

Quick Notes on Accounting

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What is Accounting?

Accounting – the practice of recording, reviewing, and reporting on all of a business's financial transactions to identify the financial health of the business.

Financial Statements – reports used to show the results of accounting. The three primary reports are the Balance Sheet, Income Statement (also referred to as the profit loss report, or P&L), and the Statement of Cash Flows. Our customers run many other reports as well, but these are the basics.

Business owners use financial statements to track trends in profit loss and gain. They submit these reports to banks they have loans with, shareholders, potential investors, and government agencies. Anyone who wants to know how profitable a business is will review the business's financial statements.

Accounting Periods – the date ranges financial statements are created for. It would not make sense to always report the total amount of profit a business has made for all time. To assess whether a business is becoming more or less profitable, investors and owners need to create financial statements for different date ranges and compare them. Those date ranges are called accounting periods, and they are usually one month or one year.

In Short – Financial statements are usually created at the end of each month, and at the end of each year, to show how well the business performed during that accounting period.

The Process of Accounting

Some basic concepts accountants use to record and report on the financial health of a business are Accounts, Chart of Accounts, General Ledger, Double Entry Accounting, Journal Entries, Debits, and Credits.

Accounts – the financial items of a business. This includes the monetary value of the business's inventory, bank accounts, loan debt, and so on. If it has a monetary value, there will be an account to track it. Businesses choose the names for their accounts, so different businesses may have the same accounts, but call them by different names. For example, the inventory account could be called 'Inventory', 'Inventory-Main', or even just 'INV', but regardless of the name, it is the account used to track the current monetary value of their inventory.

Chart of Accounts – the complete list of a business's accounts. Depending on how large a business is, and/or how detailed they are in their tracking, some businesses may have more accounts than others, but they all start with the same basic set of accounts.

General Ledger – the chart of accounts along with the transactions that show the changes in value of those accounts. It can be referenced to see the total monetary value in each account. The general ledger is abbreviated GL, and is often referred to as the business's 'books'. In SedonaOffice, the GL can be seen in the Account Register.

Double Entry Accounting – a way of book keeping that requires every transaction to affect at least two accounts, one

to show where money is coming from, and the other to show where money is going to. This ensures businesses report their monetary value fairly, since they cannot bring money in from nowhere, and they cannot send money out to nowhere. For example, if a business makes a payment on one of their loans, they would reduce their loan account by the amount of the payment. They then must also reduce their bank account by the amount of the payment, to show where that payment came from.

In Short – Double entry accounting gets its name from that fact that you can never make a single entry by itself. Every transaction in the general ledger must hit at least two accounts (sometimes more), so that we can always see where the money came from, and also where it is going.

Journal Entry – a transaction recorded in the general ledger, showing the change in the value of accounts. A journal entry must have a date, at least two accounts (although there could be more), a debit side, a credit side, and the total amount of the debits and the total amount of the credits must equal each other.

Debits and Credits – these are the two sides of every journal entry that determine which accounts are being increased and/or decreased in monetary value. Deciding which account(s) needs to be debited and which needs to be credited depends on what happened to the monetary value of the accounts, and what type of accounts they are. In the example of making a loan payment, the loan account would need to be debited, and the bank account would need to be credited. Below is an example of what that journal entry would look like:

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Note – Whether or not debits and credits increase GL accounts or decrease them is often a source of confusion. It is not as simple as debits always increasing accounts and credits always decreasing them, or vice versa. And it is not always the case that one journal entry must show one account going up and another going down. In the last example, we saw that decreasing the bank account to make a loan payment, also decreased the amount the business owed on that loan. We also see that both accounts were decreased even though one was debited and one was credited. Knowing which accounts to debit and which accounts to credit, is often the hardest part of accounting. Please see separate article [Knowing Which Accounts to Debit and Which to Credit](#) for more on this topic.
