Accounting Definitions Part 1

In order to keep your business running smoothly, you need to stay up-to-date with your financial activities and maintain accurate records. To help with this, we've put together a series of lessons to help you understand the tools that are offered in Eagle for Windows' Accounting and Financial applications.

We'll start with the Accounting Basics series - a quick review of basic accounting concepts that bookkeepers, financial controllers, accountants, and CFOs utilize on a daily basis when performing accounting routines. Since the concepts will be referenced throughout the Accounts Payable and General Ledger classes, it's important that we establish a consistent definition of these concepts, so we're all on the same page. However, the modules in the Accounting Basics series are not a substitute for professional accounting classes.

In this first Accounting Basics class, we will review debits and credits, the accounting double entry system, and the golden rule of accounting.

Topics

- Debits and Credits
- Double Entry
- Golden Rule

Debits and Credits

Let's start with the most basic concept in accounting: Debits and Credits.

Debits and Credits are the entries made in account ledgers to record changes in value due to business transactions. Generally, the source account is credited by making a Credit entry on the right hand side of the account's ledger, otherwise known as a T-account, and the destination account is debited resulting in an entry on the left hand side of the ledger.

The important thing to remember about debits and credits is that they work together to keep your accounts in balance. Each transaction will result in both a debit and a credit entry in the same amount.

For instance, if you spend $10,000 to purchase inventory items, cash would decrease by $10,000 (a credit) but assets would increase by $10,000 (a debit).

Now that you know the basics of credits and debits, let's see how they're used.

Double Entry

Recording transactions as debits and credits is known as the double-entry system of bookkeeping.

This system was introduced in Europe in the early 16th century.

It has been used for over 500 years throughout the developed world to record every business transaction that takes place in a company.

When using the double entry accounting method, each entry records related pairs of financial transactions for asset, liability, income, expense, or capital (equity) accounts.

Double-entry bookkeeping, at first glance, appears complex; you might think that you would need many years of practice before you can 'keep the books'.

Fortunately, looks can be deceiving and almost anyone can pick up the basics of this system in a very short time. This is because the double entry system can be reduced down to some very straightforward rules.

1. All transactions have one entry in two or more different accounts (the double-entry piece)

2. All transactions have one or more debit entries (left side of account) and one or more credit entries (right side of account)

3. The sum of all debit entries must equal the sum of all credit entries

Let’s go over a quick example.

A customer just purchased a bouquet of flowers from your store, and paid you $25 in cash.

Let’s assume there is a 7% sales tax in your state.

The accounting entries recorded by this transaction are as follows:

Sales have increased by $23.25 – this is the total transaction amount minus sales tax.

This entry, since it is the source account, is recorded as a credit.

Sales tax is recorded as a credit as well in the amount of $2.75.

To offset these entries the destination account – in our case Cash, has been debited by $25.

As you can see the total debits equal the total credits.

However, we are not finished recording this transaction.

The sale also triggered a reduction in inventory of $10.

We record this as a credit of $10 in the Inventory account, and the offsetting entry is a debit of $10 to the Cost of Goods Sold account.

Again, our debits and credits match. This is an example of how double entry bookkeeping is applied in real life.

Keep in mind that, within the SAME account, the debits and the credits do not have to—and usually will not—equal each other.

The difference between the total debits and total credits in a single account is the account’s balance.

If debits exceed credits, the account has a debit balance and if the sum of all credits exceed the sum of all debits, then the account has a credit balance.

If the accounting entries are recorded without error, the aggregate balance of all accounts having positive balances will be equal to the aggregate balance of all accounts having negative balances during that same period; otherwise an error has occurred during the recording process.

Accounting entries that debit and credit related accounts typically include the same date and control code in all affected accounts, so that in case of error, each debit and credit can be traced back to a journal and transaction source, thus preserving an audit trail.

The accounting entries are then further compiled into a trial balance, which is used by accountants to prepare financial statements, such as balance sheet and income statement.

These financials communicate information about the company's financial activities in a generally accepted standardized format.

We will cover in detail the keystrokes of how your Eagle System accomplishes the above in later lessons.

Golden Rule

The validity of the double entry system is based on the golden rule of accounting, otherwise known as the accounting equation, which states that Assets = Liabilities + Equity (Capital).

This equation is a statement of equality between debits and credits.

The rules of debit and credit depend on the nature of an account.

All accounts are classified as one of five types: assets, liabilities, income/revenues, expenses, or capital gains or losses.

We will cover these concepts in an upcoming module, but in general, a debit entry increases the value of an Asset and a credit entry decreases its value.

Expense and Loss accounts are also increased by debit entries and decreased by credit entries, while Liability, Revenue or income, and Capital accounts, are increased by a credit entry and decreased by a debit entry.

We'll end this quick overview of basic accounting principles here.

You'll frequently hear the above-mentioned concepts in later lessons, though as they are the building blocks of the accounting practice.

If you are new to accounting and your job requires that you are involved in daily bookkeeping, ledger maintenance, and financial statements, we recommend that you take a bookkeeping class.

This module has been designed as a quick review of already known and understood concepts rather than an in-depth and detailed course in bookkeeping and accounting.

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