contrary to the expected normal balance of that account

unearned revenue

advance payment for a product or service that has yet to be provided by the company; the transaction is a liability until the product or service is provided

unadjusted trial balance

trial balance that includes accounts before they have been adjusted

trial balance

list of all accounts in the general ledger that have nonzero balances

transaction

business activity or event that has an effect on financial information presented on financial statements

time period assumption

companies can present useful information in shorter time periods such as years, quarters, or months

T-account

graphic representation of a general ledger account in which each account is visually split into left and right sides

stockholders' equity

owner (stockholders') investments in the business and earnings

simple entry

only one debit account and one credit account are listed under the debit and credit columns of a journal entry

separate entity concept

business may only report activities on financial statements that are specifically related to company operations, not those activities that affect the owner personally

revenue recognition principle

principle stating that a company must recognize revenue in the period in which it is earned; it is not considered earned until a product or service has been provided

prepaid expenses

items paid for in advance of their use

posting

takes all transactions from the journal during a period and moves the information to a general ledger (ledger)

period

one operating cycle of a business, which could be a month, quarter, or year

original source

traceable record of information that contributes to the creation of a business transaction

normal balance

expected balance each account type maintains, which is the side that increases

monetary measurement

system of using a monetary unit by which to value the transaction, such as the US dollar

journalizing

entering information into a journal; second step in the accounting cycle

journal

record of all transactions

going concern assumption

absent any evidence to the contrary, assumption that a business will continue to operate in the indefinite future

general ledger

comprehensive listing of all of a company's accounts with their individual balances

full disclosure principle

business must report any business activities that could affect what is reported on the financial statements

expense recognition principle

(also, matching principle) matches expenses with associated revenues in the period in which the revenues were generated

expanded accounting equation

breaks down the equity portion of the accounting equation into more detail to see the impact to equity from changes to revenues and expenses, and to owner investments and payouts

ending account balance

difference between debits and credits for an account

double-entry accounting system

requires the sum of the debits to equal the sum of the credits for each transaction

debit

records financial information on the left side of each account

credit

records financial information on the right side of an account

cost principle

everything the company owns or controls (assets) must be recorded at its value at the date of acquisition

contributed capital

owner's investment (cash and other assets) in the business which typically comes in the form of common stock

conservatism

concept that if there is uncertainty in a potential financial estimate, a company should err on the side of caution and report the most conservative amount

conceptual framework

interrelated objectives and fundamentals of accounting principles for financial reporting

compound entry

more than one account is listed under the debit and/or credit column of a journal entry

chart of accounts

account numbering system that lists all the accounts a business uses in its day-to-day transactions

book of original entry

journal is often referred to as this because it is the place the information originally enters into the system

accounting cycle

step-by-step process to record business activities and events to keep financial records up to date

account

record showing increases and decreases to assets, liabilities, and equity found in the accounting equation

4.8: Practice Questions

Multiple Choice Questions

Exercise 4.8.1

1. _____ takes all transactions from the journal during an accounting period and transfers the information to the general ledger.
 - a. Hitching
 - b. Posting
 - c. Vetting
 - d. Laxing
2. Which of the following accounting records is the primary source of information used to prepare the financial statements?
 - a. Journal entries
 - b. T-accounts
 - c. Trial balance
 - d. Chart of accounts
3. If a journal entry includes a debit or credit to the Cash account, it is most likely which of the following?
 - a. A closing entry
 - b. An adjusting entry
 - c. An ordinary transaction entry
 - d. Outside of the accounting cycle
4. What is the primary purpose of posting journal entries to the general ledger?
 - a. To prepare financial statements immediately
 - b. To update the balance of each individual account
 - c. To record adjusting entries
 - d. To summarize revenues and expenses
5. Which accounting record shows the complete history and current balance of a single account?
 - a. Journal
 - b. General ledger
 - c. Trial balance
 - d. Income statement
6. After posting a journal entry, what should occur next?
 - a. The journal entry is deleted.
 - b. The affected ledger accounts are updated.
 - c. The financial statements are automatically complete.
 - d. The accounting period is closed.
7. What is the primary purpose of preparing an unadjusted trial balance?
 - a. To verify that total debits equal total credits
 - b. To record adjusting entries
 - c. To close temporary accounts
 - d. To calculate net income
8. If the debit and credit columns of an unadjusted trial balance are equal, which of the following is true?
 - a. All transactions have been recorded correctly.
 - b. No errors exist in the accounting records.
 - c. Total debits equal total credits, but some errors may still exist.
 - d. The financial statements are complete.
9. Which of the following errors is most likely to cause the trial balance to be out of balance?
 - a. Posting a debit as a credit
 - b. Recording a transaction in the wrong accounts but with equal debits and credits
 - c. Omitting the posting of one side of a journal entry
 - d. Posting equal debit and credit amounts to the wrong accounts
10. Which of the following accounts would normally appear on an unadjusted trial balance with a debit balance?
 - a. Accounts Payable
 - b. Service Revenue

- c. Supplies
 - d. Owner's Capital
11. Which step follows posting transactions to the general ledger in the accounting cycle?
- a. Prepare the unadjusted trial balance
 - b. Journalize transactions
 - c. Prepare adjusting entries
 - d. Prepare the statement of cash flows
12. Why is the unadjusted trial balance prepared before adjusting entries are made?
- a. To verify that ledger accounts are in balance before adjustments are recorded
 - b. To calculate depreciation expense
 - c. To close revenue and expense accounts
 - d. To prepare the statement of cash flows

Answer available at the end of this section.

Answers

Exercise 4.8.1

Table 4.8.1: Answers to multiple choice questions

Question	Answer	Explanation
1	b. Posting	Posting transfers journal entries to the general ledger, where each account is updated.
2	c. Trial balance	The trial balance summarizes the balances of all ledger accounts and is the primary source used to prepare the financial statements.
3	c. An ordinary transaction entry	Cash is commonly affected by day-to-day business transactions such as receiving cash, paying bills, or purchasing assets.
4	b. To update the balance of each individual account	Posting updates each account in the general ledger so the current account balances are available.
5	b. General ledger	The general ledger contains the complete history and current balance of each individual account.
6	b. The affected ledger accounts are updated.	Posting updates the balances of the accounts involved in the journal entry.
7	a. To verify that total debits equal total credits	The unadjusted trial balance checks that the ledger is mathematically in balance before adjustments are made.
8	c. Total debits equal total credits, but some errors may still exist.	A balanced trial balance does not guarantee that every transaction was recorded correctly.
9	c. Omitting the posting of one side of a journal entry	If only one side of an entry is posted, total debits and credits in the ledger will no longer be equal.
10	c. Supplies	Supplies is an asset account, and asset accounts normally carry debit balances.

Question	Answer	Explanation
11	a. Prepare the unadjusted trial balance	After transactions have been posted to the ledger, the next step is to prepare the unadjusted trial balance.
12	a. To verify that ledger accounts are in balance before adjustments are recorded	The unadjusted trial balance confirms that posting was completed correctly before making adjusting entries.

This page titled [4.8: Practice Questions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [5.6: Practice Questions](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

4.9: Alternate Text Descriptions

Figure 4.4.1: Accounting Cycle with Step 4 Highlighted

A circular diagram of the 10-step accounting cycle. An arrow labeled “We are Here” points to Step 4, **Prepare Unadjusted Trial Balance**, indicating the current stage in the process. The accounting cycle begins with analyzing transactions and recording journal entries, then posting entries to the ledger. After preparing the unadjusted trial balance, the cycle continues with adjusting entries, adjusted trial balance, financial statements, closing entries, post-closing trial balance, and optional reversing entries before repeating in the next accounting period.

This page titled [4.9: Alternate Text Descriptions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

5: ACCRUAL ACCOUNTING AND ADJUSTING ENTRIES

Overview

Ledgerline's March trial balance says the firm earned \$4,500 and incurred \$2,000 in expense—a tidy \$2,500 profit. Priya feels good about the results.

A closer look around the office tells a different story.

The supply cabinet is half empty because some of the supplies have already been used. Her laptop is a month older and has lost a little value. Her assistant worked the last three days of March but will not be paid until April. She also finished a bookkeeping job on March 30 that has not yet been billed to the client.

None of these items appears in the trial balance. Every recorded transaction is correct, but the overall picture is still incomplete because the timing of economic activity and the movement of cash do not always match. Revenues is earned and expenses are incurred in one period, while the related cash may be received or paid in another.

This chapter explains how accountants bridge that gap. You will learn the difference between cash-basis and accrual-basis accounting, why most businesses use accrual accounting, and how adjusting entries ensure the financial statements accurately reflect what happened during the accounting period.

Learning Objectives

By the end of this chapter, you can:

1. Explain the difference between cash-basis and accrual-basis accounting.
2. State when revenue is earned and when an expense is incurred.
3. Recognize the five types of adjusting entries and record each one.
4. Prepare an adjusted trial balance.

[5.1: Accrual Accounting Foundations](#)

[5.2: Cash vs Accrual comparison](#)

[5.3: Adjusting Entries](#)

[5.4: The Adjusted Trial Balance](#)

[5.5: Summary](#)

[5.6: Key Terms](#)

[5.7: Practice Questions](#)

[5.8: Alternate Text Descriptions](#)

5.1: Accrual Accounting Foundations

Overview

Earlier, we discussed the first four steps in the accounting cycle: identify and analyze transactions, record transactions to a journal, post journal information to the general ledger, and prepare an (unadjusted) trial balance (Table 4.5.11). We are now in the fifth step of the [Accounting Cycle](#), Adjusting Entries.

As we progress through these steps, you learn why the trial balance in this phase of the accounting cycle is referred to as an “adjusted” trial balance. We also discuss the purpose of adjusting entries and the accounting concepts supporting their need. One of the first concepts we discuss is accrual accounting, but before we do that, let us first discuss what Cash-basis accounting is.

Cash-basis accounting

The simplest way to keep score is to watch your bank account. Money in, money out. No judgment calls. Under cash-basis accounting, you record revenue when cash comes in, and you record expenses when cash goes out. That is the entire rule. If no cash moved, nothing happened. It is intuitive, and for a tiny operation, it is often enough. Your books match your bank statement, and there is nothing to explain.

Cash basis accounting is a method of accounting in which transactions are not recorded in the financial statements until there is an exchange of cash. Cash basis accounting sometimes delays or accelerates revenue and expense reporting until cash receipts or outlays occur. With this method, cash flows are used to measure business performance in a given period and can be simpler to track than accrual basis accounting. Some nonpublic companies may choose to use cash basis accounting rather than accrual basis accounting to report financial information.

Example 5.1.1

On March 12, Ledgerline completed a \$2,500 tax return but the client did not pay. On March 18, the client sent \$1,500.

Solution

Under the cash basis, the work on the 12th is invisible—no cash, no entry. Ledgerline records \$1,500 of revenue on 18th when the cash is received. The remaining \$1,000 will be recognized as revenue until the client actually pays it.

Caution

Watch out

The cash basis can badly misstate a period. A month where you did \$10,000 of work but collected nothing looks like a \$0 month—even though you are owed \$10,000. Judge a business by its cash-basis books and you can draw exactly the wrong conclusion.

Recap

Cash basis records revenue when cash is received and expenses when cash is paid. Simple, but can put income and costs in the wrong month.

Accrual Accounting

A business owner needs to know whether this month's work paid off, and not whether this month's mail happened to contain checks for old work. This means tying revenue and expense to the activity, not the cash.

Accrual basis accounting prescribes that revenues and expenses must be recorded in the accounting period in which they were earned or incurred, no matter when cash receipts or payments occur. It is because of accrual accounting that we have the *revenue recognition principle* and the *expense recognition principle* (also known as the *matching principle*). Of all accounting concepts and principles, the matching principle is the most important one!

The accrual method is considered to better match revenues and expenses and standardizes reporting information for comparability purposes. Having comparable information is important to external users of information trying to make investment or lending decisions, and to internal users trying to make decisions about company performance, budgeting, and growth strategies.

There are several other accounting methods or concepts that accountants will sometimes apply. The first is **modified accrual accounting**, which is commonly used in governmental accounting and merges accrual basis and cash basis accounting. The second is **tax basis accounting** that is used in establishing the tax effects of transactions in determining the tax liability of an organization.

Example 5.1.1

Let's return to the example above regarding the \$2,500 tax return that was completed on March 12.

Solution

Under accrual accounting, Priya earned the full \$2,500 the moment the return was done, so all \$2,500 is March revenue, even though \$1,000 of it is still unpaid at month-end. The cash collection later is not new revenue; it just turns a receivable into cash.

Note

In the real world

Accrual accounting is not optional for most businesses. US generally accepted accounting principles (GAAP) require it, and any business seeking a loan or outside investment will be expected to present accrual-based statements. The cash basis lingers mainly among very small firms and on certain tax returns.

Caution

Watch out

Getting paid and earning are two different events. Cash can arrive before the work, after the work, or right alongside it. Accrual accounting records the revenue when the work is done—the cash is a separate story.

Recap

Accrual basis records revenue when earned and expenses when incurred. Revenue recognition and matching put each dollar in the period it belongs to.

The Accounting Period

One fundamental concept to consider related to the accounting cycle—and to accrual accounting in particular—is the idea of the accounting period.

As we discussed, accrual accounting requires companies to report revenues and expenses in the accounting period in which they were earned or incurred. An **accounting period** breaks down company financial information into specific time spans, and can cover a month, a quarter, a half-year, or a full year. Public companies governed by GAAP are required to present quarterly (three-month) accounting period financial statements called 10-Qs. However, most public and private companies keep monthly, quarterly, and yearly (annual) period information. This is useful to users needing up-to-date financial data to make decisions about company investment and growth. When the company keeps yearly information, the year could be based on a fiscal or calendar year. This is explained shortly.

Note

In the Real World

In every industry, adjustment entries are made at the end of the period to ensure revenue matches expenses. Companies with an online presence need to account for items sold that have not yet been shipped or are in the process of reaching the end user. But what about the grocery industry? At first glance, it might seem that no such adjustment entries are necessary. However, grocery stores have adapted to the current retail environment. For example, your local grocery store might provide catering services for a graduation party. If the contract requires the customer to put down a 50% deposit, and occurs near the end of a period, the grocery store will have unearned revenue until it provides the catering service. Once the party occurs, the grocery store needs to make an adjusting entry to reflect that revenue has been earned.

The Fiscal Year and the Calendar Year

A company may choose its yearly reporting period to be based on a calendar or fiscal year. If a company uses a **calendar year**, it is reporting financial data from January 1 to December 31 of a specific year. This may be useful for businesses needing to coincide with a traditional yearly tax schedule. It can also be easier to track for some businesses without formal reconciliation practices, and for small businesses.

A **fiscal year** is a twelve-month reporting cycle that can begin in any month and records financial data for that consecutive twelve-month period. For example, a business may choose its fiscal year to begin on April 1, 2019, and end on March 31, 2020. This can be common practice for corporations and may best reflect the operational flow of revenues and expenses for a particular business. In addition to annual reporting, companies often need or choose to report financial statement information in interim periods.

Interim Periods

An **interim period** is any reporting period shorter than a full year (fiscal or calendar). This can encompass monthly, quarterly, or half-year statements. The information contained in these statements is timelier than waiting for a yearly accounting period to end. The most common interim period is three months, or a quarter. For companies whose common stock is traded on a major stock exchange, meaning these are *publicly traded* companies, quarterly statements must be filed with the SEC on a Form 10-Q. The companies must file a Form 10-K for their annual statements. As you've learned, the SEC is an independent agency of the federal government that provides oversight of public companies to maintain fair representation of company financial activities for investors to make informed decisions.

In order for information to be useful to the user, it must be timely—that is, the user has to get it quickly enough so it is relevant to decision-making. This is the basis of the time period assumption in accounting. For example, a potential or existing investor wants timely information by which to measure the performance of the company, and to help decide whether to invest, to stay invested, or to sell their stockholdings and invest elsewhere. This requires companies to organize their information and break it down into shorter periods. Internal and external users can then rely on the information that is both timely and relevant to decision-making.

The accounting period a company chooses to use for financial reporting will impact the types of adjustments they may have to make to certain accounts.

This page titled [5.1: Accrual Accounting Foundations](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li via [source content](#) that was edited to the style and standards of the LibreTexts platform.

5.2: Cash vs Accrual comparison

Overview

Most businesses are on either the cash or accrual basis, and a small percentage of businesses may combine some parts of their business as an accrual accounting and some parts of their business as cash accounting. In this basic financial accounting course, however, we focus on the cash basis and the accrual basis. These two methods can make the same month look completely different. Let us compare the difference.

Cash vs Accrual comparison

Table 5.2.1: Comparison of Cash basis versus Accrual basis of a service revenue earned

Event	Cash basis	Accrual basis
March 12 - Completed \$2,500 Tax Return service, unpaid.	\$0	\$2,500
March 18 - Client pays \$1,500	\$1,500	\$0 (already recognized on March 12)
March revenue from this client	\$1,500	\$2,500

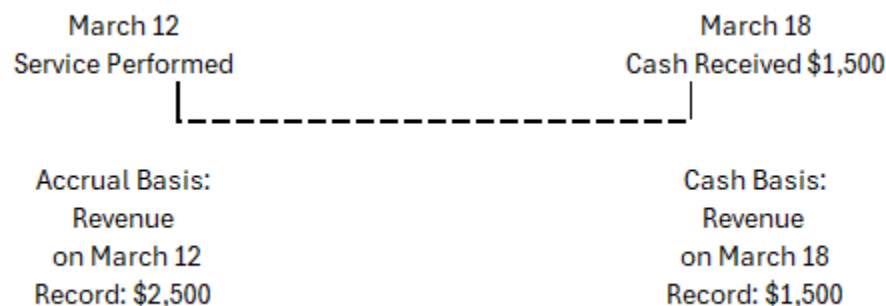


Figure 5.2.1: Timeline comparing cash and accrual accounting: cash basis recognizes revenue when cash is received on March 18; accrual basis recognizes revenue when the service is completed on March 12. (CC BY-NC-ND 4.0; Illustration by Sandra Li). [Detailed description of Figure 5.2.1.](#)

Under the cash basis, March appears to be a \$1,500 month for this client; however, under the accrual basis, it is a \$2,500 month—the true measure of the work Priya performed. Expenses work the same way in reverse: a cost you have incurred but not yet paid is recognized now under the accrual basis and later under the cash basis.

The gap between the two columns is exactly the information adjusting entries exist to capture. Accrual accounting promises to record earning and incurring as they happen — but some of that happens quietly, with no invoice or payment to trigger an entry. The rest of this chapter is how you catch it.

Note

In the real world

IRS does permit a hybrid accounting method in certain situations. A hybrid method combines elements of both cash and accrual accounting, provided it clearly reflects income and is used consistently.

Recap

The same period can show very different results under the two methods. Accrual reflects real activity; the differences are what adjusting entries fix.

5.3: Adjusting Entries

Overview

Accrual accounting says "record revenue when earned, expenses when incurred." Some earning and incurring happen gradually, with nothing to prompt an entry. Supplies get used up a little each day. Equipment wears out silently. Interest accrues by the day. At period-end, the books have quietly drifted out of date.

Definition: Adjusting Entry

An adjusting entry is a journal entry made at the end of a period to bring an account to its correct balance before you prepare financial statements.

Every adjusting entry follows two rules that make them easy to check:

- Each journal entry touches one income-statement account (a revenue or an expense), and one balance sheet account (an asset or a liability).
- None of them ever touches Cash.
- Adjusting entries fix everything except cash.



Figure 5.3.1: The accounting cycle follows ten steps used to record, adjust, summarize, and report financial information before beginning a new accounting period. Arrow points to Step 5. AI Generated Image, 2026. [Detailed Description of Figure 5.3.1.](#)

There are five types of adjusting entries that are commonly made at the end of the accounting period:

1. Accrued Revenue
2. Accrued Expenses
3. Deferred (Unearned) Revenue
4. Deferred (Prepaid) Expenses
5. Depreciation

Let us take a closer look at each one.

Example 5.3.1

Accrued Revenue Example

Priya finished \$400 of bookkeeping for a client on March 30, but has not sent the invoice. She earned it in March, so it is March revenue. What is the adjusting entry for this? What would the financial statement impact be if this entry is omitted?

Solution

Adjusting entry:

Table 5.3.1: Adjusting Entry of accrued revenue

Date	Account	Debit	Credit
March 31	Accounts Receivable	400	No data available
No data available	Service Revenue	No data available	400
No data available	Memo: Fees earned in March, not yet billed	No data available	No data available

Accounts Receivable (an asset) rose by \$400 (the client owes it), and Service Revenue captures work March actually produced.

Financial Statement Impact if Adjusting Entry is Omitted

Table 5.3.2: Impact of financial statement accounts when accrued revenue entry is omitted

Financial Statement	Account	Effect if Entry is Omitted
Income Statement	Revenues	Understated
Income Statement	Net Income	Understated
Balance Sheet	Assets	Understated
Balance Sheet	Owner's Equity	Understated

Example 5.3.2

Accrued Expenses Example

Ledgerline's assistant was last paid on March 28. She worked March 29, 30, 31 - three days earning \$150, but she will not be paid until April. That \$150 is a March expense, and an amount owed. What is the adjusting entry for this? What would the financial statement impact be if this entry is omitted?

Solution

Adjusting Entry:

Table 5.3.3: Adjusting Entry of accrued expenses

Date	Account	Debit	Credit
March 31	Wages Expenses	150	No data available
No data available	Wages Payable	No data available	150
No data available	Memo: Assistant's wages earned but not yet paid	No data available	No data available

Wages Expense rose to reflect all the labor March actually used. Wages Payable, a liability, records what the firms still owes.

Financial Statement Impact if Adjusting Entry is Omitted

Table 5.3.4: Impact of financial statement accounts when accrued expense entry is omitted

Financial Statement	Account	Effect if Entry is Omitted
Income Statement	Expenses	Understated
Income Statement	Net Income	Overstated
Balance Sheet	Liabilities	Understated
Balance Sheet	Owner's Equity	Overstated

Example 5.3.3

Deferred (Unearned) Revenue Example

Suppose a client pays Ledgerline \$1,200 on April 1 for three months of bookkeeping services, paid in advance. What is the initial entry for this? What is the Adjusting Entry? What would the financial statement impact be if this entry is omitted?

Solution

Initial entry:

Table 5.3.5: Initial journal entry when client prepays for bookkeeping services

Date	Account	Debit	Credit
April 1	Cash	1,200	No data available
No data available	Unearned Revenue	No data available	1,200
No data available	Memo: Client prepaid for three months of bookkeeping service.No data available	No data available	No data available

By April 30, one of the three months is done. Priya has earned $\$1,200 / 3 = \$400$.

Adjusting entry:

Table 5.3.6: Adjusting entry for unearned revenue now earned by one month

Date	Account	Debit	Credit
April 30	Unearned Revenue	400	No data available
No data available	Service Revenue	No data available	400
No data available	Memo: Earned one month of the prepaid fee.No data available	No data available	No data available

In the initial entry, Priya received the cash that a client had prepaid. Priya hasn't earned any of it yet, so the receipt is a liability, not revenue. Both Cash and Unearned Revenue are accounts on the Balance Sheet.

In the adjusting entry of April 30, one-third of the unearned revenue has now been earned, and therefore one-third moved from the liability into revenue. Notice that in this example, the adjusting entry has one income statement item (Service Revenue), and one balance sheet item (Unearned Revenue).

Financial Statement Impact if Adjusting Entry is Omitted

Table 5.3.7: Impact of financial statement accounts when unearned revenue now earned is omitted

Financial Statement	Account	Effect if Entry is Omitted
Income Statement	Revenues	Understated

Financial Statement	Account	Effect if Entry is Omitted
Income Statement	Net Income	Understated
Balance Sheet	Liabilities	Overstated
Balance Sheet	Owner's Equity	Understated

Unearned revenue is a liability, not income - until the work is done, that cash still "belongs" to the client.

Example 5.3.4

Deferred (Prepaid) Expenses Example

Ledgerline bought \$600 of supplies in March and recorded them as an asset. A count on March 31 shows \$250 still on the shelf. What is the initial entry? What is the Adjusting Entry? What would the financial statement impact be if this entry is omitted?

Solution

Initial entry:

Table 5.3.8: Initial journal entry when Priya purchases supplies with cash

Date	Account	Debit	Credit
March 1	Supplies	600	No data available
No data available	Cash	No data available	600
Memo: Purchased supplies.	No data available	No data available	No data available

By March 31, since \$250 is what is remaining in the supplies closet, we can do the math that \$350 was used up (\$600 - \$250)

Adjusting entry:

Table 5.3.9: Adjusting journal entry to adjust when supplies have been used

Date	Account	Debit	Credit
March 31	Supplies Expense	350	No data available
No data available	Supplies	No data available	350
Memo: Supplies used during March.	No data available	No data available	No data available

In the initial entry, Ledgerline purchased supplies. Supplies is considered an asset, and when this is consumed, the used up portion is considered a supplies expense, and the Supplies (asset) gets reduced because \$350 was consumed.

Financial Statement Impact if Adjusting Entry is Omitted

Table 5.3.10: Impact of financial statement accounts when supplies expense is omitted

Financial Statement	Account	Effect if Entry is Omitted
Income Statement	Expenses	Understated
Income Statement	Net Income	Overstated
Balance Sheet	Assets	Overstated

Financial Statement	Account	Effect if Entry is Omitted
Balance Sheet	Owner's Equity	Overstated

The fifth type of adjusting entry is Depreciation.

Definition: Depreciation

Depreciation is the process of allocating the cost of a long-term asset over its useful life because the asset helps generate revenue for more than one accounting period.

Example 5.3.5

Depreciation Example

Ledgerline had purchased a \$3,000 of equipment on March 1. This equipment will last about five years (or 60 months). Rather than expense all \$3,000, Ledgerline spreads it across the months. They have chosen the **straight-line method**. Each month, the depreciation is \$50 (\$3,000 / 60 months). What is the Adjusting entry for depreciation at the end of March 31? What would the financial statement impact be if this entry is omitted?

Solution

Adjusting Entry:

Table 5.3.11: Adjusting journal entry to depreciate an equipment

Date	Account	Debit	Credit
March 31	Depreciation Expense	50	No data available
No data available	Accumulated Depreciation - Equipment	No data available	50
No data available	Memo: One month of depreciation on equipment.	No data available	No data available

Notice that the credit is not to Equipment itself. It goes to **Accumulated Depreciation**, a **contra-asset** account — an account that sits against an asset and reduces it. Equipment stays on the books at \$3,000 cost; Accumulated Depreciation now holds \$50. The difference, \$2,950, is the equipment's **carrying value** (or book value). Keeping cost and depreciation in separate accounts preserves both facts: what you paid, and how much you have used up.

No cash leaves the business when depreciation is recorded. The cash was paid when the equipment was originally purchased.

Financial Statement Impact if Adjusting Entry is Omitted

Table 5.3.12: Impact of financial statement accounts when depreciation journal entry is omitted

Financial Statement	Account	Effect if Entry is Omitted
Income Statement	Expenses	Understated
Income Statement	Net Income	Overstated
Balance Sheet	Assets	Overstated
Balance Sheet	Owner's Equity	Overstated

Caution

Watch out

Accruals and deferrals are mirror images, and it is easy to grab the wrong one. Ask first: has the cash already moved? If yes, you are deferring - adjusting an existing asset or liability. If no, you are accruing - creating a new receivable or payable.

Recap

Adjusting entries update accounts at period-end. Accruals record activity where cash has not moved yet (accrued expenses, accrued revenues). Deferrals adjust cash that already moved (prepaid expenses, unearned revenue). Each hits one income statement and one balance sheet account, and never Cash.

Adjusting Entries Quick Reference

The following table summarizes the five common types of adjusting entries and the accounts typically debited and credited.

Table 5.3.13: Quick Reference for Common Adjusting Entries

Situation	Debit	Credit
Revenue earned but not yet billed or collected	Accounts Receivable	Service Revenue
Expense incurred but not yet paid	Expense	Payable
Cash received before revenue is earned	Unearned Revenue	Service Revenue
Prepaid asset used during the accounting period	Expense	Asset
Long-term asset depreciated during the accounting period	Depreciation Expense	Accumulated Depreciation

Remember

Every adjusting entry affects one income statement account and one balance sheet account. Adjusting entries never affect Cash.

5.4: The Adjusted Trial Balance

Overview

At the end of an accounting period, businesses record **adjusting entries** to update account balances for items such as supplies used, depreciation, accrued wages, and revenue earned but not yet recorded. Once these adjusting entries have been journalized and posted to the general ledger, several account balances change.

Before preparing the financial statements, accountants prepare another trial balance to verify that the accounting records remain in balance after all adjustments have been made. This report is called the **adjusted trial balance**.

The adjusted trial balance may be prepared as a separate report or as part of an accounting worksheet. When a worksheet is used, the adjusted trial balance columns bring together the balances from the unadjusted trial balance and the amounts recorded in the adjustments columns.

Definition: Adjusted Trial Balance

An **adjusted trial balance** is a list of all general ledger accounts and their ending balances after all adjusting entries have been posted.

The adjusted trial balance has the same basic format as the unadjusted trial balance:

- Every general ledger account with a balance is listed.
- Debit balances appear in the Debit column.
- Credit balances appear in the Credit column.
- Total debits must equal total credits.

The difference is that the adjusted trial balance includes the effects of the adjusting entries. Therefore, its balances reflect all transactions and adjustments for the accounting period.

The Adjusted Trial Balance on the Worksheet

The accounting worksheet organizes account balances into several sets of columns. The first columns contain the **unadjusted trial balance**, the next columns contain the **adjustments**, and the following columns contain the **adjusted trial balance**.

The adjusted trial balance columns are completed by combining the amount in the unadjusted trial balance with any related adjustment. The debit and credit rules continue to apply.

- If the unadjusted balance and the adjustment are on the **same side**, the amounts are added.
- If the unadjusted balance and the adjustment are on **opposite sides**, the smaller amount is subtracted from the larger amount.
- If an account has no unadjusted balance but appears in an adjusting entry, the adjustment amount becomes its adjusted balance.
- If an account is not affected by an adjustment, its unadjusted balance is carried directly to the adjusted trial balance columns.

For example, Ledgerline's unadjusted Supplies balance was \$600. The adjusting entry recorded \$350 of supplies used. Because Supplies is an asset with a debit balance and the adjustment reduces the account with a credit, the adjusted Supplies balance is calculated as follows:

$$\$600 \text{ debit} - \$350 \text{ credit} = \$250 \text{ debit}$$

Wages Expense had an unadjusted debit balance of \$1,100. The adjusting entry added \$150 of accrued wages. Because both amounts are debits, they are added:

$$\$1,100 \text{ debit} + \$150 \text{ debit} = \$1,250 \text{ debit}$$

Wages Payable did not have an unadjusted balance. The \$150 credit adjustment therefore becomes the account's adjusted credit balance.

Note: This section focuses only on the adjusted trial balance portion of the worksheet. A complete accounting worksheet, including the Unadjusted Trial Balance, Adjustments, Adjusted Trial Balance, Income Statement, and Balance Sheet columns, is presented later in **Table 6.1.1**.

Example

Ledgerline recorded and posted the following four adjusting entries for March:

- Supplies used: **\$350**
- Depreciation on equipment: **\$50**
- Accrued wages: **\$150**
- Accrued service revenue: **\$400**

The following table shows how selected amounts move through the worksheet from the unadjusted trial balance and adjustments columns into the adjusted trial balance columns.

Table 5.4.1: Selected Adjusted Trial Balance Amounts on Ledgerline's Worksheet

Account	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Accounts Receivable	\$1,000	No data available	\$400	No data available	\$1,400	No data available
Supplies	\$600	No data available	No data available	\$350	\$250	No data available
Accumulated Depreciation—Equipment	No data available	No data available	No data available	\$50	No data available	\$50
Wages Payable	No data available	No data available	No data available	\$150	No data available	\$150
Service Revenue	No data available	\$4,500	No data available	\$400	No data available	\$4,900
Wages Expense	\$1,100	No data available	\$150	No data available	\$1,250	No data available
Supplies Expense	No data available	No data available	\$350	No data available	\$350	No data available
Depreciation Expense—Equipment	No data available	No data available	\$50	No data available	\$50	No data available

Accounts that were not affected by adjusting entries, such as Cash, Equipment, Nair, Capital, Nair, Drawings, and Rent Expense, are carried directly from the unadjusted trial balance columns to the adjusted trial balance columns.

Ledgerline's Adjusted Trial Balance

After all adjusted balances have been calculated on the worksheet and the adjusting entries have been posted to the general ledger, Ledgerline prepares the following adjusted trial balance.

Table 5.4.2: Ledgerline Adjusted Trial Balance

Account	Debit	Credit
Cash	\$9,100	No data available
Accounts Receivable	\$1,400	No data available
Supplies	\$250	No data available
Equipment	\$3,000	No data available
Accumulated Depreciation—Equipment	No data available	\$50
Wages Payable	No data available	\$150
Nair, Capital	No data available	\$12,000
Nair, Drawings	\$800	No data available
Service Revenue	No data available	\$4,900
Rent Expense	\$900	No data available
Wages Expense	\$1,250	No data available
Supplies Expense	\$350	No data available
Depreciation Expense—Equipment	\$50	No data available
Totals	\$17,100	\$17,100

The adjusted trial balance remains in balance because total debits and total credits both equal **\$17,100**. This confirms that the adjusting entries were recorded and posted with equal debit and credit amounts.

How the Adjustments Changed the Accounts

The adjusting entries changed several of Ledgerline's account balances:

- **Accounts Receivable** increased from \$1,000 to \$1,400 because Ledgerline earned \$400 of service revenue that had not yet been billed or collected.
- **Service Revenue** increased from \$4,500 to \$4,900 to recognize the additional revenue earned during March.
- **Supplies** decreased from \$600 to \$250 because \$350 of supplies were used during the month.
- **Supplies Expense** increased by \$350 to recognize the cost of the supplies used.
- **Depreciation Expense—Equipment** increased by \$50 to recognize the portion of the equipment's cost used during March.
- **Accumulated Depreciation—Equipment** increased by \$50. This contra-asset account reduces the equipment's carrying amount on the balance sheet.
- **Wages Expense** increased from \$1,100 to \$1,250 because employees had earned an additional \$150 that had not yet been paid.
- **Wages Payable** increased by \$150 to recognize the amount Ledgerline owes its employees.

Effect on Net Income

After the adjusting entries, Ledgerline reports the following revenue and expenses:

Table 5.4.3: Calculation of Adjusted Net Income

Account	Amount
Service Revenue	\$4,900
Less: Expenses	No data available
Rent Expense	\$900
Wages Expense	\$1,250

Account	Amount
Supplies Expense	\$350
Depreciation Expense—Equipment	\$50
Total Expenses	\$2,550
Net Income	\$2,350

Before the adjusting entries were recorded, Ledgerline's unadjusted records showed net income of **\$2,500**. After the adjustments, net income is **\$2,350**.

Although the accrued revenue adjustment increased revenue by \$400, the supplies, depreciation, and accrued wages adjustments increased expenses by a total of \$550. As a result, the unadjusted records overstated net income by **\$150**.

From the Adjusted Trial Balance to the Financial Statements

Once the adjusted trial balance columns are completed, the adjusted account balances are extended to the appropriate financial statement columns of the worksheet.

- **Revenue and expense accounts** are transferred to the Income Statement columns.
- **Asset, liability, owner's capital, and owner's drawings accounts** are transferred to the Balance Sheet columns.

For example, Service Revenue, Rent Expense, Wages Expense, Supplies Expense, and Depreciation Expense—Equipment are extended to the Income Statement columns. Cash, Accounts Receivable, Supplies, Equipment, Accumulated Depreciation—Equipment, Wages Payable, Nair, Capital, and Nair, Drawings are extended to the Balance Sheet columns.

The worksheet helps organize the information, but it is not a formal financial statement and is generally not provided to external users. Its purpose is to help the accountant verify the adjusted balances and prepare the financial statements accurately.

Why It Matters

The adjusted trial balance provides the updated account balances needed to prepare accurate financial statements. Without the adjusting entries, Ledgerline would have:

- understated Accounts Receivable and Service Revenue;
- overstated Supplies;
- understated expenses and liabilities;
- failed to recognize depreciation; and
- overstated net income.

The adjusted trial balance is therefore the final checkpoint before the financial statements are prepared. It confirms that debits equal credits and ensures that revenues and expenses are reported in the proper accounting period.

Recap

- The adjusted trial balance is prepared after adjusting entries have been journalized and posted.
- On a worksheet, adjusted balances are calculated by combining the unadjusted trial balance with the adjustments.
- Accounts unaffected by adjustments are carried directly to the adjusted trial balance columns.
- Adjusted revenue and expense balances are extended to the Income Statement columns.
- Adjusted asset, liability, owner's capital, and owner's drawings balances are extended to the Balance Sheet columns.
- Total adjusted debits must equal total adjusted credits.
- The adjusted trial balance provides the balances used to prepare the financial statements.

This page titled [5.4: The Adjusted Trial Balance](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

5.5: Summary

Key Takeaways

- **Cash-basis accounting** records revenue when cash is received and expenses when cash is paid. It is simple to use but may report income and expenses in the wrong accounting period.
- **Accrual accounting** records revenue when it is earned and expenses when they are incurred, regardless of when cash is received or paid. This provides a more accurate measure of business performance.
- **The revenue recognition principle** requires revenue to be recorded when it is earned, while the **expense recognition (matching) principle** requires expenses to be recorded in the same period as the revenues they help generate.
- **The accounting period assumption** divides a company's activities into reporting periods (monthly, quarterly, or annually) so financial information is timely and useful for decision-making.
- **Companies may report using either a calendar year or a fiscal year**, and many also prepare interim financial statements such as monthly or quarterly reports.
- **Cash-basis and accrual-basis accounting can produce very different financial results** for the same period because accrual accounting recognizes economic activity rather than cash flows.
- **Adjusting entries** are made at the end of an accounting period to update account balances before financial statements are prepared.
- **Every adjusting entry affects one income statement account and one balance sheet account**, and **never affects Cash**.
- **The five common types of adjusting entries** are accrued revenues, accrued expenses, deferred (unearned) revenues, deferred (prepaid) expenses, and depreciation.
- **Accruals** record revenues earned or expenses incurred before cash changes hands, while **deferrals** adjust amounts where cash was received or paid before the revenue was earned or the expense was incurred.
- **Depreciation** allocates the cost of a long-term asset over its useful life using a depreciation expense and a contra-asset account called Accumulated Depreciation.
- **Without adjusting entries**, revenues, expenses, assets, liabilities, net income, and owner's equity may all be misstated, causing the financial statements to present an inaccurate picture of the business.

5.6: Key Terms

Definitions

accrual accounting

accounting method that recognizes revenues when earned and expenses when incurred, regardless of when cash is received or paid

accrual basis of accounting

accounting method that records revenues when earned and expenses when incurred to comply with the revenue recognition and expense recognition principles

accrued expense

expense that has been incurred but has not yet been paid or recorded

accrued revenue

revenue that has been earned but has not yet been received in cash or recorded

adjusted trial balance

trial balance prepared after all adjusting entries have been journalized and posted

adjusting entry

journal entry made at the end of an accounting period to update account balances before preparing financial statements

book value

cost of a long-term asset minus its accumulated depreciation

cash basis of accounting

accounting method that recognizes revenues when cash is received and expenses when cash is paid

contra-asset account

asset account with a normal credit balance that reduces the balance of a related asset account

deferred expense

cost that is initially recorded as an asset and later recognized as an expense as it is used or consumed

deferred revenue

cash received before goods or services are provided; initially recorded as a liability until earned

depreciation

systematic allocation of the cost of a long-term asset to expense over its useful life

expense recognition principle

principle requiring expenses to be recognized in the same accounting period as the revenues they help generate

matching principle

another name for the expense recognition principle; requires related expenses to be recognized in the same period as the revenues they help produce

prepaid expense

asset created when a business pays for goods or services before receiving their benefits

revenue recognition principle

principle requiring revenue to be recognized when it is earned, regardless of when cash is received

time period assumption

assumption that the life of a business can be divided into equal reporting periods for financial reporting purposes

unearned revenue

liability created when cash is received before goods or services are provided

useful life

estimated period over which a long-term asset is expected to provide benefits to a business

5.7: Practice Questions

Multiple Choice Questions

Exercise 5.7.1

1. Which accounting method records revenue only when cash is received?
 - a. Accrual basis
 - b. Modified accrual basis
 - c. Cash basis
 - d. Hybrid basis
2. Under accrual accounting, revenue is recorded when it is _____.
 - a. collected
 - b. earned
 - c. deposited
 - d. billed
3. Which accounting method is required by GAAP for most businesses?
 - a. Cash basis
 - b. Hybrid basis
 - c. Accrual basis
 - d. Modified cash basis
4. The matching principle requires expenses to be recorded _____.
 - a. when cash is paid
 - b. when they help generate revenue
 - c. only at year-end
 - d. when invoices are received
5. Which of the following best describes an adjusting entry?
 - a. A journal entry made whenever cash is received
 - b. A journal entry made before posting to the ledger
 - c. A journal entry made at the end of an accounting period to update account balances
 - d. A journal entry that closes revenue accounts
6. Every adjusting entry affects _____.
 - a. two balance sheet accounts
 - b. two income statement accounts
 - c. one income statement account and one balance sheet account
 - d. Cash and one other account
7. Which account is never affected by an adjusting entry?
 - a. Cash
 - b. Accounts Receivable
 - c. Unearned Revenue
 - d. Supplies Expense
8. Accrued revenue occurs when _____.
 - a. cash is received before work is performed
 - b. revenue has been earned but cash has not yet been received
 - c. expenses are prepaid
 - d. cash is paid before receiving goods
9. Accrued expenses occur when _____.
 - a. cash is paid before the expense is incurred
 - b. expenses have been incurred but not yet paid
 - c. revenue has been earned but not collected
 - d. inventory is purchased
10. Unearned revenue is classified as a(n) _____.
 - a. asset
 - b. expense
 - c. liability

- d. revenue
11. Supplies purchased but not yet used are initially recorded as a(n) _____.
 - a. expense
 - b. asset
 - c. liability
 - d. contra-asset
 12. Depreciation is best described as _____.
 - a. a decline in market value
 - b. allocating the cost of a long-term asset over its useful life
 - c. selling equipment at a loss
 - d. recording repairs to equipment
 13. Accumulated Depreciation is classified as a(n) _____.
 - a. asset
 - b. liability
 - c. contra-asset
 - d. expense
 14. A company may choose to report annual financial statements using _____.
 - a. only a calendar year
 - b. only a fiscal year
 - c. either a calendar year or a fiscal year
 - d. only quarterly reporting
 15. Which of the following is an example of an interim reporting period?
 - a. Five years
 - b. One month
 - c. Ten years
 - d. Twenty-four months

Answer available at the end of this section.

Answers

Exercise 5.7.1

Table 5.7.1: Answers to multiple choice questions

Question	Answer
1	c. Cash basis
2	b. earned
3	c. Accrual basis
4	b. when they help generate revenue
5	c. A journal entry made at the end of an accounting period to update account balances
6	c. one income statement account and one balance sheet account
7	a. Cash
8	b. revenue has been earned but cash has not yet been received
9	b. expenses have been incurred but not yet paid
10	c. liability
11	b. asset
12	b. allocating the cost of a long-term asset over its useful life

Question	Answer
13	c. contra-asset
14	c. either a calendar year or a fiscal year
15	b. One month

5.8: Alternate Text Descriptions

Figure 5.2.1: Cash Basis vs. Accrual Basis Revenue Recognition

A timeline compares accrual-basis and cash-basis accounting. On March 12, a service is performed. Under accrual accounting, revenue of \$2,500 is recorded on March 12 when the service is earned. On March 18, cash of \$1,500 is received. Under cash-basis accounting, revenue of \$1,500 is recorded on March 18 when the cash is received. The diagram illustrates that accrual accounting recognizes revenue when earned, while cash-basis accounting recognizes revenue when cash is received.

Figure 5.3.1: Accounting Cycle with Step 5 Highlighted

A circular diagram of the 10-step accounting cycle. An arrow labeled "We are Here!" points to Step 5, **Record Adjusting Entries**, indicating the current stage in the cycle. The surrounding steps are: Analyze Transactions, Record Journal Entries, Post to Ledger, Prepare Unadjusted Trial Balance, Record Adjusting Entries, Prepare Adjusted Trial Balance, Prepare Financial Statements, Record Closing Entries, Prepare Post-Closing Trial Balance, and optional Reversing Entries. The cycle then repeats for the next accounting period.

6: COMPLETING THE ACCOUNTING CYCLE

Overview

Priya has Ledgerline's adjusted trial balance. Every account is current, and the columns match at \$17,100. She is proud of it - and nobody else wants to see it.

Her bank does not read trial balances, and neither does she, on a Sunday night, when she really wants to know two things: did I make money this month, and what is my business worth right now? Those answers live in the financial statements - the income statement, the statement of owner's equity, and the balance sheet.

Once March is truly finished she has to reset. Revenue and expenses measure one month. Before April starts, those accounts have to go back to zero without losing a cent of what they recorded.

This chapter turns the adjusted trial balance into statements one can easily read, then closes the month so that next one can begin. You will start with the tool accountants use to keep the whole leap organized: the worksheet.

Learning Objectives

By the end of this chapter, you can:

- Build an end-of-period 10-column worksheet.
- Prepare the income statement, statement of owner's equity, balance sheet, and statement of cash flows.
- Record closing entries and explain what they reset.
- Prepare a post-closing trial balance.

[6.1: Worksheet](#)

[6.2: The Financial Statements](#)

[6.3: Closing Entries](#)

[6.4: Post-Closing Trial Balance](#)

[6.5: Key Terms](#)

[6.6: Practice Questions](#)

[6.7: Alternate Text Description](#)

6.1: Worksheet

Overview

Now that you have learned how to prepare adjusting entries, it is time to see how those adjustments affect the financial statements. Traditionally, accountants used a worksheet to organize account balances, record adjusting entries, prepare an adjusted trial balance, and assist in preparing the financial statements.

Today, most businesses use accounting software such as QuickBooks, Sage, NetSuite, or SAP, which performs these steps automatically. As a result, paper worksheets are rarely used in practice; however, the worksheet remains one of the best learning tools in accounting because it clearly shows, in one place, how adjusting entries move through the accounting cycle and ultimately affect the financial statements.

Big Picture

Before preparing financial statements, accountants need one place to organize all of the account balances. By this point in the accounting cycle, transactions have been journalized, posted to the general ledger, an unadjusted trial balance has been prepared, and adjusting entries have been recorded. The worksheet brings all of this information together into a single working document.

The worksheet is not a financial statement and is not given to outside users. Instead, it serves as an internal planning tool that helps accountants verify their work and organize the information needed to prepare the financial statements. Once the worksheet is complete, the accountant can prepare the Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows.

Why it Matters

Even though most accountants no longer prepare paper worksheets, understanding the worksheet helps you visualize how adjusting entries change account balances and flow into the financial statements. Mastering the worksheet makes the transition to computerized accounting much easier because the software is performing the same accounting logic behind the scenes.

A worksheet is not a formal accounting record. Unlike journal entries, ledgers, or financial statements, the worksheet is an internal planning document used to organize information before the financial statements are prepared.

Worksheet Columns and Their Purpose

Before you view the Worksheet example, let us explain the columns in the worksheet. Each pair of columns in the worksheet serves a specific purpose.

Table 6.1.1: Worksheet Columns and Their Purpose

Columns	Purpose
Unadjusted Trial Balance	Shows account balances before adjustments.
Adjustments	Shows the debit and credit effects of adjusting entries.
Adjusted Trial Balance	Shows account balances after adjustments.
Income Statement	Contains revenue and expense accounts.
Balance Sheet	Contains asset, liability, and owner's equity accounts.

Worksheet Example

The completed worksheet below shows how the unadjusted trial balance is transformed into the adjusted trial balance after recording adjusting entries. It also demonstrates how the adjusted account balances are separated into the Income Statement and Balance Sheet columns. Before computerized accounting systems became commonplace, accountants relied on worksheets like this to organize information before preparing the financial statements.

Example 6.1.1

Prepare a completed worksheet with net income for Ledgerline.

Solution

The worksheet information identifies the company, the report, and the accounting period. The completed worksheet is shown below.

Table 6.1.1: Identifying information for the Ledgerline end-of-period worksheet

Company	Ledgerline
Report	End-of-Period Worksheet
Accounting Period	Month Ended March 31, 20XX

Table 6.1.2: Ledgerline End-of-Period Worksheet

Account	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	9,100	No data available	No data available	No data available	9,100	No data available	No data available	No data available	9,100	No data available
Accounts Receivable	1,000	No data available	400	No data available	1,400	No data available	No data available	No data available	1,400	No data available
Supplies	600	No data available	No data available	350	250	No data available	No data available	No data available	250	No data available
Equipment	3,000	No data available	No data available	No data available	3,000	No data available	No data available	No data available	3,000	No data available
Accumulated Depreciation—Equipment	No data available	No data available	No data available	50	No data available	50	No data available	No data available	No data available	50
Wages Payable	No data available	No data available	No data available	150	No data available	150	No data available	No data available	No data available	150
Nair, Capital	No data available	12,000	No data available	No data available	No data available	12,000	No data available	No data available	No data available	12,000
Nair, Drawings	800	No data available	No data available	No data available	800	No data available	No data available	No data available	800	No data available

Account	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Service Revenue	No data available	4,500	No data available	400	No data available	4,900	No data available	4,900	No data available	No data available
Rent Expense	900	No data available	No data available	No data available	900	No data available	900	No data available	No data available	No data available
Wages Expense	1,100	No data available	150	No data available	1,250	No data available	1,250	No data available	No data available	No data available
Supplies Expense	No data available	No data available	350	No data available	350	No data available	350	No data available	No data available	No data available
Depreciation Expense	No data available	No data available	50	No data available	50	No data available	50	No data available	No data available	No data available
Totals	16,500	16,500	950	950	17,100	17,100	2,550	4,900	14,550	12,200
Net Income	No data available	No data available	No data available	No data available	No data available	No data available	2,350	No data available	No data available	2,350
Final Totals	No data available	No data available	No data available	No data available	No data available	No data available	4,900	4,900	14,550	14,550

6.2: The Financial Statements

Overview

The worksheet is for the accountant, while financial statements are for everyone else—the owner, the bank, the tax preparer. Three statements (Income Statement, Statement of Owner's Equity, and Balance Sheet) answer different questions, and they are prepared in a fixed order because each one feeds the next. The Statement of Cash Flows is the expanded version of the Cash line found in the Balance Sheet.

What are Financial Statements?

Definition: Financial Statements

Financial statements are reports prepared from a company's accounting records that summarize its financial performance and financial position. They help owners, investors, lenders, and other users make informed business decisions.

The Four Financial Statements

1. Income Statement — Reports revenues, expenses, and net income (or net loss) for a period.
2. Statement of Owner's Equity (or Statement of Stockholder's Equity) — Reports changes in equity during the period.
3. Balance Sheet — Reports assets, liabilities, and equity at a specific point in time.
4. Statement of Cash Flows — Reports cash inflows and outflows from operating, investing, and financing activities.

Income Statement

The income statement lists revenue, subtracts expenses, and reports the difference as net income or net loss. It answers the question of whether the business earned a profit for the period or a loss. It covers a span of time. Here, we have the month of March. Ledgerline earned \$4,900 and spent \$2,550, for net income of \$2,350. This net income of \$2,350 will feed into the Statement of Owner's Equity report as seen below in Example 6.2.2.

Example 6.2.1

Prepare Ledgerline's financial statement for the month of March 20XX.

Solution

Income Statement Information

Table 6.2.1: Identifying information for Ledgerline's income statement

Company	Ledgerline
Report	Income Statement
Accounting Period	Month Ended March 31, 20XX

Table 6.2.2: Income Statement of Ledgerline for the month ended March 31, 20XX

Service Revenue	No data available	\$ 4,900
------------------------	-------------------	----------

Expenses:	No data available	No data available
Wages expense	1,250	No data available
Rent expense	900	No data available
Supplies expense	350	No data available
Depreciation expense	50	No data available
Total expenses	No data available	2,550
Net Income	No data available	\$ 2,350

The Statement of Owner's Equity

The Statement of Owner's Equity explains how the owner's equity changes over the accounting period. It begins with the owner's beginning capital balance, adds any owner investments and the net income earned during the period (Example 6.2.1), subtracts any owner drawings, and arrives at the ending owner's capital balance.

Because March is Ledgerline's first month operations, beginning owner's capital is zero. Priya's \$12,000 investment and the \$2,350 of net income increase owner's capital, while her \$800 drawing decreases it. The ending owner's capital is \$13,550. This amount carries forward to the balance sheet, where it appears in the Owner's Equity section in Example 6.2.3.

Example 6.2.2

Prepare Ledgerline's Statement of Owner's Equity for the month of March 20XX.

Solution

Statement of Owner's Equity Information

Table 6.2.3: Identifying information for Ledgerline's statement of owner's equity

Company	Ledgerline
Report	Statement of Owner's Equity
Accounting Period	Month Ended March 31, 20XX

Table 6.2.4: Statement of Owner's Equity for the month ended March 31, 20XX

Nair, capital, March 1	No data available
Add: Owner Investment	12,000
Add: Net Income	2,350
Less: Owner drawings	(800)
Nair, capital, March 31	\$ 13,550

The Balance Sheet

The balance sheet is a snapshot of the business at a single point in time—the last day of the accounting period. It lists the company's assets, liabilities, and owner's equity. The ending owner's capital balance reported on the Statement of Owner's Equity (Example 6.2.2) is carried forward to the Owner's Equity section of the balance sheet.

Notice that the equipment has a carrying value of \$2,950. The **carrying value** (also called the **book value**) of an asset is its

original cost less its accumulated depreciation. i the accumulated depreciation. In this example, the equipment cost \$3,000 and has accumulated depreciation of \$50, resulting in a carrying value of \$2,950.

The total assets on the balance sheet are \$13,700. Total liabilities of \$150 plus owner's equity of \$13,550, also equal \$13,700. This demonstrates that the accounting equation remains in balance:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Example 6.2.3

Prepare Ledgerline's Balance Sheet for the month ending March 31, 20XX.

Solution

Balance Sheet Information

Table 6.2.5: Identifying information for Ledgerline's balance sheet

Company	Ledgerline
Report	Balance Sheet
Reporting Date	March 31, 20XX

Table 6.2.6: Balance Sheet of Ledgerline for March 31, 20XX

Assets	No data available	No data available
Cash	No data available	\$ 9,100
Accounts Receivable	No data available	1,400
Supplies	No data available	250
Equipment	3,000	No data available
Less: Accumulated Depreciation	(50)	No data available
Equipment, net	No data available	2,950
Total Assets	No data available	\$ 13,700
Liabilities	No data available	No data available
Wages Payable	No data available	150
Owner's Equity	No data available	No data available
Nair, capital	No data available	13,550
Total Liabilities and Equity	No data available	\$ 13,700

Caution

Watch out

Drawings never appear on the income statement. They are not cost of doing business; they are the owner taking a share of equity. They belong only on Statement of Owner's Equity.

Statement of Cash Flows

The Statement of Cash Flows reports how cash moved into and out of a business during an accounting period. It explains where the company's cash came from and how it was used. Cash flows are classified into three categories:

- Operating Activities
- Investing Activities
- Financing Activities

Unlike the income statement, which is prepared using the accrual basis of accounting, the Statement of Cash Flows reports only actual cash received and cash paid during the period. This statement helps users evaluate a company's ability to generate cash, pay its obligations, and finance future growth.

The ending cash balance reported in the Statement of Cash Flows must equal the Cash balance reported on the Balance Sheet for the same date. The statement explains how the company arrived at its ending cash balance by summarizing all cash inflows and outflows from operating, investing, and financing activities during the period. If these two cash balances do not agree, an error has occurred and the statements should be reviewed. For Ledgerline, the Balance Sheet reports a Cash balance of \$9,100, and the Statement of Cash Flows also reports an ending cash balance of \$9,100. This agreement indicates that the ending cash balance is consistent between the two financial statements.

Example 6.2.4

Prepare Ledgerline's Statement of Cash Flows for the month of March, 20XX.

Solution

Statement of Cash Flows Information

Table 6.2.7: Identifying information for Ledgerline's statement of cash flows

Company	Ledgerline
Report	Statement of Cash Flows
Accounting Period	Month Ended March 31, 20XX

Table 6.2.8: Statement of Cash Flows of Ledgerline for the month ended March 31, 20XX

Cash flows from operating activities:	No data available	No data available
Cash received from customers	\$ 3,500	No data available
Cash paid for expenses and to creditors	(2,600)	No data available
Net cash flows from operating activities	No data available	\$ 900 No data available
Cash flows from investing activities:	No data available	No data available
Cash paid to purchase equipment	No data available	(3,000)
Cash flows from financing activities:	No data available	No data available
Cash invested by Nair	\$ 12,000	No data available
Cash withdrawal by Nair	(800)	No data available
Net cash flows from financing activities	No data available	11,200
Net increase in cash	No data available	\$ 9,100
Cash balance, March 1, 20XX	No data available	0

Cash balance, March 31, 20XX	No data available	\$ 9,100
------------------------------	-------------------	----------

6.3: Closing Entries

Overview

Revenue and expense accounts measure a single period. March's \$4,900 of revenue is a March fact. It must not still be sitting in the account when you start counting April's. Before a new period begins, those accounts have to be reset to zero. Sometimes, this process is called "Closing the Books." We are now in Step 8 of the Accounting Cycle. See Figure 6.3.1.



Figure 6.3.1: The accounting cycle follows ten steps used to record, adjust, summarize, and report financial information before beginning a new accounting period. Arrow points to Step 8. AI Generated Image, 2026. [Detailed Description of Figure 6.3.1.](#)

What needs to be "reset?"

Accounts are split into two groups:

1. Permanent accounts (also called real accounts) — assets, liabilities, and capital.
2. Temporary accounts (also called nominal accounts) — revenues, expenses, and drawings.

Permanent accounts carry their balances into the next period; the cash on March 31 is the cash on April 1. In contrast, Temporary accounts measure just one period and start each new one at zero.

What is an easy way to remember what needs to be closed?

R E D

We will close Revenues, Expenses, and Drawings. These accounts will offset to the Capital accounts.

There are two journals to be made to close these entries out to the Capital accounts. The first journal entry closes the revenues and expenses. The second journal entry closes the drawings account.

Steps for Closing Entry - Journal 1 — Close all revenue accounts and expenses account:

1. Debit each revenue account for its balance. (Since the normal side for revenue is a credit, we would zero this out by debiting revenues.)
2. Credit each expense account for its balance. (Since the normal side for expenses is a debit, we would zero this out by

crediting expenses.)

3. Record the difference in the owner's capital account
 - a. Credit the owner's capital account if business has net income. (This would increase the owner's equity.)
 - b. Debit the owner's capital account if business has net loss. (This would decrease the owner's equity.)

Steps for Closing Entry - Journal 2 — Close Drawings account:

1. Debit the owner's capital account for the balance in the owner's drawing account.
2. Credit the owner's drawing account to reduce its balance to zero. (Since the normal side for drawings is a debit, we would zero this out by crediting drawings.)

Example 6.3.1

Close out Ledgerline for the month of March.

Solution

Closing Entry — Journal 1

Table 6.3.1: Journal entry to close out revenue and expenses to owner's capital account

Date	Account	Debit	Credit
Mar 31	Service Revenue	4,900	No data available
No data available	Wages Expense	No data available	1,250
No data available	Rent Expense	No data available	900
No data available	Supplies Expense	No data available	350
No data available	Depreciation Expense	No data available	50
No data available	Nair, Capital	No data available	2,350

Closing Entry — Journal 2

Table 6.3.2: Journal entry to close out drawings to owner's capital account

Date	Account	Debit	Credit
Mar 31	Nair, Capital	800	No data available
No data available	Nair, Drawings	No data available	800

After closing every temporary accounts, the balance in the account will be zero, and Nair, Capital holds $\$12,000 + \$2,350 - 800 = \$13,550$ — matching the statement of owner's equity exactly (6.2: The Financial Statements, Example 6.3.2).

Caution

Watch out

Close only the temporary accounts. Never close Cash, Equipment, or a payable — those carry forward.

Recap

Closing entries reset the temporary accounts - revenues, expenses, drawings, to zero. They move their net effect into owner's capital. Permanent accounts are never closed.

This page titled [6.3: Closing Entries](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

6.4: Post-Closing Trial Balance

Overview

After closing, you run one last check; are the books still in balance, and did every temporary account actually reach zero?

The post-closing trial balance lists only the permanent accounts and their balances, because the temporary accounts are now zero and drop off. If debits equal credits here, the ledger is balanced and ready for the next period.

Example 6.4.1

Prepare Ledgerline's Post-Closing Trial Balance at March 31.

Solution

The Post-Closing Trial Balance is headed up with three lines. The first line reveals the name of the company, which is Ledgerline. The second line is the name of the report, which is Post-Closing Trial Balance, and the third line is the period name, and in this example, it is March 31, 20XX.

Table 6.4.1: Post-Closing Trial Balance of Ledgerline.

Account	Debit	Credit
Cash	9,100	No data available
Accounts Receivable	1,400	No data available
Supplies	250	No data available
Equipment	3,000	No data available
Accumulated Depreciation - Equipment	No data available	50
Wages Payable	No data available	150
Nair, Capital	No data available	13,550
Total	13,750	13,750

Both columns total \$13,750. Only assets, one liability, and capital remains—exactly the accounts that carry into April.

Caution

Watch out

If any revenue, expense, or drawings account shows up here with a balance, a closing entry was missed. The post-closing trial balance should contain nothing temporary.

Recap

The post-closing trial balance confirms the ledger balances after closing and shows only permanent accounts, ready to start the next period.

This page titled [6.4: Post-Closing Trial Balance](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

6.5: Key Terms

Definitions

accounting worksheet

informal document used to organize account balances and assist in preparing financial statements and closing entries

adjusted trial balance

list of all general ledger accounts and their balances after adjusting entries have been journalized and posted

balance sheet

financial statement that reports a business's assets, liabilities, and owner's equity at a specific point in time

closing entries

journal entries made at the end of an accounting period to transfer temporary account balances to the owner's capital account and prepare the accounts for the next period

financial statements

formal reports that summarize a business's financial performance and financial position

income statement

financial statement that reports revenues, expenses, and net income or net loss for an accounting period

net income

amount by which revenues exceed expenses during an accounting period

net loss

amount by which expenses exceed revenues during an accounting period

permanent accounts

balance sheet accounts whose balances are carried forward from one accounting period to the next

post-closing trial balance

trial balance prepared after closing entries have been posted to verify that permanent accounts remain in balance

statement of cash flows

financial statement that reports cash receipts and cash payments from operating, investing, and financing activities during an accounting period

statement of owner's equity

financial statement that reports changes in the owner's capital account during an accounting period

temporary accounts

accounts that accumulate information for one accounting period and are closed at the end of the period

worksheet

optional accounting tool used to organize account balances before preparing financial statements

6.6: Practice Questions

Multiple Choice Questions

Exercise 6.6.1

1. Completing a worksheet helps an accountant primarily by
 - a. recording daily business transactions.
 - b. organizing account balances before preparing the financial statements.
 - c. closing temporary accounts.
 - d. preparing journal entries for the next accounting period.
2. Which of the following statements about a worksheet is correct?
 - a. It is a formal financial statement.
 - b. It is an optional internal document used to organize accounting information.
 - c. It is submitted to the IRS.
 - d. It replaces the general ledger.
3. Which columns appear on a typical 10-column worksheet?
 - a. Journal and Ledger
 - b. Income Statement and Balance Sheet
 - c. General Journal and Trial Balance
 - d. Cash Receipts and Cash Payments
4. After adjusting entries have been recorded on a worksheet, the next set of columns contains the
 - a. general ledger.
 - b. adjusted trial balance.
 - c. closing entries.
 - d. post-closing trial balance.
5. On a worksheet, where would Service Revenue normally appear?
 - a. Balance Sheet columns only
 - b. Income Statement columns only
 - c. Both Income Statement and Balance Sheet columns
 - d. Adjustment columns only
6. The primary purpose of preparing financial statements is to
 - a. update the ledger accounts.
 - b. communicate financial information to users.
 - c. record adjusting entries.
 - d. prepare closing entries.
7. Which financial statement reports revenues and expenses for an accounting period?
 - a. Balance Sheet
 - b. Statement of Owner's Equity
 - c. Income Statement
 - d. Statement of Cash Flows
8. Which financial statement explains changes in the owner's capital account during the accounting period?
 - a. Balance Sheet
 - b. Income Statement
 - c. Statement of Owner's Equity
 - d. Post-Closing Trial Balance
9. Which financial statement reports assets, liabilities, and owner's equity on a specific date?
 - a. Income Statement
 - b. Statement of Owner's Equity
 - c. Balance Sheet
 - d. Statement of Cash Flows
10. The ending owner's capital balance from the Statement of Owner's Equity is reported on the
 - a. Income Statement.
 - b. Balance Sheet.
 - c. Worksheet only.

- d. General Journal.
- 11. Closing entries are prepared at the end of an accounting period to
 - a. correct journal entry errors.
 - b. transfer temporary account balances to the owner's capital account.
 - c. prepare adjusting entries.
 - d. record depreciation.
- 12. Which of the following is a temporary account?
 - a. Cash
 - b. Accounts Receivable
 - c. Service Revenue
 - d. Equipment
- 13. Which account is closed directly to the owner's capital account?
 - a. Cash
 - b. Accounts Payable
 - c. Owner's Drawings
 - d. Supplies

Answer available at the end of this section.

Answers

Exercise 6.6.1

Table 6.6.1: Answers to multiple choice questions

Question	Answer
1	b - organizing account balances before preparing the financial statements.
2	b - It is an optional internal document used to organize accounting information.
3	b - Income Statement and Balance Sheet
4	b - adjusted trial balance.
5	b - Income Statement columns only
6	b - communicate financial information to users.
7	c - Income Statement
8	c - Statement of Owner's Equity
9	c - Balance Sheet
10	b - Balance Sheet.
11	b - transfer temporary account balances to the owner's capital account.
12	c - Service Revenue
13	c - Owner's Drawings

6.7: Alternate Text Description

Figure 6.3.1: Accounting Cycle: Focus on Step 8, Record Closing Entries

A circular diagram of the 10-step accounting cycle. An arrow labeled “We are Here” points to Step 8, Record Closing Entries. This step follows Prepare Financial Statements and precedes Prepare Post-Closing Trial Balance. The diagram illustrates how the accounting cycle moves from transaction analysis through financial reporting and closing procedures before beginning a new accounting period.

This page titled [6.7: Alternate Text Description](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

7: MERCHANDISING TRANSACTIONS

Overview

Diego runs Paws & Claws, a neighborhood pet supply store. His accounting looks nothing like Priya's bookkeeping firm, and the reason is simple: Priya sells her time, but Diego sells things. Paws & Claws sells bags of dog food, aquariums, and chew toys, just to name a few.

Diego buys his merchandise from suppliers and resells them to customers. That one difference between a service business and a merchandise business sprouts a whole new set of questions. When Diego sells a \$30 bag of food, how much did that bag actually cost him? How much merchandise is sitting on his shelves right now? When he bought the same product three times this year at three different prices, which cost does he count when one sells? A service business never has to ask any of these questions.

This chapter is about the accounting a business needs the moment it starts buying and selling goods. You will learn two ways to track inventory, the tools that keep a busy store's books manageable, and the surprisingly consequential choice of which cost to attach to a sale.

Learning Objectives

By the end of this chapter, you can:

- Record purchases and sales under a perpetual inventory system.
- Explain how a periodic system works and compute cost of goods sold.
- Compare and contrast the perpetual versus the periodic system.

7.1: The Perpetual Inventory System

7.2: The Periodic Inventory system

7.3: Comparing Inventory Systems

7.4: Accounting for Shipping Costs

7.5: Summary

7.6: Key Terms

7.7: Practice Questions

7.8: Alternate Text Description

This page titled [7: Merchandising Transactions](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by OpenStax via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [6: Merchandising Transactions](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://openstax.org/details/books/principles-financial-accounting>.

7.1: The Perpetual Inventory System

Overview

Diego wants to know two things at any moment: how much inventory he is holding, and how much profit each sale actually made. To know that, his books have to track the **cost of goods** as they come in and go out.

Definition: Cost of Goods Sold

The cost of the inventory that a business has sold to its customers during a specific period.

A merchandise business buys goods and resells them. The goods it holds for sale are merchandise inventory—an asset, sitting on the balance sheet until sold. When an item sells, its cost moves off the balance sheet and becomes an expense called cost of goods sold (COGS).

Perpetual Inventory system

Under **perpetual inventory system**, you update the inventory account continuously—every purchase adds to it, every sale removes it. The books always show the current inventory on hand.

Definition: Perpetual inventory system

A perpetual inventory system continuously updates inventory records every time inventory is bought or sold. The company always knows approximately how much inventory it has on hand.

The catch: every sale now takes two journal entries. See Table 7.1.2 below.

Entry 1 records the sale at the selling price. The customer owes you, and you have earned income.

Entry 2 records the cost. This is the cost of goods sold, and inventory comes down.

Example 7.1.1

Purchase of Inventory example:

Paws & Claws buys 40 bags of premium dog food at \$18 each—\$720 total—on account. What is the journal entry for this transaction?

Solution

Table 7.1.1: Journal entry of purchase of inventory on account

Date	Account	Debit	Credit
May 1	Merchandise Inventory	720	No data available
No data available	Accounts Payable	No data available	720
Memo: Bought 40 bags at \$18 each, on account.	No data available	No data available	No data available

Example 7.1.2

Sale of Merchandise example:

Diego sells 25 of the premium dog food at \$30 each—\$750, on account. The 25 bags cost him $25 \times \$18 = 450$. What are the entries for this transaction?

Solution

Table 7.1.2: Two journal entries of sale of merchandise. The first entry recognizes the sale, and the second entry recognizes the cost of goods sold.

Date	Account	Debit	Credit
May 6	Accounts Receivable	750	No data available
No data available	Sales Revenue	No data available	750
Memo: Sold 25 bags at \$30 each	No data available	No data available	No data available
No data available	No data available	No data available	No data available
May 6	Cost of Goods Sold	450	No data available
No data available	Merchandise Inventory	No data available	450
Memo: Cost of the 25 bags sold purchased at \$18 each	No data available	No data available	No data available

Caution

The second entry is the one that people forget. Recording the sale but not the cost of goods sold leaves inventory overstated and profit fictional. Under a perpetual system, a sales is never just one entry!

The sale brought in \$750; the goods cost \$450. The difference, \$300 is **gross profit**—what is left from sales after covering just the cost of the merchandise, before other expenses like rent and wages. It tells Diego whether his pricing and buying work, separate from his overhead has enough to cover his **overheads**. A store can have healthy sales and still fail if its gross profit is too thin to cover the rent.



Figure 7.1.1: A retail employee at Paws and Claws scans a bag of premium dog food before placing it on the shelf. In a perpetual inventory system, inventory quantities and cost of goods sold are updated immediately as transactions occur. (AI-generated image; created by OpenAI ChatGPT, 2026).

Definition: Gross Profit

Gross profit = Sales less Cost of Goods Sold.

Note

Gross Profit is the single most-watched number in retail!

Note

In the real world

A simple way to understand perpetual inventory system is the example of companies like Costco, Macy's, or Amazon. At any point in time, these companies know approximately how much inventory it has on hand with the aid of their sophisticated inventory management software systems to help them manage inventory. Barcode scanners help them scan the sale and it drops the item out of inventory and books. Hence, store managers can pull an inventory report say, at 2 pm on a Tuesday.

Freight-In

Getting goods to the store is not free. If Diego pays \$60 to have that dog food shipped in (freight-in), the cost of getting inventory ready to sell is part of the inventory's cost. More in-depth discussion about freight is in [7.4: Two Freight-In Methods](#).

Example 7.1.3

It costs Diego \$60 to ship the dog food. What is the journal entry?

Solution

Table 7.1.3: Journal entry to recognize freight costs that buyer pays to include as part of inventory cost

Date	Account	Debit	Credit
May 1	Merchandise Inventory	60	No data available
No data available	Cash	No data available	60
Memo: Freight for purchase of dog food	No data available	No data available	No data available

Recap

A merchandiser holds merchandise inventory and expenses it as cost of goods sold when it sells. A perpetual system updates inventory continuously, so each sale takes two entries—one for the revenue, and one for the cost. Sales minus COGS is gross profit.

7.2: The Periodic Inventory system

Overview

Tracking the cost of every single item at the moment it sells is a lot of work. For a store selling thousands of small, cheap items—think a bin of \$2 cat toys updating the cost of each one at checkout may not be worth it.

Under a **periodic inventory system**, you do not touch the Inventory account during the period. Purchases go into a temporary Purchases account. Sales record only revenue, and you figure out cost of goods sold just once — at period-end, after a physical count of what is left on the shelves.

Formula to calculate Cost of Goods sold in a periodic inventory system

Table 7.2.1: Formula to calculate Cost of Goods sold in a periodic inventory system

Account Description
Beginning Inventory
+ Purchases (net)
= Cost of goods available for sale
- Ending inventory (counted)
= Cost of goods sold

Example 7.2.1

Paws & Claws starts the quarter with \$2,000 of inventory and buys \$12,000 more during the quarter. A physical count on the last day finds \$3,500 still on the shelves. What's the cost of goods sold?

Solution

Table 7.2.1: Solution to Calculate Cost of Goods Sold for Paws & Claws example for a periodic system

Amount	Account Description
2,000	Beginning Inventory
+ 12,000	Purchases
= 14,000	Cost of goods available for sale
- 3,500	Ending inventory (counted)
= 10,500	Cost of goods sold

Cost of goods sold for the quarter is \$10,500 — calculated, not tracked. Notice what is missing: the period system never knew COGS until the count.

Caution

The periodic system cannot tell a sale from a theft. Anything not on the shelf at count time is assumed sold, so shrinkage—breakage, spoilage, shoplifting— quietly disappears into cost of goods sold. A perpetual system, by contrast, shows what should be on hand, so a shortage stands out.

Recap

A periodic system determines cost of goods sold once per period, using beginning inventory plus purchases minus a counted ending inventory. It is a simpler system to run, but it is blind to shrinkage and to real-time inventory levels.

7.3: Comparing Inventory Systems

Overview

Businesses either use one of two systems to keep track of inventory:

- **Perpetual inventory system** — Inventory is updated continuously after every purchase and sale.
- **Periodic inventory system** — Inventory is updated only after a physical count at the end of an accounting period.

Both systems can produce accurate financial systems, but they differ in when inventory information is recorded and available.

Perpetual vs Periodic Inventory

Table 7.3.1: Perpetual vs Periodic

Feature	Perpetual	Periodic
Inventory records	Updated continuously	Updated at period end
Inventory account	Changes with every purchase and sale	Updated only after physical count
Cost of Goods Sold	Recorded with each sale	Calculated at period end
Inventory information	Real-time	Delayed until period end
Common users	Most modern retailers	Small businesses with limited inventory systems

Key Difference

The biggest difference is timing.

- Under a perpetual system, inventory and Cost of Goods Sold are updated immediately whenever merchandise is sold.
- Under a periodic system, purchases are recorded during the period, but inventory and Cost of Goods Sold are not updated until the business performs a physical inventory count at the end of the accounting period.

Table 7.3.2 Advantages and Disadvantages of Perpetual and Periodic Inventory System

Type	Perpetual Inventory System	Periodic Inventory System
Advantage	Real-time inventory information	Lower cost to implement and maintain
Advantage	Better inventory control	Simpler recordkeeping
Advantage	Integrates with point-of-sale (POS) systems	Easier for businesses with limited inventory transactions
Disadvantage	Higher setup and maintenance costs	Inventory information is not current during the period
Disadvantage	Requires specialized software and training	Greater reliance on physical inventory counts

Merchandising Transactions

The biggest difference between the two inventory systems is how transactions are recorded. Let's look at Gearhead Outfitters, a retailer of outdoor-related gear such as clothing, footwear, backpacks, and camping equipment. Let us compare the journal entries for the same purchase and sale under each system. Notice that the business event is identical, but the accounts used are different.

Purchase of Merchandise on Account

Gearhead Outfitters purchases merchandise on account.

Table 7.3.3: Comparison of purchase journal entries under perpetual and periodic inventory systems

Perpetual Inventory System	Periodic Inventory System
Debit Merchandise Inventory	Debit Purchases
Credit Accounts Payable	Credit Accounts Payable

Under the perpetual system, the Merchandise Inventory account is updated immediately. Under the periodic system, the purchase is recorded in a temporary Purchases account instead.

Sale of Merchandise on Account

Gearhead Outfitters sells merchandise on account.

Table 7.3.4: Comparison of sales journal entries under perpetual and periodic inventory systems

Perpetual Inventory System	Periodic Inventory System
Debit Accounts Receivable	Debit Accounts Receivable
Credit Sales Revenue	Credit Sales Revenue

Perpetual Inventory System	Periodic Inventory System
Debit Cost of Goods Sold	(No entry)
Credit Merchandise Inventory	(Cost is recorded at period end)

Under the perpetual system, two journal entries are required because the cost of inventory sold is recognized immediately. Under the periodic system, only the sales entry is recorded at the time of sale. Cost of Goods Sold is calculated and recorded later, after the

*physical
inventory
count.*

This page titled [7.3: Comparing Inventory Systems](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [6.2: Compare and Contrast Perpetual versus Periodic Inventory Systems](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

7.4: Accounting for Shipping Costs

Overview

When merchandise is shipped from a seller to a buyer, someone must pay the shipping costs. The purchase agreement specifies who is responsible through FOB (Free on Board) shipping terms.

The accounting treatment depends on who owns the goods while they are in transit.

FOB Shipping Point

- Ownership transfers to the buyer when the goods leave the seller's location.
- The buyer pays the shipping costs.
- Shipping paid by the buyer is called freight-in
- Freight-in is added to the cost of Merchandise Inventory, not recorded as an expense immediately.

Buyer's journal entry

Table 7.4.1: Buyer's journal entry

Account	Debit	Credit
Merchandise Inventory	XXX	No data available
Cash	No data available	XXX

Note

For the Buyer, Freight-in becomes part of inventory and is recognized as Cost of Goods Sold only when the inventory is sold.

FOB Destination

- Ownership remains with the seller until the goods reach the buyer.
- The seller pays the shipping costs.
- Shipping paid by the seller is called freight-out (or delivery expense).
- Freight-out is recorded as a selling expense in the current period.

Seller's journal entry

Table 7.4.2: Seller's journal entry

Account	Debit	Credit
Delivery Expense (Freight-out)	XXX	No data available
Cash	No data available	XXX

Note

For the Seller, Freight-out or delivery expense is the cost of doing business.

Quick Comparison

Table 7.4.3: Comparison of FOB Shipping vs FOB Destination

FOB Shipping Point	FOB Destination
Buyer owns goods during transit	Seller owns goods during transit
Buyer pays shipping	Seller pays shipping
Buyer records Freight-in	Seller records Freight-out
Added to Merchandise Inventory	Recorded as Delivery Expense

Remember

- Freight-in: Buyer pays → Add to Merchandise Inventory
- Freight-in: Seller pays → Record as Delivery Expense

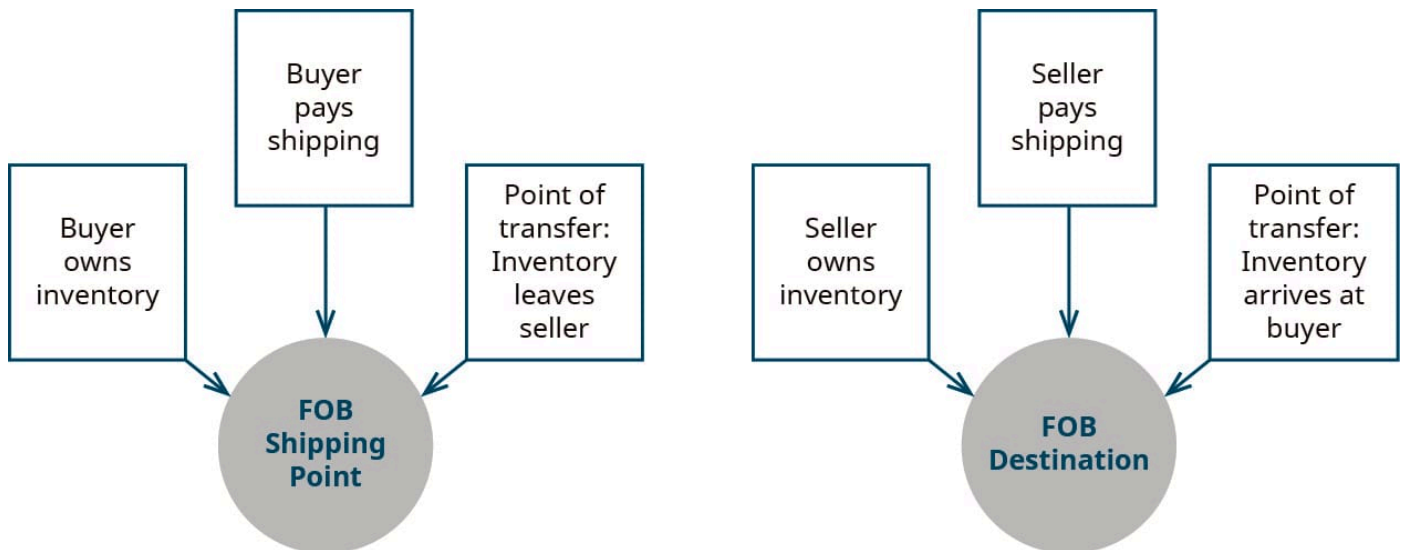


Figure 7.4.1: Shipping Point versus FOB Destination. A comparison of shipping terms. (CC BY-NC-SA 4.0; via Financial Accounting). Detailed description of the Figure 7.4.1.

7.5: Summary

Service vs Merchandise Companies

- Service companies earn revenue by providing services and do not carry inventory.
- Merchandising companies earn revenue by purchasing and reselling inventory.
- Merchandising companies report Merchandise Inventory as an asset and Cost of Goods Sold (COGS) as an expense.

Perpetual versus Periodic Inventory Systems

- Perpetual inventory systems update Merchandise Inventory and Cost of Goods Sold after every purchase and sale.
- Periodic inventory systems update inventory only at the end of the accounting period after a physical inventory count.
- Under the periodic system:

$$\text{Cost of Goods Sold} = \text{Beginning Inventory} + \text{Net Purchases} = \text{Ending Inventory}$$

- Perpetual system provide real-time inventory information but are more costly to maintain.
- Periodic systems are simpler and less expensive but do not provide current inventory balances during the accounting period.

Merchandise Purchases

- Merchandise may be purchased with cash or account (Accounts Payable).
- Under the perpetual system, purchases increase Merchandise Inventory.
- Under the periodic system, purchases increase the Purchases account instead of Merchandise Inventory.

Merchandise Sales

- Merchandise may be sold for cash or on account (Accounts Receivable)
- Under the perpetual system, every sale requires:
 - A journal entry to record the sale.
 - A second journal entry to record Cost of Goods Sold and reduce Merchandise Inventory
- Under the periodic system, the cost of goods sold entry is not recorded at the time of sale. It is determines at the end of the accounting period.

Freight Terms (FOB)

- FOB Shipping Point: Ownership transfers when the goods leave the seller.
- FOB Destination: Ownership transfers when the goods reach the buyer.
- Freight terms determine:
 - Who owns the inventory while it is in transit
 - Who pays the shipping costs.
 - Which company reports the inventory at year-end

This page titled [7.5: Summary](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [6.8: Summary](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.

7.6: Key Terms

Definitions

cash discount

Discount offered to a buyer for paying within a specified discount period after a purchase.

cost of goods sold (COGS)

Cost of inventory sold to customers during an accounting period.

FOB destination

Shipping terms indicating that ownership transfers from the seller to the buyer when goods arrive at the buyer's location; the seller pays shipping costs.

FOB shipping point

Shipping terms indicating that ownership transfers from the seller to the buyer when goods are delivered to the carrier; the buyer pays shipping costs.

freight-in

Shipping cost paid by the buyer to transport purchased merchandise; under the periodic inventory system, it is added to inventory cost.

freight-out

Shipping cost paid by the seller to deliver merchandise to customers; recorded as a selling expense.

goods in transit

Merchandise being transported from the seller to the buyer.

gross margin

Amount remaining after deducting cost of goods sold from net sales to cover operating expenses and profit.

gross profit margin ratio

Ratio measuring gross profit as a percentage of net sales, calculated as gross profit divided by net sales.

gross purchases

Total purchases before deducting purchase discounts, returns, and allowances.

gross sales

Total sales before deducting sales discounts, returns, and allowances.

income from operations

Gross margin less operating expenses.

inventory

Goods held by a business for sale to customers in the ordinary course of business.

merchandise inventory

Asset account that records the cost of merchandise available for sale.

merchandising business

Business that purchases goods and resells them to customers for a profit.

merchandising company

Company that purchases finished goods from suppliers and resells them to customers.

net income

Excess of revenues and gains over expenses and losses.

net purchases

Gross purchases less purchase discounts, returns, and allowances.

net sales

Gross sales less sales discounts, returns, and allowances.

operating cycle

Process by which a merchandising business purchases inventory, sells merchandise, and collects cash from customers.

operating expenses

Costs of daily operations not directly related to producing or selling goods and services.

other revenues and expenses

Revenues and expenses not related to a company's primary operating activities.

ownership of inventory

Determination of whether the buyer or seller owns inventory at a given point in time.

periodic inventory system

Inventory system that updates inventory and cost of goods sold only at the end of an accounting period.

perpetual inventory system

Inventory system that continuously updates inventory and cost of goods sold after each purchase and sale.

physical inventory count

Process of counting inventory on hand to determine the actual quantity available.

point of transfer

Point at which ownership and responsibility for inventory transfer from the seller to the buyer.

purchase allowance

Reduction in purchase price granted when a buyer keeps merchandise with minor defects or other agreed-upon conditions.

purchase discounts

Reductions in the amount owed by a buyer for early payment of an account.

purchase return

Return of merchandise by the buyer to the seller for a refund or credit.

purchase returns and allowances

Reductions in the cost of purchases resulting from returns or allowances granted by the seller.

sales allowance

Reduction in the selling price granted to a customer who keeps merchandise with minor defects or other agreed-upon conditions.

sales discounts

Reductions in selling price offered to customers for paying within the discount period.

sales return

Return of merchandise by a customer to the seller for a refund or credit.

sales returns and allowances

Contra-revenue account that records reductions in sales due to customer returns and allowances.

service company

Business that provides intangible services rather than selling inventory.

shipping costs

Costs incurred to transport merchandise from the seller to the buyer.

trade discount

Reduction from a manufacturer's listed price negotiated before the final purchase price is determined.

7.7: Practice Questions

Multiple Choice Questions

Exercise 7.7.1

1. A merchandising company differs from a service company because it primarily:
 - a. provides services instead of products
 - b. purchases and resells merchandise to customers
 - c. manufactures all of its own products
 - d. earns revenue only through investments
2. Which account is unique to a merchandising company?
 - a. accounts receivable
 - b. cash
 - c. merchandise inventory
 - d. supplies
3. When merchandise is purchased on account under a perpetual inventory system, which journal entry is recorded?
 - a. debit Purchases; credit Accounts Payable
 - b. debit Merchandise Inventory; credit Accounts Payable
 - c. debit Cost of Goods Sold; credit Merchandise Inventory
 - d. debit Cash; credit Merchandise Inventory
4. When a merchandising company sells inventory for cash under a perpetual inventory system, how many journal entries are required?
 - a. one
 - b. two
 - c. three
 - d. four
5. The first journal entry when merchandise is sold records:
 - a. the purchase of inventory
 - b. the cost of goods sold
 - c. the revenue earned from the sale
 - d. the physical inventory count
6. The second journal entry when merchandise is sold records:
 - a. the payment of accounts payable
 - b. the owner's withdrawal
 - c. the transfer of inventory cost to Cost of Goods Sold
 - d. the collection of accounts receivable
7. Which account increases when a company purchases merchandise?
 - a. cost of goods sold
 - b. sales revenue
 - c. merchandise inventory
 - d. sales returns and allowances
8. Cost of goods sold represents:
 - a. the selling price charged to customers
 - b. the cost of merchandise that has been sold
 - c. the amount customers still owe
 - d. the cost of office supplies purchased
9. Freight paid by the buyer to bring purchased merchandise to the buyer's business is generally:
 - a. added to the cost of merchandise inventory
 - b. recorded as sales revenue
 - c. recorded as owner's withdrawals
 - d. ignored because it is not part of inventory cost
10. Under a perpetual inventory system, Merchandise Inventory is updated:

- a. only at the end of the accounting period
 - b. once each year
 - c. every time merchandise is purchased or sold
 - d. only when a physical inventory count is completed
11. If goods are shipped FOB destination, which of the following is true?
- a. Title to the goods will transfer as soon as the goods are shipped.
 - b. FOB indicates that a price reduction has been applied to the order.
 - c. The seller must pay the shipping.
 - d. The seller and the buyer will each pay 50% of the cost.

Answer available at the end of this section.

Answers

Exercise 7.7.1

Table 7.7.1: Answers to multiple choice questions

Question	Answer	Explanation
1	b.	A merchandising company purchases and resells merchandise to customers.
2	c.	Merchandise Inventory is an account unique to merchandising companies.
3	b.	Under the perpetual inventory system, purchasing merchandise on account is recorded by debiting Merchandise Inventory and crediting Accounts Payable.
4	b.	Two journal entries are required—one records the sale (revenue) and the other records the cost of the inventory sold.
5	c.	The first journal entry records the revenue earned from selling the merchandise.
6	c.	The second journal entry transfers the cost of the inventory sold from Merchandise Inventory to Cost of Goods Sold.
7	c.	Purchasing merchandise increases the Merchandise Inventory account.
8	b.	Cost of Goods Sold represents the cost of the merchandise that has been sold to customers.
9	a.	Freight paid by the buyer (freight-in or transportation-in) becomes part of the cost of the merchandise inventory.
10	c.	Under a perpetual inventory system, Merchandise Inventory is updated each time merchandise is purchased or sold.

Question	Answer	Explanation
11	c.	Under FOB destination, the seller retains ownership while the goods are in transit and is responsible for the shipping cost until the goods reach the buyer.

7.8: Alternate Text Description

Figure 7.4.1: Comparison of FOB Shipping Point and FOB Destination transfer terms.

The diagram compares FOB Shipping Point and FOB Destination shipping terms. Under FOB Shipping Point, ownership transfers when inventory leaves the seller, and the buyer pays shipping costs. Under FOB Destination, ownership transfers when inventory arrives at the buyer, and the seller pays shipping costs. The diagram highlights the transfer point, ownership, and responsibility for shipping costs under each method.

8: INVENTORY COST FLOW ASSUMPTIONS

Overview

Diego buys the same bag of dog food several times a year, and the price keeps creeping up: \$5 last winter, \$6 in spring, \$7 in summer. The bags are identical on the shelf, but when one sell, which cost does he record? Does he record the old \$5 or the new \$7? That choice changes his profit, his taxes, and the value of his remaining inventory.

Businesses like Diego's often purchase identical inventory items at different prices over time. When those items are sold, the business must decide which cost should be assigned to Cost of Goods Sold and which costs should remain in Ending Inventory. This decision is called a **cost-flow assumption**—a rule for which cost to move to cost of goods sold.

This chapter introduces the four commonly discussed cost-flow assumptions:

- Specific Identification
- First-in, First-out (FIFO)
- Last-in, First-out (LIFO)
- Weighted Average

You will learn how each method assigns inventory costs, prepares cost of goods sold, ending inventory, and influences a company's reported financial results.

Learning Objectives

By the end of this chapter, you can:

- Explain the purpose of inventory cost-flow assumptions.
- Differentiate among specific identification, FIFO, LIFO, and weighted average-cost methods.
- Calculate cost of goods sold and ending inventory using FIFO, LIFO, and weighted average.
- Compare the effects of different cost-flow assumptions on gross profit, net income, and ending inventory.
- Identify the inventory cost-flow methods.

[8.1: Inventory Valuation Methods and Comparison](#)

[8.2: Calculate COGS and Ending Inventory](#)

[8.3: Summary](#)

[8.4: Practice Questions](#)

[8.5: Alternate Text Description](#)

8.1: Inventory Valuation Methods and Comparison

Overview

In the previous section ([8: Inventory Cost Flow Assumptions](#)), you learned why businesses use cost flow assumptions when identical inventory items have been purchased at different costs. The next step is learning how each method actually works.

Although the four inventory valuation methods all begin with the same inventory transactions, they assign costs differently. As a result, each method can produce different amounts for Cost of Goods Sold, Ending Inventory, and Net Income, even though the same number of units were purchased and sold.

In this section, you will learn how to apply the four basic inventory valuation methods—Specific Identification, FIFO, LIFO, and Weighted Average Cost. Using the same inventory data, you will calculate Cost of Good Sold and Ending Inventory under each method and compare how the results differ. Understanding these methods will help you interpret financial statements and recognize how inventory valuation can influence a company's reported financial performance.

Data for Demonstration of the Four Basic Inventory Valuation Methods

The following dataset will be used to demonstrate the application and analysis of the four methods of inventory accounting.

Company: Spy Who Loves You Corporation

Product: Global Positioning System (GPS) Tracking Device

Description: This product is an economical real-time GPS tracking device, designed for individuals who wish to monitor others' whereabouts. It is marketed to parents of middle school and high school students as a safety measure. Parents benefit by being apprised of the child's location, and the student benefits by not having to constantly check in with parents. Demand for the product has spiked during the current fiscal period, while supply is limited, causing the selling price to escalate rapidly.

Table 8.1.1: Dataset of Inventory activity of GPS tracking device for the month of July

Inventory Activity	Number of Units	Unit Cost	Sales Price
Beginning Inventory on July 1	150	\$21	No data available
Sold on July 5	120	No data available	\$36
Purchased on July 10	225	\$27	No data available
Sold on July 15	180	No data available	\$39
Purchased on July 25	210	\$33	No data available
Ending Inventory on July 31	285	No data available	No data available

Specific Identification Method

The **specific identification method** refers to tracking the actual cost of the item being sold and is generally used only on expensive items that are highly customized (such as tracking detailed costs for each individual car in automobiles sales) or inherently distinctive (such as tracking origin and cost for each unique stone in diamond sales). This method is too cumbersome for goods of large quantity, especially if there are not significant feature differences in the various inventory items of each product type. However, for purposes of this demonstration, assume that the company sold one specific identifiable unit, which was purchased in the second lot of products, at a cost of \$27.

Three separate lots of goods are purchased:

Table 8.1.2: Dataset of three different Inventory Lot with Unit cost of each lot

Inventory Lot	Number of Units	Unit Cost
Lot 1	150	\$21
Lot 2*	225	\$27
Lot 3	210	\$33

Table 8.1.3: Gross Margin calculation of unit from Lot 2

Sales Revenue	\$36
Less: Cost of Good Sold (Specific Identification) from Lot 2*	\$27
Gross Margin for one unit	\$9

First-in, First-out (FIFO) Method

FIFO (First-In, First-Out)—First items purchased are the first items sold

PURCHASES (oldest to newest)

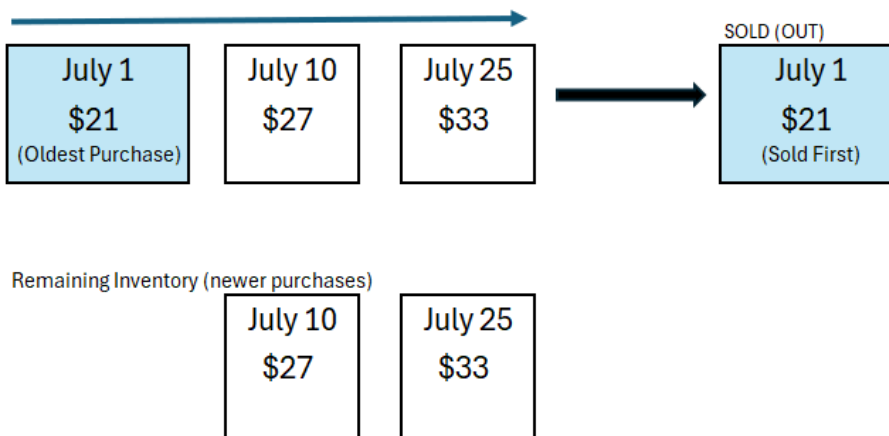


Figure 8.1.1: The oldest inventory is assumed to be sold first, leaving, leaving newer purchases in ending inventory. (CC BY-NC-ND 4.0; Illustration by Sandra Li). [Detailed text description of the Figure 8.1.1.](#)

The **first-in, first-out method (FIFO)** records costs relating to a sale as if the earliest purchased item would be sold first. However, the physical flow of the units sold under both the periodic and perpetual methods would be the same. Due to the mechanics of the determination of costs of goods sold under the perpetual method, based on the timing of additional purchases of inventory during the accounting period, it is possible that the costs of goods sold might be slightly different for an accounting period. Since FIFO assumes that the first items purchased are sold first, the latest acquisitions would be the items that remain in inventory at the end of the period and would constitute ending inventory.

Three separate lots of goods are purchased:

Table 8.1.4: Dataset of three different Inventory Lot with Unit cost of each lot

Inventory Lot	Number of Units	Unit Cost
Lot 1*	150	\$21
Lot 2	225	\$27
Lot 3	210	\$33

Table 8.1.5: Gross Margin calculation of unit from Lot 1

Sales Revenue	\$36
Less: Cost of Good Sold from Lot 1*	\$21
Gross Margin for one unit	\$15

Last-in, First-out (LIFO) Method

LIFO (Last-In, First-Out)—Latest items purchased are the first items sold

PURCHASES (oldest to newest)

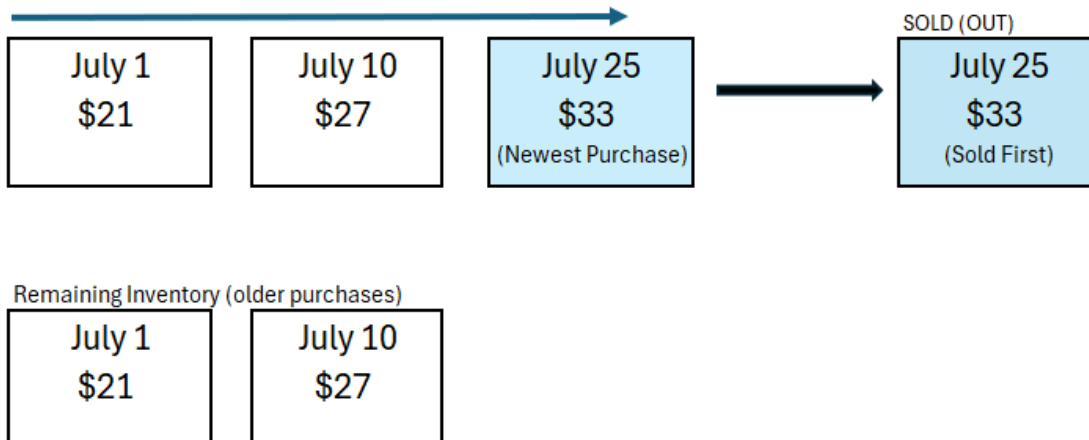


Figure 8.1.2: The newest inventory is assumed to be sold first, older purchases in ending inventory. (CC BY-NC-ND 4.0; Illustration by Sandra Li). Detailed text description of the Figure 8.1.2.

The **last-in, first out method (LIFO)** records costs relating to a sale as if the latest purchased item would be sold first. As a result, the earliest acquisitions would be the items that remain in inventory at the end of the period.

Three separate lots of goods are purchased:

Table 8.1.6: Dataset of three different Inventory Lot with Unit cost of each lot

Inventory Lot	Number of Units	Unit Cost
Lot 1	150	\$21
Lot 2	225	\$27
Lot 3*	210	\$33

Table 8.1.7: Gross Margin calculation of unit from Lot 3

Sales Revenue	\$36
Less: Cost of Good Sold from Lot 3*	\$33
Gross Margin for one unit	\$3

Weighted-Average Cost Method

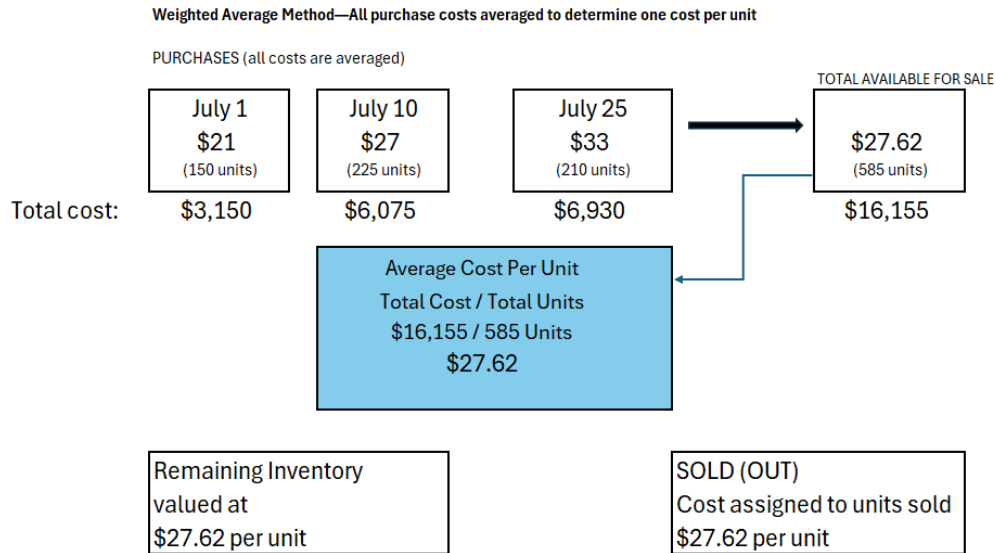


Figure 8.1.3: Weighted average cost inventory cost flow showing the average cost of \$27.62 per unit for sales and ending inventory. (CC BY-NC-ND 4.0; Illustration by Sandra Li). [Detailed text description of the Figure 8.1.3.](#)

The **weighted-average cost method** (sometimes referred to as the average cost method) requires a calculation of the average cost of all units of each particular inventory items. The average is obtained by multiplying the number of units by the cost paid per unit for each lot of goods, then adding the calculated total value of all lots together, and finally dividing the total cost by the total number of units for that product. As a caveat relating to the average cost method, note that a new average cost must be calculated after every change in inventory to reassess the per-unit weighted-average value of the goods. This laborious requirement might make use of the average method cost-prohibitive.

Three separate lots of goods are purchased:

Table 8.1.8: Dataset of three different Inventory Lot with Unit cost of each lot

Inventory Lot	Number of Units	Unit Cost
Lot 1	150	\$21
Lot 2	225	\$27
Lot 3	210	\$33

Table 8.1.9: Gross Margin calculation of unit from Lot 3

Sales Revenue	\$36.00
Less: Cost, assuming average cost of units sold from Lot 1, 2, and 3	\$27.62
Gross Margin for one unit	\$ 8.38

The total purchase amount for Lot 1 is \$3,150 which has 150 units, and the total purchase amount for Lot 2 is \$6,075 which has 225 units. Lot 3 has a total value of \$6,930, which has 210 units. We add the total available for sale inventory value and we get \$16,155. We have total available units for sale at 585 by adding up the units from Lot 1, 2, and 3. The average is taken by dividing the total amount of \$16,155 into 585 units available for sale. We get the average cost per unit of \$27.62.

Comparison of the Four Inventory methods

Comparing the various costing methods for the sale of one unit in this simple example reveals a significant difference that the choice of cost allocation method can make. Note that the sales price is not affected by the cost assumptions; only the cost amount varies, depending on which method is chosen. Table 8.1.10 depicts the different outcomes that the four methods produced.

Table 8.1.10: Comparison of the Four Costing Methods. One unit sold for \$36.

	Specific Identification	FIFO	LIFO	Weighted Average
Sales Revenue	\$36	\$36	\$36	\$36.00
Less: Cost, under each cost allocation method	\$27	\$21	\$33	\$27.62
Gross Margin for one unit	\$ 9	\$15	\$ 3	\$ 8.38

Once the methods of costing are determined for the company, that methodology would typically be applied repeatedly over the remainder of the company's history to accomplish the generally accepted accounting principle of **consistency** from one period to another. It is possible to change methods if the company finds that a different method more accurately reflects results of operations, but the change requires disclosure in the company's notes to the financial statements, which alerts financial statement users of the impact of the change in methodology. Also, it is important to realize that although the Internal Revenue Service generally allows differing methods of accounting treatment for tax purposes than for financial statement purposes, an exception exists that prohibits the use of LIFO inventory costing on the company tax return unless LIFO is also used for the financial statement costing calculations.

ETHICAL CONSIDERATIONS

Auditors Look for Inventory Fraud

Inventory fraud can be used to book false revenue or to increase the amount of assets to obtain additional lending from a bank or other sources. In the typical chain of accounting events, inventory ultimately becomes an expense item known as cost of goods sold.¹ In a manipulated accounting system, a trail of fraudulent transactions can point to accounting misrepresentation in the sales cycle, which may include

- recording fictitious and nonexistent inventory,
- manipulation of inventory counts during a facility audit,
- recording of sales but no recording of purchases, and/or
- fraudulent inventory capitalization,

to list a few.² All these elaborate schemes have the same goal: to improperly manipulate inventory values to support the creation of a fraudulent financial statement. Accountants have an ethical, moral, and legal duty to not commit accounting and financial statement fraud. Auditors have a duty to look for such inventory fraud.

Auditors follow the Statement on Auditing Standards (SAS) No. 99 and AU Section 316 Consideration of Fraud in a Financial Statement Audit when auditing a company's books. Auditors are outside accountants hired to "obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."³ Ultimately, an auditor will prepare an audit report based on the testing of the balances in a company's books, and a review of the company's accounting system. The auditor is to perform "procedures at locations on a surprise or unannounced basis, for example, observing inventory on unexpected dates or at unexpected locations or counting cash on a surprise basis."⁴ Such testing of a company's inventory system is used to catch accounting fraud. It is the responsibility of the accountant to present accurate accounting records to the auditor, and for the auditor to create auditing procedures that reasonably ensure that the inventory balances are free of material misstatements in the accounting balances.

Note

In The Real World

In the '80s, there was an electronic retailer called Crazy Eddie who became the fastest-growing retail chain in the United States. Investigators discovered that the company executives intentionally overstated inventory and manipulated financial records to produce higher profits that actually existed. Since ending inventory was overstated (more than it should have been), cost of goods sold was understated (lower than what it should have been), resulting in gross profit and net income to appear a lot higher. This fraud led to criminal convictions and the collapse of the company.

Inflationary Versus Deflationary Cycles

As prices rise (inflationary times), FIFO ending inventory account balances grow larger even when inventory unit counts are constant, while the income statement reflects lower cost of goods sold than the current prices for those goods, which produces higher profits than if the goods were costed with current inventory prices. Conversely, when prices fall (deflationary times), FIFO ending inventory account balances decrease and the income statement reflects higher cost of goods sold and lower profits than if goods were costed at current inventory prices. The effect of inflationary and deflationary cycles on LIFO inventory valuation are the exact opposite of their effects on FIFO inventory valuation.

Footnotes

- ¹ “Inventory Fraud: Knowledge Is Your First Line of Defense.” Weaver. Mar. 27, 2015. [weaver.com]
- ² Wells, Joseph T. “Ghost Goods: How to Spot Phantom Inventory.” *Journal of Accountancy*. June 1, 2001.
- ³ American Institute of Certified Public Accountants (AICPA). *Consideration of Fraud in a Financial Statement Audit* (AU Section 316).
- ⁴ American Institute of Certified Public Accountants (AICPA). *Consideration of Fraud in a Financial Statement Audit* (AU Section 316).

This page titled [8.1: Inventory Valuation Methods and Comparison](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [10.1: Describe and Demonstrate the Basic Inventory Valuation Methods and Their Cost Flow Assumptions](#) by OpenStax is licensed [CC BY-NC-SA 4.0](#). Original source: <https://openstax.org/details/books/principles-financial-accounting>.

8.2: Calculate COGS and Ending Inventory

Overview

In this section, you will learn how to calculate Cost of Goods Sold and Ending Inventory for a perpetual inventory system.

In a perpetual inventory system, merchandise inventory and cost of goods sold are updated after every purchase and sale. Although modern businesses use computerized systems to perform these calculations automatically, the underlying accounting follows the same principles demonstrated in this section.

CONCEPTS IN PRACTICE

Perpetual Inventory's Advancements through Technology

UPC barcodes and RFID technology allow businesses to track inventory in real time, making perpetual inventory systems practical and cost-effective.

Information Relating to All Cost Allocation Methods, but Specific to Perpetual Inventory Updating

Let's return to The Spy Who Loves You Corporation data to demonstrate the four cost allocation methods, assuming inventory is updated on an ongoing basis in a perpetual system.

Cost Data for Calculations

Company: Spy Who Loves You Corporation

Product: Global Positioning System (GPS) Tracking Device

Description: This product is an economical real-time GPS tracking device, designed for individuals who wish to monitor others' whereabouts. It is being marketed to parents of middle school and high school students as a safety measure. Parents benefit by being apprised of the child's location, and the student benefits by not having to constantly check in with parents. Demand for the product has spiked during the current fiscal period, while supply is limited, causing the selling price to escalate rapidly. Note: For simplicity of demonstration, beginning inventory cost is assumed to be \$21 per unit for all cost assumption methods.

Table 8.2.1: Dataset of Inventory activity of GPS tracking device for the month of July

Inventory Activity	Number of Units	Unit Cost	Sales Price
Beginning Inventory on July 1	150	\$21	No data available
Sold on July 5	120	No data available	\$36
Purchased on July 10	225	\$27	No data available
Sold on July 15	180	No data available	\$39
Purchased on July 25	210	\$33	No data available
Ending Inventory on July 31	285	No data available	No data available

Inventory Purchases and Sales (Perpetual Inventory System)

Regardless of the inventory cost flow assumption used, the perpetual inventory system records two journal entries for each sale:

one to record the sales revenue and a second to record the cost of goods sold and reduce merchandise inventory. As inventory is purchased throughout the period, its cost is added directly to the Merchandise Inventory account. Because inventory records are updated continuously, only minor adjustments, if any, are typically needed at the end of the period to reconcile the accounting records with the physical inventory count.

Specific Identification

Under the specific identification method, each inventory item is tracked individually so that its actual cost is assigned to cost of goods sold when that specific item is sold.

For this example, assume the following units were sold:

- July 5: 120 units from Lot 1 (beginning inventory) at \$21 per unit
- July 15: 20 units from Lot 1 at \$21 per unit and 160 units from Lot 2 (July 10 purchase) at \$27 per unit.

The July 5 sale results in cost of goods sold of \$2,520 (120 x \$21), leaving 30 units remaining from beginning inventory. After purchasing 225 units at \$27 on July 10, the July 15 sale removes the designated 20 units at \$21 and 160 units at \$27, resulting in cost of goods sold of \$4,740.

Following the second sale, inventory consisted of 10 units at \$21 and 65 units at \$27. After purchasing an additional 210 units at \$33 on July 25, ending inventory consisted of:

- 10 units at \$21
- 65 units at \$27
- 210 units at \$33

The total ending inventory under the specific identification method is \$8,895.

Specific Identification Calculations

Table 8.2.2 summarizes how the specific identification method assigns costs to cost of goods sold and ending inventory under the perpetual inventory system.

Table 8.2.2: Specific Identification Cost Assignments (Perpetual Method)

Inventory Activity	Cost of Goods Purchased (Number of Units)	Cost of Goods Purchased (Unit Cost)	Cost of Goods Purchased (Total Cost)	Cost of Goods Sold (Number of Units)	Cost of Goods Sold (Unit Cost)	Cost of Goods Sold (Total Cost)	Cost of Inventory Remaining (Number of Units)	Cost of Inventory Remaining (Unit Cost)	Cost of Inventory Remaining (Total Cost)
Beginning July 1	No data available	No data available	No data available	No data available	No data available	No data available	150	\$21	\$3,150
Sale, July 5	No data available	No data available	No data available	120	\$21	\$2,520	30	\$21	\$ 630
Purchase, July 10	225	\$27	\$6,075	No data available	No data available	No data available	30 225	\$21 \$27	\$ 630 \$6,075
Sale, July 15	No data available	No data available	No data available	20 160	\$21 \$27	\$ 420 \$4,320	10 65	\$21 \$27	\$ 210 \$1,755
Purchase, July 25	210	\$33	\$6,930	No data available	No data available	No data available	10 65 210	\$21 \$27 \$33	\$ 210 \$1,755 \$6,930

Inventory Activity	Cost of Goods Purchased (Number of Units)	Cost of Goods Purchased (Unit Cost)	Cost of Goods Purchased (Total Cost)	Cost of Goods Sold (Number of Units)	Cost of Goods Sold (Unit Cost)	Cost of Goods Sold (Total Cost)	Cost of Inventory Remaining (Number of Units)	Cost of Inventory Remaining (Unit Cost)	Cost of Inventory Remaining (Total Cost)
Total	No data available	No data available	\$13,005 Total Purchase in July	No data available	No data available	\$7,260 Total Cost of Good Sold	No data available	No data available	No data available

Under the specific identification method, ending inventory on July 31 is \$8,895. This amount is reported as Merchandise Inventory on the balance sheet before any necessary inventory adjustments, such as shrinkage or write-downs. Table 8.2.3 shows the inventory layers that make up the ending inventory balance of \$8,895.

Table 8.2.3: Ending Inventory under Specific Identification

Number of Units	Unit Cost	Total Cost
10	\$21	\$210
65	\$27	\$1,755
210	\$33	\$6,930
285 Total Units	No data available	\$8,895 Total Inventory Cost

Table 8.2.4: Gross Margin under Specific Identification

Sales	\$11,340
Less: Cost of Goods Sold	\$ 7,260
Gross Margin	\$4,080

Gross margin equals sales revenue minus cost of goods sold. Because sales revenue is identical under all four methods, differences in gross margin result solely from differences in the cost-flow assumption. Sales is \$11,340. Subtracting specific identification cost of goods sold of \$7,260 (Table 8.2.4) produces a gross margin of \$4,080.

First-in, First-out (FIFO)

The first-in, first-out method (FIFO) assumes that the oldest inventory costs are assigned to cost of goods sold first, leaving the newest costs in ending inventory.

Using the perpetual inventory system, the July 5 sale uses beginning inventory. The July 15 sale first uses the remaining beginning inventory and then the oldest units from the July 10 purchase.

After the July 25 purchase, ending inventory consists entirely of the remaining July 10 units and the July 25 purchase.

FIFO Cost of Goods Sold, Ending Inventory, and Gross Margin

Table 8.2.5 summarizes the FIFO cost assignments for each inventory transaction under the perpetual inventory system and shows how cost of goods sold and ending inventory are determined.

Table 8.2.5: FIFO Cost Assignments Under the Perpetual Inventory System

Inventory Activity	Cost of Goods Purchased (Number of Units)	Cost of Goods Purchased (Unit Cost)	Cost of Goods Purchased (Total Cost)	Cost of Goods Sold (Number of Units)	Cost of Goods Sold (Unit Cost)	Cost of Goods Sold (Total Cost)	Cost of Inventory Remaining (Number of Units)	Cost of Inventory Remaining (Unit Cost)	Cost of Inventory Remaining (Total Cost)
Beginning July 1	No data available	No data available	No data available	No data available	No data available	No data available	150	\$21	\$3,150
Sale, July 5	No data available	No data available	No data available	120	\$21	\$2,520	30	\$21	\$ 630
Purchase, July 10	225	\$27	\$6,075	No data available	No data available	No data available	30 225	\$21 \$27	\$ 630 \$6,075
Sale, July 15	No data available	No data available	No data available	30 150	\$21 \$27	\$ 630 \$4,050	- 75	\$- \$27	\$ - \$2,025
Purchase, July 25	210	\$33	\$6,930	No data available	No data available	No data available	75 210	\$27 \$33	\$2,025 \$6,930
Total	No data available	No data available	\$13,005 Total Purchase in July	No data available	No data available	\$7,200 Total Cost of Good Sold	No data available	No data available	

Under
FIFO,
ending
inventory
on
July
31
is
\$8,955.

Table

below
breaks
down
the
inventory
layers
that
make
up
the
ending
inventory
balance
of
\$8,955.

Table 8.2.6: Calculation of July's
ending Inventory under FIFO
method

Number of Units	Unit Cost	Total Cost
75	\$27	\$2,025
210	\$33	\$6,930
285 Total Units	No data available	\$8,955 Total Inventory Cost

Table 8.2.7: Gross Margin calculation under FIFO method

Sales	\$11,340
Less: Cost of Goods Sold	\$ 7,200
Gross Margin	\$ 4,140

Total sales is \$11,340. Subtracting FIFO cost of goods sold of \$7,200 (Table 8.2.7) results in gross margin of \$4,140.

Last-in, First-out (LIFO)

Last-in, first-out (LIFO) assumes that the newest inventory costs are assigned to cost of goods sold first, while the oldest costs remain in ending inventory.

Under the perpetual inventory system, the July 5 sale of 120 units is assumed to come entirely from beginning inventory at \$21 per unit, resulting in cost of goods sold of \$2,520. After that sale, 30 units remained in beginning inventory.

On July 10, the company purchased 225 units at \$27 each. When 180 units were sold on July 15, LIFO assigns all 180 units to the most recent purchase at \$27 per unit, resulting in cost of goods sold of \$4,860.

Following the second sale, inventory consisted of 30 units at \$21 and 45 units at \$27. After purchasing an additional 210 units at \$33 on July 25, ending inventory consisted of:

- 30 units at \$21
- 45 units at \$27
- 210 units at \$33

The total ending inventory under the LIFO method is \$8,775.

Calculations of Costs of Goods Sold, Ending Inventory, and Gross Margin, Last-in, First-out (LIFO)

Table 8.2.8 summarizes how the LIFO method assigns costs to cost of goods sold and ending inventory under the perpetual inventory system.

Table 8.2.8: LIFO Cost Assignments Under the Perpetual Inventory System

Inventory Activity	Cost of Goods Purchased (Number of Units)	Cost of Goods Purchased (Unit Cost)	Cost of Goods Purchased (Total Cost)	Cost of Goods Sold (Number of Units)	Cost of Goods Sold (Unit Cost)	Cost of Goods Sold (Total Cost)	Cost of Inventory Remaining (Number of Units)	Cost of Inventory Remaining (Unit Cost)	Cost of Inventory Remaining (Total Cost)
Beginning July 1	No data available	No data available	No data available	No data available	No data available	No data available	150	\$21	\$3,150
Sale, July 5	No data available	No data available	No data available	120	\$21	\$2,520	30	\$21	\$ 630
Purchase, July 10	225	\$27	\$6,075	No data available	No data available	No data available	30 225	\$21 \$27	\$ 630 \$6,075
Sale, July 15	No data available	No data available	No data available	180	\$27	\$4,860	30 45	\$21 \$27	\$ 630 \$1,215
Purchase, July 25	210	\$33	\$6,930	No data available	No data available	No data available	30 45 210	\$21 \$27 \$33	\$ 630 \$1,215 \$6,930
Total	No data available	No data available	\$13,005 Total Purchase in July	No data available	No data available	\$7,380 Total Cost of Good Sold	No data available	No data available	

Under
the
LIFO
method,
ending
inventory
on
July
31
is
\$8,775.

Table

below
breaks
down
the
inventory
layers
that
make
up
the
ending
inventory
balance
of
\$8,775.

Table 8.2.9: Ending Inventory
under the LIFO Method

Number of Units	Unit Cost	Total Cost
30	\$21	\$ 630
45	\$37	\$1,215
210	\$33	\$6,930
285 Total Units	No data available	\$8,775 Total Inventory Cost

Table 8.2.10: Gross Margin calculation under LIFO Method

Sales	\$11,340
Less: Cost of Goods Sold	\$ 7,380
Gross Margin	\$ 3,960

Total sales is \$11,340. Subtracting LIFO cost of goods sold of \$7,380 (Table 8.2.10) results in gross margin of \$3,960.

Weighted-Average Cost (AVG)

Under the perpetual weighted-average method (AVG) method, a new average unit cost is calculated after every inventory purchase. Each subsequent sale uses this updated average until another purchase occurs.

Beginning inventory consisted of 150 units costing \$21 each, so the first sale also used a cost of \$21 per unit.

After purchasing 225 units at \$27 each, the average cost became \$26.29 per unit.

The July 15 sale used this new average cost.

Following the July 25 purchase, the average increased to \$31.24 per unit, resulting in ending inventory of approximately \$8,902.

Calculating Costs of Goods Sold, Ending Inventory, and Gross Margin using Weighted Average (AVG)

Table 8.2.11 summarizes how the Weighted Average method assigns costs to cost of goods sold and ending inventory under the perpetual inventory system.

Table 8.2.11: Weighted Average Cost Assignments Under the Perpetual Inventory System

Inventory Activity	Cost of Goods Purchased (Number of Units)	Cost of Goods Purchased (Unit Cost)	Cost of Goods Purchased (Total Cost)	Cost of Goods Sold (Number of Units)	Cost of Goods Sold (Unit Cost)	Cost of Goods Sold (Total Cost)	Cost of Inventory Remaining (Number of Units)	Cost of Inventory Remaining (Unit Cost)	Cost of Inventory Remaining (Total Cost)
Beginning July 1	No data available	No data available	No data available	No data available	No data available	No data available	150	\$21.00	\$3,150
Sale, July 5	No data available	No data available	No data available	120	\$21.00	\$2,520	30	\$21.00	\$ 630
Purchase, July 10	225	\$27.00	\$6,075	No data available	No data available	No data available	255	\$26.29	\$6,705 No data available
Sale, July 15	No data available	No data available	No data available	180	\$26.29	\$4,733	75	\$26.29	\$1,972
Purchase, July 25	210	\$33.00	\$6,930	No data available	No data available	No data available	285	\$31.24	\$8,902
Total	No data available	No data available	\$13,005 Total Purchase in July	No data available	No data available	\$7,253 Total Cost of Good Sold	No data available	No data available	

The AVG costing assumption tracks inventory items based on lots of goods that are combined and re-averaged after each new acquisition to determine a new average cost per unit so that, when they are sold, the latest averaged cost items are used to offset the revenue from the sale. The cost of goods sold, inventory, and gross margin shown in Table 8.2.12 were determined from the previously-stated data, particular to perpetual, AVG costing.

Table 8.2.12: Gross Margin calculation under Weighted Average method

Sales	\$11,340
Less: Cost of Goods Sold	\$ 7,253
Gross Margin	\$4,087

Total sales is \$11,340. Subtracting Weighted Average cost of goods sold of \$7,253. Table 8.2.12 results in gross margin of \$4,087.

Comparison of All Four Methods, Perpetual

The outcomes for gross margin, under each of these different cost assumptions, is summarized in Table 8.2.13.

Table 8.2.13: Gross Margin Comparison

Inventory Method Comparison	Specific Identification	FIFO	LIFO	Weighted Average
Sales Revenue	\$11,340	\$11,340	\$11,340	\$11,340
Less: Cost of Goods Sold	\$7,260	\$7,200	\$7,380	\$7,253
Gross Margin	\$4,080	\$4,140	\$3,960	\$4,087

Recap

Table 8.2.14: Inventory Method and Effect

Inventory Method	Effect
Specific Identification	Uses the actual cost of the specific units sold.
FIFO	Oldest costs become cost of goods sold; newest costs remain in inventory.
LIFO	Newest costs become cost of goods sold; oldest costs remain in inventory.
Weighted Average	Assigns the same average cost to every unit until another purchase changes the average.

This page titled [8.2: Calculate COGS and Ending Inventory](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- [10.3: Calculate the Cost of Goods Sold and Ending Inventory Using the Perpetual Method](#) by [OpenStax](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://openstax.org/details/books/principles-financial-accounting>.

8.3: Summary

Inventory Cost Flow Assumptions

- Inventory cost flow assumptions determine **which inventory costs become Cost of Goods Sold (COGS)** and **which costs remain in Ending Inventory**.
- The physical flow of inventory does not have to match the accounting cost flow assumption.
- Different inventory methods can produce different amounts for:
 - Cost of Goods Sold
 - Ending Inventory
 - Gross Margin
 - Net Income

The Four Inventory Valuation Methods

- **Specific Identification** assigns the actual cost of the specific item sold and is best suited for unique or high-value inventory.
- **FIFO (First-In, First-Out)** assumes the oldest inventory costs are sold first.
- **LIFO (Last-In, First-Out)** assumes the newest inventory costs are sold first.
- **Weighted Average (AVG)** assigns an average cost to inventory units rather than tracking individual inventory layers.

Perpetual Inventory System

- A perpetual inventory system updates **Merchandise Inventory** and **Cost of Goods Sold** after every purchase and sale.
- Modern computerized inventory systems perform these calculations automatically.
- Every sale requires two journal entries:
 - One entry to record the sales revenue.
 - One entry to record Cost of Goods Sold and reduce Merchandise Inventory.

Comparing the Inventory Methods

- **Specific Identification** reports the actual cost of the specific units sold.
- **FIFO** generally reports the following during periods of rising prices:
 - Lower Cost of Goods Sold
 - Higher Ending Inventory
 - Higher Gross Margin
- **LIFO** generally reports the following during periods of rising prices:
 - Higher Cost of Goods Sold
 - Lower Ending Inventory
 - Lower Gross Margin
- **Weighted Average** produces results between FIFO and LIFO by averaging inventory costs.

Weighted Average Cost

- Under the perpetual weighted-average method, a **new average unit cost** is calculated after every inventory purchase.
- Each sale uses the current average cost until another purchase changes the average.

Financial Statement Impact

- Inventory costing methods affect:
 - Cost of Goods Sold
 - Ending Inventory
 - Gross Margin

- Net Income
- The inventory method does not affect:
 - Sales Revenue
 - Cash received from customers
 - The physical quantity of inventory sold

Consistency Principle

- Once a company selects an inventory costing method, it should apply that method consistently from period to period.
- If the company changes methods, the change should be disclosed in the notes to the financial statements.

Inventory Fraud and Ethics

- Overstating inventory causes:
 - Cost of Goods Sold to be understated.
 - Gross Margin and Net Income to be overstated.
- Auditors perform inventory observations, physical counts, and other procedures to help detect inventory fraud.
- Maintaining accurate inventory records is an important ethical responsibility for accountants.

8.4: Practice Questions

Multiple Choice Questions

Exercise 8.4.1

1. If a company has four lots of products for sale, purchase 1 (earliest) for \$17, purchase 2 (middle) for \$15, purchase 3 (middle) for \$12, and purchase 4 (latest) for \$14, which cost would be assumed to be sold first using LIFO costing?
 - a. \$17
 - b. \$15
 - c. \$12
 - d. \$14
2. If a company has three lots of products for sale, purchase 1 (earliest) for \$17, purchase 2 (middle) for \$15, purchase 3 (latest) for \$12, which of the following statements is true?
 - a. This is an inflationary cost pattern.
 - b. This is a deflationary cost pattern.
 - c. The next purchase will cost less than \$12.
 - d. None of these statements can be verified.
3. When inventory items are highly specialized, the best inventory costing method is _____.
 - a. specific identification
 - b. first-in, first-out
 - c. last-in, first-out
 - d. weighted average
4. On which financial statement would the Merchandise Inventory account appear?
 - a. balance sheet
 - b. income statement
 - c. both balance sheet and income statement
 - d. neither balance sheet nor income statement
5. When would using the FIFO inventory costing method produce higher inventory account balances than the LIFO method would?
 - a. inflationary times
 - b. deflationary times
 - c. always
 - d. never
6. Which type of inventory system (periodic or perpetual) requires two journal entries every time a sale is made?
 - a. periodic
 - b. perpetual
 - c. both periodic and perpetual
 - d. neither periodic nor perpetual
7. Which of these statements is false?
 - a. If Cost of Goods Sold is incorrect, ending inventory is usually incorrect too.
 - b. $\text{Beginning inventory} + \text{purchases} = \text{Cost of Goods Sold}$.
 - c. $\text{Ending inventory} + \text{Cost of Goods Sold} = \text{Goods Available for Sale}$.
 - d. $\text{Goods Available for Sale} - \text{beginning inventory} = \text{purchases}$.
8. Which inventory costing method is almost always done on a perpetual basis?
 - a. specific identification
 - b. first-in, first-out
 - c. last-in, first-out
 - d. weighted average
9. Which of the following describes features of a perpetual inventory system?
 - a. Technology is normally used to record inventory changes.
 - b. Merchandise purchased is recorded as Purchases.
 - c. An adjusting journal entry is required at year-end to match physical counts to the asset account.

- d. Inventory is updated only at the end of the accounting period.
10. Which financial statements would be impacted by a current-year ending inventory error when using a periodic inventory system?
- balance sheet
 - income statement
 - neither statement
 - both statements
11. Which of the following would cause periodic ending inventory to be overstated?
- Goods held on consignment are omitted from the physical count.
 - Goods purchased and delivered, but not yet paid for, are included in the physical count.
 - Purchased goods shipped FOB destination and not yet delivered are included in the physical count.
 - None of the above.

Answer available at the end of this section.

Answers

Exercise 8.4.1

Table 8.4.1: Answers to multiple choice questions

Question	Answer	Explanation
1	d.	Under the last-in, first-out (LIFO) method, the most recently purchased inventory is assumed to be sold first.
2	b.	This is a deflationary cost pattern because the purchase costs decrease over time (\$17, \$15, then \$12).
3	a.	Specific identification is best for highly specialized or unique inventory items because the actual cost of each item can be tracked.
4	a.	Merchandise Inventory is reported as a current asset on the balance sheet.
5	a.	During inflationary periods, FIFO leaves the newer, higher-cost inventory in ending inventory, resulting in a higher inventory balance than LIFO.
6	b.	Under a perpetual inventory system, each sale requires two journal entries: one to record the sale and one to record the cost of goods sold.
7	b.	This statement is false because the correct formula is: Beginning Inventory + Purchases = Goods Available for Sale, not Cost of Goods Sold.
8	a.	Specific identification is almost always maintained using a perpetual inventory system because each individual item must be tracked.

Question	Answer	Explanation
9	a.	A perpetual inventory system typically uses technology, such as barcode scanners or point-of-sale systems, to continuously update inventory records.
10	d.	An ending inventory error affects both the balance sheet (inventory) and the income statement (Cost of Goods Sold and net income).
11	c.	Goods shipped FOB destination are still owned by the seller while in transit. Including them in the buyer's physical count before delivery would overstate ending inventory.

8.5: Alternate Text Description

Figure 8.1.1: FIFO (First-In, First-Out) Inventory Cost Flow

The diagram illustrates the FIFO (First-In, First-Out) inventory method. Three inventory purchases are shown in chronological order: July 1 for \$21, July 10 for \$27, and July 25 for \$33. Under FIFO, the oldest item purchased, the July 1 item costing \$21, is sold first. The remaining inventory consists of the newer purchases from July 10 (\$27) and July 25 (\$33). The arrows indicate the flow of inventory from oldest purchases to sold items.

Figure 8.1.2: LIFO (Last-In, First-Out) Inventory Cost Flow

The diagram illustrates the LIFO (Last-In, First-Out) inventory method. Three inventory purchases are shown in order: July 1 for \$21, July 10 for \$27, and July 25 for \$33. Under LIFO, the newest item purchased, the July 25 item costing \$33, is sold first. The remaining inventory consists of the older purchases from July 1 (\$21) and July 10 (\$27). Arrows indicate that the most recently purchased inventory is the first inventory sold.

Figure 8.1.3: Weighted-Average Inventory Cost Method

The diagram illustrates the weighted-average inventory method. Inventory purchases on July 1, July 10, and July 25 have different unit costs and quantities. The total inventory cost of \$16,155 is divided by 585 units to calculate an average cost of \$27.62 per unit. This same average cost is then used to value both units sold and ending inventory.

INDEX

No index terms found.

GLOSSARY

S

Sample Word 1 | Sample Definition 1

This page titled [Glossary](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by Sandra Li.

DETAILED LICENSING

Overview

Title: Financial Accounting Foundations: A Practical Introduction to the Language of Business

Webpages: 85

Applicable Restrictions: Noncommercial

All licenses found:

- [CC BY-NC-SA 4.0](#): 92.9% (79 pages)
- [Public Domain](#): 3.5% (3 pages)
- [Undeclared](#): 3.5% (3 pages)

By Page

- Financial Accounting Foundations: A Practical Introduction to the Language of Business - [CC BY-NC-SA 4.0](#)
 - Front Matter - [CC BY-NC-SA 4.0](#)
 - [TitlePage](#) - [CC BY-NC-SA 4.0](#)
 - [InfoPage](#) - [Public Domain](#)
 - [Table of Contents](#) - [Public Domain](#)
 - [Licensing](#) - [CC BY-NC-SA 4.0](#)
 - [Program Page](#) - [Undeclared](#)
 - [Accessibility Statement](#) - [Undeclared](#)
 - [AI Use](#) - [Undeclared](#)
 - [About the Book](#) - [CC BY-NC-SA 4.0](#)
 - [About the Author](#) - [CC BY-NC-SA 4.0](#)
 - 1: Introduction to Financial Accounting - [CC BY-NC-SA 4.0](#)
 - 1.1: Importance of Accounting - [CC BY-NC-SA 4.0](#)
 - 1.2: Users of Accounting Information - [CC BY-NC-SA 4.0](#)
 - 1.3: Financial vs Managerial Accounting - [CC BY-NC-SA 4.0](#)
 - 1.4: Types of Organizations - [CC BY-NC-SA 4.0](#)
 - 1.5: Accounting Career Pathways - [CC BY-NC-SA 4.0](#)
 - 1.6: Introduction to The Accounting Cycle - [CC BY-NC-SA 4.0](#)
 - 1.7: Summary - [CC BY-NC-SA 4.0](#)
 - 1.8: Key Terms - [CC BY-NC-SA 4.0](#)
 - 1.9: Practice Questions - [CC BY-NC-SA 4.0](#)
 - 1.10: Alternate Text Descriptions - [CC BY-NC-SA 4.0](#)
 - 2: Accounting Equation and Journal Rules - [CC BY-NC-SA 4.0](#)
 - 2.1: The Accounting Equation - [CC BY-NC-SA 4.0](#)
 - 2.2: The Expanded Accounting Equation - [CC BY-NC-SA 4.0](#)
 - 2.3: Transaction Analysis - Example - [CC BY-NC-SA 4.0](#)
 - 2.4: Debit and Credit Rules - [CC BY-NC-SA 4.0](#)
 - 2.5: Applying the Debit and Credit Rules - [CC BY-NC-SA 4.0](#)
 - 2.6: Summary - [CC BY-NC-SA 4.0](#)
 - 2.7: Key Terms - [CC BY-NC-SA 4.0](#)
 - 2.8: Practice Questions - [CC BY-NC-SA 4.0](#)
 - 2.9: Alternative Text Descriptions - [CC BY-NC-SA 4.0](#)
 - 3: Journalizing Transactions - [CC BY-NC-SA 4.0](#)
 - 3.1: Journal Entry - [CC BY-NC-SA 4.0](#)
 - 3.2: Journalizing Transactions - [CC BY-NC-SA 4.0](#)
 - 3.3: Summary - [CC BY-NC-SA 4.0](#)
 - 3.4: Key Terms - [CC BY-NC-SA 4.0](#)
 - 3.5: Practice Questions - [CC BY-NC-SA 4.0](#)
 - 3.6: Alternate Text Descriptions - [CC BY-NC-SA 4.0](#)
 - 4: Posting and the Trial Balance - [CC BY-NC-SA 4.0](#)
 - 4.1: Posting to the General Ledger - [CC BY-NC-SA 4.0](#)
 - 4.2: Finding each account's balance - [CC BY-NC-SA 4.0](#)
 - 4.3: Journaling and posting to account - [CC BY-NC-SA 4.0](#)
 - 4.4: Prepare a Trial Balance - [CC BY-NC-SA 4.0](#)
 - 4.5: The Unadjusted Trial Balance - Example - [CC BY-NC-SA 4.0](#)
 - 4.6: Summary - [CC BY-NC-SA 4.0](#)
 - 4.7: Key Terms - [CC BY-NC-SA 4.0](#)
 - 4.8: Practice Questions - [CC BY-NC-SA 4.0](#)
 - 4.9: Alternate Text Descriptions - [CC BY-NC-SA 4.0](#)
 - 5: Accrual Accounting and Adjusting Entries - [CC BY-NC-SA 4.0](#)
 - 5.1: Accrual Accounting Foundations - [CC BY-](#)

- NC-SA 4.0
- 5.2: Cash vs Accrual comparison - CC BY-NC-SA 4.0
- 5.3: Adjusting Entries - CC BY-NC-SA 4.0
- 5.4: The Adjusted Trial Balance - CC BY-NC-SA 4.0
- 5.5: Summary - CC BY-NC-SA 4.0
- 5.6: Key Terms - CC BY-NC-SA 4.0
- 5.7: Practice Questions - CC BY-NC-SA 4.0
- 5.8: Alternate Text Descriptions - CC BY-NC-SA 4.0
- 6: Completing the Accounting Cycle - CC BY-NC-SA 4.0
 - 6.1: Worksheet - CC BY-NC-SA 4.0
 - 6.2: The Financial Statements - CC BY-NC-SA 4.0
 - 6.3: Closing Entries - CC BY-NC-SA 4.0
 - 6.4: Post-Closing Trial Balance - CC BY-NC-SA 4.0
 - 6.5: Key Terms - CC BY-NC-SA 4.0
 - 6.6: Practice Questions - CC BY-NC-SA 4.0
 - 6.7: Alternate Text Description - CC BY-NC-SA 4.0
- 7: Merchandising Transactions - CC BY-NC-SA 4.0
 - 7.1: The Perpetual Inventory System - CC BY-NC-SA 4.0
 - 7.2: The Periodic Inventory system - CC BY-NC-SA 4.0
 - 7.3: Comparing Inventory Systems - CC BY-NC-SA 4.0
 - 7.4: Accounting for Shipping Costs - CC BY-NC-SA 4.0
 - 7.5: Summary - CC BY-NC-SA 4.0
 - 7.6: Key Terms - CC BY-NC-SA 4.0
 - 7.7: Practice Questions - CC BY-NC-SA 4.0
 - 7.8: Alternate Text Description - CC BY-NC-SA 4.0
- 8: Inventory Cost Flow Assumptions - CC BY-NC-SA 4.0
 - 8.1: Inventory Valuation Methods and Comparison - CC BY-NC-SA 4.0
 - 8.2: Calculate COGS and Ending Inventory - CC BY-NC-SA 4.0
 - 8.3: Summary - CC BY-NC-SA 4.0
 - 8.4: Practice Questions - CC BY-NC-SA 4.0
 - 8.5: Alternate Text Description - CC BY-NC-SA 4.0
- Back Matter - CC BY-NC-SA 4.0
 - Index - Public Domain
 - Glossary - CC BY-NC-SA 4.0
 - Detailed Licensing - CC BY-NC-SA 4.0