Accounting

f you're like most people out there, just hearing the word "accounting" probably sends your brain off to sleep. You probably think accounting is hard. And boring. And for old people.

Well, the good news is, that's not entirely true. Accounting can actually be extremely interesting. In fact, a large part of accounting is basically learning about how to make more money. And most people find making money a lot of fun J.

What is Accounting?

Accounting can be defined as the production of financial information.

What this means is accounting allows us to see things like how much money you are earning, how much you are worth, how much money you spend and where you can improve to make even more money! The reason we need to know this is so we can make **decisions.**

In this Tutorial, we will Learn

- Accouting Scenario Example
- Assets and Liabilities
- Accounting Equation
- Revenue, Expense and Drawing
- Introducing The Complete Accounting Equation
- Basic Accounting Transactions
- Journal Entry
- Ledger
- Calculate Depreciation
- How to prepare Trial balance
- Profit and Loss Statement
- Balance Sheet
- Cash Flow

Consider this scenario:

You run a bakery and you bake the best cream cake in the country. It is world famous and you receive orders for your legendary cake from every continent!

However, one night a fanatic customer who believes you have a magic oven breaks into your bakery and steals it. You go ballistic.

You need $10,000 to buy a new oven. You decide to go to the bank and ask for a loan.

You ask the bank for a $10,000 loan. The thing is, you don't even have an accountant, so you do not have any **financial information** about your bakery.

The loan officer is a pretty lady named Anne.

Anne asks how much profit you made this year. You don't know so you guess. You say it was maybe $30,000.

She asks you how much your assets are worth. You have no idea.

She asks how much debt you have. You're not sure.

She asks what your cash flow is each month. You don't even know what that means.

Because you have no financial information, Anne says no.

Now let's say you go and find an accountant, who prepares some financial records for you. You return to the bank with the following information.You have $5,000 of cash in the bank.

- You have sold $52,000 worth of cakes this year.
- This year you made a profit of $27,000, and profit has been increasing at an average rate of 6% per year for the last 3 years.
- Your operating expenses are $25,000 this year. The largest is wages at $11,000 per year. The next largest is advertising at $7,500 per year. The smallest is telephone expenses at $600 per year.
- Your bakery has net assets of $122,000 and no debt.
- Your bakery had a net positive cash flow of $13,000 this year.

Now you can tell Anne the loan officer exactly how much money you make, how much you spend, what you spend it on, how much you owe, how much you have in the bank, and how much your assets are worth.

Because she now has **information,** she is able to make a **decision** to loan you the money. This is because she knows how much money you make each month and can be confident you will be able to repay the loan.

Now, don't worry if you don't understand all the fancy terms up there like **"cash flow"** and **"net assets"**. We'll be learning what all that means very soon.

So, what does accounting do for us? I'm sure you already know that when you're in business, you need to know whether you're making money or not. Well, accounting helps you determine exactly that! And remember, it's important for the people you do business with (like the loan officer) to know that too.

Even if you're not in business, chances are you work for somebody that is. Whether you fix the computers, write advertisements or makes sales over the phone, your role is designed to help your employer achieve one key objective – making a profit. Your ability to understand financial information makes you that much more valuable, not only to your employer but to your clients and customers too. By understanding accounting, you have the ability to understand how a business makes money, making you a more complete professional and connecting you with your employer, your clients and their goals.

We also cannot forget the benefits of good personal finance. Accounting is as much a personal tool as it is a business one. Money is a big problem for many people all over the world. Perhaps you are finding it difficult to make ends meet, or maybe you're trying to save for a vacation but can't seem to figure out where all your money goes. Accountancy provides you with the skills you need to manage your money, where you can trace and categorise your expenses and effectively budget your income. This allows you to determine exactly how much you spend on non-essentials such as movies and fancy dinners, while also ensuring the important stuff such as rent and food for the family is always paid on time.

What are Assets and Liabilities in Accounting

The words "asset" and "liability" are two very common words in accounting.

Some people simply say an asset is something you own and a liability is something you owe. In other words, assets are good and liabilities are bad. That's not wrong, but there's a little more to it than that. Let's look at a more complete definition.

Assets

Assets are something that your business uses to help generate a profit.

To make your famous cream cake, you need your oven. These two things are examples of **assets.**

To be an asset it has to satisfy 3 requirements:

- It's something you have control over
- You have control as a result of a past event
- It has a future economic benefit

Now, let's say after you got your loan of $10,000, you went out and bought a new oven. But not just any oven. You bought the latest and greatest model. You bought the Bakemaster X Series 3000.

Let's see if your new Bakemaster fits the requirements of an asset.

Something you have control over?

You paid for it didn't you? You can keep it, you can sell it, you can even bake your shoes in it if you want to! Yep, it's definitely in *your control.*

As a result of a past event?

In this case, going to the store and handing over your cash will constitute a *past event.*

Has a future economic benefit?

With your new Bakemaster, you're definitely going to be baking some serious cream cakes which customers are going to pay top dollar for. That's definitely a *future economic benefit.*

Because your new oven meets above 3 requirements, it's definitely an asset.

Now let's take a look at an example, where something might not fit the definition of an asset.

Example B

A customer calls your store and says he had a dream about your cakes. He says he's coming in tomorrow to spend $1,000 in your bakery on every lemonade butter cream flavoured treat he can find.

You think the $1,000 should be recorded as an asset in your records.

Let's see if it fits the definition of an asset.

Something you have control over?

Sorry, you don't have the $1,000 yet. You can't spend it. You can't even touch it! *Definitely not in your control.*

As a result of a past event?

The event needed for you to gain control of that cash will be when he comes in and hands it to you. Hasn't happened yet though! So in this case, *no event has taken place.*

Has a future economic benefit?

$1,000 can buy a lot of things. Of course it has a future economic benefit.

Sorry, but this time you're only 1 for 3. The $1,000 holds a future benefit, however you do not have control of the money and the past events needed for you to gain control have not occurred yet.

Therefore, **the $1,000 is not an asset.**

Another example:

Your friend lets your borrow his car as a delivery vehicle. However, one night the road is slippery and your driver crashes into a tree. The car is completely damaged and is no longer drivable. Let's see if the car is an asset:

Something you have control over?

The car doesn't belong to you. It was lent to you by a friend, and you didn't sign a lease or contract giving you any rights to the car. Therefore, *the car is not in your control.*

As a result of a past event?

The event needed for you to gain control of the car is you signing an agreement and paying to purchase the car or rent it. Sorry, but *no such event has taken place.*

Has a future economic benefit?

The car is completely damaged and cannot be driven. *It won't be providing a future economic benefit for anyone.*

Sorry, but this time you're 0 for 3. The car is definitely not an asset.

Hopefully that gives you an understanding of assets and when you recognize them. But what about liabilities?

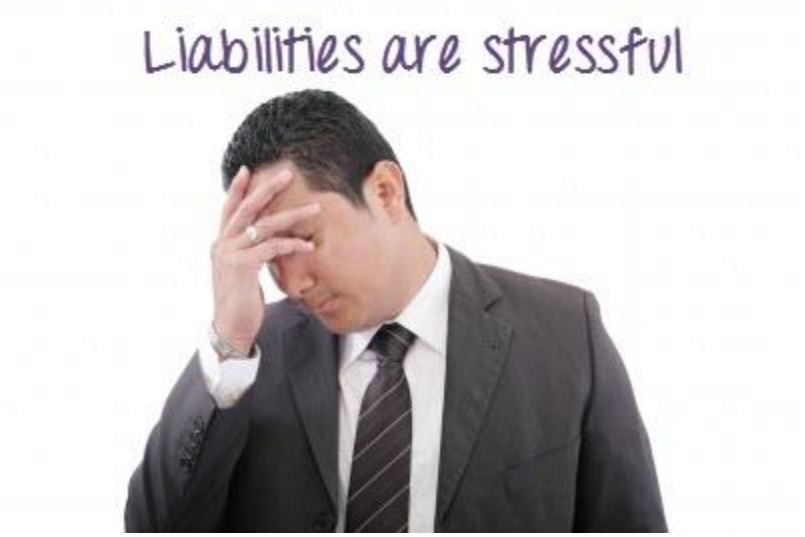
Let's take a look.

Liability

A liability requires 3 things:

- Presents the business with an obligation
- Obligation is a result of past events
- Settling the obligation will require an outflow of valuable resources

Remember when Anne decided to give you that loan? Well, before you walked out of the bank she said to you, "You're going to need to pay $1,000 each month until the whole $10,000 is paid back!"



Let's see if the loan from Anne fits the definition of a liability.

Presents the business with an obligation?

You took the money. Now you're required to pay it back! Definitely presents *an obligation.*

As a result of past events?

You signed the loan agreement. The obligation comes as a result of this *past event.*

Requires an outflow of valuable resources?

Paying back the loan requires the outflow of money. Money is valuable! That's certainly an *outflow of valuable resources.*

Bingo! The loan satisfies all the requirements, so we'll be recording it in our books as a liability.

Example B:

The sink in your store is leaking. One of your staff takes a look at it and tells you that you'll definitely need a plumber to come in and fix it, which will cost you around $200. You want to list the $200 as a liability in your records.

Let's see if the $200 fits the definition of a liability.

Presents the business with an obligation?

You are not obliged to pay anybody at this stage. The leaking sink is simply an inconvenience which you can either choose to fix or not to fix. Therefore there's no obligation to the business...yet.

As a result of past events?

You'll need to actually call the plumber and receive the $200 invoice before any liability can be recognised. This event hasn't occurred yet!

Requires an outflow of valuable resources?

With no obligation to pay anybody just yet, no outflow of resources should be expected.

Luckily for you, the $200 doesn't fit the requirements for a liability. You can keep this one off your records!

Activity:

Think about the stuff you have in your life. Perhaps you drive a Ferrari, or maybe you simply ride a bicycle. Maybe you own a mansion or maybe you live at the bottom of the ocean in a submarine. Either way, you probably needed a mortgage for it. In this case, your Ferrari would be an example of an **asset** whereas your mortgage is a **liability.** Use the worksheet below and list at least 3 assets and 3 liabilities you have in your business or your personal life. Use the checklist to make sure they fit the definition of an asset.

Assets Interactivity

Enter name of asset:

Liability Interactivity

Enter name of LIABILITY:

Below is a list of everyday thing you come across. Classify them as Asset, Liability or perhaps neither

	Assets	Liability	Neither	Status
1. Bank	1. ☐	1. ☐	1. ☐	
1. Loan	1. ☐	1. ☐	1. ☐	
1. Building	1. ☐	1. ☐	1. ☐	
1. Hired furniture	1. ☐	1. ☐	1. ☐	
1. Rented property	1. ☐	1. ☐	1. ☐	
1. Mortgage	1. ☐	1. ☐	1. ☐	
1. Car	1. ☐	1. ☐	1. ☐	
1. Lawyer's fees	1. ☐	1. ☐	1. ☐	
1. Bank account	1. ☐	1. ☐	1. ☐	
1. Credit Debit Card	1. ☐	1. ☐	1. ☐	
1. Investments	1. ☐	1. ☐	1. ☐	

1. Bonds	1. ☐	1. ☐	1. ☐	
1. Job	1. ☐	1. ☐	1. ☐	
1. Unpaid bills	1. ☐	1. ☐	1. ☐	
1. House	1. ☐	1. ☐	1. ☐	
1. Hire purchase contracts	1. ☐	1. ☐	1. ☐	
1. Future bills	1. ☐	1. ☐	1. ☐	
1. Computer	1. ☐	1. ☐	1. ☐	
1. Cellphone	1. ☐	1. ☐	1. ☐	
1. Past bills	1. ☐	1. ☐	1. ☐	
1. Television	1. ☐	1. ☐	1. ☐	
1. Furniture	1. ☐	1. ☐	1. ☐	

The Accounting Equation

The accounting equation! Probably sounds intimidating. Don't worry, it really is as simple as ABC.

Here's what it looks like.

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Assets = Liabilities + Owners Equity

Or

A = L + OE
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We already know what the words "Asset" and "Liability" mean from the previous lesson. Let's quickly define this new term, "Owners Equity".

Owner's Equity

We can define **Owners Equity** as **"the amount of money that you (the owner) have invested in the business."**

Whenever you contribute any personal assets to your business your owner's equity will increase. These contributions can be any asset, such as cash, vehicles or equipment. For example, if you put your car worth $5,000 into the business, your owner's equity will increase by $5,000. If you invest $10,000 of your savings into the business, your owner's equity will increase by $10,000.

Likewise, if you take money out of the business your owner's equity will decrease. For example, you go into your store and take $100 from the cashier to buy yourself a shirt. Because you are taking $100 out of the business, your owner's equity will decrease by $100.

Let's see if you can identify which of the following transactions will result in a change in owner's equity:

Activity: For each of these transactions we could simply have a "yes" and "no" button. I'll write the correct answer below for you to code.

Transaction 1:
You invest $1,000 of your personal savings into the business.

Change in owner's equity? ☐ Yes ☐ No

Transaction 2:
Your new oven breaks. You hire a repairman $50 to fix it.

Change in owner's equity? ☐ Yes ☐ No

Transaction 3:
You purchase a computer for the business using the business bank account.

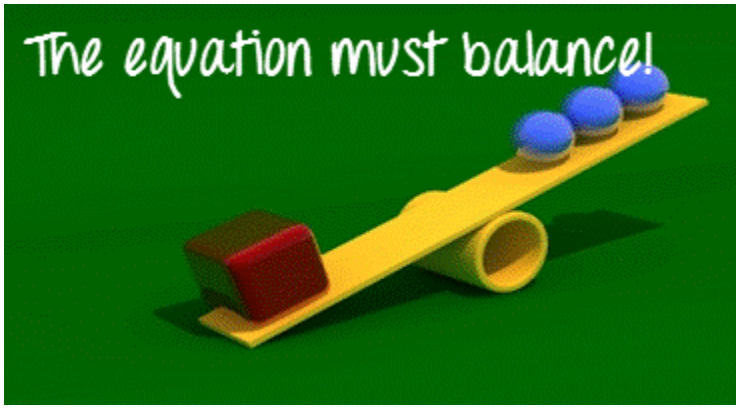
Change in owner's equity? ☐ Yes ☐ No

Introduction to the accounting equation

Every single transaction that occurs in your bakery will be recorded using the accounting equation.

Before we go any further, there are 3 very important things to remember about the equation:

1. The left side is referred to as “The Debit Side”
2. The right side is referred to as “The Credit Side”
3. The equation must always be in balance.



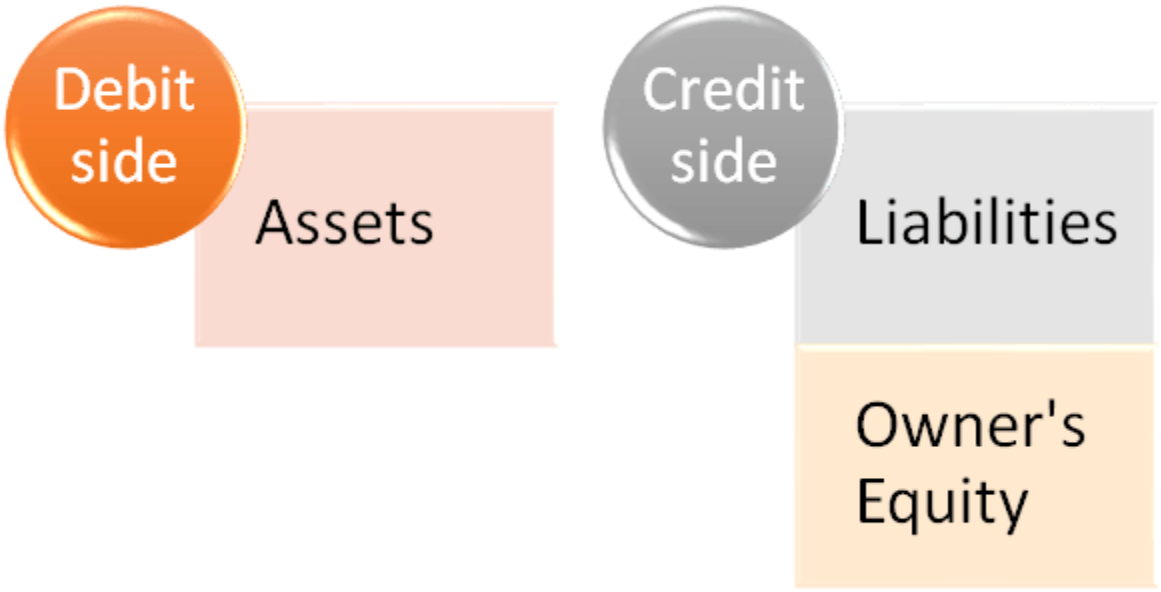
The two sides to the equation:

The Debit Side

The left side of the equation is known as **the debit side**. As you can see, the left side of the equation consists of **Assets.**

The Credit Side

The right side of the equation is known as **the credit side.** As you can see, the right side of the equation consists of **Liabilities and Owners Equity.**



Remember, the equation must ALWAYS balance.

Note: Throughout this lesson you will also notice that we refer to different "accounts". An account can be thought of as a collection of related entries. For example, every entry that relates to our loan will be recorded in the "loan account". Every transaction that relates to our oven will be recorded in the "oven account". Might be part of the reason this subject is called "accounting"!

Let's look at some examples to see the accounting equation in action.

Transaction 1

After making cupcakes in your Grandma's kitchen your whole life, you decide to open a bakery. You use your $10,000 in savings to start your business.

Now let's look at how this fits into the accounting equation.

Accounts affected:

You have just put $10,000 into the bank, which is an asset. This goes on the debit side.

Now that the debit side has gone up, we need to balance this with $10,000 on our credit side.

We know that our $10,000 investment represents an increase in owner's equity, and owner's equity will go on the credit side.

With these two entries, the equation is now balanced.

Let's fit this into the accounting equation.

We started off with $0 = $0 + $0. Doesn't get much easier than that!

Now it's changed a little.

As you can see, we have +$10,000 on the left side (the debit side), and we have +$10,000 on the right side (the credit side). Because both sides went up by $10,000, we're still in balance. Phew!

Still don't get it? Don't worry, it'll click soon enough. Let's look at another example.

Debit side	Credit Side
Bank +$10,000	Owner's Equity +$10,000

Transaction 2

You need an iPhone to take delivery calls from all your crazy customers. You buy one off eBay for $500.

Accounts affected:

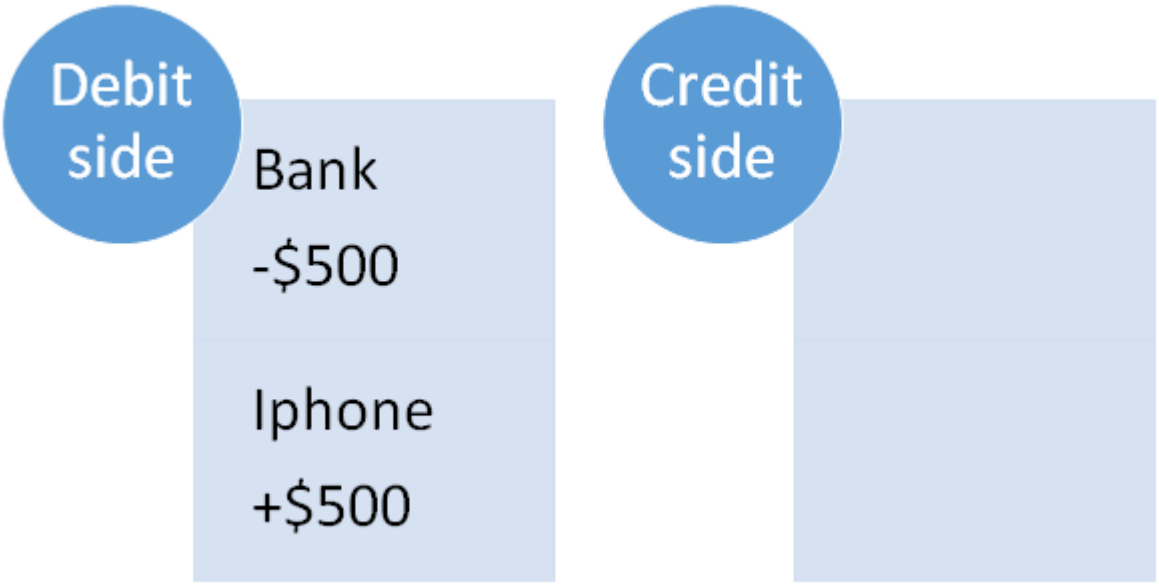
Remember in the first example we put money into the bank? Well, this time we'll be using the bank again, only now we'll be spending money. That means our bank account, an asset, is going to **decrease**.

Now that we know the Debit side has decreased, we need to record the second side of the transaction that will keep the equation in balance.

We're going to create a new asset account called IPHONE, because we need to record the new phone as an asset. Remember, it cost $500, so the two sides of the transaction are:

BANK -$500 (Debit side decrease)
IPHONE+$500 (Debit side increase)

Our bank caused the debit side to decrease, but then our new phone caused it to increase. That means our debit side had no change in the end, and our equation still balances.



You may be wondering, why didn't the credit side change in this example like it did in the previous example?

Remember, the credit side is only involved in transactions that relate to liabilities and owner's equity. In this particular transaction, only assets were involved: we used an asset (bank) to purchase another asset (iphone).

We saw above that owner's equity only relates to investments made personally by the owner. In this example, we used the business bank account to purchase a business asset. Therefore the owner was not involved. If we had used the **owner's personal bank account** to buy the iPhone, then our owner's equity on the credit side would have increased.

Still not getting it? Let's do a few more examples.

Activity

Have a go at working out the two sides of each transaction. Remember, it needs to balance!

Transaction 3:

It's time to go oven shopping, but first you need some cash. You visit Anne the loan officer and she gives you a loan of $10,000.

Debit Side		Credit Side	
Account	Amount	Account	Amount
Bank	$10000	Loan	$10000

Drag & Drop the blocks into correct positions in table

Transaction 4:

It's your lucky day. You just won a lottery prize of $5,000. You decide to invest your $5,000 into the business.

Drag & Drop the blocks into correct positions in table

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• • • • • • • Debit Side		Credit Side	
Account	**Amount**	**Account**	**Amount**
1.	1.	1.	1.

Transaction 5:

We don't want Anne to get angry. You better pay back some of the loan. You decide to pay back $1,000.

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• • • • • • • • • Debit Side		Credit Side	
Account	**Amount**	**Account**	**Amount**
1.	1.	1.	1.

Transaction 6:

You need a computer to start taking internet orders and also to watch funny Youtube videos after work. You purchase a computer for $1,500.

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• • • • • • • Debit Side		Credit Side	
Account	**Amount**	**Account**	**Amount**
1.	1.	1.	1.
1.	1.	1.	1.

Transaction 7:

Your oven got stolen! Time to purchase the new Bakemaster X Series! It costs you $2,000

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Debit Side		Credit Side	
Account	**Amount**	**Account**	**Amount**
1.	1.	1.	1.
1.	1.	1.	1.

After recording these 7 transactions, our accounts now look like this. We have all our assets listed on the debit side and all our liabilities and owner's equity listed on the credit side.

Take a quick look back and see if you can follow how the numbers have changed.

DEBIT SIDE	**CREDIT SIDE**
Bank $20,000	Loan $9,000
Computer $1,500	
Oven $2,000	Owner's Equity $15,000
Iphone $500	
Balance$24,000	**Balance**$24,000

Still in balance. Perfect!

In case you haven't figured out how we got to these figures, we've broken it down step by step for you below.

Let's use our Bank account as an example.

Our bank account started at $0. Then the following happened:

Transaction	**Running bank balance**
We put $10,000 into the business	$10,000
We spent $500 on an iPhone	$9,500
We got a loan of $10,000 from the bank	$19,500

We invested another $5,000 in the business	$24,500
We paid back $1,000 of the loan	$23,500
We bought a new computer for $1,500	$22,000
We bought a new oven for $2,000	**$20,000**

As you can see, we added all transactions that related to the bank to arrive at our ending balance of $20,000. This is the same approach we took for all the accounts.

What is Revenue, Expense and Drawing

In Lesson 2 we defined the terms Asset and Liability. In this lesson we will complete the last of our definitions by defining the terms Revenue, Expense and Drawings.

Revenue

Revenue is money your business receives from its normal business activities. When the old man with a top hat comes in each morning and hands over $5 for his slice of cream cake, that $5 is considered to be revenue. Sometimes, revenue is referred to as turnover.

Remember, not all money you receive is revenue. Revenue is money received from the sale of goods or services.

Consider the following:

Your friend Jane meets a handsome boy at the gym. The next day, the boy calls Jane and asks her on a date. However, Jane has no money to buy a dress!

Jane borrows $100 from the bank so she can buy a dress for her date, which charges her interest of 10%.

A week later, Jane pays the bank back its $100 and the additional $10 in interest. Hence the bank receives $110.

How much of the $110 is revenue?

Remember revenue is only money received from business activities. Therefore, Jane's payment of $100 is not from the sale of goods or services. It is simply repayment of the $100 the bank lent to her in the first place.

However, the $10 in interest arises as a payment for **the service of providing the loan**. Hence, of the $110 paid to the bank, *only the $10 interest is actually considered revenue.*

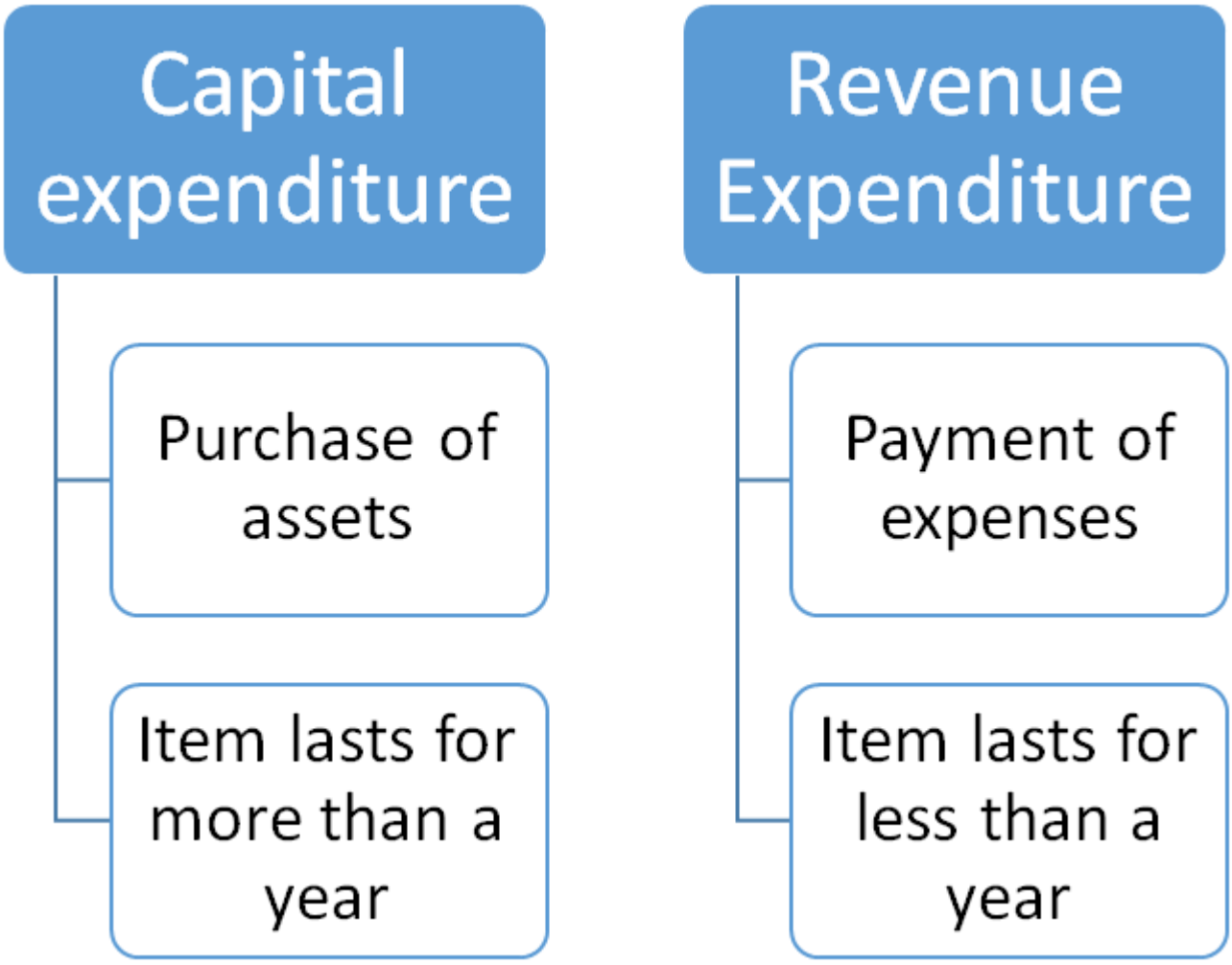
Expenses

The basic definition of an expense is money you spend to run your business.

For example, to run your bakery, you need to pay for much more than just cake mix. You need to pay rent to Arnold the landlord each month. You need to pay for repairs to the delivery car every time you ding your bumper in the parking lot. And you need to pay for internet so you can check how many likes you have on the bakery's Facebook page. All these things you are paying for are examples of the business's expenses.

An important characteristic of an expense is that it is **a cost which does not result in the acquisition of an asset.**

For example, purchasing a car is not an expense. It is the purchasing of an **asset**, which we refer to as **capital expenditure**. However, purchasing of insurance and gasoline for the car are examples of expenses, which is known as **revenue expenditure.** We can loosely define **capital expenditure** as purchasing something that lasts for more than one year, while **revenue expenditure** is the purchase of something that lasts for less than one year.



Go through the following transactions and see if you can distinguish between capital and revenue expenditure.

Drawings

As the owner, you will put money into the business from time to time. For example, on the day the business started you would've deposited some of your own money into the business. This means you can also take money **out** of the business.

For example, imagine one day you're running late for dinner with your mother. As you're running down the street to the restaurant, you realize in your panic that you've forgotten your wallet!

There's no way you can go back home, it's an hour away! Then you realize the bakery is just around the corner. You quickly pop over and take $100 out of the cashier.

This $100 will be recorded as **drawings.** Drawings is any amount the owner withdraws from the business for **personal use.**

Drawings is generally only a factor in smaller, owner operated (proprietor) businesses. Large companies and corporations will not deal the issue of drawings very often, simply because owners can be quite detached from day to day running of the business. While it easy to account for drawings in a small business such as a bakery, it is impossible for a Microsoft shareholder to simply go into a Microsoft store and take a bundle of cash as drawings! In such cases, owner's receive money from the business via **dividends** or a **shareholder's salary.**

Example 1:
You purchase a new oven for $1,000 for your bakery.

☐ Revenue Expenditure ☐ Capital Expenditure

Example 2:
Your new oven breaks. You hire a repairman $50 to fix it.

☐ Revenue Expenditure ☐ Capital Expenditure

Example 3:

You decide to furnish your store. You purchase 5 sets of tables and chairs at a total cost of $2,000.

☐ Revenue Expenditure ☐ Capital Expenditure

Example 4:

The delivery car is out of petrol! You take it to the gas station and fill up the tank for $100.

☐ Revenue Expenditure ☐ Capital Expenditure

Example 5:

We need more cream for the cakes! One of your staff heads to the supermarket and picks up a couple of litres for $25.

☐ Revenue Expenditure ☐ Capital Expenditure

Introducing The Complete Accounting Equation

Remember in Lesson 2 we learned the basic form of the accounting equation as:

Assets = Liabilities + Owners Equity

Now that we also understand the terms Revenue, Expense and Drawings, we can finally understand the accounting equation in its complete form. Let's take a look.

Assets + Expenses + Drawings = Liabilities + Revenue + Owners Equity

In Lesson 2 we learned that the left side is known as the debit side and the right side is known as the credit side. The same rules apply here, only now we have some new additions to each side.

The Debit Side

The debit side now consists of not only Assets, but also Expenses and Drawings.

The Credit Side

The credit side now consists not only of Liabilities and Owners Equity, but also Revenue.

Let's look at some common transactions that might occur in your day to day business, and how they are recorded in the accounting equation.

Example 1:Purchasing a car with cash

Step 1: Identify the accounts involved in the transaction

Let's identify the 2 accounts involved in this transaction

1. Bank – an Asset (you will draw money to pay for car)
2. Car – an Asset (car will give you benefit for more than 1 year and is an asset)

Step 2: Determine where the accounts lie on Debit/ Credit Side

Both the accounts lie on the left hand side of the equation.

Step 3: Determine which accounts will increase or decrease

So in order to balance the equation, one asset must increase (Car) and other must decrease (Bank).

Debit side				**Credit side**		
Assets	**Expenses**	**Drawings**	=	**Liabilities**	**Revenue**	**Owner's Equity**
Increase						
Decrease						

Example 2: Receiving revenue for selling Cakes

Step 1: Identify the accounts involved in the transaction

Let's identify the 2 accounts involved in this transaction

1. Bank – an Asset (you will deposit your revenue money into Bank)
2. Cake Sales – aRevenue account

Step 2: Determine where the accounts lie on Debit/ Credit Side

In this case**,** the 2 accounts lie on the opposite sides of the accounting equation.

Step 3: Determine which accounts will increase or decrease

Both the accounts could increase or decrease

But, it will be never be the case that one account is increasing and other decreasing, otherwise the equation will not balance.

In this scenario, money from cake sale will be deposited in the bank. So Assets will increase. Likewise, Revenues will increase as well

Debit side				**Credit side**		
Assets	**Expenses**	**Drawings**	**=**	**Liabilities**	**Revenue**	**Owner's Equity**
Increase					Increase	

Example 3: Paying expenses with cash

Debit side				**Credit side**		
Assets	**Expenses**	**Drawings**	**=**	**Liabilities**	**Revenue**	**Owner's Equity**
Decrease	Increase					

Example 4 :Owner invests money in the business

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• **Debit side**				**Credit side**		
Assets	Expenses	Drawings	=	Liabilities	Revenue	Owner's Equity
1.	1.	1.		1.	1.	1.

Example5: Owner withdraws money

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• **Debit side**				**Credit side**		
Assets	Expenses	Drawings	=	Liabilities	Revenue	Owner's Equity
1.	1.	1.		1.	1.	1.

Example 6: Pay back loan

-

• Debit side				Credit side		
Assets	Expenses	Drawings	=	Liabilities	Revenue	Owner's Equity
1.	1.	1.		1.	1.	1.

Notice every time the equation balances. If a debit account increases, then another debit account decreases. There will never be a time when two debit accounts increase, because then the equation won't balance!

Similarly, it's also common to see a debit account increase and then a credit account increase with it. This also allows the equation to balance. You will never see a debit account increase and a credit account decrease, because the equation will be left out of balance.

At the end of the day, the equation is just basic maths you learned at school!

1 = 1

If you add 5 to one side, we have to add 5 to the other side, otherwise it will simply be wrong:

1+5 = 1
Wrong!

Or, we can minus 5 from the same side to keep it balanced.

1+5-5 = 1

Don't let the debits and credits confuse you. At the end of the day, it's all just good ol' pluses and minuses.

If you're still not quite getting it, don't worry. In the following lesson, we'll look at some examples of recording transactions to get some practice at using the full accounting equation.

Basic Accounting Transactions

In this lesson, we are going to learn how basic transactions move through the accounting equation. What we need to remember is that because the accounting equation always balances,**every movement in the equation must be countered by another movement of the same amount.**

Now, here's what the bakery's accounts look like right now:

ASSETS	LIABILITIES
Bank $20,000	Loan $9,000
Computer $1,500	
Oven $2,000	OWNERS EQUITY $15,000
iPhone $500	
Balance $24,000	Balance $24,000

As you can see, on the left side we have assets of a $20,000 in the bank, a computer which cost $1,500, our favourite Bakemaster X Series oven worth $2,000, and an iPhone we scored off eBay for $500. On the right side we have a single liability which is a loan from Anne at the bank for $9,000. The balance is made up of Owners Equity of $15,000.

Notice how both the **debit side and the credit side are in balance with each other**, as they both add up to **$24,000.**

That's a good start.

Now it's time for business. Below are some everyday transactions in the life of your bakery. Let's start selling cakes!

Transaction 1: You buy some cake mix for your store for $3,000

Purchasing our famous cake mix is like purchasing inventory. For now, we are going to classify inventory purchases as an **expense**. Hence, our **expenses are going to increase.** Remember, this will result in an **increase in the debit side.**

So now that expenses (CAKE MIX) has increased on the debit side, another movement is needed to keep the equation in balance. The other side of our transaction will need to be either:

- An increase on the credit side
- A decrease on the debit side

In this case, because we are spending cash to buy the cake mix, the movement is obviously a decrease in our bank account of $3,000.

Hence the transaction will look like:

DEBIT SIDE		**CREDIT SIDE**	
Account	**Amount**	**Account**	**Amount**
Bank (asset)	-$3,000		
Cake mix (expense)	+$3,000		
Movement	$0	Movement	$0

Notice how our debit side increased by $3,000 due to an increase in the Cake Mix Expenses. Then, our debit side decreased by $3,000 because our bank account, an asset, decreased when we paid for the cake mix. The result is that both entries cancel each other out and our equation stays in balance. Perfect!

Transaction 2: Anne the loan officer calls. She asks for interest of $1,000 to be paid on the loan.

OK, so we're dealing with an expense, which is interest. We know that expenses sit on the debit side. That means we'll record interest expenses of $1,000.

To pay the interest, we took money out of the bank account, so the other side of the equation will be a decrease in our bank account of $1,000. Let's see how it balances.

DEBIT SIDE		**CREDIT SIDE**	
Account	**Amount**	**Account**	**Amount**
Bank	-$1,000		
Interest expense	+$1,000		

Movement	$0	Movement	$0

Perfect!

Now it's your turn. Have a go at dragging the correct accounts and their amounts onto the correct side.

Transaction 3:

You sell a box of cakes for $5,000.

Hint - SALES is revenue. Revenue sits on the credit side. When you make sales, you receive money in the BANK.

-

• • • • • • • DEBIT SIDE **CREDIT SIDE**

Account	Amount	Account	Amount
1.	1.	1.	1.

Transaction 4:

You pay your telephone bill of $300

Hint – TELEPHONE bill is an expense. Expenses sit on the debit side. Paying your telephone bill will require money to be taken from the BANK.

-

• • • • • • • DEBIT SIDE		CREDIT SIDE	
ACCOUNT	**AMOUNT**	**ACCOUNT**	**AMOUNT**
1.	1.	1.	1.
1.	1.	1.	1.

Transaction 5:

You sell another box of cakes for $2,000

•

• • • • • • • DEBIT SIDE		CREDIT SIDE	
Account	**Amount**	**Account**	**Amount**
1.	1.	1.	1.

Transaction 6:

You've been playing with your bakery's Facebook page for too long and the computer overheats. You pay a repairman $50 to fix it.

Hint – REPAIRS is an expense. Expenses sit on the debit side. Paying expenses requires money to be taken from the BANK.

•

• • • • • • • **DEBIT SIDE** **CREDIT SIDE**

ACCOUNT	AMOUNT	ACCOUNT	AMOUNT
1.	1.	1.	1.
1.	1.	1.	1.

Transaction 7:

It's time to go on holiday. Hawaii maybe? You withdraw $1,000 from the bakery's bank account to purchase your ticket.

Hint – When an owner withdraws money for personal reasons, this is considered DRAWINGS. Drawings sits on the debit side.

•

• • • • • • • **DEBIT SIDE** **CREDIT SIDE**

ACCOUNT	AMOUNT	ACCOUNT	AMOUNT
1.	1.	1.	1.
1.	1.	1.	1.

Transaction 8:

You visit Johns Car Shop to buy a delivery car. You choose the pink beetle with yellow polka dots and a big flower in the middle. It costs $3,000. You purchase the car on credit, meaning you will pay for it in full next month.

Hint – CAR is an asset. Assets sit on the debit side. When you purchase something on credit, it is similar to debt. You owe money, which is a liability. Liabilities sit on the credit side.

-

• • • • • • • DEBIT SIDE **CREDIT SIDE**

Account	Amount	Account	Amount
1.	1.	1.	1.

We've just had 8 new transactions run through our business. Let's have a look at what our accounts look like now:

The below table is simply an expanded version of our accounting equation. Notice how on the left side we still have assets, expenses and drawings. On the right side we have revenue, liabilities and owner's equity.

Debit side		Credit Side	
Bank	$21,650	Sales	$7,000
Computer	$1,500		
Car	$3,000		
iPhone	$500		
Oven	$2,000	Loan	$9,000
		Johns Car Shop	$3,000
Cake mix expense	$3,000		
Interest expense	$1,000	Owner's Equity	$15,000
Telephone expense	$300		
Repairs	$50		

Drawings	$1,000		
Balance	$34,000	Balance	$34,000

It can also be helpful to classify our "accounts" into their respective categories. For example, "bank" is an asset, hence we can display it in the Assets category. Sales are a form of revenue, and hence we can place it in the Revenue category.

This allows us to split our debit side up into assets, expenses and drawings, while our credit side is split up into liabilities, revenue and owner's equity. This is very helpful when trying to monitor changes in our accounting equation.

Let's go ahead and break down our debit and credit side into categories. As long as each account is in the right place, everything should stay in balance:

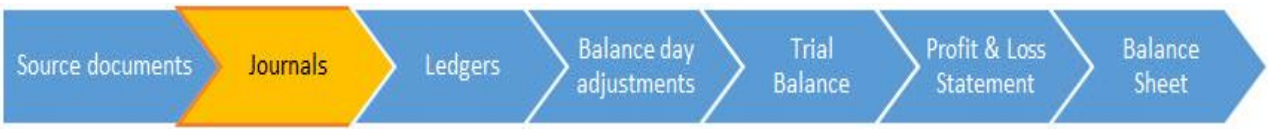
Debit side		Credit Side	
ASSETS		**REVENUE**	
Bank	$21,650	Sales	$7,000
Computer	$1,500		
Car	$3,000		
iPhone	$500	**LIABILITIES**	
Oven	$2,000	Loan	$9,000
EXPENSES		Johns Car Shop	$3,000
Cake mix expense	$3,000		
Interest expense	$1,000	**OWNERS EQUITY**	$15,000
Telephone expense	$300		
Repairs	$50		
DRAWINGS	$1,000		
Balance	$34,000	Balance	$34,000

Still in balance? Perfect!

How to do a Journal Entry

OK soldiers. Time to do some real accounting!

Everything we do from this point on will be stuff that real accountants and bookkeepers are doing in their offices at this very moment. That means this lesson will be a little more technical than the previous ones. Don't let that spook you though. You'll be surprised at how simple it can be! Now would be a good time for us to lay out the steps in the accounting process:



You'll notice the above diagram shows the first step as "Source Documents". Source documents are things such as receipts , invoices, bank statements and credit card statements that are collected during the year, so that we have all the information we need when the time comes for us do our accounting. Obviously in these lessons we won't be asking you to go out and collect invoices and receipts, so we'll conveniently "skip" that step for now.

The next step is **entering journals**. Every time a transaction occurs, it's recorded using a **journal entry.**

A journal entry is simply a summary of the debits and credits of a transaction. Journal entries are important because they allow us to sort our transactions into manageable data. Imagine having a large stack of receipts and invoices from different shops, suppliers and customers. All the information you need is there, but it's useless when it's all messed up like that! Journal entries help us sort all this into meaningful information.

Here's what a typical journal entry looks like:

Transaction: Pay an expense of $100.

Journal entry:

Dr	Expense	$100
Cr	Bank	$100

Let's take a look at what this means.

First of all, **Dr** and **Cr** are simply abbreviations for Debit and Credit.

Every single transaction consists of two movements: a debit movement and a credit movement. Be careful not to confuse this with the debit and credit *sides*. These are two different things.

Debit and credit movements are used in accounting to show increases or decreases in our accounts. Therefore instead of saying there has been an increase or a decrease in an account, we say there has been a debit movement or a credit movement.

For example, in the previous lesson we learned to show the above transaction like this:

DEBIT SIDE		**CREDIT SIDE**	
Account	**Amount**	**Account**	**Amount**
Expense	+$100		
Bank	-$100		

Now, instead of showing these as pluses and minuses, we will show them in a journal entry as debit movements and credit movements:

Dr	Expenses	$100
Cr	Bank	$100

The nature of each movement is explained below:

	DEBIT SIDE (Assets, Expenses, Drawings)	**CREDIT SIDE** (Liabilities, Revenue, Owner's Equity)
Increase	**Debit movement**	**Credit movement**

Decrease	**Credit movement**	**Debit movement**

Let's apply this to our example:

When we pay expenses that means our expenses have increased. Also, when we pay expenses our bank account is obviously going to go down.

So in summary we need to record a transaction that will increase expenses and decrease bank.

Referring back to our matrix, we can see that to increase expenses we require a debit movement.

	DEBIT SIDE (Assets, **Expenses**, Drawings)	CREDIT SIDE (Liabilities, Revenue, Owner's Equity)
Increase	**Debit movement**	Credit movement
Decrease	Credit movement	Debit movement

We can also see that decreasing our bank requires a credit movement:

	DEBIT SIDE (**Assets**, Expenses, Drawings)	CREDIT SIDE (Liabilities, Revenue, Owner's Equity)
Increase	Debit movement	Credit movement
Decrease	**Credit movement**	Debit movement

Hence our journal entry will involve a debit movement to expenses, a credit movement to bank, just as we saw before:

Dr	Expenses	$100
Cr	Bank	$100

Now it's your turn. Have a go at writing journal entries for the transactions we've had in the previous lessons. The first one has been done for you.

	DEBIT SIDE (Assets, Expenses, Drawings)		**CREDIT SIDE (Liabilities, Revenue, Owner's Equity)**	
Increase	Rent	Rent Increased so Debit movement	Loan	Loan Increased so Credit movement
Decrease	Bank	Bank Decreased so Credit movement	Service Income	Service Income Decreased so Debit Movement

Transaction 1: You decide to start a business. To start the business off, you deposit $10,000 of your savings into the business bank account.

Dr	**Bank**	$10000
Cr	**Owners Equity**	$10000

Transaction 2: You buy your trusty iPhone off eBay for $500

Cr	**Bank**	$500
Dr	**iPhone**	$500

Transaction 3: You take out a business loan of $10,000.

Cr	**Loan**	$10000
Dr	**Bank**	$10000

Transaction 4: You put another $5,000 of your own money into the business.

Dr	**Bank**	$5000
Cr	**Owner's Equity**	$5000

Transaction 5: You pay back $1,000 of the loan (no interest).

Dr	**Loan**	$1000
Cr	**Bank**	$1000

Transaction 6: You purchase a computer for $1,500.

Cr	**Bank**	$1500
Dr	**Computer**	$1500

Transaction 7: You purchase your Bakemaster Oven for $2,000

Dr	**Oven**	$2000

Cr	**Bank**	$2000

Transaction 8: You buy some cake mix for your store for $3,000

Cr	**Bank**	$3000
Dr	**CakeMix**	$3000

Transaction 9: You pay interest on the loan of $1,000

Dr	**Interest**	$1000
Cr	**Bank**	$1000

Transaction 10: You sell a box of cakes for $1000.

Dr	**Bank**	$1000
Cr	**Sales**	$1000

Transaction 11: You pay your telephone bill of $300

Cr	**Bank**	$300
Dr	**Telephone Expense**	$300

Transaction 12: You sell another box of cakes for $2,000

Cr	**Sales**	$2000
Dr	**Bank**	$2000

Transaction 13: Your computer breaks. You pay a repairman $50 to fix it.

Cr	**Bank**	$50
Dr	**Repairs**	$50

Transaction 14: As the owner of the business, you withdraw $1,000 in cash for a personal holiday.

Cr	**Bank**	$1000
Dr	**Drawings**	$1000

Transaction 15: You purchase a car from Johns Car Shop for $3,000. You purchase the car on credit, meaning you will pay for it in full next month.

Dr	**Car**	$3000
Cr	**John's Car Shop**	$3000

Congrats! We've just prepared journal entries from our business transactions. This is the first step in preparing a set of financial statements. In the next lesson, we'll enter these journals into **ledgers.**

What is the difference between the debit and credit side and debit and credit movements?

Debit side	Credit Side
The debit side is the left side of the accounting equation.	The credit side is the right side of the accounting equation.
The accounts of the debit side are ASSETS, EXPENSES AND DRAWINGS. These are known as debit accounts.	The accounts of the credit side are LIABILITIES, REVENUE AND OWNER'S EQUITY. These are known as credit accounts.

For every transaction that occurs, two accounts will change. These two changes are known as a debit movement and a credit movement. The effects of these movements are shown below.

Debit movements	Credit movements
Increase the debit side	Increase the credit side
Decrease the credit side	Decrease the debit side

It is important you do not think of debit movements and credit movements as "pluses and minuses" or "good and bad". This line of thinking is incorrect. Using the above chart you can see that a debit movement has the ability to both increase and decrease an account, as does a credit movement.

Therefore try and focus on the actual effect each movement has on the different accounts.

What is Ledger & How to create One

We've just processed all our transactions into **journals**. The next step in the accounting process is entering these journal entries into **ledgers**.

Think of a ledger as a summary of transactions that relate to a certain account. For example, our bank ledger will summarise all the transactions that involved our bank account; our loan ledger will summarise all the transactions that involved our loan account and so on.

Ledgers are important because they summarise all our transactions into a single balance. For example, instead of knowing that we spent $100 on car expenses in July, $300 in August, $600 in September, $500 in November and so on, our ledger will simply tell us we spent $1,500 in total. By using ledgers, we are able to summarise hundreds or even thousands of transactions into a single balance! Obviously that makes things a lot easier to manage.

A ledger consists of 4 things:

1. An opening balance
2. A debit side
3. A credit side
4. A closing balance

Let's have a look at an example.

BANK LEDGER	DEBIT	CREDIT
Opening balance	$0	

This is an empty BANK ledger. Notice how the opening balance is on the debit side, because BANK is an asset, which is a debit account.

Likewise, for a credit account like Owners Equity, the opening balance will be on the credit side.

Every journal entry which includes the bank account will be recorded in this ledger. Let's take a look at a journal entry from the previous lessons. Here's the first one.

Transaction 1: You decide to start a business. To start the business off, you deposit $10,000 of your savings into the business bank account.

Dr	Bank	$10,000
Cr	Owners' Equity	$10,000

So the two accounts in this transaction are Bank and Owners Equity. That means we'll be making entries to our Bank and Owners Equity ledgers. Let's do the Bank ledger first.

The journal entry says we need to make a debit movement to the bank account of $10,000. Let's enter it in our ledger below. It's as simple as entering $10,000 in the debit column.

BANK LEDGER

Details	DEBIT	CREDIT
Opening balance	$0	
Owners Equity	$10,000	

That's it!

In the Details column, we will write "Owners' Equity". This allows us to see where the $10,000 came from.

Easy! Now let's do the Owners' Equity ledger.

OWNERS EQUITY LEDGER

Details	DEBIT	CREDIT
Opening balance		$0
Bank		$10,000

Because Owners Equity is a credit account, we put the opening balance on the credit side.

The journal entry shows a credit of $10,000 to Owners Equity. To record this in the ledger, it is as simple as putting $10,000 in the credit column. In the Details column, we'll write "Bank", as this allows us to see what the other side of the transaction was.

Done! We've just done our first two entries into our ledgers.

Now let's look at the rest of the journals from our lesson 7, and see if we can enter them correctly into our ledgers.

Transaction 2: You take out a business loan of $10,000.

Dr	Bank	$10,000
Cr	Loan	$10,000

Because our journal consists of entries to the Bank and Loan accounts, we'll need the Bank and Loan ledgers.

BANK LEDGER

Details	DEBIT	CREDIT
Opening balance	$0	
Owners Equity	$10,000	
Loan	$10,000	

The journal shows a debit to bank of $10,000, so we simply put $10,000 in the debit column of our bank ledger. Notice how the previous entry, the $10,000 to Owners Equity from our earlier transaction, is in the ledger also. This is because the idea of a ledger is to collect ALL transactions related to an account in one place. By the end of the exercise, there will be over 10 transactions in this ledger alone.

Now let's look at the other side of the transaction – the Loan account.

LOAN LEDGER

Details	DEBIT	CREDIT
Opening balance		$0
Bank		$10,000

Because the journal entry shows a credit to Loan of $10,000, we simply enter $10,000 in the credit column of the Loan ledger. We'll put the corresponding side of the journal in the details column. In this case, it's Bank!

Now that we've entered all our journals into our ledgers, let's take a look at what to do next. Here's the first one.

LOAN LEDGER

Details	DEBIT	CREDIT
Opening balance		$0
Bank		$10,000
Bank	$1,000	
TOTAL	**$1,000**	**$10,000**
Minus debits		-$1,000
BALANCE		**$9,000**

Ok troops, listen carefully! This gets a little tricky.

In this ledger we have entries on both the debit and credit sides.

First, we total up both sides. Take a look at the row that reads “TOTAL”. We have a total of $1,000 on the debit side and $10,000 on the credit side.

Now we simply SUBTRACT THE SMALLER SIDE FROM THE LARGER SIDE to find our balance. In this case we subtract the $1,000 from the $10,000. This is illustrated in the row that reads “MINUS DEBITS”.

This leaves us with a balance on the credit side of $9,000. That’s it! High five amigo - you’ve completed your first ledger.

Now let's go ahead and complete the rest of them.

This first one is easy. Because there's only movements on the credit side, there's no need to fiddle around with it. Simply total up the CREDIT column and there's your balance!

JOHNS CAR SHOP LEDGER

Details	Debit	Credit
Opening balance		$0
Car		$3000
Balance		$3000

CAR LEDGER

Details	Debit	Credit
Opening balance	$0	

Car	$3000	
Balance	$3000	

BANK LEDGER

Details	DEBIT	CREDIT
Opening balance	$0	
Owner's Equity	$10,000	
Loan	$10,000	
iPhone		$500
Oven		$2,000
Owner's Equity	$5,000	
Loan		$1,000
Computer		$1,500
Cake mix		$3,000
Interest		$1,000
Sales	$5,000	
Telephone		$300
Sales	$2,000	
Repairs		$50
Drawings		$1,000
TOTAL	**$32,000**	**$10,350**
Minus credits	-$10,350	

BALANCE	**$21,650**	

Magnifico! We've just completed all our ledgers. So what does this mean?

This means we finally have a balance of all our accounts. After entering all our sales in the sales ledger, we know the total amount of our sales. After entering all our bank transactions in our bank ledger, we know the final balance in our bank. And after entering all our expense payments in our expense ledgers, we know the total amounts of each expense!

Now that we have all our balances, we're ready to start putting together some reports! My gosh, you're starting to look like an accountant already.

Ok, you ready? Let's go.

How to calculate Depreciation (Balance Day Adjustment)

Earlier we discussed the term **capital expenditure.** Let's explore this a little further.

Capital expenditure is when you purchase an asset. It might be a car, a house, a merry-go-round for your daughter, maybe even a submarine to use as your secret lab. Whatever it is, we label it as capital expenditure rather than an expense.

An easy way to think of it is, an expense is when you purchase something you use up in less than a year, whereas an asset is something that lasts for more than a year.

Now, assets don't last forever. When you buy a car for $5,000, it's worth $5,000.

But what about the next year? Because you drive it every day, leave pizza in the back seat and draw smiley faces on the windows, the value goes down. Perhaps you can only sell it for $4,000 after a year. After three years, it might only be worth $1,500! This gradual reduction in value is called **depreciation.** We normally calculate depreciation on balance day, which is the last day of the financial year. For this reason, depreciation is known as a **balance day adjustment.**

So how do we account for depreciation?

The most common method is called the **straight line method.**

The Straight Line Method

Let's look at an example:

Let's say you decide to buy a secret underwater submarine lab. You purchase the most beautiful submarine you've ever seen for $100,000. However, you know that in 5 years of time, the submarine will only be worth $20,000.

The straight line method assumes that the asset will **depreciate by the same amount each year until it reaches its residual value**. The residual value is how much it will be worth at the end of its life. In this case, we know this amount is $20,000. That means the submarine is going to depreciate by $80,000 over 5 years.

Let's work that out using some simple maths we learned back in elementary school.

$80,000 / 5 years = $16,000 per year

Now we have our answer. The submarine will depreciate by $16,000 every year for 5 years. After 5 years it will have depreciated in value by $80,000, leaving it with a residual value of $20,000.

Perfect. Let's have a go using one of our bakery examples.

Remember the car we bought from John's Car Shop? If I remember correctly, it was a green lotus, and it cost $3,000.

Now John tells us that in 5 years we'll be able to sell that car for $1,000.

We now have all the information we need to work out for our car's depreciation.

Value at time of purchase: $3,000

Value in 5 years time: $1,000

Amount to be depreciated (HINT: Initial value minus residual value): $2,000

Depreciation per year: $400

Great, so we now know that we will be depreciating our car at $400 per year. Now although there is no cash involved, these are still transactions. That means they have a journal entry and need to be entered into a ledger!

Depreciation is an EXPENSE. Therefore, we are going to create a depreciation expense account, which is a debit account.

Accumulated depreciationis a term we haven't come across yet. Accumulated depreciation, as the name suggests, is the total amount of depreciation that has built up over the years. For example, if our asset depreciates by $100 for each of the last 3 years, our accumulated depreciation will be $300.

Accumulated Depreciation is a LIABILITY.

Therefore, we're going to create an Accumulated Depreciation account that will sit on the credit side of our accounting equation.

To record the depreciation for the year, we'll need to prepare a journal entry. Here's what the journal entry looks like:

Dr	Depreciation expense	$400
Cr	Accumulated depreciation	$400

Now it's your turn. Enter this journal into the following ledgers and calculate the balance.

DEPRECIATION EXPENSE

Detail	Debit	Credit
Opening Balance	0	

Accumulated Depreciation	400	
BALANCE	400	

ACCUMULATED DEPRECIATION

Detail	Debit	Credit
Opening Balance		0
Accumulated Depreciation		400
BALANCE		400

Diminishing value method

Another common method of depreciation is the diminishing value method.

When using this method, assets do not depreciate by an equal amount each year. Rather, depreciation is recalculated each year based on the assets depreciated value or 'book value'. This is best illustrated in an example:

Remember our car from John's Car Shop? It cost $3,000, and we were told it would last for 5 years.

With this method we need to estimate the amount of depreciation we expect it to have. For the purpose of this example, let's say 20% per year.

Year 1:

The value of our car is $3,000, and it's going to depreciate by 20%.

20% of $3,000 is **$600.**

We've now worked out our first year's depreciation! Here's what the journal entry will look like:

Dr	Depreciation expense	$600
Cr	Accumulated depreciation	$600

Have a go at entering this journal entry into the ledger below:

DEPRECIATION EXPENSE

Details	DEBIT	CREDIT
Opening balance	$0	
Accumulated Depreciation	$600	
BALANCE	**$600**	

Details	DEBIT	CREDIT
Opening balance		$0
Depreciation		$600
BALANCE		**$600**

Year 2:

We are now looking to depreciate our car for the second year. Our car was originally valued at $3,000.

However, when using this method we calculate depreciation based on the car's **current** value, not original value.

We already depreciated our car by $600 in the first year (above). This means the current value of our car is considered to be **$2,400** ($3,000 - $600 = $2,400).

This is the value we'll use to calculate this year's 20% depreciation:

20% of $2,400 comes to**$480**. This will be the amount of depreciation for our car this year.

Here's what the journal entry will look like:

Dr	Depreciation expense	$480
Cr	Accumulated depreciation	$480

Have a go at entering this journal entry into the ledger below:

DEPRECIATION EXPENSE

Details	DEBIT	CREDIT
Opening balance	$0	
Accumulated Depreciation	$480	
BALANCE	**$480**	

ACCUMULATED DEPRECIATION.

Details	DEBIT	CREDIT
Opening balance		$600
Depreciation		$480
BALANCE		**$1080**

Notice how in this second year our depreciation expense ledger has an opening balance of $0 whereas our accumulated depreciation ledger has an opening balance of $600.

This is because depreciation expense is recalculated every year. It is an expense account, and the nature of expenses is that they only relate to the year in which they are calculated. At the end of the year, they restart back at zero.

On the other hand, accumulated depreciation represents the depreciation from all previous years added together; hence the name ‘accumulated’ depreciation. It is a liability, and the nature of liabilities is that their value carries forward year after year.

In the real world, we would be depreciating all our assets. That is, we would also need to work out depreciation on our oven, our computer and our iPhone. For the sake of keeping things as

simple as possible, we'll let that side for now. The purpose of this lesson was to simply explain the concept of depreciation and how we record it.

Alright, let's move on!

NOTE: Usually it's the government that prescribes the depreciation rates for different asset class.

How to prepare trial balance

The Trial Balance is, as the name suggests, a table where we lay out all our debit accounts and all our credit accounts to see if they balance or not.

A trial balance is important because it acts as a summary of all of our accounts. By looking at our trial balance we can immediately see our bank balance, our loan balance, our owner's equity balance. In fact, we can immediately see the balance of every single account in our business.

Why is this important?

Well, as you know, accounting is all about balancing. The accounting equation needs to balance, every transaction needs to be balanced, our debits and credits need to be balanced and so on.

A trial balance is basically the accounting equation of our business laid out in detail. It has our assets, expenses and drawings on the left (the debit side) and our liabilities, revenue and owner's equity on the right (the credit side). We can see everything clearly and make sure it all balances.

A trial balance that balances tells us that we've done all our journals and ledgers correctly. Basically, it's saying, "All your transactions for the year have been entered and everything looks right!"

As you may have already guessed, in the real world trial balances do not always balance the first time. As with anything, human errors will occur and somewhere along the line someone is likely to have entered a bad journal or processed a ledger incorrectly. Therefore at the trial balance stage accountants and bookkeepers are often forced to go back and review vouchers, journals and ledgers to locate the errors and bring the accounts back to balance. This shows the importance of producing a trial balance in the first place – it tells the user that the accounting equation is out of balance and it needs to be fixed before going any further.

Producing the trial balance is the final step of data processing – after that, we can start producing our financial statements!

So how is our trial balance prepared?

First of all, we take all the balances from our ledgers and enter them into our trial balance table. Remember the accounting equation:

DEBIT SIDE	CREDIT SIDE
Assets + Expenses + Drawings	**Liabilities + Revenue + Owners Equity**

Below is a list of all of our balances from our ledgers. You have calculated these balances in Lesson 8. Now you need to place them on the trial balance to see if they fit into the accounting equation!

Credit Side	**Debit Side**
Assets 1. Bank $21,650 1. Computer $1,500 1. Car $3,000 1. iPhone $500 1. Oven $2000	Liabilities 1. Loan $9,000 1. John's Car Shop $3,000 1. Accumulated depreciation $400 1. Add your items here 1. Add your items here
Expenses 1. Cake mix $3,000 1. Interest expense $1,000 1. Telephone expense $300 1. Repairs expense $50	Revenue 1. Sales $7,000 1. Add your items here 1. Add your items here 1. Add your items here

1. Depreciation $400	1. Add your items here
Drawings 1. Drawings $1,000	Owners' Equity 1. Owner's Equity $15,000

Calculate Assets	**$28650**	Calculate Liabilities	**$12400**
Calculate Expenses	**$4750**	Calculate Revenue	**$7000**
Calculate Drawings	**$1000**	Calculate Owners' Equity	**$15000**
Total Balance	**$34400**	Total Balance	**$34400**

Wow. You've just balanced your first trial balance. We now know that all our numbers are correct, and can start compiling financial statements! Go take a break and celebrate with a bowl of fries and a chocolate milkshake. You deserve it!

How to produce a Profit and Loss Statement

A Profit and Loss Statement illustrates how much profit you made in any given period, usually it is 1 year.

A Profit and Loss Statement is important because it illustrates whether or not we have made a profit – one of the most important objectives of being in business. This is also important to various other parties – the bank would like to know we made a profit so they can be sure we can continue to repay their loan, and the government would like to know the size of our profit in order to calculate our tax. It also summarises our revenue and expenses for the year, which is important for analysing how money has come in and out of our business.

On our Trial Balance we have 6 sections – Assets, Liabilities, Expenses, Revenue, Drawings and Owner's Equity. Take another look:

TRIAL BALANCE FOR (NAME)'S BAKERY AS AT (TODAY'S DATE)	
DEBIT SIDE	**CREDIT SIDE**
Assets	Liabilities
Bank $21,650	Loan $9,000
Computer $1,500	John's Car Shop $3,000
Car $3,000	Accumulated depreciation $400
iPhone $500	
Oven $500	
Expenses	Revenue
Cake mix $3,000	Sales $7,000
Interest expense $1,000	
Telephone expense $300	
Repairs expense $50	
Depreciation $400	
Drawings	Owners' Equity
Drawings $1,000	Owner's Equity $15,000
Balance $34,400	Balance $34,400

To check our Profit and Loss we're going to have the figures from two of these sections – **Revenue and Expenses.**

Let's have a look at these numbers:

Revenue:

Sales $7,000

Expenses:

Cake Mix $3,000
Telephone $300
Repairs $50
Interest $1,000
Depreciation $400

This is all the information that we need to produce for our Profit and Loss Statement. Let's get started.

The basic format of a Profit and Loss Statement is simply:

Revenue– Expenses = Profit

Using the figures from our trial balance, simply fill in the figures in the Profit and Loss Statement below to work out your profit!

PROFIT AND LOSS STATEMENT FOR (NAME)'S BAKERY FOR THE PERIOD ENDED (TODAYS DATE)		
Revenue		
Sales	$7,000	
Total Revenue		$7,000 (A)
Less: Expenses		

Cake mix expense	$3,000	
Telephone expense	$300	
Repairs expense	$50	
Interest expense	$1,000	
Depreciation expense	$400	
Total Expenses		$4,750 (B)
Net Profit		$2,250 (C)

Congratulations. You made a profit! As we can see in our Profit and Loss Statement, your bakery made a profit of $2250

Now, before you get too excited, you need to remember that you don't get to keep all that profit for yourself! There's a very important man known as the taxman who takes his cut each year:

Taxation

Now that we've worked out our profit, we can work out how much tax we need to pay.

Your profit is $2,250. Assuming 30% tax rate , you need to pay a tax of $675

Remember, this is just an example - every country has its own tax rate!

Let's go ahead and do one last journal entry to record our tax expense:

Dr	Tax Expense	$675
Cr	Accounts Payable	$675

Tax Expense is an expense, so this causes our debit side to increase. The other side of the equation is accounts payable, which is a liability.

It's a liability because it is still owing; it's a bit like a bill that's waiting to be paid. This liability will be carried forward on our balance sheet until we pay our tax the following year. At the time

we finally pay it, we will credit our bank account by $675 and debit our accounts payable by $675. By now, you should be able to see that this will reduce our accounts payable to zero, and the liability will be eliminated from our accounts.

Tax is interesting because it is a journal entry that we do AFTER our profit and loss has been prepared. This means we have to go ‘backwards’ in the accounting process, so to speak.

After that, we prepare our tax ledgers as per usual, and add the balances to the trial balance.

TAX EXPENSE LEDGER

Details	DEBIT	CREDIT
Opening balance	$0	
Tax Payable	$675	
BALANCE	**$675**	

TAXATION PAYABLE LEDGER

Details	DEBIT	CREDIT
Opening balance		$0
Tax expense		$675
BALANCE		**$675**

Here is how our updated P & L statement looks like-

PROFIT AND LOSS STATEMENT FOR (NAME)’S BAKERY FOR THE PERIOD ENDED (TODAYS DATE)		
Revenue		
Sales	$7,000	
Total Revenue		$7,000 (A)

Less: Expenses		
Cake mix expense	$3,000	
Telephone expense	$300	
Repairs expense	$50	
Interest expense	$1,000	
Depreciation expense	$400	
Total Expenses		$4,750 (B)
Net Profit		$2,250 (C)
Less taxation (30%)		$675
Net profit after tax		$1,575

Revenue		
1. **Sales**	1. 7000	
1. **Calculate Revenue**		**Your Total Revenue is 7000**

Less: Expenses		
1. **Cake mix expense**	1. $3,000	

1. **Telephone expense**	1. $300	
1. **Repairs expense**	1. $50	
1. **Interest expense**	1. $1,000	
1. **Depreciation expense**	1. $400	
1. **Calculate Expenses**		**Your Total Expenses is 4750**
1. **Calculate Net Profit**		**Your Total Profit is 2250**

Importance of a P&L Statement

The Profit and Loss Statement is a very important report. It's the report you'll submit to the bank next time you apply for a loan. They'll use it to see whether or not your business makes enough money to pay it back.

It's the report you'll submit to investors who want to invest in your bakery. They'll use it to determine whether your business is profitable and will give them a good return on their investment.

It's the report you'll submit to the government. They'll use it to work out how much money you made and how much tax you need to pay.

Anyone who needs information about your business's profitability will use this report. Good job! Now let's take care of the Profit and Loss Statement's big brother – the Balance Sheet.

How to create Balance Sheet

The Balance Sheet attempts to show how much the business is *worth.* It does this by illustrating the value of the business's net assets.

In order to do this, our balance sheet displays the difference between a business's assets and liabilities. This difference is known as the business's **net assets**, and is considered to be the "value" of the business. Obviously, every successful business owner wants to amass the highest amount of **net assets** as possible!

To create our balance sheet, we're going to need the remaining sections from our Trial Balance – Assets, Liabilities, Owners Equity and Drawings. Take a quick look at those.

TRIAL BALANCE FOR (NAME)'S BAKERY AS AT (TODAY'S DATE)	
DEBIT SIDE	**CREDIT SIDE**
Assets	Liabilities
Bank $21,650	Loan $9,000
Computer $1,500	John's Car Shop $3,000
Car $3,000	Accumulated depreciation $400
iPhone $500	Taxation Payable $675
Oven $500	
Expenses	Revenue
Cake mix $3,000	Sales $7,000
Interest expense $1,000	
Telephone expense $300	
Repairs expense $50	
Depreciation $400	
Tax Expense $675	
Drawings	Owners' Equity
Drawings $1,000	Owner's Equity $15,000
Balance $34,400	Balance $34,400

Let's take a look at these numbers:

Assets
Bank $24,150
Computer $1,500
Car $3,000

Liabilities
Loan $9,000
Johns Car Shop $3,000
Taxation Payable $675
Accumulated Depreciation $400

Owners' Equity
Owners Equity $15,000
Drawings $1,000

We'll also need to know our **net profit** for the year, which we know from our Profit and Loss statement, which is**$1,575.** Alright, that's all the information we need. Let's get started. The basic format of a Balance Sheet is:

Assets – Liabilities = Owners Equity (Net Assets)

Using the figures from our Trial Balance, simply fill in the blanks on the Balance Sheet below. Note that there are two formats, a "T" format and a list format. Both formats are commonly used, and are simply different methods of displaying the same information.

BALANCE SHEET FOR (NAME)'S BAKERY AS AT (TODAYS DATE)					
Assets			**Liabilities**		
Bank	$21,650		Loan	$9,000	
Computer	$1,500		John's Car Shop	$3,000	
Oven	$2,000		Taxation Payable	$675	
iPhone	$500				
Car less accumulated depreciation	$2,600				
Total Assets		**$28,250**	**Total Liabilities**		**$12,675**
			Owner's Equity		
			Owner's Equity at start of year	$15,000	
			Minus: Drawings	$1,000	

			Plus: Net Profit After Tax	$1,575	
			Owner's Equity at year end		**$15,575**
Total		**$28,250**	**Total**		**$28,250**

BALANCE SHEET FOR (NAME)'S BAKERY AS AT (TODAYS DATE)		
Owner's Equity		
Owner's Equity at start of year	$15,000	
Minus: Drawings	$1,000	
Plus: Net Profit After Tax	$1,575	
Owner's Equity at year end		**$15,575**
Represented by:		
Assets		
Bank	$21,650	
Computer	$1,500	
Oven	$2,000	
iPhone	$500	
Car less accumulated depreciation	$2,600	
Total Assets		**$28,250**

Less: Liabilities		
Loan	$9,000	
John's Car Shop	$3,000	
Taxation Payable	$675	
Total Liabilities		**$12,675**
NET ASSETS (Total Assets minus Total Liabilities)		**$15,575**

GREAT! We've just completed our Balance Sheet.

Let me point out a few interesting things about it.

1. Notice how the Owner's Equity at the top of the statement *balances* with the Net Assets at the bottom of the statement. They're both $15,575. This is where the term *Balance* Sheet comes from. If your Balance Sheet doesn't balance, you've got a problem!

2. Notice how your Owner's Equity changed. It's now $15,575, even though you've only put $15,000 into the business, which was the original amount. This is because you made a **profit.** As the owner, this profit is yours! Each year, any profit you make will carry over to the Owner's Equity section of the Balance Sheet. If you've been in business for 10 years, then 10 years of profit will have been accumulated in your Owner's Equity. Think of Owner's Equity as the amount the business owes to you, so whenever you make a profit, it's yours! Oh the joys of being a business owner!

3. Your Owner's Equity only increased by $575, even though you made $1,575 in profit. Why is that? It's because you took $1,000 of **drawings** during the year. That means although the $2,250 profit is yours, you already took $1,000 of it. Owners need to be careful not to withdraw so much in **drawings** that their Owner's Equity falls below zero.

That's it friends! We've started our business, recorded all our transactions, prepared a list of journal entries, entered them into our ledgers, taken our ledger balances into a trial balance, and finally produced a Profit and Loss Statement and a Balance Sheet!

This is the accounting process in action, and we now have two key reports that provide valuable information and will allow us to make good financial decisions.

We'll talk a bit about that in a later tutorial.

Why monitoring Cash Flow is important for business

The cash flow report is the third component of a company's financial statements. The report portrays how a company has spent its cash, and is often used in tandem with the other two key reports – the Profit and Loss and the Balance Sheet.

The cash flow report is important because it informs the reader of the business cash position. For a business to be successful, it must have sufficient cash at all times. It needs cash to pay its expenses, to pay bank loans, to pay taxes and to purchase new assets. A cash flow report determines whether a business has enough cash to do exactly this.

Having cash is a key requirement for a business to stay **solvent**. When a business has no longer enough cash to pay its dues, it is often declared **bankrupt**.

For the purposes of this introduction to accounting, we will not go through the actual preparation of an actual cash flow report. In fact in the business world, small businesses rarely produce a cash flow report, as profit and loss report is sufficient for their needs. It is unlikely that a small business such as a bakery will involve complex non cash transactions that would warrant such information. Therefore, it is considered a waste of time and money to have an accountant prepare a report that would be of little use to anyone!

On the other hand, for large entities such as Nike and Microsoft, having a cash flow report is imperative. Such companies will often have a significant amount of non-cash transactions, sometimes even billions of dollars in revenue that is simply owed to them but hasn't been received in cash yet. In these situations, a profit and loss statement is not always sufficient and a cash flow report is valuable to many users, such as banks and shareholders.

Example:

Let's imagine you start a business with $1,000.

With your $1,000 you buy a box of ingredients and bake cakes.

You sell all the cakes to a customer for $5,000.

The customer asks if he can purchase the cakes on credit, meaning he will pay for the cakes at the end of the month. You agree.

Let's determine your cash position in this scenario.

Revenue: $5,000

Under accounting rules revenue is recognised when it is earned, **not** when it is received. Therefore, since you have made the sale to your customer, the sale must be recognised as revenue received.

Profit: $4,000

You spent $1,000 on the cakes and sold them for $5,000. This leaves you with a profit of $4,000.

Cash: ZERO!

Even though you have earned $5,000 in revenue and $4,000 in profit, you have ZERO CASH! This scenario can play out often in the business world, particularly with large corporations, which signifies the importance of producing a cash flow report.

The purpose of this lesson is to describe the merits of a cash flow report and when it may be necessary. However, you will probably find that the majority of small businesses don't find this report necessary – a profit and loss statement is often all they require for their tax and planning needs.

Appendix: Different types of accounting statements

	Trial Balance	**Profit and Loss**	**Balance Sheet**	**Cash Flow Statement**
Accounts included	All Accounts	Revenue & Expenses	Assets, Liabilities, Drawings and Owner's Equity	Bank
Type	For internal users	For external users	For external users	For external users
Key information displayed	Confirmation that our debit accounts balance with our credit accounts	Profit/Loss for the year	Value of the business's net assets	Increase/decrease in bank balance
Structure	All debit accounts on left side, all credit accounts right side	Revenue minus expenses equals profit	Assets minus liabilities equals Owner's Equity	Starts with bank balance at start of the year Add cash received Minus cash spent Equals closing bank balance

	• A trial balance is a detailed summary of all our accounts, split into a debit and credit side. It is used to ensure that our debit side and credit side balance, hence the name 'trial balance' • It is an internal report and not generally provided to third parties • If the trial balance balances, we can be confident that all our ledgers are correct, allowing us to proceed with financial statement preparation	• A profit and loss (P&L) statement is prepared to display our revenue and expenses. It is used to show how much the business earned during the year • If revenue exceeds expenses there will be a profit • If expenses exceed revenue there will be a loss • Assets, liabilities,drawings and owner's equity do not affect profit and so are not included in the P&L	• A balance sheet is prepared to display our assets, liabilities and owner's equity. It is used to show how much a business is worth. • It display the equation: Owner's Equity = Assets - Liabilities • It is important the both sides of this equation balance, hence the name "Balance sheet" • Every year profit is taken form the P&L and added to Owner's Equity. This represents an increase in how much the business is worth	• A cash flow statement shows how the business used it's cash during the year. Basicaally it aims to show the change in a business's bank balance • If cash inflow exceeds cash outflow, the business is said to have a positive cash flow. For the opposite, the business will have negative cash flow • Cash flow is different from profit and loss because it only relates to cash transactions. Things like depreciation, credit sales etc are not included.

How to analyze financial reports to make informed decisions

So you might be asking yourself, why did we just do all of that? Seems like a lot of effort for just a couple of reports.

Well here's the answer.

You cannot make good business decisions without good information. With these two reports, we now have accurate, well prepared, easy to understand financial information about our little bakery. Here's what we now know:

1. How much we sell

2. How much we spend

3. What we spend it on

4. How much profit we make

5. How much our assets are worth

6. How much we owe other people

7. How much the business owes us

Now, imagine next year when we prepare our next set of financial reports. Then we'll also know

8. If our profit is increasing

9. If our expenses are increasing

10. If our asset values are increasing

11. What we're spending more money on

12. What we're spending less money on

13. If our debt is increasing

14. If the business is improving in terms of higher sales, higher profits and higher net worth

This is the whole reason we prepare financial information - to pinpoint the strengths and weaknesses in our business and see where we can improve. Every year corporations spend millions of dollars on accountants and consultants, seeking advice on how to improve their profits. And can you guess what these accountants and consultants use to base their advice on? Financial statements!

For a well-educated professional, a set of financial statements can tell them an incredible amount of information about a business. Just a profit and loss statement and a balance sheet is enough to generate an abundance of suggestions and ideas. Right now, I'm going to pretend to be a consultant for your bakery. Let's see what I can come up with.

Financial Analysis

PROFIT AND LOSS STATEMENT FOR (NAME)'S BAKERY FOR THE PERIOD ENDED (TODAYS DATE)		
Revenue		
Sales	$7,000	
Total Revenue		$7,000
Less: Expenses		
Cake mix expense	$3,000	
Telephone expense	$300	
Repairs expense	$50	
Interest expense	$1,000	
Depreciation expense	$400	
Total Expenses		$4,750
Net Profit		$2,250
Less taxation (30%)		$675
Net profit after tax		$1,575

BALANCE SHEET FOR (NAME)'S BAKERY AS AT (TODAYS DATE)

Assets			**Liabilities**		
Bank	$21,650		Loan	$9,000	
Computer	$1,500		John's Car Shop	$3,000	
Oven	$2,000		Taxation Payable	$675	
iPhone	$500				
Car less accumulated depreciation	$2,600				
Total Assets		**$28,250**	**Total Liabilities**		**$12,675**
			Owner's Equity		
			Owner's Equity at start of year	$15,000	
			Minus: Drawings	$1,000	
			Plus: Net Profit After Tax	$1,575	
			Owner's Equity at year end		**$15,575**
Total		**$28,250**	**Total**		**$28,250**

Observation 1:

Enter the Account with Largest Expense

Observation 2:

Do you see advertising expense? Yes No

Observation 3:

Do you see any wages? Yes No

Observation 4:

How much money is in bank ?

Observation 5:

Do you see rent expense ? Yes No

Observation 6:

What is the car worth after depreciation?

Now, some of these suggestions may be worthwhile and some of them may not, but that is beside the point. The lesson here is, from just looking at a profit and loss and a balance sheet - two reports which fit on one piece of paper, you can derive such a wealth of information about your business. Not only can you ascertain exactly where your money is coming from and going to, you also have enough information to make a decent list of ideas and suggestions about areas of concern and improvement. Now just imagine what an effective consultant could come up with for a large corporate like Toyota or McDonald's, armed with a few more pages of financial information.