

Accounting -- Episode 4
Preparing Financial Statements and Closing the Books

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| | <i>FADE IN ---RADIO SHOW THEME MUSIC</i> |
| Glenn | Good day everyone. Welcome to Radio Glencoe Podcasting. I'm your host Glenn Coe. |
| McGraw | And I'm your host, McGraw Hill. Today, on Accounting Away we're <i>on location</i> at the corporate headquarters of a national chain of Chinese restaurants, China Lotus. We're talking with the CFO, which means the Chief Financial Officer of the operation, Mr. Li Kuang. |
| Li | Good morning and welcome. |
| Glenn | Li, I have to admit that I thought we were meeting you in one of your restaurants and I'm starved. |
| Li | Sorry Glenn, but as you can see, these are our corporate offices, where the restaurant management works. You know, running a chain of 95 restaurants takes a lot of serious management – and accounting plays a big role in the success of this corporation. |
| McGraw | Li, tell us exactly what the CFO of a restaurant business does? |
| Li | Sure. First of all, each one of our locations has an accountant who records all the daily financial data for that one restaurant into a standardized software system. My job is to oversee their work and prepare the corporate financial statements that combine the financial data for all 95 restaurants. |
| Glenn | So you prepare the statements that are available to the public for anyone who might be interested in buying stock in your company? |
| Li | That's right. Stockholders want to understand our financials, like how we're performing in the sense of "Are we making income?" They also want to know how we're utilizing our assets and whether we'll be able to pay them a dividend. |
| McGraw | Given how much financial data comes across your desk, how do you show stockholders what they want to know? |
| Li (deadpan) | We send them a fortune cookie. |
| Glenn | Really? Is that true? |
| Li (laughing) | C'mon Glenn, I was just kidding. Ok, let me answer your question seriously. Accountants produce four financial statements that provide information about the financial health of a business. These are the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows. |
| Glenn | Can you go over these one at a time for me and our listeners? |
| Li | Sure. The income statement is very important to a business because it shows the profit or loss over a specific period of time. It summarizes the revenue and expenses for the period, and once you know that, you can calculate the net profit or loss. |
| McGraw | How often do you prepare an income statement? |
| Li | In the restaurant business with a company our size, we prepare an income statement every month. |
| Glenn | Isn't the income statement prepared first because the net income or loss is needed to prepare the other financial statements? |
| Li | Yes, that's right Glenn. The net income or loss is used to prepare the |

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| | Statement of Retained Earnings. |
| McGraw | What does this report show? |
| Li | The statement of Retained Earnings reports the changes that have occurred in the Retained Earnings account over the current period. For example, if we show a net income for this month on the Income Statement, the Retained Earnings account balance is <i>increased</i> by that same amount. Also, any dividends we pay to our stockholders <i>decrease</i> the Retained Earnings account. |
| Glenn | You also mentioned the balance sheet. What kind of information does this statement contain? |
| Li | Unlike the income statement, the balance sheet doesn't report financial information for a period of time. It's more like a picture of the business on a specific date. It reports all the assets of the business and the claims against those assets by creditors and stockholders. The balance sheet is always <i>in balance</i> because it represents the basic accounting equation: $Assets = Liabilities + Owner's Equity$. |
| McGraw | And what was the last report you mentioned; something about cash flowing...? |
| Li | Yes, (<i>slight chuckle</i>)...you mean the statement of cash flows. This report summarizes the <i>sources</i> of cash and the <i>uses</i> of the cash that flow in and out of the business for the period. Our creditors and investors like to review it to see if the restaurants are bringing in enough cash to meet our obligations and pay dividends. [<i>pause</i>] Oh excuse me a minute, Glenn and McGraw, I see my daughter just came in. |
| Joanne | Hi, Dad! Oh, sorry. I didn't realize you had company today. |
| Li | Joanne, these are the famous radio show hosts, Glenn and McGraw. We were just talking about the financial statements we prepare at the end of each month. |
| Glenn | Nice to meet you Joanne. Do you work with your father here? |
| Joanne | I actually do. I come in after school and work part-time. Right now, I'm verifying the company's closing journal entries because we're closing the books for this month. |
| McGraw | What are the closing journal entries about? |
| Joanne | Well, at the end of each accounting period, we close the books. That means we set certain accounts back to zero and start over with a clean slate. Since we have a computerized system, the software prepares the journal entries to close the accounts, but I need to verify them, meaning that I check them before they are posted. |
| Glenn | Which accounts are closed? |
| Joanne | The accounts that appear on the income statement, because you need to do an income statement each period starting from scratch. |
| Glenn | That makes sense. Otherwise, you'd be mixing income from one period with another period. |
| Joanne | That's why all the accounts that go into the Income Statement are called temporary accounts, and we close them. Meanwhile, other accounts are considered permanent, and these are not closed. Their balances are carried into the new period. |
| McGraw | Once you verify that the closing entries are correct, what happens? |
| Joanne | It's actually pretty simple since we use a computerized system. I just click a button called 'Post.' The entries are posted by the software |

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| | application into the general ledger accounts, and all account balances are recalculated. |
| McGraw | That's it? Then you're ready to start the new accounting period? |
| Joanne | One more thing – the post-closing trial balance. I generate a report to show that the general ledger is still in balance. If everything was posted correctly it should contain balances of only the permanent accounts since all of the temporary accounts have been closed. |
| Glenn | Joanne, you sound like you really understand accounting. |
| Li | I'm very proud of my daughter. Actually I wanted her to be a chef, but she loves accounting. |
| Glenn | Oh, Joanne, you know how to cook Chinese food? |
| Joanne | No way. I took Italian cooking in summer school. I love making pastas and sauces. |
| Glenn | Hey, what an idea for a new restaurant – Italian & Chinese – you know, like Kung Pao Chicken with Bolognese sauce. |
| Joanne | Hmm, I don't think so, Glenn. |
| McGraw | Well that's our time for today. Thanks for listening. This is McGraw Hill for <i>Accounting Away</i> |
| Glenn | And I'm Glenn Coe, saying Have a great day. (<i>thinking the mic is off</i>) Li, you don't have any fortune cookies in your office, do you? I really am starved. |
| McGraw | Glenn, sssh. The mic is still on. |