

Accounting Basics

(Cheat Sheet)



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Accounting Basics

Accounting basics is often described by the following actions:

- *Recording* the vast number of *transactions* that a business (or other organization) experiences.
- *Sorting and storing* the transactions in *accounts* within the company's *general ledger*.
- *Adjusting* the account balances prior to issuing financial statements in order to comply with the *accrual method of accounting* as well as other accounting principles and standards.
- *Issuing financial statements* to a variety of people for various accounting periods (annual, monthly, etc.).

However, the field of accounting also includes management accounting, income tax accounting, auditing, accounting systems, SEC reporting, and more.

Double-entry System

Generally, accounting is accomplished by the use of the *double-entry system* (or *double-entry bookkeeping*). This means that every transaction and/or accounting entry will affect a *minimum of two accounts*. For example, paying the rent usually means an entry to the account Cash and to the account Rent Expense.

In addition, double entry requires that *at least one account will be debited* (entering an amount on the left side of an account) **and** *at least one other account will be credited* (entering an amount on the right side of an account). As a result of double entry, the company's general ledger accounts should always have the total amount of the debit amounts equal to the total amount of the credit amounts.

Double entry also assures that the accounting equation will remain in balance. (The accounting equation is: Assets = Liabilities + Stockholders' Equity.)

Types of General Ledger Accounts

The accounts in the general ledger of a corporation consist of two major categories:

- Balance sheet accounts (assets, liabilities, stockholders' equity)
- Income statement accounts (revenues, expenses, gains, losses)

A few examples of the *balance sheet accounts* include Cash, Accounts Receivables, Prepaid Expenses, Equipment, Accounts Payable, Notes Payable, Accrued Expenses Payable, Common Stock, Retained Earnings and more. The balance sheet accounts are also referred to as *permanent accounts* since the balances in these accounts are not closed at the end of the accounting year. Rather, the balances at the end of the year are carried forward to become the beginning balances of the following year.

A few examples of the *income statement accounts* include Sales Revenues, Service Revenues, Investment Income, Wages Expense, Rent Expense, Utilities Expense, Advertising Expense, Insurance Expense, Depreciation Expense, Interest Expense, Gain on Sale of Assets, Loss from Lawsuit, and many more. The income statement accounts are referred to as *temporary accounts* because the account balances are closed at the end of the accounting year. When the income statement accounts are closed, the net amount will be recorded in a stockholders' (or owner's) equity account. The income statement accounts will begin each accounting year with zero balances.

External Financial Statements

When a corporation releases its financial statements to people outside of the corporation, they are to include the following:

- Income statement
- Statement of comprehensive income
- Balance sheet
- Statement of stockholders' equity
- Statement of cash flows
- Notes to the financial statements

Income Statement

The income statement is also known as *statement of earnings*, *statement of operations*, *profit and loss statement (P&L)*. The amounts on the income statement are the revenues, expenses, gains, losses, and the resulting net income that occurred in the accounting period. This is best done by following the *accrual method of accounting*.

Statement of Comprehensive Income

The statement of comprehensive income reports 1) the amount of net income from the income statement, plus 2) some additional items referred to as *other comprehensive income*.

Examples of other comprehensive income include gains and losses from foreign currency adjustments, hedging, and postretirement liabilities.

Balance Sheet

The balance sheet is also known as the *statement of financial position*. The balance sheet reports the balances in the asset, liability, and stockholders' equity accounts as of the *final moment of the accounting period*. Similar to the accounting equation, the balance sheet must always be in balance. For instance under the accrual method of accounting, when a corporation earns revenues and allows the customer to pay 30 days later, both the asset Accounts Receivable and the stockholders' equity account Retained Earnings will increase. (However, the amount earned will first be recorded in the *temporary account* Revenues Earned in order for the amount to easily be reported on the income statement.)

Statement of Stockholders' Equity

The statement of stockholders' equity lists the changes that occurred during the accounting period in the corporation's stockholders' equity accounts. These general ledger accounts include common stock, preferred stock, retained earnings, accumulated other comprehensive income, and treasury stock.

Statement of Cash Flows

The statement of cash flows (SCF) is also referred to as the *cash flow statement*. The SCF is necessary because the income statement reflects the accrual method of accounting (not the cash method). The statement of cash flows lists a corporation's significant cash inflows and cash outflows that had occurred during the accounting period. The cash flows are listed under one of the following categories: *operating activities*, *investing activities*, and *financing activities*. The total of the three categories should equal the *change* in the amount of the corporation's cash and cash equivalents during the accounting period.

Notes to the Financial Statements

The amounts appearing on the face of the financial statements cannot adequately communicate all of the complexities involved in the business activities. Therefore, additional information must be disclosed in the notes to the financial statements.