

Bookkeeping

(Cheat Sheet)

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Bookkeeping in the Past

Historically, bookkeepers were responsible for the following steps in the accounting cycle:

- Record all the company's transactions in journals
- Post the amounts from the journals to accounts in the general ledger and subsidiary ledgers
- Calculate the balance in each of the accounts
- Prepare a trial balance (a list of the balances in the general ledger accounts)
- Identify and correct any errors that caused the trial balance to not balance (total debit balances did not equal total credit balances)

After the bookkeeper completed these time-consuming tasks each month, an accountant prepared the necessary adjusting entries and the financial statements for the month and year-to-date.

Bookkeeping Today

Thanks to computers and the discipline imposed by the accounting software, the accounts and trial balance will always be in balance. Further, the previously distinct steps in the accounting cycle now appear to happen simultaneously. For example, when a distributor sells goods on credit, the software prepares the sales invoice, credits the general ledger's Sales account, debits the general ledger's Accounts Receivable, updates the customer's detailed account, reduces the Inventory account, increases the Cost of Goods Sold, updates all balances in the general ledger accounts, prepares a trial balance and financial statements on demand, and more.

Of course, the bookkeeper must be certain that only legitimate business transactions are processed by the accounting software.

Double-entry Accounting System

Behind the computer screens, most accounting software is based on the double-entry system of accounting which has been in existence for more than 500 years. The double-entry system means the following:

- Every transaction affects two (or more) general ledger accounts
- Every transaction must have an amount recorded in at least one account as a debit (left side of the account), and an amount must be recorded in at least one account as a credit (right side of the account)
- The amounts entered for each transaction must have the debit amounts equal to the credit amounts
- At all times, the total of the amounts entered as debits must equal the total amount entered as credits
- At all times, the total of the debit balances in the accounts must be equal to the total of the credit balances in the accounts

Here are a few examples of what will be occurring automatically when using accounting software:

- Cash will be credited whenever a check is written
- Cash will be debited when money is received
- Accounts Receivable will be debited when a sales invoice is issued for a credit sale

Accounting Equation

In addition to the general ledger accounts having its debit amounts equal to its credit amounts, and its debit balances equal to its credit balances, the balances in the general ledger accounts must satisfy the *accounting equation*, which is:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Asset accounts (normally debit balances) include:

- Cash
- Accounts receivable
- Inventory
- Prepaid expenses
- Equipment

Liability accounts (normally credit balances) include:

- Accounts payable
- Loans payable
- Wages and payroll taxes payable
- Interest payable
- Deferred or unearned revenues

Stockholders' equity accounts (normally credit balances) include:

- Common stock
- Retained earnings
- Other comprehensive income
- Treasury stock (a subtraction)

NOTE:

The asset accounts normally have debit (or left side) balances, which is consistent with the total amount of the asset account balances appearing on the left side of the accounting equation.

The liability accounts normally have credit (or right side) balances, which is consistent with the total amount of the liability account balances appearing on the right side of the accounting equation.

The stockholders' equity accounts normally have credit (or right side) balances, which is consistent with the total amount of the stockholders' equity account balances appearing on the right side of the accounting equation.

Example 1

If Jay Corporation borrows \$10,000 from its bank, Jay Corporation's asset Cash increases by \$10,000 and its liability Loans Payable increases by \$10,000. Hence, the accounting equation remains in balance. The debits and credits are as follows: debit Cash for \$10,000; credit Loans Payable for \$10,000.

If Jay Corporation repays \$3,000 of the loan amount, Jay Corporation's asset Cash will decrease by \$3,000 and its liability Loans Payable will decrease by \$3,000. Hence, the accounting equation remains in balance. The debits and credits are as follows: debit Loans Payable for \$3,000; credit Cash for \$3,000.

Recording Revenues and Expenses

When a corporation earns revenues (such as fees for having provided services for a client), the corporation's assets will increase and its stockholders' equity will increase. Similarly, when the corporation pays its monthly rent, the corporation's assets decrease and its stockholders' equity decreases.

Since a corporation will have thousands of transactions involving revenues and expenses, it is useful to have:

- *Separate accounts for every category of revenues, and*
- *Separate accounts for every category of expenses.*

The revenue and expense accounts should be thought of as *temporary stockholders' equity accounts* or *subaccounts of stockholders' equity*.

Next, we list just a few examples of the hundreds of revenue and expense accounts typically used by a company.

Revenue accounts (normally credit balances) include:

- Sales of product A
- Fees earned from services
- Interest earned on bank accounts

Expense accounts (normally debit balances) include:

- Cost of goods sold
- Salaries expense
- Rent expense
- Interest expense

NOTE:

Since revenues increase stockholders' equity, the revenue accounts must have *credit balances*.

Since expenses decrease stockholders' equity, the expense accounts must have *debit balances*.

Example 2

Jay Corporation provides a customer with \$4,000 of services and allows the customer to pay in 30 days. As a result, Jay Corporation's assets increase by \$4,000 and its stockholders' equity increases by \$4,000. The debits and credits for recording this transaction are: debit Accounts Receivable for \$4,000; credit Fees Earned for \$4,000.

Example 3

Jay Corporation paid \$1,500 for the current month's rent. This causes a decrease in Jay Corporation's assets and a decrease in its stockholders' equity. The debits and credits are: debit Rent Expense for \$1,500; credit Cash for \$1,500.

NOTE:

A complete list of a company's general ledger accounts in which amounts can be recorded is known as the *chart of accounts*. Accounts can be added when necessary.

An internal report that lists the general ledger accounts which have balances (with the debit

balances listed in one column and the credit balances listed in another column) is known as a *trial balance*.

Accrual Method of Accounting

The accrual method (as opposed to the cash method) of accounting is the preferred method for measuring and reporting a corporation's revenues, expenses, gains, losses, and net income for a month, year, etc. The accrual method is also the preferred method for reporting a corporation's assets, liabilities, and stockholders' equity at the end of the accounting period.

Under the accrual method, revenues are reported in the accounting period in which they are earned (which is often different from the accounting period when cash is received). For example, if a business earns \$1,000 today by providing consulting services, but issues an invoice stating that the client has 30 days in which to pay, the business reports the \$1,000 as today's revenue. Today's accounting entry is: debit Accounts (or Fees) Receivable for \$1,000; credit Fees Earned (Revenues) for \$1,000.

Under the accrual method, expenses are reported in the accounting period in which they occur (which is often different from where cash is paid). For example, if a company incurs an \$800 emergency repair today but has 10 days in which to pay the vendor's invoice, today's accounting entry is: debit Repairs Expense \$800; credit Accounts Payable \$800.

The accrual method of accounting is necessary so that revenues are reported in the period when they are earned, and expenses are matched with the related revenues or are reported in the period in which a cost is used up.

NOTE:

Our focus is on financial accounting and financial reporting which culminates with a company's financial statements.

We do *not* discuss income tax reporting, which may require or allow for recognizing revenues and/or expenses differently.

Adjusting Entries

For a company's financial statements to comply with the accrual method of accounting, it is likely that some *adjusting entries* must be recorded before the financial statements are issued. Typically, the adjusting entries include recording some expenses that have occurred, but the bookkeeper did not yet record the transactions in the accounts. For instance, a company may have incurred interest expense on its bank loan, but the interest payment is not due until the loan is due in 60 days.

Another common example of an adjusting entry is the depreciation of certain assets. Assume that a company purchased equipment last year at a cost of \$120,000 and the equipment is expected to be used for 5 years or 60 months. Each month the company's accounts must include the following adjusting entry: debit Depreciation Expense for \$2,000; credit Accumulated Depreciation Expense for \$2,000.

It is also possible that revenues were earned, but the sales invoice has not yet been issued. As a result, an adjusting entry will be needed to report the revenues earned on the income statement and to report the receivable on the balance sheet.

Accountants often categorize adjusting entries into three types: accruals, deferrals, and other.

You can learn more by visiting our topic *Adjusting Entries*.

Financial Statements

The main objective of recording the huge number of business transactions is to generate a complete set of financial statements. The complete set includes the following:

- Balance sheet (or statement of financial position)
- Income statement (or statement of earnings, statement of operations, profit and loss)
- Statement of comprehensive income (if a company has certain types of transactions)
- Statement of cash flows (SCF or cash flow statement)
- Statement of stockholders' equity

In addition to the amounts appearing on the face of the financial statements, the company must include *notes to the financial statements*. The notes are necessary to disclose important information regarding the amounts shown (or not shown) on the face of the financial statements.

You can learn more by visiting our topic *Financial Statements*.

Internal Controls

It is critical that a company have internal controls to safeguard its assets. In the area of accounting and bookkeeping, it is best to separate the duties. In other words, instead of one person handling the cash, recording the amounts in the accounts, making the bank deposits, reconciling the bank statement, and preparing the financial statements, it is wise to separate the responsibilities between two or more people. For example, the person receiving and handling the cash should not be the person recording the amounts in the general ledger. The amounts on the company's bank statement should be reconciled with the amounts in the company's records by someone not involved with recording the amounts. Customer credit memos should be approved by someone not involved in the accounts receivable transactions.

The reason for separating (or segregating) duties is to minimize losses. For instance, if one person handles all the transactions, then only one person (if dishonest) could falsify records so that the loss is not detected for months. With the separation of responsibilities, it is less likely for two dishonest employees working together to steal some of the company's assets.

Bank Reconciliation

As often as is feasible and soon after a bank statement is received, the company should reconcile the bank statement. This involves comparing the detailed information on the bank statement with the detailed information in the company's pertinent general ledger account.

The bank reconciliation is important for several reasons, including:

- To be certain that the general ledger accounts are complete

- To be certain of the company's cash amount to avoid writing checks for more than the actual cash balance
- To report the correct amount of cash on the company's balance sheet

Having an independent person prepare the bank reconciliation may result in finding some questionable amounts being deducted from the company's bank account.

You can learn more by visiting our topic *Bank Reconciliation*.

Accounts Receivable

Accounts receivable arise when a company sells goods on credit. For instance, some companies provide its customers with goods and/or services and allow them to pay the amount owed 30 days later.

If a customer does not pay the amount owed, the company will report Bad Debts Expense for the amount not collected. Because of this risk, a company should review a new customer's credit rating before selling to the customer on credit. If there is some uncertainty, the company should require the customer to pay with a credit card when the goods are shipped. While there is a credit card processing fee, the company may be avoiding a complete loss of the transaction amount.

The amounts owed by customers should be reviewed often. Today's software will generate a report known as an *aging of accounts receivable*. This report sorts each credit customer's balance into several columns such as: current, 1-30 days past due, 31-60 days past due, 61-90 days past due, and 90+ days past due. This report allows for a quick review of the amounts that the company has not yet collected.

Monitoring accounts receivable is critical because the company needs to collect the amount it is owed so it can make payments to its employees, accounts payable, loans payable, etc.

Accounts Payable

Accounts payable is a general ledger liability account containing the amounts owed to vendors/suppliers and supported by purchase invoices that the bookkeeper has entered in the accounting system.

To avoid entering a bogus invoice or an incorrect invoice amount, it is common to use what is known as the three-way match. The name results from the requirement to match (compare or reconcile) the details contained in the following:

1. Vendor's invoice
2. Company's purchase order
3. Company's receiving report

The vendor's invoice is entered in Accounts Payable only after the three-way match is completed. If some amounts are owed, but the *three-way match* is not completed, an adjusting entry will be recorded in a liability account such as Other Accrued Liabilities.

You can learn more by visiting our topic *Accounts Payable*.