



Accounting 101

MYOB[®]

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Like all small business owners, you went into business with a dream: to sell your unique product or services and make a living for you, your family, and your employees. As your business grows 'beyond the checkbook' your record keeping and reporting and compliance needs also increase. Now you have customers to track, vendors to pay, sales to record, and a full set of accounts to maintain. You probably also have an accountant who is preparing your federal and state taxes for you and your growing business.

But now you find yourself spending more time keeping your books than keeping your customers happy. You understand the importance of having accurate books, but you have a lot of stresses on your time, so accounting never seems to get the time it requires. Further, you willingly skipped all those high school and college accounting courses, figuring you weren't "going to be an accountant anyway". Well, surprise! Not only are you an accountant, you are a lawyer, a shipping clerk, a customer service rep and more – all in the pursuit of your dream.

So what can you do to make this work? The first step is to understand what all those accounting terms mean and how they all fit together. At the end of this booklet is a glossary of all the relevant accounting terms that will help you understand the science of accounting. Much like computers, understanding the terminology will help you understand their meaning and their relevance to you and, more importantly, help you analyze and run your small business.

Before we go any further, keep this in mind: **you don't have to be an accountant to run MYOB.** All too often small business owners use this line to shun doing any type of record keeping, to their own detriment. The reality is, I'm not a mechanic, but I can drive my car. I'm also not a plumber, but I can fix a running toilet and I'm certainly not a doctor, but I can put a band-aid on my kid's bumps and bruises. All it takes is the will to succeed and the desire to run a successful operation. Period. Will it be easy? I wish I could say yes. Will it be frustrating? I wish I could say no. Will it be invaluable to your business and your long-term success? You bet! While our goal here is to help you understand the basic concepts of accounting, one of the great things about MYOB is that it does all the debits and credits for you.

■ Your Daily Lives

First, let's start with an overview of how accounting fits into your daily life. Quite simply, every transaction you make results in an entry into your "books". Whether it is a receipt of cash, a sale, a check you've written or a deposit from a customer – every transaction gets recorded in your books at some point. The timeliness and accuracy of when and how you record your transaction directly affects your ability to manage your business and your cash flow.

If you think your business is "checkbook-centric", remember that there are plenty of transactions that do not involve cash that should be recorded in your books. Anything that affects the things you own (assets) like repairs or purchases, all require a transaction. Anything that affects what you owe (liabilities) like sales taxes or payroll taxes requires a transaction to be recorded. Anything that affects sales (revenue), like an invoice or a product return needs to be recorded. And, as you no doubt already know, all your vendor bills (expenses) are recorded when paid. Just because cash is not exchanged does not mean there are no entries to record. For example, you probably sell items or services on credit. In this simple example, you record the sales when your invoice is issued, and then subsequently record the cash receipt when your customer pays you.

■ Cash vs. Accrual Accounting

Simply put, cash based accounting recognizes revenue and expenses when cash is received or expensed. In our simple example above, your revenue would be recognized when you receive payment from your customer – not when you invoice them. Conversely, expenses would be recognized when cash is disbursed – not when the bill is received. For most small businesses, a hybrid system works best and it looks something like this: Revenue is recorded when invoiced so you have the ability to track receivables. Expenses are recorded when bills are paid. In effect, you are using accrual based accounting for revenue recognition and you use cash based accounting for recognizing expenses. In the end, your accountant will make the necessary adjustments in order to prepare and file your tax returns. They will take your hybrid system and adjust it to reflect cash based or accrual based numbers.

■ The Golden Rules of Accounting

Lets discuss the Golden Rules of Accounting. They are:

- 1.) Debits **ALWAYS EQUAL** Credits
- 2.) Increases **DO NOT NECESSARILY EQUAL** Decreases
- 3.) Assets - Liabilities = Owner's Equity (The accounting equation!)

Don't let the words **Debits** and **Credits** scare you. They simply refer to the **Left** side and **Right** side of a '**T Account**', a graphical representation of the amounts recorded into an **account** (see the examples below). Every transaction recorded into MYOB is posted to your accounts as a combination of debits and credits, we do all the work for you. For an individual transaction, total debits always equal total credits. A check written to pay rent is an increase to Rent Expense (a debit) and a decrease to Cash (a credit).

■ Chart of Accounts

The chart of accounts, or simply accounts, is a list of categories into which all your accounting transactions will be recorded. In MYOB they are defined by a five digit number and account name: A one digit prefix designates what type of account it is (and where it will be displayed on your financial statements), followed by a four digit main account number. With MYOB, you have complete control over your account numbers and their names.

Here is a table that will help you understand what this means and how it applies to your business.

	ACCOUNT NUMBER	ACCOUNT TYPE	INCREASE	DECREASE
Balance Sheet (As of a 'point of time')	1-xxxx	Assets	DEBIT	CREDIT
	2-xxxx	Liabilities	CREDIT	DEBIT
	3-xxxx	Owner's Equity	CREDIT	DEBIT
Profit and Loss (For a 'period of time')	4-xxxx	Revenue	CREDIT	DEBIT
	5-xxxx	Cost of Goods Sold	DEBIT	CREDIT
	6-xxxx	Expenses	DEBIT	CREDIT

The exceptions are *contra accounts*, which are accounts that are offset against another account. Examples include: Accumulated Depreciation, Sales Discounts, and Sales Returns and Allowances.

Let's drill down on how each account type actually relates to *your* business.

■ Assets

An asset is anything you own in your business. They are the things in your office, your computers, your vehicles, your receivables owed by customers and your cash on hand. Everything you own is considered an asset of the business. Assets are used to generate revenue and purchase other assets. For example, when you buy a new computer, you use one asset (cash) in exchange for another asset (equipment).

■ Liabilities

Your liabilities are the things you owe, like sales taxes received from sales but not yet paid to the state, or loans payable to your bank. Another example are your credit cards, unless you pay your balance off every month, the money you owe to your credit card company is considered a liability on your books. Liabilities represent claims against your assets.

■ Owner's Equity

The difference between the value of your assets and the total of your liabilities is the value of your company. As the Accounting Equation states: Assets - Liabilities = Owner's Equity. Depending on the type of taxable entity you created when you first formed your company, the Owner's Equity section of your Chart of Accounts and Balance Sheet may have another name.

■ Revenue

The revenue of your company is the total amount of proceeds generated for providing goods and services to your customers. This is typically the total amount of the invoices you generated for your customers.

■ Cost of Sales

Cost of Sales refers to the total value of the goods and services that were sold to your customers. Typically, this refers to items based businesses that buy inventory for resale or a manufacturer who builds items for resale. Total revenue less cost of goods sold equals your gross profit.

■ Expenses

Expenses are the costs you incur to run your business, whether they are fixed costs (independent of how much business activity you have, like rent) or variable costs (directly related to how much business activity you have, like shipping).

■ T Accounts and Double-Entry Accounting

T accounts are a graphical representation of debits (left side) and credits (right side) in a specific General Ledger account. Double-entry accounting means that every transaction has at least one debit and one corresponding credit. The total debits always equal the total credits

Account Name (x-xxxx)	
debits	credits
debits	credits
debits	credits

Below is a series of typical accounting transactions and their affect on the appropriate General Ledger accounts. The next page shows the financial statements resulting from these entries.

■ Examples:

- 1.) You buy a desk at the office supply store and pay \$250 cash
- 2.) You buy a new computer for \$1,000 with your company credit card*
- 3.) You buy 10 Widgets for inventory at \$150 each and pay on COD
- 4.) You sell 4 Widgets from inventory for \$250 each on Net 30 terms
- 5.) You pay your monthly rent of \$800
- 6.) You pay your credit card company for your new computer
- 7.) Your customer pays for the Widgets they purchased
- 8.) You sell 3 Widgets for \$300 each, cash
- 9.) You buy 10 Widgets for inventory at \$150 each and pay on COD
- 10.) You sell 3 widgets for \$350 each and take a \$500 deposit

NOTE: When your bank says that they are **crediting** your account, they are referring to an entry on **THEIR** books.

Your money in the bank is a liability to the bank; therefore when they **credit** your account, they are increasing their liability to you on their books.

* No transaction is recorded until the bill is paid

Cash (1-xxxx)	
7.) \$1,000	1.) \$250
8.) \$900	3.) \$1,500
10.) \$500	5.) \$800
	6.) \$1,000
	9.) \$1,500

Accounts Receivable (1-xxxx)	
4.) \$1,000	7.) \$1,000
10.) \$550	

Inventory (1-xxxx)	
3.) \$1,500	4.) \$600
9.) \$1,500	8.) \$450
	10.) \$450

Sales (4-xxxx)	
	4.) \$1,000
	8.) \$900
	10.) \$1,050

COGS (5-xxxx)	
4.) \$600	
8.) \$450	
10.) \$450	

Office Expense (6-xxxx)	
1.) \$250	
6.) \$1,000	

Rent (6-xxxx)	
5.) \$800	

■ Financial Statements

The primary financial statements of any business include the Balance Sheet and the Profit and Loss. Together, they represent the total financial picture of your business. They must be reviewed as a set because collectively they tell you about your business, both in the short term and the long term.

■ The Balance Sheet

The Balance Sheet, one of the primary financial statements, is a reflection of your total assets, less total liabilities and the difference, or owner's equity. The balance sheet reflects a 'point in time'; for example, you could produce a Balance Sheet as of December 31, 2002 that would reflect all the account balances "as of" that date, or as of a point in time. For example, you would see the balance of your assets, liabilities and owner's equity accounts on December 31.

■ The Profit and Loss Statement (or Income Statement)

The Profit and Loss, also one of the primary financial statements, is a reflection of your total revenue generated, less the cost of items sold (which equals your Gross Profit), less your operating expenses (which equals your Net Income or Loss). The profit and loss reflects results for a 'period of time': the net income or loss for a specific period of time, for example, January 1, 2002 through December 31, 2002.

These are the financial statements that result from the example transactions above. In our example below, the owner also invested \$5,000 cash into the business at the start of the year to fund its operations.

ABC Inc. Balance Sheet June 30, 2002	
Assets	
Cash	\$2,350
Accounts Receivable	\$550
Inventory	<u>\$1,500</u>
Total Assets	<u>\$4,400</u>
Liabilities	
	\$ 0
Equity	
Owners Investment	\$5,000
Current Year Earnings	<u>(\$600)</u>
Total Equity	\$4,400
Total Liabilities and Equity	<u>\$4,400</u>

ABC Inc. Profit and Loss Statement January 1, 2000 through June 30, 2002	
Revenue	
Sales	\$2,950
COGS	<u>(\$1,500)</u>
Gross Profit	\$1,450
Expenses	
Office Expense	\$1,250
Rent	<u>\$800</u>
Total Expenses	\$2,050
Net Income/(Loss)	<u>(\$600)</u>

The Equity section of your Balance Sheet includes an account called "Current Year Earnings" which represents the year to date net income or loss of your business. The life to date history of profit and losses for your business is recorded into the Retained Earnings account. At the close of every year, the Current Year Earnings accounting is rolled into (closed) the Retained Earnings account. In our example above, our business is brand new, so the loss for the year is presented on the Balance Sheet as a reduction of Equity in the Current Year Earnings account. If the next fiscal year produces a \$2000 profit, the Retained Earnings account will reflect the balance of \$1,400 (a \$600 loss plus a \$2,000 profit), the cumulative balance. Each year, your Profit and Loss information is closed into your Retained Earnings account, that is how the Balance Sheet and the Profit and Loss report are tied together.

Again, it is important to remember, that a Balance Sheet represents a point in time (as of June 30), while a Profit and Loss represents a period of time (January 1 through June 30).

■ Terminology

Accounts Payable: Money or other obligations owed to creditors for services and materials, a Liability on the Balance Sheet.

Accounts Receivable: Money or other obligations due for services rendered or items sold on terms, an Asset on the Balance Sheet.

Accrual Based Accounting: Represents a method of recording accounting transactions when they occur, whether or not cash has changed hands.

Accrued Liabilities: Represents expenses that are incurred prior to being paid. For example, salaries earned by your employees and paid in a subsequent month are accrued as a liability until they are paid.

Accrued Revenue: Represents revenue that is earned and recorded but not yet received in the form of cash.

Asset: The things a company owns, seen on the Balance Sheet and represented as 1-xxxx accounts in your Chart of Accounts.

Balance Sheet: The primary financial statement that shows detailed assets, liabilities and equity at a point in time.

Cash Based Accounting: Represents a method of recording accounting transactions most easily described as accounting for cash transactions. Entries do not affect your financial statements until cash changes hands. In this environment, you do not track receivables and payables. Cash received is recorded as income when received and expenses are recorded when paid.

Chart of Accounts: A list of categories or accounts where transactions are recorded.

Cost of Goods Sold (COGS): Represents the cost of items or services sold to customers. These costs are kept in the Inventory asset account (1-xxxx) until they are sold. Then they are passed over to the COGS (5-xxxx) account. Seen on the Profit and Loss and represented as 3-xxxx accounts in your Chart of Accounts.

Credit: A credit is the right hand side of an account, represented in T-Account format on the previous page.

Current Year Earnings: This account represents year to date earnings, not yet recorded into the Retained Earnings account.

Debit: A debit is the left hand side of an account, represented in T-Account format on the previous page.

Deferred Revenue: Represents income received, but not yet earned. This is typically a liability account.

Double Entry Accounting: MYOB products follow the convention of Double Entry Accounting. Every accounting transaction is comprised of debits that equal credits.

Equity (Capital): The owner's interest in the business, which is the total assets minus the total liabilities of a company, seen on the balance sheet and represented in as 3-xxxx accounts in your Chart of Accounts.

Expenses: Costs incurred in the business used to generate revenue, seen on the Profit and Loss report and represented in your Chart of Accounts as 6-xxxx accounts.

General Ledger: An accounting record where all of your accounts are maintained. In MYOB products, when you enter any transaction, the General Ledger accounts are automatically updated.

Gross Profit: Represents your revenue from sales of inventory or services, less Cost of Goods Sold, before overhead expenses.

Journals: Account ledgers where entries are recorded. MYOB products have General, Disbursements, Receipts, Sales, Purchases, and Purchases journals. Every transaction creates a corresponding set of debit and credit entries in a specific journal.

Liability: The things a company owes in cash or other resources, represented as 2-xxxx in your Chart of Accounts. These are claims against assets.

Net Profit/Loss: Total Income minus Total Expenses. The bottom line!

Operating Profit: Profit before Other Income is added and Other Expenses are subtracted.

Overhead Expenses: Represents the expenses of a business independent of how much revenue is generated. Can also be considered Fixed Costs, things like rent, salaries, and utilities.

Profit and Loss Statement (or Income Statement): The primary financial statement that shows detailed revenues and expenses for a period of time.

Prepaid Expenses: Represents expenses that are paid in advance of incurring them. For example, you might pay a year's worth of insurance and accrue 1/12 of it each month. This is typically an asset account.

Retained Earnings: Represents the cumulative net income or loss of a business since its inception. When you Start a New Year in MYOB products, the program automatically transfers your year-end income or (Current Year's Earnings) loss to this account. This is called the closing entry.

Start a New Year: The process in MYOB products that closes a fiscal year, transfers your Current Years Earnings to Retained Earnings and prepares the accounts for a new fiscal year. All Income and Expense accounts are 'zeroed out' to start the new year.

Subsidiary Ledgers: Customer and vendor balances that equal the amount of the Accounts Receivable and Accounts Payable General Ledger accounts.

Trial Balance: A list of all your General Ledger accounts and their current balances.

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