Accounting

Basics

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Bookkeeping basics

The Accounting Equation

All accounting entries in the books of account for an organisation have a relationship based on the 'accounting equation':

Assets = Liabilities + Owner's equity

Assets

Assets are tangible and intangible items of value which the business owns. Examples of assets are:

- Cash
- Cars
- Buildings
- Machinery
- Furniture
- Debtors (money owed from customers)
- Stock / Inventory

Liabilities

Liabilities are those items which are owed by the business to bodies outside of the business. Examples of liabilities are:

- Loans to banks
- Creditors (money owed to suppliers)
- Bank overdrafts

Owner's Equity

The simplest way to understand the accounting equation is to understand what makes up 'owner's equity'.

By rearranging the accounting equation you can see that Owner's Equity is made up of Assets and Liabilities.

Owner's Equity = Total Assets* less *Total Liabilities

Owner's Equity can also be expressed as:

Owner's Equity = Capital invested by owner + Profits (Losses) to date
(also known as 'Retained Earnings')

Rearranging the equation again, therefore:

Total Assets - Total Liabilities = Capital + Retained Earnings

The Balance Sheet

The balance sheet shows a snapshot of the business's net worth at a given point in time. Below is a basic balance sheet. Have a look at how it displays the elements of the accounting equation:

Balance Sheet example

Assets			$
	Current Assets		
		Stock	X
		Debtors	X
		Bank	X
		Cash	X
	Fixed Assets		
		Buildings	X
		Vehicles	X
Total Assets			XX
Liabilities			
	Current Liabilities		
		Overdraft	X
		Creditors	X
	Long-term Liabilities		
		Bank Loan	X
Total Liabilities			XX
Total Assets less Total Liabilities			ZZ
Owner's Capital			Y
Retained Earnings			Y
Owner's Equity			ZZ

The accounting equation establishes the basis of Double Entry Bookkeeping.

Profit and Loss account

Whereas the balance sheet shows a snapshot at a point in time of the net worth of the business, the profit and loss account shows the current financial year's net operating profits, broken down into various sales, cost of sales and expenses ledger accounts.

Profit and Loss account example

Sales		$
	Books	X
	CD's	X
	Magazines	X
Total Sales		XX
Cost of Sales		
	Purchases of Books	X
	Purchases of CDs	X
	Purchases of Magazines	X
Total Cost of Sales		XX
Gross Profit (Sales – Cost of Sales)		YY
Expenses		
	Advertising	X
	Marketing	X
	Salaries & Wages	X
	Electricity	X
Total Expenses		XX
Net Profit (Gross profit – Expenses)		ZZ

Sales

Sales accounts show all sales made in the period, regardless of whether or not money has been received yet, and are shown as a credit in the Profit and Loss accounts. Where money has not yet been received, the debit is not to cash (as per the CD example above), but to a Debtors account (money owed from customer account).

Cost of Sales

Cost of Sales are expenses that can be directly attributed to sales items, such as purchases of stocks.

Expenses

These are all other expenses (other than purchases of assets) which cannot be attributed directly to sales items, such as rent, electricity or advertising.

Double Entry Bookkeeping

All accounting transactions are made up of 2 entries in the accounts: a debit and a credit.

For example, if you purchased a book, your value of books would increase, but your value of cash would decrease by the same value, at the same time. This is double entry bookkeeping.

Ledger Accounts

A ledger account is an item in either the Profit & Loss account (which we'll discuss shortly) or the balance sheet. A Ledger account is either a:

- Asset
- Liability
- Equity
- Income
- Expense

The example of purchasing a book, mentioned above, can be shown in the form of ledger "T" accounts as follows:

"Dr" is short for Debit

"Cr" is short for Credit

Purchases - Books

Dr	Cr
Cash $20	

Cash

Dr	Cr
	Books $20

If all transactions are entered into the books in this way, then the sum of all of the debits would equal the sum of all of the credits.

Trial Balance

A trial balance is a list of all of the ledger accounts of a business and the balance of each. Debits are shown as positive numbers and credits as negative numbers. The trial balance should therefore always equal zero

Following on from the previous example, if we were to sell a CD for $25 cash then the ledger accounts and trial balance would look like this:

Purchases - Books

Dr	Cr
Cash $20	

Sales - CDs

Dr	Cr
	Cash $25

Cash

Dr	Cr
Sales - CDs $25	Books $20

Trial Balance example

	$
Purchases - Books	20
Sales - CDs	(25)
Cash ($25 - $20)	5
Total	**0**

Cash v Credit transactions

Some sales and purchases will be sold or bought on credit, others for immediate payment, either by cash, credit card or EFTPOS. Sales and purchases on credit will involve entries to the Debtors and Creditors accounts on the balance sheet.

Debtors

This account on the balance sheet displays any amounts owed to the business by it's customers i.e. the business has sold to them on credit, and the customer has a period of time to pay for the goods or services. Whenever a credit sales transaction is entered in MYOB the credit goes to an income account and the debit goes to Debtors (Receivables). When the customer makes a payment, the credit goes to Debtors, giving a net effect of zero in that account, and the debit goes to Cash.

Creditors

This account on the balance sheet displays any amounts owed by the business to it's suppliers i.e. the business has purchased goods or services on credit, and has a period of time to pay for those goods or services. Whenever a credit puchases transaction is entered in MYOB the debit goes to an expense account and the credit goes to Creditors (Payables). When a payment is made to the supplier, the debit goes to Creditors, giving a net effect of zero in that account, and the credit goes to Cash.