Accounting Basics, Part 1

Accrual, Double-Entry Accounting, Debits & Credits, Chart of Accounts, Journals and, Ledger
What’s Here…

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- Business Types
- Business Organization
- Professional Advice
- Accounting and Records
- Accrual Accounting
- Basic Bookkeeping
- Chart of Accounts
- Double-Entry Accounting
- Debits & Credits
- The Journal
- The Ledger
- Additional Information
Accounting is the bookkeeping methodology involved in creating a financial record of all business transactions and in preparing statements concerning the assets, liabilities and operating results of the business.

Accounting methods and terms have standard rules known as:

- *Generally Accepted Accounting Principles (GAAP)*
Causes of recurring business difficulty and failure include:
- Inadequate planning
- Lack of business knowledge
- Lack of capital
- Poor management, judgment, and decisions

Successful business managers understand their business information and make comparisons from month-to-month and year-to-year.
Accounting collects, organizes and presents business information in a timely manner and standardized format.

This tutorial outlines accounting “basics” with a primary focus on manual, double entry, accrual accounting processes.
In Part 2 of this series, we pick up where this one ends. It illustrates and discusses the accounting cycle, adjusting entries, closing entries, trial balance and closing balance.

In Part 3, we illustrate and discuss the Balance Sheet, Income Statement and analyzing these financial reports.
Business Types

● Let’s imagine you are going to open a new business – what will be its purpose?
  – Service
  – Sales
  – Manufacturing

● Why does this matter?
  – This is one important factor in deciding which type accounting systems, processes and methods to use
Business Organization

- How will you structure the business?
  - Sole proprietorship
  - Partnership
  - Corporation
  - Limited Liability Company

- Why does this matter?
  - This decision is another major factor in determining which type accounting systems, processes, and methods you will use
Starting and operating a business without professional assistance is ill-advised.
Cash-basis Accounting
Single-entry record keeping
Double-entry record keeping
Accrual-basis Accounting

These each have merit, purpose, and applicability.

The business type/purpose and size and the ownership structure will determine which accounting method and record keeping system is most appropriate for your business venture.
Typical Business Records:

- Journals
- General Ledger
- Petty Cash Record
- Inventory Records
- Fixed Asset Log
- Accounts Receivable
- Accounts Payable
- Payroll Records
- Mileage Log
- Travel Record
- Entertainment Record
- Customer Records
- Business Checkbook
- Filing System
Businesses can record revenue and expenses in one of two ways – cash-basis or accrual-basis.

Accrual accounting is used in businesses involved in production, purchase and sale of merchandise. Revenue is a factor.
In accrual-basis accounting, revenue is recorded when earned, expenses are recorded when they are incurred whether they are paid or not.

When transactions are posted may have nothing to do with when cash is received or payments are made.

Cash is not necessarily the same as revenue.
Bookkeeping deals with five major accounting categories:
- Assets
- Liabilities
- Owner’s Equity (Equity/Capital/ Net Worth)
- Revenue
- Expense

Accounting is the bookkeeping processes that records financial transactions and creates records and statements concerning the assets, liabilities, and operating results of a business.
Basic bookkeeping process for each business transaction:

1. Determine correct account category (assets, liabilities, net worth, revenue, or expense)

2. Identify correct line item account (e.g., Salaries & Wages; Employer Share of FICA; Sick Leave Expense, Annual Leave Expense, etc.)

3. Ensure correct amount used when recording (posting) the transaction

4. Be consistent and accurate
- Dollar signs are **not** used in journals or ledgers. They **are** used in financial reports.
- Commas used to show thousands of dollars are **not** required in journals or ledgers. They **are** used in financial reports.
- Decimal points are **not** required on ruled journals or ledgers. They **are** used in financial reports.
All accounting systems use a Chart of Accounts
- A listing of accounts in a financial system generally using numeric or alpha-numeric characters to designate the transactions that comprise the Balance Sheet and Income Statement
- The chart of accounts is used as the basis for preparing financial reports from an accounting system
- The reports should be designed to capture financial information necessary to make good financial decisions
A Chart of Accounts could include the following account series (groups):

- 100 - Assets
- 200 - Liabilities
- 300 - Net worth
- 400 - Revenue
- 500 - Expenses
<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Net Worth</th>
<th>Revenue</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable</td>
<td>Capital Withdrawals</td>
<td>Sales</td>
<td>Salaries and wages</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Note payable</td>
<td></td>
<td>Services</td>
<td>Utilities</td>
</tr>
<tr>
<td>Automobile</td>
<td>Mortgage payable</td>
<td></td>
<td>income</td>
<td>Supplies</td>
</tr>
<tr>
<td>Equipment</td>
<td>Salaries payable</td>
<td></td>
<td>Interest</td>
<td>Repairs</td>
</tr>
<tr>
<td>Building</td>
<td></td>
<td></td>
<td>earnings</td>
<td>Rent</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td></td>
<td></td>
<td>Office</td>
</tr>
<tr>
<td>Supplies</td>
<td></td>
<td></td>
<td></td>
<td>Interest</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td></td>
<td></td>
<td>Insurance</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Advertising</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Depreciation</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>expense</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Miscellaneous</td>
</tr>
</tbody>
</table>
Example Chart of Accounts:

100 - Assets
101 - Cash
102 - Accounts receivable
103 - Automobile
104 - Equipment
105 - Building
106 - Land
107 - Supplies
108 - Accumulated Depreciation

200 - Liabilities
201 - Accounts payable
202 - Note payable
203 - Mortgage payable
204 - Salaries payable

300 - Net worth
301 - Capital
302 - Withdrawals

400 - Revenue
401 - Sales
402 - Services Income
403 - Interest Earnings

500 – Expenses
501 - Salaries and Wages
502 - Utilities
503 - Supplies
504 - Repairs
505 - Rent
506 - Office
507 - Interest
508 - Insurance
509 - Advertising
510 - Depreciation Expense
514 - Miscellaneous
A double-entry system requires the use of two or more accounts for each transaction. Like a see-saw, these must balance in a double-entry accounting system.
Example 1 – A business starts with an investment of $75,000 which is recorded (posted) as:

- **Assets**
  - Cash $75,000

- **Liabilities**

- **Net Worth Capital** $75,000

- **Revenue**

- **Expenses**
Example 2 – The business buys a $55,000 building with $5,000 cash and a mortgage which is posted as:

- **Assets**
  - Cash: $5,000
  - Building: $50,000

- **Liabilities/Mortgage Payable**
  - $50,000

- **Net Worth**
  - $5,000

+ Revenue - Expenses
Accountants have used the terms *debit* and *credit* for hundreds of years to describe where numbers are placed in Journals and Ledger Books.

- Debit means left
- Credit means right

Latin Dr and Cr:
- Dr for Debit
- Cr for Credit
Debits and Credits,
Page 2 of 2

When recording transactions in the Journal and Ledgers, the five major account categories are increased or decreased by debits or credits as shown.
The Journal or General Journal is used to record all transactions in chronological order.

The Journal is the *book of original entry*.

Entries are made on a daily basis, according to the time and date they occur.

The Journal records debits (left side) and credits (right side) as illustrated on the next slide.
<table>
<thead>
<tr>
<th>Date</th>
<th>Description of Entry</th>
<th>PR</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>20XX</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar</td>
<td>Cash</td>
<td></td>
<td>40000</td>
<td>40000</td>
</tr>
<tr>
<td>1</td>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Invested in the business</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Rent</td>
<td></td>
<td>600</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td>600</td>
</tr>
</tbody>
</table>

- Indent Credits
- Skip between entries
- Explain transaction
- Record account number after amount posted to ledger
<table>
<thead>
<tr>
<th>Date</th>
<th>Description of Entry</th>
<th>PR</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>20XX</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apr 1</td>
<td>Truck</td>
<td></td>
<td>28000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td>10000</td>
</tr>
<tr>
<td></td>
<td>Note payable</td>
<td></td>
<td></td>
<td>18000</td>
</tr>
<tr>
<td></td>
<td>Purchase a new truck</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

April 1 – bought new truck. Invested $10,000 cash in truck with remainder on a note payable. The truck cost $28,000.

- **Truck**: 28000 (increase)
- **Cash**: 10000 (decrease)
- **Note Payable**: 18000 (decrease)
Types of Journals

Sales Journal
Purchase Journal
Cash Receipts Journal
Cash Disbursement Journal
General Journal
The Journal, Page 5 of 5

- **Sales Journals**: Record only sales on credit
- **Purchases Journals**: Record everything bought on credit
- **Cash Receipts Journals**: Record all incoming cash
- **Cash Disbursements Journals**: Record all outgoing cash
- **General Journal**: Everything not recorded in the other Journals
Each business transaction is recorded in the Journal, then posted (placed) into the applicable Ledger book.

The Ledger has all the accounts listed in order (assets, liabilities, net worth, revenue, and expenses).
Transactions are typically recorded as follows:

- After reviewing details of the transaction, determine the accounts affected
  - Two or more accounts will be affected in a double-entry system
- Decide if the applicable accounts are increased or decreased by the transaction
- Place the correct amount on the proper side of the “T” account to reflect the increase or decrease

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Truck</td>
<td>28000</td>
<td>Plus</td>
</tr>
<tr>
<td>Cash</td>
<td>10000</td>
<td>Minus</td>
</tr>
<tr>
<td>Note Payable</td>
<td>18000</td>
<td>Plus</td>
</tr>
</tbody>
</table>
Additional Information,

- My Bean Counter website at:
  http://www.dwmbeancounter.com/