

ACCOUNTING DEMYSTIFIED

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The Demystified Series of electronic courseware is designed for the busy entrepreneur. It's intentionally brief and intense because we believe you don't have time to read 300 pages of text to discover the data on the five to ten pages you will use. One spark of enlightenment from our series of small business reports and eBooks will return your investment many times over. Enjoy!

Your instructor for this course is Daniel Horne. Mr. Horne holds a Bachelor of Arts Degree in Business with an Accounting Major and an Economics Minor. He also holds a Master of Science Degree in Finance with post-graduate work in benefits & insurance planning. He has worked in high technology for the past 33 years, most recently as a Chief Financial Officer for seven years at a defense contractor.

Most people feel intimidated when they first encounter Accounting. I know that it gave me a serious headache and even though I've mastered all of the nuances, I still remember that first head scratching experience.

Then a kindly professor put aside the world of Journals and Ledgers and made it simple for me. All the "things" in your business are owned by someone. If you own them, then they are called "equity". If someone else owns them, they are called "liabilities" or debts if you prefer.

The Value of All Things = What You Owe + What You Own

Of course, accounting like any trade has to have official terms that seldom get used any other place on earth. For accountants it is called the Accounting Equation, $A = L + E$, and it's about the only mathematics in general ledger accounting.

Assets = Liabilities + Equity

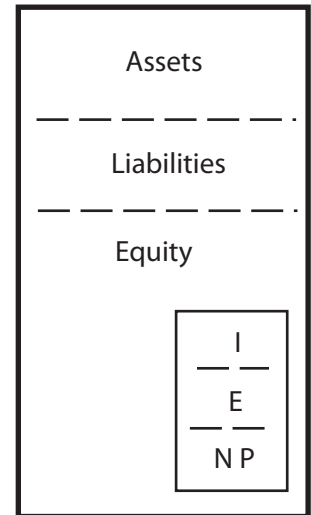
I say "general ledger" accounting for the benefit of those who may run into someone who is an accountant. Accountants come in as many flavors as doctors. Some of these specialties are cost accounting, tax accounting, forensic accounting and general ledger accounting.

Certified Public Accountants are predominantly experts in general ledger accounting, although some have gone on to specialize in tax accounting as well.

If important not to confuse accounting and finance. Here's a physical trick to understand the difference. Take two steps across the room looking at the wall you're heading toward. Now, go back to where you started and do the same thing looking at the wall you're walking away from (walking backwards).

Finance is the science of walking into the future trying to predict the financial result of new (or desired) events, and accounting is the profession of walking into the future focused on organizing the past.

Accountants memorize as many rules as lawyers do laws, but many know almost no mathematics beyond arithmetic and some simple algebra. That's okay, they don't need much math to be a good accountant. Focus, patience and a tendency to be anal about details will serve accountants better than two semesters of algebra.



However, the same is not true for finance. While accountants are more like lawyers, finance professionals are more like engineers.

I point to the current economic disaster, hedge funds, and the current events of the day to prove just how creative financial engineering can be. Accountants couldn't have designed such a thing in a million years, it's not in their skills and it isn't in their nature.

Both sets of professionals, as well as any business major, get some accounting courses in college, but it is the accountants who specialize in the myriad of rules that make up accounting.

The next thing that seems to give people a bit of a fright is the trial balance.

People are programmed by their check books to understand that debits are checks and credits are deposits. This is true for a bank.

A bank's books are a mirror image of yours. While your checking account is an Asset to you, it's a Liability for the bank. Liabilities are reduced by credit entries and Assets are reduced by debit entries. That's what you are doing when you make entries in your check book. Clear as mud, huh? No worry, I am going to gently explain.

The confusion starts with this whole idea of debit and credit, so let's start with a clean slate.

First, forget the bank for a moment and erase your check book from your mind. That's important.

Debit means left, nothing more—just left. It comes from the Latin word *debilitum*.

Credit means right, nothing more than that. It comes from the Latin word *creditum*.

<i>debilitum</i>	<i>creditum</i>
Debit	Credit
Left	Right
Assets	Liabilities
	Equity
Expenses	Income

Accounting is about balance. The idea is that the total of all the numbers on the left should always equal the total of all the numbers on the right, nothing more than that. If that is true, then you have 'accounted' for everything to be entered into the accounting records.

This is usually true, although it's not foolproof, errors can and do occur. For example, if you make the same error on the left and the right because you wrote the number wrong that was on the receipt, then your books will balance, but they will not be correct. So, while it's a good rule, it isn't the only rule that accountants pay attention to.

After all, the job of the accounting records is to report reality correctly, not just balance the books.

However, this idea of balance is important. The system of accounting we use is engineered to make this happen, so it turns out that all of the numbers on the debit side (the left) do equal all of the numbers on the credit side (the right).

Herein is the key to the mysterious world of "dual entry" accounting. If you put a number on the left, then you have to put the same number on the right so the totals of debits and credits remain in balance. It doesn't matter which number goes first (left or right) so much as it matters that both numbers are entered.

By placing Assets and Expenses on the left and Liabilities, Equity and Income on the right the two totals are the same—by design.

Knowing that accounting, like a car, works correctly when the rules are followed, but doesn't work at all when they are ignored might help you understand some accountants' disdain for a software like QuickBooks® in the hands of the uneducated.

Accounting has a process called posting, I won't get into it more than to say that it's a process of making sure that the left and right totals are the same before entering the transaction into the accounting records.

This is important because accounting has another rule to prevent theft and fraud (among other things) and that rule is that you can't erase anything after it has been entered into the accounting records (after it's been posted). Never is a harsh word, so there are techniques to make sure all is well before the accounting records ever see the numbers from a transaction.

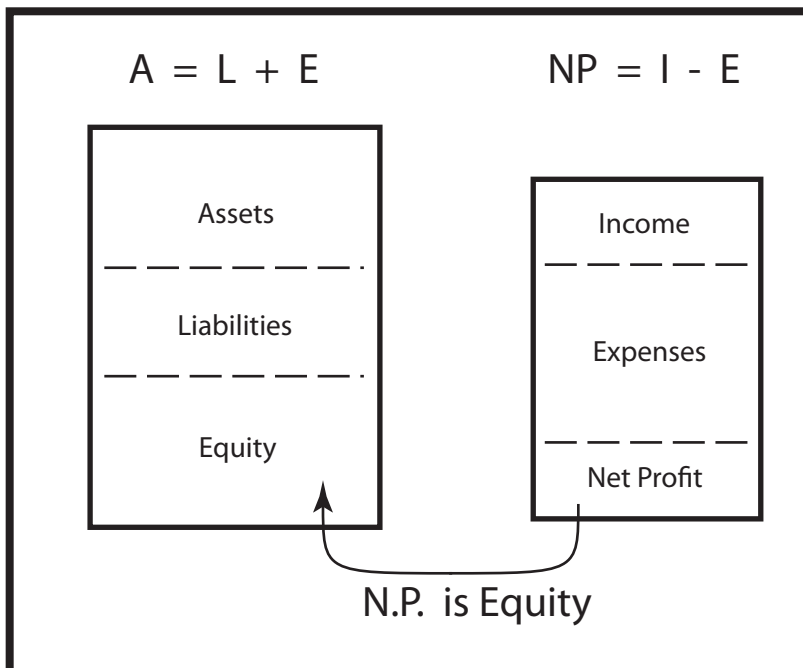
This is where you'll hear another term. The reversing entry draws a line through errors that were posted by posting the reverse transaction into the accounting records and neutralize the effect of the error.

Accounting was engineered way back when so that the totals work out that way. You might remember that A is the same as $L+E$, but I and E are hopefully different, so how's that balance? You probably already know that $\text{Net Profit} = \text{Income} - \text{Expenses}$. This is the Income Statement result (called a Profit & Loss statement, or P&L, by most lay people)

Most entrepreneurs focus totally on this equation. After all, if NP is a negative number the business eventually dies. However, this is not the most important accounting equation. Just because it gets a lot of press or creates a lot of emotion doesn't make it more than a financial reference point to the astute. Other, less obvious, financial indicators (reference points) when paid attention to will do more to keep NP a positive number than focusing on the Income Statement ever will.

Now for accountants, when I is larger than E , NP is a credit (right) balance. When E is larger than I , NP will be a debit (left) balance.

QB ignores a lot of accounting controls by design. This makes it both pleasing to use and a minefield of opportunity to go wrong. Accountants are people too and they can get distressed bailing good people out of bad situations.



Note here that the Income Statement is a slice, a data point, of the total picture reported by the accounting records. The Income Statement is a record of your day-to-day operations from the first day of the year continuously to today, resetting at the first day of the next year. As a data point, it's what you do with the information that is critical.

After all, it's reporting the past. All the events on it are behind you in time and as an entrepreneur, your chief challenges always lie in front of you, not behind you. Celebrating or crying over the P&L, won't change the past nor will it ensure the future.

This is a bit of a harsh statement, but in the final analysis, business is war and if you stay focused on the yesterday's victory or defeat, it won't help you win tomorrow's battle—other than yesterday may certainly be a good indicator of tomorrow's best strategy to use, or avoid.

Money is an asset in accounting lingo. Assets are good things to have on the left as long as they correspond to Equity, and not Liability, on the right. If you are making money, your asset balance is increasing. If you are making money your equity in the business is growing too. If you are losing money, then your cash asset is shrinking and your equity in the business is shrinking too.

Of course, if you are using debt to make money, then the asset and liability increase and equity doesn't change. It's all about $A=L+E$. Here's the nasty thing about debt—it doesn't go down because your assets go down.

The fact that debt is a constant (until it's paid off) means that when your asset balance falls, you equity eventually turns into a negative number. This is not good and far too many businesses fall victim to the cycle of a poor debt to equity ratio (my report on *How to Use Financial Ratios* goes into this in great detail). The risk here is that they will not only go out of business, but strap the owners with a debt that will haunt them for years to come.

As you may already know, a Balance Sheet is a collection of the value of all the Assets, Liabilities and Equity. So, in a sense, the Income Statement is nested inside of the Balance Sheet.

After all, the net profit is the Income Statement result shown at the bottom, and when it is transferred to the Balance Sheet it is a change in Equity. Only then will Equity and Assets Balance, keeping in mind that debt (Liabilities) is a constant for this little bit of accounting algebra.

The idea of a Trial Balance is yet another scary topic for beginning accountants. I can only imagine that approaching the Trial Balance for the first time is similar to the fear in a medical student's eyes when they first lay sight on a cadaver.

Now, that you've gotten your mind around left and right, you should be able to see that $\text{Assets} + \text{Expenses} = \text{Liabilities} + \text{Equity} + \text{Income with Net Profit}$ being the missing ingredient that makes the two columns balance. Net profit can go on either side of the equals sign to accomplish its mission.

A word of advice, you want NP to be on the right of the equals sign. That's where it goes when you are making a profit (a positive number) on the Income Statement.

When NP is on the right, then its corresponding value on the left is buried in the A, usually either cash or accounts receivable. When NP is on the left, then its corresponding value is buried in L or E. It means that your income was insufficient to cover your expenses, or your asset purchases, and that either your debt grew or you invested more of your own money (or property) into the business to compensate for the shortage of equity.

Those two columns, $\text{Left} = A + Ex + [NP]$ and $\text{Right} = L + Eq + I + [NP]$, are the infamous Trial Balance Sheet.

The Trial Balance is nothing more than a listing of all accounts without the benefit of breaking them into any particular financial statement. You want the total on the left to match the total on the right.

As you know, NP is only on one side or the other, not both as I show it. I've placed it in *[brackets]* on both sides to indicate that it is a hidden value which can be on either side and it is what makes the two column totals equal.

Let's close by going back to the banking example. Now that you understand that your checking account is a Liability to the banker, and as such is a credit entry that goes on the right, does it make sense why you put your deposits on the right in your check book?

In like manner, reductions in your account balance mean that the bank's liabilities decrease. This is a left side entry to the bank's books—a debit entry to a credit (liability) account.

What makes the whole check book thing so confusing is that banks have given you a journal to record your deposits and checks that reflects their liability to you. No one explains that so people naturally believe they are looking at the cash asset they own.

See the difference now that you know your check book reflects the banker's books, not yours, and as such is a mirror image in the whole right and left scheme of thing!

This is how accounting works between two sets of books. An entry in one business is offset by a mirror image entry in the other business. An asset on your books is a liability on someone else's books, your Accounts Receivable, their Accounts Payable. For accountants this is Satori.

The Zen of accounting is when the columns balance. Never mind that you might be going out of business. That's a finance problem.

Or it's a Management problem depending on your point of view.