EasyPC Training

Accounting Basics

Contents

Accounting Basics

This booklet is designed to give the reader an overview of general bookkeeping practices and accounting terminology, in preparation for EasyPC Training's MYOB accounting or manual bookkeeping courses.

As you read through, please note that words or phrases underlined appear in a glossary at the back of the booklet

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 '<u>Retained Earnings</u>')*

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

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.

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

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

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		
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.

Reporting Period & Conversion Period

The reporting period is usually a 12 month period ending 30 June each year. At the end of each financial year the profit and loss account balance is transferred to the Retained Earnings account in the Balance Sheet (under Equity). A new profit and loss account is started for the new financial year

The Balance sheet is continuous, the Profit and Loss account is just for the current financial year

The conversion period is the month in which you transfer over to a new accounting system. If you are transferring to a new accounting system at the beginning of a financial year, the final balance in the profit and loss account would be transferred to the new system (retained earnings account) along with all of the current balance sheet account balances.

Conversion partway through year

If you are transferring your accounts partway through a year, all of the individual Profit and Loss account balances must be individually transferred to the new system as opening balances so that all of the current year's financial data is stored. The individual balances on the balance sheet are transferred as normal.

Other conversion issues

Only the balances of accounts will usually be transferred to the new system. Generally a business would not re-input all of their individual transactions, such as invoices, receipts, payments etc. This means that there are likely to be cut-over issues.

For example you may have written a cheque to a supplier but as at the cut-over date the supplier has not cashed the cheque. Even though the bank would have been credited and the supplier's account would be correct, this cheque would be outstanding, and the new accounting system e.g. MYOB, would not have a record of the outstanding cheque to enable a reconciliation of the bank account. This issue is covered in the course "Getting started with MYOB accounting software".

Other similar cut-over issues would include:

- Monies received but not yet cleared through the bank
- Supplier invoices not yet paid
- Customer receipts not yet received

We hope you have found this brief introduction useful. If you would like more information on EasyPC Training's range of courses or consultancy services, please contact us at:

PO Box 154, Northgate, QLD 4013 web: www.easypctraining.com.au

e-mail: **info@easypctraining.com.au**

Glossary

• **Accounting Equation**	All accounting entries made in the books of account of a business have a relationship based on the accounting equation: Assets = Liabilities + Owner's Equity
• **Asset**	Tangible or intangible items of value owned by a business e.g. cash, stock, buildings & vehicles
• **Balance Sheet**	Shows a snapshot at a given point in time of the net worth of the business. It details the assets, liabilities and owner's equity
• **Capital**	Amount invested in the business (usually at start up, but may include additional funds raised)
• **Conversion Period**	The period (month) in which the accounts are being converted, or transferred over, from one system to another
• **Cost of Sales**	Expenses in the financial year which can be directly attributed to sales of those goods or services
• **Credit**	Revenue in the Profit and Loss or Liability in the Balance sheet
• **Creditor**	Amount owed to a supplier from the business
• **Current Asset**	Short-term asset (items or amounts to be used or received within 12 months) e.g. stock or cash
• **Current Liability**	Short-term liability (items or amounts to be paid within 12 months) e.g. supplier or bank overdraft
• **Debit**	Expenses in the Profit and Loss or Asset in the Balance sheet
• **Debtor**	Amount owed to the business from a customer
• **Double Entry Bookkeeping**	System of bookkeeping where all transaction have 2 entries, a debit and a credit, which net to zero.
• **Expense**	Amount relating to expenditure for the financial year (excluding purchases of assets or cost of sales) regardless of whether cash has been paid or not
• **Fixed Asset**	Long-term asset (items or amounts to be used or

received after 12 months) e.g. building or vehicle

- **Gross Profit** Sales less Cost of Sales
- **Income** Amount of sales made in the current financial year, regardless of whether cash has been received or not
- **Ledger Account** An account containing transaction data relating to a specific type of item, whether in the Profit and Loss or Balance sheet. The full list of ledger accounts for a business is called the business's Chart of Accounts
- **Liability** Amounts owed to entities outside of the business e.g. bank loan, supplier payments & overdrafts
- **Long-term Liability** Long-term liability (items or amounts to be paid after 12 months) e.g. bank loan
- **Net Profit** Gross Profit less Expenses. Amount to be carried over to retained earnings at the end of each financial year
- **Owner's Equity** Net worth of the business to the owner
- **Reporting Period** The 12 month period which the business runs / reports to in a normal year (period may be shorter in start and end years). Normally 1July to 30 June
- **Retained Earnings** Total profits and/or losses from start of business, to date
- **Trial Balance** A list of all the business's account balances which should net to zero i.e. should 'balance'