Accounting 101

This quick reference is for those who are new to accounting and need an introduction to some of its fundamental concepts.

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Accounting methods



Cash-basis accounting

In this method, transactions are recorded to the general ledger (GL) accounts at the time cash is affected, either payments or receipts.

This method reflects the transactions that have already had an effect on your bank account.

Cash-basis accounting can provide tax advantages for small businesses.



Accrual-basis accounting

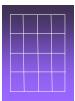
In this method, transactions are recorded to the GL accounts at the time they occur, rather than when cash is paid out or received.

This method reflects the transactions that will have an effect on your bank account in the future.

Accrual-basis accounting can provide greater visibility to business performance.



Chart of accounts



This is a grouping of accounts that are used to receive accounting transactions and provide balances for financial reporting.

Each account in the chart of accounts is assigned an account type.

The account type determines how the account's balance is increased or decreased:

Account type	Normal balance	To increase the balance, you would
Asset (what the business owns)	Debit	Debit
Liability (what the business owes)	Credit	Credit
Equity, Retained Earnings (what the business is worth)	Credit	Credit
Income (revenue) (what the business has sold; i.e., sales)	Credit	Credit
Cost (what the business spent to produce the sales; i.e., direct cost)	Debit	Debit
Expense (what the business spent not directly related to the sales; i.e., overhead cost)	Debit	Debit

When you make an entry into an accounting system, total credits and total debits always equal. These examples show how an entry affects the account balances in a cash-basis transaction and in an accrual-basis transaction:

Cash-basis transaction



Client invoice

You invoice a client \$1,000 for work completed on a project.

The account balances do not change because no cash is received, even though the revenue is earned during this accounting period.

Client receipt

The client pays you the \$1,000:

	Debit	Credit
Cash (asset) increase	\$1,000	
Labor revenue (income) increase		\$1,000

The account balances change to recognize the revenue at the time cash is received.

Accrual-basis transaction



Client invoice

You invoice a client \$1,000 for work completed on a project:

	Debit	Credit
Accounts receivable (asset) increase	\$1,000	
Labor revenue (income) increase		\$1,000

The account balances change to recognize the revenue earned during this accounting period, even though no cash is received.

Client receipt

The client pays you the \$1,000:

	Debit	Credit
Accounts receivable (asset) decrease		\$1,000
Cash (asset) increase	\$1,000	

The account balances change to reduce the accounts receivable so it is not carried over into the next accounting period.

Financial reports



Financial reports list all the accounts in your chart of accounts and their account balances. Accountants use financial reports to review their business accounts and recorded transactions. There are two main financial reports:

- Trial balance
- Ledger

Trial balance

This report lists all the accounts in the chart of accounts with the account balances.

Asset

What the business owns.

- · All accounts
- Account balances

Liability

What the business owes.

- All accounts
- Account balances

Equity, Retained Earnings

What the business is worth.

- All accounts
- Account balances

Income (revenue)

The money the business has received (cash) or billed (accrual) for its sales this period.

- All accounts
- Account balances

Cost, Expense

The costs and expenses the business has **paid** (cash) or **spent** (accrual) in this period.

- All accounts
- Account balances

Ledger

This report lists all the accounts in the chart of accounts with the account transactions and the account balances.

Asset

What the business owns.

- · All accounts
- Account balances
- Account transactions

Liability

What the business owes.

- All accounts
- Account balances
- Account transactions

Equity, Retained Earnings

What the business is worth.

- All accounts
- Account balances
- Account transactions

Income (revenue)

The money the business has **received** (cash) or **billed** (accrual) for its sales this period.

- All accounts
- Account balances
- · Account transactions

Cost, Expense

The costs and expenses the business has **paid** (cash) or **spent** (accrual) in this period.

- All accounts
- Account balances
- Account transactions

Financial statements



Financial statements interpret account balances and allow you to analyze the health of your business. Principals and managers use financial statements to make decisions that affect the operations of their business. There are two main financial statements:

- Balance sheet
- Profit and loss statement (also called an income statement)

Financial statements and the chart of accounts

Here is how these two statements relate to the chart of accounts:

Balance sheet accounts		
Asset	Liability	Equity, Retained Earnings
Bank account Accounts receivable Equipment (that you own)	Accounts payable Credit cards Client prepayments Payroll payables	Capital investment

Profit and loss statement accounts		
Income (revenue)	Cost	Expense
Labor revenue Expense revenue Consultant revenue	Direct labor (project-related) Project-related expenses	Indirect labor Payroll taxes Office expenses

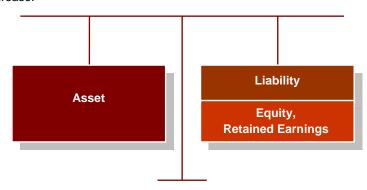
Balance sheet

The balance sheet provides a "snapshot" of your business's financial health at a particular point in time (for example, April 30, 2011).

In a balance sheet, assets equal liabilities plus equity:



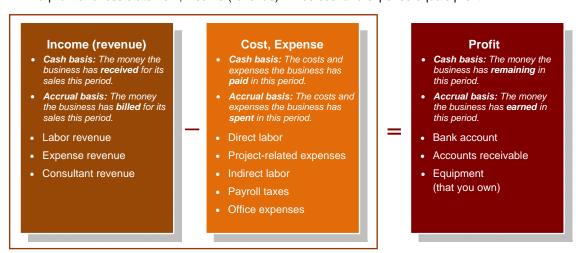
In short, they are in balance. So, if liabilities plus equity increase, assets must also increase:



Profit and loss statement

The profit and loss statement shows whether your business made or lost money during a particular time period (for example, from January 1, 2011, through March 31, 2011). The profit and loss statement displays the revenues recognized for that time period and the cost and expenses charged against those revenues.

In a profit and loss statement, income (revenue) minus cost and expense equals profit:



Reconciliation



There are two important concepts to keep in mind in regards to reconciliation:

- Reconciliation is critical to producing accurate financial statements.
- So, be sure to reconcile monthly, quarterly, and annually.
 This is important because you may reconcile accounts at the end of a quarter or year that you would not reconcile at the end of a month.

Fiscal year end



At the close of the fiscal year, balances in accounts with the account type of Income, Cost, and Expense are set to zero and the account balances are moved to the Retained Earnings account.

So, each fiscal year, the profit and loss accounts begin with zero balances and begin accumulating balances for the current year.

Balances in accounts with the account type of Asset, Liability, and Equity are not affected at the fiscal year end.

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