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:

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

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:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (asset) increase</td>
<td>$1,000</td>
</tr>
<tr>
<td>Labor revenue (income) increase</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable (asset) increase</td>
<td>$1,000</td>
</tr>
<tr>
<td>Labor revenue (income) increase</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable (asset) decrease</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cash (asset) increase</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

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.

Ledger

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

<table>
<thead>
<tr>
<th>Balance sheet accounts</th>
<th>Liability</th>
<th>Equity, Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank account</td>
<td>Accounts payable</td>
<td>Capital investment</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Credit cards</td>
<td></td>
</tr>
<tr>
<td>Equipment (that you own)</td>
<td>Client prepayments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Payroll payables</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profit and loss statement accounts</th>
<th>Cost</th>
<th>Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income (revenue)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Labor revenue</td>
<td></td>
<td>Indirect labor</td>
</tr>
<tr>
<td>Expense revenue</td>
<td></td>
<td>Payroll taxes</td>
</tr>
<tr>
<td>Consultant revenue</td>
<td></td>
<td>Office expenses</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct labor (project-related)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project-related expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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:

\[
\text{Asset} \quad \text{Liability} \quad \text{Equity, Retained Earnings}
\]

\[
\text{Asset} = \text{Liability} + \text{Equity, Retained Earnings}
\]

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

\[
\text{Asset} = \text{Liability} + \text{Equity, Retained Earnings}
\]

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:

\[
\text{Income (revenue)} - \text{Cost, Expense} = \text{Profit}
\]

\[
\text{Income (revenue)} = \text{Cash basis: The money the business has received for its sales this period.}
\]

\[
\text{Expense revenue}
\]

\[
\text{Consultant revenue}
\]

\[
\text{Cost, Expense} = \text{Cash basis: The costs and expenses the business has paid in this period.}
\]

\[
\text{Direct labor}
\]

\[
\text{Project-related expenses}
\]

\[
\text{Indirect labor}
\]

\[
\text{Payroll taxes}
\]

\[
\text{Office expenses}
\]

\[
\text{Profit} = \text{Cash basis: The money the business has remaining in this period.}
\]

\[
\text{Accrual basis: The money the business has earned in this period.}
\]

\[
\text{Bank account}
\]

\[
\text{Accounts receivable}
\]

\[
\text{Equipment (that you own)}
\]
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.