Adjusting Entries and the Completion of the Accounting Cycle

The one thing that most accounting students come out of a four-year education not understanding is adjusting entries. For some reason this concept is one that escapes even the hardest workers and the most intelligent students of accounting (and we are all students of accounting, no matter how long we have been studying).

Adjusting entries refer to the adjusting journal entries. There are four types of adjusting entries:

1. recorded (prepaid) expense (RE),
2. recorded (unearned) revenue (RR),
3. Unrecorded expense (UE--payables) and
4. Unrecorded revenue (UR--receivables).

The four can be expressed as a 2 x 2 matrix:

\[
\begin{array}{cc}
RE & UE \\
RR & UR \\
\end{array}
\]

The construction from memory of the two-dimensional adjusting entry chart starts with two groups of two variables that you combine and permutate into the four types of adjusting entries. This chart should help you to more fully understand adjusting entries beyond any understanding you obtained in undergraduate (or even graduate) accounting.

Every adjusting entry has an associated journal entry that involves the recordation of cash. The cash is recorded either before or after the adjusting journal entry. *Recorded* and *unrecorded* refer to the timing of the cash payment or cash receipt which is recorded in the journal. Recorded adjusting journal entries come after the recording of the cash payment or cash receipt. Unrecorded adjusting journal entries come before the recording of the cash payment or cash receipt. The cash payment or cash receipt can be recorded in two ways: before or after the adjusting entry is recorded.

The cash payment or cash receipt can be made before the recorded adjusting journal entry into either a permanent (real or balance sheet) account (i.e., asset or liability account) or a temporary (nominal or income statement) account (i.e., expense or revenue account). Recorded adjusting entries are alternately referred to as deferred. Deferred is defined as the aligning (matching) of recorded costs and revenues with appropriate periods, where cash has previously been received or disbursed, but revenue has not been earned nor has expense been incurred.

The preferred recordation of the disbursement of an advance payment for products to be used or services to be performed or delivered in the future is into an asset account. This asset account could be called prepaid expense or deferred expense, but is most often more specific as to the type of expense, such as Unexpired Insurance. These accounts appear in the asset account section of the balance sheet and do not affect or appear in the income statement until the product is used or service is performed.
The preferred method of recording the cash is into a permanent account, so that the expense can be apportioned or deferred into the correct period, where the revenue is earned or the expense is used in the production of revenue. The alternate method, where the cash is recorded into an expense or revenue account at the time the cash is received or disbursed, will require a “correcting” adjusting entry to apportion the expense or revenue and to establish the corresponding asset or liability account to be apportioned in future periods.

While this might in text be confusing, let us look at the journal entries, so that we can see the pragmatic points in this discussion.

In business, many items are paid in advance that benefit or affect multiple subsequent accounting periods. An example of a prepaid (recorded) expense is the prepayment of insurance:

<table>
<thead>
<tr>
<th>Unexpired Insurance (asset)</th>
<th>600</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>600</td>
</tr>
</tbody>
</table>

(The recordation of the cash payment)

This journal entry represents the recordation of the payment (disbursement) of $600 for a one-year fire insurance policy. The apportioned cost is $50 per month for 12 months ($50 x 12 months equals $600 for one year). The policy becomes effective on the first of the month of the following adjusting entry.

<table>
<thead>
<tr>
<th>Insurance Expense (expense)</th>
<th>50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unexpired Insurance (asset)</td>
<td>50</td>
</tr>
</tbody>
</table>

(The adjusting entry)

Alternatively, the cash could be recorded directly into the expense account. Many bookkeepers, in order to keep from getting confused and to speed the recordation of journal entries, will use this method when they make journal entries. The adjustment at the end of the month for the adjusting entry requires specific knowledge of the transaction in order to apportion the amounts correctly. Recording the journal entry directly into expense requires no such knowledge, and speeds the day-to-day business activity.

<table>
<thead>
<tr>
<th>Insurance Expense (expense)</th>
<th>600</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>600</td>
</tr>
</tbody>
</table>

(The recordation of the cash payment)

The subsequent adjusting entry must be obtained from knowledge of the results of the first two transactions, where the cash was recorded against the asset account and not the expense account. T account (ledger account) analysis is the common means of doing the analysis.
In the first two journal entries (two transactions), the Cash account is reduced by $600 (credit), which is not material to the analysis. The Unexpired Insurance (asset) account is increased by $600 (debit), with the recordation of the cash, and then reduced by $50 (credit) with the adjusting entry. The result is a $550 debit balance in Unexpired Insurance (asset).

Since after the above cash payment entry directly to expense, there is no entry into the Unexpired Insurance (asset) account, the adjusting journal entry requires a debit to Unexpired Insurance (asset) in the amount of $550 to make the balance in the Unexpired Insurance (asset) account correct.

The Insurance Expense account has $600 (debit) in the account and it is supposed to have $50 (debit) for one month’s expired insurance in the Insurance Expense Account. In order to bring this account to the “correct balance,” the $600 in the Insurance expense account must be reduced (credited) by $550. The resulting adjusting journal entry is:

\[
\begin{align*}
\text{Unexpired Insurance (asset)} & \quad 550 \\
\text{Insurance Expense (expense)} & \quad 550 \\
\end{align*}
\]
(The adjusting entry)

A similar journal entry can be used to record the apportionment of prepaid Office Supplies (asset) into Office Supplies Expense as the supplies are used. The taking of an office supplies inventory will yield the proper amount for the adjusting journal entry. It should be noted that a Cost of Goods Sold computation is very similar, and is a recorded expense adjusting entry.

Any prepaid expense should be recorded similarly. The best example with which you are all familiar is the recorded expense adjusting entry for depreciation, amortization, and depletion. When preparing taxes, this apportionment is required in cash, accrual, and hybrid accounting methods.

The second type of adjusting entry that we will deal with is the apportioning of unearned (recorded) revenue. In business, it is common to be paid in advance for something that is refundable to the payee should services or product not be provided as agreed when the payment was made. Under the accrual basis of accounting the revenue is not recorded until the revenue is earned.

The preferred recordation of the receipt of an advance payment for future products or services is into a liability account. This liability account could be called unearned revenue or deferred revenue. These accounts appear in the liability account section of the balance sheet and do not affect or appear in the income statement until the revenue is earned.

In this example, a company that does real estate management receives an advance payment for real estate management fees of $300 per month for six months in the amount of $1800. The management fees are not considered earned until the end of the month.
Cash……………………………………………………………….. 1,800 
Unearned Management Fees (liability)………………….…  1,800 
(The recordation of the receipt of the cash payment)

At the end of the first month covered by the real estate management contract, it is proper to record the $300 earned in the first month of managing the real estate. The following adjusting entry is made to transfer an appropriate amount from the unearned revenue account (liability) to the earned revenue account (revenue).

Unearned Management Fees (liability)…………………………   300 
Management Fees Earned (revenue)……………………    300 
(The adjusting entry)

Just like we discussed with the journal entries for recorded (prepaid or deferred) expense, the journal entries for recorded (unearned or deferred) revenue can be recorded in a manner that makes the life of the day to day bookkeeper far less complicated and go more smoothly and quickly. In this case the bookkeeper would record any receipt of cash as revenue and let the end of the month journal entries sort out those items that require more thought, knowledge and time.

Cash……………………………………………………………….. 1,800 
Management Fees Earned (revenue)………………………  1,800 
(The recordation of the receipt of the cash payment)

When the person who has to do the end of the month adjusting entries goes to prepare the adjusting entry for this transaction, a ledger account (T account) analysis must be made. The cash account is fine and just like the earlier set of journal entries for recorded expense, the cash account is not material to this analysis.

The Management Fees Earned (revenue) account has a credit balance of $1,800 in the account and should only have the credit balance amount of $300 in the account for this transaction after the adjusting journal entry is made. This will require a debit to Management Fees Earned (revenue) in the amount of $1,500 (1,800 minus 300).

The balancing or credit portion of the adjusting journal entry is the establishment of the Unearned Management Fees (liability) account in the amount appropriate after the adjusting journal entry is made. This amount will equal the recordation of the cash receipt of $1,800 (credit) and the reduction of the Unearned Management Fees (liability) account by the $300 in Management Fees Earned (revenue) for a credit of $1,500 since this account must not only be credited for the correct amount but needs to be established.

Management Fees Earned (revenue)................. 1,500 
Unearned Management Fees (liability)........  1,500 
(The adjusting entry)
The other side of the coin is where the adjusting journal entries are unrecorded. This means that the cash payment or receipt occurs after the adjustments must be made. These two adjusting journal entries are referred to as accrued or unrecorded expense and revenue. They are commonly known as receivables and payables.

At first this may seem confusing because there may be several sets of journal entries that seem related but do not figure into the logic of why we break these journal entries down into two sets of two entries. One set is unrecorded. The other set is recorded. The recordation or “unrecordation” refers to the recording of the cash as separate from the recordation of the revenue or expense in the accrual basis of accounting.

Why, you might ask, is this confusing? Well, take the accrual of interest expense, where someone receives cash and presents a note payable in return. During the time when the note is outstanding, interest expense is recorded prior to the payment of the interest. Accountants consider the cash received or paid from the note payable to be the principle, and separate from the cash paid or received for interest, which is either expense or revenue, depending upon which side of the transaction you are on.

Let us take the situation where we take out a note so that we can get the cash we need to conduct business. We take out a three-month, 12 %-per-year note for three months. We agree to pay the 1% per month interest fee at the time the note matures in three months.

The face value of the note is $3,000. The interest (either stated or implied) is 3% times 3,000, or $90. The note matures in 90 days from the date of signing, when the principal of $3000 and the $90, or $3090 maturity value, must be paid back to the creditor who loaned us the money. Under the accrual basis of accounting we must recognize interest accrued monthly with an adjusting entry at the end of the month. The monthly interest is 1% per month times $3,000 or $30 per month.

Cash………………………………………………………. 3,000
Notes Payable …………………………………….   3,000
(To record the Note Payable when the bank loan obtained)

It should be noted that Notes Payable does not change until the note is paid off. The interest must be accrued (amortized or apportioned) monthly:

Interest Expense (expense)……………………………… 30
Interest Payable (liability)…………………………. 30
(Recorded expense adjusting entry)

The associated $90 cash payment of the three months of interest at $30 of interest per month is recorded later when the note matures:

Interest Payable (liability)…………………………. 90
Cash (asset)……………………………………. 90
(The recordation of the cash payment)
The maturity date payment of the note payable would be represented by this journal entry.

**Notes Payable…………………………………. 3,000**  
Cash………………………………………………………. 3,000  
(The payoff of the note)

In real life the, two journal entries of the cash payment of accrued interest payable of $90 and the $3000 payoff of the note are combined into one compound transaction.

**Notes Payable (liability)………………………………. 3,000**  
**Interest Payable (liability)…………………………… 90**  
Cash (asset)……………………………………. 3,090  
(Combined journal entry)

A compound journal entry involves more than one debit or one credit or both. A simple journal entry is one debit and one credit, hopefully in equal amounts.

(http://www.businessdictionary.com/definition/compound-journal-entry.html)

The fourth type of adjusting entry is the recording of unrecorded revenue. Many businesses perform work on an implied promise that they will get paid. Many accountants prepare taxes and then once they complete the work they contact the client to come in and pick up the return.

In accrual basis of accounting when the work is finished and made available to the client the revenue is earned. Under the accrual basis of accounting the receivable should be recorded when the bill is prepared for the client. This recordation is an unrecorded or accrued revenue adjusting journal entry.

If the client says I will send you a check, the recordation of the check when received would be the associated cash receipt journal entry.

In this example our real estate management company agrees to be billed after one month of service a fee of $240. The first 15 days of managing the property end on the last day of the month. One half of the monthly fee that will be billed at the end of the second month has been earned at the end of the current month. Under accrual accounting the proper thing to do is to recognize the revenue when earned. We need to journalize earned revenue for 15 days or $120. It is agreed that the money is earned at the end of the month of services performed.

**Management Fees Receivable (asset)……………….. 120**  
**Management Fees Earned (revenue)………… 120**  
(The unrecorded or accrued adjusting journal entry)
The next half of the $240 per month management fee is earned in the first 15 days of the second month. At this time the fill is prepared. If the bill is paid before the end of the second month, the following transaction is recorded.

Cash……………………………………………………  240
  Management Fees Receivable (asset)…………  120
  Management Fees Earned (revenue)………  120
(The entry to record the receipt of cash)
## CLASSIFYING ACTIVITIES IN THE STATEMENT OF CASH FLOWS

### OPERATING ACTIVITIES

**Cash inflows from**
- Sale of goods or services
- Interest
- Dividends
- Sale of trading securities
- Other operating receipts

**Cash outflows to**
- Suppliers of goods and services
- Salaries and wages
- Government for taxes
- Lenders for interest
- Purchase of trading securities
- Others for expenses

### INVESTING ACTIVITIES

**Cash inflows from**
- Sale of property plant, and equipment
- Sale of debt or equity securities of other entities
- Collection of principal on loans to other entities
- Selling (discounting) of loans

**Cash outflows to**
- Purchase property plant, and equipment
- Purchase debt or equity securities of other entities
- Make loans to another entity

### FINANCING ACTIVITIES

**Cash inflows from**
- Sale of capital stock (or owner investment)
- Issuance of debt (bonds and notes)
- Issuing short-term liabilities

**Cash outflows to**
- Shareholders as dividends (or owner’s withdrawal)
- Repay debts
- Purchase treasury stock

### NONCASH INVESTING AND FINANCING ACTIVITIES

- Retirement of debt by issuing stock
- Conversion of preferred stock to common stock
- Purchase of a long-term asset by issuing a note payable
- Leasing of assets classified as a capital lease
VISUAL #20

**STEPS TO DETERMINE INFORMATION**

**STATEMENT OF CASH FLOWS**

1. Find change in Cash—This is the target #.

2. Find Cash Flow from Operation
   (Using Direct or Indirect Method)

3. Find Cash Flow from
   A. Financing and
   B. Investing

   **Procedure:**

   In real life: Using data from comparative balance sheets, trace
   changes through ledgers and journals probably using a work sheet
   to organize, analyze and prove data disclosed.

   In the classroom: Determine the changes in noncurrent accounts
   and notes from comparative balance sheets. Use the relevant data
   the text provide that comes from the ledgers and the journals to
   systematically analyze the data using or chart and/or reconstructing
   journal entries.

4. Combine cash flows from all three activities (from #2 and 3) to
   find net cash flow) and prove with change in cash. (Target #
   determined in Step 1).

   **Note:** Once the above information has been gathered, the statement
   can be prepared following the required format. If the direct method
   was used, GAAP requires a reconciliation of net income to cash
   provided from operations.
Determining Cash Flows from Operating Activities

Direct Method

(Need income statement and balance sheet data)

1. \[ \text{Cash} = \text{Sales} + \text{Decrease in Accounts Receivable or Increase Accounts Receivable} \]

2. \[ \text{Cash} = \text{Cost of Goods Sold} + \text{Increase in Accounts Payable or Decrease in Accounts Payable} \]

3. \[ \text{Cash} = \text{Operating Expenses} + \text{Increase in Accrued Liabilities or Decrease in Accrued Liabilities} - \text{Depreciation and Other Noncash Expenses} \]

4. \[ \text{Cash} = \text{Income Taxes} + \text{Increase in Income Taxes Payable or Decrease in Income Taxes Payable} \]

5. \[ \text{Cash} = \text{Interest Expense} + \text{Decrease in Interest Payable or Increase in Interest Payable} \]

*use similar computations for CR from Interest and CR from Dividends

**Wage expense would be taken out if CP for wages was to be reported separately. The related prepaids and payables would be considered in the computation.
VISUAL #22

START WITH

NET INCOME OR (NET LOSS)

Add

1. Write-offs or non cash expenses
2. Losses
3. Decreases in current assets
4. Increases in current liabilities.

Subtract

1. Gains
2. Increases in current assets
3. Decreases in current liabilities.

RESULT

CASH FLOWS FROM OPERATING ACTIVITIES
Alternate Demo Problem Seventeen

The Carpet Company’s 19X2 and 19X1 balance sheets included the following items:

<table>
<thead>
<tr>
<th>Debits</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>19X2</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>8,000</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>21,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>18,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$57,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Credits</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated depreciation, equipment</td>
<td>$4,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>7,000</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>1,000</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>1,500</td>
</tr>
<tr>
<td>Common stock, $10 pay value</td>
<td>27,000</td>
</tr>
<tr>
<td>Contributed capital in excess of par, common stock</td>
<td>6,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>11,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$57,500</td>
</tr>
</tbody>
</table>

The Carpet Company’s income statement was as follows:

CARPET COMPANY
Income Statement
For the Year Ended December 31, 19X2

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$61,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$40,000</td>
</tr>
<tr>
<td>Wages and other operating expenses</td>
<td>6,300</td>
</tr>
<tr>
<td>Income taxes expense</td>
<td>4,200</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>1,500</td>
</tr>
<tr>
<td>Net income</td>
<td>$9,000</td>
</tr>
</tbody>
</table>
Required:

Prepare the statement of cash flows under both the direct method and the indirect method for the year ended December 31, 19X2. Additional information includes the following:

a. Equipment costing $3,500 was purchased during the year.

b. Fully depreciated equipment that cost $500 was discarded and its cost and accumulated depreciation were removed from the accounts.

c. Two hundred shares of stock were sold and issued at $15 per share.

d. The company declared $4,000 of cash dividends and paid $2,500.
Solution: Alternate Demo Problem Seventeen

Direct Method:

CARPET COMPANY
Statement of Cash Flows
For Year Ended December 31, 19X2

Cash flows from operating activities:
- Cash received from customers ................... $ 62,000
- Cash paid for merchandise .................... (41,000)
- Cash paid for wages and other operating expenses ....................... (6,300)
- Cash paid for taxes ............................ (5,200)
- Net cash provided by operating activities ........ $ 9,500

Cash flows from investing activities:
- Cash paid for purchase of plant assets ........... $(3,500)
- Net cash used by investing activities ............ (3,500)

Cash flows from financing activities:
- Cash received from issuing stock ................ $ 3,000
- Cash paid for dividends ........................... (2,500)
- Net cash provided by financing activities .......... 500

Net increase in cash ................................... $ 6,500
Cash balance at beginning of 19X2 ..................... 4,000
Cash balance at end of 19X2 ........................... $10,500
Indirect Method:

**CARPET COMPANY**  
Statement of Cash Flows  
For Year Ended December 31, 19X2

<table>
<thead>
<tr>
<th>Cash flows from operating activities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income .......................................................... $  9,000</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities:</td>
</tr>
<tr>
<td>Decrease in accounts receivable ............... 1,000</td>
</tr>
<tr>
<td>Increase in merchandise inventory ............... (3,000)</td>
</tr>
<tr>
<td>Increase in accounts payable ....................... 2,000</td>
</tr>
<tr>
<td>Decrease in taxes payable ........................... (1,000)</td>
</tr>
<tr>
<td>Depreciation expense ...................................... 1,500</td>
</tr>
<tr>
<td>Net cash provided by operating activities ............. $ 9,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from investing activities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid for purchase of plant asset ........... (3,500)</td>
</tr>
<tr>
<td>Net cash used by investing activities ............. (3,500)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from financing activities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from issuing stock ............... 3,000</td>
</tr>
<tr>
<td>Cash paid for dividends .......................... (2,500)</td>
</tr>
<tr>
<td>Net cash provided by financing activities ............. 500</td>
</tr>
<tr>
<td>Net increase in cash ......................... 6,500</td>
</tr>
</tbody>
</table>

| Cash balance at beginning of 19X2 ................... 4,000 |
| Cash balance at end of 19X2 .......................... $10,500 |
## Methods of Financial Depreciation

<table>
<thead>
<tr>
<th>Type</th>
<th>Method</th>
<th>Basis</th>
<th>Rate</th>
<th>Convention – to adjust for time period</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight Line</td>
<td>Straight Line</td>
<td>Cost minus salvage value</td>
<td>$\frac{1}{n}$ – where $n$ = useful life</td>
<td>Mid-month</td>
<td>n can be years or months</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mid-quarter</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Half-year</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Whole month</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Units of Activity</td>
<td>Cost minus salvage value</td>
<td>Activity during period/total estimated activity for useful life</td>
<td>Computation automatically adjusts for period of use</td>
<td>e.g. – estimate of total miles is 100,000, and car is driven 25,000 in the period, then rate is 25%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accelerated</td>
<td>Sum of the Years’ Digits</td>
<td>Cost minus salvage value</td>
<td>$n$ minus prior years/$n(n+1)/2$ – where $n$ = useful life</td>
<td>Mid-month</td>
<td>Trick to remember denominator – e.g., when $n = 5$, denominator is 15, calculated thus – $1 + 2 + 3 + 4 + 5 = 15$, or $1 + 5 = 6$, $2 + 4 + 6$, then $6 + 6 + 3 = 15$ (5(5 + 1)/2 = 15)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mid-quarter</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Half-year</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Whole month</td>
<td></td>
</tr>
<tr>
<td>Declining Balance</td>
<td>Declining Balance</td>
<td>Cost minus prior years’ depreciation – or beginning book value</td>
<td>$% \times \frac{1}{n}$ – where $n$ = useful life</td>
<td>Mid-month</td>
<td>Double Declining Balance rate = 200% Can also use 175%, 150%, 125%, etc. Caution: cannot depreciate beyond salvage – therefore, the last year’s depreciation is equal to remaining book value minus salvage value</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mid-quarter</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Half-year</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Whole month</td>
<td></td>
</tr>
</tbody>
</table>

Note – bold boxed item is what is unique about the method.
Each type of account – Asset, Liability, Equity, Revenue, and Expense – has a “normal balance” – that is, either a debit or a credit balance. It is easy to become confused when first introduced to the concept of debits and credits. We have found the normal balance table to be a good tool to ensure you do not make a mistake when recording journal entries. One of our professors used to say, “If you understand the journal entry, you understand accounting.” Hopefully, this will help you keep your debits and credits straight.

### Normal Balance Table

<table>
<thead>
<tr>
<th>Left</th>
<th>Right</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Assets</td>
<td>Liabilities</td>
</tr>
<tr>
<td></td>
<td>Equity</td>
</tr>
<tr>
<td>Expenses</td>
<td>Revenue</td>
</tr>
<tr>
<td>Loss</td>
<td>Gain</td>
</tr>
<tr>
<td></td>
<td>Profit</td>
</tr>
</tbody>
</table>

The normal balance is a positive balance. Normally we increase the balance of certain accounts. In order for a journal entry to work correctly, the debits must equal the credits.

The normal balance table helps us to think correctly about the journal entry. The normal balance table is composed of the first three equations of accounting. These include the balance sheet, the income statement and the statement of equity.

The cash flow statement is related to but does not exactly follow the definitions of the prior three statements. The statement of cash flows relates to my adjusting entry chart. The cash flow statement will be dealt with later.

The balance sheet, statement of financial position, is where assets (A), what you own, equals liabilities (L), what the business owes creditors and others, and equity (E), what the business owes owners. The accepted form of the accounting equation is \( A = L + E \). The accepted alternative form of the accounting equation is \( A - L = E \).

The equation can also be expressed as \( A - E = L \). While this form is mathematically correct it is not the accepted or the accepted alternative form. This basic is seen in accounting where you have preferred ways of expressing information, accepted alternative ways, and other mathematically correct but not necessarily accepted ways of presenting information.
The income statement is expressed as Income (I) minus Expenses (Exp) equals Profit or Loss, which can also be expressed as Net Income. The statement of equity is expressed as equity equals beginning equity plus profits plus investments minus losses minus withdrawals. In the case of a corporation, equity is bifurcated into invested equity (stocks) and earned equity (retained earnings).
The Four Types of Adjusting Entries

<table>
<thead>
<tr>
<th>Deferred</th>
<th>Accrued</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Liabilities</strong></td>
</tr>
<tr>
<td>Recorded Expense</td>
<td>Unrecorded Expense</td>
</tr>
<tr>
<td>Prepaid</td>
<td>Payable</td>
</tr>
<tr>
<td><strong>Recorded Revenue</strong></td>
<td><strong>Unrecorded Revenue</strong></td>
</tr>
<tr>
<td>Unearned</td>
<td>Receivable</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td><strong>Assets</strong></td>
</tr>
</tbody>
</table>

Deferred – aligning (matching) recorded costs and revenues with appropriate periods (i.e., cash has previously been received or disbursed, but revenue has not been earned nor has expense been incurred)

Accrued – apportioning unrecorded costs and revenues to appropriate periods (i.e., cash has not been received or disbursed, but revenue has been earned or expense has been incurred)

Adjusting Entry Rules
1. Simple entries: Each adjusting entry is a simple entry meaning one debit and one credit.
2. One permanent account and one temporary account
3. The purpose is to convert asset or liability to expense or revenue
4. Recorded at the End of the Period (EOP) usually the end of the month (EOM)
5. No Cash: Adjusting entries never involve cash.
6. Adjusting entries are the means by which we record transactions on the accrual basis, without adjusting entries all businesses would be on the cash basis.
7. Adjusting entries are critical to an understanding of the statement of cash flows.
8. There are four types of adjusting entries.

Adjusting entries are defined precisely. Adjustments could be reclassifications and are not necessarily adjusting entries. If the above criteria are not met, you are not dealing with adjusting entries.
The Statement of Cash Flows by Al Giovetti

There are some rules.
(This is another of my charts).

Direct Method
1. starts with zero ($0) or individual revenue and expense accounts
2. Investing and financing are the same as indirect method.
3. specific cash inflows and outflows are covered
4. Recommended method
5. Not required
6. Start with accrual based revenue and expense accounts, subtract increases and add decreases of associated accrued (payables and receivables) accounts, add increases and subtract decreases of associated deferred (recorded, prepaid or unearned) accounts.
7. Subtract non-cash expenses from operating expenses

Indirect method
1. Starts with net income
2. Investing and financing are the same as direct method.
3. Explains why the cash flows differ from net income.
4. not recommended
5. required
6. net credit changes are added and net debit changes are subtracted
7. Add back non cash expenses.

The above chart compares and contrasts the different methods for preparing a statement of cash flows that will be discussed in detail below.

There are four financial statements. Robert F Meigs wrote in his classical textbook, Meigs & Meigs, Accounting the Basis for Business Decisions before his son Walter B Meigs took over the writing of the textbook that the four financial statements are divided into three major financial statements and one minor financial statement.

The statement of cash flows is also divided into three major sections and one minor section. The three major sections are activity classifications of operating, investing and financing or OIF as I prefer to remember them mnemonically. The fourth or final area is Supplemental Information.

Prior to 1988, the financial statement showing the sources and uses of liquid resources was called a statement of changes in financial position. As with most changes, most of those who understood and liked the Statement of Changes in Financial Position did not like the changes made.

In 1987, FASB (Financial Accounting Standards Board) issued Statement No. 95, “Statement of Cash Flows (Norwalk Conn.: 1987). The biggest problem with the Statement of Changes in Financial Position was that companies were free to define
“liquid resources” in a number of different ways. Some of the statements showed the sources and uses of cash while others used some other type of “liquid resources.” The different definitions made it difficult to compare one company’s statement to another.

Similar to a cash basis income statement in some ways, the Statement of Cash Flows was designed to provide information about cash receipts and cash payments. The statement also provides information about investing and financing activities of the company.

There are two ways to prepare a statement of cash flows. The only difference from one method to the other in terms of calculation involves the operating section of the statement of cash flows. The investing and financing (and the supplemental information) sections are virtually the same.

The direct method statement of cash flows “cash flows from operating activities” starts out with an income statement (temporary or nominal) account and then determines the change in the associated deferred (prepaid or unearned) or accrued (payables and receivables) balance sheet (permanent or real) accounts. The indirect method statement of cash flows “cash flows from operating activities” section starts out with net income and analyzes how the changes in the associated operating accounts, such as deferred (prepaid or unearned) or accrued (payables and receivables) balance sheet (permanent or real) accounts modifies the income statement amount.

In the statement of cash flows FASB Statement No. 95 defines cash as including both cash and cash equivalents. Cash equivalents include highly liquid short-term investments such as money market funds, commercial paper, and Treasury bills. In order to qualify as a cash equivalent for the purposes of the statement of cash flows “a short-term investment must convert into a known number of dollars within three months of acquisition.”

For the purposes of a statement of cash flows, marketable securities, such as stocks and bonds do not qualify as cash equivalents. Purchases and sales of marketable securities do result in cash flows reported in the statement of cash flows in the “cash flows from investing activities” section.

Operating activities are defined differently in a statement of cash flows from operating activities in an income statement. In an income statement, certain expenses such as interest expense and interest income are defined as non-operating income. In a statement of cash flows, payments and receipts of interest from investments are considered part of “cash flows from operating activities.” As with most of accounting definitions are very precise and are related to the context they appear in (context sensitive definitions?).

Dividends received from stock other than treasury stock (stock in companies other than our company or companies within a controlled group which includes our company) are considered operating activities. The sales and purchase of marketable securities (bonds, loans other than those to customers for a valid business purpose, and stocks) is in the “cash from investing activities” section. Payments to owners, such as cash dividends, belong in the “cash from investing activities” section.
Repayment of amounts borrowed (not payments made on accounts payable or accrued liabilities) belong in the “cash from financing activities” section. The payments made on accounts payable or accrued liabilities belong in the “cash from operating activities” section. All interest payments are considered “cash from operating activities.”

The statement of cash flows is grouped into three major categories

1. operating activities
2. investing activities, and
3. financing activities
4. effects of changes in exchange rates on cash may be used as a fourth major category in the statement of cash flows of companies with holdings of foreign currency. We will ignore this category.

“Operating activities include all cash flows other than those associated with investing and financing.” (Definition is from Meigs and Meigs).

Cash receipts from operating activities include

1. Collections from customers for sales of goods and services which include cash sales, and collections on accounts receivable (AR)
2. Interest and dividends received, and
3. Other receipts from operations, such as, proceeds from settlement of litigation.

Cash payments from operating activities include

1. Payments to suppliers of merchandise and services, including payments to employees composed of accounts payable paid and cash expenses.
2. Payments of interest
3. payments of income taxes
4. Other expenditures relating to operations, such as, payments in settlement of litigation

Cash flows from investing activities include cash receipts and cash payments.

Cash receipts from investing activities include

1. Cash proceeds from selling investments or plant assets
2. Cash proceeds from collecting principal amounts of loans

Cash payments for investing activities include

1. Payments to acquire investments or plant assets
2. Amounts advanced to borrowers

Cash flows from financing activities include cash receipts and cash payments.

Cash receipts from financing activities include

1. Proceeds from both short term and long term borrowing
2. Cash received from owners, such as the issuing of stock for cash
Cash payments for financing activities include
1. Repayments of the principal amounts borrowed. This does not include interest payments
2. Payments to owners, such as cash dividends when paid (not when declared).

Unfortunately an accrual basis income statement does not contain one account that is called “Cash received from customers.” We have to use analysis to “back into” the number needed for cash flows from operating activities. It is usually more efficient to examine changes in non cash accounts than by locating and combining numerous entries in the company’s cash disbursement and cash receipts journals.

The most important thing to remember is to understand how this statement works and the relationship between the income statement, the balance sheet, the statement of owner’s equity and the statement of cash flows. In order to understand the statement of cash flows we need to understand why increases and decreases in a number of asset and liability accounts represent differences between an accrual basis net income and net cash flow for the period.

Memorizing the transactions and how to deal with them is not useful or easy. What is useful is identifying the types of transactions that cause a given account balance to increase or decrease. Understanding these increases and decreases explains how these changes also change accrual net income and net cash flow. This basic understanding of the differences between accrual accounting and cash transactions (or cash basis accounting) will open up to an even greater understanding the more you explore the effects of these transactions.

Formulae (Latin for Formulas—If you talk Latin to your clients, you can raise your fees by 50 %.)

The formulae are the same for the direct method and the indirect method for cash flows from operating activities when dealing with revenues. The Unearned Revenue (UR—liability account) and the Accounts Receivable (AR—asset account) for Sales are associated liability and asset accounts, respectively.

\[
\text{Cash Received} = \text{Net} + \text{Increase in UR} + \text{Decrease in AR} \\
\text{From Customers} = \text{Sales} - \text{Decrease in UR} - \text{Increase in AR}
\]

If there are no unearned revenues the UR account portion of this calculation drops out. The equation becomes more like what most of us see in accrual based income statements and balance sheets.

\[
\text{Cash Received} = \text{Net} + \text{Decrease in Accounts Receivable} \\
\text{From Customers} = \text{Sales} - \text{Increase in Accounts Receivable}
\]

Expenses are different for the Direct and Indirect Method of preparing a statement of cash flows. In the direct method the Cash flows from operating activities shows the detail for cash received from customers (+), and interest and dividends received (+) with
a subtotal of cash provided by operating activities (+), Cash paid to suppliers and employees (-), Interest paid (-) and income taxes paid (-) with a subtotal Cash disbursed for operating activities. The final total for the section is cash flow from operating activities.

Full and Unabbreviated Company Name
Statement of Cash flows
For the Year Ended <Month Day Year>

Direct Method (We don’t say “Direct Method.” We hope the reader knows what s/he is looking at.)

Cash Flows from operating activities
Cash received from customers………………………………………..#####
Interest and dividends received………………………………………#####
    Cash provided by operating activities…………………………….. ######
Cash paid to suppliers and employees………………………………. #####
Interest paid…………………………………………………………. #####
Income taxes paid…………………………………………………… #####
    Cash disbursed for operating activities…………………………….. ######
Net cash flow from operating activities………………………………… ######

Non-operating gains and losses are ignored for the sake of the operating section of the statement of cash flows.

Indirect Method (We don’t say “Indirect Method” in the Statement. We assume/hope the reader knows what s/he is looking at.)

Cash flows from operating activities
Net cash flows from operating activities (see supplementary schedule A) …………………………………………………………………. ######

Supplementary Schedule A: Net Cash Flow from Operating Activities.
Net Income………………………………………………………………..#####
Add:  Depreciation expense……………………………………………. ######
    Decrease in accrued interest receivable…………………………….. ###
    Increase in accounts payable ………………………………………. ######
    Increase in accrued liabilities………………………………………. ######
    Non operating loss on sales of marketable securities………………….. ####
Subtotal ……………………………………………………………………. ######
Less:  Increase in accounts receivable ……………………………….. ######
    Increase in inventory ……………………………………………….. ######
    Increase in prepayments …………………………………………. ####
    Decrease in accrued liabilities ……………………………………. ###
    Non operating gain on sales of plant assets ………………. ###### ######
Net cash flow from operating activities ……………………………….. ######
Both the direct and indirect methods are based upon the same accounting data and result in the same net cash flow. Both methods convert accrual based income statement amounts/accounts into cash flows by adjusting for changes in related balance sheet amounts/accounts.

There are reasons for why the direct method is recommended and the indirect method is required. The indirect method explains why the net cash flow from operating activities is different from the accrual basis income statement net income. The direct method informs the reader of the nature and dollar amounts of the specific cash inflows and cash outflows which comprise the operating activities of the business. Both of these functions are important.

The writers of the FASB Statement No 95 felt that the explanation of the why was essential and therefore required this statement be included as an appendix or addendum to the indirect method statement and in the “reconciliation of net income to net cash provided by operations” section of the direct method statement.

A summary of the indirect method is the following listing of the additions and subtractions shown in the indirect addendum A of the statement of cash flows.

Net income
Add: Depreciation, amortization of intangibles, and depletion
Decrease in accounts receivable (asset)
Decrease in inventories (asset)
Decrease in prepaid expenses (asset)
Increase in accounts payable (liability)
Increase in accrued expenses payable (liability)
Increase in deferred income taxes payable (liability)
“Non-operating” losses deducted in computing net income
Deduct: Increase in accounts receivable (asset)
Increase in inventories (asset)
Increase in prepaid expenses (asset)
Decrease in accounts payable (liability)
Decrease in accrued expenses payable (liability)
Decrease in deferred income taxes payable (liability)
“Non-operating” gains deducted in computing net income

Observe first that there are a lot of reversals. Notice that you add a decrease in an asset (deduct an increase in an asset) and add an increase in a liability (deduct a decrease in a liability) in the indirect method. Notice that you add losses and deduct gains from net income in the indirect method. You ignore the gains and losses in the direct method.

Most businesses do not use the direct method. FASB hoped to encourage businesses to use the direct method by listing the direct method as the preferred method. Unfortunately, listing the indirect method as the required method convinced most businesses that they did not want to spend the extra money doing the direct method when the indirect method
was required. FASB achieved just what they did not want to achieve by setting up these two confusing and unfathomable combination of a recommendation and a requirement. Simply stated their goal backfired and has not been rethought.

Both the direct and the indirect method compute the cash flows from investing activities and the cash flows from financing activities the same no matter which method is used. The only differences in computing the two methods are within the statement of cash flows from operating activities section.

Computing the statement of cash flows cash flows from operating activities section

Computing the statement of cash flows cash flows from operating activities section is different depending upon whether you are doing the direct or the indirect method.

Cash Flows from Operating Activities

The Cash flows from operating activities section is composed of several parts:
1. Cash received from customers
2. Interest and dividends received
3. Cash paid for purchases of merchandise
4. Cash payments for expense
5. Cash paid to suppliers and employees
6. Cash payments for interest and taxes

You need to go over this section of the course over and over again until you understand why the income statement accounts must be increased or decreased by the changes in the associated non-cash balance sheet accounts in order to determine the related cash flow.

Cash Received from Customers

In this example, accounts receivable increased by $30,000 during the year. If accounts receivable increased during the year, this represents cash that we did not collect, therefore the Net Sales must be decreased by a net increase in accounts receivable. A net increase means that you add the debits to accounts receivable and subtract the credits to accounts receivable to find the net increase or decrease to accounts receivable. A net decrease in accounts receivable means that the business collected more than it sold and you must add the decrease to net sales to get the cash collected from customers.

Another way to compute this is to compare the end of last year balance in accounts receivable to the end of this year’s balance to accounts receivable and see if the amount went up or down during the year. If the balance in accounts receivable remains the same from one year to the next, the net sales equals the cash collected from customers.  
Cash Received = Net Sales + Decrease in Accounts Receivable From Customers
Cash Received = Net Sales − Increase in Accounts Receivable From Customers

Net sales (accrual basis).............................................. $1,000,000
Less: increase in accounts receivable ......................... $130,000
Cash received from customers ............................... $870,000

Interest and Dividends Received

The formula for Interest Received is similar to that for Cash received from customers. We must add a decrease in the receivable (subtract an increase in the receivable). There is no unearned interest so that we can ignore the deferred accounts associated with interest received. The formula therefore is.

\[
\text{Interest} = \text{Interest Revenue} + \text{Decrease in interest receivable}
\]
\[
\text{Decrease in interest receivable} - \text{Increase in interest receivable}
\]

Interest revenue (accrual basis) ................................. $6,000
Add: Decrease in accrued interest receivable ............... $1,000
Interest received (cash basis) ................................. $7,000

A similar computation for dividends received can be computed, if there is a dividend receivable change. Usually, the dividend receivable only has a balance for a very short period of time if at all on the balance sheet. No computation is necessary usually for dividends received.

You can then combine interest received with dividends received.

Interest received (cash basis) .................................. $7,000
Dividend received (cash basis) .............................. $3,000
Interest and dividends received (cash basis) ............... $10,000

Cash Paid for Purchases of Merchandise

In the case of cash payments for purchases of merchandise the prepaid is the inventory and the trade accounts payable (AP) for purchases of inventory must be kept separate. In this example the accounts payable that we refer to is only the accounts payable for the purchase of inventory or merchandise for resale.

\[
\text{Cash Payments} = \text{Cost of Goods Sold} + \text{increase in inventory} + \text{decrease in AP\ for\ Purchases} - \text{decrease in inventory} - \text{increase in AP}\]
\[
\text{AP} = \text{Accounts Payable} \text{ for purchases of inventory for resale to customers}
\]

Cost of goods sold ................................................. $500,000
Add: increase in inventory ...................................... 10,000
Net purchases (accrual basis) ................................. $510,000
Less: increase in accounts payable to suppliers of inventory ... 15,000
Cash payments for purchase of merchandise ................. $495,000
When inventory increases (decreases), a company is buying more (less) inventory than it sells during the period. Buying more (less) than you sell will decrease (increase) the cash if AR for inventory purchases remains unchanged. When a company increases (decreases) its accounts payable to suppliers of inventory, it is not paying cash for all (paying cash for more than all) of the purchases. If inventory remains equal (the same) increases (decreases) to accounts payable will decrease (increase) cash. (Notice all the reversals here. As one account goes up the other goes down. Understanding this relationship is the key to computing the statement of cash flows.)

Cash Payments for Expense

Depreciation, amortization, and depletion expenses require no cash payment and must be added back to the expenses other than cost of goods sold. These three expenses have no effect on cash and must be subtracted from accrued expenses. Prepayments (a payment made in advance) represent money paid in a prior period (later period) for an expense in the current period thus there is cash payments for accrued expenses are less (more) than accrued expense. When the pre-payment and expense are in the same period (year) there is no effect.

Accrued liabilities represent paying for expenses in a later period; there is a reduction in the amount of cash used when accrual expenditures are examined. In the following equation RP is related prepayments (deferrals) and RAL is related accrued liabilities (payables or accounts payable).

\[
\text{Cash Payments} = - \text{depreciation and} + \text{increase in RP} + \text{decrease in RAL}
\]

For Expenses other non-cash: - decrease in RP - increase in RAL

(RP is related prepayments and RAL is related accrued liabilities)

Operating expenses (including depreciation—accrual basis) ……… $300,000
Less: Non cash expenses (depreciation, amortization, depletion) … (40,000)
Subtotal .......................... $260,000
Add: Increase in short-term prepayments  .......... $3,000
Decrease in accrued liabilities .............. 6,000 9,000
Cash payments for operating expenses .......... $269,000

Cash paid to suppliers and employees

Though not required but often recommended, the cash payments for operating expenses and cash paid for the purchase of merchandise can/should be combined to form the line item cash paid to suppliers and employees

Cash payments for purchases of merchandise .............. $495,000
Cash payments for operating expenses .................. 269,000
Cash payments to suppliers and employees ............. $764,000
Cash Payments for Interest and Taxes

If the liability for unpaid interest (interest payable) increased (decreased) over the year, less (more) than the interest expense showed in the income statement was paid in cash. The following calculation takes into account the changes in interest payable and its effect on the sources and uses of cash.

Cash payments = Interest + decrease in interest payable
For interest expense - increase in interest payable

Interest expense ................................................................. $35,000
Less: Increase in related accrued liability (interest payable) … 7,000
Interest paid (cash basis) ................................................. $28,000

The same type of calculation is used for income tax expense and its relation to income taxes paid in cash. The increase or decrease in the related income tax payable account or “income tax receivable” account makes up the difference.

Cash payments = Income tax + decrease in income taxes payable
For income taxes expense - increase in income taxes payable

Income taxes expense ...................................................... $36,000
Add: decrease in income tax payable ................................. 2,000
Income taxes paid .......................................................... $38,000

Partial Cash Flow Statement

Direct method

Cash flows from operating activities
Cash received from customers ................................. $870,000
Interest and dividends received ................................. $10,000
Cash provided by operating activities ....................... $880,000
Cash payments to suppliers and employees .............. $764,000
Interest paid (cash basis) ................................. 28,000
Income taxes paid .................................................. 38,000
Cash disbursed for operating activities ..................... (830,000)
Net cash flow from operating activities ...................... $50,000

The differences between the statement of cash flow and the accrual basis income statement are three things
1. expense without cash outlay
2. timing differences (adjusting entries)
3. non-operating gains and losses
The indirect method uses the following format:

Net income
Add: Expenses that do not require cash outlays in the period (Such as depreciation, amortization, and depletion expense)
      Operating cash inflows not recorded as revenue in the period
      “Non-operating” losses deducted in the determination of net income
Less: Revenue that does not result in cash inflows in the period
      Operating cash outflows not recorded as expense in the period
      “Non-operating” gains included in the determination of net income

Indirect Method (same set of facts)

Net income ................................................................. $65,000
Add: Depreciation expense ........................................... 40,000
      Decrease in accrued interest receivable ..................... 1,000
      Increase in accounts payable (for merchandise for resale) .... 15,000
      Increase in accrued interest liabilities ...................... 7,000
      Non-operating loss on sales of marketable securities ....... 4,000
Subtotal ................................................................. $132,000
Less: Increase in accounts receivable ......................... $30,000
      Increase in inventory ........................................... 10,000
      Increase in prepaid expenses ............................... 3,000
      Decrease in accrued operating expenses payable ......... 6,000
      Decrease in accrued income taxes payable ...... 2,000
      Non-operating gain on sales of plant assets ......... 31,000
Subtotal ............................................................... 82,000
Net cash flow from operating activities ................................. $50,000

Cash Flows from Investing Activities

Cash flows from investing activities deals with four sections of accounts
  1. Purchases and sales of securities
  2. Loans made and collected
  3. Cash paid to acquire plant assets
  4. Proceeds from the sales of plant assets.

Purchases and Sales of Securities

The marketable securities account needs to be examined for two things, one which was not envisioned in 1987 when FASB Statement 95 was written. Under this rule, for the reporting of marketable securities, unrealized gains and losses on marketable securities are now booked. One must make adjustments for how these changes are booked when preparing this section of the investing activities portion of the statement of cash flows. For this illustration, we will ignore these effects and assume that the books have been kept in such a way that this part need not be overly confusing.
Debit entries to the marketable securities account (asset) represents the cost of securities purchased. Purchases of marketable securities would be reported as a cash outflow and shown as a negative number in the statement. In this example let us say those debit entries equaled $60,000.

Credit entries to the marketable securities account represents the cost of securities sold. Proceeds from sales of marketable securities would be reported as a cash inflow and shown as a positive number in the statement. In this example let us say those credit entries equaled $40,000.

A loss on marketable securities sales would decrease the proceeds from sales of marketable securities. A gain would increase them. Let us say we had a gain of $5000 from the sale of marketable securities. The gain amount would be computed as follows.

Credit entries to marketable securities accounts of $40,000  
Plus gain on marketable securities sales of $5,000  
Minus loss on marketable securities sales (none in this case)  
Proceeds from sales of marketable securities ............$45,000

Those marketable securities which are viewed as cash equivalents would have to be adjusted. In this example, it is assumed that no adjustment is necessary since none of the marketable securities are viewed as cash equivalents.

Purchases of marketable securities ........................................ $(60,000)  
Proceeds from sales of marketable securities .........................$45,000

Loans made and collected should be reflected in the notes receivable increases and decreases. Cash lent to borrowers would be represented by debit entries to notes receivable which would be a reduction in cash. Remember that debits and credits to the notes receivable represent changes in the principal amounts of the loans. Let us say that the debit entries to notes receivable equaled $15,000.

Credit entries to notes receivable would indicate cash collected on the payoff of existing loan principal. Remember that the collection of interest was recorded in the interest revenue account and is included in the cash inflows from operating activities. If there was a write off of a note because the note became uncollectable this would not be included as a cash inflow and the credit amount would have to be adjusted for the write off. Let us say that the loans paid off this year were the credit entries to notes receivable in the amount of $10,000 and there were no bad debts.

Loans made to borrowers .................................................. $(15,000)  
Collections on loans ......................................................... $10,000
Cash Paid to Acquire Plant Assets

Cash paid to acquire plant assets showing an increase (debit) in the plant asset account in the amount of $200,000. Of that 200,000, $160,000 was an issuance of a long term note payable and $40,000 was a cash disbursement.

Supplementary Schedule of Noncash Investing and Financing Activities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases of plant assets</td>
<td>$200,000</td>
</tr>
<tr>
<td>Less: Portion financed through issuance of long-term debt</td>
<td>$160,000</td>
</tr>
<tr>
<td>Cash paid to acquire plant assets</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

Proceeds from Sales of Plant Assets

The company sold plant assets with a book value of $50,000. The book value is the combination of the credits to plant assets of 120,000 and a debit to accumulated depreciation (contra asset account) for the same assets of $70,000. There was also a gain on the sale of plant assets of $30,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value of plant assets sold (credit to plant assets minus debit to accumulated depreciation on plant assets due to the sale)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Add: Gain on sales of plant assets</td>
<td>$30,000</td>
</tr>
<tr>
<td>Proceeds from sales of plant assets</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

Cash Flows from Financing Activities

Cash flows from financing activities includes

1. Short-term borrowing transactions
2. proceeds from issuing bonds payable and capital stock
3. cash dividends paid to stockholders

Short-Term Borrowing Transactions

The company borrowed $40,000 during the year by issuing short-term notes payable to banks. The company repaid $50,000 of short-term notes payable by paying off the principal amounts due on these notes payable. Interest payments on these short-term notes were included in the cash flows from operating activities.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from short-term borrowing</td>
<td>$40,000</td>
</tr>
<tr>
<td>Payments to settle short-term debts</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

The sum of the credit entries to short-term notes payable is the Proceeds from short-term borrowing. The sum of the debit entries to short-term notes payable is the Payments to settle short-term debts.
Proceeds from Issuing Bonds Payable and Capital Stock

The company issued bonds payable for $100,000 cash and the company issued for cash 1,000 shares of $10 par value capital stock for $50 per share. The bonds payable account shows an increase (credit entries) of $100,000. There are no debit entries therefore no redemption/retirement of bonds payable was made during the year. No calculation is necessary here.

Proceeds from issuing bonds payable ........................................ $100,000
Proceeds from issuing capital stock ................................. $50,000

Had there been a retirement of bonds payable it would have been shown as Payments to retire bonds payable in the amount used to debit or decrease the bonds payable account. Similar treatment would be used for purchase of treasury stock. Payments to retire bonds payable or to purchase treasury stock would appear as negative numbers.

Cash dividends declared and paid to stockholders amounted to $50,000 during the year. Dividends declared during the year may differ from dividends paid during the year. Starting with the amounts of dividends paid during the year, we would need to add any decrease or subtract any increase in the dividends payable account during the year to determine the effects on cash.

Cash dividends paid to stockholders ................................. $(40,000)

Amounts debited to retained earnings represent dividends declared during the year, which may differ from dividends paid.
Statement of Cash Flows (SCF) Part II by Alfred Giovetti

SFAS (Statement of Financial Accounting Standards) 95, November 1987, Statement of Cash Flows. The statement is required wherever a balance sheet and income statement are presented together.

SFAS 117, Para. 30 The statement of cash flows is not required for individuals, but is required for a profit-oriented business or nonprofit organization.

Interpretation No. 14 to SAS (Statement on Accounting Standards) No. 29 The statement of cash flows is not required for OCBOA (other comprehensive basis of accounting), but is an optional statement.

SFAS 102, par 6-7 Defined pension plans and certain investment companies that meet specific requirements are exempt from presenting a cash flow statement.

SFAS No. 159, proceeds from loans and short-term investments of three months or less may be reported at net rather than gross method of reporting

Net method of presentation of cash flows from investing and financing activities

Cash flows from investing activities
  Net purchase of property plant and equipment 40,000
  Net cash provided (used by) investing activities 40,000

Gross method of presentation of cash flows from investing and financing activities

Cash flows from investing activities
  Proceeds from the sale of property plant & equipment 140,000
  Purchase of replacement property plant & equipment (60,000)
  Construction of real property building (40,000)
  Net cash provided (used by) investing activities 40,000
### Types of Liabilities

<table>
<thead>
<tr>
<th>Type of Liability</th>
<th>Existence</th>
<th>Amount</th>
<th>How to Handle</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definite</strong></td>
<td>Definite or known – arose from a past event</td>
<td>Definite or known</td>
<td>Book</td>
</tr>
<tr>
<td><strong>Estimated</strong></td>
<td>Definite or known – arose from a past event</td>
<td>Specific amount known</td>
<td>Book May book – high/low/average – conservative best data; footnote range</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Range</td>
<td>Footnote</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Unknown</td>
<td></td>
</tr>
<tr>
<td><strong>Contingent</strong></td>
<td>Based upon the occurrence of some future event</td>
<td>Known</td>
<td>If existence is:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Estimated</td>
<td>Probable or likely – Book</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Unknown</td>
<td>Reasonable possible – Footnote</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Remote – Do nothing</td>
</tr>
<tr>
<td><strong>Combination</strong></td>
<td>e.g., Estimated Contingent</td>
<td>Known</td>
<td>Book</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Estimated</td>
<td>(see above)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Unknown</td>
<td>Footnote</td>
</tr>
<tr>
<td><strong>Commitment</strong></td>
<td>Determined by the occurrence of some future event</td>
<td>Can be known, estimated, or unknown (Usually triggered by the rise or fall of prices in a contract that commits a company to buy something at some future date)</td>
<td>Always book a loss</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Book gains only to the extent of prior booked losses</td>
</tr>
</tbody>
</table>