Excellence in Design Firm Management SDA
Seattle

# Accounting 101*

One of our chapter's lifetime member, Tena Martins, presented a workshop focusing on an overview of the journals and ledgers that make up financial reporting.

Whether you are new to accounting, or need a refresher course, this document should help you gain an understanding of typical accounting functions.

Note: This handout from the workshop is an accounting primer, and does not cover:

- Firm statistical information
- Profitability ratios
- Overhead analysis
- Converting accounts receivables into cash
- How to budget
- Project management and other related issues

* While Tena's handout was titled "A/E Accounting 101," (she presented it to staff working in architectural and engineering firms at the time) the information she shared isn't specific to just those types of firms.

# A/E ACCOUNTING 101

The two objectives of any business are to earn a profit and to remain solvent (having the cash to pay debts on time). The accounting system is the means by which profitability and solvency are measured.

Accounting assembles and maintains historical data about the firm's financial transactions.

This workshop is designed to foster a better understanding of the accounting process of journalizing business transactions. This topic has been developed with the understanding that class participants have very little (if any) accounting experience. The data covered make up day to day typical accounting functions necessary to record and classify accounting information.

## Glossary

| | |
|---|---|
| Account | A tabular record of financial transactions related to a particular item or class of items used to classify and record financial details of business transactions of the firm. |
| Accounting | The collective methods for recording the financial details of business transactions and systematically assembling, presenting and interpreting these data to provide financial information about a business. This information is needed by owners to assist in making informed decisions. |
| Accounting Equation | Assets = Liabilities + Owner's Equity. |
| Accounts Payable | Current liabilities in accrual accounting, representing the amount owed by the firm to vendors and consultants for merchandise or services provided to the firm. |
| Accounts Receivable | Money owned by clients to the firm for services rendered or for reimbursement of expenses. |
| Assets | The listing of what things the business owns (i.e., building, cash, equipment) |
| Balance Sheet | A statement of the firm's financial condition as of a specific date. It is a statement of the balance between the asset accounts and the liability and owner's equity accounts. |
| Bookkeeping | Mechanical aspects of recording and classifying transactions, and is but a small part of the field of accounting. |
| Chart of Account | A list of accounts used by the firm in keeping its books. The detail of accounts must be appropriate to the needs of the firm for management and for tax return preparation. |
| Controller | Chief accounting officer. |
| Credit | The right-hand entry of a double entry bookkeeping system. |
| Debit | The left-hand entry of a double entry bookkeeping system. |
| Double Entry Accounting | A system of keeping books of accounts in which there are always two entries, of an equal dollar amount of debits and credits. |
| Expenses | The cost of goods and services used during the period used up in the process of obtaining revenue. |
| Income Statement | The basic operating financial statement showing the activity of the firm for the accounting period specified; it shows revenues, expenses and the resulting income (profit) or loss. |
| Journals | A chronological record of transactions. |
| Ledgers | A book of accounts used to summarize all transactions recorded |

| | |
|---|---|
| | in journals. The form of record used to record increases and decreases in a single balance sheet item is called an account. The entire group of accounts is called a ledger. |
| Liabilitilies | Debts or obligations of the firm owed to others. Borrowing money or buying on credit will create a liability. Examples of liabilities are accounts payable and notes payable. Liabilities represent the claims of creditors to the resources of the business. |
| Net Income | Profits remaining after expenses have been subtracted from revenue. |
| Owner's Equity | Value of the firm's assets in excess of its liabilities; represents the owner's investment in the business. |
| Posting | The process of transferring the debit and credit totals from journals to the ledger accounts. |
| Revenue | Financial inflows from the activities of the firm. |

## METHODS OF ACCOUNTING

There are two methods of maintaining accounting records: the cash basis and the accrual basis.

In accounting for transactions on the **cash basis**, revenue is recognized only when cash is received, and expenses are only recognized when they are paid in cash.

> Financial statements using the cash basis do not give an accurate view of the financial status of the firm since the cash basis does not reflect revenues that the firm has earned. Expenses in cash accounting show only costs that have been paid in cash.

A business which recognizes revenue in the period in which it is earned and which deducts in the same period the expenses incurred in generating this revenue is using the **accrual basis** of accounting.

> Accrual basis of accounting recognizes revenue when it is earned, whether or not payment has been received in cash, and recognizes expenses when they are incurred whether or not the firm has made cash payment.
>
> The most common example of such is the cost of a consultant. After a consultant bills the architect, the architect bills the owner but may not pay the consultant until the owner pays. On the architect's books the architect's invoice to the owner is a receivable, and the consultant's fee is a payable. In accrual accounting the revenue has been recognized, and the related expenses have been matched even though there has been no exchange of cash.

We will be working with the accrual basis of accounting throughout this class.

## ACCOUNTING PERIODS

An accounting period is a period of time such as a week, month, quarter or year that is established as being meaningful for collecting, reporting and analyzing financial data. Financial statements present summary information for the financial position and activity during these accounting periods.

The most common period is twelve months. This annual period is called the fiscal year, and it may or may not coincide with the calendar year.

## ACCOUNTING EQUATION

The "accounting equation" is **Assets = Liabilities + Owner's Equity**. The listing of assets shows us what things the business owns; the listing of liabilities and owner's equity tells us who supplied these resources to the business.

## CHART OF ACCOUNTS

Each account has a number and is arranged in the ledger in the same sequence as they appear. This arrangement makes it easier to prepare the balance sheet and income statement and to locate any account in the ledger.

### Sample Chart of Accounts

On the Balance Sheet: Asset accounts first, then liabilities, and finally owner's equity.

**Assets**

| | |
|---|---|
| 100 | Checking |
| 100 | Savings |
| 101 | Petty Cash |
| 102 | Accounts Receivable |
| 103 | Fixed Assets |
| 104 | Less Deprecation |

**Liabilities**

| | |
|---|---|
| 200 | Salaries Payable |
| 201 | Notes Payable |
| 202 | Accounts Payable – Consultants |
| 203 | Accounts Payable – Trade |

**Owner's Equity**

| | |
|---|---|
| 300 | Owner's Equity |

<u>On the Income Statement</u>: Revenue accounts first, then direct expenses, and indirect expenses.

**Income**

400 Fee Revenue
401 Reimbursable Revenue

**Reimbursable Expenses**

500 Consultants Expenses
501 Reprographic Services
502 Postage/Delivery
503 Long Distance Telephone

**Direct Expenses**

600 Direct Salaries – Principals
601 Direct Salaries – Employees

**Indirect Expenses**

701 Administrative Salaries – Principals
702 Administrative Salaries – Staff
703 Holiday, Sick Vacation
704 Payroll Taxes
705 Medical/Dental Insurance
706 Rent
707 Telephone
708 Office Supplies
709 Excise Taxes
710 Legal & Accounting
711 Business Development
712 Depreciation

## ACCOUNTS

In its simplest form, an account is divided into two sections by a vertical line drawn down the center of the page. The left half of the page is called the **debit** side; the right half of the page is the **credit** side.

Title of Account

| Left (Debit) | Right (Credit) |
|---|---|

An amount recorded on the left side of an account is called a **debit entry**; an amount recorded on the right side is called the **credit entry**, regardless of whether account represents an asset, a liability, or owner's equity. For every debit, there must be a corresponding credit or series of credits totaling the same amount,

## LEDGERS

1. A ledger account is maintained for every account (item) on the balance sheet. The ledger is a permanent, important, and basic accounting record. Each ledger account occupies a separate page in a loose-leaf book called a ledger. For example, cash is typically the first page in a ledger. It would show increases and decrease in cash, resulting from the many transactions in which cash is received or paid.

2. In its simplest form, a ledger page is divided into two sections by a vertical line drawn down the center of the page. The left half of the page is called the **debit** side; the right half the page is the **credit** side.

Title of Account

| Left (Debit) | Right (Credit) |
|---|---|

3. Am amount recorded on the left side of a ledger page is called a debit entry; an amount recorded on the right side is called a credit entry, regardless of whether the account represents an asset, a liability, or owner's equity. For every debit, there must be a corresponding credit or series of credits totaling the same amount.

4. Asset accounts normally have debit balances; that is, the sum of amounts entered on the debit (left) side is larger than the sum of the amounts entered on the credit (right) side. For example, Cash is an asset account and has a debit balance.

5. For all asset accounts, increases are recorded by debits, and decreases are recorded by credits.

Any Asset Account

| Debit<br>(Increase) | Credit<br>(Decrease) |
|---|---|

6. Liability accounts and owner's equity accounts normally have credit balances because the sum of the amounts entered on the credit (right) side is greater than the sum of the amounts entered on the debit (left)

side. For all liability accounts and owner's equity accounts, increases are recorded by credits, and decreases are recorded by debits.

Any Liability Account
Or Owner's Equity Account

| Debit (Decrease) | Credit (Increase) |
|---|---|

7. The double-entry system of accounting requires that **equal debits and credits** be recorded for every transaction.

Recording in transactions in ledger accounts: shown in T form is convenient for illustrative purposes. Details are avoided and we can concentrate on basic ideas.

**Transaction 1**: Tena Martins invested $20,000 to start business

| Cash | |
|---|---|
| 20,000 | |

| T. Martins Capital | |
|---|---|
| | 20,000 |

Result: Debit (increase) cash; Credit (increase) equity.

**Transaction 2**: Purchased desk and chair on credit from Dania Furniture

| Furniture | |
|---|---|
| 1,000 | |

| Accounts Payable | |
|---|---|
| | 1,000 |

Result: Debit (increase) asset; Credit (increase) liability.

**Transaction 3**: Purchased computer paying cash.

| Equipment | |
|---|---|
| 800 | |

| Cash | |
|---|---|
| | 800 |

Result: Debit (____________) asset; Credit (____________) cash.

## SPECIAL JOURNALS

1. An accounting system consists of the business documents, journals, ledgers, procedures and internal controls needed to produce reliable financial statements and other accounting reports. Accounting systems in common use range from simple systems in which accounting records are maintained by hand to sophisticated systems in which accounting records are maintained on computers. The accounting system to be used in any given company should be especially tailored to the size and to the information needs of the company.

2. To handle the large volume of transactions rapidly and efficiently, it is helpful to group the transactions into like classes and to use a specialized journal for each class. The great majority of transactions usually fall into three major categories.

| Type of Transactions | Name of Special Journal |
|---|---|
| Sales on Credit | Sales Journal |
| Receipts of Cash | Cash Receipts Journal |
| Payments of Cash | Cash Disbursement Journal |

3. In addition to these special journals, a general journal will be used for recording transactions which do not fit into any of the above three types. The general journal is added merely to distinguish it from the special journals.

### Sales Journal

A sales journal is a chronological listing of all sales on account. When the services are rendered, a sales invoice is prepared. The information listed on the invoice usually includes the date of the services, the serial number of the invoice, the client's name and the amount of the sale.

| *Invoice Date* | *Account Debited* | *Invoice #* | *Invoice Amount* |
|---|---|---|---|
| January 31, 2003 | Starbucks Corporation | 301 | 20,000 |
| January 31, 2003 | Tully's Corporation | 302 | 15,000 |
| January 31, 2003 | Martin Selig Realty | 303 | 25,300 |
| January 31, 2003 | City of Seattle | 304 | 60,000 |
| January 31, 2003 | King County Library | 305 | 12,000 |
| January 31, 2003 | Seattle Mariner | 306 | 80,500 |
| | | | 212,800 |

Each entry represents a debit to the Accounts Receivable account. The offsetting credit to the Sales account.

**Transaction in T form into corresponding ledger account:**

| Accounts Receivable | |
|---|---|
| 212,800 | |

| Fee Revenue | |
|---|---|
| | 212,000 |

| Reimb. Revenue | |
|---|---|
| | 800 |

**Cash Receipts Journal**

Transactions involving the receipt of cash are recorded in the cash receipts journal. One common example is the collection of accounts receivable.

| ***Receipt Date*** | ***Cash Receipt (Debit to Cash)*** | ***Collected From*** | ***Amount Collected (Credit to Accounts Receivable)*** |
|---|---|---|---|
| Feb 2, 2003 | 25,300 | Martin Selig Realty | 25,300 |
| Feb 15, 2003 | 80,500 | Seattle Mariners | 80,500 |
| Feb 22, 2003 | 15,000 | Tully's Corporation | 15,000 |
| | 120,800 | | 120,800 |

**Transaction in T form into corresponding ledger account:**

| Cash | |
|---|---|
| 120,800 | |

| Accounts Receivable | |
|---|---|
| | 120,800 |

**Cash Disbursements**

The cash disbursements (or cash payments) journal, sometimes commonly referred to as **Cash Register** is used to record payments of cash. Among the more common of these transactions are payments of accounts payable to creditors, payment of operating expenses, and cash purchases of merchandise.

The cash payments journal illustrated below contains entries for January transactions of the Tena Martins Company which required the payment of cash.

| ***Check Date*** | ***Check #*** | ***Payee*** | ***Check Amount*** | ***Description*** |
|---|---|---|---|---|
| January 1, 2003 | 1001 | Windemere Realty | 1,000 | Jan.Rent |
| January 5, 2003 | 1002 | Dania Furniture | 500 | Accounts Payable |
| January 15, 2003 | 1003 | Qwest Dex | 25 | Advertising |
| January 22, 2003 | 1004 | Puget Power | 50 | Utilities |

**Transaction in T form into corresponding ledger account:**

| Cash | |
|---|---|
| | 1,000 |
| | 500 |
| | 25 |
| | 50 |

| Accts Payable | |
|---|---|
| 500 | |

| Rent | |
|---|---|
| 1,000 | |

| Advertising | |
|---|---|
| 25 | |

| Utilities | |
|---|---|
| 50 | |

**General Journal**

A transaction that does not typically involve cash or sales is recorded in a General Journal.

(Example: Tena Martins sells a company car with payment to be collected in 30 days.)

| Car | |
|---|---|
| | 10,000 |

| Note Receivable | |
|---|---|
| 10,000 | |

Additionally, you would record a general journal transaction when you record depreciation expense for the month.

(Example: Dania furniture purchased for $1,000 has a depreciable life of five years – or 60 months – monthly depreciable "expense" of $17 per month.)

**Transaction in T form into corresponding ledger account:**

| Accum. Depreciation (Furniture) | |
|---|---|
| | 17 |

| Depreciation Expense | |
|---|---|
| 17 | |

**Exercise #1**

Can you give us another example of an entry you would record to General Journal. Give us the corresponding T form ledger account.

**Exercise #2**

What special journal would you use to record Interest earned from a Money Market Account. Give us the corresponding T form ledger account.

**Exercise #3**

You have just written a $1,200 check to pay your business insurance for the year. Give us examples of the T form ledger account: 1) to record the payment; and 2) show how you would expense it over twelve months.

**Exercise #4**

Following this list of account titles is a series of transactions. For each transaction you are to indicate the proper accounts to be debited and credited by placing the appropriate account title in the space provided.

Cash
Accounts Receivable
Office Equipment
Notes Payable
Accounts Payable
Accumulated Depreciation
Owner's Equity

Office Supplies
Salaries Expense
Depreciation Expense
Rent Expense

| *Transaction* | *Account Debited* | *Account Credited* |
|---|---|---|
| 1. Owner invested cash in the business | | |
| 2. Obtained a loan from the bank, signed a note to be paid in full in 3 years | | |
| 3. Received cash from a client for services rendered | | |
| 4. Purchased office supplies on credit | | |
| 5. Paid bill from #4. | | |
| 6. Paid salaries of employees. | | |
| 7. Record Depreciation for Feb. | | |
| 8. Paid March rent | | |

**Transaction in T form corresponding to ledger account**




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## FINANCIAL STATEMENTS

Financial Statements are the primary source of accounting information to persons outside the business enterprise. These statements show the financial position of the business at a given date and also the operating results which caused it to arrive at this position.

The two most widely used financial statements are the **Balance Sheet** and the **Income Statement**.

Balance Sheet: A balance sheet shows the financial position at a specific date. It consists of a list of the company's assets (what the firm owns), liabilities (what the firm owes to creditors), and owner's equity (what the owners have invested in the firm).

### Sample Balance Sheet

Tena Martins Company
Balance Sheet
January 31, 2003

| | | | |
|---|---|---|---|
| ASSETS: | | LIABILITIES & OWNER'S EQUITY | |
| Cash | 140,000 | Liabilities; | |
| Accounts Receivable | 92,000 | Consultant Payable | 2,000 |
| Furniture & Equipment | 1,800 | Accounts Payable (Dania) | 500 |
| Note Receivable | 10,000 | Total Liabilities | 2,500 |
| Accum Depreciation | ( 17) | | |
| Total Assets: | 243,783 | Owner's Equity: | |
| | | Tena Martins, Capital | 2,375 |
| | | Prev. Yr Retained Earnings | 185,300 |
| | | Current Year Earnings | 53,608 |
| | | Total Equity: | 238,283 |
| | | Total Liability & O/E | 243,783 |

## Income Statement

The Income Statement is a formal financial statement which lists the revenue, deducts the expenses, and shows the net income of a business of the same time period. The income statement relates to the balance sheet because the net income figure is one of the causes of changes in owner's equity.

## Sample Income Statement

Tena Martins Company
Income & Expenses
Period January 1 – 31, 2003

| | |
|---|---|
| Fee Revenue | 212,000 |
| Reimbursable Revenue | 800 |
| | 212,800 |
| | |
| Direct Salaries Expense | 120,000 |
| Direct Consultants Expense | 2,000 |
| Misc. Direct Expenses | 1,000 |
| | 123,000 |
| | |
| Gross Profit on Sales: | 89,800 |
| | |
| Indirect (Administrative) Expenses: | |
| Indirect Salaries | 20,000 |
| Payroll Taxes | 15,000 |
| Rent | 1,000 |
| Advertising | 25 |
| Utilities | 50 |
| Misc. Office Supplies | 100 |
| Depreciation Expense | 17 |
| | 36,192 |
| | |
| Net Income on Sales: | 53,608 |

Profits from profitable operations cause the owner's equity to increase. Losses from unprofitable operations cause the owner's equity to decrease.

## Exercise #5

Net Income on Sales is a ________________ (debit or credit) to owner's equity?

**Exercise #6**

Which of the following is not considered an expense on the Income Statement.

a. Depreciation
b. Direct Labor
c. Dividends
d. Indirect Expenses

**Exercise #7**

What are the two main objectives of any business.