Accounting & Book Keeping

Introduction

Learn Bookkeeping
In order to run a business and know what, where, and when to take corrective actions requires business information. By keeping accurate and current records about our business financial activities (bookkeeping), we can collect the final business information.

Users of Financial Information
Users can be grouped into two broad categories namely internal users and external users.

Internal users are the managers and the owners and employees who actually work for the business. External users include lenders and other creditors (suppliers), investors, customers, and governmental regulatory and taxing agencies.

Need financial information
Users need this information to make knowledgeable decisions. Lenders and other creditors want to make sure that they will be paid back for the credit that they have extended to a business. By analyzing financial information, they at least have something to base their lending or credit decision on. You need to provide them with financial information as a basis for their loan decisions

Accounting is the art of analyzing, recording, summarizing, reporting, reviewing, and interpreting financial information.

Bookkeeping is the process of recording and classifying business financial transactions (activities). In simple language-maintaining the records of the financial activities of a business or an individual. Bookkeeping's objective is simply to record and summarize financial transactions into a usable form that provides financial information about a business or an individual.

Accountants normally plan and set up the accounting and bookkeeping system for a business and turn over the day to day record keeping to the owner or one of his/her employees. In this age of computers, more and more of the daily bookkeeping is being done using bookkeeping software and computers although some businesses still maintain manual records. Due to the reasonable cost of computers and software,

Types Of Business Organization
One of the first decisions that a person(s) needs to make is how the company should be structured. The four basic legal forms of ownership for small businesses are a Sole Proprietorship, Partnership, Corporation, and Limited Liability Company. There are advantages and disadvantages as well as income tax ramifications associated with each type of organization. We aren't going to delve in to this area but a brief description of the different types of organization and what they are is needed.

- Sole Proprietorship
  Most small business start out as sole proprietorships. These firms are owned by one person who is normally active in running and managing the business.
- Partnership
  A partnership is two or more people who share the ownership of a single business. In order to avoid misunderstandings about how profits/losses are shared , who's responsible for what, and other management, ownership, and operating decisions the partners normally have a formal legal partnership agreement.
- Corporation
  A corporation is an organization that is made up of many owners who normally are not active in the decision making and operations of the business. These owners are called shareholders or stockholders. Their ownership interest is represented by certificates of ownership (stock) issued by the corporation.
  Two types of corporations:
    - Regular or "C" Corporation
      Earnings are taxed to the corporation. Shareholders not personally liable for income taxes unless dividends are paid.
    - Subchapter-S
      A special type of corporation allowed by the Internal Revenue Service (IRS) that passes or transfers its earnings to the individual shareholders who personally pay the income taxes.
- Limited Liability Company (LLC)
  The LLC is a relatively new type of business structure that combines the benefits of a partnership and corporation.

Factors To Consider
Some Factors and a brief description of what to consider when choosing a type of organization:

- Tax Consequences - National and State
  What taxes do you have to pay to the national and state taxing authorities ?
  Is the business organization a pass-through (income only taxed once) or is the income taxed twice ?
- Ease and cost of formation and recurring registration fees
  What documents do you need to file and what are the initial and recurring costs for the type of organization ?
- Degree of control
  Do you want to call all the "shots" ?
  As a sole owner you get to.
- Liability (personal)
  Do your personal assets need protection from legal liability ?
  Are you willing to be liable for others (partners) ?
- Ability to get money (capital)
  Do you need other investors to get your business "off the ground" ?
- Type of Business
  If your type of profession requires a special license, is it limited to what type of organization that can be selected ?

All the different types have some unique methods and rules for accounting for their transactions associated with their equity (ownership) accounts. Small businesses start out organized as sole proprietorships will focus on bookkeeping for a sole proprietorship.

Types Of Business Activity

Our society is made up of all kinds of different types of businesses. Some sell products directly to the consumer and are known as retailers. Other businesses called wholesalers warehouse and sell large quantities of products to the retailers who in turn sell it to us (consumer). Some businesses provide and sell services to other businesses and individuals. Some businesses even tackle the task of actually producing (make) the products and are called manufacturers.

Many of these businesses are required to maintain and account for inventories of the products that they stock or have on hand.

Accounting Period

A business needs to select an annual tax year. Your two main choices are a calendar or fiscal tax year. A Calendar Tax Year is 12 consecutive months beginning January 1 and ending December 31. A Fiscal Tax Year is 12 consecutive months ending on the last day of March 31. The calendar tax year is used by most businesses.

A reason a business might choose a fiscal tax year is that they could select an ending month for their fiscal year when business activity is low. This makes the process of what is called closing the books a little easier.

Types Of Bookkeeping Systems

A business also needs to determine the type of bookkeeping system that will be used for recording their business transactions. Many small businesses start out using the single entry system.

- Single Entry System

  The single entry system is an "informal" accounting/bookkeeping system where a user of this system makes only one entry to enter a business financial transaction. It generally includes a daily summary of cash receipts and a monthly record of receipts and disbursements (worksheets).

  A checkbook, for example, is a single entry bookkeeping system where one entry is made for each deposit or check written. Receipts are entered as a deposit and a source of revenue. Checks and withdrawals are entered as expenses. If a manual system is used, in order to determine your revenues and expenses you have to prepare worksheets to summarize your income and categorize and summarize your different types of expenses. Bookkeeping software and spreadsheets are also available to do this for you.

  The emphasis of this system is placed on determining the profit or loss of a business.

While the single entry system may be acceptable for tax purposes, it does not provide a business with all the financial information needed to adequately report the financial affairs of a business.

- Double Entry System
  The double entry system is the standard system used by businesses and other organizations to record financial transactions. Since all business transactions consist of an exchange of one thing for another, double entry bookkeeping using debits and credits, is used to show this two-fold effect. Debits and credits are the device that provide the ability to record the entries twice and are explained in more detail later in this tutorial.

  The double entry system also has built-in checks and balances. Due to the use of debits and credits, the double-entry system is self-balancing. The total of the debit values recorded must equal the total of the credit values recorded.

  This system, when used along with the accrual method of accounting, is a complete accounting system and focuses on the income statement and balance sheet. This system has worldwide support as the system to use by businesses for recording their financial transactions.

If inventories are a major part of a business, the decision is made for the business owner by the Internal Revenue Service (IRS). Some business will be required to use the accrual method of accounting while others may be granted an exception and allowed to use the cash basis along with some special rules.

You're more than likely to encounter both the term method and basis used when this topic is discussed. In some cases you'll see the term cash method used and other cases see the term cash basis used. Likewise you'll see the term accrual method used and the term accrual basis used. They both refer to the same concept and are used interchangeably.

- Cash Method
  The cash method or basis of accounting recognizes revenues (earnings) in the period the cash is received and expenses in the period when the cash payments are made. Actually, two types of cash methods (basis) of accounting exist:
  - strict cash method (basis)
  - modified cash method (basis)

  A strict cash method follows the cash flow exactly. A modified cash method includes some elements from the accrual method of accounting and provides special methods for handling items such as inventory and cost of goods sold, payroll tax expenses and liabilities, and recording and depreciating property and equipment.

  Many small businesses are actually using a modified cash method.

By concentrating on recording revenues and expenses, the purpose of the cash or modified cash method of accounting is on determining the net income or loss for a period based on the cash received and the cash spent.

Information, such as the amounts billed to customers for products and/or services and not paid, and the amounts billed by suppliers for their products and/or services and not paid is not normally recorded and maintained in the "books" using the cash method.

Many small businesses start out using the cash basis rather than the accrual basis of accounting.

Use of the cash basis generally is not considered to be in conformity with generally accepted accounting principles (GAAP). In most cases, audited statements are only required for the companies whose ownership interests are publicly traded. A business should strongly consider using the accrual method of accounting.

- Accrual Method
  The accrual method or basis of accounting records income in the period earned and records expenses and capital expenditures such as buildings, land, equipment, and vehicles in the period incurred.

  The purpose of the accrual method of accounting is to properly match income and expenses in the correct period.

  The accrual method of accounting records revenue as earned when the product and/or service is shipped or rendered and invoiced (billed) to customers. Likewise, expenses and capital expenditures are recorded as incurred when the product and or service is shipped or rendered and invoiced (billed) by the supplier.

  Information, such as the amounts billed to customers for products and/or services and not paid, and the amounts billed by suppliers for their products and/or services and not paid is recorded and maintained in the "books" using the accrual method. This is the accounting method that is required to be used in order to conform to generally accepted accounting principles (GAAP) in preparing financial statements for external users.

Difference Between The Two Methods

The difference between the two methods used for recording revenues and expenses results from when the business transaction is recorded in the "books" (timing). A business using the accrual method will record revenues and expenses in their "books" before a business using the cash method. In other words, unlike the cash method, they don't wait until they get paid by the customer or wait until they pay a supplier to record the transaction.

Comment: Cash Flow and Profits are two different things. Due to the timing difference as to when revenue and expenses are recorded and when the cash resulting from the revenue and expenses is actually received or paid out , a business using the accrual method of accounting and reporting a heavy profit does not necessarily mean that they have the cash to pay their bills.

Even though the accrual method provides a better measure of profit and loss, many small businesses still use the cash basis of accounting.

Relationship Between the Type of Bookkeeping System Used and the Accounting Method Used

The Single Entry bookkeeping system is used along with the Cash Method of accounting. Debits and Credits are not used to record financial events.

The Double Entry bookkeeping system can be used with both the Cash and Accrual methods of accounting. Debits and Credits are used to record financial events.

Main Points:
You can use a different accounting method, the cash method or the accrual method, for each business that you set up.

You can keep two sets of books, one on the cash basis and the other on the accrual basis, for the same business. However, have to select one of the methods for tax purposes and continue to use it in the future. This is perfectly legal.

Accounting and Bookkeeping Software

You need a properly trained bookkeeper or accountant that is also familiar with the software product in order to properly use the software.
Some accounting software allows you to convert data back and forth between a cash basis and accrual basis of accounting.

Single or Double Entry:
Accounting and bookkeeping software programs actually allow the user to make a single (one) entry and the software handles creating the debit and credit entries. The double-entry system is still there, but it's hidden from the user. The one exception is the general journal where the user does enter debits and credits.

An invoice to a customer is created and printed and the resulting transaction is automatically recorded in the "books" as an increase to the amounts owed by customers and an increase to revenues (sales) using debits and credits.

Recommended Type of Bookkeeping System and Accounting Method:

It is recommend that for a business, use the double entry bookkeeping system and the accrual basis or method of accounting which is based on the revenue realization principle and a principle called the matching concept. The revenue realization principle states that revenue should be recorded when actually earned.

The following sample business transactions for a land and Mining company will be used to illustrate the accrual basis of accounting/matching concept and the cash basis of accounting.

January 2013 Billed Rs30,000 To Customers For Services Performed & Completed In January 2013
January 2013 Received Payments From Customers of Rs15,000
January 2013 Billed Rs12,000 by Outside Contractors For Services Performed & Completed In January 2013
January 2013 Paid Outside Contractors Rs8,000

February 2013 Received Payments From Customers of Rs15,000
February 2013 Paid Outside Contractors Rs4,000

	Cash Basis			Accrual Basis		
	Jan 2013	Feb 2013	Total	Jan 2013	Feb 2013	Total
Revenue	Rs15,000	Rs15,000	Rs30,000	Rs30,000	0	Rs30,000
Expenses	Rs8,000	Rs4,000	Rs12,000	Rs12,000	0	Rs12,000
Profit/Loss	Rs7,000	Rs11,000	Rs18,000	Rs18,000	0	Rs18,000

Possible Conclusions From The Cash Method

- Made money in January and February.
- Our company is making more profit on the same amount of revenues. We had revenues of Rs15,000 in both January & February but made a bigger profit in February.
- In February, we must have implemented some expense saving measures or got cheaper prices on our contracted services.

The accrual method shows we had a great January and made Rs18,000 but February was very bad. We celebrated our great January and get additional business and buy some more yards and do some more Mining.

Rules of The Accounting
In addition to the revenue realization and matching principles or concepts, accounting and bookkeeping is guided by some additional underlying rules.

If a business was wanting a loan or credit, they would have a tendency to overstate the value of their assets and the value of their business. If it came to taxes (we don't

like to have to pay them), let's expense and write off everything. As for measuring performance (profitability) and comparing businesses in the same industry.

The current accounting rules and standards are continually reviewed, studied, changed, and added to in order to make financial presentations more consistent, comparable, meaningful, and informative.

- Accrual Concept (discussed earlier)
  Supports the idea that income should be measured at the time major efforts or accomplishments occur rather than when cash is received or paid.
- Revenue Realization Concept (discussed earlier)
  The revenue recognition principle requires companies to record revenue when it is realized or realizable and actually earned. In other words, at the time the goods are actually sold or the services are rendered.
- Matching Concept (discussed earlier)
  The Matching Principle goes hand in hand with the Revenue Realization Principle. The matching principle is recording the revenues earned during a period using the revenue realization principle and matching (offsetting) the revenues with the expenses incurred in generating this revenue.
- Accounting Period Concept
  This assumption assumes that business operations can be recorded and separated into different time periods such as months, quarters, and years. This is required in order to provide timely information that is used to compare present and past performance.
- Money Measurement Concept
  This assumption assumes accounting measures transactions and events in money and only transactions that can be monetized (stated in a monetary unit such as the dollar) are recorded and presented in financial statements. Simply stated, money is the common denominator (measurement unit) used for reporting financial information.
- Business Entity Concept
  This assumption requires every business to be accounted for separately from the owner. Personal and business-related transactions are kept apart from each other. In other words, the separate personal transactions of owners and others are not commingled with the reporting of the economic activity of the business. One of the first recommendations almost all accountants tell a client is to at least establish a business checking account and to use it to only record their business transactions.
- Going Concern Concept
  This assumption assumes that a business will continue operating and will not close or be sold. It assumes that a business will be in operation for a long time. Based on this assumption, actual costs instead of liquidation values are used for presenting financial information. This assumption is abandoned in the event that a business is actually going out of business.
- Cost Concept
  This principle requires that most assets are recorded at their original acquisition cost and except for a relatively few exceptions (marketable securities) no adjustment is made for increases in market value. In other words, the value of an asset is never "written up" even though the asset may

actually be worth more than its cost. On the other hand, the cost is sometimes "written down" for example marketable securities and inventory.

- Conservatism Concept
  Revenues and gains are recognized slower and expenses and losses are recognized quicker. Accountants have a tendency to stray away from painting too rosy a picture. While accountants don't want to misinform users of financial information, they also don't want to be sued.
- Consistency Concept
  The same accounting methods should be applied from period to period and all changes to more acceptable methods should be well explained and justified. Deviations in measured outcomes from period to period should be the result of deviations in performance not changes in methods.
- Comparable
  Information must be measured and reported in a similar manner by all types of businesses. This allows comparison of the financial statements of different entities (businesses) or comparisons for the same entity (business) over different periods.
- Materiality Concept
  The significance and importance of an item should be considered in order to determine what is reported. Insignificant events need not be measured and recorded.
- Cost-Benefit Convention
  The benefit of providing the financial information should also be weighed against the cost of providing it.
- Industry Practices Convention
  When customary industry practices exists they should be followed and used for financial reporting.

Want a more in depth discussion concerning the rules of accounting and Generally Accepted Accounting Principles .

All examples are based on the accrual method of accounting, the double entry method of bookkeeping, and the sole proprietor type of business organization.

Major Categories that are used to organize our financial information.

Assets

Formal Definition: The properties used in the operation or investment activities of a business.

Informal Definition: All the good stuff a business has (anything with value). The goodies.

Additional Explanation: The good stuff includes substantial and insubstantial stuff. Substantial stuff you can physically see and touch such as vehicles, equipment and buildings. insubstantial stuff is like pieces of paper (sales invoices) representing loans to your customers where they promise to pay you later for your services or product. Examples of assets that many individuals have are cars, houses, boats,

furniture, TV's, and appliances. Some examples of business type assets are cash, accounts receivable, notes receivable, inventory, land, and equipment.

Liabilities

Formal Definition: Claims by creditors to the property (assets) of a business until they are paid.

Informal Definition: Other's claims to the business's good stuff. Amounts the business owes to others.

Additional Explanation: Usually one of a business's biggest liabilities is to suppliers where a business has bought goods and services and charged them. This is similar to us going out and buying a TV and charging it on our credit card. Our credit card bill is a liability. Another good personal example is a home mortgage. Very few people actually own their own home. The bank has a claim against the home which is called a mortgage. This mortgage is another example of a personal liability. Some examples of business liabilities are accounts payable, notes payable, and mortgages payable.

Owner's Equity also called Owner's Capital

Comment: Both terms may be used interchangeably.

Formal Definition: The owner's rights to the property (assets) of the business; also called proprietorship and net worth.

Informal Definition: What the business owes the owner. The good stuff left for the owner assuming all liabilities have been paid.

Additional Explanation: Owner's Equity (Capital) represents the owner's claim to the good stuff (assets). Most people are familiar with the term equity because it is so often used with lenders wanting to loan individuals money based on their home equity. Home equity can be thought of as the amount of money an owner would receive if he/she sold their house and paid off any mortgage (loan) on the property.

Revenue (Income), Expenses, Investment, and Draws

Revenues, expenses, investment, and draws are sub categories of owner's equity (capital).

Revenue (Income)

Formal Definition: The gross increase in owner's equity (capital) resulting from the operations and other activities of the business.

Informal Definition: Amounts a business earns by selling services and products. Amounts billed to customers for services and/or products.

Additional Explanation: Individuals can best relate by thinking of revenue as their earnings/wages they receive from their job. Most business revenue results from selling their products and/or services.

Expense (Cost)

Formal Definition: Decrease in owner's equity (capital) resulting from the cost of goods, fixed assets, and services and supplies consumed in the operations of a business.

Informal Definition: The costs of doing business. The stuff we used and had to pay for or charge to run our business.

Additional Explanation: Some examples of personal expenses that most individuals are familiar with are utilities, phone, clothing, food, gasoline, and repairs. Some examples of business expenses are office supplies, salaries & wages, advertising, building rental, and utilities.

Owner's Investments

Formal Definition: Increase in owner's equity (capital) resulting from additional investments of cash and/or other property made by the owner.

Informal definition: Additional amounts, either cash or other property, that the owner puts in his business.

Additional Explanation: Although these amounts can be kept up with as a separate item, they are usually recorded directly in the Owner's Capital Account. In other words, immediately put into Ma Equity's purse.

Owner's Drawing

Formal Definition: Decrease in owner's equity (capital) resulting from withdrawals made by the owner.

Informal definition: Amounts the owner withdraws from his business for living and personal expenses.

Additional Explanation: The owner of a sole proprietorship does not normally receive a "formal" pay check from the business, but just like most of the rest of us needs money to pay for his house, car, utilities, and groceries. An owner's draw is used in order for the owner to receive money or other "goodies" from his business to take care of his personal bills.

Types of Assets

Cash-Monetary items that are available to meet current obligations of the business. It includes bank deposits, currency & coins, checks, money orders, and traveler's checks.

Accounts Receivable-Business claims against the property of a customer arising from the sale of goods and/or services on account.

Notes Receivable-Formal written promises given by customers or others to pay definite sums of money to the business at specified times.

Inventory-Expenditures for items held for resale in the normal course of a business's operations.

Office Supplies-Expenditures for maintaining a supply of on hand supplies such as typewriter, copier, and computer paper, pens, pencils, and special forms.

Land-Expenditures for parcels of the earth. It includes building sites, yards, and parking areas.

Buildings-Expenditures for structures erected on land and used for the conduct of business.

Equipment-Expenditures for physical goods used in a business, such as machinery or furniture. Equipment is used in a business during the production of income.

Furniture-includes items needed in a business office such as tables, desks, chairs, and cabinets.

Types Of Liabilities

Accounts Payable-Creditor's claims against the business's property arising from the business's purchase of goods and/or services on account.

Notes Payable-Formal written promises to pay definite sums of money owed at specified times.

Mortgage Payable-Notes payable which are secured by a lien on land, buildings, equipment, or other property of the borrower (your company).

Types of Revenue (Income)

Sale of Products-Amounts earned from the sale of merchandise.

Sale Of Services-Amounts earned from performing services.

Rental Income-Amounts earned from renting properties.

Interest Income-Amounts earned from investments.

Types of Expenses

Supplies-Expenditures for incidental materials needed in the conduct of business, such as office supplies.

Salaries-Expenditures for work performed by employees.

Payroll Taxes-Expenditures for taxes based on wages paid to employees.

Advertising-Promotional expenditures, such as newspapers, handbills, television, radio and mail.

Utilities-Expenditures for basic services needed to function in the modern world, such as water, sewer, gas, electricity and telephone. Most businesses track the amount spent for each type of utility service.

Building Rental-Expenditures paid to an owner of property (building) for use of the property. A rental agreement called a lease contains the terms.

Maintenance & Repairs-Expenditures paid to repair and or maintain buildings and/or equipment.

Other Terms Bookkeeping

Accounting Equation-mathematical expression of the relationship of property and property rights. Also called the Balance Sheet Equation.

The equation may be expressed in three forms:

- Abbreviated or Simple Version:

Property = Property Rights

- Expanded Version:

Assets = Liabilities + Owner's Equity (Capital)

- Fully Expanded Version:

Assets = Liabilities + Beginning Owner's Equity (Capital) + Additional Owner Investments + Revenues - Expenses - Draws

Transaction-Any event or condition that must be recorded in the books of a business because of its effect on the financial condition of the business, such as buying and selling. A business deal or agreement.

Single Entry-Type of "informal" accounting/bookkeeping system where a user of this system makes only one entry to enter a business financial transaction. It generally includes a daily summary of cash receipts and a monthly record of receipts and disbursements (worksheets).

Double Entry-Type of accounting/bookkeeping system that requires every transaction to be recorded in at least two places (accounts) using a debit and a credit. Every transaction is recorded in a "formal" journal as a debit entry in one account, and as a credit entry in another account. Periodically, usually monthly, the summarized balances from the journals are posted (transferred) to a formal business record called the general ledger.

Cash Method (Basis) of Accounting-method of accounting that recognizes revenues (earnings) in the period the cash is received and expenses in the period when the cash payments are made.

Accrual Method (Basis) of Accounting-method of accounting that records income in the period earned and records expenses and capital expenditures such as buildings, land, equipment, and vehicles in the period incurred.

Debit-

- An entry in the financial books of a firm that increases an asset, draw or an expense or an entry that decreases a liability, owner's equity (capital) or income.
- Also, an entry entered on the left side (column) of a journal or general ledger account.

- Let's combine the two above definitions into one complete definition.

An entry (amount) entered on the left side (column) of a journal or general ledger account that increases an asset, draw or an expense or an entry that decreases a liability, owner's equity (capital) or revenue.

Credit-

- An entry in the financial books of a firm that increases a liability, owner's equity (capital) or revenue, or an entry that decreases an asset, draw, or an expense.

- Also, an entry entered on the right side (column) of a journal or general ledger account.

- Let's combine the two above definitions into one complete definition.

An entry (amount) entered on the right side (column) of a journal or general ledger account that increases a liability, owner's equity (capital) or revenue, or an entry that decreases an asset, draw, or an expense.

Posting-Process of transferring balances from bookkeeping records called journals to a "final" bookkeeping record called the general ledger.

T-Account-a skeleton outline of an account which provides the same basic data as a formal ledger account. Used as a teaching aid.

Account-a separate record for each type of asset, liability, equity, revenue, and expense used to show the beginning balance and to record the increases and decreases for a period and the resulting ending balance at the end of a period.

Contra Account-an account which offsets and reduces or offsets the balance of another account.

- A contra-asset account has a credit balance and offsets and decreases the debit balance of the related asset account. An example account is Accumulated

Depreciation which reduces the equipment account to arrive at the equipment's net value.

- A contra-liability account has a debit balance and offsets and decreases the credit balance of the related liability account. An example accounts is the bond discount account that reduces the bonds payable account to arrive at the bond's net value.

Balance Sheet Account-a type of account that is included in the Balance Sheet; namely the Assets, Liabilities, and permanent Equity Accounts.

Permanent or Real Account-another term used to refer to the balance sheet accounts.

Income Statement Account-a type of account that is included in the Income Statement; namely the Revenue and Expense Accounts.

Temporary Account-another term used to refer to the income statement accounts. The accounts are called temporary due to the fact that their balances are set to zero when the books are closed.

Closing the Books-process of transferring the balances from the temporary income statement accounts (revenues and expenses) to the permanent balance sheet equity account(s).

Profit-amount a business's revenues exceed (greater than) expenses. In other words, the amounts we earned were greater than our expenses.

Loss-amount a business's expenses exceed (greater than) revenues. In other words, we earned less than we spent.

Property-is another term for assets. In future lessons the term property and assets both mean the same thing-all the good stuff a business has.

Current Asset-cash and other assets normally expected to be converted to cash or used up usually within a year.

Current Liability-amounts owed (liabilities) that need to be paid or settled usually within a year.

Working Capital-net difference between current assets and current liabilities.
Working Capital = Current Assets - Current Liabilities

Major Types of Accounting & Bookkeeping Records and Documents

General Ledger-A book containing the accounts and balances for all of a business's assets, liabilities, equity, revenue, and expense accounts.

Chart Of Accounts-A coded listing of all the accounts in the general ledger.

Journals-A preliminary record where business transactions are first entered into the accounting system. The journal is commonly referred to as the book of original entry.

Specialized Journals-Journals used to initially record special types of transactions such as sales, cash disbursements, and cash receipts in their own journal.

Trial Balance-A worksheet listing of all the accounts appearing in the general ledger with the dollar amount of the debit or credit balance of each. Used to make sure the books are "in balance" -total debits and credits are equal.

Subsidiary Ledgers-A separate record set up to record the individual items relating to a single general ledger account (control account). Examples include an accounts receivable and accounts payable ledger.

Worksheets-Forms which are used to summarize all the information necessary to complete the end-of-period financial reports and prepare other financial analysis.

Invoice-a business document showing the names and addresses of the buyer and the seller; the date and terms of the sale; the description, quantity, unit price, and total price of goods purchased or sold and the method of delivery.
Selling business refers to this document as a Sales Invoice.
Buying business refers to this document as a Supplier Invoice.

Receiving Report-A document originated by the buying business listing the quantities and condition of the goods and/or services received from a supplier.

Sales Order-A documented originated by the seller listing the goods and/or services ordered by a customer and other information such as prices and delivery dates.

Purchase Order-A document originated by the purchaser (buyer) requesting the supplier to ship goods or perform services.

Check Book-Formal record of all checks written, deposits, bank charges, and miscellaneous charges and credits.

Check-A written order directing a bank to pay cash from the account of the writer (drawer) of the check.

Bank Reconciliation-The process of bringing the checkbook and bank statement balances into agreement.

Bank Statement-A copy of the bank's record of the business's account showing the balance of the account at the beginning of the month, the deposits and withdrawals (mostly checks) made during the month, service charges, and the balances at the end of the month.

Financial Statements-Accounting reports prepared periodically to inform the owner, creditors, and other interested parties as to the financial condition and operating results of the business. The four basic financial statements are:

Balance Sheet-The financial statement which shows the amount and nature of business assets, liabilities, and owner's equity (capital) as of a specific point in time. It is also known as a Statement Of Financial Position or a Statement Of Financial Condition.

Income Statement-The financial statement that summarizes revenues and expenses for a specific period of time, usually a month or a year. This statement is also called a Profit and Loss Statement or an Operating Statement.

Capital Statement-The financial report that summarizes all the changes in owner's equity (capital) that occurred during a specific period.

Statement of Changes in Financial Position-The financial statement that reports the sources and uses of cash or working capital for a specific period of time, normally a year.

ACCOUNTING EQUATION

and is also referred to as the Balance Sheet Equation The equation may be expressed in three forms:

- Abbreviated or Simple Version.

Property = Property Rights

- Expanded Version:

Assets = Liabilities + Owner's Equity (Capital)

- Fully Expanded Version:

Assets = Liabilities + Beginning Owner's Equity (Capital) + Additional Owner Investments + Revenues - Expenses - Draws

The two basic elements of any organization are what it owns (property) and who it owes (property rights). Property and assets are both terms that define the same thing and that property rights is an abbreviated term for liabilities and equity.

The simple or abbreviated accounting equation (Property = Property Rights) states that the property of the business must equal the rights to the property or stated another way the claims against the property.

Double Entry Bookkeeping System

Double Entry is a type of accounting/bookkeeping system that requires every transaction to be recorded in at least two places (accounts) using debits and a credits (discussed later) to represent increases and decreases.

We make two entries for every business transaction. These entries represent increases or decreases in property (assets) and/or property rights (liabilities and owner's equity).

Claims To The Assets ("Good Stuff")

Claims to the property (assets) arise from two sources:

- Creditors of the business (liabilities)

Those from whom the business borrows from or buys from on credit are called creditors. The creditors have a claim to the property (assets) of the business until they are paid. These creditor claims are called liabilities. Two common types of creditors are a business's suppliers and banker.

- Owner(s) of the business (owner's equity)

Yes the owner(s) also has a claim to the property (assets) for property (assets) invested into their business and any increases or decreases resulting from operating the business.

Another way to think about these increases and decreases to equity is to relate it to your personal financial situation. Your earnings (revenue) increase your personal wealth (equity) and your living expenses and draws (money you give your wife) decrease your personal wealth (equity).

It should now be apparent that the assets (property) are subject to two kinds of claims (property rights), those arising from the rights (claims) of creditors (liabilities) and those arising from the rights (claims) of the owner (owner's equity).

Developing Our Different Versions Of the Accounting Equation

Since
(1) Property = Assets and
(2) Property Rights (Claims to the Property) = Liabilities + Owner's Equity (Capital),

the simple or abbreviated accounting equation Property = Property Rights expanded or restated now becomes

Assets = Liabilities + Owner's Equity (Capital).

We're now going to concentrate on the Owner's Equity (Capital) section of the equation.

- Businesses normally operate with the objective of making a profit. Profit is determined by using two of Revenue and Expense ie subtracting the expenses from revenue (income). Any profits made by a business go to the owner. Therefore, the effects of revenue (income) and expenses are shown under the Owner's Equity section of the accounting equation. An increase in revenues represents an increase in profit and therefore an increase in Owner's Equity .

Using the above information we can present this information in the following equation:

Current Owner's Equity (Capital) = Beginning Owner's Equity (Capital) + Owner's Investments + Revenues - Expenses - Draws

This new Owner's Equity Equation illustrates the relationships and effects investments, revenue, expense, and draws have on Owner's Equity (Capital).

Let's take this one final step to arrive at our Fully Expanded Accounting Equation which includes all the components that make up and affect Owner's Equity (Capital).

Our Expanded Accounting Equation Assets = Liabilities + Owner's Equity (Capital) expanded or restated now becomes our Fully Expanded Version

Assets = Liabilities + Beginning Owner's Equity (Capital) + Additional Owner Investments + Revenues - Expenses - Draws.

While all three of the equations illustrate the relationship of property and property rights, the accounting equation most often used and referred to is the Expanded Equation:

Assets = Liabilities + Owner's Equity

Observation: In using the expanded accounting equation, if two of the three components are known, the third can easily be calculated by using some simple Algebra to rearrange the equation. Don't worry, you're not going to get an Algebra Lesson.

The accounting equation can be expressed in the following different ways:

- Asset emphasis:

Assets = Liabilities + Owner's Equity

- Equity emphasis:

Owner's Equity = Assets - Liabilities

- Liability emphasis:

Liabilities = Assets â€“ Owner's Equity

So, You Can:

- Calculate Assets if Liabilities and Owner's Equity are known

Assets = Liabilities + Owner's Equity (Normal Formula)

- Calculate Owner's Equity if Assets and Liabilities are known

Owner's Equity = Assets - Liabilities

- Calculate Liabilities if Assets and Owner's Equity are known

Liabilities = Assets - Owner's Equity

Examples

If Liabilities are 70,000 and Owner's Equity is 30,000 what is the value of the Assets ?
Assets = Liabilities + Owner's Equity
Assets = 70,000 + 30,000
Assets= 100,000

If Assets are 100,000 and Liabilities are 70,000 what is the value of our Owner's Equity ?
Owner's Equity = Assets - Liabilities
Owner's Equity = 100,000 - 70,000
Owner's Equity = 30,000

If Assets are 100,000 and Owner's Equity is 30,000 what is the value of our Liabilities ?.
Liabilities = Assets - Owner's Equity
Liabilities = 100,000 - 30,000
Liabilities = 70,000

I will use both the simple or abbreviated version (Property = Property Rights) and the expanded version
(Assets = Liabilities + Owner's Equity) of the Accounting Equation in this lesson to demonstrate bookkeeping concepts. Lesson 3 continues to explore the Fully Expanded Accounting Equation.

Types Of Transactions Table Using the Simple (Abbreviated) Accounting Equation

Property = Property Rights

Navigation:
Interactive Links are provided in this table in the Examples Of Transactions Column.

- Click on the Underlined Number (1,2,3,etc.) links to navigate to the Transaction Analysis Using The Simple Accounting Equation Table to see a sample transaction that illustrates the affect of this type of transaction on our Simple Accounting Equation.

Let's use our simple or abbreviated accounting equation and get an overview of the types of transactions that can occur and their effects on our simple equation. The table illustrates the four basic types of transactions represented by the letters a. b. c. and d. and their effects on our simple or abbreviated accounting equation.

Property =		Property Rights		Examples Of Transactions
Left Side =		Right Side		
(a)	Increase In Property	(a)	Increase In Property Rights	#1 #2 #4 #5 #10
(b)	Decrease In Property	(b)	Decrease In Property Rights	#3 #6 #7
(c)	Increase In One Type Of Property			#8
(c)	Decrease In Another Type Of Property			#8
		(d)	Increase In One Type Of Property Rights	#9
		(d)	Decrease In Another Type Of Property Rights	#9

Details:

Although transactions may require increases to both sides of the equation (left and right side both increase - transaction type (1), decreases to both sides of the equation (left and right side both decrease - transaction type (2), or an increase and decreases on the same side of the equation (increase and decrease on the left side - transaction type (3) or an increase and decrease on the right side transaction (4), the equation always balances.

Did you also notice we made two entries for each of the example transactions illustrated in our table ? There's that double entry thing again. The table also illustrates that by using double entry bookkeeping the dollar amount of the property will at all times equal the dollar amount of the property rights.

Business Transactions and Their Effects on The Accounting Equation

The remainder of this lesson will be examples used to demonstrate recording transactions using the double entry bookkeeping system in conjunction with our accounting equation.

We are now going to analyze the effects of typical types of business transactions and how they affect our Accounting Equation. We will use the fictional VISHAL business which is a service type business (lawn land), sole proprietorship, uses double entry accounting, and the accrual basis of accounting for our example.

Our analysis will use both the simple or abbreviated and expanded Accounting Equation to demonstrate the transaction effects.

1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.
The property cash is increased and the owner's property rights (claims to the property) are increased.

2. VISHAL purchases Rs100 worth of office supplies for inventory and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).
The property office supplies is increased and the creditor's property rights (claims to the property) are increased.

3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.
The property cash is decreased and the owner's property rights (claims to the property) are decreased.

4. VISHAL purchases five buyers for Rs10,000 and finances them with a note from the local bank.
The property equipment (buyers) is increased and the creditor's property rights (claims to the property) are increased.

5. VISHAL buys another customer's yard and sends the customer a bill (invoice) for Rs75 for the service they performed. They allow their customer 10 days to pay them for this service (on account).
The property amounts owed by customers is increased and the owner's property rights (claims to the property) are increased.

6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.
The property cash is decreased and the owner's property rights (claims to the property) are decreased.

7. VISHAL pays the office supply company Rs100 with a check for the office supplies that they charged (promised to pay).
The property cash is decreased and the creditor's property rights (claims to the property) are decreased.

8. VISHAL receives a check from the customer who they billed (invoiced) Rs75 for services and allowed 10 days to pay.
The property cash is increased and the property amounts owed by customers are reduced. This is actually a swap of one type of property for another.

9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.
The property right amount owed a supplier is increased and the owner's claim on the property rights (claims to the property) is decreased.

10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.
The property cash is increased and the owner's property rights (claims to the property) are increased.

Transaction Analysis Using The Simple (Abbreviated) Accounting Equation

Property = Property Rights

Transactions	Property = Left Side		Property Rights Right Side	
	Increase	Decrease	Decrease	Increase
1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.	50			50
2. VISHAL purchases Rs100 worth of office supplies and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).	100			100
3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.		25	25	
4. VISHAL purchases five buyers for Rs10,000 and finances them with a note from the local bank.	10,000			10,000
5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).	75			75
6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.		500	500	
7. VISHAL pays the office supply company Rs100 with a check for the office supplies that they charged (promised to pay).		100	100	
8. VISHAL receives a check from the customer who they billed (invoiced) Rs75 for services and allowed 10 days to pay.	75	75		
<="" a=""> 9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.			60	60
10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.	80			80
Totals	Rs10,380 Increase	Rs700 Decrease	Rs685 Decrease	Rs10,365 Increase
Total Net Changes	Rs9,680 Increase		Rs9,680 Increase	

Types Of Transactions Table Using the Expanded Accounting Equation
Assets = Liabilities + Owner's Equity

Now let's use our expanded accounting equation and get an overview of the types of transactions that can occur and their effects on our expanded equation. The table illustrates the four basic types of transactions represented by the letters a. b. c. and d. and their effects on our expanded accounting equation.

Assets =		Liabilities + Owner's Equity		Examples Of Transactions
Left Side =		Right Side		
(a)	Increase In Assets	(a)	Increase In Liabilities or Owner's Equity	#1 #2 #4 #5 #10
(b)	Decrease In Assets	(b)	Decrease In Liabilities or Owner's Equity	#3 #6 #7
(c)	Increase In One Type Of Asset			#8
(c)	Decrease In Another Type Of Asset			#8
		(d)	Increase In One Type of Liability or Owner's Equity	#9
		(d)	Decrease In Another Type of Liability or Owner's Equity	#9

Transaction Analysis Using The Expanded Accounting Equation

Assets = Liabilities + Owner's Equity

Transactions	Assets = Left Side		Liabilities + Right Side		Owner's Equity Right Side	
	Increase	Decrease	Decrease	Increase	Decrease	Increase
1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.	50					50
2. VISHAL purchases Rs100 worth of office supplies and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).	100			100		
3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.		25			25	
4. VISHAL purchases five buyers for	10,000			10,000		

Rs10,000 and finances them with a note from the local bank.						
5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).	75					75
6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.		500			500	
7. VISHAL pays the office supply company Rs100 with a check for the office supplies that they charged (promised to pay).		100	100			
8. VISHAL receives a check from the customer who they billed (invoiced) Rs75 for services and allowed 10 days to pay.	75	75				
9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.				60	60	
10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.	80					80
Totals	Rs10,380	Rs700	Rs100	Rs10,160	Rs585	Rs205
Net Change	Rs9,680 Increase		Rs10,060 Increase		Rs380 Decrease	
Total Net Changes	Rs9,680 Increase		Rs9,680 Increase			

Equity Table

Analysis of the Effects of Revenue, Expense, and Draws on Owner's Equity (Capital)

In the previous table, we entered all the transactions that affected Owner's Equity under one heading; namely, Owner's Equity and disregarded whether it was a revenue, expense, or draw item. The following table illustrates where the transaction affecting Owner's Equity would actually be entered.

This table is provided to help illustrate the effects that "Ma Capital's "Kids" Revenue, Expense, and Draw have on Owner's Equity ("Ma Capital"). Of course only the sample transactions that affect Owner's Equity have been included.

Instead of recording transactions directly to "Ma Capital" (Owner's Equity), proper bookkeeping actually uses her kids revenue, expense, and draws to record the increases and decreases to "Ma Capital" (Owner's Equity) in order to provide us with the answers to the how and why the owner's claim to the business's property increased or decreased.

	"Ma Capital"		"Ma's Kids"		
Proper Recording Actually Uses Revenue, Expense & Draws Instead Of Owner's Equity	Original Recording		Proper Recording Uses		
Transactions	Owner's Equity Right Side		Revenue	Expense	Draw
	Decrease	Increase	Revenue Increases Resulting In an Increase to Equity	Expenses Increase Resulting In a Decrease to Equity	Draws Increase Resulting in a Decrease to Equity
1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.		50	50		
3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.	25			25	
5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).		75	75		
6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.	500				500
9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.	60			60	
10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.		80	80		

1. How different types of business transactions affect the Accounting Equation.
2. How each transaction was recorded twice illustrating double entry bookkeeping.

3. The total amounts for the tables prove the self-balancing nature of the Accounting Equation.
4. How transactions may require increases to both sides of the equation (increase left side and increase right side), decreases to both sides of the equation (decrease left side and decrease right side), or an increase and decreases on the same side of the equation (increase and decrease the left side or increase and decrease the right side), but the equation must always balance.
5. The Equity Table illustrates that, while transactions that affect Owner's Equity could be entered using only one column, additional useful information is obtained by breaking Owner's Equity into its component parts using the revenue, expense, and draws categories to record the transactions.
6. That revenues increase owner's equity while expenses and draws decrease owner's equity.

Actually, there's really nothing difficult about debits and credits. It's just our method used to record business transactions.

For Every Action There Is An Opposite Reaction

Accounting and Bookkeeping's similar rule is:

For Every Debit There Is A Credit

OR

Debits = Credits

This rule is the basis for the double entry bookkeeping system. If you recall, the double entry system is an accounting system that requires at least two entries to record a financial transaction.

What enables the double entry accounting system to work ? In two words Debits and Credits.

We've already discussed transactions and how they increase or decrease the assets, liabilities, and owner's equity of a business and their effects on the Accounting Equation.

Definitions of Debits and Credits

Debit (Left)

- An entry in the financial books of a firm that increases an asset, draw, or an expense or an entry that decreases a liability, owner's equity (capital) or income.
- Also, an entry entered on the left side (column) of a journal or general ledger account.

- Let's combine the two above definitions into one complete definition.

An entry (amount) entered on the left side (column) of a journal or general ledger account that increases an asset, draw or an expense or an entry that decreases a liability, owner's equity (capital) or revenue.

Credit (Right)

- An entry in the financial books of a firm that increases a liability, owner's equity (capital) or revenue, or an entry that decreases an asset, draw, or an expense.
- Also, an entry entered on the right side (column) of a journal or general ledger account.

- Let's combine the two above definitions into one complete definition.

An entry (amount) entered on the right side (column) of a journal or general ledger account that increases a liability, owner's equity (capital) or revenue, or an entry that decreases an asset, draw, or an expense.

Many accounting text books discuss debits and credits by concentrating on the simplistic definition of debits and credits. Debit means left, credit means right. In other words, a debit is a number written on the left side of an account and a credit is a number written on the right side of an account. While this is true, it only tells us on what side of an account we should place an entry. We also need to know when is an entry a debit (entered on the left side) and when is an entry a credit (entered on the right side) and how the entry affects the account.

This is where the key terms increase and decrease and the type of account (asset, liability, owner's equity, revenue, and expense) come into play. The term debit does not mean increase or decrease, nor does the term credit mean increase or decrease until the term is also associated with a type of account. In other words, debit does not always mean an increase nor does credit always mean a decrease , or vice versa. Also, the terms debit and credit do not refer to something good or bad.

In my opinion, good usable definitions of the terms debit and credit contain all three of the elements we just discussed:

- Left Side / Right Side
- Increase / Decrease
- Associated Type Of Account

Can you guess what definitions I prefer to use for debit and credit from the three definitions that I presented earlier ? The ones that contains all three elements.

- Debit

An entry (amount) entered on the left side (column) of a journal or general ledger account that increases an asset, draw or an expense or an entry that decreases a liability, owner's equity (capital) or revenue.

- Credit

An entry (amount) entered on the right side (column) of a journal or general ledger account that increases a liability, owner's equity (capital) or revenue, or an entry that decreases an asset, draw, or an expense.

Debits and Credits are Related To Our Accounting Equations

Abbreviated or Simple Version:
Property = Property Rights
and our
Expanded Version:
Assets = Liabilities + Owner's Equity

These versions of the accounting equation simply state that assets, also called property, equals what is owed to creditors (liabilities) and the owners (owner's equity), these two elements are also called property rights.

The Balance of the Left Side of the Equation (Asset Accounts) will normally have a DEBIT Balance and the Balance of the Right Side (Liability and Permanent Equity Accounts) will normally have a CREDIT Balance.

Left Side	Right Side	
Property =	Property Rights	
Assets =	Liabilities +	Owner's Equity
Debit Balances=	Credit Balances +	Credit Balances
Debit Increases	Credit Increases	
Credit Decreases	Debit Decreases	

Notice in our table that a debit increases the balances on the left side of the accounting equation (assets) and has the opposite effect and decreases the balances on the right side of the equation (liabilities and owner's equity). Likewise, a credit decreases the balances on the left side of the accounting equation (assets) and has the opposite effect and increases the balances on the right side of the accounting equation (liabilities and owner's equity).

Generally, anything that increases the left side of the equation (property or assets) or decreases the right side of the equation (property rights or liabilities and equity) is considered a debit and anything that increases the right side of the equation (property rights or liabilities and equity) or decreases the left side of the equation (property or assets) is considered a credit.

What we're doing here is relating the types of accounts (assets, liabilities, owner's equity, revenue, expense, and draws) and the terms increases and decreases to the terms debits and credits. The terms debit and credit by themselves do not mean an

increase or a decrease. The terms have to be associated with the types of accounts in order to gain their meaning.

In other words, whether a debit or credit is an increase or decrease depends on the type of account.

Before we continue our discussion of debits and credits, let's take a look at how the terms are used with the major types of accounts. First we'll discuss assets, liabilities and owner's equity and then revenue, expense, and draws.

Types Of Transactions Table using the Expanded Accounting Equation

Navigation:
Interactive Links are provided in this table in the Examples Of Transactions Column.

- Click on the Underlined Number (1,2,3,etc.) links to navigate to the Transaction Analysis Table Using The Expanded Accounting Equation to see a sample transaction that illustrates the effects of debits and credits on the Expanded Accounting Equation.

The four basic types of transactions and their effects on our expanded accounting equation are represented by the letters a. b. c. and d.

Assets =		Liabilities + Owner's Equity		Examples Of Transactions
Left Side =		Right Side		
(a)	Increase In Assets Debit	(a)	Increase In Liabilities or Owner's Equity Credit	#1 #2 #4 #5 #10
(b)	Decrease In Assets Credit	(b)	Decrease In Liabilities or Owner's Equity Debit	#3 #6 #7
(c)	Increase In One Type of Asset Debit			#8
(c)	Decrease In Another Type of Asset Credit			#8
		(d)	Increase In One Type of Liability or Owner's Equity Credit	#9
		(d)	Decrease In Another Type of Liability or Owner's Equity Debit	#9

Take note, this small table illustrates that each transaction is recorded by using a debit and a credit:

- Transaction Type (a) Increases an Asset Account on the Left Side using a Debit and Increases a Liability or Owner's Equity Account on the Right Side using a Credit.
- Transaction Type (b) Decreases an Asset Account on the Left Side using a Credit and Decreases a Liability or Owner's Equity Account on the Right Side using a Debit.
- Transaction Type (c) Increases an Asset Account on the Left Side using a Debit and also Decreases an Asset Account on the Left Side using a Credit.
- Transaction Type (d) Increases a Liability or Owner's Equity Account on the Right Side using a Credit and also Decreases a Liability or Owner's Equity Account on the Right Side using a Debit.

The result of this debit and credit "scheme" is that the accounting equation will always be in balance.

Transaction Analysis Using The Simple (Abbreviated) and Expanded Accounting Equations and Debits and Credits

This table presents both accounting equations in one table and adds our terms debit and credit to illustrate the effect of debits and credits on our accounting equations.

Simple (Abbreviated) Accounting Equation	Property =		Property Rights			
Expanded Accounting Equation	Assets =		Liabilities +		Owner's Equity	
Side of the Accounting Equation	Left Side =		Right Side			
Increase/Decrease Columns	Increase	Decrease	Decrease	Increase	Decrease	Increase
Our New Terms In Action	Debit	Credit	Debit	Credit	Debit	Credit
Description of Transactions and Their Effects On The Equation						
1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.	50					50
2. VISHAL purchases Rs100 worth of office supplies and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).	100			100		
3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.		25			25	
4. VISHAL purchases five buyers for Rs10,000 and finances them with a note from the local bank.	10,000			10,000		

5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).	75					75
6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.		500			500	
7. VISHAL pays the office supply company Rs100 with a check for the office supplies that they charged (promised to pay).		100	100			
8. VISHAL receives a check from the customer who they billed (invoiced) Rs75 for services and allowed 10 days to pay.	75	75				
9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.				60	60	
10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.	80					80
Totals	Rs10,380	Rs700	Rs100	Rs10,160	Rs585	Rs205

Let's see if you've been fibbing to me about those debits and credits.

Account Type	Debits	Credits
Asset Transactions	Rs10,380	Rs700
Liability Transactions	100	10,160
Equity Transactions	585	205
Totals	Rs11,065	Rs11,065

By golly those debits and credits do equal each other.

Equity Table

Analysis of the Effects of Debits and Credits and Revenue, Expense, and Draws on Owner's Equity

In the previous table, we entered all the transactions that affected Owner's Equity under one heading; namely, Owner's Equity and disregarded whether it was a revenue, expense, or draw item. The following table illustrates where the transactions affecting Owner's Equity would actually be entered.

Instead of recording transactions directly to Owner's Equity ("Ma Capital"), proper bookkeeping actually uses her "Kids" Revenue, Expense, and Draws to record the increases and decreases to "Ma Capital" (Owner's Equity) in order to provide us with the answers to the how and why the owner's claim to the business's property increased or decreased.

This table also illustrates the effects of debits and credits on "Ma Capital's Kids" Revenue, Expense, and Draw. Of course only the sample transactions that affect Owner's Equity (Revenue, Expense, and Draws) have been included.

	"Ma Capital"		"Ma's Kids"		
Proper Recording Actually Uses Revenue, Expense & Draws Instead Of Owner's Equity	Original Recording		Proper Recording Uses		
Transactions	Owner's Equity		Revenue	Expense	Draw
	Decrease	Increase	Revenue Increases Resulting In an Increase to Equity	Expenses Increase Resulting In a Decrease to Equity	Draws Increase Resulting in a Decrease to Equity
	Debit	Credit	Credit	Debit	Debit
1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.		50	50		
3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.	25			25	
5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).		75	75		
6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.	500				500
9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.	60			60	

10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.		80	80		

1. How different types of business transactions affect the Accounting Equation.
2. How it associates increases and decreases and the types of accounts with the terms debits and credit.
3. How each transaction was recorded twice illustrating double entry bookkeeping.
4. The total amounts for the tables prove the self-balancing nature of the Accounting Equation.
5. How transactions may require increases to both sides of the equation (increase left side using a debit and increase right side using a credit), decreases to both sides of the equation (decrease left side using a credit and decrease right side using a debit), or an increase and decreases on the same side of the equation (increase and decrease the left side or increase and decrease the right side of the equation using a debit and a credit), but the equation must always balance.
6. The Equity Table illustrates that, while transactions that affect Owner's Equity could be entered using only one column, additional useful information is obtained by breaking Owner's Equity into its component parts (kids) using the revenue, expense, and draws categories to record the transactions.
    1. That revenues increase owner's equity while expenses and draws decrease owner's equity.
    2. It illustrates that we could use only the Main Account Types - Assets, Liabilities, and Owner's Equity (Capital) contained in our Basic Expanded Accounting Equation (Assets = Liabilities + Owner's Equity) to record our transactions and not use "Ma Capital's Kids" Revenue, Expense, and Draws.

       The drawback of just using "Ma Capital" (the Owner's Equity Account) is that the Owner's Equity (Capital) Account would require a great deal of analysis and time in order to determine the income or loss for a period and the reasons for this income or loss.

From here on out, transactions will be recorded using "Ma's Kids" revenue, expense, and draws.

Fully Expanded Version of The Accounting Equation and Debits and Credits

We have previously observed that:

(1) Property = Assets and
(2) Property Rights (Claims to the Property) = Liabilities + Equity,

the simple or abbreviated accounting equation Property = Property Rights expanded or restated became

Assets = Liabilities + Owner's Equity.

We also concentrated on the Owner's Equity (Capital) portion of the equation and discussed how the balance of Owner's Equity ("Ma Capital") is affected by her "kids" Revenue, Expense, Investment, and Draws.

Let's review these effects one more time:

- Owner Investments (Kid Investment) increase Owner's Equity
- Revenues (Kid Revenue) increase Owner's Equity
- Expenses (Kid Expense) decrease Owner's Equity
- Owner's Draws (Kid Draws) decrease Owner's Equity

Using the above information we arrived at the following equation:

Current Owner's Equity = Beginning Owner's Equity + Owner's Investments + Revenues - Expenses - Draws

Our new owner's equity equation illustrated the relationships and effects investments, revenue, expense, and draws have on Owner's Equity.

Taking this one step further, we arrived at our Fully Expanded Accounting Equation which included all the components that make up and affect Owner's Equity.

Our Expanded Accounting Equation Assets = Liabilities + Owner's Equity expanded or restated became our
Fully Expanded Accounting Equation
Assets = Liabilities + Beginning Owner's Equity + Additional Owner Investments + Revenues - Expenses - Draws.

In the Expanded Version of the Accounting Equation, "Ma Capital's Kids". They're there; you just don't see them. The fully expanded version un hides them and shows you their affects on Owner's Equity ("Ma Capital").

Normal Debit Balances	Normal Credit Balances	Normal Debit and Credit Balances	Profit or Loss
Assets =	Liabilities +	Beginning Owner's Equity (Normal Credit Balance)	
		+ Additional Owner Investments (Normal Credit Balance)	
		+ Revenue (Normal Credit Balance)	+ Revenue
		- Expenses (Normal Debit Balance)	- Expense

			= Profit or Loss
		- Draws (Normal Debit Balance)	
		= Ending Owner's Equity (Normal Credit Balance)	

- Assets = Liabilities + Ending Owner's Equity
- Revenues - Expenses = Profit or Loss
- Beginning Owner's Equity + Owner's Contributions + Revenue - Expense - Draws = Ending Owner's Equity
- Asset Accounts normally have Debit Balances.
- Liability Accounts normally have Credit Balances.
- Owner's Equity (Capital) Account normally has a Credit Balance.
- Two of Ma's Kids, Expense and Draws, normally have a Debit Balance.
- Two of Ma's Kids, Revenue and Investments normally have a Credit Balance.
- Revenues increase Owner's Equity (Capital) because they're added to Owner's Equity.
- Expenses decrease Owner's Equity (Capital) because they're subtracted from Owner's Equity.
- Draws decrease Owner's Equity (Capital) because they're subtracted from Owner's Equity.
- Besides the Owner's Original Investment in his/her business, at times, the owner may have to contribute or invest additional assets which increase Owner's Equity.
  Note: Additional owner investments are normally added directly (credited) to the Owner's Capital Account Balance.
- Owner Draws are not used to figure the profit or loss of the business.
  Note: The owner's draws could be equal, less than, or more than the profit / loss of the business.
- Additional Owner Contributions, Revenues, Expenses, and Draws eventually are all merged together and become a part of the Ending Owner's Equity Balance. If you've heard the phrase Closing The Books, believe it or not, this is all that's basically involved in Closing The Books.

Account Definition

An Account is a separate record for each type of asset, liability, equity, revenue, and expense used to show the beginning balance and to record the increases and decreases for a period and the resulting ending balance at the end of a period.

You should be aware that All Accounts:

- Can Be Debited and Credited
- Have an Increase Side (Column) and a Decrease Side (Column)
- Have a Debit Side (Column) and a Credit Side (Column)
  Debit Side is the Left Side (Left Column)
  Credit Side is the Right Side (Right Column)

- Have a Type and are classified as an Asset, Liability, Equity, Revenue, Expense, or Draw
- Are Either a Balance Sheet or Income Statement Account
- Have a Normal Balance Amount that is normally a Debit Balance or a Credit Balance

The Normal Balance is the debit or credit balance that an account is expected to have.
The normal balance is also the side of the account that increases the balance of the account. Since the increase side of assets, draws, and expense accounts is the left (debit) side these accounts normally have a debit balance. Likewise, since the increase side of liabilities, revenue, and owner's equity (capital) accounts is the right (credit) side these accounts normally have a credit balance. In other words, since debits increase asset, draw, and expense accounts, they normally have a debit (left side balance). Conversely, because credits increase liability, equity, and revenue accounts, they normally have a credit (right side) balance.

Comment: An account can occasionally end up with a balance that is not its normal balance. A good example would be a business "strapped" for cash that ends up with a credit balance in its cash account by writing out checks for more funds than they have on deposit in the bank. This credit balance signifies that the account is overdrawn, and instead of being classified as an asset, which it normally is, is now a temporary liability (amount owed to bank).

Do you remember this Equation ?

The Debit and Credit Equation is just a variation (rearranged version) of the Fully Expanded Accounting Equation. Some simple Algebra was used to rearrange the major types of accounts.

Debit and Credit Equation
Assets + Draws + Expenses = Liabilities + Owner's Equity + Revenue
Normal Debit Balance Accounts = Normal Credit Balance Accounts

In this rearranged form of our fully expanded accounting equation, all the types of accounts that have a normal debit balance are listed on the left side of the equal sign and all the types of accounts that have a normal credit balance are listed on the right side of the equal sign.

Based on our Debit and Credit Equation we can state the following:

Normal Account Balance

Debit Balances

- Asset - Normally a Debit Balance
- Draws - Normally a Debit Balance
- Expense - Normally a Debit Balance

Credit Balances

- Liabilities - Normally a Credit Balance
- Owner's Equity (Capital) - Normally a Credit Balance
- Revenue - Normally a Credit Balance

Just knowing the normal balances for the types of accounts makes it much easier to determine when to use debits and credits.

Methods for DeterMining What To Debit and Credit.
While they all require some degree of memorization, some are less taxing on the brain cells than others.

(1) Memorize the definitions for debits and credits.

Debit - An entry (amount) entered on the left side (column) of a journal or general ledger account that increases an asset, draw or an expense or an entry that decreases a liability, owner's equity (capital) or revenue.

Credit - An entry (amount) entered on the right side (column) of a journal or general ledger account that increases a liability, owner's equity (capital) or revenue, or an entry that decreases an asset, draw, or an expense.

This is actually no different than memorizing the other terms that were presented in Lesson 1.

(2) Convert the Definitions To Detail Debit and Credit Rules and Memorize The Rules

At least I've supplied a Table and a T-Account presentation of the Accounts to help in this endeavor.

Our Summarized Debit and Credit Rules Table

Account Type	Debit	Credit	Normal Account Balance
Assets	Increase	Decrease	Debit Balance
Liabilities	Decrease	Increase	Credit Balance
Owner's Equity	Decrease	Increase	Credit Balance
Revenue	Decrease	Increase	Credit Balance
Expense	Increase	Decrease	Debit Balance
Draw	Increase	Decrease	Debit Balance

A debit increases an asset while a credit decreases an asset.
A debit decreases a liability while a credit increases a liability.
A debit decreases owner's equity while a credit increases owner's equity.
A debit decreases revenue while a credit increases revenue.
A debit increases an expense while a credit decreases an expense.
A debit increases a draw while a credit decreases a draw.

If you look at the expense and draw categories, there appears to be a contradiction. In the Equity Table presented earlier in this lesson, the description for a debit to an expense says it decreases equity which is exactly what an expense does. It reduces the owner's claim to the property (assets). What might be a "little" confusing is that our summary of how debits and credits affect categories says that a debit to an expense is an increase. This is also true. The debit increases the amount of the expense which in turn decreases owner's equity.

Example: Assume my business has advertising expenses of Rs2,000.00 as of yesterday. I write a check today for a another Rs1,000.00 for advertising. I debit advertising for Rs1000.00 which increases the amount spent on advertising to a total of Rs3,000.00 and has the additional effect of decreasing my equity by an additional Rs1,000.00.

The same logic applies to draws.

Our Rules Illustrated With T-Accounts

Asset, Drawing, and Expense Accounts Normal Balance Debit Amount		Liability, Owner's Equity (Capital) and Revenue Accounts Normal Balance Credit Amount	
Account Name		Account Name	
Increase	Decrease	Decrease	Increase
Debit	Credit	Debit	Credit
Left Side or Debit Side of Account	Right Side or Credit Side of Account	Left Side or Debit Side of Account	Right Side or Credit Side of Account

T-Accounts are used as a tool to illustrate business transactions, debits and credits, double entry bookkeeping, and the purpose of accounts. It is called this because it has the form of the letter T. On the top of the horizontal bar there is the account title (name). Increases and Decreases are placed on the side of the vertical bar depending on whether the account type is an asset, liability or equity account. The left side of the T-account is called Debit, and the right side is called Credit. These terms are often abbreviated as Dr. and Cr.

We accountant types say an account has been debited when an amount is placed on the left side of an account and credited when the amount is placed on the right side. The difference between the debit and the credit side of an account (total increases less total decreases) is called the account balance.

(3) Simplify and Summarize the Detail Debit and Credit Rules
This develops rules based on our earlier discussion of normal account balances and our Debit and Credit Equation that was derived from our Fully Expanded

Accounting Equation and was presented earlier.
Assets + Draws + Expenses = Liabilities + Owner's Equity + Revenue
Normal Debit Balance Accounts = Normal Credit Balance Accounts

Using this knowledge, we can state our simplified debit and credit rules as:

All Accounts that Normally Have a Debit Balance (Left Side of Our Debit and Credit Equation) are Increased with a Debit and Decreased with a Credit.

- Assets
- Draws
- Expenses

All Accounts that Normally have a Credit Balance (Right Side of Our Debit and Credit Equation) are Increased with a Credit and Decreased with a Debit.

- Liabilities
- Owner's Equity (Capital)
- Revenue

(4) Simplify Even More
If you're anything like me you like it as simple as possible. As others have done using acronyms, I've developed my own method for deterMining when to use debits and credits that builds on and simplifies the prior method.

Bean Counter's Simple Debit and Credit Rule

- Identifying the major types of accounts which of course are Assets, Liabilities, Owner's Equity, Revenue, Expense, and Draws.
- Major types of accounts are listed. Our listing includes 6 (six).
- Assuming that we wanted to group these 6 (six) accounts into 2 (two) equal groups, how many account types would be included in each group ? If my math is correct 6/2 (six divided by two) is equal to 3 (three).
- Also assuming that we wanted to alphabetize our account groups, our listing would appear as Assets, Draws, Expenses, Liabilities, Owner's Equity, and Revenue.
- Now, dividing this listing into our 2 (two) groups with three account types in each we have:

    - Group 1
      Assets, Draws, and Expenses
      This group is the types of accounts that normally have a debit balance.
    - Group 2
      Liabilities, Owner's Equity, and Revenue
      This group is the types of accounts that normally have a credit balance.

- Now, let's just use the first letter of each group to represent the type of account.

    - Group 1
      A (Asset), D (Draw), and E (Expense)

- Group 2
  L(liability), O (Owner's Equity), and R (Revenue)

Now we have our ingredients for Bean Counter's Simple Debit and Credit Rule.

All A, D, and E (Asset, Draw, and Expense) types of accounts, which normally have a debit balance, are increased with a debit and decreased with a credit.
All L,O, and R (Liability, Owner's Equity, and Revenue) type accounts, which normally have a credit balance, are increased with a credit and decreased with a debit.

All you have to remember is that:

1. Group 1 types of accounts (A, D, and E) all normally have a debit balance and their balances are increased by using a debit.
2. Group 2 types of accounts (L, O, and R) all normally have a credit balance and their balances are increased by using a credit.
3. Just use the other term (reverse) to record the decrease for each group.
   In other words, if a debit increases the balance of a type of account in the group, then a credit is going to decrease the balance of the type of account in the group. Likewise, if a credit increases the balance of a type of account in the group, then a debit is going to decrease the balance of the type of account in the group.

(5) When all else fails, there's my Debit Credit Cheat Sheet.
Who says you can't have a cheat sheet unless of course you're taking an exam ?

All You Need To Know About Debits and Credits
Summarized In One Sentence:

Enter an amount in the Normal Balance Side of an Account to Increase the Balance of an Account and in the Opposite Side of an Account to Decrease the Balance of an Account.

Additional Clarification:
Since Assets, Draw, and Expense Accounts normally have a Debit Balance, in order to Increase the Balance of an Asset, Draw, or Expense Account enter the amount in the Debit or Left Side Column and in order to Decrease the Balance enter the amount in the Credit or Right Side Column.

Likewise, since Liabilities, Owner's Equity (Capital), and Revenue Accounts normally have a Credit Balance in order to Increase the Balance of a Liability, Owner's Equity, or Revenue Account the amount would be entered in the Credit or Right Side Column and the amount would be entered in the Debit or Left Side column to Decrease the Account's Balance.

How To Use and Apply The Debit and Credit Rules:

(1) Determine the types of accounts the transactions affect-asset, liability, revenue, or expense account.
(2) Determine if the transaction increases or decreases the account's balance.
(3) Apply the debit and credit rules based on the types of accounts and whether the balance of the account will increase or decrease.

Summery:
There are various symbols that are used to indicate Debits and Credits and whether an account's balance is a Debit or a Credit.

Ways and symbols you might run across are:

- Dr for Debit and Cr for Credit
- + (Plus Sign) for Debit and - (Minus Sign) for Credit
- No Bracket for Debit and < > (Brackets) for Credit
- No Parentheses for Debit and ( ) (Parentheses) for Credit

Symbol	Indicates a Debit	Indicates a Credit
Dr / Cr	Dr	Cr
+ / -	+	-
No Bracket / Bracket < >		< >
No Parentheses / Parentheses ( )		( )

Note: The plus (+) and minus (sign) are often used by accounting and bookkeeping programs to indicate debits and credits. Don't get confused and think that the plus sign means an increase or that the minus sign means a decrease. They do not. In this case, they are simply symbols that mean either a debit or a credit.

Know About Debits and Credits

- An Account has an Increase Side (Column) and a Decrease Side (Column).
- The Left Side (Column) of an Account is the Debit Side (Column) and the Right Side (Column) of an Account is the Credit Side (Column).
- Debits are simply entries in the left column of an account and Credits are simply entries in the right column of an account.
- When you record an entry in the Left Side (Column) of an Account this is called Debiting an Account.
- When you record an entry in the Right Side (Column) of an Account this is called Crediting an Account.
- Debits do not always represent increases to an account's balance. Nor, do they always represent decreases to an account's balance.
- Likewise, Credits do not always represent increases to an account's balance. Nor, do they always represent decreases to an account's balance.
- Whether a Debit or Credit to an Account is an Increase or Decrease depends on the Type of Account - Asset - Liability - Owner's Equity - Revenue - Expense - Draw.

- A credit to a particular type of account always does the opposite that a debit does. In other words - if a debit increases an account's balance a credit decreases the account's balance or vice versa - if a debit decreases an account's balance a credit increases the account's balance.
- All Accounts have a Normal Balance which is either a Debit Balance or a Credit Balance.
  Assets, Draws, and Expenses all have Normal Debit Balances.
  Liabilities, Owner's Equity (Capital), and Revenue all have Normal Credit Balances.
- When using the double entry bookkeeping system, the sum of the debits must equal the sum of the credits for a transaction to be in balance.
- Every transaction must have a dollar entry entered on the left side of an account(s) and a dollar entry entered on the right side of an account(s).
- When calculating an Account's Balance, Debits are always added together and Credits are always added together; but a Debit and Credit are subtracted from each other.
- Just as you have a left and right side of the accounting equation, you also have a left and right side of an account.
- Every transaction involves at least one debit and one equal offsetting credit. If a transaction has more than one debit and/or credit, the total of the debits must equal the total of the credits. This is called a compound entry.
- The term Debit should not be associated with good or bad. Likewise the term Credit should not be associated with good or bad.
- If we properly use debits and credits to record and summarize our bookkeeping records, our Debits will always equal our Credits and provide some assurance that our records are accurate.

Type Of Accounts

In prior lessons, we mainly used "The Big Three" (Assets, Liabilities, and Owner's Equity) and "Ma Capital's (Owners Equity) Kids" (Revenue, Expense, Investment, and Draws) as our "accounts" to learn how business transactions affect account balances.

These seven "big" type of accounts were defined in Lesson 1 as follows:

Assets

Formal Definition: The properties used in the operation or investing activities of a business.
Informal Definition: All the good stuff a business has (anything with value). The goodies.

Liability

Formal Definition: Claims by creditors to the property (assets) of a business until they are paid.
Informal Definition: Other's claims to the business's stuff. Amounts the business owes to others.

Owner's Equity also called Owner's Capital

Formal Definition: The owner's rights to the property (assets) of the business; also

called proprietorship and net worth.
Informal Definition: What the business owes the owner. The good stuff left for the owner assuming all liabilities (amounts owed) have been paid.

"Ma Capital's (Owner's Equity) Four Kids"

- Revenue

Formal Definition: The gross increase in owner's equity resulting from the operations and other activities of the business.
Informal Definition: Amounts a business earns by selling services and products. Amounts billed to customers for services and/or products.

- Expense

Formal Definition: Decrease in owner's equity resulting from the cost of goods, fixed assets, and services and supplies consumed in the operations of a business.
Informal Definition: The costs of doing business. The stuff we used and had to pay for or charge to run our business.

- Draws

Formal Definition: Decrease in owner's equity resulting from withdrawals made by the owner.
Informal definition: Amounts the owner withdraws from his business for living and personal expenses.

- Owner's Investments

Formal Definition: Increase in owner's equity (capital) resulting from additional investments of cash and/or other property made by the owner.
Informal definition: Additional amounts, either cash or other property, that the owner puts in his business.

In the real bookkeeping world, we want to know the detail types of assets, liabilities, equity (capital), revenues, expenses, and draws.

In Lesson 1 we discussed some of the detail types of assets, liabilities, equity, revenue, and expenses. Can You name a few ? I'll help you.
Examples of Assets-Cash, Accounts Receivable, Notes Receivable, Buildings, and Equipment
Examples Of Liabilities-Accounts Payable, Notes Payable, and Mortgage Payable
Examples Of Revenue-Product Sales, Rental Income, and Service Revenue
Examples Of Expenses-Employee Wages, Building Rental, Telephone, Utilities, Advertising, Office Supplies

Rules for Debits and Credits that we will use in this lesson were just covered in Lesson 3. If you've slept since then, the following procedure is what you use in order to use and apply the Debit and Credit Rules when recording bookkeeping transactions.

Additional Clarification:
Since Assets, Draw, and Expense Accounts normally have a Debit Balance, in order to Increase the Balance of an Asset, Draw, or Expense Account enter the amount in the Debit or Left Side Column and in order to Decrease the Balance enter the amount in the Credit or Right Side Column.

Likewise, since Liabilities, Owner's Equity (Capital), and Revenue Accounts normally have a Credit Balance in order to Increase the Balance of a Liability, Owner's Equity, or Revenue Account the amount would be entered in the Credit or Right Side Column and the amount would be entered in the Debit or Left Side column to Decrease the Account's Balance.

How To Use and Apply The Debit and Credit Rules:

(1) Determine the type of account(s) the transactions affect-asset, liability, revenue, or expense account.
(2) Determine if the transaction increases or decreases the account's balance.
(3) Apply the debit and credit rules based on the type of account and whether the balance of the account will increase or decrease.

Account-a separate record for each type of asset, liability, equity, revenue, and expense used to show the beginning balance and to record the increases and decreases for a period and the resulting ending balance at the end of a period.

Any of these or any others that our business needs or wants to track have their own separate and individual account. What officially do we call this detail listing of accounts that we set up for our business ? Simply a Chart Of Accounts.

Let's take a step in this direction by setting up a simple chart of accounts for VISHAL Land.

Simple Chart Of Accounts For VISHAL Land

Assets Account Name: Cash Description: Currency and checks and balance in bank Account Name: Accounts Receivable Description: Amounts due from customer's for services rendered Account Name: Inventory-Office Supplies Description: On hand supplies of such items as copier & computer paper, pens, pencils and other office supplies Account Name: Land Equipment Description: Buyers purchased Liabilities Account Name: Accounts Payable Description: Amounts owed suppliers for business purchases and expenses Account Name: Note Payable-Bank Description: Mortgages and loans owed to bank	Equity Account Name: Owner's Capital Description: Amounts invested by owner and earned by operations Account Name: Owner's Draws Description: Amounts withdrawn by owner for personal expenses Revenue Account Name: Land Revenues Description: Earnings from land yards Expenses Account Name: Advertising Expense Description: Expenditures for TV, radio, newspaper, and other promotions. Account Name: Mulch Expense Description: Expenditures for mulch used for yard work

In order to record the information in our accounts, we also need to be familiar with the source documents that provide us with the necessary information for recording our transactions.

Source Documents

The original sources of information that provide documentation (proof) that a transaction has occurred are sales invoices (tickets), invoices from suppliers, contracts, checks written and checks received , promissory notes, and various other types of business documents. These documents provide us with the information needed to record our financial transactions in our bookkeeping records.

Typical Types Of Business Transactions and the Debits and Credits and Accounts Used To Record Them

In a typical business transaction we get something and we give up something.

- Sale-Sell goods and/or services
  - Cash Sale-customer pays at the time of sale
    The business gets cash or a check from their customer and gives up a product or service to their customer.
    Accounts Used:
    Debit: Cash
    Credit: Sales
  - On Account Sale-business allows the customer time to pay
    The business gets a promise to pay from their customer and gives up a product or service to their customer.
    Accounts Used:
    Debit: Accounts Receivable
    Credit: Sales
- Purchase goods and/or services
  - Cash Purchase-business pays the supplier at the time of purchase
    The business gets a product or service from their supplier and gives up cash or a check to their supplier.
    Accounts Used:
    Debit: Expense or Inventory Account
    Credit: Cash
  - On Account Purchase-supplier allows the business time to pay
    The business gets a product or service from a supplier and gives up a promise to pay to their supplier.
    Accounts Used:
    Debit: Expense or Inventory Account
    Credit: Accounts Payable
- Pay Supplier Charge Purchases -pay suppliers for products and/or services that we promised to pay for later (charge).
  The business gets the amount of their promise to pay the supplier reduced and gives up cash or a check.
  Accounts Used:

Debit: Accounts Payable
Credit: Cash

- Receive Customer Charge Payments -receive payments from a customer that promised to pay us later (charge sale).
  The business gets cash or a check from their customer and gives up (reduces the amount of) their customer's promise to pay.
  Accounts Used:
  Debit: Cash
  Credit: Accounts Receivable
- Borrow Money (Loans) The business gets cash or equipment and gives up a promise to pay.
  Accounts Used:
  Debit: Cash or Equipment
  Credit: Note Payable
- Repay a Loan
  The business gets the amount of their promise to pay reduced and gives up cash or a check.
  Accounts Used:
  Debit: Note Payable
  Credit: Cash
- Draw
  The business gets the owner's claim to the business assets reduced and gives up cash or a check.
  Accounts Used:
  Debit: Owner's Draw
  Credit: Cash
- Payroll (not covered in this tutorial)
  The business gets services from their employees and gives up a check.
  Accounts Used:
  Debit: Salary & Wages Expense
  Credit: Cash

T-Accounts

We're going to record our transactions using our ole buddy the T-Account.

Notice that Assets, Draws, and Expense Type of Accounts are increased using the Left Side (Column) of the account (debited) and decreased using the Right Side (Column) of the account (credited). The reverse is true for the Liability, Equity, and Revenue Type of Accounts. These Type Of Accounts are increased using the Right Side (Column) of the account (credited) and decreased using the Left Side (Column) of the account (debited).

Asset Accounts			Liability Accounts	
Account Name			Account Name	
Increase	Decrease		Decrease	Increase
Debit	Credit		Debit	Credit

Left Side or Debit Side of Account	Right Side or Credit Side of Account		Left Side or Debit Side of Account	Right Side or Credit Side of Account

Equity (Capital) Accounts

Account Name

Decrease Debit	Increase Credit
Left Side or Debit Side of Account	Right Side or Credit Side of Account

Revenue Accounts

Account Name

Decrease Debit	Increase Credit
Left Side or Debit Side of Account	Right Side or Credit Side of Account

Expense Accounts

Account Name

Increase Debit	Decrease Credit
Left Side or Debit Side of Account	Right Side or Credit Side of Account

Draw Accounts

Account Name

Increase Debit	Decrease Credit
Left Side or Debit Side of Account	Right Side or Credit Side of Account

Now, I think we should be ready to revisit our VISHAL Land Company and record the transactions presented in prior lessons in our detailed accounts (T-Accounts). We are going to assume that VISHAL has beginning balances already recorded in their accounts. These balances are as of December 1, 2013.

Note: If these balances were as of the beginning of the year the nominal or temporary accounts - revenues, expenses, and draws would all have zero balances.

Lastly, we are going to thoroughly review each transaction for December 2013 and show you the hows and whys to properly recording each transaction and present the steps for properly analyzing and recording a transaction.

VISHAL's Beginning Account Balances as of December 1, 2013

Assets		Liabilities		Equity	
Cash	Rs5,500 Dr	Accounts Payable	Rs2,000 Cr	Owner's Capital	Rs7,500 Cr
Accounts Receivable	Rs1,600 Dr			Land Revenue	Rs1,000 Cr

Land Equipment Rs2,500 Dr
Inventory-Office Supplies Rs 0 Dr

Advertising Expense Rs200 Dr
Mulch Expense Rs100 Dr
Owner Draws Rs600 Dr

Notice I used the symbols Dr and Cr to abbreviate the Debit and Credit balances in the table of VISHAL's beginning balances. While this is a common method of representing debits and credits, other symbols that we discussed in Lesson 3 are also used.

You'd better check me out to see if our books balance before we start recording VISHAL's transactions. We're going to perform two checks that relate to what we've been learning in prior lessons.

The first check is to see if our Accounting Equation balances and the second to make sure that the debit balances equal the credit balances.

Equation Check Calculations

Total Assets = Cash + Accounts Receivable + Land Equipment
Total Assets = 5,500 + 1,600 + 2,500
Total Assets = 9,600

Total Liabilities is easy because there is only one account (Accounts Payable) with a balance of 2,000.
Total Liabilities = 2,000

Total Equity = Owner's Capital + Revenues - Expenses - Draws
Since we have more than one expense let's summarize them before we use them in our equation.
Total Expenses = Mulch Expense + Advertising
Total Expenses = 100 + 200
Total Expenses = 300

Total Equity = Owner's Capital + Revenues - Expenses - Draws
Total Equity = 7,500 + 1000 - 300- 600
Total Equity = 7,600

Substituting our totals into the Accounting Equation we find that our equation balances.

Assets =	Liabilities +	Owner's Equity
9,600	2,000	7,600

Our second check is to see if our debit account balances equal our credit account balances.

Let's total our Debit Balances

Cash	5,500
Accounts Receivable	1,600
Land Equipment	2,500
Advertising Expense	200
Mulch Expense	100
Owner's Draw	600
Total Debits	10,500

Now we'll total our Credit Balances

Accounts Payable	2,000
Owner's Capital	7,500
Land Revenue	1,000
Total Credits	10,500

It looks like we passed muster again.

1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.
2. VISHAL purchases Rs100 worth of office supplies and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).
3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.
4. VISHAL purchases five buyers for Rs10,000 and finances them with a note from the local bank.
5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).
6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.
7. VISHAL pays the office supply company Rs100 with a check for the office supplies that they charged (promised to pay).
8. VISHAL receives a check from the customer who they billed (invoiced) Rs75 for services and allowed 10 days to pay.
9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.
10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.

We will discuss each transaction and "post" the entry to the appropriate account (T-Account). Keep in mind that each entry will have a debit and a credit.

In your actual formal General Ledger, which will be discussed and explained in Lesson 5, each account has an amount column for debits (left side or first column) and an amount column for credits (right side or second column).

Detail Transaction Information

For each transaction for VISHAL Land, we will identify the Source Document, Type Of Transaction, Accounts Affected, and determine and explain the Debits and Credits needed to properly record and post to our T-Accounts.

Entry 1
1. VISHAL buys a client's yard and receives a check from the customer for Rs50 for the service provided.

Source Document: Customer's Check
Type Of Transaction: Cash Sale
Accounts Affected: Cash Sales
Debits and Credits:
Increase (Left Side) Cash: Debit
Increase (Right Side) Land Revenue (Sales): Credit

Explanation Using Our Debit/Credit Rules: The asset cash is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of cash, which is an asset, is the left (debit) side of the account so we increase cash by entering the amount in the left side as a debit. Land Revenue (Equity) is also increased. Again, an increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of a revenue account is the right (credit) side of the account so we increase land revenue (sales) by entering the amount in the right side as a credit.

Asset Account Cash Increase Debit		Decrease Credit		Revenue (Equity) Account Land Revenues Decrease Debit	Increase Credit	
Beg Bal.	5,500				Beg Bal.	1,000
(1)	50				(1)	50

Entry 2
2. VISHAL purchases Rs100 worth of office supplies and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).

Source Document: Supplier's Invoice
Type Of Transaction: On Account Purchase
Accounts Affected: Inventory-Office Supplies Accounts Payable
Debits and Credits:
Increase (Left Side) Inventory-Office Supplies: Debit
Increase (Right Side) Accounts Payable: Credit

Explanation Using Our Debit/Credit Rules: The asset inventory-office supplies is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of inventory-office supplies, which is an asset, is the left (debit) side of the account so we increase inventory-office supplies by entering the amount in the left side as a debit. The liability accounts payable is also increased. Again, we record an increase by entering the amount in the normal balance side of an account. The normal balance side of accounts payable, which is a liability, is the right (credit) side of the account so we increase accounts payable by entering the amount in the right side as a credit.

Asset Account Inventory-Office Supplies					Liability Account Accounts Payable		
Increase Debit		Decrease Credit			Decrease Debit	Increase Credit	
(2)	100					Beg Bal.	2,000
						(2)	100

Entry 3

3. VISHAL places an ad in the local newspaper receives the invoice from the supplier and writes a check for Rs25 to the newspaper.

Source Document: Supplier's Invoice and Company Check
Type Of Transaction: Cash Purchase
Accounts Affected: Advertising Expense (Equity) Cash
Debits and Credits:
Increase (Left Side) Advertising Expense (Decrease Equity): Debit
Decrease (Right Side) Cash: Credit

Explanation Using Our Debit/Credit Rules: The expense advertising expense is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of advertising expense, which is an expense account, is the left (debit) side so we increase advertising expense by entering the amount in the left side as a debit. The asset cash is decreased. We record a decrease by entering the amount in the opposite side of the normal balance side of an account. The normal balance side of cash, which is an asset, is the left (debit) side so we decrease cash by entering the amount in the opposite side which is the right (credit) side of the account as a credit.

Some additional clarification might be useful in order to clarify why an expense is recorded as an increase with a debit. The actual amount of the advertising expense has increased. The business now has spent more for advertising. More expenses are not what a business or an individual wants. Increased personal expenses reduce our personal equity and likewise increased business expenses reduce the owner's equity of a business. Since an increase in an expense reduces equity it is recorded as an increase using a debit.

Asset Account Cash		Expense (Equity) Account Advertising Expense

Increase Debit		Decrease Credit			Increase Debit		Decrease Credit	
Beg Bal.	5,500	(3)	25		Beg Bal.	200		
(1)	50				(3)	25		

Entry 4

4. VISHAL purchases five buyers for Rs10,000 and finances them with a note from the local bank.

Source Document: Bank Note
Type Of Transaction: Borrow Money
Accounts Affected: Land Equipment   Note Payable-Bank
Debits and Credits:
Increase (Left Side) Land Equipment: Debit
Increase (Right Side) Note Payable-Bank: Credit

Explanation Using Our Debit/Credit Rules: The asset land equipment is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of land equipment, which is an asset account, is the left (debit) side so we increase land equipment by entering the amount in the left side as a debit. The liability note payable-bank is also increased. Again, an increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of note payable-bank, which is a liability account, is the right (credit) side , so we increase note payable-bank by entering the amount in the right side as a credit.

Asset Account Land Equipment Increase Debit		Decrease Credit			Liability Account Note Payable-Bank Decrease Debit		Increase Credit	
Beg Bal.	2,500						(4)	10,000
(4)	10,000							

Entry 5
5. VISHAL buys another customer's yard and sends the customer a Rs75 bill (invoice) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).

Source Document: Sales Invoice
Type Of Transaction: On Account Sale
Accounts Affected: Accounts Receivable   Land Revenue (Sales)
Debits and Credits:
Increase (Left Side) Accounts Receivable: Debit
Increase (Right Side) Land Revenue (Sales): Credit

Explanation Using Our Debit/Credit Rules: The asset accounts receivable is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of accounts receivable, which is an asset, is the left (debit) side of the account so we increase accounts receivable by entering the amount in the left side as a debit. Land Revenue (Equity) is also increased. Again, an increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of a revenue account is the right (credit) side of the account so we increase land revenue (sales) by entering the amount in the right side as a credit.

Asset Account Accounts Receivable Increase Debit	Decrease Credit		Revenue (Equity) Account Land Revenues Decrease Debit	Increase Credit
Beg Bal. 1,600				Beg Bal. 1,000
(5) 75				(1) 50

Entry 6

6. The owner of VISHAL needs a little money to pay some personal bills and writes himself a check for Rs500.

Source Document: Check
Type Of Transaction: Draw
Accounts Affected: Cash Draw
Debits and Credits:
Increase (left Side)Owner's Draw (Decrease Equity): Debit
Decrease (Right Side) Cash: Credit

Explanation Using Our Debit/Credit Rules: The draw account owner's draw is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of owner's draw, which is a draw account, is the left (debit) side so we increase owner's draw by entering the amount in the left side as a debit. The asset cash is decreased. We record a decrease by entering the amount in the opposite side of the normal balance side of an account. The normal balance side of cash, which is an asset, is the left (debit) side so we decrease cash by entering the amount in the opposite side which is the right (credit) side of the account as a credit.

Asset Account Cash Increase Debit	Decrease Credit		Draw (Equity) Account Owner's Draw Increase Debit	Decrease Credit
Beg Bal. 5,500	(3) 25		Beg Bal. 600	
(1) 50	(6) 500		(6) 500	

Entry 7
7. VISHAL pays the office supply company Rs100 with a check for the office supplies that they charged (promised to pay).

Source Document: Check
Type Of Transaction: Pay Supplier Charge Purchases
Accounts Affected: Cash Accounts Payable
Debits and Credits:
Decrease (Left Side) Accounts Payable: Debit
Decrease (Right Side) Cash: Credit

Explanation Using Our Debit/Credit Rules: The asset cash is decreased. We record a decrease by entering the amount in the opposite side of the normal balance side of an account. The normal balance side of cash, which is an asset, is the left (debit) side so we decrease cash by entering the amount in the opposite side which is the right (credit) side of the account as a credit. The liability account accounts payable is also decreased. We record a decrease by entering the amount in the opposite side of the normal balance side of an account. The normal balance side of accounts payable, which is a liability, is the right (credit) side so we decrease accounts payable by entering the amount in the opposite side which is the left (debit) side of the account as a debit.

Asset Account Cash Increase Debit		Decrease Credit			Liability Account Accounts Payable Decrease Debit		Increase Credit	
Beg Bal.	5,500	(3)	25		(7)	100	Beg Bal.	2,000
(1)	50	(6)	500				(2)	100

Entry 8
8. VISHAL receives a check from the customer who they billed (invoiced) Rs75 for services and allowed 10 days to pay.

Source Document: Customer Check
Type Of Transaction: Receive Customer Charge Payments
Accounts Affected: Cash Accounts Receivable
Debits and Credits:
Increase (Left Side) Cash: Debit
Decrease (Right Side) Accounts Receivable: Credit

Explanation Using Our Debit/Credit Rules: The asset cash is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of cash, which is an asset, is the left (debit) side of the account so we increase cash by entering the amount in the left side as a debit. Another asset account, accounts receivable decreased. We record a decrease by entering the amount in the opposite side of the normal balance side of an account. The normal balance side of accounts receivable, which is an asset, is the left (debit)

side so we decrease accounts receivable by entering the amount in the opposite side which is the right (credit) side of the account as a credit. We actually "swapped" one asset accounts receivable for another asset cash.

Asset Account Cash Increase Debit		Decrease Credit	
Beg Bal.	5,500	(3)	25
(1)	50	(6)	500

Asset Account Accounts Receivable Increase Debit		Decrease Credit	
Beg Bal.	1,600	(8)	75
(5)	75		

Entry 9

9. VISHAL purchased some mulch for Rs60 and received an invoice from their supplier who allows them 15 days to pay. The mulch was used on a customer's yard.

Source Document: Supplier's Invoice
Type Of Transaction: Purchase on Account
Accounts Affected: Mulch Expense   Accounts Payable
Debits and Credits:
Increase (Left Side) Mulch Expense (Decrease Equity): Debit
Increase (Right Side) Accounts Payable: Credit

Explanation Using Our Debit/Credit Rules: The expense mulch expense is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of mulch expense, which is an expense account, is the left (debit) side so we increase mulch expense by entering the amount in the left side as a debit. The amount owed to a supplier increased. The liability accounts payable is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of accounts payable, which is a liability, is the right (credit) side of the account so we increase accounts payable by entering the amount in the right side as a credit.

Liability Account Accounts Payable Decrease Debit		Increase Credit	
(7)	100	Beg Bal.	2,000
		(2)	100
		(9)	60

Expense (Equity) Account Mulch Expense Increase Debit		Decrease Credit	
Beg Bal.	100		
(9)	60		

Entry 10

10. VISHAL bills (prepares an invoice) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 from the customer.

Source Document: Sales Invoice and Customer Check
Type Of Transaction: Cash Sale
Accounts Affected: Cash   Land Revenue (Sales)
Debits and Credits:
Increase (Left Side) Cash: Debit
Increase (Right Side) Land Revenue (Equity): Credit

Explanation Using Our Debit/Credit Rules: The asset cash is increased. An increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of cash, which is an asset, is the left (debit) side of the account so we increase cash by entering the amount in the left side as a debit. Land Revenue (Equity) is also increased. Again, an increase is recorded by entering the amount in the normal balance side of an account. The normal balance side of a revenue account is the right (credit) side of the account so we increase land revenue (sales) by entering the amount in the right side as a credit.

Asset Account			
Cash			
Increase		Decrease	
Debit		Credit	
Beg Bal.	5,500	(3)	25
(1)	50	(6)	500
(8)	75	(7)	100
(10)	80		

Revenue (Equity) Account			
Land Revenue			
Decrease		Increase	
Debit		Credit	
		Beg Bal.	1,000
		(1)	50
		(5)	75

VISHAL's Calculated Ending Account Balances After Posting

Me, being the nice guy that I am, calculated the ending account balances for you.

Assets			Liabilities			Equity		
Cash	Rs5,080	Dr	Accounts Payable	Rs2,060	Cr	Owner's Capital	Rs7,500	Cr
Accounts Receivable	Rs1,600	Dr	Note Payable-Bank	Rs10,000	Cr	Land Revenue	Rs1,205	Cr
Land Equipment	Rs12,500	Dr				Advertising Expense	Rs225	Dr
Inventory-Office Supplies	Rs100	Dr				Mulch Expense	Rs160	Dr
						Owner Draws	Rs1,100	Dr

Let's perform our checks on our ending balances after posting.

The first check is to see if our Accounting Equation balances and the second to make sure that the debit balances equal the credit balances.

Equation Check Calculations

Total Assets = Cash + Accounts Receivable + Land Equipment +Office Supplies
Total Assets = 5,080 + 1,600 + 12,500 + 100
Total Assets = 19,280

Total Liabilities = Accounts Payable + Notes Payable
Total Liabilities = 2,060 + 10,000
Total Liabilities = 12,060

Total Equity = Owner's Capital + Revenues - Expenses - Draws
Since we have more than one expense let's summarize them before we use them in our equation.
Total Expenses = Mulch Expense + Advertising
Total Expenses = 160 + 225
Total Expenses = 385

Total Equity = Owner's Capital + Revenues - Expenses - Draws
Total Equity = 7,500 + 1205 - 385- 1100
Total Equity = 7,220

Substituting our totals into the Accounting Equation we find that our equation balances.

Assets =	Liabilities +	Owner's Equity
19,280	12,060	7,220

Our second check is to see if our debit account balances equal our credit account balances.

Let's Total Our Debit Balances

Cash	5,080
Accounts Receivable	1,600
Land Equipment	12,500
Inventory-Office Supplies	100
Advertising Expense	225
Mulch Expense	160
Owner's Draw	1100
Total Debits	20,765

Now we'll total our Credit Balances

Accounts Payable	2,060

Note Payable-Bank	10,000
Owner's Capital	7,500
Land Revenue	1,205
Total Credits	20,765

Looks like everything is still in balance after we posted our transactions.

Assets = Liabilities + Owner's Equity
and our Debit Balance Accounts = our Credit Balance Accounts.

General Ledger

T-Accounts to record the transactions for VISHAL, the lawn land guys. What you didn't know at the time is that we were actually recording transactions in General Ledger Accounts. A General Ledger is just a formal set of T-Accounts. Each account that we want to track and keep up with has a separate page or pages maintained in a record book called the General Ledger. The general ledger's major sections are Assets, Liabilities, Owner's Equity, Revenues, Expenses, and Draws.

For each item (account) in our General Ledger, we record the increases and decreases for a period (usually a month) and calculate its ending balance. The ending balance of the account is easily determined by adding the increases and subtracting the decreases from the account's beginning period balance.

Ending Account Balance = Beginning Balance + Increases - Decreases

If you noticed in my above equation I used the terms increases and decreases.

We also should know by now that the type of accounts have a normal balance that is either a debit or credit balance. So actually the above equation is stated in two ways. The equation is stated one way for debit balance accounts, and another way for credit balance accounts.

Using our bookkeeping terms debits and credits, we come up with the following equations.

Debit Balance Accounts Equation

- Ending Account Balance for Normal Debit Balance Accounts = Beginning Balance + Debits(Increases) - Credits(Decreases)

Credit Balance Accounts Equation

- Ending Account Balance for Normal Credit Balance Accounts = Beginning Balance + Credits(Increases) - Debits(Decreases)

Simply stated a General Ledger is just a book containing the summarized financial transactions and balances of the accounts for all of a business's assets, liabilities, equity, revenue, and expense accounts.

One other record that goes hand in hand with the general ledger and that we've touched on before and used in the prior lesson is The Chart Of Accounts. Remember The Chart Of Accounts is simply a listing of all the accounts in the general ledger that contains the account's name, a brief description of the account, and usually an account number assigned to aid in recording and tracking transactions.

It's chief purpose is to serve as an aid (reference) for looking up accounts and their associated account numbers.

Chart Of Accounts For VISHAL Land

Note: The charts of accounts used in this tutorial were purposely kept simple and used to illustrate what the chart of accounts is and how it's used. For those of you that are curious, I've provided a detailed list of the accounts you might encounter in the "real" world.

- Balance Sheet Accounts
- Income Statement Accounts

You might also want to check out my tutorial So, you want to learn Bookkeeping! - Chart Of Accounts.

Normally a numbering system is set up with a range of numbers for assets, liabilities, equity, revenue, and expense accounts. VISHAL Assets have a range from 100-199 ;Liabilities a range from 200-299, Equity a range from 300-399, Revenues a range from 400-499, and Expenses a range from 500-599.

Assets (100-199) Account Name: Cash Account Number: 100 Description: Currency and checks and balance in bank Account Name: Accounts Receivable Account Number: 110 Description: Amounts due from customer's for services rendered Account Name: Inventory-Office Supplies Account Number: 115 Description: On hand supplies of such items as copier & computer paper, pens, pencils and other office supplies	Equity (300-399) Account Name: Owner's Capital Account Number: 300 Description: Amounts invested by owner and earned by operations Account Name: Owner's Draws Account Number: 310 Description: Amounts withdrawn by owner for personal expenses Revenue (400-499) Account Name: Land Revenues Account Number: 400 Description: Earnings from land yards Expenses (500-699)

Account Name: Land Equipment Account Number: 150 Description: Buyers purchased Liabilities (200-299) Account Name: Accounts Payable Account Number: 200 Description: Amounts owed suppliers for business purchases and expenses Account Name: Note Payable-Bank Account Number: 210 Description: Mortgages and loans owed to bank	Account Name: Advertising Expense Account Number: 510 Description: Expenditures for TV, radio, newspaper, and other promotions. Account Name: Mulch Expense Account Number: 520 Description: Expenditures for mulch used for yard work

Of course most businesses have many more than our eleven accounts we used for our sample VISHAL business. How about telephone, utilities, professional fees (that's me), salaries & wages, equipment rental, building rental, maintenance & repairs, contract labor, office equipment just to name a few.

Back To The General Ledger

- Name of Account and Account Number
- Date of Posting
- Description-additional notes about the entry if needed
- Posting Reference-journals name (abbreviation) , page, and entry reference
- Amounts of the debits or credits transferred
- Current Balance of the Account

Sample of a General Ledger Page

The Posting Reference GJ-1-1 refers to:
GJ-General Journal
1-Page 1
1-Entry Number 1

Click on the posting reference to see the journal entry

Account Name: Cash				Account Number: 100	
Date	Description	Post Ref.	Debit Amount	Credit Amount	Balance
Jan 1, 2013	Beg Bal				5000
Jan 5, 2013		GJ-1-1		1000	4000
Jan 8, 2013		GJ-1-2	200		4200
Jan 10, 2013		GJ-1-3		400	3800

Notice that the account has an amount column for debits (left side or first column) and an amount column for credits (right side or second column).

General Journal

Journals are preliminary records where business transactions are first entered into the accounting system. The journal is commonly referred to as the book of original entry. Specialized Journals-are journals used to initially record special types of transactions such as sales, cash disbursements, and cash receipts in their own journal.

The end result of double entry bookkeeping is having an up to date , in balance, and properly posted Ledger. In our prior lessons we recorded all our debits and credits (transactions) directly in the General Ledger. This would work for a small business that had very few transactions but would become unwieldy for most businesses with any volume of activity. By its very definition the General Ledger is supposed to be a summary record of a business's financial transactions.

It logically follows that since we only want summary amounts in our Ledger we need to record our detail entries some place else first. What record(s) do we use to do this ? You're right ! Journals are our preliminary records. All our transactions are first entered in a preliminary record called a journal or book of original entry. This process is called journalizing. After our business transactions have been entered in our journal(s), they are then periodically (usually monthly) summarized and totaled and then transferred (posted) to the General Ledger as summary entries.

What type of information is included in the Journal Record ?

- Entry Number
- Date of each transaction
- Names and/or the account numbers of the accounts to be debited or credited
- Amounts of the debits and credits
- Posting Reference-Account Number in the General Ledger
- Explanation or description of the entry

The journals contain all the chronological (by date) information necessary to record debit and credit amounts in the accounts of the General Ledger.

Sample of A General Journal Page

General Journal			Page 1		
Entry No	Date	Account Name	Post Ref.	Debit	Credit

GJ-1-1	Jan 5, 2013	Supplies	502	1000	
		Cash	100		1000
Record Supplies Expense					
GJ-1-2	Jan 8, 2013	Cash	100	200	
		Sales	300		200
Record Cash Sale					
GJ-1-3	Jan 10, 2013	Advertising Expense	500	400	
		Cash	100		400
Record Advertising Expense					
GJ-1-4	Jan 20, 2013	Utilities		650	
		Cash			650
Record Utilities Expense					

Do you notice anything odd about any of our entries in our General Journal ? Look at entry number 4 (GJ-1-4). It doesn't have a posting reference. Why not ? The answer is simple. Entry Number 4 has not yet been posted to the General Ledger. This is our way of keeping up with what entries have and have not been posted to the General Ledger.

VISHAL's Beginning Account Balances as of December 1, 2013

Assets		Liabilities		Equity	
Cash	Rs5,500	Accounts Payable	(Rs2,000)	Owner's Capital	(Rs7,500)
Accounts Receivable	Rs1,600			Land Revenue	(Rs1,000)
Land Equipment	Rs2,500			Advertising Expense	Rs200
				Mulch Expense	Rs100
				Owner Draws	Rs600

Note: Credit balances are indicated by using parentheses ( ).

1. December 2, 2013 VISHAL buys a client's yard and receives a check # 484 from the customer for Rs50 for the service provided.
Journal Entry 1
2. December 4, 2013 VISHAL purchases Rs100 worth of office supplies and stores them in their storage room. The office supply store gives them an invoice # 983 that allows them to pay for them in 15 days (on account).
Journal Entry 2
3. December 8, 2013 VISHAL places an ad in the local newspaper receives the invoice from the supplier # 555 and writes a check # 900 for Rs25 to the newspaper.
Journal Entry 3
4. December 10, 2013 VISHAL purchases five buyers for Rs10,000 and finances them with a note from the local bank.
Journal Entry 4
5. December 15, 2013 VISHAL buys another customer's yard and sends their customer a Rs75 bill (invoice # 1000) for the service they performed. They allow their customer ten (10) days to pay them for this service (on account).
Journal Entry 5
6. December 20, 2013 the owner of VISHAL needs a little money to pay some personal bills and writes himself a check # 901 for Rs500.
Journal Entry 6

7. December 22, 2013 VISHAL pays the office supply company Rs100 with a check # 902 for the office supplies that they charged (promised to pay invoice # 983).
Journal Entry 7
8. December 27, 2013 VISHAL receives a check # 55 from the customer who they billed (invoiced # 1000) Rs75 for services and allowed 10 days to pay.
Journal Entry 8
9. December 29, 2013 VISHAL purchased some mulch for Rs60 and received an invoice # 777 from their supplier with terms of 15 days. The mulch was used on a customer's yard.
Journal Entry 9
10. December 31, 2013 VISHAL bills (prepares an invoice # 1001) the customer Rs80 for the mulch and land his yard and receives a check for Rs80 # 555 from the customer.
Journal Entry 10

General Journal

The transactions for VISHAL are presented below in a formal General Journal. Review the entries and if you have any questions go back to Lesson 4 for detailed discussions for each of the transactions.

The reference numbers refer to General Journal, Entry Number, and Page Number. GJ-1-1 means GJ (General Journal), Page 1, and Entry 1. The Posting Reference (Post Ref.) is the General Ledger Account Number taken from our Simple Chart Of Accounts.

General Journal			Page 1		
Entry Number	Date	Account Name	Post Ref.	Debit	Credit
GJ-1-1	Dec 2, 2013	Cash	100	50	
		Land Revenue	400		50
Record customer check # 484 and revenue from land job.					
GJ-1-2	Dec 4, 2013	Inventory-Office Supplies	115	100	
		Accounts Payable	200		100
Record invoice # 983 for office supplies purchased on account.					
GJ-1-3	Dec 8, 2013	Advertising Expense	510	25	
		Cash	100		25
Record check # 900 for advertising services					
GJ-1-4	Dec 10, 2013	Land Equipment	150	10000	
		Note Payable-Bank	210		10000
Record purchase of land equipment financed by bank note.					
GJ-1-5	Dec 15, 2013	Accounts Receivable	110	75	
		Land Revenue	400		75
Invoice (# 1000) customer on account for revenue earned from land yard.					
GJ-1-6	Dec 20, 2013	Owner's Draw	310	500	
		Cash	100		500
Record owner's draw check # 901.					
GJ-1-7	Dec 22, 2013	Accounts Payable	200	100	

VISHAL

		Cash	100		100
Record check # 902 paid to supplier for office supplies charged on account (invoice # 983).					
GJ-1-8	Dec 27, 2013	Cash	100	75	
		Accounts Receivable	110		75
Record customer's check # 55 received from customer on account.					
GJ-1-9	Dec 29, 2013	Mulch Expense	520	60	
		Accounts Payable	200		60
Record mulch purchase/expense (invoice # 777) with credit terms.					
GJ-1-10	Dec 31, 2013	Cash	100	80	
		Land Revenue	400		80
Record check # 555 received from customer paying our invoice #1001 for land services.					

VISHAL's General Ledger

VISHAL's General Ledger with the transactions posted (transferred) from the General Journal follows.

Assets

Account Name: Cash			Account Number: 100		
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				5500
Dec 2		GJ-1-1	50		5550
Dec 8		GJ-1-3		25	5525
Dec 20		GJ-1-6		500	5025
Dec 22		GJ-1-7		100	4925
Dec 27		GJ-1-8	75		5000
Dec 31		GJ-1-10	80		5080

Account Name: Accounts Receivable			Account Number: 110		
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				1600
Dec 15		GJ-1-5	75		1675
Dec 27		GJ-1-8		75	1600

Account Name: Inventory-Office Supplies			Account Number: 115		
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				0
Dec 4		GJ-1-2	100		100

Account Name: Land Equipment			Account Number: 150		
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				2500
Dec 10		GJ-1-4	10000		12500

Liabilities

Account Name: Accounts Payable				Account Number: 200	
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				(2000)
Dec 4		GJ-1-2		100	(2100)
Dec 22		GJ-1-7	100		(2000)
Dec 29		GJ-1-9		60	(2060)

Account Name: Note Payable-Bank				Account Number: 210	
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				0
Dec 10		GJ-1-4		10000	(10000)

Equity

Account Name: Owner's Capital				Account Number: 300	
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				(7500)

Account Name: Owner's Draws				Account Number: 310	
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				600
Dec 20		GJ-1-6	500		1100

Revenue & Expense

Account Name: Land Revenue				Account Number: 400	
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				(1000)
Dec 2		GJ-1-1		50	(1050)
Dec 15		GJ-1-5		75	(1125)
Dec 31		GJ-1-10		80	(1205)

Account Name: Advertising Expense				Account Number: 510	
Date	Description	Post Ref.	Debit	Credit	Balance
Dec 1	Beg Bal.				200
Dec 8		GJ-1-3	25		225

Account Name: Mulch Expense				Account Number: 520	
Date	Description	Post Ref.	Debit	Credit	Balance

Dec 1	Beg Bal.				100
Dec 29		GJ-1-9	60		160

Trial Balance

A Trial Balance is a listing of all the accounts appearing in the general ledger with the dollar amount of the debit or credit balance of each. It is used to make sure the books are "in balance" -total debits and credits are equal.

A trial balance is just a worksheet that bookkeeper's and accountants prepare from the General Ledger to check that the books (General Ledger) are in balance (Debit Account Balances = Credit Account Balances).

Let's prepare our trial balance for VISHAL at the end of December.

Account	Debit Balances	Credit Balances
Asset Accounts		
Cash	5080	
Accounts Receivable	1600	
Inventory-Office Supplies	100	
Land Equipment	12500	
Liability Accounts		
Accounts Payable		2060
Note Payable-Bank		10000
Equity Accounts		
Owner's Capital		7500
Owner's Draws	1100	
Revenue Accounts		
Land Revenue		1205
Expense Accounts		
Mulch Expense	160	
Advertising Expense	225	
Totals	20765	20765

Sure enough our debit balances equal our credit balances. It was easy because we used the parentheses ( ) to denote that an account balance was a credit. Therefore, all the balances that are not enclosed in parentheses make up our Debit Balance Accounts and all the balances enclosed in parentheses make up our Credit Balance Accounts.

Remember

- Dr for Debit and Cr for Credit
- + (Plus Sign) for Debit and - (Minus Sign) for Credit
- No Bracket for Debit and < > (Brackets) for Credit
- No Parentheses for Debit and ( ) (Parentheses) for Credit

Symbol	Indicates a Debit	Indicates a Credit
Dr / Cr	Dr	Cr
+ / -	+	-
No Bracket / Bracket < >		< >
No Parentheses / Parentheses ( )		( )

Note: The plus (+) and minus (sign) are often used by accounting and bookkeeping programs to indicate debits and credits. Don't get confused and think that the plus sign means an increase or that the minus sign means a decrease. They do not. In this case, they are simply symbols that mean either a debit or a credit.

Normal Balances for the Types of Accounts

Just to keep you on your toes - do you recall what type of accounts normally have a debit or credit balance ?

- Assets, Expenses, and Draws normally have Debit Balances.
- Liabilities, Owner's Capital, and Revenue accounts normally have Credit Balances.

Need proof

Refer back to our preceding Trial Balance for VISHAL. The Trial Balance has a column for Debit Balance Accounts and a column for Credit Balance Accounts.

Sure enough, our Assets, Owner's Draws, and Expense Type of Accounts are listed in the Debit Balance Column. Likewise, our Liability, Owner's Capital, and Revenue Type of Accounts are listed in the Credit Balance Column.

How do you initially determine that an Account has a Debit or Credit Balance ? This is simply a matter of deterMining if the Account has more Debit Amounts Posted or More Credit Amounts Posted. If More Debits Than Credits have been posted to the Account, the Account will have a Debit Balance. Likewise, if More Credits Than Debits have been posted to the Account, the Account will have a Credit Balance.

You have now been introduced to some of bookkeeping and accounting's formal records, namely the General Ledger and General Journal. You could get by with just these two records, but if your business like most has many transactions instead of the few that VISHAL had you'd be spending a heck of a lot of time recording and posting. What's the solution to streamlining the recording and posting processes.

Some Special Journals a business will normally have are:

- Cash Receipts Journal
- Cash Disbursements Journal (Check Register)
- Payroll Journal
- Sales Journal
- Purchase Journal
- General Journal

All these journals are designed to record special types of business transactions and post the totals accumulated in these journals to the General Ledger periodically (usually once a month).

Instead of using just one journal to record all our business transactions we use many.

Source Documents provides the initial data about business transactions.
Journals use the information from the source documents to create a chronological listing of all business transactions and detailed information about each transaction.
General Ledger uses the information transferred from the journal(s) to summarize the data into individual accounts.
Trial Balance uses the information from the General Ledger to summarize the data to use for preparing the Financial Statements.
Financial Statements uses the summarized data contained in the Trial Balance to prepare the business's financial reports .

Reviewing a few definitions:

Financial Statements are summary accounting reports prepared periodically to inform the owner, creditors, and other interested parties as to the financial condition and operating results of the business. The four basic financial statements or reports are:

Balance Sheet- The financial statement which shows the amount and nature of business assets, liabilities, and owner's equity as of a specific point in time. It is also known as a Statement Of Financial Position or a Statement Of Financial Condition.

Income Statement- The financial statement that summarizes revenues and expenses for a specific period of time, usually a month or a year. This statement is also called a Profit and Loss Statement or an Operating Statement.

Capital Statement-The financial report that summarizes all the changes in owner's equity that occurred during a specific period.

Statement of Changes in Financial Position-The financial statement that reports the sources and uses of cash or working capital for a specific period of time, normally a year.

The Balance Sheet

A Balance Sheet is simply a picture of a business at a specific point in time, usually the end of the month or year. By analyzing and reviewing this financial statement the current financial "health" of a business can be determined. The balance sheet is derived from our accounting equation and is a formal representation of our equation

Assets = Liabilities + Owner's Equity.

If you recall, in an earlier lesson we learned that this equation is also called the Balance Sheet Equation.

The categories and format of the Balance Sheet are based on what are called Generally Accepted Accounting Principles (GAAP). These principles are the rules established so that every business prepares their financial statements the same way.

Assets

Formal Definition: The properties used in the operation or investment activities of a business.

Informal Definition: All the good stuff a business has (anything with value). The goodies.

Additional Explanation: The good stuff includes tangible and intangible stuff. Tangible stuff you can physically see and touch such as vehicles, equipment and buildings. Intangible stuff is like pieces of paper (sales invoices) representing loans to your customers where they promise to pay you later for your services or product. Examples of assets that many individuals have are cars, houses, boats, furniture, TV's, and appliances. Some examples of business type assets are cash, accounts receivable, notes receivable, inventory, land, and equipment.

Assets are listed based on how quickly they can be converted into cash which is called liquidity. In other words, they're ranked. The asset most easily converted into

cash is listed first followed by the next easiest and so on. Of course since cash is already cash it's the first asset listed.

Liabilities

Formal Definition: Claims by creditors to the property (assets) of a business until they are paid.

Informal Definition: Other's claims to the business's stuff. Amounts the business owes to others.

Additional Explanation: Usually one of a business's biggest liabilities (hopefully they are not past due) is to suppliers where they have bought goods and services and charged them. This is similar to us going out and buying a TV and charging it on our credit card. Our credit card bill is a liability. Another good personal example is a home mortgage. Very few people actually own their own home. The bank has a claim against the home which is called a mortgage. This mortgage is another example of a personal liability. Some examples of business liabilities are accounts payable, notes payable, and mortgages payable.

Liabilities are listed in the order of how soon they have to be paid. In other words, the liabilities that need to be paid first are also listed first.

Owner's Equity (Capital)

Formal Definition: The owner's rights to the property (assets) of the business; also called proprietorship and net worth.

Informal Definition: What the business owes the owner. The good stuff left for the owner assuming all liabilities (amounts owed) have been paid.

Additional Explanation: Owner's Equity represents the owner's claim to the good stuff (assets). Most people are familiar with the term equity because it is so often used with lenders wanting to loan individuals money based on their home equity. Home equity can be thought of as the amount of money an owner would receive if he/she sold their house and paid off any mortgage (loan) on the property.

Owner's equity (or net worth or capital) is increased by money or property contributed and any profits earned and decreased by owner withdrawals and losses.

All Balance Sheets contain the same categories of assets, liabilities, and owner's equity.

If you look below at our Balance Sheet for VISHAL Land you can readily see that there are three main sections, assets, liabilities, and owner's equity just like the accounting equation. The major sections of a balance sheet are the heading, the assets, the liabilities, and the owner's equity. The heading contains the name of the company, the title of the statement, and the date of the statement.

VISHAL Land
Balance Sheet

As Of December 31, 2013			
Assets		Liabilities	
Cash	Rs5,080	Accounts Payable	2,060
Accounts Receivable	1,600	Notes Payable	10,000
Office Supplies	100		
Land Equipment	12,500	Total Liabilities	12,060
		Owner's Equity	
		VISHAL Capital	7,220
Total Assets	Rs19,280	Total Liabilities & Equity	Rs19,280

This layout is called the account form. In this form the major categories are presented side by side.

Another layout sometimes used is called the report form. In this form the major categories are stacked on top of each other. An example of the report form follows.

VISHAL Land		
Balance Sheet		
As Of December 31, 2013		
Assets		
Cash	Rs5,080	
Accounts Receivable	1,600	
Office Supplies	100	
Land Equipment	12,500	
Total Assets		Rs19,280
Liabilities		
Accounts Payable	Rs2,060	
Notes Payable-Bank	10,000	
Total Liabilities		Rs12,060
Owner's Equity		
VISHAL Capital		Rs7,220
Total Liabilities & Equity		Rs19,280

The Income Statement

The Income Statement is a formal financial statement that summarizes a company's operations (revenues and expenses) for a specific period of time usually a month or year.

A fiscal year is the period used for calculating annual (yearly) financial statements. While a large number of businesses use the calendar year (January-December) as their fiscal year, a business can elect to use any other twelve month period such as June-May as their fiscal year.

The categories and format(s) of the Income Statement also follow the rules known as Generally Accepted Accounting Principles (GAAP) and contains specific revenue and expense categories.

The following types of accounts are used to prepare the Income Statement.

Revenue (Also Called Income)
Formal Definition: The gross increase in owner's equity resulting from the operations and other activities of the business.

Informal Definition: Amounts a business earns by selling services and products. Amounts billed to customers for services and/or products.

Expense (Also Called Cost)
Formal Definition: Decrease in owner's equity resulting from the cost of goods, fixed assets, and services and supplies consumed in the operations of a business.

Informal Definition: The costs of doing business. The stuff we used and had to pay for or charge to run our business.

Additional Explanation: Some examples of business expenses are office supplies, salaries & wages, advertising, building rental, and utilities.

Hopefully a business earns a profit called net income (revenues are larger than expenses). If however, expenses are larger than revenues a net loss results.

The major sections of an income statement are the heading, the revenue section, the expense section, and the final calculation of a profit or loss. The heading should contain the name of the company, the title of the statement, and the period covered by the statement.

An Income Statement is just a formal summary of "Mom Capital's "Kids" Revenue and Expense.

The Income Statement for VISHAL Land is presented below.

VISHAL Land
Income Statement
For The Period Ending December 31, 2013

Revenue from operations		Rs1,205
Expenses		
Advertising Expense	Rs225	
Mulch Expense	160	
Total Expenses		Rs385
Net Income		Rs820

Note: In the real world an income statement would have many more expense categories than the two types illustrated in our simple example. Some additional expenses that would normally be included are:

- Office Supplies Used
- Telephone
- Building/Office Rent
- Utilities
- Depreciation Expense
- Maintenance and Repairs
- Interest Expense
- Memberships
- Donations
- Bank Fees and Charges
- Salaries & Wages
- Employment Taxes
- Equipment Rental
- Contract Labor
- Professional Fees
- Travel
- Entertainment
- Any other type that your business incurs

Our Income Statement or what is sometimes also referred to as a Profit and Loss Statement was prepared for a service type of business. Businesses that are retailers, wholesalers, or manufacturers that sell products have a special section included in their income statement called Cost Of Goods Sold. This section computes the Cost Of The Goods Sold that were either purchased and sold or manufactured and sold. In retailing and wholesaling, computing the cost of goods sold during the accounting period involves beginning and ending inventories. In manufacturing it involves finished-goods inventories, raw materials inventories and goods-in-process inventories.

The Capital Statement

The next financial statement, the capital statement, is prepared to report all the changes in owner's equity that occurred over a period of time usually a month or year. The major sections of the statement are the heading, the owner's capital

balance at the beginning of the period, the increases and decreases during the period , and the calculated ending balance.

What do you think affects "Mom" (Owner's Equity) ? Of course her "kids" (revenue, expense, and draws) and any capital contributed to the business by the owner. We learned earlier that the activities of the "kids" revenue and expense are summarized in the Income Statement. This net income or loss is presented on a line in the Capital Statement. All the owner withdrawals (kid draws) is also presented on a line in the statement.

The capital statement serves as the bridge between the income statement and balance sheet. It uses the net income/loss from the income statement in addition to the owner's investments and withdrawal to determine the Owner's Capital balance shown on the balance sheet.

Let's illustrate this statement with a simple equation.
Ending Owner's Equity = Beginning Equity + Additional Capital Contributed + Profit or - Loss - Draws

VISHAL Land		
Capital Statement		
For The Period Ending December 31, 2013		
Capital Beginning		Rs7500
Capital Contributed	0	
Net Income	820	
Less withdrawals	1,100	
Decrease in capital		280
Ending Capital		Rs7,220

The Balance Sheet, Income Statement, and Capital Statement

If you compare the owner's equity (owner's claim to assets) for two year end balance sheets, the difference (increase or decrease) is explained by the Income Statement and Capital Statement. Remember, revenues increase equity; capital contributed to the business increases equity; expenses decrease equity; and owner's draws decrease equity.

Statement Of Changes in Financial Position

The last financial statement, the statement of changes in financial position, is prepared to report all the changes in cash or working capital that occurred over a period of time usually a month or year.

The working capital form of the statement explains the increase or decrease in working capital for a period.
Note: Working capital is the difference between current assets and current liabilities (Working Capital = Current Assets - Current Liabilities).

As you might expect, the cash form of the statement explains the increase or decrease in cash for a period. The statement is often called the Sources and Uses of Cash Statement when cash is used as the basis for preparing the statement.

Since more and more of the accounting regulatory agencies are promoting using cash instead of working capital as the basis for preparing this statement, our example statement will also use cash.

The major sections of the statement are the heading, a section for reporting the increases in cash (resources provided by), a section for reporting the decreases in cash (resources applied to), and a summary of the change in cash (increase/decrease) for the period.

If the business was in operation in the previous year, the prior year balance sheet along with the current year balance sheet and current year income statement is needed in order to prepare the statement. Additional analysis of some of the accounts may also be needed.

Our example assumes that VISHAL Land's prior year balance sheet is as follows:

VISHAL Land		
Balance Sheet		
As Of December 31, 2013 (Prior Year)		
Assets		
Cash	Rs6,400	
Accounts Receivable	600	
Land Equipment	2,500	
Total Assets		Rs9,500
Liabilities		
Accounts Payable	Rs2,000	
Total Liabilities		Rs2,000
Owner's Equity		
VISHAL Capital		Rs7,500
Total Liabilities & Equity		Rs9,500

Using the above prior year balance sheet along with the current year balance sheet and income statement we prepared the following Statement Of Changes in Financial Position:

Summary of how to prepare the statement:

- The first step is deterMining the cash provided or used by operations and begins with the operating income for the period.
- Adjustments are made to the income for revenue or expenses items that did not provide or use cash.
- Additional adjustments are made for all current and noncurrent accounts and are recorded as addition or subtractions depending upon their effect on cash based on their beginning of the year and end of the year balances.

VISHAL Land				
Statement Of Changes in Financial Position (Cash)				
As Of December 31, 2013 (Current Year)				
Sources of cash:				
Financing from bank loan			Rs10,0000	
Total sources				Rs10,000
Uses of cash:				
Income from operations	Rs820			
Add:				
Increase in accounts payable	60	Rs880		
Deduct:				
Increase in supplies inventory	100			
Increase in accounts receivable	1000	1,100		
Cash used by operations			220	
Payment of owner's draws			1,100	
Acquisition of equipment			10,000	
Total uses				11,320
Decrease in cash				Rs1,320

Change in cash balance:	
Cash balance, December 31, 2013 (Current Year)	Rs5,080
Cash balance, December 31, 2013 (Prior Year)	6,400
Decrease in cash	Rs1,320

Notes To The Financial Statements

Notes to the financial statements are an integral part of the statements and are required by Generally Accepted Accounting Principles. Notes to financial statements, sometimes referred to as footnotes, are used to provide additional information about a business's financial condition and methods used at arriving at the amounts presented in the financial statements.

The Information used to prepare these formal financial statements

Once you have a Trial Balance it's simply a matter of transferring the amounts from the Trial Balance to use to prepare the Balance Sheet, Income Statement, and Capital Financial Statements. Add in the prior year's balance sheet and you have the information needed for preparing the Statement of Changes in Financial Position (cash).

VISHAL Land's Trial Balance at the end of December

Account	Debit Balances	Credit Balances	Account Type
Asset Accounts			
Cash	5080		Balance Sheet
Accounts Receivable	1600		Balance Sheet
Inventory-Office Supplies	100		Balance Sheet
Land Equipment	12500		Balance Sheet
Liability Accounts			
Accounts Payable		2060	Balance Sheet
Note Payable-Bank		10000	Balance Sheet
Equity Accounts			
Owner's Capital		7500	Balance Sheet
Owner's Draws	1100		Balance Sheet
Revenue Accounts			
Land Revenue		1205	Income

			Statement
Expense Accounts			
Mulch Expense	160		Income Statement
Advertising Expense	225		Income Statement
Totals	20765	20765	

It should be apparent that by having the information from the General Ledger and the Trial Balance one can readily prepare the Balance Sheet, Income Statement, and Capital financial statements.

The Trial Balance/Worksheet normally contains additional columns for adjusting and closing entries. Briefly, closing entries transfer (close) the balances in the General Ledger's individual revenue, expense, and drawing account(s) to the owner's capital account at the end of a period (usually year end) which results in the same General Ledger Capital Account ending balance as contained in the Capital Statement. This Ending Capital balance becomes the new Beginning Capital Balance for the new year. All the revenues, expense, and drawing account balances are reset to zero so that their balances will only represent transaction amounts (increases and decreases to owner's equity) in the new year.