
Accounting Basics

Important Disclaimer

 **Important Note:** *The text in this chapter is intended to clarify business-related concepts. It is not intended nor can it replace formal legal advice. Before taking any actions relating to your business, always consult your accountant or a business law/tax attorney.*

The Need for Accounting

Every organization needs to maintain good records to track how much money they have, where it came from, and how they spend it. These records are maintained by using an accounting system.

These records are essential because they can answer such important questions as:

- Am I making or losing money from my business?
- How much am I worth?
- Should I put more money in my business or sell it and go into another business?
- How much is owed to me, and how much do I owe?
- How can I change the way I operate to make more profit?

Even if you do not own or run a business, as an accountant you will be asked to provide the valuable information needed to assist management in the decision making process. In addition, these records are invaluable for filing your organization's tax returns.

The modern method of accounting is based on the system created by an Italian monk *Fra Luca Pacioli*. He developed this system over 500 years ago. This great and scientific system was so well designed that even modern accounting principles are based on it.

In the past, many businesses maintained their records manually in books – hence the term “bookkeeping” came about. This method of keeping manual records was cumbersome, slow, and prone to human errors of translation.

A faster, more organized, and easier method of maintaining books is using Computerized Accounting Programs. With the decrease in the price of computers and accounting programs, this method of keeping books has become very popular.

Accounting and Business

Accounting is the system a company uses to measure its financial performance by noting and classifying all the transactions like sales, purchases, assets, and liabilities in a manner that adheres to certain accepted standard formats. It helps to evaluate a Company's past performance, present condition, and future prospects.

A more formal definition of accounting is *the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof.*

What Accountants Do



We have said that accounting consists of these functions:

- Recording
- Classifying
- Summarizing
- Reporting and evaluating the financial activities of a business

Before any recording can take place, there must be something to record. In accounting, the something consists of a transaction or event that has affected the business. Evidence of the transaction is called a document.

For example:

- A sale is made, evidenced by a sales slip.
- A purchase is made, as evidenced by a check and other documents such as an invoice and a purchase order.
- Wages are paid to employees with the checks and payroll records as support.
- Accountants do not record a conversation or an idea. They must first have a document.

In almost any business, these documents are numerous and their recording requires some sort of logical system. Recording is first carried out in a book of original entry called the journal. A journal is a record, listing transactions in a chronological order.

At this point, we have a record of a great volume of data. How can this data best be used? Aside from writing down what has occurred for later reference, what has been accomplished? The answer is, of course, that the accountant has only started on his task. This great

volume of data in detailed listings must be summarized in a meaningful way.

When asked, the accountant must turn to these summaries to answer questions like:

- What were total sales this month?
- What were the total expenses and what were the types and amounts of each expense?
- How much cash is on hand?
- How much does the business owe?
- How much are the accounts receivable?

The next task after recording and classifying is summarizing the data in a significant fashion.

The records kept by the accountant are of little value until the information contained in the records is reported to the owner(s) or manager(s) of the business. These records are reported to the owners by preparing a wide variety of financial statements.

The accountant records, classifies, summarizes, and reports transactions that are mainly financial in nature and affect the business. The reporting, of course, involves placing his interpretation on the summarized data by the way he arranges his reports.

Every business has a unique method of maintaining its accounting books. However, all accounting systems are similar in the following manner:

- Business documents representing transactions that have taken place. (A business transaction occurs when goods are sold, a contract is signed, merchandise is purchased, or some similar financial transaction has occurred).
- Various journals where the documents are recorded in detail and classified
- Various ledgers where the details recorded in the journals are summarized
- Financial reports where the summarized information is presented

Where variations exist, they have to do with the way the business transaction is assembled, processed, and recorded.

These methods are partly arbitrary. First, you must understand certain simple principles of accounting. When you have a firm grasp of the fundamentals you can deal with any kind of accounting problem.

Advantages of Computerized Accounting

Some of the advantages of using a computerized accounting system are:

- The arithmetic of adding up debits and credits columns is done automatically and with total accuracy by the computer.
- Audit trails or details are automatically maintained for you.
- Produce financial statements simply by selecting the appropriate menu item.
- A computerized system lets you retrieve the latest accounting data quickly, such as today's inventory, the status of a client's payment, or sales figures to date.
- Data can be kept confidential by taking advantage of the security password systems that most accounting programs provide.

Computerized accounting programs usually consist of several modules.

The principal modules commonly used are:

- General Ledger
- Inventory
- Order Entry
- Accounts Receivable
- Accounts Payable
- Bank Manager
- Payroll

In a good accounting system, the modules are fully integrated. When the system is integrated, the modules share common data. For example, a client sales transaction can be entered in as an invoice, which automatically posts to the General Ledger module without re-entering any data. This is one of the greatest advantages of a

computerized accounting system – you need to enter the information only once. As a result of this:

- Data entry takes less time.
- There is less chance that errors will occur.
- You do not have to re-enter data for posting.

Types of Business Organizations

Three principal types of organizations have developed as ways of owning and operating business enterprise.

In general, business entity or organizations are:

- Sole proprietorship
- Partnerships
- Corporations

Let us discuss these concepts starting with the simplest form of business organization, the single or sole proprietorship.

Sole Proprietorship

A sole proprietorship is a business wholly owned by a single individual. It is the easiest and the least expensive way to start a business and is often associated with small storekeepers, service shops, and professional people such as doctors, lawyers, or accountants. The sole proprietorship is the most common form of business organization and is relatively free from legal complexities.

One major disadvantage of sole proprietorship is unlimited liability since the owner and the business are regarded as the same, from a legal standpoint.

Partnerships

A partnership is a legal association of two or more individuals called partners and who are co-owners of a business for profit. Like proprietorships, they are easy to form. This type of business organization is based upon a written agreement that details the various interests and right of the partners and it is advisable to get legal advice and document each person's rights and responsibilities.

There are three main kinds of partnerships

- General partnership
- Limited partnership
- Master limited partnership

General Partnership

A business that is owned and operated by 2 or more persons where each individual has a right as a co-owner and is liable for the business's debts. Each partner reports his share of the partnership profits or losses on his individual tax return. The partnership itself is not responsible for any tax liabilities.

A partnership must secure a **Federal Employee Identification** number from the **Internal Revenue Service (IRS)** using special forms.

Each partner reports his share of partnership profits or losses on his individual tax return and pays the tax on those profits. The partnership itself does not pay any taxes on its tax return.

Limited Partnership

In a Limited Partnership, one or more partners run the business as General Partners and the remaining partners are passive investors who become limited partners and are personally liable only for the amount of their investments. They are called limited partners because they cannot be sued for more money than they have invested in the business.

Limited Partnerships are commonly used for real-estate syndication.

Master Limited Partnership

Master Limited Partnerships are similar to Corporations trading partnership units on listed stock exchanges. They have many advantages that are similar to Corporations e.g. Limited liability, unlimited life, and transferable ownership. In addition, they have the added advantage if 90% of their income is from passive sources (e.g. rental income), then they pay no corporate taxes since the profits are paid to the stockholders who are taxed at individual rates.

Corporations

The **Corporation** is the most dominant form of business organization in our society. A Corporation is a legally chartered enterprise with most legal rights of a person including the right to conduct business, own, sell and transfer property, make contracts, borrow money, sue and be sued, and pay taxes. Since the Corporation exists as a separate entity apart from an individual, it is legally responsible for its actions and debts.

The modern Corporation evolved in the beginning of this century when large sums of money were required to build railroads and steel mills and the like and no one individual or partnership could hope to raise. The solution was to sell shares to numerous investors (shareholders) who in turn would get a cut of the profits in exchange for their money. To protect these investors associated with such large undertakings, their liability was limited to the amount of their investment.

Since this seemed to be such a good solution, Corporations became a vibrant part of our nation's economy. As rules and regulations evolved as to what a Corporation could or could not do, Corporations acquired most of the legal rights as those of people in that it could receive, own sell and transfer property, make contracts, borrow money, sue and be sued and pay taxes.

The strength of a Corporation is that its ownership and management are separate. In theory, the owners may get rid of the Managers if they vote to do so. Conversely, because the shares of the company known as stock can be sold to someone else, the Company's ownership can change drastically, while the management stays the same. The Corporation's unlimited life span coupled with its ability to raise money gives it the potential for significant growth.

A Company does not have to be large to incorporate. In fact, most corporations, like most businesses, are relatively small, and most small corporations are privately held.

Some of the disadvantages of Corporations are that incorporated businesses suffer from higher taxes than unincorporated businesses. In addition, shareholders must pay income tax on their share of the Company's profit that they receive as dividends. This means that corporate profits are taxed twice.

There are several different types of Corporation based on various distinctions, the first of which is to determine if it is a public, quasi-public or Private Corporation. **Federal or state governments form Public Corporations** for a specific public purpose such as making student loans, building dams, running local school districts etc. **Quasi-public Corporations** are public utilities, local phones, water, and natural gas. **Private Corporations** are companies owned by individuals or other companies and their investors buy stock in the open market. This gives private corporations access to large amounts of capital.

Public and private corporations can be for-profit or non-profit corporations. **For-profit corporations** are formed to earn money for their owners. **Non-profit Corporations** have other goals such as those targeted by charitable, educational, or fraternal organizations. No stockholder shares in the profits or losses and they are exempt from corporate income taxes.

Professional Corporations are set up by businesses whose shareholders offer professional services (legal, medical, engineering, etc.) and can set up beneficial pension and insurance packages.

Limited Liability Companies (LLCs as they are called) combine the advantages of S Corporations and limited partnerships, without having to abide by the restrictions of either. LLCs allow companies to pay taxes like partnerships and have the advantage of protection from liabilities beyond their investments. Moreover, LLCs can have over 35 investors or shareholders (with a minimum of 2 shareholders). Participation in management is not restricted, but its life span is limited to 30 years.

Subchapter S Corporation

Subchapter S Corporation, also known as an S Corporation is a cross between a partnership and a corporation. However, many states do not recognize a Subchapter S selection for state tax purposes and will tax the corporation as a regular corporation.

The flexibility of these corporations makes them popular with small- and medium-sized businesses. Subchapter S allows profits or losses to travel directly through the corporation to you and to the shareholders. If you earn other income during the first year and the corporation has a loss, you may deduct against the other income, possibly wiping out your tax liability completely subject to the limitations of Internal Revenue Service tax regulations.

Subchapter S corporations elect not to be taxed as corporations; instead, the shareholders of a Subchapter S corporation include their proportionate shares of the corporate profits and losses in their individual gross incomes. Subchapter S corporations are excellent devices to allow small businesses to avoid double taxation. If your company does produce a substantial profit, forming a Subchapter S Corporation would be wise, because the profits will be added to your personal income and taxed at an individual rate. These taxes may be lower than the regular corporate rate on that income.

To qualify under **Subchapter S**, the corporation must be a domestic corporation and must not be a member of an affiliated group. Some of the other restrictions include that it must not have more than 35 shareholders – all of who are either individuals or estates. Subchapter S corporations can have an unlimited amount of passive income from rents, royalties, and interest. For more information on the rules that apply to a Subchapter S corporation, contact your local IRS office.

Limited Liability Company

Limited Liability Companies (LLCs as they are called) combine the advantages of S Corporations and limited partnerships, without having to abide by the restrictions of either. LLCs allow companies to pay taxes like partnerships and have the advantage of protection from liabilities beyond their investments. Moreover, LLCs can have over 35 investors or shareholders (with a minimum of 2 shareholders). Participation in management is not restricted, but its life span is limited to 30 years.

The Business Entity Concept

It is an important accounting principle that the business is treated as an entity separate and distinct from its owners and any other people associated with it. This principle is called the **Business Entity Concept**. It simply means that accounting records and reports are concerned with the business entity, not with the people associated with the business. Now, let's review the two main accounting methods.

Types of Accounting

The two methods of tracking your accounting records are:

- Cash Based Accounting
- Accrual Method of Accounting

Cash Based Accounting

Most of us use the cash method to keep track of our personal financial activities. The cash method recognizes revenue when payment is received, and recognizes expenses when cash is paid out. For example, your personal checkbook record is based on the cash

method. Expenses are recorded when cash is paid out and revenue is recorded when cash or check deposits are received.

Accrual Accounting

The accrual method of accounting requires that revenue be recognized and assigned to the accounting period in which it is earned. Similarly, expenses must be recognized and assigned to the accounting period in which they are incurred.

A Company tracks the summary of the accounting activity in time intervals called Accounting periods. These periods are usually a month long. It is also common for a company to create an annual statement of records. This annual period is also called a Fiscal or an Accounting Year.

The accrual method relies on the principle of matching revenues and expenses. This principle says that the expenses for a period, which are the costs of doing business to earn income, should be compared to the revenues for the period, which are the income earned as the result of those expenses. In other words, the expenses for the period should accurately match up with the costs of producing revenue for the period.

In general, there are two types of adjustments that need to be made at the end of the accounting period. The first type of adjustment arises when more expense or revenue has been recorded than was actually incurred or earned during the accounting period. An example of this might be the pre-payment of a 2-year insurance premium, say, for \$2000. The actual insurance expense for the year would be only \$1000. Therefore, an adjusting entry at the end of the accounting period is necessary to show the correct amount of insurance expense for that period.

Similarly, there may be revenue that was received but not actually earned during the accounting period. For example, the business may have been paid for services that will not actually be provided or earned until the next year. In this case, an adjusting entry at the end of the accounting period is made to defer, that is, to postpone, the recognition of revenue to the period it is actually earned.

Although many companies use the accrual method of accounting, some small businesses prefer the cash basis. The accrual method generates tax obligations before the cash has been collected. This benefits the Government because the IRS gets its tax money sooner.

Cash versus Accrual Accounting

Accounts Receivable is an asset that is owed to you but you do not have money in the bank or property to show you own something - it is intangible, on paper. It grows or accumulates as you issue invoices; therefore, Accounts Receivable is part of an accrual accounting system.

Double-entry accounting is the most accurate and best way to keep your financial records. With a computer, you don't have to fully understand all the accounting details. Basically, in double entry accounting each transaction affects two or more categories or accounts, so everything stays in balance. Therefore, if you change an asset balance by issuing an invoice some other category balance changes as well. In this case, when you issue an invoice, the category that balances the asset called Accounts Receivable is an income or a sales account.

When you bill your client, there is an increase in income (on paper) and hence an increase in Accounts Receivable. When you are paid, the paper asset turns into money you put in the bank – a tangible asset. Through a process of recording the payment and the deposit, Accounts Receivable decreases and the bank balance increases. This accounting program takes care of all the accounting details.

This paper income can be confusing if you don't understand that it is the total of all invoiced work, both paid and unpaid. If you have invoiced clients for a total of \$10,000 but only \$2,000 has been paid, your income will be \$10,000 and your Accounts Receivable balance will be \$8,000, and your bank account has increased by the \$2,000 you received. An accountant would call this an accrual accounting method.

A cash accounting method only counts income when money is received, and it does not keep track of Accounts Receivable.

However, in real life, small businesses tend to use both methods without realizing the difference until income tax time.

This program can handle both accrual and cash based accounting. You can use the **G/L Setup** option in the **G/L** module to select either Cash or Accrual based accounting. We recommended that you consult with your accountant to determine which system will work best for you.

Accounts

The accounting system uses Accounts to keep track of information. Here is a simple way to understand what accounts are. In your office, you usually keep a filing cabinet. In this filing cabinet, you have multiple file folders. Each file folder gives information for a specific topic only. For example you may have a file for utility bills, phone bills, employee wages, bank deposits, bank loans etc.

A chart of accounts is like a filing cabinet. Each account in this chart is like a file folder. Accounts keep track of money spent, earned, owned, or owed. Each account keeps track of a specific topic only. For example, the money in your bank or the checking account would be recorded in an account called Cash in Bank. The value of your office furniture would be stored in another account. Likewise, the amount you borrowed from a bank would be stored in a separate account.

Each account has a balance representing the value of the item as an amount of money. Accounts are divided into several categories like Assets, Liabilities, Income, and Expense accounts. A successful business will generally have more assets than liabilities. Income and Expense accounts keep track of where your money comes from and on what you spend it. This helps make sure you always have more assets than liabilities.

Account Types

In order to track money within an organization, different types of accounting categories exist. These categories are used to denote if the money is owned or owed by the organization. Let us discuss the three main categories: Assets, Liabilities, and Capital.

Assets

An Asset is a property of value owned by a business. Physical objects and intangible rights such as money, accounts receivable, merchandise, machinery, buildings, and inventories for sale are common examples of business assets as they have economic value for the owner. Accounts receivable is an unwritten promise by a client to pay later for goods sold or services rendered.

Assets are generally listed on a balance sheet according to the ease with which they can be converted to cash. They are generally divided into three main groups:

- Current
- Fixed
- Intangible

Current Asset

A **Current Asset** is an asset that is either:

- Cash – includes funds in checking and savings accounts
- Marketable securities such as stocks, bonds, and similar investments
- Accounts Receivables, which are amounts due from customers
- Notes Receivables, which are promissory notes by customers to pay a definite sum plus interest on a certain date at a certain place.
- Inventories such as raw materials or merchandise on hand
- Prepaid expenses – supplies on hand and services paid for but not yet used (e.g. prepaid insurance)

In other words, cash and other items that can be turned back into cash within a year are considered a current asset.

Fixed Assets

Fixed Assets refer to tangible assets that are used in the business. Commonly, fixed assets are long-lived resources that are used in the production of finished goods. Examples are buildings, land, equipment, furniture, and fixtures. These assets are often included under the title property, plant, and equipment that are used in running a business. There are four qualities usually required for an item to be classified as a fixed asset. The item must be:

- Tangible
- Long-lived
- Used in the business
- Not be available for sale

Certain long-lived assets such as machinery, cars, or equipment slowly wear out or become obsolete. The cost of such as assets is systematically spread over its estimated useful life. This process is called **depreciation** if the asset involved is a tangible object such as a building or **amortization** if the asset involved is an intangible asset such as a patent. Of the different kinds of fixed assets, only land does not depreciate.

Intangible Assets

Intangible Assets are assets that are not physical assets like equipment and machinery but are valuable because they can be licensed or sold outright to others. They include cost of organizing a business, obtaining copyrights, registering trademarks, patents on an invention or process and goodwill. Goodwill is not entered as an asset unless the business has been purchased. It is the least tangible of all the assets because it is the price a purchaser is willing to pay for a company's reputation especially in its relations with customers.

Liabilities

A Liability is a legal obligation of a business to pay a debt. Debt can be paid with money, goods, or services, but is usually paid in cash. The most common liabilities are notes payable and accounts payable. Accounts payable is an unwritten promise to pay suppliers or lenders specified sums of money at a definite future date.

Current Liabilities

Current Liabilities are liabilities that are due within a relatively short period of time. The term Current Liability is used to designate obligations whose payment is expected to require the use of existing current assets. Among current liabilities are **Accounts Payable, Notes Payable, and Accrued Expenses**. These are exactly like their receivable counterparts except the debtor-creditor relationship is reversed.

Accounts Payable is generally a liability resulting from buying goods and services on credit

Suppose a business borrows \$5,000 from the bank for a 90-day period. When the money is borrowed, the business has incurred a liability – a **Note Payable**. The bank may require a written promise to pay before lending any amount although there are many credit plans, such as revolving credit where the promise to pay back is not in note form.

On the other hand, suppose the business purchases supplies from the ABC Company for \$1,000 and agrees to pay within 30 days. Upon acquiring title to the goods, the business has a liability – an **Account Payable** – to the ABC Company.

In both cases, the business has become a debtor and owes money to a creditor. Other current liabilities commonly found on the balance sheet include salaries payable and taxes payable.

Another type of current liability is **Accrued Expenses**. These are expenses that have been incurred but the bills have not been received

for it. Interest, taxes, and wages are some examples of expenses that will have to be paid in the near future.

Long-Term Liabilities

Long-Term Liabilities are obligations that will not become due for a comparatively long period of time. The usual rule of thumb is that long-term liabilities are not due within one year. These include such things as bonds payable, mortgage note payable, and any other debts that do not have to be paid within one year.

You should note that as the long-term obligations come within the one-year range they become Current Liabilities. For example, mortgage is a long-term debt and payment is spread over a number of years. However, the installment due within one year of the date of the balance sheet is classified as a current liability.

Capital

Capital, also called net worth, is essentially what is yours – what would be left over if you paid off everyone the company owes money to. If there are no business liabilities, the Capital, Net Worth, or Owner Equity is equal to the total amount of the Assets of the business.

Key Accounting Concepts

The two fundamental accounting concepts which were developed centuries ago but remain central to the accounting process are:

- The accounting equation
- Double-entry bookkeeping

The Accounting Equation

Now let us discuss the accounting equation, which keeps all the business accounts in balance. We will create this equation in steps to clarify your understanding of this concept. In order to start a business, the owner usually has to put some money down to finance the business operations. Since the owner provides this money, it is called **Owner's equity**. In addition, this money is an **Asset** for the company. This can be represented by the equation:

$$\text{ASSETS} = \text{OWNER'S EQUITY}$$

If the owner of the business were to close down this business, he would receive all its assets. Let's say that owner decides to accept a loan from the bank. When the business decides to accept the loan, their Assets would increase by the amount of the loan. In addition, this loan is also a Liability for the company. This can be represented by the equation:

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

Now the Assets of the company consist of the money invested by the owner, (i.e. **Owner's Equity**), and the loan taken from the bank, (i.e. a **Liability**). The company's liabilities are placed before the owners' equity because creditors have first claim on assets.

If the business were to close down, after the liabilities are paid off, anything left over (assets) would belong to the owner.

The Double Entry System



As we had mentioned earlier that today's accounting principles are based on the system created by an Italian Monk Fra Luca Pacioli. He developed this system over 500 years ago. Pacioli had devised this method of keeping books, which is today known as the Double Entry system of accounting. He explained that every time a transaction took place whether it was a sale or a collection – there were two

offsetting sides. The entry required a two-part “give-and-get” entry for each transaction.

Here is a simple explanation of the double entry system. Say you took a loan from the bank for \$5,000. Now if you can recall in an earlier discussion we had mentioned that:

ASSETS = LIABILITIES + OWNER’S EQUITY

Since the company borrowed money from the bank, the \$5,000 is a liability for the company. In addition, now that the company has the extra \$5,000, this money is an asset for the company. If we were to record this information in our accounts, we would put \$5,000 in an account called **Loan Taken from the Bank**, and \$5,000 in an account called **Cash Saved in the Bank**. The former account will be a Liability and the second account would be an Asset. As you can see, we created two entries. The first one is to show from where the money was received (i.e. the source of the money). The second entry is to show where the money was sent (i.e. the destination of the money received).

In a double entry accounting system, every transaction is recorded in the form of debits and credits. Even for the simplest double entry, transaction there will be a debit and a credit. In simpler terms, a debit is the application of money, and credit is the source of money.

Let us discuss some examples to help you understand the concept of debits and credits:

Example 1

Let’s say you wrote a check for \$100 to purchase some stationary. This transaction would be recorded as a Credit of \$100 to the Cash in Bank account, and a Debit of \$100 to the Stationary account. In this case, we made a credit to the Cash in Bank, as it was the source of the money. The Stationary account was debited, as it was the application of the money.

Example 2

Let's say you received \$200 cash for services rendered to a client. This transaction would be recorded as a Credit of \$200 to the Income from Services account, and a Debit of \$200 to the Cash in Bank account. In this case, we made a credit to the Income from Services, as it was the source of the money. The Cash in Bank account was debited, as it was the application of the money.

Example 3

Let's say you received a \$10,000 loan from a bank. This transaction would be recorded as a Credit of \$10,000 to the Loan Payable account, and a Debit of \$10,000 to the Cash in Bank account. In this case, we made a credit to Loan Payable, as it was the source of the money. The Cash in Bank account was debited, as it was the application of the money.

Example 4

Let's say you made out a payroll check to an employee for \$300. This transaction would be recorded as a Credit of \$300 to the Cash in Bank account, and a Debit of \$300 to the Payroll Expense account. In this case, we made a credit to the Cash in Bank, as it was the source of the money. The Payroll Expense account was debited, as it was the application of the money.

Example 5

Let's say you invested \$10,000 in starting a new business. This transaction would be recorded as a Credit of \$10,000 to the Owner's equity account, and a Debit of \$10,000 to the Cash in Bank account. In this case, we made a credit to the Owner's equity, as it was the source of the money. The Cash in Bank account was debited, as it was the application of the money.

You may remember from our discussion earlier that in order to start a business, the owner usually has to put some money down to finance the business operations. Since the owner provides this money, it is called **Owner's Equity**.

Overview

The previous examples illustrated some of the transactions that are recorded in a double entry accounting system. These transactions are also referred to as Journal Entries. Your accounting application automatically creates the journal entries for you. In example 1 above, you would create a check in the system, and on the check you would give the expense account number for stationary. The checkbook program would then automatically credit the cash account, and debit the stationary expense account.

Journals

Looking at the ledger account alone, it is difficult to trace back all the accounts that were affected by a transaction. For this reason, another book is used to record each transaction as it takes place and to show all the accounts affected by the transaction. This book is called the General Journal, or Journal.

Each transaction is first recorded in the journal and then the appropriate entries are made to the accounts in the G/L. Because the journal is the first place a transaction is recorded it is called the book of original entry. The advantage of the journal is that it shows all the accounts that are affected by a transaction, and the amounts the appropriate accounts are debited and credited, all in one place.

Also included with each transaction is an explanation of what the transaction is for. Transactions are recorded in the journal as they take place, so the journal is a chronological record of all transactions conducted by the business. There is a standard format for recording transactions in the journal. A journal transaction usually consists of the following:

- Journal Transaction Number
- Transaction Date
- Journal Type (General Journal, Sales Journal etc.)
- Actual Journal entries adjusting the account balances

In addition to the General Journal, other specialized journals contain entries from other accounting modules to track sales, purchases, and the disbursement of cash. Some of the important journals are:

- Invoice Journal Report
- The Cash Receipts Report
- The Purchases Journal
- A/P Journal (Transactions & Payments) Reports

This program comes with sample chart of accounts already installed. If you prefer, you can modify these accounts or create your own chart of accounts. In addition, all the Debits, Credit, and Journals are automatically maintained for you. When you create invoices, checks and other transactions in the system all the journal entries are created for you automatically. It is that easy!

Managing Your Business

We have covered the areas of accounts, debits, credits, and the accounting equation. In order to control your business you must manage key areas. These areas are Cash, Sales, Income, Expenses, Assets, Inventory, and Payroll. We will discuss each of these areas in the following sections.

Managing Cash

Bank Reconciliation

Typically, a business will use a bank checking account to help control the flow of cash. Cash received during the day is deposited periodically in the bank account and checks are written on the account whenever cash is paid out.

When the bank account is opened, each authorized person signs a signature card. The bank can use the signature card at any time to

make sure that the signature on the check is authentic and that money can be paid out of that account.

When cash is deposited into the account, a deposit ticket is filled out listing the check number and the amount of each check and any additional currency.

As the business makes payments, it will write checks on the bank account and record each check payment in the checkbook or on the check stub. Every month, the bank will send the business a bank statement, along with the cancelled checks paid that month.

The bank statement shows the balance at the beginning of the month, it lists each check paid, each deposit, any other charges or credits to the account, and it shows the balance at the end of the month.

Usually the ending balances on the bank statement will not match the current cash account balance shown in the checkbook. This is because there may be checks that have been written and recorded in the checkbook but have not yet been processed and paid by the bank. There may also be service or other charges the bank has deducted from the bank statement balance but which have not yet been recorded and deducted from the checkbook balance.

For this reason, it is necessary at the end of each month to reconcile your bank statement. This is simply the process of making the proper adjustments to both the bank statement balance and to the checkbook balance to prove that they do in fact balance.

There are three steps to reconcile your bank statement.

Step 1: Compare the deposits shown in the checkbook with those shown on the bank statement. Any deposits not yet shown on the bank statement are deposits in transit, that is, they are not yet received and recorded by the bank. Subtract the total of the deposits in transit from the final balance in your checkbook.

Step 2: Compare the canceled checks as shown on the bank statement with those recorded as written in the checkbook. Checks that have been written but not yet

processed and paid by the bank are called outstanding checks. Add the total of the outstanding checks to the final balance in your checkbook.

Step 3: Now look at the bank statement and see if there are any service charges or credits that are not yet recorded in the checkbook. Add the credits and subtract the charges from the final balance of your checkbook. The adjusted balances of your checkbook will now be equal to the ending balance on the bank statement.

All the checks and deposits entered in this program automatically list on the checkbook reconciliation screen. This saves time and makes the reconciliation process quick and easy.

Petty Cash

As we had discussed earlier, the principal method for maintaining internal control of cash is using a checking account. However, a business usually has minor expenses, such as postage or minor purchases of supplies that are easier to pay for with currency rather than with a check.

To handle these minor expenses, a petty cash fund is set up. A small amount of money, like \$100, is placed in a petty cash box or drawer and an individual is given responsibility for the funds. This individual is the petty cashier.

When money is needed for an expense, the cashier prepares a petty-cash ticket, which shows the date, amount, and purpose of the expense and includes the signature of the person receiving the money. This ticket is then placed in the petty cash box. At any time, the total amount of cash in the box plus the total amount of all tickets should equal the original fixed amount of cash originally placed in the box.

As expenditures are made, the petty cash fund will eventually need to be replenished. This is usually done by writing a check to bring the amount in the fund back to the original amount of \$100.

Managing Sales

Sales made by businesses can be broken down into the following main categories:

- Cash sales
- Sales on account

Cash Sales

Some businesses sell merchandise for cash only, while others sell merchandise either for cash or on account. A variety of practices are followed in the handling of cash sales. If such transactions are numerous, it is probable that one or more types of cash registers will be used. In this instance, the original record of the sales is made in the register.

Often, registers have the capability of accumulating more than one total. This means that by using the proper key, each amount that is punched in the register can be classified by type of merchandise, by department, or by salesperson. Where sales tax is involved, the amount of the tax may be separately recorded. In accounting terms, a cash sale means that the asset **Cash** is increased by a debit and the income account **Sales** and a liability account **Sales Tax Payable** are credited. This displays in the table below:

| | Debit | Credit |
|--------------|--------------|---------------|
| Cash | 110.00 | |
| Sales | | 100.00 |
| Sales Tax | | 10.00 |
| Total | 110.0 | 110.00 |

In many retail establishments, the procedure in handling cash sales is for the sale clerks to prepare sale tickets in triplicate. Sometimes the preparation of the sales tickets involves the use of a cash register that prints the amount of the sale directly on the ticket. Modern electronic cash registers serve as input terminals that are **online** with computers, that is, in direct communication with the central

processor. At the end of each day, the cash received is compared with the record that the register provides. The receipts may also be compared with the total of the cash-sales tickets, if the system makes use of the latter.

Sales on Account

Sales on account are often referred to as **charge sales** because the seller exchanges merchandise for the buyer's promise to pay. In accounting terms, this means that the asset Accounts Receivable of the seller is increased by a debit or charge, and the income account sales is increased by a credit. Selling goods on account is common practice at the retail level of the distribution process.

Firms that sell goods on account should investigate the financial reliability of their clients. A business of some size may have a separate credit department whose major function is to establish credit policies and decide upon requests for credit from persons and firms who wish to buy goods on account.

Seasoned judgment is needed to avoid a credit policy that is so stringent that profitable business may be refused, or a credit policy that is so liberal that uncollectable account losses may become excessive.

Generally, no goods are delivered until the salesclerk is assured that the buyer has established credit - that there is an account established for this client with the company. In the case of many retail businesses, clients with established credit are provided with credit cards or charge plates, which provide evidence that the buyer has an account. These are used in mechanical or electronic devices to print the client's name and other identification on the sales tickets. In the case of merchants who commonly receive a large portion of their orders by mail or by phone, this confirmation of the buyer's status can be handled as a matter of routine before the goods are delivered.

Managing Expenses

The Expense Authorization system is a commonly used method to keep track of and control expenses. It is based upon the use of tickets. These tickets are written authorizations prepared for each expense.

With this system, before a check is written, a ticket is prepared authorizing payment. This system provides an excellent control over expenses. It does this by making sure that each expense is justified and by requiring more than one person to be responsible for preparing and authorizing the payment. A ticket is prepared for every transaction that results in an expense.

When an invoice for a purchase is received, it is attached to a ticket, which is then filled out and signed. The information that goes on the front side of the ticket verifies the information on the invoice. Once the information is verified, an approval signature is required to authorize the expense. Once the ticket is approved, it is recorded in an expense register.

Tickets are recorded in the register in date order. Once recorded, the ticket is put into an Unpaid Ticket File where it remains until it is paid. The tickets are filed according to the date they should be paid in order to take advantage of discounts.

When it comes time to pay a ticket, it is removed from the Unpaid Tickets File and a check is issued. The check number and payment date is recorded on the ticket and in the Ticket Register next to that ticket entry. Each ticket is paid by check. As each ticket is paid, the payment is recorded in a Check Register. With the ticket system, the Check Register is the book of original entry for recording payments and it takes the place of a cash payments journal.

In a computerized accounting system, the function for controlling expenses is controlled by the Accounts Payable program. You would enter, track and pay your invoices with Accounts Payable.

Managing Inventory

Merchandise Inventory

Merchandise inventories are the goods that are on hand for the production process or available for sale to final customers. There are two basic methods for determining inventory:

- Perpetual inventory method
- Periodic inventory method

With the perpetual inventory method, the cost of each item in the inventory is recorded when purchased. When an item is sold, its cost is deducted from the inventory. This results in a perpetual record of exactly what is in inventory.

The perpetual inventory method is best suited for those businesses that have a relatively low number of sales each day and whose merchandise has a high unit value. For example, a car dealer might use the perpetual inventory method to keep track of inventory because it is easy to keep track of each item as it is purchased by the business and then resold.

This program uses the perpetual method and automatically tracks your inventory value. This program makes it easy for businesses such as department and grocery stores that have a large number of sales each day to track inventory value on a real-time basis.

For businesses that manually maintain track inventory value, it wouldn't be practical to adjust the cost of inventory each time an item is sold. Instead, these types of business use the periodic inventory method, which involves periodically taking a physical count of the merchandise on hand, usually once a year at the end of the accounting period.

Once the physical count is done, the exact quantity of merchandise on hand is known. The costs of all items on hand are then totaled to give a total cost of the inventory on hand at the end of the year.

Calculating Inventory Value

A company can raise or lower its earnings by changing the way it calculates the cost of goods sold. As inventory items are purchased during the accounting period, their unit cost may vary. A costing method is a way of calculating the cost of goods sold. The first time you purchase a product, the value is whatever you paid. Once you receive more stock at a different price, it is necessary to use one of the three standard methods to determine the value of what you sell. The three most popular methods used to determine the value of the ending inventory are:

- First in, First out (FIFO)
- Last in, First out (LIFO)
- Average cost



Important Note: You should consult your accountant regarding the method that best suits your needs.

First in, First out (FIFO)

This method assumes that the first item to come into the inventory are the first items sold, so the most recent unit cost is used to determine the inventory's value. FIFO assumes that the oldest stock you have is sold first. At a time when your cost is constantly increasing, the first items sold are the least expensive ones, therefore your cost of goods sold is low and your income is greater.

Last in, First out (LIFO)

This method assumes that the last item to come into the inventory are the first items sold, so the oldest unit cost is used to determine the inventory's value. With LIFO, the newest stock is sold first. An inventory value should generally reflect the replacement cost of your stock and that is what LIFO does. When prices are increasing LIFO will calculate cost of goods sold at the most recent price, resulting in a higher cost of goods and lower income.

Average Cost

This method uses the average unit cost for all items that were available for sale during the accounting period. The Average method

is the total cost of all goods divided by the number in stock. This has the effect of leveling out price fluctuations, providing a constant cost of goods and income.

Let us discuss an **example** that will clarify this concept. For example, suppose you sell Boxes. On August 1, you purchase 100 Boxes for \$1.00 each for a total cost of \$100. On August 2, you purchase another 100 Boxes, this time at \$1.25 per box for a total cost of \$125. You now have purchased 200 Boxes for \$225.

On August 3, you sell 50 Boxes for \$1.50 each for a total of \$75. Depending which costing method you are using, your income will be different:

FIFO: This method would assume the 50 boxes you sold were from the first 100 boxes you bought (at \$1 each). Your cost of goods would be \$50 and your profit would be \$25.

LIFO: It is assumed that the 50 boxes sold were from the last 100 boxes you purchased (at \$1.25 each). Your cost of goods is then \$62.50 for a profit of \$12.50.

Average: This method will consider only that you bought 200 boxes for \$225, for an average cost of \$1.125 each. Your cost for the 50 boxes sold is \$56.25 and you will have a profit of \$18.75.

When the income statement is prepared, the cost of inventory on hand is subtracted from the Cost of Goods Available for Sale during the year. This yields the Cost of Goods Sold for the year. You should check with your accountant to determine which method suits your needs.

Break-Even Point

One of the first steps in evaluating a business is determining your **break-even point**. This is the number of units of your product, which must be sold for income to equal all expenses incurred in producing the merchandise. Logic would dictate that if you are in a high rent area and need to sell half your stock of art objects each month in order to break even, you have started a losing business.

Assuming your product or service is a worthwhile one, the control of your overhead is the key to your profit.

Overhead consists of fixed costs, such as rent, insurance, and payment on bank notes, etc., which will not vary if your production increases. It also includes variable and semi-variable costs. Variables mean such items as commissions to salespeople, purchases of raw materials; and other overhead, which increase in direct proportion to changes in production volume. That is to say, if a company that has been making 10,000 snow shovels per month, for example, doubled production to the 20,000 level, then purchase of raw materials, sales commissions, and other expenses would also increase. Semi-variable costs will vary with volume, but not in direct proportion. The cost of lighting and power will increase with greater production.

Each unit produced should provide some margin for fixed costs and profits. Or expressed a different way, at no point should the direct cost, not the fixed cost, of producing a unit be greater than its sales price. Your fixed cost per unit will vary inversely with changes in volume. Since your fixed overhead will not increase as a result of greater production, and semi-variable costs will increase by a percentage considerably lower than the rate of increased production, it follows that your cost per unit will lessen as greater quantities are produced.

The experienced businessman uses his break-even charts to indicate profit margins at a given rate of production. However, the chart is useful only when fixed costs remain the same, when variable percentage can be plotted with reasonable accuracy, and when a company produces only one item.

Managing Payroll

Payroll Records

An employer, regardless of the number of employees, must maintain all records pertaining to payroll taxes (income tax withholding, Social Security, and federal unemployment tax)

There are several different kinds of employment records that must be maintained to satisfy federal requirements. These records are summarized below:

Income-Tax-Withholding Records

- Name, address, and Social Security number of each employee
- Amount and date of each payment of compensation
- Amount of wages subject to withholding in each payment
- Amount of withholding tax collected from each payment
- Reason that the taxable amount is less than the total payment
- Statement relating to employees' non-resident alien status
- Market value and date of non-cash compensation
- Information about payments made under sick-pay plans
- Withholding exemption certificates
- Agreements regarding the voluntary withholding of extra cash
- Dates and payments to employees for non-business services
- Statements of tips received by employees
- Requests for different computation of withholding taxes

Social Security (FICA) Tax Records

- Amount of each payment subject to FICA tax
- Amount and date of FICA tax collected from each payment
- Explanation for the difference, if any

Unemployment and Disability Records

- Total amount paid during calendar year
- Amount subject to unemployment tax
- Amount of contributions paid into the state unemployment fund
- Any other information requested on the unemployment tax return
- State disability contributions

Financial Statements

In order to manage your business effectively you need reports that tell you how your business is performing. For example, you may want to know the value of your assets like, Cash you have on hand,

Cash in bank, and Inventory in stock. In addition, you would like to know the value of your liabilities, loans, income earned, and expenses incurred. Accountants prepare financial statements that summarize these transactions. Two of the most important reports for managing your business are Income Statement and the Balance Sheet.

Income Statement

An Income Statement is also called a Profit and Loss Report. In addition, the word Revenue is often used in place of the word Income. An Income Statement is used to inform you about the income earned, expenses incurred, and the total profit or loss in a particular period. Two common periods for creating an income statement are monthly and annually.

This report summarizes all Income (or sales), the amounts that have been or will be received from customers for goods delivered or services rendered to them, and all expenses, the costs that have arisen in generating revenues. To show the actual profit or loss of a company, the expenses are subtracted from the revenues to show the **Net Income** – profit or the “bottom line”.

Income Accounts: These accounts are used to track income earned during the process of operating your business. The income of a business comes from sales to customers or fees for services or both. Some of the common names for income accounts are:

- Income from Sales
- Income from Freight
- Other Income

Expense Accounts: These accounts are used to track expenses incurred during the process of operating your business. Expenses include both the costs directly associated with creating products and general operating expenses. Some of the common names for expense accounts are:

- Cost of Sales
- Office Supplies
- Utilities

- Payroll Expenses
- Tax Expenses

A very simple form of an income statement displays in the following example:

| | |
|---|------------------|
| Joe's Bicycle Company 123 Main Street Any Town CA 99999 <i>Income Statement</i> | |
| <u>Income</u> | |
| Income from Sales | 15,000.00 |
| Income from Freight | 1,000.00 |
| Other Income | <u>250.00</u> |
| Total Income | 16,250.00 |
| <u>Expenses</u> | |
| Cost of Sales | 2,000.00 |
| Office Supplies | 250.00 |
| Telephone Expense | 500.00 |
| Utilities | 100.00 |
| Consulting Fees | 750.00 |
| Maintenance | 300.00 |
| Insurance | 250.00 |
| Miscellaneous Expenses | 375.00 |
| Travel & Entertainment | 650.00 |
| Bank Charges | 25.00 |
| Payroll Expense | 4,000.00 |
| Tax Expense | <u>2,500.00</u> |
| Total Expenses | 11,700.00 |
| Net Income/Loss | 4,550.00 |

Balance Sheet

A Balance sheet is like a “snapshot” that gives you the overall picture of the financial health of a company at one moment in time. This report lists the assets, liabilities, and owner’s equity in the business. Unlike the income statement, this report is always created to show the financial status as of a certain date. Two common ending periods to create a balance sheet are the **end of a month** and the **end of the year**.

The Balance Sheet has two sections. The first section lists all the Asset accounts and their balances. At the end of the list, the totals of all assets are listed. In the second section, the Liability and Owner’s Equity accounts are listed. There are two sub-totals for the Liability and the Equity accounts. At the end, there is a combined total of the Liabilities and Owner’s Equity. As discussed earlier in the accounting equation, the Assets equal the sum of the Liabilities and the Equities. You will also notice that the Profit from the income statement is listed in the Equity section of the balance sheet. Some of the important accounts in the balance sheet are:

Current Assets: Current assets are always listed first and include cash and other items that can be converted into cash within the following year. This includes funds in checking and savings accounts.

Accounts Receivable: Accounts Receivable represents money owed to the business. These usually result from the sale of merchandise or performance of services for a client on account. The phrase **On Account** indicates that on the date the goods were sold to the client, or the service performed for him, the business did not receive full payment. However, it did obtain an asset – the right to collect payment for merchandise sold or Services performed. The claim a business has against a credit client is referred to as an Account Receivable. It is an asset because it represents a legal claim to cash.

Inventory: Inventories may represent merchandise purchased for resale as well as the raw materials acquired by a manufacturing firm to put into the product. In the case of a manufacturer, the term inventories also includes manufacturing supplies, purchased parts, the work that is in process, and finished goods. Inventory is also an asset account.

Accounts Payable: When you purchase goods or services on account, you are usually required to pay within a fixed period of time. These amounts you owe for the goods or services purchased are called accounts payable. The payment of these purchases is usually due within a relatively short period of time. Usually this period is one year or less. Typical periods are thirty to sixty days. The payment for these short-term liabilities requires the use of existing resources like the Cash or The Checking Account.

A very simple form of a balance sheet displays in the following example:

| | |
|--|--------------------------|
| Joe's Bicycle Company 123 Main Street Any Town CA 99999 <i>Balance Sheet</i> | |
| | |
| <i>Assets</i> | |
| Checking Account | 25,000.00 |
| Investments | 75,000.00 |
| Inventory | 25,000.00 |
| Accounts Receivable | 10,000.00 |
| Machinery & Equipment | 22,500.00 |
| Investments | <u>100,000.00</u> |
| <i>Total Assets</i> | 257,500.00 |
| | |
| <i>Liabilities & Equity</i> | |
| Accounts Payable | 15,000.00 |
| Loans Payable | 60,450.00 |
| Salaries Payable | 75,000.00 |
| Taxes Payable | <u>2,500.00</u> |
| Total Liabilities | 152,950.00 |
| | |
| Owner's Equity | 100,000.00 |
| Profit/Loss | <u>4,550.00</u> |
| Total Equity | 104,550.00 |
| | |
| <i>Total Liabilities & Equity</i> | <u>257,500.00</u> |

This program automatically creates the Balance Sheet and the Income Statements for you. All the accounts are automatically updated when you create invoices, checks, and transactions in the system. To create a Balance Sheet or an Income Statement all you have to do is to select the report from the menu and print it.

Linking the Income and Balance Sheet

Generally, a balance sheet and an income statement are prepared and issued together because in a way they are twin reports, the income statement showing what happened over a period of time and the balance sheet showing the resulting condition at the end of that period.

Since these statements are usually studied in relation to one another, it is highly desirable for them to tie together with one common figure. You will see that the Net Profit/Loss on the bottom of the income statement discussed earlier was \$4,550.00. If you look at the Equity section of the balance sheet shown earlier, you will notice that the \$4,550.00 Profit/Loss lists as a part of the total equity. This ties the income statement to the balance sheet report.