



Accounting & Bookkeeping 101

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So, anytime I start teaching accounting I always start with this we call this the fundamental accounting equation and in fact accounting is really simple. There is usually addition, subtraction... it isn't until you get into the taxes there is multiplication and division. It's all just addition just addition and subtraction at its core basic level.

This is the fundamental accounting equation: $\text{Assets} = \text{Liabilities} + \text{Equity}$.

Now, initially you go "hey what does that mean?" Well most people are very familiar with something in their daily lives, something they deal with all the time. For example, let's say you buy a home. If you buy a home and you pay 400,000 for that home and you take out a 350,000 mortgage and you put 50,000 down you have the fundamental accounting equation right there.

Your asset is the house, your liabilities are the 350,000 and that is how much equity you have in the home 50,000 dollars down. It isn't any different, none at all. The only difference is there are more kinds of assets, more kinds of liabilities, and more kinds of equity.

Ok, make sense so far?

So we take that and turn it on its side. There's something called the chart of accounts. And this is nothing more than that same equation except now on its side. So we start with assets. We have liabilities. And we have Equity.

And when we do a Balance Sheet, it is the sum of all the assets and the sum of all the liabilities and the equity. That's a Balance Sheet.

A P&L: Profit and Loss is actually a sub set of the balance sheet. It is the change in equity for a period of time. That's all it is. When it gets right down to it, that's why accounts are always balance sheet focused and people who don't do accounting very well are usually profit and loss focused, P&L focused.

The P&L is only one little side item in here. Broken up into a bunch of different further categories like how much revenue and how much expenses. At the end of the day it becomes one line in equity. That line in equity is net income.

The important thing to understand about a P&L and Balance Sheet is they actually have different date recording. A P&L is for a time range. Let's say it's from January 1st to December 31st. The Balance Sheet actually has 1 date. New modern accounting software actually sort of has 2 because the beginning date becomes important.

The Balance Sheet is a snapshot as of a certain date. Let's say its 12/31. It's what did the numbers look like on that date. The P&L is what is the activity between a range of dates. You will

sometimes see a balance sheet with a beginning date. Let's look at the equity section. The net income is for the period, it's the change in the P&L for the period for the beginning to the end date of the balance sheet.

If it was prior to the beginning date of the balance sheet, it goes in a different account called retained earnings. Which is another important account in the chart of accounts.

So, if we were dealing with the date from Jan 1st to 12/31 on the P&L, then the net income is from 1/1 to 12/31 and the retained earnings is everything prior to 1/1 that the companies historically earned.

If you change this date range to being 12/1 to 12/31 and you change the beginning date on the Balance Sheet at the same time. Net income becomes only the number that's on the bottom of the P&L and then the retained earnings now includes that other 11 months because of the opening date of the balance sheet.

That's the only reason the opening date of the Balance Sheet is important.

Before computerized accounting systems, this was a big deal. You literally had to close your books because they were kept on paper. What you would do is you would close your books usually monthly, you would also have an annual close. You would take all the balances and all the paper ledgers that were on your P&L and you close them to one number. The Net Income number. You would then take that number and close it against retained earnings at the end of the next month.

With computers now, they can literally add all these numbers up in a snap. All you have to do is change the date range and it recalculates everything for you. So instead of babysitting retained earnings, it becomes an automated account. It's kept by the books for you.

Let's take a look at some other assets and liabilities. When you're dealing with a company you might have a bank account and you might have some fixed assets like an automobile. You might have liabilities like an auto loan. So we're now starting to fill in the typical things you would see on a business balance sheet.

When you look on the chart of accounts inside Cheqbook, you will see a series of key categories in this chart of accounts. These are the 3 major ones. But if you actually break it down in subsets the chart of accounts runs in order, a very specific order.

Inside Assets is current assets, fixed assets and long term assets.

When you get into Liabilities, it almost always starts with accounts payable, then you have other current liabilities, then you have long-term liabilities.

When you get into the Equity section, typically we have talked about Net income, but you also have common stock, capital, and other types of things and or dividends or distributions (which is money that came in or out from the owner of the company).

Then you get into the P&L. Starts with Sales at the top. Again, we are just continuing the chart of accounts. If you look on the chart of accounts inside Cheqbook, you will see they are arranged in

this very convenient order and this is the traditional order.

Even though in theory the balance sheet has ended with a simplified P&L, really what we have done is we are going into this new P&L section which Cheqbook will automatically close into the balance sheet for you regularly.

Chart of the accounts is a continuation that just keeps going. So you have sales. You might have COGS (cost of goods sold) it might be the labor to produce the product you have, it might be the materials that go into that product. You might have other expenses like rent, overhead, rent, utilities, liabilities insurance, things like that. Then you get an operating income. Usually a subtotal. It shows you what the results of operations are. Underneath that you get other income and expenses. In those expenses, you'll see things like depreciation; you might see other unrelated income to the operations of the company, something else the company is doing that isn't part of its core operations.

Cheqbook adds something additional, something special right here.

If you happened to have turned on the Personal expense tracking in Cheqbook, we add it in the end of this chart of accounts. We have personal income and personal expenses. To give you a little recap, that shows you whether you made or lost money. It gives you a total.

Then we take this total and we have to put it in the equity side. We call it Net two from personal. Just like the retained earnings from earlier, the income statements close to the equity section. So you can see for example, something make 10,000 bucks but you spent 4000 in personal expenses, your P&L for your business would show you make 10,000 bucks, your combined P&L would show you have 6,000 left because you spent 4,000 in personal expenses.

But in the chart of accounts it will show you net income from your business where it should be your retained earnings and this one extra special account over here shows would show you basically if it was a dividend or distribution to yourself because you took the money out and spent it on personal expenses. This is how we combine business and personal together in one account.

You will notice the balance sheet is presumed to be all business. You wouldn't put your home in here. You would just put your business assets in there. Your P&L is all business, this personal add on financial accounts statements with about 40 accounts or so track your personal expenses at your end. When you run the reports you can either include it or separate it from what you are doing. That's how we simplify the inclusion of personal spending in a set of books for business without mixing them up and making them unmanageable. So when you're working with your books. The question is, how do you categorize something?

If you're buying an automobile, the first thing everyone thinks of is everything goes on the P&L, well automobiles don't go on the P&L. Why? Because they are an asset that lasts a long time.

If I'm buying a stapler or a roll of tape, you're going to expense it. It's not very material; you might throw it away tomorrow. If you're buying a car, it is going to have value for years. The car, shows up as an asset. The stapler goes to the P&L and gets expensed.

In theory, yes it's an asset but because it's a small ticket item, usually there is a cut off in everybody's set of books around 100 or 500 or 100 bucks, depending on the size of the company

that says if its bigger than that it gets capitalized. If it's smaller it goes to the P&L and gets expensed. So that's how you deal with one type of expense.

Now, when you make payments on an automobile, it covers a lot of things on the P&L. When you make your auto loan payments, you're paying down the principle.

If I make a \$400 payment, \$50 of that is interest, the interest gets expensed on the P&L and the other \$350 reduces the balance I owe on the loan.

That is why you have to be able to split transactions like you do in Cheqbook, this ability to split this transaction can show what you are doing. Additionally, a car will lose value over time so you have to depreciate it. That follows usually tax rules for most small businesses.

Every year there will be a certain piece of this we deduct and we will reduce the value of this car based on how much its lost value over time and book that on the P&L under depreciation expense in other income and expenses. Then the asset value will go down and the loan value will go down. But just like your home, where you have equity in your home and you're paying that on loan. The home might actually increase in value, but in this case we only depreciate items on a set of books. We never actually mark them the fair market value on company set of books. We just book them at whatever their original cost was and depreciate them reasonably over time.

This is in essence, your chart of accounts. Anything you categorize is going to have a place for it. Most things you categorize are in the P&L. It's going to be a sales item or an immediate cost. If it feels material, like a big ticket item, like writing a check for 5000 bucks it will likely end up on the balance sheet. But it can change. It depends if your running advertising, it gets expensed. If you're buying something like a physical asset that lasts a while it goes on the Balance Sheet.

If the beginning balance sheet and the ending balance sheet are correct, then we know the net income is correct. IT has to be. Now the categorizations could be wrong. The sales could be booked as operating income and vice versa. But if the beginning and the ending balance sheet are tight, the net income must be right. Especially for tax accounting, that becomes a very important consideration.

So one of the things we do when we get a client that has been a mess for years, and they don't want to spend the money to back and clean up years and years' worth of books, the only thing we will do is we will tightly tie down their ending balance sheet. Why? That first year might be kind of a mess because the beginning balance sheet isn't good, but at least we've stemmed the bleeding. From this point forward, once we have a good ending balance sheet, which becomes next year's good beginning balance sheet. We know we now have a set of books we can trust and rely upon as an accountant.

Now, how do we reconcile a balance sheet or how do we know a balance sheet is right? We reconcile it. For instance, we reconcile the bank account if the bank statements reconciled against the balance. Well how do we make sure the auto is correct? Well we look at the depreciation tables, we make sure the auto was valued correctly based on the purchase. We make sure the depreciation has been reported correctly based on taxed or other rules. How do we look at the auto loan? We look at the auto loan statement. If the balance statement says its \$17,461.05 on 12/31 that's what goes in there. Everything else goes to interest or some other place because

that's where it should be.

Essentially we keep moving through the balance sheet. You can know what the balance is on everything in the balance sheet and everything in there can be verified and checked. Once you have done that, then you know you have a good set of books you can work with.

The accounts who are formally trained know this is where you start. The P&L is just a sub-piece of the Balance Sheet and shows you how the equity changed over a course of a period of time.

Other interesting questions that come up when discussing Accounting, the first one that comes up is cash vs. accrual. Everybody goes am I cash business or accrual, what's the difference. We'll accrual is a better method but its twice as much work. Why is it a better method? Let me give you an example. Suppose you have an electric bill for October and your receive it in November and you pay it December. Under the cash method of accounting. It's an expense in December. Imagine if you hadn't paid it until January or February wouldn't be expensed until the next year but you actually owed the money in the current year. In the accrual method of accounting it's an expense in October. IN October you make an entry expense and book it to payables. Hey I owe \$100 to the electric company and it shows up as a payable so then you owe a liability. Then in December when you actually pay it, you don't expense it again, you just relieve the liability.

Segway into Double Entry Accounting.

What is double entry accounting? Well anytime you have, a transaction that occurred, there is always two sides. Let's discuss them. Let's say you bought a car. Well, I'm going to write a check for the used car for 5,000 from my bank account and I'm going to reduce the balance in the bank account and I'm going to increase the balance in my car. Double entry. Hey, I have an electric bill. I'm going to book an expense in the P&L and I'm going to book a liability in the Balance Sheet. Electric bill cash basis, I'm going to book an expense on the P&L and I'm going to book a reduction to the bank account in the Balance Sheet. Everything you touch, you has an opposite side. If you think only in the terms of the P&L you're going to think "where is the offsetting side?" When you work in most software, including Cheqbook, they hide it from you. If you're a bank account and you're expensing that to someplace, you'd think hey I'm going adding it to one side. But the truth is you were in the bank account. You made an entry in the bank account to reduce your balance by 5000 bucks. Guess what, the bank account went down by 5,000. The other entry was to the auto loan for 5000 bucks. It's always double entry. It's the account you're in when you're working in the register, that's one account. Then the account you code that to, the expense you categorize it to is the offsetting category you choose, that's the offsetting account.

What's a split transaction? We've cover one of those already. When you write a check to the auto financing company for the loan, some of it is for interest and some of it is for principle. Let's say you write a 400 check to the bank and 50 is for interest. 50 goes on the P&L to interest. And the other 350 goes to deduct the balance of the auto loan. That's a split transaction. You might have to do that depending on what you're doing with your business. It doesn't always go to the same place.

You go to Costco and you buy something, some of it is personal expenses and some is business expenses. You have to take that Costco purchase and you have to split it up between the personal and the business expense. In fact, you might buy things at Costco, some of which are different

types of business expenses. You might buy food for the office, for the office party which would be meals and entertainment expense. You might buy supplies which might be office supplies. You have to split that payment to Costco up into categories.

So far we have covered the Cash vs. Accrual, We have covered the chart of accounts, we have covered the balance sheet, and we have covered the P&L.

One more thing I like to cover is Debits and Credits.

Debits and Credits, I have this trick question I like to ask people. Would you prefer to have debits or credits or in your bank account of your general ledger. Most of them go "Credits" but that's not the right answer. The right answer is debits. Most assets start off with a debit balance.

Liabilities and credit balance, equity is a credit balance. The sum of the credits= the sum of the debits. Sales is a credit balance, and all the expenses are all debit balances. So if I put a 100 in my bank account. I debit my bank account 100. Now the offset might be a contribution from the owner, so we have the credit equity for that contribution. Now let's go through another transaction. I go and to the bank and I put money in the bank. Well guess what that is to the bank. Now this where people get into this idea they want to credit their bank account. To the bank, your bank account is on their liabilities side of their balance sheet. They owe you that money. And when you think hey I want credit my bank account, you're thinking in terms of how the bank thinks. The bank knows you're a liability and we are going to recognize that liability by crediting your account.

A liability is a credit.

So when you're working in a set of books, especially in Cheqbook, where we don't have separate columns for deposits and expenses. You have to look carefully at the top and make sure you put the right sign in front of something. Sometimes it's a debit and sometimes it's a credit.

Accountants will know what to do. They know sign is important. It can be common error when you're in your bank account not to put a minus sign in front of an expense you just incurred in your bank account while working in Cheqbook. Keep that in mind.

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