TARRAS UNIVERSITY

TARRAS ON TAXES

ACCOUNTING 101

What is Accounting?

Accounting is a system of rules and regulations that measure economic and financial activity so that we may allocate scarce resources efficiently.

Accounting allows us to create reports that reflect economic activity that has occurred over a specific period or as of a specific day, depending on the report.

The rules and regulations of accounting allow comparisons of financial condition to be made across industries, entities, and activities.

Banks use accounting reports to allocate their scarce resource-cash.

Suppliers use accounting reports to determine whether or not to provide credit to their customers.

Investors use accounting reports to make decisions as to how they invest their capital.

BASIC DEFINITIONS AND CONCEPTS

DEBIT: Positive or plus entry

CREDIT: Negative or minus entry

DOUBLE ENTRY BOOKKEEPING: An accounting requirement that debits equal credits.

ASSET: An tangible or intangible item or expenditure that has future economic value. Assets normally have a debit or positive balance.

LIABILITY: A future economic obligation expressed monetarily. Liabilities normally have a credit or negative balance.

EQUITY: The net investment of owners plus retained earnings. Equity may be either a debit or positive balance or a credit or negative balance.

REVENUE: Amounts earned. Revenues have a credit or negative balance.

EXPENSES: Amounts expended to earn current period revenues. Expenses have a debit or positive balance.

MATCHING PRINCIPLE: The accounting requirement that the expenses incurred to earn revenue be reported in the same period as the revenue.

ACCRUAL METHOD OF ACCOUNTING: A method of accounting wherein revenues are recognized when earned and expenses are recognized when incurred and not necessarily when received or paid. This is the preferred method of accounting.

CASH METHOD OF ACCOUNTING: A method of accounting wherein revenues are recognized when they are received and expenses are recognized when they are paid, irrespective of when they are earned or incurred. Most small business use the cash method of accounting.

BASIC FINANCIAL STATEMENTS

There are two basic financial statements accounting allows us to create: The Balance Sheet or Statement of Assets, Liabilities, and Equity and the Income Statement or Statement of Revenues and Expenses.

The Balance Sheet is a snapshot of assets, liabilities, and equity as of the date of the Balance Sheet.

The Income Statement is a schedule of financial and economic activity over a period of time.

The Income Statement reports revenues, expenses, and net income over a period of time, usually a fiscal or calendar year.

EXAMPLE OF ACCOUNTING FOR ABC COMPANY

The following example illustrates the accounting entries necessary to create ABC Company's Balance Sheet and Income Statement using the accrual method of accounting.

The facts used to create ABC Company's financial statements:

1. ABC Company's owner invested $500.00 to start ABC Company;
2. ABC used $200.00 to purchase inventory for sale, paying $50.00 in cash and incurring an accounts payable of $150.00;
3. ABC purchased Equipment for $200.00 with $50.00 in cash and a $150.00 mortgage payable;
4. ABC sold 1/2 of its inventory for $350.00 in cash and an accounts receivable of $50.00;
5. ABC incurred $250.00 in expenses paying cash.

Accounting Entries To Create The Balance Sheet and Income Statement of ABC Company

We will use T Accounts to display the entries. T Accounts are pictorial or graphic images of the accounting entries necessary to create our financial statements. Debits are recorded in the left column of the T Account and credits are reported in the right column of the T Account.

To record the owner's $500 investment to start ABC Company we debit cash to record the owner's cash investment and we credit common stock to record the owner's receipt of ABC's stock for his cash investment.

Cash	
500	

Common Stock	
	500

To record ABC’s purchase of inventory for $200.00 using $50.00 of cash and incurring an accounts payable of $150.00 we debit inventory for $200.00, we credit cash for $50.00, and we credit accounts payable for $150.00.

Cash	
500	50

Inventory	
200	

Accounts Payable	
	150

To record ABC's purchase of $200.00 for equipment we debit equipment for $200.00, we credit cash for $50.00, and we credit mortgage payable for $150.00 as follows:

Cash

500	50
	50

Equipment

200	

Mortgage Payable

	150

To record ABC’s sale of $100.00 worth of inventory for $350.00 in cash and $50.00 in accounts receivable we debit cash for $350.00, we debit accounts receivable for $50.00, we credit inventory for $100.00, and we debit cost of goods sold for $100.00 as follows:

Cash		A/R		Inventory		Sales		Cost of Goods Sold	
500	50	50		200	100		400	100	
350	50								

The entry above reports a reduction in inventory by crediting inventory and a deduction on the income statement for the cost of the inventory sold by debiting the expense cost of goods sold.

To record the $250 in expenses we debit expenses for $250.00 and credit cash for $250.00 as follows:

Cash

500	50
350	50
	250

Expenses

250	

When we add and subtract the entries in the T Accounts we arrive at the numbers reported in the Balance Sheet and Income Statement.

The following Balance Sheet and Income Statement for ABC Company are the result of the preceding accounting entries based upon the facts provided earlier.

Balance Sheet ABC Company
As Of 12-31-15

Assets:	
Cash	$500
Accounts Receivable	$50
Inventory	$100
Equipment	$200
	______
Total Assets	$850
	=====
Liabilities and Equity:	
Accounts Payable	$150
Mortgages Payable	$150
Common Stock	$500
Retained Earnings	$50
	______-
Total Liabilities & Equity	$850
	=====

The Income Statement of ABC Company
For the Year Ended 12-31-15

Sales	$400
Cost of Goods Sold	100
	——-
Gross Profit	$300
Expenses	250
	——-
Net Income	$50
	=====

Explanation of Retained Earnings

Retained Earnings is the account used to capture all prior periods' revenue, expenses, and distributions to owners. We zero the income statement to retained earnings and zero distributions to owners to retained earnings at the end of each period so that we may begin each new period with only the revenue and expenses and distributions that occurred during the new period. There are some other adjustments to retained earnings. Those will be discussed in a later installment of Tarras on Taxes.

The preceding slide show should provide you with a basic understand of how accounting operates to create a balance Sheet and Income Statement. In actual practice transactions are more complicated and may impact multiple accounts not included in our example. However, the principles remain the same. Debits must equal credits; assets, liabilities, and equity accounts must be recorded on the balance sheet; and income and expense are reported on the income statement.

We will provide additional courses that will elaborate on the accounting concepts presented herein. Please stay tuned.

If you have any questions, please contact William J. Tarras, C.P.A., P.A.

Thank you.

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