

# BASIC ACCOUNTING

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Monica Haven, E.A. presents introductory accounting principles to help you with your personal bookkeeping and record keeping needs. Whether you come to learn how to balance your own checkbook or be forewarned of the next Enron scandal, you'll find that does equal four!

An employer tests various job applicants by asking each one, "What is two and two?" The mathematician immediately responds, "Four." The next applicant who was a physicist consulted the U.S. Bureau of Standards and performed numerous calculations before answering, "Four." Finally, the lawyer closed all window shades and doors and conspiratorially whispered, "What do you want it to be?"

## I. Definition and Purpose of Accounting

- Standardized method
- Record of financial activities
- Ongoing business entity or individual

Accounting provides an *organized system* which allows for *comparative analysis* between firms and from year-to-year.

## II. Practical Application

### A. Journal entries (in lieu of T-Chart)

\$ In	\$ Out
Debit	Credit
Left	Right
Plus (+)	Minus (-)

#### Examples:

1. XYZ Corporation buys \$6,500 equipment for cash
 

Equipment	\$6,500	
Cash		\$6,500
  
2. XYZ Corporation buys \$6,500 equipment on account
 

Equipment	\$6,500	
Accounts Payable		\$6,500
Accounts Payable	\$6,500	
Cash		\$6,500
  
3. XYZ Corporation sells \$9,000 of merchandise for cash
 

Sales Revenues	\$9,000	
Merchandise		\$9,000
Cash	\$9,000	
Sales Revenues		\$9,000



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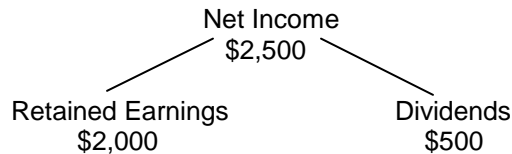
4. XYZ Corporation records net income of \$2,500

Net Income	\$2,500
Retained Earnings	\$2,500

5. XYZ Corporation declares and then pays a \$500 dividend

Retained Earnings	\$500
Dividends Payable	\$500
Dividends Payable	\$500
Cash	\$500

XYZ Corporation has the choice to keep or share its earnings...



B. Types of Journals: Sales Journal; Purchases Journal; Cash Receipts Book; Cash Payments Book; Debtor's or Customer Ledger; Creditor's or Supplier Ledger; General Ledger (= summary of all of the above)

C. Accounts

- Assets (A) = items owned
- Liabilities (L) = items owed
- Equity = difference between items owned and owed = A – L



D. Financial Statements = summary of journal entries.

1. Income Statement (a.k.a Profit and Loss Statement or Cash Flow Statement)  
Shows how money is made and spent *over time*.

<b>Sales Revenues</b>
<b>- Expenses</b>
= <b>EBIT</b> (Earnings before Interest & Taxes)
<b>- Interest</b>
= <b>EBT</b> (Earnings before Taxes)
<b>- Taxes</b> (@ 35%)
= <b>Net Income (Loss)</b>

2. Balance Sheet (a.k.a. Net Worth Statement)  
Shows financial status *at a specific point in time*—similar to a photographic snapshot.

<u>Assets</u>	<u>Liabilities &amp; Equity</u>
Current	Current
Long-Term	Long-Term (Bonds)
Plant & Equipment	Subtotal
Intangibles	Common Stock
	Preferred Stock
	Paid-in Surplus
	Retained Earnings
	Subtotal
<b>TOTAL = \$XXX</b>	<b>TOTAL = \$XXX</b>
<i>Balance!</i>	

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## 3. Purpose

## a. Investment analysis → beware of accounting scandals!

- Enron: Booked illusionary profits by making internal deals with wholly owned subsidiaries and limited partnerships. Employees were forced to invest retirement funds in company stock.
- WorldCom: Based on overstated profits, the company was able to borrow \$30 billion in 90's which it later could not repay. Expenses were capitalized (deducted over time) rather than deducted in full at time of incurrence.
- Adelphia: Corporate executives were self-dealing (funneling company money into personal accounts).
- Stock options (introduced in 1990's as executive compensation) encourage companies to disclose bad news just prior to issuance of options and then overstate good news just before exercise of options. Thus, the stock price will be depressed when the option is granted at-the-money and will rise significantly just prior to exercise.
- Shareholder greed often leads to high dividend payout ratios, but then depletes retained earnings for future expansion and other obligations.
- Assets are overstated, although Generally Accepted Accounting Principles (GAAP) calls for lower-of-cost-or-market method.




## b. Personal borrowing

- Ratios
- Credit Reports
  - Equifax (800) 685-1111
  - Experian (888) 397-3742
  - TransUnion (800) 916-8800
  - FREE report <https://www.annualcreditreport.com> or (877) 322-8228

## c. Ways to improve...

## a. Cash flow: ↑ income &amp; ↓ expenses (make more and spend less)

- Shop for dividends and yields  
BUT be mindful of scale

*One bank offers 5 year CD for 1.98%; another at 2.37% (Difference = 0.39%)  
→ On \$100,000 that difference equates to \$390/year for a total of \$1,950; but on \$10,000 the difference is only \$195 over 5 years!*

- Take advantage of discounts, coupons and specials

## b. Equity: ↑ assets &amp; ↓ liabilities (own more and owe less)

- Gifts, inheritances and "miracles"
- Decrease debt

## III. Money Management

- A. Covering the basics: Emergency reserve; Insurances (medical, disability, long-term care, life, auto, homeowner's, casualty, liability); Retirement planning; Estate planning; Charity and gifts
- B. Budgeting

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C. Recordkeeping—Tax Records (taxpayer has burden of proof)

1. Statute of Limitations

a. IRS

- 3 years to audit from date of filing, including extensions (6 years if gross understatement in excess of 25% and unlimited if fraud suspected or return unfiled or not signed by taxpayer)
- 6 years to collect after assessment of tax
- 2 years to claim refund after payment

b. FTB

- 4 years to audit

2. Cohan Rule: Allows for *estimated* deductions (except travel, entertainment, and charity)

*Cohan vs. Commissioner, 39 F. 2d 540 (2d Cir. 1930)*

*Judge Learned Hand allowed George M. Cohan—of Broadway fame—to substantiate cab fares, tips, hotel and restaurant costs based on his recollections and approximations.*

3. Supporting Documentation

a. Medical

- cancelled checks
- Rx printout from pharmacy
- mileage and travel

b. Charity

- cancelled checks & credit cards receipts okay if aggregate < \$250/organization
- letters of acknowledgment for all others
- appraisal for donation > \$5,000
- Goodwill receipts
- mileage for volunteer work

c. Alimony Payments

- court documents & separation agreement no longer usable to claim dependency exemption for non-custodial parent
- must use Form 8332 for release

d. Securities

- trade confirmations, 1099s, K-1s
- worthless securities

e. Retirement Accounts (contributions & withdrawals)

f. Real Estate

- escrow statements
- refinance information
- property taxes paid
- home improvements
- depreciation computations, if business property



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