Fundamentals of Accounting-Part 2

ACCOUTING -**What are debits and credits?**

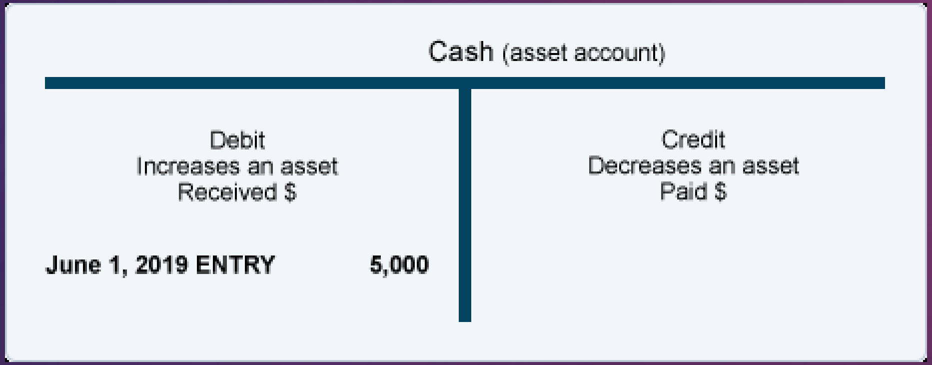
- Debits and credits are terms used by bookkeepers and accountants when recording transactions in the accounting records. The amount in every transaction must be entered in one account as a debit (left side of the account) and in another account as a credit (right side of the account). This double-entry system provides accuracy in the accounting records and financial statements. The initial challenge is understanding which account will have the debit entry and which account will have the credit entry. Before we explain and illustrate the debits and credits in accounting and bookkeeping, we will discuss the accounts in which the debits and credits will be entered or posted.
- After you have identified the two or more accounts involved in a business transaction, you must debit at least one account and credit at least one account. To debit an account means to enter an amount on the left side of the account. To credit an account means to enter an amount on the right side of an account.

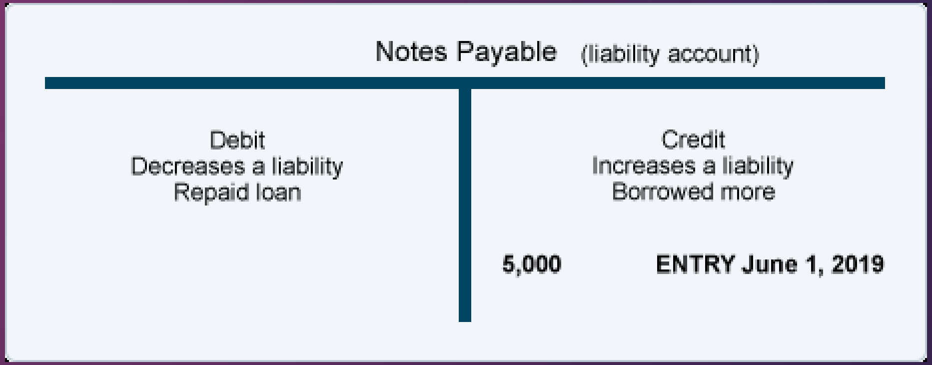
ACCOUTING -**What are debits and credits?**

- Generally these types of accounts are *increased* with a debit:
- **D**ividends (Draws)
  Expenses
  Assets
  Losses
- You might think of **D - E - A - L** when recalling the accounts that are *increased* with a debit.
- Generally the following types of accounts are *increased* with a credit:
- **G**ains
  Income
  Revenues
  Liabilities
  Stockholders' (Owner's) Equity
- You might think of **G - I - R - L - S** when recalling the accounts that are *increased* with a credit.
- To *decrease* an account you do the opposite of what was done to increase the account. For example, an asset account is increased with a debit. Therefore it is *decreased* with a credit.
- The abbreviation for debit is dr. and the abbreviation for credit is cr.

T-accounts

- Accountants and bookkeepers often use T-accounts as a visual aid to see the effect of a transaction or journal entry on the two (or more) accounts involved. On June 1, 2019 a company borrows $5,000 from its bank. As a result, the company's asset Cash must be increased by $5,000 and its liability Notes Payable must be increased by $5,000. To increase the asset Cash the account needs to be debited. To increase the company's liability Notes Payable this account needs to be credited. After entering the debits and credits the T-accounts look like this:





Journal entries

- Another way to visualize business transactions is to write a general journal entry. Each general journal entry lists the date, the account title(s) to be debited and the corresponding amount(s) followed by the account title(s) to be credited and the corresponding amount(s). The accounts to be credited are indented. Let's illustrate the general journal entries for the two transactions that were shown in the T-accounts above.

Date	Account Name	Debit	Credit
June 1, 2019	Cash	5,000	
	Notes Payable		5,000

SUMMARIZATION

- Debit means left.
- Credit means right.
- Every transaction affects two accounts or more.
- At least one account will be debited and at least one account will be credited.
- The total of the amount(s) entered as debits must equal the total of the amount(s) entered as credits.
- When cash is received, debit Cash.
- When cash is paid out, credit Cash.
- To increase an asset, debit the asset account.
- To increase a liability, credit the liability account.
- To increase owner's equity, credit an owner's equity account.
- To increase revenues, credit the revenues account

What Is An Account?

To keep a company's financial data organized, accountants developed a system that sorts transactions into records called accounts. When a company's accounting system is set up, the accounts most likely to be affected by the company's transactions are identified and listed out. This list is referred to as the company's chart of accounts. Depending on the size of a company and the complexity of its business operations, the chart of accounts may list as few as thirty accounts or as many as thousands. A company has the flexibility of tailoring its chart of accounts to best meet its needs.

1. Assets- Things that are resources owned by a company and which have future economic value that can be measured and can be expressed in dollars. Examples include cash, investments, accounts receivable, inventory, supplies, land, buildings, equipment, and vehicles. Assets are reported on the balance sheet usually at cost or lower. Assets are also part of the accounting equation: Assets = Liabilities + Owner's (Stockholders') Equity. Some valuable items that cannot be measured and expressed in dollars include the company's outstanding reputation, its customer base, the value of successful consumer brands, and its management team. As a result these items are not reported among the assets appearing on the balance sheet.

2. Liability-Obligations of a company or organization. Amounts owed to lenders and suppliers. Liabilities often have the word "payable" in the account title. Liabilities also include amounts received in advance for a future sale or for a future service to be performed.

What Is An Account?

3. Owner's equity- The book value of a company equal to the recorded amounts of assets minus the recorded amounts of liabilities.

4. Revenues/ Income- Fees earned from providing services and the amounts of merchandise sold. Under the accrual basis of accounting, revenues are recorded at the time of delivering the service or the merchandise, even if cash is not received at the time of delivery. Often the term income is used instead of revenues. Examples of revenue accounts include: Sales, Service Revenues, Fees Earned, Interest Revenue, Interest Income. Revenue accounts are credited when services are performed/billed and therefore will usually have credit balances. At the time that a revenue account is credited, the account debited might be Cash, Accounts Receivable, or Unearned Revenue depending if cash was received at the time of the service, if the customer was billed at the time of the service and will pay later, or if the customer had paid in advance of the service being performed. If the revenues earned are a main activity of the business, they are considered to be operating revenues. If the revenues come from a secondary activity, they are considered to be non-operating revenues. For example, interest earned by a manufacturer on its investments is a nonoperating revenue. Interest earned by a bank is considered to be part of operating revenues.

5. Expenses- Costs that are matched with revenues on the income statement. For example, Cost of Goods Sold is an expense caused by Sales. Insurance Expense, Wages Expense, Advertising Expense, Interest Expense are expenses matched with the period of time in the heading of the income statement. Under the accrual basis of accounting, the matching is NOT based on the date that the expenses are paid. Expenses associated with the main activity of the business are referred to as operating expenses. Expenses associated with a peripheral activity are nonoperating or other expenses. For example, a retailer's interest expense is a nonoperating expense. Generally, expenses are debited to a specific expense account and the normal balance of an expense account is a debit balance. When an expense account is debited, the account credited might be Cash (if cash was paid at the time of the expense), Accounts Payable (if cash will be paid after the expense is recorded), or Prepaid Expense (if cash was paid before the expense was recorded.)

What is an account

6. Gains- Gains result from the sale of an asset (other than inventory). A gain is measured by the proceeds from the sale minus the amount shown on the company's books. Since the gain is outside of the main activity of a business, it is reported as a non-operating or other revenue on the company's income statement.

7. Losses- Losses result from the sale of an asset (other than inventory) for less than the amount shown on the company's books. Since the loss is outside of the main activity of a business, it is reported as a non-operating or other loss.

Double entry system

- Because every business transaction affects at least two accounts, our accounting system is known as a double-entry system.
- For example, when a company borrows $1,000 from a bank, the transaction will affect the company's Cash account and the company's Notes Payable account. When the company repays the bank loan, the Cash account and the Notes Payable account are also involved.
- If a company buys supplies for cash, its Supplies account and its Cash account will be affected. If the company buys supplies on credit, the accounts involved are Supplies and Accounts Payable.
- If a company pays the rent for the current month, Rent Expense and Cash are the two accounts involved. If a company provides a service and gives the client 30 days in which to pay, the company's Service Revenues account and Accounts Receivable are affected.
- Although the system is referred to as double-entry, a transaction may involve more than two accounts.

THE ACCOUNTING EQUATION

- From the large, multi-national corporation down to the corner beauty salon, every business transaction will have an effect on a company's financial position. The financial position of a company is measured by the following items:
  - Assets (what it owns)
  - Liabilities (what it owes to others)
  - Owner's Equity (the difference between assets and liabilities)
- The **accounting equation** (or basic accounting equation) offers us a simple way to understand how these three amounts relate to each other. The accounting equation for a sole proprietorship is:

Assets = Liabilities + Owner's Equity

- The accounting equation for a corporation is:

Assets = Liabilities + Stockholders' Equity

THE ACCOUNTING EQUATION

- Assets are a company's resources—things the company owns. Examples of assets include cash, accounts receivable, inventory, prepaid insurance, investments, land, buildings, equipment, and goodwill. From the accounting equation, we see that the amount of assets must equal the combined amount of liabilities plus owner's (or stockholders') equity.
- Liabilities are a company's obligations—amounts the company owes. Examples of liabilities include notes or loans payable, accounts payable, salaries and wages payable, interest payable, and income taxes payable (if the company is a regular corporation).
- If a company keeps accurate records, the accounting equation will always be "in balance," meaning the left side should always equal the right side. The balance is maintained because every business transaction affects at least two of a company's accounts. For example, when a company borrows money from a bank, the company's assets will increase and its liabilities will increase by the same amount. When a company purchases inventory for cash, one asset will increase and one asset will decrease. Because there are two or more accounts affected by every transaction, the accounting system is referred to as double-entry accounting.