**Accounting** — the process of recording, assessing, and communicating financial transactions

— Helps individuals and organizations understand their financial health.

—Accountants do this work by keeping track of ***expenses, profits, and losses***, making use of this accounting formula.

**Basic Accounting Terms**

**Assets = Liability + Equity**

Business owners may also understand the benefit of setting up functional accounting systems, including how to use that information to make better, more profitable business decisions. A preliminary understanding of accounting may help some business owners realize the necessity or benefit of hiring professional accountants to help them with their business's finances.

**Basic Accounting Terms**

**Accounts Payable**

Accounts payable refers to the money a business owes to its suppliers, vendors, or creditors for goods or services bought on credit. A short-term debt that must be paid back quickly to avoid default, accounts payable shows up as a liability on an organization's balance sheet. An example of accounts payable includes when a restaurant receives a beverage order on credit from an outside supplier. Accounts payable acts as an IOU (**I owe you** )to another company.

### Accounts Receivable

Essentially the opposite of accounts payable, accounts receivable refers to the money owed to a business, typically by its customers, for goods or services delivered. An example of accounts receivable includes when a beverage supplier delivers a beverage order on credit to a restaurant. While the restaurant records that transaction to accounts payable, the beverage supplier records it to accounts receivable and a current asset in its balance sheet.

### Accounting Period

An accounting period refers to the span of time in which a set of financial statements are released. Businesses and investors analyze financial performance over time by comparing different accounting periods. Accounting cycles track accounting events from when the transactions first occur to when they end, all within given accounting periods. Publicly held companies must report to the Security and Exchanges Commission every three months, so they go through four accounting periods per year. Other organizations use different accounting periods, but no matter the length, accounting periods should remain consistent over time.

### Accruals

A type of record-keeping adjustment, accruals recognize businesses' expenses and revenues before exchanges of money take place. Accruals include expenses and revenues not yet recorded in companies' accounts. Accruals affect businesses' net income and must be documented before financial statements are issued. Types of accrual accounts include accrued interest, accounts receivable, and accounts payable. Companies note accrued expenses before receiving invoices for goods or services. Businesses indicate accrued revenue for goods or services for which they expect to receive payment later on.

### Accrual Basis Accounting

Accrual basis accounting deals with anticipated expenses and revenues by incorporating accounts receivable and accounts payable. In contrast, cash basis accounting focuses more on immediate expenses and revenues and does not document transactions until the company pays or receives cash. Most people find cash basis accounting easier, but it does not offer as accurate a portrayal of an organization's financial health as accrual basis accounting.

### Assets

Assets are resources with economic value which companies expect to provide future benefits. These can reduce expenses, generate cash flow, or improve sales for businesses. Companies report assets on their balance sheets. Asset types include fixed, current, liquid, and prepaid expenses. Assets may include long-term resources like buildings and equipment. Current assets include all assets a company expects to use or sell within one year. Liquid assets can easily convert to cash in a short timeframe. Prepaid expenses include advance payments for goods or services a company will use in the future.

### Balance Sheet

Balance sheets are financial statements providing snapshots of organizations' liabilities, assets, and shareholders' equity at specific moments in time. Balance sheets represent one type of financial statement used to evaluate companies' financial health and worth. Accountants use the accounting equation, also known as the balance sheet equation, to create balance sheets: "Assets = Liabilities + Equity."

### Capital

Capital refers to a person's or organization's financial assets. Capital may include funds in deposit accounts or money from financing sources. Working capital refers to a business's liquid capital, which the owner can use to pay for day-to-day or ongoing expenses. A company's working capital indicates its overall health and ability to meet financial obligations due within a year.

### Cash Basis Accounting

Cash basis accounting is an accounting method that does not incorporate transactions until the business receives or pays cash for goods and services. This method focuses on immediate revenues and expenses. Alternatively, accrual basis accounting includes future revenues and expenses, documenting accounts payable and accounts receivable.

### Cash Flow

Cash flow is the total amount of money that comes into and goes out of a business. Net cash flow refers to the sum of all money a business makes. Cash flow statements are financial statements, and they include all cash a business receives from its operations, investments, and financing.

### Chart of Accounts

An index of the financial accounts in a company's general ledger, a chart of accounts (COA) provides a snapshot of all the financial transactions a company has conducted in a specific accounting period. COAs help companies organize their finances and provide insight into organizations' financial health for investors and stakeholders. COAs can include assets, liabilities, and shareholders' equity.

### Closing the Books

Referring to when accountants used physical ledger books to track transactions, closing the books means accounting for all financial transactions within a certain period. This helps ensure the accuracy of companies' reports for given time periods, including their income statements and balance sheets. Closing the books is simple for organizations using cash basis accounting, but it's more complicated for those employing accrual basis accounting. Accountants refer to closing the books at the end of the year as year-end closing.

### Cost of Goods Sold

The total cost of producing the goods sold by a business is called cost of goods sold (COGS). COGS includes the direct costs of creating goods, including materials and labor, and it excludes indirect costs, such as distribution expenses.

### Credit

Accountants using double-entry bookkeeping systems record numbers for each business transaction in two accounts: credit and debit. Credits are accounting entries that either increase an equity or liability account or decrease an expense or asset account. Credits are made on the right side of an account. Debits must equal credits for an account to be in balance.

### Debit

The opposite of a credit, a debit is an accounting entry made on the left side of an account. Used in double-entry bookkeeping systems, debits either increase expense or asset accounts or decrease equity or liability accounts.

### Depreciation

The depreciation accounting method determines the decreasing value of a tangible asset over its lifetime. A business can make money from a depreciating asset by expensing or deducting part of the asset each year it is in use, for accounting and tax purposes. The Internal Revenue Service (IRS) requires companies to spread out the cost of depreciating assets over time.

### Diversification

A risk management strategy, diversification mixes many different investments and assets in one portfolio, allowing individuals or businesses to spread out risk and protect themselves from financial ruin if any investments or assets fail. Many financial experts think diversified portfolios boast better performance in the long term, but short-term growth may prove slower.

### Dividends

Dividends consist of company earnings, or profit, which a business pays to its shareholders as a reward for their investment in its equity. Companies may distribute dividends as cash or additional shares of stock. Shareholders may receive regularly scheduled or special one-time dividends. Exchange-traded funds and mutual funds also pay dividends.

### Double-Entry Bookkeeping

A type of bookkeeping system that keeps the accounting equation ("Assets = Liabilities + Equity") in balance, double-entry bookkeeping requires every entry to an account to have an opposite, corresponding entry in another account. Every transaction impacts at least two accounts in double-entry bookkeeping, including liability, asset, revenue, equity, or expense accounts. Credits and debits make up the two types of entries, with credits entered on the left side and debits entered on the right. A much more simplified system, single-entry bookkeeping records only one entry per transaction.

### Expenses

Expenses refer to costs of conducting business. Companies can deduct some eligible expenses from their taxes. Types of expenses include fixed, variable, accrued, and operation expenses. Fixed expenses do not change from month to month, including rent, salaries, and insurance payments. Variable expenses do change monthly, and they may include discretionary or unpredictable but necessary costs. Accountants recognize accrued expenses when companies incur them, not when companies pay for them. Primarily necessary and unavoidable, businesses incur operating expenses (often abbreviated as OPEX), like rent, marketing, and payroll, through their normal operations. The IRS allows companies to deduct operating expenses.

### Equity

Equity, often called stockholders' equity or owners' equity, is the amount of money left over and returned to shareholders after a business sells all assets and pays off all debt, represented by the equation "Equity = Assets - Liabilities." An indicator of a company's financial health, equity can consist of both tangible (buildings, cash, land) and intangible (copyrights, patents, brand recognition) assets. It exists as a record on a company's balance sheet. Sole proprietorships only use the term owners' equity, because there are no shareholders.

### Fixed Cost

A type of expense, fixed costs do not change from month to month. Fixed costs include things like payroll, rent, and insurance payments. Variable costs, on the other hand, change each month and may include discretionary spending or unpredictable expenses.

### General Ledger

Accountants use a general ledger to record financial transactions and data for companies. Employed by companies that use double-entry bookkeeping, general ledgers include debit and credit account records. Companies use the information in their general ledgers to prepare financial reports and understand their financial performance and health over time.

### Generally Accepted Accounting Principles

[Generally accepted accounting principles (GAAP)](https://www.accounting.com/resources/gaap/) refer to a group of major accounting rules, standards, and ways of reporting financial information. The Financial Accounting Standards Board sets GAAP. Using GAAP can improve the consistency and transparency of financial reporting across organizations. The U.S. Securities and Exchange Commission requires publicly traded companies to use GAAP. Internationally, most countries use the International Financial Reporting Standards. [Guide to GAAP](https://www.accounting.com/resources/gaap/)

### Gross Profit

Gross profit, also called gross income or sales profit, is the profit businesses make after subtracting the costs related to supplying their services or making and selling their products. Accountants calculate gross profit by subtracting the cost of goods sold from revenue. Gross profit considers variable costs, not fixed costs. Analysts can look at gross profit as indicative of a company's efficiency at delivering services or producing goods.

### Gross Margin

Gross margin refers to businesses' net sales revenue after subtracting the costs of goods sold. It represents the revenue companies keep as gross profit. An indicator of financial health, higher gross margins typically mean that a company can make more profit on its sales. Lower gross margins may mean a business needs to reduce production costs. The formula for gross margin is "Gross Margin = Net Sales - Cost of Goods Sold."

### Income Statement

Also known as statements of revenue and expense or profit and loss statements, income statements provide information about businesses' expenses and revenue in specific periods of time. Along with balance sheets and statements of cash flows, income statements offer insight into companies' financial health.

### Inventory

Inventory refers to a company's goods and raw materials used for making the goods it sells. It appears on a balance sheet as an asset. Inventory includes finished goods, raw materials, and works-in-progress. Generally, companies should avoid holding large amounts of inventory for long periods of time, due to the risk of obsolescence and storage costs.

### Journal Entry

A journal entry refers to a business transaction recorded in a business's general ledger. A journal entry may include the journal entry date and number, account name and number, debit, and credit. The recorder may also include a description or miscellaneous information about the entry.

### Liabilities

A liability is when someone owes someone else money. Someone can fulfill the obligation of settling a liability through the transfer of money, services, or goods. Types of liabilities can include loans, mortgages, accounts payable, and accrued expenses. Short-term liabilities conclude in less than a year, while businesses may expect long-term liabilities to take longer than a year to resolve.

### Liquidity

Liquidity relates to how easily an individual or business can convert an asset to cash for its full market value. The most liquid asset, cash, can easily and quickly convert to other assets. Accounting liquidity measures how easily someone can pay for things using liquid assets. Market liquidity refers to how easily a market (such as a housing market or stock market) facilitates the transparent buying and selling of assets at stable prices.

### Net Income

Also called net earnings or net profit, net income is the amount an individual or business earns after subtracting deductions and taxes from gross income. To calculate the net income of a business, subtract all expenses and costs from revenue. Sometimes called the bottom line in business, net income appears as the last item in an income statement. Investors and shareholders look at net income to assess companies' financial health and determine businesses' loan eligibility.

### On Credit

On credit, also called on account, is an agreement for an individual or company to pay for a good or service at a later date. Using credit cards is one way of buying on credit.

### Overhead

Overhead refers to the ongoing costs of doing business, other than those related to directly creating a good or service. Companies must understand the cost of overhead to figure out how much they need to charge for their goods or services and make a profit. Income statements include information about overhead expenses.

### Payroll

Human resources and accounting departments typically handle payroll, the total compensation a company pays its employees for a specific time period. Determining payroll includes keeping track of hours worked, distributing payments, and separating out money for Social Security and Medicare taxes.

### Present Value

Money today is typically assumed to be worth more than the same amount of money received in the future. This is due to the assumed rate of return and inflation. Present value is the current value of money in the future, with a specific assumed interest rate that could accrue over that period of time.

### Profit and Loss Statement

A profit and loss statement, also called an income statement, shows the expenses, costs and revenues for a company during a specific time period. This financial statement, along with the cash flow statement and the balance sheet, provides information about a business's financial health and ability to generate profit.

### Receipts

Receipts are written notices acknowledging that one party received something of value from another. An acknowledgement of ownership, receipts are proof of a financial transaction. The IRS requires small businesses to hold onto some receipts to document tax deductible expenses.

### Retained Earnings

Retained earnings, also called an earnings surplus, refers to the amount of net income left for a business to use after paying dividends to its shareholders. A company's management typically decides whether to keep the earnings or give them to shareholders.

### Return on Investment

Return on investment (ROI) measures the efficiency of an investment, including the amount of return on an investment relative to its cost. Accountants can also use ROI to compare the efficiency of more than one investment. To calculate ROI, subtract the cost of investment from the current value of investment, and divide that by the cost of the investment. A popular metric, ROI helps investors choose the best investment opportunities.

### Revenue

Revenue, also called sales, is the gross income a business makes through normal business operations. To calculate sales revenue, multiply sales price by number of units sold. Accrual accounting and cash accounting methods calculate revenue differently. When using the accrual accounting method to calculate revenue, accountants include sales made on credit. Those who use the cash accounting method only count sales as revenue once the business receives payment.

### Single-Entry Bookkeeping

Single-entry bookkeeping is a type of accounting system that records the financial transactions of a business. The system uses one entry per transaction to record cash, taxable income, and tax-deductible expenses going in or out of the business. Businesses can use accounting software or even simple tables to perform single-entry bookkeeping. Single-entry bookkeeping is much simpler than double-entry bookkeeping, which requires two entries per transaction.

### Trial Balance

A periodical bookkeeping worksheet, a trial balance compiles the balance of ledgers into credit and debit columns that equal each other. Companies create trial balances to ensure the mathematical accuracy of their bookkeeping systems entries.

### Variable Cost

Variable cost refers to expenses that change depending on the level of a business's production. Variable costs go up when production increases and down when production decreases. In contrast to variable cost, fixed cost refers to expenses for a company that stay the same, regardless of production. Fixed costs may include insurance, rent, and interest payments.