



How to Speak Accounting

You've heard the saying that nothing happens until someone sells something. After that sale, accounting takes over as the basic activity of business.

The Three Questions

Every business asks three key questions:

- How much money came in?
- Where did the money go?
- How much money is left?

The answer to each question can come only from the practice known as accounting. Like other practices such as medicine and law, accounting has its own vocabulary. In many ways, accounting is the language of business.

Accounting can become quite complex. It has a high MEGO factor. MEGO stands for that state of mental saturation when "My Eyes Glaze Over" in stupefaction. An exasperated student was once overheard complaining, "Who ever thought addition and subtraction could be this hard?"



In the Beginning

Accounting is one of our oldest skills. The earliest collections of understandable writing track how many bushels of grain came into the king's warehouse. From the very beginning of commerce, counting stuff made it possible. That started around 3500-3100 B.C. Those clay tablets also tell who brought in the grain and how much the king took. Tax collecting is an activity closely linked to accounting. We'll learn how crucial that can be to your business health in Chapter 9.

Whatever your responsibilities are in your business or organization, you need accounting skills to perform at your best. If you are in sales, you learn your product's features and how to show them to buyers. Those features include the cost or value proposition and how it affects your customers' buying decisions. Marketing managers study how to find and appeal to a product's target groups. Working up price points can mean some detailed cost analysis. Production managers learn how to plan workflow to control costs. Senior managers use financial statements to speak to those outside about their business's prospects.



Visualize

Many successful managers find it easier to visualize or imagine what they are trying to learn. This technique helps them bridge from the known to the unknown. You'll find several visual image examples used throughout this book to help you see key concepts clearly. Because accounting often deals with numbers and abstractions, it's useful to work with these images as a guide to better understanding.

Whatever your management level, you need to know accounting because your decisions will often be determined by "the numbers." That is how managers keep score and are graded. That's why you bought this book and that's what we're going to give you. Fasten your seat belt. We're taking off!

Visualize to Understand

Start with an aerial view. Imagine your business or organization as a country. It may be a big country or a small one. You may

live in a small town or the bustling capital. Your country has mountains and forests, fields and farms, rivers and lakes. Next, imagine that all the cash that comes into your business is water. Water helps your crops to grow. You can dam water to make power to drive your factories. Store the water in lakes to save for the dry season. You can give water to your people to slake their thirst.

That water may come from distant springs high in the mountains. It may come as a river that flows by your door. It may be piped to you across a desert. But it must come to you. And you must manage it.

In the desert colonies of the old Southwest, the Spanish governors set up the *acequia*, or water management system. You can still see its charming canal running through Santa Fe and it is still working, providing water for gardens throughout the city. The canals are called *domos* and the manager is the *majordomo*, or canal manager. It is a very important job. The canals must be kept clean and in good repair, and he organizes this work. In addition, the canal runs through the property of many people. Each is supposed to take water only on a certain day, so that everyone has enough. The majordomo makes sure everyone follows the rules.

An accounting system does for your business exactly what a water-management system does for a city. It makes sure that the money that comes in flows to all the right places. It helps you make sure that you know where the money is. Accounting, or money management, is the art of knowing where the money is and making the right decisions about what to do with it so that your business will grow.

If the money doesn't come in, your business or your organization will die an agonizing death from thirst.

Many of the dot-com start-ups of the late 1990s began with a large pool of venture capital cash. They had high liquidity. The managers, more often than not, spent that money on fancy furniture, equipment, and offices and on heavy advertising, and large salaries. The venture capital cash poured out before any

comparable flow of cash came in from customers. The result? All the cash drained away and businesses died of thirst. In Chapter 3, we will cover cash flow. This short example should give you an idea how important it is to manage cash flow. Pay close attention when we get there: this is a lesson that could have kept some dot-coms from turning into dot-bombs. Then, in Chapter 4, we'll cover some ways you can actually measure the liquidity/cash position of your business.



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Liquidity Ability to meet current obligations with cash or other assets that can quickly be converted to cash. The more cash, the more liquid. The less cash, the less liquid.

So, the first thing your business needs to become real is cash. How do you get that cash? You can get it from selling things. You can also get it through a loan. Almost all businesses start with a loan, whether from the owner's

savings, money collected from friends and family, the basic venture capitalists, or a bank.

If things don't pan out, you may be able to mournfully bid farewell to your money. Family may be grudgingly forgiving. However, friends and banks have this quaint idea that they want their money back. Therefore, you need a way to track all those loans coming in. Who gave you how much and when? What did you spend the money on? Goods to put on the shelves? The shelves themselves?

Then, a miracle occurs. That first customer or client comes in and gives you cash for what you sell. What do you do with that cash? Buy more goods? More shelves? Pay off your parents? The bank? Things are going to get really complicated really fast. Your accounting system and your understanding of how it works will save you.

Your accounting system is nothing more than a series of locks, lakes, and levees for your cash flow. It's a way of channeling and classifying the cash so that you can start to make some decisions about what to do with it and how to get more of it. You're now doing what a manager does: you're controlling



Think like an Owner

“Wait a minute,” you say. “I’m a first-line supervisor in a machine shop. What do I need to know about starting and running a business?” Here’s a news flash. The key to becoming a successful manager is to start thinking like an owner. That single attitude adjustment will put you head and shoulders above many, if not most of your peers. You will now start to see the relationships between and among business activities. Make that adjustment and you have earned back the price of this book in multiples of thousands. Of course, the second key is to wait until you’ve absorbed and practiced the lessons in the rest of this book before telling the CEO how to run the business.

and directing resources.

Hold that image of cash as water in your mind for another moment. It can easily evaporate. It can easily trickle away. You now begin to appreciate how important tracking what happens to that cash can be. As a manager you assign resources: people, cash, materials, time. You need some way of knowing where your resources are, what they should be doing, and how well they’re doing it.

The Accounting System

You need an accounting system that’s the right size to handle the demands of your business. It also has to be well designed so that it gives you the information you need. Many businesses can be managed successfully with nothing more complicated than a checkbook register. As volume increases, however, you may go to a manual system or a computer spreadsheet. Higher volumes and more transactions demand a computerized system. These systems range in price from under \$500 to well into seven figures for large organizations.

To start another image in your mind, your accounting system is the plumbing of your business. It is the way you direct, match, and track your resources. What were the sales of Product X? How much time did Bob spend on Project Y? Am I over my travel budget for the year? These answers come from your accounting system. The plumbing in a pup tent is pretty basic. As you

move up in complexity, the plumbing in a 1000-square-foot house with one bathroom and one kitchen is simpler than in a mansion with a dozen bathrooms and several kitchens. You want an accounting system that meets your needs.

The information an accounting system provides has two faces—external and internal. To provide these two different views, your accounting system divides into two parts—*financial* accounting and *management* accounting. Each of these areas is a separate discipline in its own right.

Financial accounting is the face your business shows the outside world. Here the daily “gozinta” and “gozouta” become the financial statements that you present to your bank, your stockholders and investors, and taxing authorities. These financial statements are basically historical records that



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Key Concepts

“Gozinta” and “gozouta” are sophisticated accounting terms representing the generic sum of all inputs into an entity and the generic sum of all outputs from that same entity. The smart manager keeps in mind that those liquid assets are just coming into or going out of the business. Those are the basics in accounting.

cover a particular time period. It could be yesterday or a year. Each has certain valuable information to help managers make decisions. We will cover financial accounting in Chapters 2, 3, and 4.

Management accounting can be thought of as real-time accounting. It provides the information

you need to run your business, and it begins with day-to-day record keeping. Gathering this information on the “gozinta” and “gozouta” forms the basis for many of your managerial decisions. These numbers can be sliced and diced many ways to help you do your job. We’ll cover management accounting in Chapters 5, 6, and 7.

Accounting from the Bottom Up

We opened this chapter with three questions that every business asks:

- How much money came in?
- Where did the money go?
- How much money is left?

However, to get to the answer to these questions, we need to understand several ideas. We're going to start from the simplest and work our way up to the financial statements that will answer our questions. Our explanation of accounting will also follow history; accounting developed slowly over the last 500 years to the sophisticated computer systems and highly specialized accounting standards we use today.

Double Entry

The first principle of accounting we need to understand is called *double-entry* bookkeeping. Each transaction made in the accounting system is entered twice. No, this does not mean we are keeping two sets of books. We enter every transaction twice, to show where the money comes from and where it is going.

Financial statements A set of accounting documents prepared for a business that cover a particular time period and describe the financial health of the business.



An Italian monk, Luca Pacioli, gets the credit for developing double entry in 1494, although it first appeared some 50 years earlier. Next time you think you're getting confused by double entry, remember this. It's been around for more than 500 years. Most of the people who used it didn't know how to program VCRs. You are way ahead at the start.

Transaction Any event that affects the financial position of the enterprise and requires recording. In some transactions, such as depositing a check, money changes hands. But in others, such as sending an invoice to a customer, no money changes hands.

Account A place where we record amounts of money involved in transactions. An account shows the total amount of money in one place as a result of all transactions affecting that account.





Assets What a business owns or is owed. Examples are real property, equipment, cash, inventory, accounts receivable, and patents and copyrights.

Liabilities What a business owes. Examples are debt, taxes, accounts payable, and warranty claims.

Equity Cash that owners or stockholders have put into the business plus their accumulated claims on the assets of the business. Also known as *owner's equity* or *stockholder's equity*, depending on how the business is organized.

Accounting is concerned with three basic concepts:

- assets
- liabilities
- equity

Let's use a series of T accounts to trace a small job all the way through a business. Let's say you do some work for a customer and you take along a contractor as an assistant. You invoice the client; the client pays. Also, the contractor bills you. How does this look in double-entry bookkeeping, illustrated with T accounts? Let's walk through it one step at a time.

Your customer calls you and asks you to do



T Account

A T account let you visualize both sides of an account. We use T accounts in pairs to set up the double entry.

The left side of the T is called the *debit* and right side is the *credit*. Later on, we'll explain why some entries always go on the left and others on the right. Here's a pair of T accounts for writing a check to buy \$100 of office supplies.

Assets: Corporate Checking

Expenses: Office Supplies

Assets: Corporate Checking		Expenses: Office Supplies	
Debit	Credit	Debit	Credit
	6/7 \$100	6/7 \$100	

Notice that we always record a date for each transaction.

the work. You plan the job, put it on the schedule, and arrange for the contractor to come with you. All of this is important business, but none of it shows up in accounting. No transaction has happened yet; if the appointment falls through, you will not get paid anything.


You go and do the work and the contractor comes with you. The customer tells you he is happy with the work and looks forward to receiving your invoice, which he'll pay promptly. The contractor says she'll send you a bill and you promise to pay within one month. Still, no transaction has occurred. If no invoices are sent, and no one gets paid, then it's as if you'd worked for free.

The next day, you write up an invoice for \$1,000 and mail it to the customer. The invoice has gone out; now a transaction has occurred. In a pair of T accounts, it looks like this.

Income: Consulting Services		Assets: Accounts Receivable	
Debit	Credit	Debit	Credit
	6/2 \$1,000	6/2 \$1,000	

What do these two diagrams mean?

The first one says that on June 2 the company received \$1,000 in income. How is this possible, if you haven't gotten a check yet? Because in accounting, we count the money as coming in when we bill it. Why? Because the money we are owed is an asset and we want to keep track of it. It is of value to our company. We could go to a bank and borrow against the money our customers are due to pay us. So, the value of the company has increased, from an accountant's perspective. The company is



Fixing the Books
 Once in a while, we make a mistake. Here's a tip for hunting down that lost entry. Grab a scratch pad and start making T accounts for the ledgers that don't balance or the entry that is partly missing. Make each one carefully. As you work it through, you will see the entry that got missed.

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worth \$1,000 more than the day before, because income has come in. So we have a credit to income—money coming in.

The balancing T account is a debit to assets. But if our assets have increased, why do we debit them? This is one odd aspect of accounting. Asset accounts are debit accounts. So a debit to an asset is an increase of money in the company. Later on, we'll



Debit A reduction in the amount of money in an account. It shows up on the left side of a T account.

Credit An increase in the amount of money in an account. It shows up on the right side of a T account.

see how this keeps the books in balance.

But, in double-entry bookkeeping, all transactions are entered twice, so that all accounts are balanced. That is a fundamental rule of accounting.

If the income account goes up (is credited) by \$1,000, then a debit for \$1,000 must show up somewhere else. It shows up in *Assets—Accounts Receivable*, as we see in the second T account diagram.

Accounts receivable is a single account that shows all of the money that you are owed by everyone. Accounts receivable is an asset account. That is, it is one of the accounts that show how much money is in the company.

The next day, you receive a bill in the mail from your subcontractor. This is another transaction. You enter the bill in your accounting ledger or system to show that you owe her the money. The T accounts look like this:

Expenses: Subcontractor		Liabilities: Accounts Payable	
Debit	Credit	Debit	Credit
6/3 \$200			6/3 \$200

Together, these two T accounts say that your company has a \$200 expense and owes a subcontractor \$200. Even though you haven't paid her bill yet, your company owes the money, so the value of the company is \$200 less than it was.

At the end of the week, you receive a \$1,000 check from your customer and deposit it into the corporate checking account. Again, two T accounts record this in your accounting system. These two diagrams may seem backwards. But remember: all asset accounts are debit accounts, so an entry in the debit column is an increase to the account and an entry to the credit column is a decrease.


Assets: Accounts Receivable		Assets: Corporate Checking	
Debit	Credit	Debit	Credit
	6/4 \$1000	6/4 \$1,000	

Now you feel like your business is up and running. You feel so good that you want to pay your subcontractor’s bill. Only you can’t—the check from the customer hasn’t had time to clear the bank. While you’re waiting for the check to clear, you ask those three basic questions all managers want to know:

- How much money came in?
- Where did the money go?
- How much money is left?

Since you’ve entered every transaction, your accounting system should be able to answer those questions. The questions are answered in reports called *financial statements*. The two most important financial statements are the *income and expense statement* and the *balance sheet*.

If you’re using a computerized accounting package, you simply go to the



Income and expense statement A document that shows all of the gozinta and gozouta for a business during a particular period of time. Sometimes it is just called an *income statement*. *Revenue* is a synonym for income, so this can also be called a *statement of revenue*.

Balance sheet A financial statement that shows the financial position—that is, the assets, liabilities, and value—of a company on a particular day.



Automagic Accounting

Even though all accounting systems are double entry, on many computerized accounting systems we enter each number only once. How does it do that? The computer maintains a chart of accounts. The bookkeeper enters the transaction in one account (say, the bank's checkbook) and then selects another account (perhaps a particular type of expense). When the bookkeeper clicks OK, the transaction is recorded in both accounts. The computer automagically takes care of the second entry, keeping the books in balance. Program instructions also block transactions that do not fit the accounting equation. Try paying your rent out of your insurance account. It won't work.

There are two big advantages of computerized accounting systems. One is that they make it hard to make errors. The other is that you enter the information once, and then see it in several different ways: as data entry screens, account ledgers, and reports.

reports menu, select the report you want, select the start and end dates, and print it out. But, rather than relying on the magic of a computer program, let's walk through the process of build-



Chart of accounts A list of all the accounts in the accounting system. Some of them may be used every day, such as Cash, and some rarely or even never.

ing our financial statements, so that you can see how accounting moves from the recording of each transaction to the presentation of useful reports.

Bookkeeping and Accounting

Many people confuse *bookkeeping* and *accounting*. They think that bookkeeping is accounting. Bookkeeping is the act of recording transactions in the accounting system in accordance with the principles discussed in Chapter 2.

Accounting is the way we set up the system, the principles behind it, and the ways we check the system to make sure that it is working properly. Accounting ensures that bookkeeping is honest and accurate and, through financial accounting and management accounting, it provides people outside and inside

the business the picture they need of where the company's money is.

Accountants developed bookkeeping procedures as a way to organize records, to classify the many transactions that take place. Bookkeeping puts related transactions together into groups so that their impact on the accounting equation can be recorded and analyzed.

When we put several transactions together into one account, we're creating a *ledger*. Each account has a ledger that lists all its transactions. Every transaction is entered twice, in two ledgers, once as a credit and once as a debit. The individual lines in a ledger are called *entries*. In a manual system, each entry is first put on a master page called the *journal*, or *book of first entry*, and then copied to the appropriate individual account pages. As a result, the books stay in balance; the total of all credits equals the total of all debits.

Right from the Start



If you are a sole proprietor, you may be doing much of your bookkeeping yourself. If so, you might consider taking a bookkeeping course. If someone else is doing it, either inhouse or outside, recognize that it's critical that the initial entries go in correctly. Running down bookkeeping entry mistakes is a tedious task, especially if they happen regularly.

Ledger The record of all transactions in a particular account. The detail generally includes the date the transaction took place, the amount, whether it was a debit or a credit, and a short memo, if necessary.



Entry An individual line in a ledger.

Journal Where a transaction is first entered. It's also called the *book of first entry*. While the ledger shows all the action in a particular account, the journal shows the original transaction and all the accounts affected by it. A \$1,000 dollar payment could be \$250 of fuel, \$75 of oil, and \$675 of maintenance. The date, the accounts debited and credited, and the memo are also recorded.

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Before we overload you with more accounting terminology, let's use the example of our new service business to show how all this works. As a result of the three transactions we've entered, here are the ledgers for five accounts:

Income: Consulting Services

Debit	Credit	Notes
	6/2 \$1000	Invoice for consulting services
	\$1,000	Total

Assets: Accounts Receivable

Debit	Credit	Notes
6/2 \$1,000		Invoice for consulting services
	6/4 \$1000	Check received
	0	Total

Assets: Corporate Checking

Debit	Credit	Notes
6/4 \$1,000		Check received
\$1,000		Total

Liabilities: Accounts Payable

Debit	Credit	Notes
	6/3 \$200	Bill received
	\$200	Total

Expenses: Subcontractor

Debit	Credit	Notes
6/3 \$200		Bill received
\$200		Total

- Income: Consulting Services
- Assets: Accounts Receivable
- Assets: Corporate Checking
- Liabilities: Accounts Payable
- Expenses: Subcontractor

With these five account ledgers laid out, we can trace the transactions related to that one day of work. For example, we can see that accounts receivable increased by \$1,000 when we sent the invoice, then decreased back to zero when we received the invoice and deposited the check.

Take a moment to trace all the entries from the previous pages in these ledgers. In fact, take more than a moment. Visualize the action that was taken related to each transaction. See yourself first writing an invoice, then receiving and entering a bill, and finally receiving and depositing a check. Find the two entries related to each of these actions. When it's all clear in your mind, you're ready for the big leap—from bookkeeping to accounting.

Financial Statements

After just one job, it's pretty easy to understand the accounts in the ledger. But when we've entered dozens, hundreds, or even thousands of transactions—think how many customers come into a restaurant every day—we need reports that show us what's going on. Looking at the account ledgers would just make our eyes pop out and give us a headache.

First, let's look at the income and expense statement for our company:

Revenues	
Contracting Services	\$1,000
Revenue (gross income)	\$1,000
Expenses	
Subcontractor	\$200
Net Income	\$800

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The income and expense statement shows details and totals of income accounts and expense accounts. Note that it does not show individual journal entries. From this report, we don't know if we did one job or three jobs—just that the total was \$1,000 of contracting jobs billed. *Revenue* or *gross income* is all the money that has come in, without considering expenses. *Net income* is gross income less total expenses; that is, it's the amount of money we've made after expenses. Net income is a key factor in business success. When we're spending more than we're making, that money is a negative number, called *net loss*.

The income and expense statement is useful, but it doesn't show the whole picture. For example, it doesn't tell us how much money we have in the bank account or even whether or not we've paid our subcontractor. To get the rest of the picture, we need a balance sheet.

Assets	
Accounts Receivable	0
Corporate Checking	\$1,000
Total Assets	\$1,000
Liabilities	
Accounts Payable— Subcontractor	\$200
Total Liabilities	\$200
Equity	\$800

Now we see that, even though we have \$1,000 in the checking account, we owe \$200 to someone, so our company is worth only \$800. In simple terms, *equity* is the financial value, or worth, of a company.

Accounting Principles

Do you remember the scene from the end of *The Wizard of Oz* where the great big voice says, “Pay no attention to that man behind the curtain!”? Accounting is kind of like that. Behind all

the terms and rules and reports, there are a few levers and gears that keep the whole thing working. In this chapter, we're taking you behind the scenes. You've already learned the most basic principle—double-entry bookkeeping to keep the books in balance. Let's look at a few more.

- All accounts are assigned a type. These are the most basic types of accounts:
 - income
 - expense
 - asset
 - liability
 - equity
- Each type of account has a normal balance, a side of the T account where normal entries (that increase the account balance) are made.
 - Asset and expense accounts are *debit* accounts, with normal entries that increase account value on the right side of the T account.
 - Liability, equity, and income accounts are *credit* accounts, with normal entries that increase account value on the left side of the T account.
- Income and expense statements always have a period, from a beginning date to an ending date.
- Balance sheets have a single date, reporting the status of the company on that date.
- An income and expense statement shows the change in the balance sheet from the start date to the end date of the income and expense statement.

Normal balance The balance an account is usually expected to have, the side on which an account increases. (The word “normal” here means usual.) Having income as a credit account and expenses as a liability account is logical. But the balance sheet accounts seem to be reversed logically—asset accounts are debited and liability and equity accounts are credited. Yes, this is backwards. This “crossing of the wires” is the trick behind the scenes that makes all the accounts balance.





Getting a Handle on Financial Statements

Tracing changes in the balance sheet to the income and expense statement is more than just an exercise. It is the fastest way to get a handle on accounting. Sure, the first few times, it feels like you're banging your head against a wall. But keep at it. A good manager will check over his or her financial statements every month or at least every quarter. Once you understand them, financial statements help you keep the pulse of your business. If you look at them regularly, they also help you see changes as they happen, so you can catch problems before they become too big to handle.

In our example, the company started on June 1, 2003, with no assets or liabilities in each account. Can you trace every item on the balance sheet for June 5, 2003 to an item on the income and expense statement for June 1 to 5, 2003 (called “month-to-date”)?

The Fundamental Equations of Accounting

The preceding sections of this chapter have shown you the gears and wires behind the scenes that make everything work. Now, we are ready for the show: this is how accounting answers the three big questions we introduced at the beginning of the book:

- How much money came in?—revenue or gross income
- Where did the money go?—expenses
- How much money is left?—net income

The Income Equation

We find the direct answer to these three questions on the income and expense statement. The *income statement equation*—revenue – expenses = net income—is the key to the income statement. The result here is simple arithmetic: revenue (the gozinta) minus expenses (the gozouta) yields net income.

The Balance Sheet Equation

The balance sheet answers another set of crucial questions for a company. Today, what is my company worth? What's in my

bank account? How much money do other companies or people owe me? How much money do I owe other people or companies?

The fundamental equation of accounting underlies the balance sheet. It looks like this:

$$\begin{aligned} \text{assets} &= \text{liabilities} + \text{equity} \\ \text{assets} - \text{liabilities} &= \text{equity} \\ \text{assets} - \text{equity} &= \text{liabilities} \end{aligned}$$

The physical layout of the balance sheet matches the first equation:

$$\text{assets} = \text{liabilities} + \text{equity}$$

This makes logical sense: the value of what the company owns (assets) minus the value of what the company owes (liabilities) leaves you with what the company is worth (equity).

The Equations and the Normal Accounts

This table illustrates how the income equation balances if we enter our transactions properly on the normal side of each account.

Revenue		-	Expenses		=	Net Income
Debits	Credits		Debits	Credits		
Decrease	Increase		Increase	Decrease		
	Normal Balance		Normal Balance			

This table illustrates how the balance sheet equation—that is, the fundamental equation of accounting—balances properly if we enter our transactions on the normal side of each account.

Assets		=	Liabilities		+	Owner's Equity	
Debits	Credits		Debits	Credits		Debits	Credits
Increase	Decrease		Decrease	Increase		Decrease	Increase
Normal Balance				Normal Balance			Normal Balance

Every transaction we enter follows the basic accounting equations. In fact, the T accounts are designed to make sure that we follow the equations. That is why some accounts are credit accounts and others are debit accounts.

If each entry is balanced, then all of the entries are balanced and our balance sheet and income statement will come out right. If there is an error in one transaction, it will show up because our financial statements will be out of balance.

The Advantages of an Accounting System

It's possible to run a business on a checkbook. However, you gain a lot by setting up a simple, appropriate accounting system. The reports an accounting system generates let you do these things much more easily than you can if you just keep a checkbook.

- **Find errors.** If a transaction is missing or entered wrong, the books will be out of balance.
- **Plan for the future.** Seeing the gozinta, the gozouta, and what you've got, you can figure out what you're going to need—when to borrow money and what work to do to improve your business.
- **Stop fraud and theft.** If you know your business and your books, you can find out if people are cheating.
- **Get financing.** A good set of books impresses bank loan officers and investors.
- **Make taxes easy.** If you have just a checkbook and shoeboxes full of receipts, tax time can be a nightmare. It can actually cost less to keep good books all year than to clean up the mess just for the IRS.

A Few Important Details

There are a few more details of the wires and gears behind the scenes that we should mention before we close the chapter.



Getting into the T Account Habit

If you want to learn bookkeeping and accounting quickly—and keep your errors down to a minimum—keep this cheat sheet close to you and memorize it well. Routine transactions usually get applied to standard accounts the same way almost every time. Here are the most common ones.

Transaction	Account 1	Account 2
Invoicing a client	Asset:Accounts Receivable	Income
Depositing a client's check	Asset: Checking Account	Asset:Accounts Receivable
Receiving a bill	Expense (appropriate category)	Liability:Accounts Payable
Paying a bill	Liability:Accounts Payable	Asset: Checking Account (enter on right side, debit, as you are reducing account balance)
Buying supplies by check	Expense (appropriate category)	Asset: Checking Account (enter on right side, debit, as you are reducing account balance)
Buying an asset by check	Asset: Equipment	Asset: Checking Account (enter on right side, debit, as you are reducing account balance)
Buying supplies by credit card	Expense (appropriate category)	Liability: Credit Card (enter on right side, debit, as you are reducing account balance)
Paying a credit card in full by check	Liability: Credit Card (enter on left side to increase account balance to zero)	Asset: Checking Account (enter on right side, debit, as you are reducing account balance)

Compound Entries and Split Accounts

Sometimes, we write one check for several items. This requires a more complex entry: our accounts still balance, but they are spread out over several transactions, not just two.

We'll illustrate this with a general journal entry for a check that was written to an office supply store. Let's say we bought a

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printer, ink cartridges, and supplies for the annual Christmas party.

The PR column stands for *posting reference*. We use a checkmark in the PR column to indicate that the item has been entered on the separate accounting page in our ledger for that particular account and that it has been checked.

This simple example illustrates the advantages of an accounting system over trying to run a business on a check-book. Imagine seeing a check for \$600 for office supplies six months later and wondering, “What in the world did I spend all that money on?” You start digging. With your accountant’s help (at \$50/hour) you find the receipt. You discover what you paid

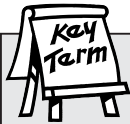
Date	Account and Explanation	PR	Debit	Credit
12/10/0x	Asset: Computer Equipment (Printer)		\$250	
	Expense: Office Supplies (Ink)		\$50	
	Expense: Office Party		\$300	
	Asset: Checking—Check #105 paid to The Office Store			\$600

for. Your accountant says, “Gee, I wish I’d seen this before we did your taxes. We treated it all as expenses, but the computer

printer really is an asset.”

And you’re wondering, “What in the world was I thinking, spending \$300 on an office party!”

Long experience has led to a standardized chart of accounts for many businesses. All the accounting software packages come with a built-in chart of accounts, often several.



Posting reference (PR)

column A column in journals where ledger account numbers are entered when entries are posted to those ledger accounts. The number in the PR column serves two purposes: it gives the ledger account number of the account involved and it indicates that the posting has been completed for the entry.

How Fine a Sieve?



One damaging mistake new managers make is to try and break every transaction down into its most basic atomic elements. If you go below three layers, you've almost certainly gone too far, unless you work for a very, very large organization. You may want to have an account for Computers and then break that down into Computers: Hardware and Computers: Software. There may even be a need to break the Software account down into, say, Accounting Software and Scheduling Software. Beyond that you create problems for whoever will be recording the transactions and whoever must build the information back up to analyze. You also create a complex structural system that invites error. As in all things, Keep It Simple, Señor/Señora/Señorita.

You may only need to put in the name of your bank for the cash account. Make adjustments as necessary so that your accounting system returns the information you need to make effective decisions. The bookkeeping system is a tool. It should not be your master.

Cash vs. Accrual

As you can see, an accounting system offers a great deal more than a simple checkbook. There are two basic approaches to accounting; you'll want to choose one for your business. The two approaches are *accrual basis* and *cash basis*.

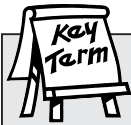
In this chapter, our example used accrual accounting. You can recognize accrual accounting because you see an asset category called accounts receivable and you see short-term liabilities for bills you need to pay. You can see how valuable accrual accounting is for the internal management



Accrual basis An accounting method that tracks income when you send an invoice, even before you receive payment, and tracks expenses when an invoice comes in, even before you pay it.

Cash basis An accounting method that tracks income when you receive the checks or cash and tracks expenses when you make payments.

of your business. It keeps you from being fooled by a big balance in your checking account when you have lots of bills to pay. It also lets you know when business is starting to pick up, as accounts receivable goes up even before the money comes in, and it helps you with collections. In addition, accrual accounting gives you a special report of accounts receivable called the *aging report* that shows you who owes you money—and how late they are in paying it. We will talk more about accrual and cash basis in Chapter 2.



Aging report A list of accounts receivable amounts by age. The report is usually divided into columns by 30-day increments, such as 0-30, 31-60, 61-90, 91-120, and 120+. It shows any customers that are slow to pay and reveals problems with collecting on accounts.

At this point you may feel a bit like you’ve been “rode hard and put up wet,” as we say in South Texas. I just wanted to get past the fear factor as quickly as possible. We’ll look at these concepts further as we navigate through the other general concepts of accounting, financial and management accounting, taxes, accounting systems,

financial ratio analysis, and auditing. But that should not be difficult, since you now understand the basics. Believe me, you’ve got it licked. It’s all downhill from here.

Manager’s Checklist for Chapter 1

- There are three basic questions you ask as a manager—How much money came in? Where did the money go? How much money is left? You’ll be a better manager if you think like an owner and keep the big picture in mind.
- Because accounting can get dry, it helps to visualize the concepts to see the underlying dynamics. Thinking of cash as water is a useful tool to help understand the ways you can use an accounting system.

- ❑ Double-entry bookkeeping keeps the books in balance.
- ❑ We illustrate double-entry bookkeeping by writing transactions in T accounts. The left side of the T is always a debit. The right side is always a credit. Depending on where the account is classified within the equation elements, an increase or a decrease could be either a debit or a credit. For each transaction, the total debits equal the total credits.
- ❑ The accounting system is based on a chart of accounts that establishes all of the pots where you're going to record transactions.
- ❑ The complete details of each transaction are recorded in the general journal. Each account in the chart of accounts has its own ledger. A running balance is often kept in these account ledgers.
- ❑ The statement of revenue, also called the income and expense statement, shows how much money came in, where the money went, and how much money is left over a given period of time. It's based on the equation *revenue - expenses = net income*.
- ❑ The balance sheet shows you how much money the company is owed, how much it has, how much it owes, and how much it is worth. It expresses the fundamental equation of accounting.
- ❑ The accounting equation— $\text{assets} = \text{liabilities} + \text{equity}$ —is the foundation of any accounting system. It assigns an increase component and a decrease component to each element of the accounting equation, establishing normal balances for the increase of each type of account.