Passport Software, Inc.

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Accounting Basics
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Important Points for Accounting Basics:

- Debits/Credit
  - These are opposite to the bank's terminology concerning your money
  - B/S - Debit = asset, positive increase
  - B/S - Credit= liability, negative increase
  - P&L - Debit=Expense, positive increase
  - P&L -Credit= Income/Revenue/Sales, negative increase
  - Note since Debits are positive values and Credits are negative values netting these together is the same as adding the signed values or is equivalent to subtracting the unsigned values of the credits from the debits.
    - I.O.W. Debits + Credits = Net
    - or [Debits] – [Credits] = Net. (Here "[]" brackets are used to show Unsigned values.)

- Corporation as a "container"
  - Consider the corporation as a container, a box which has no net intrinsic worth. Its only value is in what it contains.
  - All transactions, in and out, are paired and net to zero
    - E.g., a loan:
      - A positive (= Debit) transaction increases the total in the Cash account;
      - A negative (=Credit) transaction increases (negatively) the total value in the Loans Account
  - Therefore, all transaction sets must balance to zero – enforced by the program.

- Chart of Accounts
  - A list, often numeric, of all the categories of assets, liabilities, income/revenues, expenses that need to be tracked.

  - Because of the second point above, the total value of all transactions entered into the General Ledger and controlled by the Chart of Accounts will be zero. The list of all transactions in a period is called a Trial Balance so we also specify that a Trial Balance must also net to zero.

  - The Chart of Accounts (usually just referred to as "the Chart") is divided into two sections – one for *Value* and the second for Operations or *Profitability*:
    - The total *Value* is the section called the *Balance Sheet* and equals what the disposal value would be for the business if it were to be liquidated at a particular time, i.e., if all assets and liabilities in the Balance Sheet were netted together. As such, the primary value coming from the Balance Sheet is the *Period End Value*. It is also called the *Closing Value* for the period.

- (Note - in the sense of giving the net value of the business, this value does not take into account actual market conditions, whether or not all of your assets are real, etc. It is a Book value.)

- At the year end when the overall picture of the company's Value and Profitability are assessed, the Balance Sheet total is therefore the net value of the company as of the closing date (e.g.,12/31/20). In other words, it is the net value of the Balance Sheet, the Closing Value, as of 12/31/20. For example, if, at year end, you had $10K of cash in bank, $5K loans and $7K of Accounts Receivable, your Balance Sheet would be 10 – 5 + 7 = 12K. I.e., your closing value would be 12K.

- By contrast, the totals of the ***changes*** in value of the entries in the second section is called Profit & Loss (P&L), (or Operations or Income & Expense). The P&L gives us the net change for a particular stretch of time (a period) of all the income and expense entries. (A period is typically a month, a quarter or a year).

- For each period, the net change in value of all these transactions corresponds to the profitability for that period. For example, say, in June, if your opening value for the revenue account as of June 1st was $125K and by June 30 your (closing) value was $200K, you would say that your June revenue was 75K. Putting this another way, if we started the month with "x" dollars in a P&L account, the account would have "x" plus the net change at the period end. Suppose, in addition that, the net change (n/c) in each of the following was: Cost of Sales - n/c 35K, payroll wage expense - n/c 10K and other overheads -7K. Then for the month of June your net P&L would be the sum of the net changes for the period i.e. (75) + 35 +10 + 7 which would be a profit of (23).

- Here we use the accounting convention of enclosing credit values (negative values) in parentheses – which means that the revenue and the profit are credits. In this context a credit value for a profit means the value of the (credit) revenues exceeds the values of the (debit) expenses and so this is "real" profit, i.e., a profit is represented by a credit amount. If the net of all P&L net change credits and debits were a debit value (positive) then that represents a loss.

- Year End is a special time

  - At year end the net of all income and expense for the year are tallied and become the annual net profit.

  - At year end the P&L section is also cleared to make way for a new year and the net profit for the year that is being closed is moved to Retained Earnings.

  - Retained Earnings can be considered a liability to the stockholders because this is basically the value of the profits that will pay dividends to the stockholders. This is also the same basic reason why revenues are booked as credits: ultimately any revenue that exceeds the expenses is potentially a liability to be paid to the stockholders.

- Sample Chart:
  - 1000 Assets
  - 2000 Liabilities
  - 3000 Stockholder Equity, Dividends, Retained Earnings
  - 4000 Income/Revenue
  - 5000 Cost of Goods Sold (direct sales costs)
  - 6000 Operating costs
  - 7000 Labor Costs
  - 8000 Misc.

- Accrual
  a) A process of time-shifting all or a portion of a transaction to better represent the period when those values were involved: For example, a 2-week payroll straddles the end of the year covering the last part of December and the first part of January. The payroll checks are dated in January at the end of the pay period. You could accrue the portion of the payroll costs that were actually worked in December, so that the December books receive their "fair" share of the payroll costs for that period of time.

  b) A process of entering an estimate of a transaction when the exact value is not yet known but is expected to be known shortly: For example, a vendor is late in getting a large and therefore significant invoice to you. The work being billed is in the prior month and you want to close the month, but you want to include that vendor's invoice as part of the expense. In this case you would take your best guess and enter that as the cost of the vendors services and distribute it into the month of your choice. When the vendor's bill comes in the next month you would enter the actual invoice in the new month normally and for the full value but you would also enter an adjustment for this month with a reversing value to offset the estimated charge from last month. E.g., post a 10K accrual into last month as an estimated expense. The when the invoice comes in the current month (value 11,400), post that as a new invoice and post a credit for 10K as well in the current month. This way only $1,400 is the only value "misplaced" in time.