

Explanation:

Accounting Basics

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Introduction to Accounting Basics

This explanation of accounting basics will introduce you to some basic accounting principles, accounting concepts, and accounting terminology. Once you become familiar with some of these terms and concepts, you will feel comfortable navigating through the explanations, drills, puzzles, and other features on AccountingCoach.com.

Some of the basic accounting terms that you will learn include revenues, expenses, assets, liabilities, income statement, balance sheet, and statement of cash flows. You will become familiar with accounting debits and credits as we show you how to record transactions. You will also see why two basic accounting principles—the revenue recognition principle and the matching principle, assure that a company's income statement reports a company's profitability.

In this explanation of accounting basics, and throughout the entire website, AccountingCoach.com will often omit some accounting details and complexities in order to present clear and concise explanations. This means that you should always seek professional advice for your specific circumstances.

A Story for Relative to Accounting Basics

We will present the basics of accounting through a story of a person starting a new business. The person is Joe Perez—a savvy man who senses the need for a parcel delivery service in his community. Joe has researched his idea and has prepared a business plan that documents the viability of his new business.

Joe has also met with an attorney to discuss the form of business he should use. Given his specific situation, they concluded that a corporation will be best. Joe decides that the name for his corporation will be Direct Delivery. In addition, the attorney also advises Joe on the various permits and government identification numbers that will be needed for the new corporation.

Joe is a hard worker and a smart man, but admits he is not comfortable with matters of accounting. He assumes he will use the accounting software, but wants to meet with a professional accountant before making his selection. He asks his banker to recommend a professional accountant who is also skilled in explaining accounting to someone without an accounting background. Joe wants to understand the financial statements and wants to keep on top of his new business. The banker recommends Marilyn, an accountant who has helped many of the bank's small business customers.

Read the topic *Accounting Career* to learn more about the roles of accountants and CPAs.

At his first meeting with Marilyn, Joe asks her for an overview of accounting, financial statements, and the need for accounting software. Based on Joe's business plan, Marilyn sees that there will likely be thousands of transactions each year. She states that accounting software will allow for the electronic recording, storing, and retrieval of those many transactions. Accounting software will permit Joe to generate the financial statements and other reports that he will need for running his business.

Joe seems puzzled by the term transaction, so Marilyn gives him five examples of transactions that Direct Delivery, Inc. will need to record:

1. Joe will no doubt start his business by putting some of his own personal money into it. In effect, he is buying shares of Direct Delivery's common stock.
2. Direct Delivery will purchase a dependable delivery vehicle.
3. The business will begin earning fees and billing clients for delivering their parcels.
4. The business will be collecting the fees that were earned.
5. The business will incur expenses in operating the business, such as a salary for Joe, expenses associated with the delivery vehicle, advertising, etc.

With thousands of such transactions in a given year, Joe is smart to start using accounting software right from the beginning. Accounting software will generate sales invoices and accounting entries simultaneously, create invoices for customers with no additional work, write checks, automatically update accounting records, etc.

By getting into the habit of entering all of the day's business transactions into his computer, Joe will be rewarded with fast and easy access to the specific information he will need to make sound business decisions. Marilyn tells Joe that accounting's "transaction approach" is useful, reliable, and informative. She has worked with other small business owners who think it is enough to simply "know" that they own \$30,000 during the year (based only on the fact that it owns \$30,000 more than it did on January 1). Those are the people who start off on the wrong foot and end up in Marilyn's office looking for financial advice.

If Joe enters all of Direct Delivery's transactions into his computer, good accounting software will allow Joe to print out his financial statements with a click of a button. Next, Marilyn will explain the content and purpose of the three main financial statements:

1. Income Statement
2. Balance Sheet
3. Statement of Cash Flows

Income Statement

Marilyn points out that an income statement will show how *profitable* Direct Delivery has been during the time interval shown in the statement's heading. This period of time might be a week, a month, three months, five weeks, or a year. Joe can choose whatever time period he deems most useful.

The reporting of profitability involves two things: the amount that was earned (revenues) and the expenses necessary to earn the revenues. As you will see next, the term *revenues* is not the same as receipts, and the term *expenses* involves more than just writing a check to pay a bill.

A. Revenues

The main revenues for Direct Delivery are the fees it earns for delivering parcels. Under the accrual basis of accounting (as opposed to the less-preferred cash method of accounting), revenues are recorded when they are *earned*, not when the company *receives* the money. Recording revenues when they are earned is the result of one of the basic accounting principles known as the revenue recognition principle.

For example, if Joe delivers 1,000 parcels in December for \$4 per delivery, he has technically *earned* fees totaling \$4,000. Joe sends invoices to his clients for these fees and his terms require that his clients must pay by January 10. Even though his clients won't be paying Direct Delivery until January 10, the accrual basis of accounting requires that the \$4,000 be recorded as *December* revenues since that is when the delivery work actually took place. After expenses are matched with the revenues, the income statement for December will show just how *profitable* the company was in delivering parcels in December.

When Joe receives the \$4,000 in checks from his customers on January 10, he will make an accounting entry to show the money was received. This \$4,000 of receipts will not be considered to be January revenues, since the *revenues* were already reported as revenues in December when they were earned. The \$4,000 of receipts will be recorded in January as a reduction in Accounts Receivable (in December Joe had made an entry to Accounts Receivable and to Sales.)

B. Expenses

Now Marilyn turns to the second part of the income statement—expenses. The December income statement should show *expenses incurred* during December regardless of when the company actually *paid* for the expenses. For example, if Joe hires someone to help him with December deliveries and she agrees to pay him \$500 on January 3, that \$500 expense needs to be shown on the *December* income statement. The actual date that the \$500 is paid out doesn't matter—what matters is when the work was done—when the expense was *incurred*—and in this case, the work was done in December. The \$500 expense is counted as a

December expense even though the money will not be paid out until January 3. The recording of expenses with the related revenues is associated with another basic accounting principle known as the matching principle.

Marilyn explains to Joe that showing the \$500 of wages expense on the December income statement will result in a *matching* of the cost of the labor used to deliver the December parcels with the revenues from delivering the December parcels. This matching principle is very important in measuring just how profitable a company was during a given time period.

Marilyn is delighted to see that Joe already has an intuitive grasp of this basic accounting principle. In order to earn revenues in December, the company had to incur some business expenses in December, even if the expenses don't be *paid* until January. Other expenses to be matched with December revenues are such things as gas for the delivery van and advertising spots on the radio.

Joe asks Marilyn to provide an example of a cost that wouldn't be paid in December, but would have to be shown/matched as an expense on December's income statement. Marilyn uses the Interest Expense on borrowed money as an example. She asks Joe to assume that on December 1 Direct Delivery borrows \$20,000 from Joe's aunt and the company agrees to pay his aunt 6% per year interest. That's \$1,200 per year. This interest is to be paid in a lump sum each on December 1.

Now even though the interest is being paid out to his aunt only once per year as a lump sum, Joe can see that in reality the interest expense is *incurred* each and every day he's in business. If Joe is preparing *monthly* income statements, Joe should report one month of Interest Expense on each month's income statement. The amount that Direct Delivery will incur as Interest Expense will be \$100 per month all year long ($\$20,000 \times 6\% \div 12$). In other words, Joe needs to match \$100 of interest expense with each month's revenues. The interest expense is considered a cost that is necessary to earn the revenues shown on the income statements.

Marilyn explains to Joe that the income statement is a bit more complicated than what she just explained, but for now she just wants Joe to learn some basic accounting concepts and some of the accounting terminology. Marilyn does make sure, however, that Joe understands one simple yet important point: an income statement, does *not* report the *cash* coming in—rather, its purpose is to (1) report the *revenue* earned by the company's efforts during the period, and (2) report the expenses incurred by the company during the same period. The purpose of the income statement is to show a company's *profitability* during a specific period of time. The difference (or "net") between the revenues and expenses for Direct Delivery is often referred to as the **bottom line** and it is labeled as either Net Income or Net Loss.

Balance Sheet - Assets

Marilyn moves on to explain the balance sheet—a financial statement that reports the amount of a company's **(A)** assets, **(B)** liabilities, and **(C)** stockholders' (or owner's) equity at a specific *point in time*. Because the balance sheet reflects a specific *point in time* rather than a *period of time*, Marilyn likes to refer to it as a "snapshot" of a company's financial position at a given moment. For example, if a balance sheet is dated December 31, the amounts shown on the balance sheet are the balances in the accounts after all transactions pertaining to December 31 have been recorded.

(A) Assets

Assets are things that a company owns and are sometimes referred to as the resources of the company. Joe readily understands this—off the top of his head he names things such as the company's vehicle, its cash in the bank, all of the supplies he has on hand, and the dolly he uses to help move the heavy parcels. Marilyn nods and shows Joe how these are reported in accounts called Vehicles, Cash, Supplies, and Equipment. She mentions one asset Joe hadn't considered—Accounts Receivable. If Joe delivers parcels, but isn't paid immediately for the delivery, the amount owed to Direct Delivery is an asset known as Accounts Receivable.

Prepays

Marilyn brings up another less obvious asset—the unexpired portion of prepaid expenses. Suppose Direct Delivery paid on November 1 for a six-month insurance premium on its delivery vehicle. That dividend turned out to be \$200 per month ($\$1,200 \div 6$ months). Between December 1 and December 31, \$200 worth of insurance premium is "used up" or "expires". The *expired* amount will be reported as Insurance Expense on December's income statement. Joe asks Marilyn where the remaining \$1,000 of unexpired insurance premium would be reported. On the December 31 balance sheet, Marilyn tells him, in an asset account called Prepaid Insurance.

Other examples of things that might be paid for before they are used include supplies and annual dues to a trade association. The portion that expires in the current accounting period is listed as an expense on the income statement, the part that has not yet expired is listed as an asset on the balance sheet.

Marilyn assures Joe that he will soon see a significant link between the income statement and balance sheet, but for now she continues with her explanation of assets.

Cost Principle and Conservatism

Joe learns that each of his company's assets was recorded at its *original cost*, and even if the fair market value of an item increases, an accountant will not increase the recorded amount of that asset on the balance sheet. This is the result of another basic accounting principle known as the cost principle.

Although accountants generally do not *increase* the value of an asset, they might *decrease* its value as a result of a concept known as **conservatism**. For example, after a few months in

business, Joe may decide that he can help out some customers—as well as earn additional revenues—by carrying an inventory of packing boxes to sell. Let's say that Direct Delivery purchased 100 boxes whose sale for \$1.00 each. Since the time when Joe bought them, however, the wholesale price of boxes has been cut by 40% and at today's price he could purchase them for \$0.60 each. Because the replacement cost of his inventory (\$60) is less than the *original recorded cost* (\$100), the principle of conservatism directs the accountant to report the lower amount (\$60) as the asset's value on the balance sheet.

In short, the cost principle generally prevents assets from being reported at more than cost, while conservatism might require assets to be reported at less than their cost.

Depreciation

Joe also needs to know that the carrying amounts on his balance sheet for assets such as equipment, vehicles, and buildings are routinely reduced by depreciation. Depreciation is required by the basic accounting principle known as the matching principle. Depreciation is used for assets whose life is not infinite—equipment wears out, vehicles become too old and costly to maintain, buildings age, and some assets (like computers) become obsolete. Depreciation is the allocation of the cost of the asset to Depreciation Expense on the income statement over its useful life.

As an example, assume that Joe's company has a useful life of five years and was purchased at a cost of \$20,000. The accountant might match \$4,000 ($\$20,000 \div 5$ years) of Depreciation Expense with each year's revenues for five years. Each year the carrying amount of the van will be reduced by \$4,000 (the carrying amount—or "book value"—is reported on the balance sheet and it is the cost of the van minus the total depreciation since the van was acquired.) This means that after one year the balance sheet will report the carrying amount of the delivery van as \$16,000, after two years the carrying amount will be \$12,000, etc. After five years—the end of the van's expected useful life—its carrying amount is zero.

Joe wants to be certain that Marilyn understands what Marilyn is telling him regarding the assets on the balance sheet, so he asks Marilyn if the balance sheet is, in effect, showing what the company's assets are worth. He is surprised to hear Marilyn say that the assets are *not* reported on the balance sheet at their worth (or market value). Long-term assets (such as buildings, equipment, and furnishings) are reported at their cost *minus* the amounts already sent to the income statement as Depreciation Expense. The result is that a building's market value may actually have increased since it was acquired, but the amount on the balance sheet has been *consistently reduced* as the accountant moved some of its cost to Depreciation Expense on the income statement in order to achieve the matching principle.

Another asset, Office Equipment, may have a fair market value that is much smaller than the carrying amount reported on the balance sheet. (Accountants view depreciation as an *allocation* process—allocating the cost to expense in order to match the costs with the revenues generated by the asset. Accountants do *not* consider depreciation to be a *valuation* process.) The asset Land is not depreciated, so it will appear at its original cost even if the land is now worth one hundred times more than its cost.

Short-term (current) asset amounts are likely to be close to their market values, since they tend to "turn over" in relatively short periods of time.

Marilyn cautions Joe that the balance sheet reports only the assets acquired and only at the cost reported in the transaction. This means that a company's reputation—as excellent as it might be—will not be listed as an asset. It also means that Jeff Bezos will not appear as an asset on Amazon.com's balance sheet, Nike's logo will not appear as an asset on its balance sheet; etc. Joe is surprised to hear this, since in his opinion these items are perhaps the most valuable things those companies have. Marilyn tells Joe that he has just learned an important lesson that he should remember when reading a balance sheet.

Balance Sheet – Liabilities and Stockholders' Equity

(B) Liabilities

The balance sheet reports Direct Delivery's liabilities as of the date noted in the heading of the balance sheet. Liabilities are obligations of the company; they are amounts owed to others as of the balance sheet date. Here are some examples of liabilities: the loan he received from his aunt (Notes Payable or Loan Payable), the interest on the loan he owes to his aunt (Interest Payable), the amount he owes to the supply store for items purchased on credit (Accounts Payable), the wages he owes an employee but hasn't yet paid to him (Wages Payable).

Another liability is money received in advance of actually *earning* the money. For example, suppose that Direct Delivery enters into an agreement with one of its customers stipulating that the customer prepays \$600 in return for the delivery of 30 parcels every month for 6 months. Assume Direct Delivery receives that \$600 payment on December 1 for deliveries to be made between December 1 and December 31. Direct Delivery has a cash *receipt* of \$600 on December 1, but it does *not* have revenues of \$600 at this point. It will have revenues only when it *earns* them by delivering the parcels. On December 1, Direct Delivery will show that its asset Cash increased by \$600, but it will also have to show that it has a liability of \$600. (It has the *liability* to deliver \$600 of parcels within 6 months, or return the money.)

The liability account involving the \$600 received on December 1 is Unearned Revenue. Each month, as the 30 parcels are delivered, Direct Delivery will be earning \$100, and as a result, each month \$100 moves from the account Unearned Revenue to Service Revenues. Each month Direct Delivery's liability decreases by \$100 as it fulfills the agreement by delivering parcels and each month its revenues on the income statement increase by \$100.

(C) Stockholders' Equity

If the company is a corporation, the third section of a corporation's balance sheet is Stockholders' Equity. (If the company is a sole proprietorship, it is referred to as Owner's

Equity.) The amount of Stockholders' Equity is exactly the difference between the asset amounts and the liability amounts. As a result, accountants often refer to Stockholders' Equity as the difference (or residual) of assets minus liabilities. Stockholders' Equity is also the "book value" of the corporation.

Since the corporation's assets are shown at cost or lower (and not at their market values) it is important that you do **not** associate the reported amount of Stockholders' Equity with the market value of the corporation. (Hence, it is a poor choice of words to refer to Stockholders' Equity as the corporation's "net worth".) To find the market value of a corporation, you should obtain the services of a professional familiar with valuing businesses.

Within the Stockholders' Equity section you may see accounts such as Common Stock, Paid-in Capital in Excess of Par Value, Preferred Stock, Retained Earnings, and Current Year's Net Income.

The account Common Stock increased when the corporation issues shares of stock in exchange for cash (or some other asset). Another account Retained Earnings will increase when the corporation earns a profit. There will be a decrease when the corporation has a net loss. This means that revenues will automatically cause an *increase* in Stockholders' Equity and expenses will automatically cause a *decrease* in Stockholders' Equity. This illustrates a link between a company's income statement.

Statement of Cash Flows

The third financial statement that you need to understand is the Statement of Cash Flows. This statement shows how Direct Delivery's cash amount has changed during the time interval shown in the heading of the statement. You will be able to see at a glance the cash generated and used by his company's operating activities, its investing activities, and its financing activities. Much of the information on this financial statement will come from Direct Delivery's balance sheets and income statement.

The three financial reports that Marilyn introduced to Joe—the income statement, the balance sheet, and the statement of cash flows—represent one segment of the valuable output that good accounting software can generate for business owners.

Marilyn now explains to Joe the basics of getting started with recording his transactions.

Double Entry System

The field of accounting—both the older manual systems and today's basic accounting software—is based on the 100-year-old accounting procedure known as **double entry**. Double entry is a simple yet powerful concept: each and every one of a company's transactions will result in an amount recorded in two of the accounts in the accounting system.

The Chart of Accounts

To begin the process of setting up Joe's accounting system, he will need to make a detailed listing of all the names of the accounts that Direct Delivery, Inc. might find useful for reporting transactions. This detailed listing is referred to as a chart of accounts. (Accounting software often provides sample charts of accounts for various types of businesses.)

As he enters his transactions, Joe will find that the chart of accounts will help him select the two (or more) accounts that are involved. Once Joe's business begins, he may find that he needs to add more account names to the chart of accounts, or delete account names that are never used. Joe can tailor his chart of accounts so that it best sorts and reports the transactions of his business.

Because of the double entry system all of Direct Delivery's transactions will involve a combination of two or more accounts from the balance sheet and/or the income statement. Marilyn lists out some sample accounts that Joe will probably need to include on his chart of accounts:

Balance Sheet accounts

- Asset accounts (Examples: Cash, Accounts Receivable, Supplies, Equipment)
- Liability accounts (Examples: Notes Payable, Accounts Payable, Wages Payable)
- Stockholders' Equity accounts (Examples: Common Stock, Retained Earnings)

Income Statement accounts

- Revenue accounts (Examples: Service Revenues, Investment Revenues)
- Expense accounts (Examples: Wages Expense, Rent Expense, Depreciation Expense)

To help Joe really understand how this works, Marilyn illustrates the double entry with some sample transactions that Joe will likely encounter.

Sample Transactions #1

Sample Transaction #1

On December 1, 2010 Joe starts his business, Direct Delivery, Inc. The first transaction that Joe will record for his company is Joe's investment of \$20,000 in exchange for 5,000 shares of Direct Delivery's common stock. Direct Delivery's accounting system will show an increase in its account Cash from zero to \$20,000, and an increase in its stockholders' equity account Common Stock by \$20,000. Both of these accounts are balance sheet accounts. There are no revenues because *no* delivery fees were *earned* by the company, and there were no expenses.

After Joe enters this transaction, Direct Delivery's balance sheet will look like this:

Direct Delivery, Inc. Balance Sheet December 1, 2010			
Assets		Liabilities & Stockholders' Equity	
Cash	\$ 20,000	Liabilities	
		Stockholders' Equity	
		Common Stock	\$ 20,000
Total Assets	<u>\$ 20,000</u>	Total Liabilities & Stockholders' Equity	<u>\$ 20,000</u>

Marilyn asks Joe if he can see that the balance sheet is just that—in *balance*. Joe looks at the total of \$20,000 on the asset side, and looks at the \$20,000 on the right side, and says yes, of course, he can see that it is indeed in balance.

Marilyn shows Joe something called the **basic accounting equation**, which, she explains, is really the same concept as a balance sheet, it's just presented in an equation format:

$$\begin{array}{r} \text{Assets} = \text{Liabilities} + \text{Stockholders' (or Owner's) Equity} \\ \$20,000 = \$0 + \$20,000 \end{array}$$

The accounting equation (and the balance sheet) should always be in balance.

Debits and Credits

Did the first sample transaction follow the double entry system and affect two or more accounts? Joe looks at the balance sheet again and answers yes, both Cash and Common Stock were affected by the transaction.

Marilyn introduces the next basic accounting concept: the double entry system requires that the same dollar amount of the transaction must be entered on both the *left* side of one account, and on the *right* side of another account. Instead of the word *left*, accountants use the word *debit*; and instead of the word *right*, accountants use the word *credit*. (The terms *debit* and *credit* are derived from Latin terms used 500 years ago.)



Here's a Tip

Debit means *left*.
Credit means *right*.

Joe asks Marilyn how he will know which accounts he should debit—meaning he should enter the numbers on the left side of one account—and which accounts he should credit—meaning he should enter the numbers on the right side of another account. Marilyn points back to the basic accounting equation. Once he memorizes this simple equation, it will be easier to understand the debits and credits.



Here's a Tip

Memorizing the simple accounting equation will help you learn the debit and credit rules for entering amounts into the accounting records.

Let's take a look at the accounting equation again:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' (or Owner's) Equity}$$

Just as assets are on the left side (or debit side) of the accounting equation, the asset accounts in the general ledger have their balances on the left side. To *increase* an asset account's balance, you put more on the left side of the asset account. In accounting jargon, *you debit the asset account*. To *decrease* an asset account balance you *credit* the account, that is, you enter the amount on the right side.

Just as liabilities and stockholders' equity are on the right side (or credit side) of the accounting equation, the liability and equity accounts in the general ledger have their balances on the right side. To *increase* the balance in a liability or stockholders' equity account, you put more on the right side of the account. In accounting jargon, you credit the liability or the equity account. To *decrease* a liability or equity account, you debit the account, that is, you enter the amount on the left side of the account.

As with all rules, there are exceptions, but Marilyn's reference to the accounting equation may help you to learn whether an account should be debited or credited.

Since many transactions involve cash, Marilyn suggests that Joe memorize how the Cash account is affected when a transaction involves cash: if Direct Delivery *receives* cash, the Cash account is debited; if Direct Delivery *pays* cash, the Cash account is credited.

 **Here's a Tip**

When a company *receives* cash, the Cash account is *debited*.

When the company *pays* cash, the Cash account is *credited*.

Marilyn refers to the example on December 1. Since Direct Delivery received \$20,000 *in cash* from Joe in exchange for 5,000 shares of common stock, one of the accounts for this transaction is Cash. Since cash was *received*, the Cash account will be *debited*.

In keeping with double entry, two (or more) accounts need to be involved. Because the first account (Cash) was *debited*, the second account needs to be *credited*. All Joe needs to do is find the right account to credit. In this case, the second account is Common Stock. Common stock is part of stockholders' equity, which is on the right side of the accounting equation. As a result, it should have a credit balance, and to increase its balance the account needs to be *credited*.

Accountants indicate account names and amounts using the following format:

Account Name	Debit	Credit
Cash	20,000	
Common Stock		20,000

Accountants usually first show the account and amount to be debited. On the next line, the account to be credited is indented, and the amount appears further to the right than the debit amount shown in the line above. This entry format is referred to as a general journal entry.

(With the decrease in the price of computers and accounting software, it is rare to find a small business still using a manual system and making entries by hand. Accounting software has made the process of recording transactions so much easier that the general journal is rarely needed. In fact, entries are often generated automatically when a check or sales invoice is prepared.)

Sample Transactions #2 - #3

Sample Transaction #2

Marilyn illustrates for Joe a second transaction. On December 2, Direct Delivery purchases a used delivery van for \$14,000 by writing a check for \$14,000. The two accounts involved are Cash and Vehicles (or Delivery Equipment). When the check is written, the accounting software will automatically make the entry into these two accounts.

Marilyn explains to Joe what is happening within the software. (Since the company *pays* \$14,000, the Cash account debits. Accountants consider the checking account to be Cash, and the TIP you learned is that when cash is *paid*, you *credit* Cash.) So we know that the Cash account will be *credited* for \$14,000 and we know the other account will have to be *debited* for \$14,000. We need to choose the best account to debit. In this case we choose Vehicles (or Delivery Equipment) and the entry is:

Account Name	Debit	Credit
Vehicles	14,000	
		14,000

The balance sheet will look like this after the vehicle transaction is recorded:

Direct Delivery, Inc.			
Balance Sheet			
December 2, 2010			
Assets		Liabilities & Stockholders' Equity	
Cash	\$ 6,000	Liabilities	
Vehicles	14,000	Stockholders' Equity	
	20,000	Common Stock	\$ 20,000
Total Assets	\$ 20,000	Total Liabilities & Stockholders' Equity	\$ 20,000

The balance sheet and the accounting equation remain in balance:

Assets	=	Liabilities	+	Stockholders' (or Owner's) Equity
\$20,000	=	\$0	+	20,000

As you can see in the balance sheet, the asset Cash decreased by \$14,000 and another asset Vehicles increased by \$14,000. Liabilities and stockholders' equity were not involved and did not change.

Sample Transaction #3

The third sample transaction also occurs on December 2 when Joe contacts an insurance agent regarding insurance coverage for the vehicle Direct Delivery just purchased. The agent informs him that \$1,200 will provide insurance protection for the next six months. Joe immediately writes a check for \$1,200 and mails it in.

Let's consider this transaction. Using double entry, we know there must be a minimum of two accounts involved—one (or more) of the accounts must be *debited*, and one (or more) must be *credited*.

Since a check is written, we know that one of the accounts involved is Cash. Since cash was *paid*, the Cash account will be *credited*. (Take another look at the last TIP.) While we have not yet identified the second account, what we do know for certain is that the second account will have to be *debited*.

At this point we have most of the entries, all we are missing is the *name* of the account to be debited:

Account Name	Debit	Credit
???	1,200	
Cash		1,200

We know the transaction involves insurance, and a quick look through the chart of accounts reveals two possibilities:

Prepaid Insurance (an asset account reported on the balance sheet) and Insurance Expense (an expense account reported on the income statement)

Assets include costs that have not yet expired (not yet used up), while expenses are costs that have expired (have been used up). Since the \$1,200 payment is for an expense that will not expire in its entirety within the current month, it would be logical to debit the account Prepaid Insurance. (At the end of each month, when \$200 has expired, \$200 will be moved from Prepaid Insurance to Insurance Expense.)

The entry in the general journal format is:

Account Name	Debit	Credit
Prepaid Insurance	1,200	
Cash		1,200

After the first three transactions have been recorded, the balance sheet will look like this:

Direct Delivery, Inc. Balance Sheet December 2, 2010			
Assets		Liabilities & Stockholders' Equity	
Cash	\$ 4,800	Liabilities	
Prepaid Insurance	1,200	Stockholders' Equity	
Vehicles	40,000	Common Stock	\$ 20,000
Total Assets	\$ 20,000	Total Liabilities & Stockholders' Equity	\$ 20,000

Again, the balance sheet and the accounting equation are in balance and all of the changes occurred on the asset/left/debit side of the accounting equation. Liabilities and Stockholders' Equity were not affected by the insurance transaction.

Sample Transactions #4 - #5

Sample Transaction #4

The fourth transaction occurs on December 3 when a customer gives Direct Delivery a check for \$10 to deliver two parcels on that day. Because of double entry, we know there must be a minimum of two accounts involved—one of the accounts must be debited, and one of the accounts must be credited.

Because Direct Delivery *received* \$10, it must *debit* the account Cash. It must also *credit* a second account for \$10. The second account will be Service Revenues, an income statement account. The reason Service Revenues is *credited* is because Direct Delivery must report that it *earned* \$10 (not because it *received* \$10). Recording revenues when they are earned results

from a basic accounting principle known as the revenue recognition principle. The following tip reflects that principle.

 **Here's a Tip**

Revenues accounts are *created* when the company *earns* a fee (or sells merchandise) regardless of whether cash is received at the time.

Here are the two parts of the transaction as they would look in the general journal format:

Account Name	Debit	Credit
Cash	10	
Service Revenues		10

Sample Transaction #5

Let's assume that on December 2 the company gets its second customer—a local company that needs to have 50 parcels delivered immediately. Joe's price of \$250 is very appealing, so Joe's company is hired to deliver the parcels. The customer tells Joe to submit an invoice for the \$250, and they will pay it within seven days.

Joe delivers the 50 parcels on December 3 as agreed, meaning that on December 3 Direct Delivery has *earned* \$250. This amount is reported as revenues on *December 3*, even though the company did not receive any cash on that day. The *effort* needed to complete the job was done on December 3. (Depositing the check for \$250 in the bank when it arrives seven days later is not considered to take any effort.)

Let's identify the two accounts involved and determine which needs a debit and which needs a credit.

Because Direct Delivery has earned the fee, one account will be a revenues account, such as Service Revenues. (If you refer back to the last TIP, you will read that revenue accounts—such as Service Revenues—are usually credited, meaning the second account will need to be debited.)

In the general journal format, here's what we have identified so far:

Account Name	Debit	Credit
???	250	
Service Revenues		250

We know that the unnamed account cannot be Cash.

Account Name	Debit	Credit
Accounts Payable	250	
Service Revenues		250

Again, reporting revenues when they are earned results from the basic accounting principle known as the revenue recognition principle.

Sample Transaction #6

For simplicity, let's assume that the only expense incurred by Direct Delivery so far was a fee to a temporary help agency for a person to help Joe deliver parcels on December 3. The temporary agency fee is \$80 and is due by December 12.

If a company does not pay cash immediately, you cannot credit Cash. But because the company owes someone the money for its purchase, we say it has an **obligation** or **liability** to pay. Most accounts involved with obligations have the word "payable" in their name, and one of the most frequently used accounts is Accounts Payable. Also keep in mind that expenses are almost always *debited*.

The accounts and amounts for the temporary help are:

Account Name	Debit	Credit
Temporary Help Expense	80	
Accounts Payable		80

 **Here's a Tip**

Expenses are (almost) always credited.

 **Here's a Tip**

If a company does not pay cash right away for an expense or for an asset, you cannot credit Cash. Because the company owes someone the money for its purchase, we say it has a liability to pay. The most likely liability account involved in business obligations is Accounts Payable.

Revenues and expenses appear on the income statement as shown below:

Service Revenues	\$ 260
Temporary Help Expense	<u>80</u>
Net Income	<u>\$ 180</u>

After the entries through December 3 have been recorded, the balance sheet will look like this:

Direct Delivery, Inc.			
Balance Sheet			
December 3, 2010			
Assets		Liabilities & Stockholders' Equity	
Cash	\$ 4,810	Liabilities	
Accounts Receivable	250	Accounts Payable	\$ 80
Prepaid Insurance	1,200	Stockholders' Equity	
Vehicles		Common Stock	20,000
		Retained Earnings	<u>180</u>
		Total Stockholders' Equity	20,180
Total Assets	<u>\$ 20,260</u>	Total Liabilities & Stockholders' Equity	<u>\$ 20,260</u>

Notice that the year-to-date net income (bottom line of the income statement) increased Stockholders' Equity by the same amount, \$180. This connection between the income statement and balance sheet is important. For one, it keeps the balance sheet and the accounting equation in balance. Secondly, it demonstrates that revenues will cause the stockholders' equity to increase and expenses will cause stockholders' equity to decrease. After the end of the year financial statements are prepared, you will see that the income statement accounts (revenue accounts and expense accounts) will be closed or zeroed out and their balances will be transferred into the Retained Earnings account. This will mean the revenue and expense accounts will start the new year with zero balances—allowing the company "to keep score" for the new year.

Marilyn suggested that perhaps this introduction was enough material for their first meeting. She wrote out the following notes summarizing for Joe the important points of their discussion:

1. **When a company pays cash for something**, the company will *credit* Cash and will have to *debit* a second account. Assuming that a company prepares *monthly* financial statements—
 - If the amount is used up or will expire in the current month, the account to be debited will be an expense account. (Advertising Expense, Rent Expense, Wages Expense are three examples.)
 - If the amount is *not* used up or does *not* expire in the current month, the account to be debited will be an asset account. (Examples are Prepaid Insurance,

Supplies, Prepaid Rent, Prepaid Advertising, Prepaid Association Dues, Land, Buildings, and Equipment.)

- If the amount reduces a company's obligations, the account to be debited will be a liability account. (Examples include Accounts Payable, Notes Payable, Wages Payable, and Interest Payable.)

2. **When a company receives cash**, the company will *debit* Cash and will have to credit another account. Assuming that a company will prepare *monthly* financial statements—
 - If the amount received is from a cash sale, or for a service that has just been performed but has not yet been recorded, the account to be credited is a revenue account such as Service Revenues or Fees Earned.
 - If the amount received is an advance payment for a service that has not yet been performed or earned, the account to be *credited* is Unearned Revenue.
 - If the amount received is a payment from a customer for a sale or service delivered earlier and has already been recorded as revenue, the account to be credited is Accounts Receivable.
 - If the amount received is the proceeds from the company signing a promissory note, the account to be credited is Notes Payable.
 - If the amount received is an investment of additional money by the owner of the corporation, a stockholders' equity account such as Common Stock is credited.
3. Revenues are recorded as Service Revenues or Sales when the service or sale has been performed, *not* when the cash is received. This reflects the basic accounting principle known as the revenue recognition principle.
4. Expenses are matched with revenues or with the period of time shown in the heading of the income statement, *not* in the period when the expenses were paid. This reflects the basic accounting principle known as the matching principle.
5. The financial statements also reflect the basic accounting principle known as the cost principle. This means assets are shown on the balance sheet at their *original* cost or *less* and not at their current value. The income statement expenses also reflect the cost principle. For example, the depreciation expense is based on the *original cost* of the asset being depreciated and *not* on the current replacement cost.

Conclusion

Because the material covered here is considered an introduction to this topic, many complexities have been omitted. You should always consult with an accounting professional for assistance with your own specific circumstances.

SAMPLE