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??

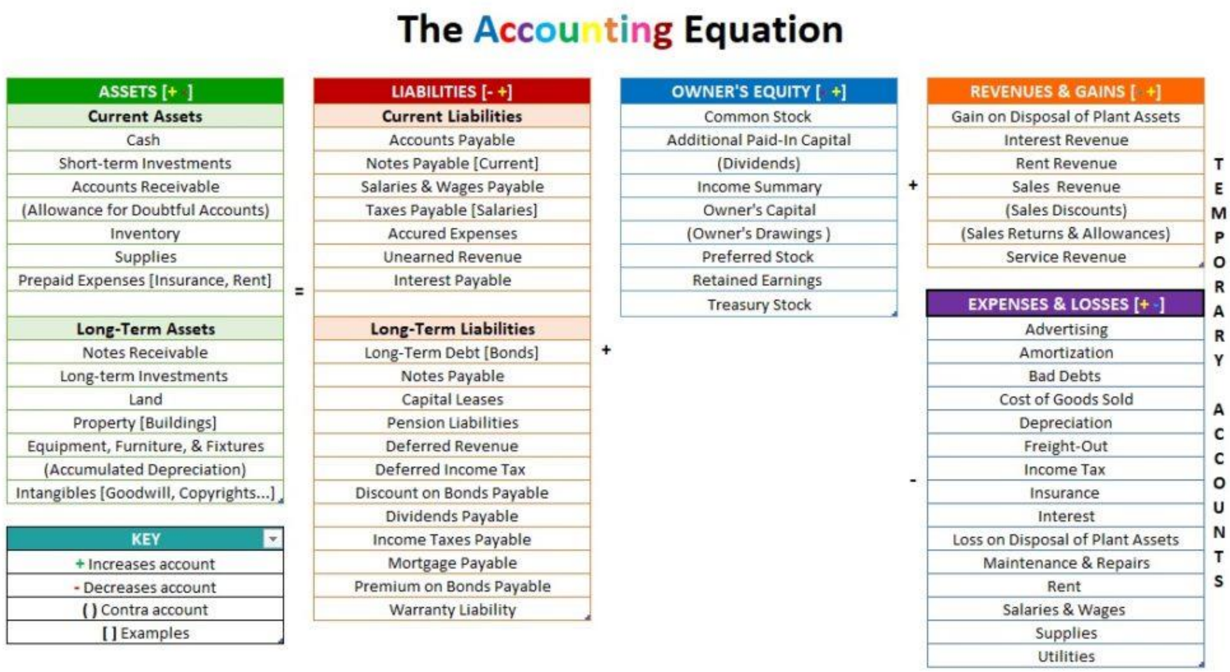
Of course, you will want to earn money. It could be through selling a product or a service. Now that is your income/ revenue.

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

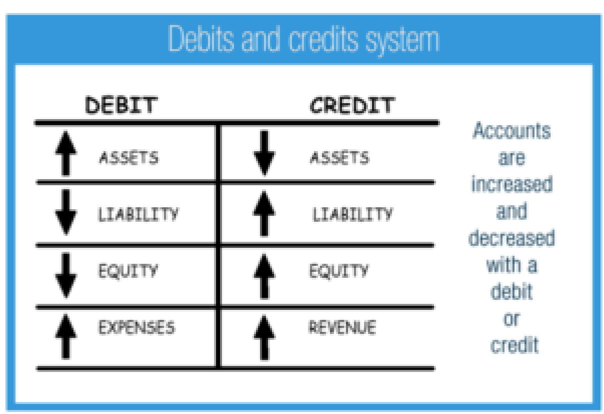
Where would you get money to buy your equipment (asset)? Either you invest your own money (Owner's equity), or borrow money from bank in form of loans (liabilities).

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.



Let’s look at the accounting rules as follows:



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. **<u>Unearned Revenue</u>:** 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. **<u>Prepaid Expenses:</u>** 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.