

Financial Accounting

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Accounting is actually simple, let's begin with small steps.

First thing you need to remember is we follow double-entry system. This means, for every DEBIT, we will have a CREDIT.



Think about you running a business, what kind of accounting and financial elements of business will you be dealing with??

Of course, you will want to earn money. It could be through selling a product or a service. Now that is your income/ revenue.

You would also require equipments to produce the products. These equipments are your assets, if you own them.

Where would you get money to buy your equipment (asset)? Either you invest your own money (Owner's equity), or borrow money from bank in form of loans (liabilities).

But how will you know when to debit which account and when to credit what account? The general rule is: **Assets and Expenses** have a **DEBIT** balance and **Liabilities and Income** has a **CREDIT** balance.

Let's look at the examples and classifications of Assets, Liabilities, Expenses, Income and Owner's Equity.

The Accounting Equation

ASSETS [+]	LIABILITIES [- +]	OWNER'S EQUITY [+]	REVENUES & GAINS [+]	
Current Assets	Current Liabilities	Common Stock	Gain on Disposal of Plant Assets	+
Cash	Accounts Payable	Additional Paid-In Capital	Interest Revenue	
Short-term Investments	Notes Payable [Current]	(Dividends)	Rent Revenue	
Accounts Receivable	Salaries & Wages Payable	Income Summary	Sales Revenue	
(Allowance for Doubtful Accounts)	Taxes Payable [Salaries]	Owner's Capital	(Sales Discounts)	
Inventory	Accrued Expenses	(Owner's Drawings)	(Sales Returns & Allowances)	
Supplies	Unearned Revenue	Preferred Stock	Service Revenue	
Prepaid Expenses [Insurance, Rent]	Interest Payable	Retained Earnings		
		Treasury Stock		
Long-Term Assets	Long-Term Liabilities		EXPENSES & LOSSES [+ -]	
Notes Receivable	Long-Term Debt [Bonds]		Advertising	
Long-term Investments	Notes Payable		Amortization	
Land	Capital Leases		Bad Debts	
Property [Buildings]	Pension Liabilities		Cost of Goods Sold	
Equipment, Furniture, & Fixtures	Deferred Revenue		Depreciation	
(Accumulated Depreciation)	Deferred Income Tax		Freight-Out	
Intangibles [Goodwill, Copyrights...]	Discount on Bonds Payable		Income Tax	
	Dividends Payable		Insurance	
	Income Taxes Payable		Interest	
	Mortgage Payable		Loss on Disposal of Plant Assets	
	Premium on Bonds Payable		Maintenance & Repairs	
	Warranty Liability		Rent	
			Salaries & Wages	
			Supplies	
			Utilities	

KEY
+ Increases account
- Decreases account
() Contra account
[] Examples

Let's look at the accounting rules as follows:

Debits and credits system		
DEBIT	CREDIT	
↑ ASSETS	↓ ASSETS	Accounts are increased and decreased with a debit or credit
↓ LIABILITY	↑ LIABILITY	
↓ EQUITY	↑ EQUITY	
↑ EXPENSES	↑ REVENUE	

Let's take an example where your company is, XYZ Ltd. and record journal entries, also lets learn the accounting rule of income, liabilities, expenses and assets.

For example:

1. Sam (You/Owner) invest \$100,000 of cash into your company, XYZ Ltd, to start the business.

Journal Entry:	Accounting Rule:
DEBIT Cash/Bank \$100,000 CREDIT Owner's Equity \$100,000	When Asset/ Expenses ↑↑ :- DEBIT When Owner's Equity↑:- CREDIT Note: In this case, Cash is our current asset, more cash coming into the business means, our asset in going up/ increasing. Also, equity is increasing.

2. XYZ Ltd, purchases equipment for \$25000. Payment was made by Cash.

Journal Entry:	Accounting Rule:
DEBIT Equipment \$25,000 CREDIT Cash \$25,000	When Asset ↑:- DEBIT When Asset ↓:- CREDIT Note: In this case, Equipment is our Long-term asset. Purchase of new equipment leads to increase in asset. On the other hand, the amount is paid in cash, cash (current asset) is reducing, therefore, when asset reduces it's a credit.

3. XYZ Ltd, purchased raw materials worth \$5,000 from their supplier on credit.

Journal Entry:	Accounting Rule:
DEBIT Raw- Material Inventory \$5,000 CREDIT Accounts Payable \$ 5,000	When Asset ↑:- DEBIT When Liabilities ↑:- CREDIT Note: In this case, Accounts Payable (Current Liability) is increasing.

4. XYZ Ltd. Took a long-term loan from bank of \$50,000.

Journal Entry:	Accounting Rule:
DEBIT Cash \$50,000 CREDIT Bank Loan \$50,000	When Asset ↑:- DEBIT When Liabilities ↑:- CREDIT

5. Sam withdraws \$5,000 from XYZ Ltd.

Journal Entry:	Accounting Rule:
DEBIT Owner's Equity \$5,000 CREDIT Cash \$5,000	When Owner's Equity ↓:- DEBIT When Asset ↓:- CREDIT

6. XYZ Ltd. Paid \$250 for Advertisement by cash.

Journal Entry:	Accounting Rule:
DEBIT: Advertisement Expense \$250 CREDIT: Cash \$250	When Asset/ Expenses ↑↑ :- DEBIT

7. XYZ Ltd. Sold goods worth \$6500 for Cash and goods worth \$2000 on credit.

Journal Entry:	Accounting Rule:
DEBIT Cash \$6500 DEBIT Accounts Receivable \$2000 CREDIT Revenue \$ 8500	When Asset ↑:- DEBIT When Asset ↑:- DEBIT When Income ↑:- CREDIT

8. XYZ Ltd. Supplier (Transaction No.-3) has paid the amount XYZ Ltd. owed of \$5000.

Journal Entry:	Accounting Rule:
DEBIT Accounts Payable \$5000 CREDIT Cash \$5000	When Liability ↓:- DEBIT When Asset ↓:- CREDIT

Special Scenario:

1. **Unearned Revenue:** Unearned revenue is money received by an individual or company for a service or product that has yet to be provided or delivered. It can be thought of as a "prepayment" for goods or services that a person or company is expected to supply to the purchaser at a later date.

For example, XYZ Ltd. has to sell goods worth \$2500 to Apple Inc. on 23rd July 2020, however, Apple Inc, paid \$2500 in cash today to XYZ Ltd. (Today's Date June 1,2020)

In this scenario, goods will be sold at a later date, that is on 23rd July. However, the cash is received today. Therefore, there should be journal entry recorded today because we received Cash.

If the goods were sold today, then the journal entry would have been simple, Debit Cash \$2500 and Credit Revenue \$2500. However, here this is not the case. The revenue is still not earned because goods are not sold yet. Therefore, it is termed as unearned revenue.

The correct journal entry on June 1, 2020 would be:

DEBIT	Cash	\$2500
CREDIT	Unearned Revenue	\$2500

The correct journal entry on July 23, 2020, when good are actually handed over to the customer would be:

DEBIT	Unearned Revenue	\$2500
CREDIT	Revenue	\$2500

2. **Prepaid Expenses:** Prepaid Expenses are expenses paid in advance. For example, if its June 1, 2020 today and you paid your house rent for both June 2020 and July 2020. The rent for June 2020 was due today, therefore it will be expensed.

However, the rent for July 2020 is not due until July1. You paid it in advance. This is not an expense for today, it is a temporary asset until its actually due and becomes an expense, that is on July1.

Let's understand this with an example:

XYZ Ltd. paid rent of Office Premises due today for the month of June. (Today is June 1, 2020). Rent amount is \$1000 and its paid in cash.

Debit	Rent Expense	\$1,000
Credit	Cash	\$1,000

What if, XYZ Ltd. paid the following amounts for rent today at June 1,2020.

Rent due on June 1, 2020 \$1000

Rent due on July 1, 2020 \$1000

In this scenario, even the July's rent is paid in June. Therefore, the journal entries would be as follows:

On June 1:

DEBIT	Rent Expense	\$1000
DEBIT	Prepaid Rent	\$1000
CREDIT	CASH	\$2000

On July 1:

DEBIT	Rent Expense	\$1000
CREDIT	Prepaid Rent	\$1000

Rent of July is due on July 1, but we offset with prepaid rent because we already paid it in June and recorded that entry.

Because we follow double-entry bookkeeping, for every debit, we have to record a credit.