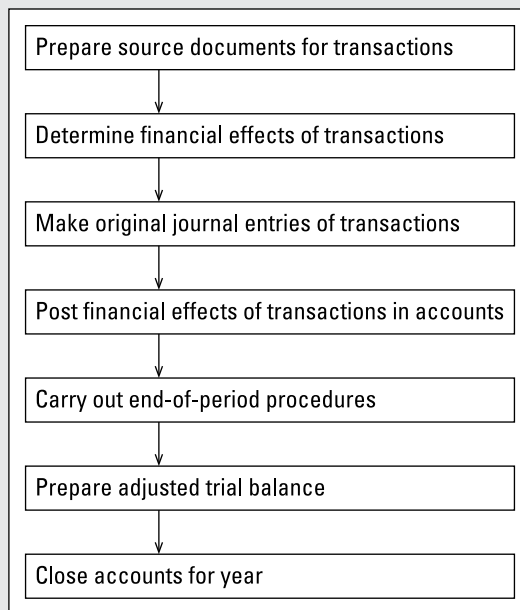


Book I

Setting Up Your Accounting System



In this book...

- ✔ Wrap your brain around bookkeeping and accounting fundamentals. These basic concepts allow you to correctly post accounting transactions.
- ✔ Create a chart of accounts, so you can track debits and credits by using double-entry accounting. Every type of accounting transaction uses some combination of accounts.
- ✔ Maintain financial journals and the general ledger and use accounting software to simplify these tasks. These tools help you generate meaningful financial statements.
- ✔ Distinguish among cash, accrual, and other accounting methods and choose the right method for a business. Most businesses use accrual accounting, which allows the company to match revenue with the expenses incurred to generate the revenue.

Chapter 1

Grasping Bookkeeping and Accounting Basics

In This Chapter

- ▶ Examining the differences between bookkeeping and accounting
 - ▶ Getting to know the accounting cycle
 - ▶ Maintaining balance with the fundamental accounting equation
-

Most folks aren't enthusiastic bookkeepers. You probably balance your checkbook against your bank statement every month and somehow manage to pull together all the records you need for your annual federal income tax return. But if you're like most people, you stuff your bills in a drawer and just drag them out once a month when you pay them.

Individuals can get along quite well without much bookkeeping — but the exact opposite is true for a business. A business needs a good bookkeeping and accounting system to operate day to day. A business needs accurate and timely data to operate effectively.

In addition to facilitating day-to-day operations, a company's bookkeeping and accounting system serves as the source of information for preparing its periodic financial statements, tax returns, and reports to managers. The accuracy of these reports is critical to the business's survival. That's because managers use financial reports to make decisions. If the reports aren't accurate, managers can't make intelligent decisions.

Obviously, then, a business manager must be sure that the company's bookkeeping and accounting system is dependable and up to snuff. This chapter shows you what bookkeepers and accountants do, so you have a clear idea of what it takes to ensure that the information coming out of the accounting system is complete, accurate, and timely.

Knowing What Bookkeeping and Accounting Are All About

In a nutshell, accountants “keep the books” of a business (or not-for-profit or government entity) by following systematic methods to record all the financial activities and prepare summaries. This summary information is used to create financial statements.

Financial statements are sent to *stakeholders*. Stakeholders are people who have a stake in the business’s success or failure. Here are some examples of stakeholders:

- ✓ **Stockholders:** If you own stock in General Electric, for example, you receive regular financial reports. Stockholders are owners of the business. They need to know the financial condition of the business they own.
- ✓ **Creditors:** Entities that loan money to your business are creditors. They need to review financial statements to determine whether your business still has the ability to repay principal and make interest payments on the loan.
- ✓ **Regulators:** Most businesses have to answer to some type of regulator. If you produce food, you send financial reports to the Food and Drug Administration (FDA). Reviewing financial statements is one responsibility of a regulator.

The following sections help you embark on your journey to develop a better understanding of bookkeeping and accounting. Here you discover the differences between the two and get a bird’s-eye view of how they interact.

Distinguishing between bookkeeping and accounting



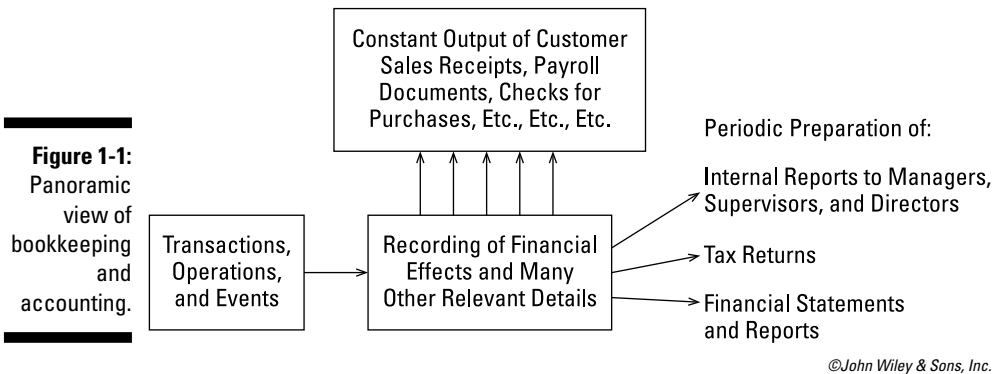
Distinguishing between bookkeeping and accounting is important, because they’re not completely interchangeable. *Bookkeeping* refers mainly to the recordkeeping aspects of accounting — the process (some would say the drudgery) of recording all the detailed information regarding the transactions and other activities of a business (or other organization, venture, or project).

The term *accounting* is much broader; it enters the realm of designing the bookkeeping system, establishing controls to make sure the system is working well, and analyzing and verifying the recorded information. Accountants give orders; bookkeepers follow them.

Bookkeepers spend more time with the recordkeeping process and dealing with problems that inevitably arise in recording so much information. Accountants, on the other hand, have a different focus. You can think of accounting as what goes on before and after bookkeeping: accountants design the bookkeeping and accounting system (before) and use the information that the bookkeepers enter to create financial statements, tax returns, and various internal-use reports for managers (after).

Taking a panoramic view of bookkeeping and accounting

Figure 1-1 presents a panoramic view of bookkeeping and accounting for businesses and other entities that carry on business activities. This brief overview can't do justice to all the details of bookkeeping and accounting, of course. But it serves to clarify important differences between bookkeeping and accounting.



Bookkeeping has two main jobs: recording the financial effects and other relevant details of the wide variety of transactions and other activities of the entity; and generating a *constant* stream of documents and electronic outputs to keep the business operating every day.

Accounting, on the other hand, focuses on the *periodic* preparation of three main types of output — reports to managers, tax returns (income tax, sales tax, payroll tax, and so on), and financial statements and reports. These outputs are completed according to certain schedules. For example, financial statements are usually prepared every month and at the end of the year (12 months).



Accounting All-In-One For Dummies is concerned predominately with financial and management accounting. *Financial accounting* refers to the periodic preparation of general-purpose financial statements (see Books IV and V). *General purpose* means that the financial statements are prepared according to standards established for financial reporting to stakeholders, as explained earlier in this chapter.

These financial statements are useful to managers as well, but managers need more information than is reported in the external financial statements of a business. Much of this management information is confidential and not for circulation outside the business. *Management accounting* refers to the preparation of internal accounting reports for business managers. Management accounting is used for planning business activity (Book VI) and to make informed business decisions (Book VII).

This chapter offers a brief survey of bookkeeping and accounting, which you may find helpful before moving on to the more hands-on financial and management topics.

Wrapping Your Brain around the Accounting Cycle

Figure 1-2 presents an overview of the accounting cycle. These are the basic steps in virtually every bookkeeping and accounting system. The steps are done in the order presented, although the methods of performing the steps vary from business to business. For example, the details of a sale may be entered by scanning bar codes in a grocery store, or they may require an in-depth legal interpretation for a complex order from a customer for an expensive piece of equipment. The following is a more detailed description of each step:

- 1. Prepare *source documents* for all transactions, operations, and other events of the business; source documents are the starting point in the bookkeeping process.**

When buying products, a business gets an *invoice* from the supplier. When borrowing money from the bank, a business signs a *note payable*, a copy of which the business keeps. When preparing payroll checks, a business depends on *salary rosters* and *time cards*. All of these key business forms serve as sources of information entered into the bookkeeping system — in other words, information the bookkeeper uses in recording the financial effects of the activities of the business.

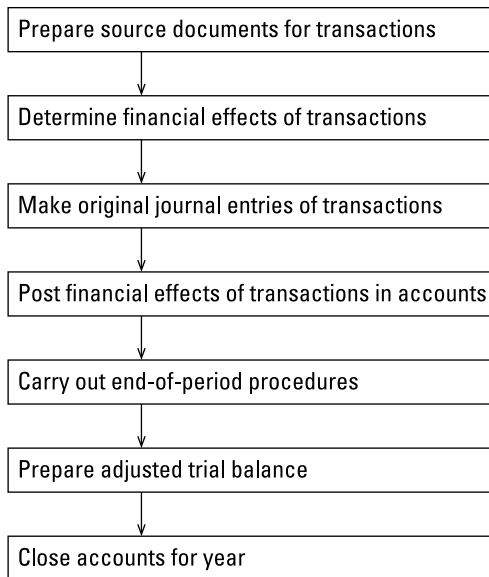


Figure 1-2:
Basic
steps of the
accounting
cycle.

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2. Determine the *financial effects* of the transactions, operations, and other events of the business.

The activities of the business have financial effects that must be recorded — the business is better off, worse off, or affected in some way as the result of its transactions. Examples of typical business transactions include paying employees, making sales to customers, borrowing money from the bank, and buying products that will be sold to customers. The bookkeeping process begins by determining the relevant information about each transaction. The chief accountant of the business establishes the rules and methods for measuring the financial effects of transactions. Of course, the bookkeeper should comply with these rules and methods.

3. Make *original entries* of financial effects in journals, with appropriate references to source documents.

Using the source documents, the bookkeeper makes the first, or original, entry for every transaction into a journal; this information is later posted in accounts (see the next step). A *journal* is a chronological record of transactions in the order in which they occur — like a very detailed personal diary.

Here's a simple example that illustrates recording a transaction in a journal. Expecting a big demand from its customers, a retail bookstore purchases, on credit, 100 copies of *The Beekeeper Book* from the publisher, Animal World. The books are received, a few are placed on

the shelves, and the rest are stored. The bookstore now owns the books and owes Animal World \$2,000, which is the cost of the 100 copies. This example focuses solely on recording the purchase of the books, not recording subsequent sales of the books and payment to Animal World.

The bookstore has established a specific inventory asset account called “Inventory–Trade Paperbacks” for books like this. And the liability to the publisher should be entered in the account “Accounts Payable–Publishers.” Therefore, the original journal entry for this purchase records an increase in the inventory asset account of \$2,000 and an increase in the accounts payable account of \$2,000. Notice the balance in the two sides of the transaction: an asset increases \$2,000 on the one side and a liability increases \$2,000 on the other side. All is well (assuming no mistakes).

4. Post the financial effects of transactions to accounts, with references and tie-ins to original journal entries.

As Step 3 explains, the pair of changes for the bookstore’s purchase of 100 copies of this book is first recorded in an original journal entry. Then, sometime later, the financial effects are *posted*, or recorded in the separate accounts — one an asset and the other a liability. Only the official, established chart, or list of accounts, should be used in recording transactions. An *account* is a separate record, or page, for each asset, each liability, and so on. One transaction affects two or more accounts. The journal entry records the whole transaction in one place; then each piece is recorded in the accounts affected by the transaction. After posting all transactions, a *trial balance* is generated. This document lists all the accounts and their balances, as of a certain date.



The importance of entering transaction data correctly and in a timely manner cannot be stressed enough. The prevalence of data entry errors is one important reason that most retailers use cash registers that read bar-coded information on products, which more accurately captures the necessary information and speeds up data entry.

5. Perform end-of-period procedures — the critical steps for getting the accounting records up-to-date and ready for the preparation of management accounting reports, tax returns, and financial statements.

A *period* is a stretch of time — from one day (even one hour) to one month to one quarter (three months) to one year — that’s determined by the needs of the business. Most businesses need accounting reports and financial statements at the end of each quarter, and many need monthly financial statements.



Before the accounting reports can be prepared at the end of the period (see Figure 1-1), the bookkeeper needs to bring the accounts up to date and complete the bookkeeping process. One such end-of-period requirement, for example, is recording the *depreciation expense* for the period (see Book III, Chapter 1 for more on depreciation).

The accountant needs to be heavily involved in end-of-period procedures and be sure to check for errors in the business's accounts. Data entry clerks and bookkeepers may not fully understand the unusual nature of some business transactions and may have entered transactions incorrectly. One reason for establishing *internal controls* (see Book II, Chapter 1) is to keep errors to an absolute minimum. Ideally, accounts should contain no errors at the end of the period, but the accountant can't assume anything and should perform a final check for any errors.

6. Compile the *adjusted trial balance* for the accountant, which is the basis for preparing management reports, tax returns, and financial statements.

In Step 4, you see that a trial balance is generated after you post the accounting activity. After all the end-of-period procedures have been completed, the bookkeeper compiles a comprehensive listing of all accounts, which is called the *adjusted trial balance*. Modest-sized businesses maintain hundreds of accounts for their various assets, liabilities, owners' equity, revenues, and expenses. Larger businesses keep thousands of accounts.

The accountant takes the adjusted trial balance and combines similar accounts into one summary amount that is reported in a financial report or tax return. For example, a business may keep hundreds of separate inventory accounts, every one of which is listed in the adjusted trial balance. The accountant collapses all these accounts into one summary inventory account presented in the balance sheet of the business. In grouping the accounts, the accountant should comply with established financial reporting standards and income tax requirements.

7. *Close the books* — bring the bookkeeping for the fiscal year just ended to a close and get things ready to begin the bookkeeping process for the coming fiscal year.

Books is the common term for a business's complete set of accounts along with journal entries. A business's transactions are a constant stream of activities that don't end tidily on the last day of the year, which can make preparing financial statements and tax returns challenging. The business has to draw a clear line of demarcation between activities for the year ended and the year to come by *closing the books* for one year and starting with fresh books for the next year.



Most medium-sized and larger businesses have an *accounting manual* that spells out in great detail the specific accounts and procedures for recording transactions. A business should regularly review its chart of accounts and accounting rules and policies and make revisions. Companies don't take this task lightly; discontinuities in the accounting system can be major shocks and have to be carefully thought out. The remaining chapters in Book I lead you through the process of developing an accounting system. See Book III for details on adjusting and closing entries.

Working the Fundamental Accounting Equation



The *fundamental accounting equation* (also known as the *accounting equation* or the *balance sheet equation*) helps explain the concept that all transactions must balance.

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

Net assets equals assets minus liabilities. If you do some algebra and subtract liabilities from both sides of the previous equation, you get this formula:

$$\text{Assets} - \text{Liabilities} = \text{Owners' equity}$$

Or:

$$\text{Net assets} = \text{Owners' equity}$$

Before going any further, acquaint yourself with the cast of characters in the equation:

- ✓ **Assets** are resources a company owns. Book IV, Chapter 3 discusses all the typical types of business assets. Some examples are cash, equipment, and cars. You use assets to make money in your business. In other words, the resources are used up over time to generate sales and profits.
- ✓ **Liabilities** are debts the company owes to others — people other than owners of the business. See Book IV, Chapter 4 for the scoop on liabilities. The biggies are accounts payable and notes payable.
- ✓ **Owners' equity (or simply equity)** is what's left over in the business at the end of the day. If you sold all your assets for cash, then paid off all your liabilities, any cash remaining would be equity. Many accounting textbooks define equity as the owners' claim to the company's net assets. Book IV, Chapter 5 discusses the different components of equity.



You may read the explanation of owners' equity and think, "That's just another way to say 'net worth.'" But you can't use the term *net worth* interchangeably with *owners' equity* in an accounting setting. Generally accepted accounting principles (GAAP), explained in Book IV, Chapter 1, don't allow accountants to restate all assets to their fair market value, which would be required to calculate a company's net worth.

Here's a simple example of the fundamental accounting equation at work:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

$$\$100 = \$40 + \$60$$

Or, after subtracting liabilities from each side of the equation:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

$$\$100 - \$40 = \$60$$

Finally, you can restate assets less liabilities and net assets:

$$\text{Net assets} = \text{Owners' equity}$$

$$\$60 = \$60$$

Chapter 2

Outlining Your Financial Road Map with a Chart of Accounts

In This Chapter

- ▶ Introducing the chart of accounts
 - ▶ Warming up with balance sheet accounts
 - ▶ Creating your own chart of accounts
 - ▶ Grasping the basics of debits and credits
 - ▶ Getting schooled in double-entry accounting
-

Can you imagine the mess your checkbook would be if you didn't record each check you wrote? If you're like most people, you've probably forgotten to record a check or two on occasion, but you certainly learn your lesson when you realize that an important payment bounces as a result. Yikes!

Keeping the books of a business can be a lot more difficult than maintaining a personal checkbook. You have to carefully record each business transaction to make sure that it goes into the right account. This careful bookkeeping gives you an effective tool for figuring out how well the business is doing financially.

You need a road map to help you determine where to record all those transactions. This road map is called the chart of accounts. This chapter introduces you to the chart of accounts and explains how to set up your chart of accounts. This chapter also spells out the differences between debits and credits and orients you to the fine art of double-entry accounting.

Getting to Know the Chart of Accounts

The *chart of accounts* is the road map that a business creates to organize its financial transactions. After all, you can't record a transaction until you know where to put it! Essentially, this chart is a list of all the accounts a

business has, organized in a specific order; each account has a description that includes the type of account and the types of transactions that should be entered into that account. Every business creates its own chart of accounts based on the nature of the business and its operations, so you're unlikely to find two businesses with the exact same chart.

Connecting the chart of accounts to financial statements

Some basic organizational and structural characteristics are common to all Charts of Accounts. The organization and structure are designed around two key financial reports:

- ✓ The *balance sheet* shows what your business owns (assets) and who has claims on those assets (liabilities and equity).
- ✓ The *income statement* shows how much money your business took in from sales and how much money it spent to generate those sales.

You can find out more about income statements and balance sheets in Books IV and V. The following lists present a common order for these accounts within each of their groups, based on how they appear on the financial statements.

Organizing the accounts

The chart of accounts starts with the balance sheet accounts, which include

- ✓ **Current assets:** Accounts that track what the company owns and expects to use in the next 12 months, such as cash, *accounts receivable* (money collected from customers), and inventory
- ✓ **Long-term assets:** Accounts that track what assets the company owns that have a lifespan of more than 12 months, such as buildings, furniture, and equipment
- ✓ **Current liabilities:** Accounts that track debts the company must pay over the next 12 months, such as *accounts payable* (bills from vendors, contractors, and consultants), interest payable, and credit cards payable
- ✓ **Long-term liabilities:** Accounts that track debts the company must pay over a period of time longer than the next 12 months, such as mortgages payable and bonds payable

- ✓ **Equity:** Accounts that track the owner's claims against the company's net assets, which includes any money invested in the company, any money taken out of the company, and any earnings that have been reinvested in the company

The rest of the chart is filled with income statement accounts, which include

- ✓ **Revenue:** Accounts that track sales of goods and services as well as revenue generated for the company by other means
- ✓ **Cost of goods sold:** Accounts that track the direct costs involved in selling the company's goods or services
- ✓ **Expenses:** Accounts that track expenses related to running the business that aren't directly tied to the sale of individual products or services

When developing the chart of accounts, you start by listing all asset, liability, equity, revenue, and expense accounts. All these accounts come from two places: the balance sheet and the income statement.



This chapter introduces the key account types found in most businesses, but this list isn't cast in stone. You should develop an account list that makes the most sense for how you're operating your business and the financial information you want to track.

The chart of accounts is a management tool that helps you make smart business decisions. You'll probably tweak the accounts in your chart annually and, if necessary, add accounts during the year if you find something that requires more detailed tracking. You can add accounts during the year, but it's best not to delete accounts until the end of a 12-month reporting period.

Balancing transactions

A chart of accounts helps you keep your balance sheet accounts *in balance* in accordance with the balance sheet equation discussed in Chapter 1:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

As you see in the prior section, the chart of accounts groups accounts based on the three categories in the balance sheet equation. All the asset accounts, for example, have account numbers that are close together, as explained in the next section. You can easily separate the chart of accounts into assets, liabilities, and equity — and see whether the balance sheet equation balances (in total dollars).

Setting Up Your Chart of Accounts

Cooking up a useful chart of accounts doesn't require any secret sauce. All you need to do is list all the accounts that apply to your business. A good brainstorming session usually does the trick.



When first setting up your chart of accounts, don't panic if you can't think of every type of account you may need for your business. Adding to the chart of accounts at any time is very easy. Just add the account to the list and distribute the revised list to any employees who use the chart of accounts for entering transactions into the system. (Even employees not involved in bookkeeping need a copy of your chart of accounts if they code invoices or other transactions or indicate to which account those transactions should be recorded.)

The chart of accounts usually includes at least three columns:

- ✓ **Account:** Lists the account names
- ✓ **Type:** Lists the type of account — asset, liability, equity, revenue, cost of goods sold, or expense
- ✓ **Description:** Contains a description of the type of transaction that should be recorded in the account

Nearly all companies also assign numbers to the accounts, to be used for coding charges. If your company is using a computerized system, the computer automatically assigns the account number. Otherwise, you need to develop your own numbering system. The most common number system is:

- ✓ **Asset accounts:** 1,000 to 1,999
- ✓ **Liability accounts:** 2,000 to 2,999
- ✓ **Equity accounts:** 3,000 to 3,999
- ✓ **Revenue accounts:** 4,000 to 4,999
- ✓ **Cost of goods sold accounts:** 5,000 to 5,999
- ✓ **Expense accounts:** 6,000 to 6,999

This numbering system matches the one used by computerized accounting systems, making it easy for a company to transition to automated books at some future time.



Most companies create an accumulated depreciation account and match it with each unique fixed asset account. So, if you have a fixed asset account called delivery trucks, you likely have an account called accumulated depreciation – delivery trucks. *Book value* is defined in Book III, Chapter 1 as cost less accumulated depreciation. This chart of accounts approach allows

management to view each asset's original cost and the asset's accumulated depreciation together — and calculate book value.

If you choose a computerized accounting system, one major advantage is that a number of different Charts of Accounts have been developed for various types of businesses. When you get your computerized system, whichever accounting software you decide to use, all you need to do is review its list of chart options for the type of business you run, delete any accounts you don't want, and add any new accounts that fit your business plan.



If you're setting up your chart of accounts manually, be sure to leave a lot of room between accounts to add new accounts. For example, number your cash in checking account 1,000 and your accounts receivable account 1,100. That leaves you plenty of room to add other accounts to track cash.

Mulling Over Debits versus Credits

In this section, you discover the mechanism of *journal entries*, which you use to enter financial information into the company's accounting software. To properly post journal entries, you need to understand *debits* and *credits*.

Writing journal entries is a major area of confusion for anyone who's just getting started in accounting, because they involve debits and credits that are often counterintuitive. If you're just starting out in accounting, consider reading this section more than once. After you read this section and start posting some journal entries, you'll get the hang of it.



These rules regarding debits and credit are always true:

- ✓ Debits are always on the *left*. In journal entries, debits appear to the left of credits.
- ✓ Credits are always on the *right*. In journal entries, credits appear to the right of debits.

See the next section for examples of journal entries.

The following rules are also true, but with a few exceptions:

- ✓ Assets and expenses are debited to add to them and credited to subtract from them. In other words, for assets and expenses, a debit *increases* the account, and a credit *decreases* it.
- ✓ Liability, revenue, and equity accounts are just the opposite: These accounts are credited to add to them and debited to subtract from them. In other words, for liability, revenue, and equity accounts, a debit *decreases* the account, and a credit *increases* it, as you would expect.

This book covers three exceptions to these two rules. Treasury stock (covered in Book IV, Chapter 5), allowance for doubtful accounts (see Book IV, Chapter 3), and accumulated depreciation (Book III, Chapter 1) are *contra-accounts*, which offset the balance of a related account. Other than these exceptions, these two rules hold true.

Understanding Double-Entry Accounting

All businesses, whether they use the cash-basis or accrual accounting method (see Chapter 4), use *double-entry accounting* — a practice that helps minimize errors and increase the chance that your books balance. Double-entry accounting doesn't mean you enter all transactions twice; it means that you enter *both sides* of the transaction, debiting one account and crediting another.

Revisiting the balance sheet equation

In double-entry accounting, the balance sheet equation plays a major role, as explained in “Balancing transactions” earlier in this chapter.

In order to change the balance of any accounts, you use a combination of *debits* and *credits*. In some cases, you may debit and credit multiple accounts to record the same transaction. Regardless of how many accounts are affected, these additional rules hold true:

- ✓ The total dollar amount debited will equal the total amount credited.
- ✓ The total dollar *change* in the asset accounts (increase or decrease) will equal the *change* in the total dollar amount of liabilities and equity. This concept is consistent with the balance sheet equation: Assets on the left must equal liabilities on the right.

Recording journal entries

All accounting transactions for a business must be recorded as journal entries, following a specific three-column format followed by a transaction description:

- ✓ Account titles in the left column
- ✓ Debit dollar amounts in the middle column
- ✓ Credit dollar amounts in the right column
- ✓ Transaction description below the journal entry (to indicate the nature and purpose of the transaction for future reference)

Here's an example:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
Inventory	\$3,000	
Accounts payable		\$3,000

To purchase sprockets for sale to customers.

The following sections present some typical journal entries — entries that many companies frequently post in their accounting records.

Posting entries to one side of the balance sheet equation

Suppose you purchase a new \$1,500 desk for your office. This transaction actually has two parts: You spend an asset — cash — to buy another asset — furniture. So, you must adjust two accounts in your company's books: the cash account and the furniture account. Here's what the transaction looks like in double-entry accounting:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
Furniture	\$1,500	
Cash		\$1,500

To purchase a new desk for the office.

In this transaction, the debit increases the value of the furniture account, and the credit decreases the value of the cash account. Both accounts impacted are asset accounts, so the transaction affects only the assets side of the balance sheet equation:

$$\text{Assets} + \$1,500 \text{ furniture} - \$1,500 \text{ cash} = \text{Liabilities (no change)} + \text{Equity (no change)}$$

In this case, the books stay in balance because the exact dollar amount that increases the value of the furniture account decreases the value of the cash account.

Using both sides of the equation

To see how you record a transaction that impacts both sides of the balance sheet equation, consider an example that records the purchase of inventory. Suppose you purchase \$5,000 worth of widgets on credit. These new

widgets add value to both inventory (an asset account) and accounts payable (a liability) account. Here's what the transaction looks like in double-entry accounting:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
Inventory	\$5,000	
Accounts payable		\$5,000

To purchase widgets for sale to customers.

In this case, the books stay in balance because both sides of the equation (assets on the left and liabilities on the right) increase by \$5,000:

$$\text{Inventory} + \$5,000 = \text{Accounts payable} + \$5,000 + \text{Equity (no change)}$$



You can see from the two example transactions in this section how double-entry accounting helps to keep your books in balance — as long as each entry into the books is balanced. Balancing your entries may look simple here, but sometimes entries can get complex when more than two accounts are impacted by the transaction.

Figuring out a complex journal entry

To take the subject of journal entries one step further, take a look at a more complex journal entry. Assume you sell a company truck. You bought the truck for \$30,000. As of the date of sale, you've recognized \$25,000 of accumulated depreciation. You receive \$6,000 for the sale. The transaction is complex, because more than one debit and credit are required.

Starting with cash

As an accountant, you have several issues to resolve. First, consider which accounts in the chart of accounts are affected. Second, the total debits must equal total credits.

Accountants figure out journal entries every day. If you're not sure where to start, think about whether or not cash should be part of the journal entry. In this case, the answer is yes. Because cash increased, you need to debit the asset account cash for \$6,000.

Now go over the other "knowns" for this transaction. You sold someone the truck (an asset). In the "Mulling over Debits versus Credits" section earlier in this chapter, you see that you credit to reduce assets. The truck account should be credited for \$30,000.

Getting to a balanced entry

In Book III, Chapter 1, you discover that accumulated depreciation represents all depreciation taken on an asset since the purchase date. You also see that accumulated depreciation carries a credit balance. When you sell the truck, you remove the accumulated depreciation by debiting the account for \$25,000.

Now for the hardest part. So far, you've debited cash \$6,000 and debited accumulated depreciation for \$25,000. On the credit side, you credited the truck account for \$30,000. In total, you have \$31,000 in debits ($\$6,000 + \$25,000$) and \$30,000 in credits. To balance this entry you need an additional \$1,000 credit. Think about which account you should use.

If you sell an asset, accounting standards require that you record a gain or loss on sale. Because you need a credit entry, you record a gain. Here's how your complex journal entry looks:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
Cash	\$6,000	
Accumulated depreciation	\$25,000	
Truck		\$30,000
Gain on sale of truck		\$1,000

To record the sale of a truck for a gain.

The combination for the cash received and depreciation removed (\$31,000) was more than the original cost of the truck sold (\$30,000). The result is a gain of \$1,000.

This thought process is what accountants use to post complex journal entries.

Chapter 3

Using Journal Entries and Ledgers

In This Chapter

- ▶ Becoming familiar with journals and the general ledger
 - ▶ Writing journal entries
 - ▶ Balancing the books
 - ▶ Saving time and reducing errors with accounting software
-

Accounting involves a great deal of record keeping or *booking* — the process of recording accounting transactions. Some booking tasks involve basic data entry done by clerks. Junior accountants or bookkeepers may perform other booking tasks, such as preparing *journal entries* — the accountant’s way to enter transactions into the accounting system. (For example, the accountant records any bank charges shown on the company’s monthly bank statement.) You find out more about journal entries later in this chapter.

Whether you’ll need to book journal entries during your accounting career depends on a couple factors. If you work for a small company in a one- or two-person accounting department, you could very well be the *controller* (the chief accounting officer for the business) and be doing the journal entries yourself. If, instead, you work for a large accounting firm that provides services to many clients, chances are you won’t book journal entries yourself. However, you’ll most certainly review journal entries while providing your services, such as when you audit a company’s financial statements. And you may propose journal entries for your client to book if you find errors.

No matter where your accounting career takes you, you need to know what booking involves, as explained in this chapter.

Keeping a Journal

Accounting journals, like diaries, keep a record of events. But accounting journals record business transactions taking place within a company’s accounting department. Accountants call journals the *books of original entry* because no transactions get into the accounting records without being entered into a journal first.

A business can have many different types of journals. In this section you find out about the most common journals, which are tailored to handle cash, accrual, and special transactions.

Using journals to record cash transactions

All transactions affecting cash go into the cash receipts or cash disbursements journal. Some accountants and accounting software programs refer to the record of cash disbursements as the *cash payments* journal. No worries — both terms mean the same thing.



When accountants use the word *cash*, it doesn't just mean paper money and coinage; it includes checks and credit card transactions. In accounting, *cash* is a generic term for any payment method that is assumed to be automatic. See Book IV, Chapter 3 for balance sheet details.

When you sign a check and give it to the clerk behind the store counter, part of your implicit understanding is that the funds are immediately available to clear the check. Ditto paying with a credit card, which represents an immediate satisfaction of your debit with the vendor.

Cash receipts journal

The *cash receipts journal* keeps a record of all payments a business receives in cash or by check, debit card, or credit card. Book II, Chapter 3 discusses cash activity related to sales to customers. This discussion of cash covers a variety of transactions. Here are examples of some cash events that require posting to the cash receipts journal:

- ✓ **Customer sales made for paper money and coinage:** Many types of businesses still have booming cash sales involving the exchange of paper money and coins. Some examples are convenience stores, retail shops, and some service providers such as hair salons.
- ✓ **Customers making payments on their accounts:** If a business lets its customers buy now and pay later, any payments due are entered into *accounts receivable*, which is money customers owe the business. See “Recording accrual transactions,” later in this chapter, for details. Any payments a customer makes toward those amounts owed are recorded in the cash receipts journal.
- ✓ **Interest or dividend income:** When a bank or investment account pays a business for the use of its money in the form of interest or dividends, the payment is considered a cash receipt. Many businesses record interest income reported on their monthly bank statements in the general journal, discussed a little later in this section.



Interest and dividend income is also known as *portfolio income* and may be considered passive income because the recipient doesn't have to work to receive the portfolio income (as you do for your paycheck).

- ✓ **Asset sales:** Selling a business asset, such as a car or office furniture, can also result in a cash transaction. As an example, suppose a company is outfitting its executive office space with deluxe new leather chairs and selling all the old leather chairs to a furniture liquidator; the two parties exchange cash to complete the sale.

Keep in mind that this list isn't comprehensive; these are just a few of the many instances that may necessitate recording a transaction in the cash receipts journal.



Cash receipts may receive different treatment on a company's income statement. For example, cash sales to customers are treated one way, while cash received for the sale of a building — a transaction that's not part of the normal business activity — is treated differently. The details are explained in Book IV, Chapter 2.

Setting up the cash receipts journal

The cash receipts journal normally has two columns for debits and four columns for credits:

- ✓ **Debit columns:** Because all transactions in the cash receipts journal involve the receipt of cash, one of the debit columns is always for cash. The other is for *sales discounts*, which reflect any discount the business gives to a good customer who pays early. For example, a customer's invoice is due within 30 days, but if the customer pays early, it gets a 2 percent discount.
- ✓ **Credit columns:** To balance the debits, a cash receipts journal contains four credit columns:
 - Sales
 - Accounts receivable
 - *Sales tax payable*, which is the amount of sales tax the business collects on a transaction (and doesn't apply to every transaction)
 - *Miscellaneous*, which is a catchall column where you record all other cash receipts such as interest and dividends



Not all sales are subject to sales tax. Your state department of revenue determines which sales transactions are taxable. For example, in many states, fees for accounting or legal services aren't subject to sales tax.

In addition to the debit and credit columns, a cash receipts journal also contains at least two other columns that don't have anything to do with debits or credits:

- ✓ The date the transaction occurs
- ✓ The name of the account affected by the transaction

Depending on the company or accounting system, additional columns may be used as well.

Figure 3-1 shows an example of a portion of a cash receipts journal.

Cash Receipts Journal								
			Misc	Sales	Sales Tax	Accounts Payable	Sales Receivable	Cash
	Date	Account	Credit	Credit	Credit	Credit	Debit	Debit
1	1/15	Interest Income	\$32.50					\$32.50
2	1/16	XYZ Corporation				\$5,100.00		\$5,100.00
3	1/23	Customer Sale		\$100.00	\$6.00			\$106.00

Figure 3-1:
A partial cash receipts journal.

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Cash disbursements journal

On the flip side, any payment the business makes by using a form of cash gets recorded in the cash disbursements (or payments) journal. Here are a few examples of transactions that appear in a cash disbursements journal:

- ✓ **Merchandise purchases:** When a *merchandiser*, a company selling goods to the public, pays cash for the goods it buys for resale (inventory), the transaction goes in the cash disbursement journal.
- ✓ **Payments the company is making on outstanding accounts:** This includes all cash disbursements a company makes to pay for goods or services it obtained from another business and didn't pay for when the original transaction took place. More on this topic in the "Recording accrual transactions" section later in this chapter.
- ✓ **Payments for operating expenses:** These transactions include checks or bank transfers a business uses to pay utility or telephone invoices. Operating expenses are incurred to manage your day-to-day business, in addition to your cost of sales.

The cash disbursements journal normally has two columns for debits and two for credits:

- ✔ **Credit columns:** Because all transactions in the cash disbursements journal involve the payment of cash, one of your credit columns is for cash. The other is for *purchase discounts*, which are reductions in the amount a company has to pay the vendors for any purchases on account. For example, a business offers vendors a certain discount amount if they pay their bills within a certain number of days. It's the same process that's explained in the earlier cash receipts journal section. In this case, the company *pays* less, due to a discount. With cash receipts, a discount means that the company may *receive* less.
- ✔ **Debit columns:** To balance these credits, the debit columns in a cash disbursements journal are accounts payable and *miscellaneous* (a catchall column in which you record all other cash payments for transactions, such as the payment of operating expenses).

A cash disbursements journal also contains at least three other columns that don't have anything to do with debiting or crediting:

- ✔ The date the transaction occurs
- ✔ The name of the account affected by the transaction
- ✔ The *pay-to entity* (to whom the payment is made)

Depending on the company or accounting system used, more columns could be used as well. Figure 3-2 shows an example of a partial cash disbursements journal.

Figure 3-2:
A partial
cash
disburse-
ments
journal.

Cash Disbursements Journal								
						Accounts	Purchase	
		Ck			Misc	Payable	Discount	Cash
	Date	Num	Pay-To	Account	Debit	Debit	Credit	Credit
1	1/3	125	USPS	Postage Expense	\$352.63			\$352.63
2	1/4	126	Vendor A	Merchandise Purchase	\$412.00			\$412.00
3	1/5	127	Vendor B	Payment to Vendor		\$5,000.00	\$100.00	\$4,900.00

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Recording accrual transactions

Accrual transactions take place whenever cash doesn't change hands. For example, a customer makes a purchase with a promise to pay within 30 days. Using accruals and recording business transactions using the accrual method are the backbone of accounting. Unfortunately, figuring out accruals, understanding how accrual transactions interact with cash transactions, and knowing when to record an accrual transaction can be quite a challenge.

Never fear. The following sections introduce the two accrual workhorse journals — the *sales* and *purchases journals* — walk you through the accrual transactions you're likely to encounter, and provide a sampling of typical accrual transactions. Book III, Chapter 6 explains many types of accrual journal entries in detail.

Sales journal

The sales journal records all sales that a business makes to customers *on account*, which means no money changes hands between the company and its customer at the time of the sale. A sales journal affects two different accounts: accounts receivable and sales. In the sales journal, accounts receivable and sales are always affected by the same dollar amount.

Figure 3-3 presents an example of a sales journal.

Figure 3-3:
A partial
sales
journal.

Sales Journal				
		Inv		Accounts Receivable Debit/ Sales Credit
	Date	Num	Name of Customer	
1	6/15	3254	Customer A	\$3,000.00
2	6/17	3255	Customer B	\$521.23
3	6/21	3256	Customer C	\$785.25

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When you record credit sales in your sales journal, you follow up by posting the transactions to each customer's listing in the accounts receivable ledger. (See the "Bringing It All Together in the Ledger" later in this chapter.)



Use the sales journal only for recording sales on account. Sales returns, which reflect all products customers return to the company after the sales are done, aren't recorded in the sales journal. Instead, you record them in the general journal, discussed later in this chapter.

Purchases journal

Any time a business buys products or services by using credit (*on account*), it records the transaction in its purchases journal. The purchases journal typically has a column for date, number, and amount. It also has the following columns:

- ✓ **Accounts payable:** Because the company is purchasing on account, the current liability account called "accounts/trade payable" is always affected.
- ✓ **Terms:** This column shows any discount terms the company may have with the vendor. For example, *2/10, n/30* means the company gets a 2 percent discount if it pays within 10 days; otherwise, the full amount is due in 30 days. (The *n* in this shorthand stands for "net.")

- ✓ **Name:** The company records the name of the vendor from whom the purchase is made.
- ✓ **Account:** This column shows to which financial statement account(s) the purchase is taken. The example in Figure 3-4 shows two accounts — accounts payable (A/P) and purchases. Because no other accounts (such as sales tax) are affected, A/P and purchases are for the same dollar amount. If the company collects sales tax too, a column is added to report this amount as well.

Figure 3-4:
A partial
purchases
journal.

Purchases Journal					Accounts Payable Credit/ Purchase Debit
		Inv			
	Date	Num	Name	Terms	
1	2/4	1993	Vendor 1	2/10, n/30	\$125.63
2	2/8	2357	Vendor 2		\$2,587.00
3	2/13	185	Vendor 3	2/10, n/30	\$5,000.00

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Exploring other journals

The discussion of journals wouldn't be complete without a brief rundown of other special journals you'll see during your foray into accounting, as well as the general journal. The following sections cover both topics.

Special journals

Here are three additional journals you'll encounter:

- ✓ **Payroll journal:** This journal records all payroll transactions including gross wages, taxes withheld, and other deductions (such as health insurance paid by the employee) leading to *net pay*, which is the amount shown on the employee's check. Head over to Book II, Chapters 4 and 5 for more on payroll accounting.
- ✓ **Purchases return and allowances journal:** This journal shows all subtractions from gross purchases because of products a company returns to a vendor or discounts given to the company by the vendor.
- ✓ **Sales returns and allowances journal:** This journal shows all subtractions from gross sales as a result of products customers return or discounts given to customers.



This list isn't all-inclusive; some companies have other journals, and some smaller companies may not use all of these. However, if you understand the basic methodology of all the journals discussed in this chapter, you'll be well prepared to tackle journal entries.

General journal

The *general journal* is a catchall type of journal in which transactions that don't appropriately belong in any other journal show up. Many companies record interest income and dividends in the general journal.

This journal is also used for adjusting and closing journal entries:

- ✔ **Adjusting journal entries:** One key reason you would adjust journal entries is to make sure the accounting books are recorded by using the accrual method. For example, on April 30, employees have earned but not yet been paid \$5,000 in gross wages (the next payroll date is May 2). So to make sure that your company's revenue and expenses are matched, you book an adjusting journal entry debiting wages expense account for \$5,000 and crediting wages payable (or accrued wages) for \$5,000.

You also adjust journal entries to *reclassify* transactions. This occurs when the original transaction is correct but circumstances change after the fact and the transaction needs to be adjusted. For example, your company buys \$1,000 of supplies on April 1, and the transaction is originally booked as supplies inventory. On April 30, an inventory of the supplies is taken. Only \$800 of the supplies remain, so you have to debit your supplies expense account for \$200 and credit supplies inventory for \$200.

- ✔ **Closing journal entries:** You use this type of entry to zero out all *temporary accounts*. These accounts don't make it into the financial statements. Revenue and expense accounts are temporary accounts, because their balances are adjusted to zero at the end of each accounting period (month or year). You then transfer the net amounts (net income or a net loss) to the balance sheet. (See Book IV, Chapter 2 for information about the income statement.) There are four closing journal entries:
 - You debit all revenue accounts and credit income summary for the same amount. *Income summary* is a temporary holding account you use only when closing out a period.
 - You credit all expenses and debit income summary for the same amount.
 - You either debit or credit income summary to reduce it to zero and take the same figure to *retained earnings*. Retained earnings represent the cumulative net income, less all dividends (distributions of profit) paid to owners since the company was formed.

Here's an example: If in step one you credit income summary for \$5,000 and in step two you debit income summary for \$3,000, you now have a credit balance of \$2,000 in income summary. So to reduce income summary to zero, you debit it for \$2,000 and credit retained earnings for the same amount.

- Finally, if the owners have paid themselves any dividends during the period, you credit cash and debit retained earnings.



Honestly, you likely never have to prepare the first three closing entries yourself because all accounting software systems perform this task for you automatically. However, you do need to understand what goes on with the debits and credits when the books close. You have to do the fourth closing entry yourself. That's because the automated accounting systems requires a manual journal entry for the dollar amount of the dividend.



You clear out only temporary accounts with closing journal entries. Balance sheet accounts are *permanent accounts*. Until you cease using the account (for example, you close a bank account), no balance sheet accounts are zeroed out at closing.

Checking out examples of common journal entries

It's time for you to review a few journal entries so the concepts related to them really come to life. First, keep in mind the general format of a journal entry, which is shown in Figure 3-5:

Figure 3-5:
The standard journal entry format.

Date 12/31	Debited account Credited account	\$XX,XXX	\$XX,XXX
---------------	-------------------------------------	----------	----------

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- ✓ The date of the entry is in the left column.
- ✓ The accounts debited and credited are in the middle column.
- ✓ The amounts are shown in the two right columns.

Proper journal entries always list debits first followed by credits. See Book II, Chapter 2 for an explanation of debits and credits.



Journal entries can have more than one debit and more than one credit. And the number of accounts debited and credited doesn't have to be the same. For example, you can have five accounts debited and one account credited. However, the dollar amount of the debits and credits has to match.

Consider an example of a journal entry for service income, which records cash and accrual income. You provide a service to your client, Mr. Jones, on May 15, giving him invoice #200 in the amount of \$700 for services rendered. Before he leaves your office, he pays you \$200 in cash with a promise to pay the remaining balance of \$500 next week. The journal entry to record this transaction is shown in Figure 3-6.

5/15	Cash	\$200.00	
	Accounts Receivable	\$500.00	
	Service Revenue		\$700.00
	To record invoice #200		

Figure 3-6:
Recording
service
income.

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Under the accrual method of accounting (see Chapter 4), both the cash receipts and the promise to pay the remaining balance have to be reported at the time the transaction takes place because the service has been rendered and the income has been earned.



Every journal entry should have a brief description. It doesn't have to be a paragraph but should be long enough that you or anyone else reviewing the journal entry can figure out why you made it. A common mistake is to make the description just a little too brief, forcing you to go back through the transaction to figure out why you made the journal entry. The description for the journal entry in Figure 3-6 ("To record invoice #200") is brief but totally understandable.

Take a look at one more journal entry before moving on. Suppose you borrow \$5,000 from your bank on July 1. Your arrangement calls for you to pay \$200 interest on July 31 and pay back the loan in full plus another \$200 in interest on August 30. Figure 3-7 shows how your journal entries look from soup to nuts.

7/1	Cash Notes Payable	\$5,000.00	\$5,000.00
	Bank loan received		
7/31	Interest Expense Cash	\$200.00	\$200.00
	To record interest paid on note		
8/31	Notes Payable Interest Expense Cash	\$5,000.00 \$200.00	\$5,200.00
	Payment of bank note and interest		

Figure 3-7:
Journalizing
a loan
transaction.

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Bringing It All Together in the Ledger

At this point you may be thinking, “Okay, the journals are the books of original entry, but what happens then? How do entries into these journals turn into financial statements?” That’s the topic of this section. The accounts and amounts debited or credited affect the company’s ledgers, as explained next.

Realizing what a ledger is

A *ledger* records applicable transactions taking place in a company during a particular accounting cycle. Picture a big book. Every page of the book has a title that corresponds with an account from the chart of accounts. For instance, page 1 may be titled “1001 Cash in Bank.” On this page, you’d list the total of the funds you deposited in your company checking account, as well as the total of all the withdrawals for a given period — say for a month.

A business has one big dog ledger: the *general ledger*, which lists all transactions taking place in all the accounts during the specified accounting period. You may also see subsidiary ledgers that list in detail transactions happening only in specific accounting circumstances. For example, the *payroll subsidiary ledger* lists all payroll transactions. The *accounts receivable subsidiary ledger* lists all customers owing your company money and the amount of their current outstanding balances.

Posting to the ledgers

When you *post to the ledgers*, you simply take accounts and numbers from transactions entered in the journals and record them in the correct ledger. If a subsidiary ledger is the first point of recording, the transaction eventually flows through the subsidiary ledger to the general ledger. For example, a customer sale on account first posts to the sales journal and then is reported in the accounts receivable subsidiary ledger under the customer's name.

Then that amount flows from the accounts receivable subsidiary ledger to the accounts receivable listing in the general ledger, combining with all other customers owing the business money to show a grand total of accounts receivable. Following with the same transaction, the combined total of all the transactions in the sales journal also posts to the sales listing in the general ledger.

Until modern accounting software arrived, posting to the ledgers was a laborious process requiring the use of ledger paper with 14 columns. Fortunately, this practice has become a thing of the past because accounting software has become so affordable and easy to use.



Most accounting software programs require no formal procedure to post to the ledgers. Every time you enter a transaction in a journal, it automatically posts to the correct ledger. However, *proprietary* accounting software (which means a business holds exclusive rights to use) may require the user to actively select the posting command.

Viewing an example of a general ledger

General ledgers vary according to the nature of the business, a company's preferences, and the software used. Figure 3-8 shows a very simple partial general ledger for a small services company. It starts with a revenue account, "consulting fees," and ends with an operating expense account, "bank charge."

Columns similar to the debit, credit, and balance columns in Figure 3-8 are used in earlier figures in this chapter. Here's what some of the other columns mean:

- ✓ **Type:** The original nature of the transaction.
- ✓ **Date:** The day the transaction took place.
- ✓ **No.:** The identifying number from the journal of original entry. For example, 1008 is the company check number used to pay James Fine.
- ✓ **Name:** Whatever name you put in the journal of original entry.

Metropolitan Services, Inc. General Ledger									
Type	Date	No.	Name	Memo	Debit	Credit	Balance		
4050 - Consulting Fees								\$0.00	
Deposit	1/1	7		Calderwood Job	\$0.00	\$55,000.00	\$55,000.00		
Deposit	3/26	2		John's office colors	\$0.00	\$500.00	\$55,500.00		
Deposit	3/31	3		Walk in job	\$0.00	\$100.00	\$55,600.00		
Invoice	5/15	1	Bakerfield		\$0.00	\$1,725.00	\$57,325.00		
Invoice	5/15	5	Johnson	Monthly storage fee	\$0.00	\$75.00	\$57,400.00		
Invoice	5/31	3	Thompson	Original quote #3 hou	\$0.00	\$4,207.50	\$61,607.50		
Total 4050 - Consulting Fees							\$61,607.50	\$61,607.50	
5300 - Labor								\$0.00	
Check	5/31	1008	James Fine	Gross wages	\$800.00	\$0.00	\$800.00		
Check	5/31	1009	Phil Lock	Gross wages	\$200.00	\$0.00	\$1,000.00		
Total 5300 - Labor							\$1,000.00	\$0.00	\$1,000.00
5400 - Subcontract Labor								\$0.00	
Check	5/31	1010	Bob Smith	Thompson job	\$1,500.00	\$0.00	\$1,500.00		
Total 5400 - Subcontract Labor							\$1,500.00	\$0.00	\$1,500.00
5500 - Bank Charge								\$0.00	
Bank fee	3/31	14		March Bank Charges	\$15.00	\$0.00	\$15.00		
Total 5500 - Bank Charge							\$15.00	\$0.00	\$15.00

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Figure 3-8:
A partial
general
ledger.

✓ **Memo:** Any explanation for the transaction that you put in the original entry. Using this section is important. If your journal entry involves four accounts, each account has this same memo information when it's posted to general ledger. The memo notes make it much easier to understand why the entry was posted.

Recognizing the purpose of the trial balance

The *trial balance* is a listing of all the accounts in the general ledger and the balance of each account as of a certain date. The trial balance checks to make sure all debits equal credits. Any imbalance indicates the presence of an error that must be identified and corrected. Accountants also use the trial balance as a front-line tool to review the accuracy of the financial statements.

To find out more about running trial balances, see Book III, Chapter 5. This chapter provides a short explanation, and an example trial balance.

Suppose you run a trial balance, quickly scan it, and see that an expense account carries a balance that seems too high based on your professional judgment and knowledge of the company. You check the general ledger and see that a rent payment of \$5,000 was posted to postage expense by mistake. You can then correct the error before producing any financial statements.

Figure 3-9 shows an example of a partial trial balance.

Metropolitan Services, Inc.				
Trial Balance				
Account Name	Account No.	Debit	Credit	
Petty Cash	1001	\$50.00		
Checking Account	1005	\$2,078.30		
Accounts Receivable	1500	\$13,194.556		
Merchandise Inventory	1015	\$27,488.50		
Delivery Van	1600	\$35,000.00		
Accounts Payable	2600			\$2,500.00
Sales Tax Payable	2000			\$265.31
Pending Item Receipts	2500			\$2,389.25
Business Credit Card	2010			\$535.00
Social Security Tax	2120			\$124.00
Medicare Tax	2130			\$29.00
Federal Income Tax	2140			\$240.00
State Income Tax	2150			\$60.00
Note Payable - Computer Equipment	2510			\$25,000.00
Common Stock	3050			\$5,000.000
Service Income	4000			\$14,910.20
Consulting Fees	4050			\$61,007.50
Other Sales	4060			\$180.00
Cash Discount Taken	5000			\$26.85
Purchases	5200	\$19,835.75		
Labor	5300	\$1,000.00		
Subcontract Labor	5400	\$1,500.00		
Bank Charge	5500	\$15.00		
Insurance Expense	6500	\$3,150.00		
Officer Wages	6700	\$1,000.00		
Postage Expense	6900	\$100.00		
Rent Expense	7200	\$6,125.00		
Telephone Expense	7600	\$1,730.00		
Total		\$112,267.11		\$112,267.11

Figure 3-9:
A partial trial
balance.

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Accounting software shouldn't allow a user to enter a transaction that's out of balance. (*Out of balance* means that the total dollar amount of debits doesn't equal credits.) If an out-of-balance transaction occurs, the software has a serious bug that you need to report to the developer.

Putting Accounting Software to Work for You

A bewildering array of accounting software is available today for small- and medium-sized businesses. (Larger corporations tend to develop their own computer-based accounting systems or hire a programmer to develop specialized software.)



Today a business can select from a wide array of accounting software packages. Two popular choices for small businesses are QuickBooks and Sage Peachtree. A quick Internet search for "accounting software" can help you track down additional options. Unless your company has its own custom

accounting software and information technology (IT) staff, consider seeking the advice and assistance of an outside consultant in choosing, implementing, upgrading, and replacing accounting software. If you don't have the funds to hire a consultant, here's some free advice:

- ✔ Choose your accounting software very carefully. Switching to a different accounting program later is a major headache, so choose software that serves your current needs and provides room to grow.
- ✔ In evaluating accounting software, you and your accountant should consider three main factors: ease of use; whether it has the particular features and functionality you need; and the likelihood that the vendor will continue in business and be around to update and make improvements to the software.
- ✔ Make sure your accounting software leaves good audit trails, which you need for management control, for your CPA when auditing your financial statements, and for the IRS when it decides to audit your income tax returns. The lack of good audit trails looks very suspicious to the IRS. See Book IX for a discussion of audits.
- ✔ Pay attention to security features and best practices. You need very tight controls over all aspects of using the accounting software and who is authorized to make changes in any of the modules.

Online accounting systems that permit remote input and access over the Internet or a local area network with multiple users present special security problems. Think twice before putting any part of your accounting system online (and if you do, institute airtight controls).

More and more businesses seem to be switching to the cloud for doing more and more of their accounting tasks. The *cloud* consists of a network of offsite computer servers that users connect with over the Internet. You can choose to do your accounting in the cloud or use the cloud simply as the backup storage location for your accounting records. Cloud providers offer a wide variety of accounting and business software and services that are too numerous to discuss here. Cloud servers have a reputation of being very secure, but you still need very strong controls over the transmission of accounting information to and from the cloud.

Chapter 4

Choosing an Accounting Method

In This Chapter

- ▶ Getting clear on the cash and accrual methods of accounting
- ▶ Walking through other types of accounting
- ▶ Finding out about FASB's conceptual framework

To perform accounting tasks, you must choose to follow either of two methods: cash basis or accrual basis. In addition, you can approach accounting in several ways, depending on the nature of your business and the audience that reads your financial statements. For example, businesses use accounting to track transactions and keep investors informed; and their managers use accounting to make better decisions. Not-for-profit organizations primarily use accounting to help with budgeting and grant proposals. Accountants serving government agencies must also focus on budgeting while providing citizens and government agencies and officials with the information they need.

This chapter explains the differences between cash and accrual basis accounting, describes the various ways accounting is used, and introduces you to the Financial Accounting Standards Board's Statements of Financial Accounting Concepts. (If you aren't familiar with the FASB, check out Book IV, Chapter 1.) This chapter walks you through some of these concepts, tying them into material you encounter in Books IV and V.

Distinguishing between Cash and Accrual Basis

You can't keep books unless you know how you want to go about doing so. The two basic accounting methods are *cash-basis accounting* and *accrual accounting*. The key difference between these two accounting methods is the point at which you record revenue and expenses in your books. If you choose

cash-basis accounting, you record transactions only when cash changes hands. If you use accrual accounting, you record revenue when it's *earned*, and expenses when they're *incurred* — regardless of when cash changes hands.



The accrual method of accounting allows you to apply the *matching principle* of your transactions. This principle states that revenue should be matched with the expenses incurred to produce the revenue, regardless of when cash changes hands.

Suppose your company buys products to sell from a vendor but doesn't actually pay for those products for 30 days. If you're using cash-basis accounting, you don't record the purchase until you actually lay out the cash to the vendor. If you're using accrual accounting, you record the purchase when you receive the products, and you also record the future debt in an account called accounts payable.

The following sections describe each method in greater detail along with the pros and cons of each method.

The cash basis

Cash-basis accounting couldn't be easier. You record revenue when the company receives payments, and you record expenses when the company pays for something. The cash basis is essentially posting accounting transactions by using your checkbook. Your checkbook deposits for March represent March revenue, and your checks and debits for March are your expenses for that month.

Missing the matching principle

The ease of using the cash method is more than offset by the fact that the method fails to match revenue to the expenses the company incurs to earn that revenue. Because the matching principle isn't applied, cash basis financial statements usually don't present as accurate a picture of how the business is performing as accrual method financial statements do.

Consider an example. Let's say ABC Corp. has revenue of \$40,000 and expenses totaling \$15,000 associated with that revenue in April. \$20,000 of the revenue was received in cash, and the rest is on account. ABC Corp. paid cash for the entire \$15,000 of expenses. Using the cash method, ABC Corp.'s net income for April is \$5,000 (\$20,000 cash revenue less \$15,000 cash expenses). But that \$5,000 of net income grossly under-represents the volume of activity the company had during the month. The figures could be just as wildly inaccurate if the company didn't pay any of its expenses and had cash sales of \$30,000 — or for any other scenario involving the use of cash changing hands as a criteria for recording net income.

Adjusting the accounting records

Some small businesses use the cash method because they have little activity in the way of accounts receivable or payable. But the vast majority of businesses use the accrual basis, explained in the next section.

Because of the issues companies encounter with the cash method, most companies eventually switch to the accrual method. Often a financial statement user insists on the change. Maybe you're applying for a company bank loan. Your banker believes that the accrual method provides a more accurate view of your profit and loss each period. So, the banker asks to see *prior year* financials using the accrual period.

As you can imagine, adjusting your accounting records from the cash to accrual method may take a lot of work. You must review every revenue and expense transaction and determine whether the accounting needs to be changed.

The accrual basis

Using the accrual method of accounting, you record revenue when it's earned and realizable, and you record expenses when they're incurred — regardless of whether or when money changes hands. Wondering what the criteria are for revenue to be earned and realizable? The *earned* criterion is satisfied when the vendor satisfactorily performs on its contract with the customer.

Typically, revenue is considered earned when the vendor delivers the goods or services. *Realizable* means that the company has good reason to believe it will receive payment; for example, the customer swipes his debit card and enters his PIN.



A company can choose the criteria it uses to recognize revenue in the accounting records. The timing of revenue recognition depends on the company's industry, as well as the firm's history of receiving payments. A company may recognize revenue when it sends an invoice, or when it ships the goods. Even if the revenue is realizable, the point at which the revenue is considered *earned* can vary.

The accrual method takes cash out of the equation, because money changing hands doesn't determine whether you recognize a transaction. As a result, a company using the accrual method has an *accounts receivable*, which shows how much money customers owe to the business, and an *accounts payable*, which shows all the money a company owes to its vendors.



The statement of cash flows, discussed briefly at the end of this chapter and explained in detail in Book V, Chapter 2, is the accountant's bridge between the cash and accrual methods of accounting. That's because the statement of cash flows shows cash sources and uses — an aspect missing from the accrual method. Therefore, it gives the users of the financial statements a chance to look beyond and through the accrual-based numbers.

Sorting through Standards for Other Types of Accounting

Financial accounting is the process of compiling accounting transactions to create financial statements. Here are some other types of accounting that accountants may perform:

- ✓ **Managerial accounting:** Creating internal accounting reports that company managers use to make decisions.
- ✓ **Not-for-profit accounting:** Generating financial statements for not-for-profit entities, using a different set of financial reports. Not-for-profit firms raise money from donations, grants, and other sources. They don't produce revenue primarily from selling a product or service. As a result their financial reports are different.
- ✓ **Governmental accounting:** Like not-for-profits, governments (federal, state, and local) have a unique method for creating financial statements.
- ✓ **International accounting:** The global accounting industry is attempting to create a single set of accounting standards for international commerce. At this point, countries outside the U.S. maintain at least some accounting rules that are different. As a result, rules for foreign entities may differ from U.S. accounting rules.

The following sections explore these different areas of accounting more closely.

If you work in an accounting field other than financial accounting, you must follow standards different from (or in addition to) those discussed in Book IV, Chapter 1. Other organizations besides the financial accounting standard-setters give official guidance on how to prepare financial statements and reports. For example, instead of following generally accepted accounting principles (GAAP), governmental entities follow procedures set up by the Governmental Accounting Standards Board (GASB).

To find out more about financial accounting, see “Considering the Conceptual Framework of Financial Accounting,” later in this chapter. The next few sections give you the lowdown on other types of accounting and note who provides guidance to accountants in these fields.

Managerial accounting

Managerial accountants provide economic and financial information for the internal users of financial statements, such as a company’s department heads, shift leaders, and human resources department. For example, human resources personnel use managerial accounting reports to make sure they have the right mix of employees to maintain a smooth-running operation. Additionally, managerial accounting reports measure quality, performance, and how close each department or business unit comes to meeting its goals. They also measure managerial effectiveness and efficiency.

In order to be useful, managerial reports are issued frequently — sometimes daily. There’s no messing around! Other times, accounting staff prepare and distribute the reports the day after a reporting period ends. For internal reporting to management, the rules are similar to those you follow when playing horseshoes — getting close is often good enough.



Because managerial reports are used only internally, no regulatory bodies or other outside agencies mandate how managerial accountants do their job. Instead, managerial accountants look to the Institute of Management Accountants (IMA) for guidance on carrying out their accounting duties. The managerial accountant code of ethics is contained in the *Standards of Ethical Conduct for Management Accountants*. For more information, check out the IMA website at www.imanet.org. To find out more about managerial accounting, see *Managerial Accounting For Dummies* by Mark P. Holtzman, CPA (Wiley).

Not-for-profit accounting

Not-for-profit businesses are run for the public good — not driven by any profit motive. You may consider these entities to be “mission-driven.” Every not-for-profit has a particular mission that it has defined for itself. These types of organizations include hospitals, schools, religious organizations, and charitable agencies.



Net income of an exempt organization isn’t taxed federally. To qualify for exempt status in the United States, an organization fills out an application package that must be approved by the Internal Revenue Service. After the approval process, which can take months, the organization is then exempt from paying the normal taxes levied on a for-profit business by the federal government.

The not-for-profit accountant's job involves two important components (in addition to the typical accounting duties): preparing budgets and preparing the financial information for grant applications. Budgets are crucial because the organization needs to be able to predict what amount of money it must obtain through grants, donations, and fundraising efforts in order to serve the organization's purpose.

Not-for-profits apply for grants awarded by government entities and private foundations. The purpose of the grant should fit the organization's mission. If your organization promotes trails for hiking and biking, you might apply for a grant to encourage kids to walk or ride bikes to school. The entity awarding the grant requests financial information in the grant application and insists that the not-for-profit report periodically on how the funds are used.

Wondering if not-for-profits also have to report by using accrual basis accounting and according to FASB and GAAP standards? As explained in Book IV, Chapter 1, the FASB Accounting Standards Codification is the source of authoritative GAAP to be applied by all nongovernmental entities. So the answer is yes, a not-for-profit follows FASB and GAAP unless an FASB pronouncement specifically excludes not-for-profits.



One difference in keeping the books for profit seeking versus not-for-profit organizations is that not-for-profits use *fund accounting*, which groups accounting transactions together into funds or accounts that share a similar purpose. This way, the organization has a better idea of the resources it has available for each specific function.

If not-for-profit accounting interests you, check out *Nonprofit Bookkeeping & Accounting For Dummies* by Sharon Farris (Wiley) for much more information about this field.

Governmental accounting

Governmental accountants work for city, county, state, and federal government agencies. Their job is similar to the not-for-profit accountant's job because they deal with budgets and government agencies that have no profit motive. Budgeting is important because budgets serve as the primary tool in allocating governmental cash sources to urban, suburban, and rural parts of the communities served.

At the city, county, or state level, the cash comes in from sources such as *ad valorem* (property) taxes; funding from the federal government such as for schools, streets, and roads; interdepartmental governmental transfers; fines and forfeitures; sales and use tax; licenses and permits; and municipal bond issuances. Funds are then appropriated to cover costs. The appropriations are either approved or disapproved during the setting of the budget. Finally, disbursements are made throughout the fiscal year for approved budget items.

Governmental accountants also prepare financial statements that are open to the general public. The financial statements must show accountability to citizens while pursuing the goals of efficiency and effectiveness. The financial statements are also used by external users to decide whether to invest in the municipality's bond issuances. The regulatory authority for governmental accountants is the Governmental Accounting Standards Board (GASB). You can find out more information about GASB at www.gasb.org.

International accounting

International accountants work for multinational businesses performing financial and managerial accounting, tax return preparation, and auditing. (*Auditing* is the process of investigating financial information prepared by someone else to see whether it's stated fairly. Check out Book IX for additional details.) They should be familiar with the legal regulations and standards of the countries in which their employers conduct business.

International accountants have to deal with foreign currency translations, such as how many U.S. dollars (USD) equal how many euros (EUR). They also manage two special risks:

- ✓ **Expropriation:** The seizure of company assets by the host government
- ✓ **Blocked funds:** When the host government doesn't allow any company funds to be repatriated to the United States

An important organization for international accountants is the International Accounting Standards Board (IASB), whose website is www.iasb.org. The IASB is currently working in tandem with the FASB to provide comparability between the accounting standards — in other words, to bring U.S. and international GAAP together. This process is referred to as *harmonization*, and the purpose is to develop a single set of global accounting standards that will provide high quality, transparent, and comparable financial statement reporting.

Considering the Conceptual Framework of Financial Accounting

Accounting dates back to the Stone Age as a way of figuring out the supply and demand of commerce. Long before people had stores and cash registers, they had to have some way of ensuring an equitable trade of goods for goods or goods for service. Also, accounting was put to use as far back as the Holy Roman Empire (and probably even earlier) to make sure that all subjects to the empire were paying their assessed taxes.

As noted in Book IV, Chapter 1, accounting standards were virtually nonexistent until the Great Depression of 1929. And it wasn't until the mid-1970s that the Financial Accounting Standards Board (FASB) began the process of spelling out a framework of financial accounting concepts.

The FASB organizes its conceptual framework in *Statements of Financial Accounting Concepts* or *Concept Statements*. (Accountants use the abbreviation *CONs* to refer to them.) Financial accounting textbooks usually mention these *CONs* only in passing. However, if you're new to the wonderful world of financial accounting, these concepts can give you a firm foundation for understanding financial accounting. The information that comes next provides general background on why financial accounting standards work the way they do and what they attempt to accomplish.

The following sections provide the condensed version of the concepts, but first you find out about what financial accounting is attempting to accomplish.

The objective of financial reporting

The purpose of financial accounting is to classify and record all accounting events taking place during the course of a company's business. These events include earning revenue, paying bills, bringing in gains, and incurring losses.

The results of all these events are arranged on the correct financial statement (the balance sheet, income statement, and/or statement of cash flows) and reported to the external users of the financial statements. External users include investors, creditors, banks, and regulatory agencies such as the IRS and the U.S. Securities and Exchange Commission (SEC).

Characteristics of accounting information

Besides organizing accounting events into financial statements, financial accountants serve the needs of external users by delivering the information they need in a format they understand. To achieve this goal, accountants must produce financial reports that exhibit the following characteristics:

- ✓ **Understandability:** The information on the financial statement has to be understandable to people not privy to the internal workings of the business. The financial information must be laid out in a fashion so that users with a reasonable understanding of the business world (and a willingness to do research on specific topics as needed) can ferret out all important accounting facts about the business.

- ✔ **Relevance:** This characteristic means that the financial statements give the users enough info so they can form opinions about the final outcome of events that took place in the past and how any present or future events are likely to shake out. Also, the financial statements should give the users enough info so that they can tell whether any opinions they made about future events that have now come to fruition were indeed correct.
- ✔ **Reliability:** Financial statements aren't worth the paper they're written on unless the information they present is verifiable, neutral, and materially correct. For example, if the income statement (see Book IV, Chapter 2) shows \$10 million of sales, that \$10 million should represent sales that actually took place, not projections (or what company management wants the users to think occurred).
- ✔ **Comparability:** *Comparability* means the quality of the information is such that users can identify differences and similarities among companies they're evaluating — or among different financial periods for the same company. For example, users need to know what method(s) the companies are using to depreciate assets. Without this knowledge, the users can't accurately evaluate the relative worth of one company over the other. (Head over to Book III, Chapter 1 for more on depreciation.)
- ✔ **Consistency:** *Consistency* means the company uses the same accounting treatment for the same type of accounting transactions — both within a certain financial period and among various financial periods. Doing so allows the user to know that the financial accountant isn't doing the accounting equivalent of comparing apples to oranges.

Elements of the financial statements

A primary focus of accounting in the business world centers on the proper preparation of financial statements: the income statement, balance sheet, and statement of cash flows. Accountants can't just stick accounting transaction data on the statements wherever they feel like. GAAP contains many, many rules that dictate how information must be organized on the statements (see Book IV, Chapter 1). These rules pertain to both how the financial accountant shows the accounting transactions and on which financial statements the information relating to the transactions appears:

- ✔ **Income statement:** This financial statement shows the results of business operations consisting of revenue, expenses, gains, and losses for a specific period of time. The end product is net income or net loss. Here are the basic facts on the four different income statement components:
 - **Revenue:** Gross receipts earned by the company selling its goods or services
 - **Expenses:** The costs to the company to earn the revenue



- **Gains:** Income from non-operating-related transactions, such as selling a company asset
- **Losses:** The flip side of gains, such as losing money when selling the company car

A lot of non-accountants call the income statement a *statement of profit or loss* or simply a *P&L*. These terms are fine to use because they address the spirit of the statement.

- ✓ **Balance sheet:** The balance sheet, which is compiled as of a certain date, has three sections: assets, liabilities, and equity. Standing on their own, these sections contain valuable information about a company. However, a user has to see all three together on the balance sheet to form an opinion about the company's operations.

Here are the basics about each balance sheet component:

- **Assets:** Resources owned by a company, such as cash, equipment, and buildings
 - **Liabilities:** Debt the business incurs for operating and expansion purposes, such as accounts payable, accrued wages and notes payable
 - **Equity:** The amount of ownership left in the business after deducting total liabilities from total assets
- ✓ **Statement of cash flows:** The statement of cash flows, created as of a specific date, contains certain components of both the income statement and the balance sheet. The purpose of the statement of cash flows is to show cash sources and uses during a specific period of time — in other words, how a company brings in cash and what the company uses that cash for.

Financial statement measurements

Communicating via the financial statements with parties interested in the business requires the measurement of all accounting transactions. *Measurement* refers to the fact that every accounting event must have a cost or a value in order to be recognized on the financial statements. You may be confused about the difference between cost and value. Well, you're not alone. This issue can be thorny even among seasoned financial accountants.

Depending on their nature, accounting transactions may be recorded in different ways. If a transaction is recorded at *historic cost*, it shows how much the company paid in cash or assumed in debt during the transaction. *Net realizable value (NRV)* can also be used, which is the amount of cash a business anticipates receiving from an asset in the normal course of business — after factoring in any related costs. You find all sorts of good information about historic cost in Book IV, Chapter 3.