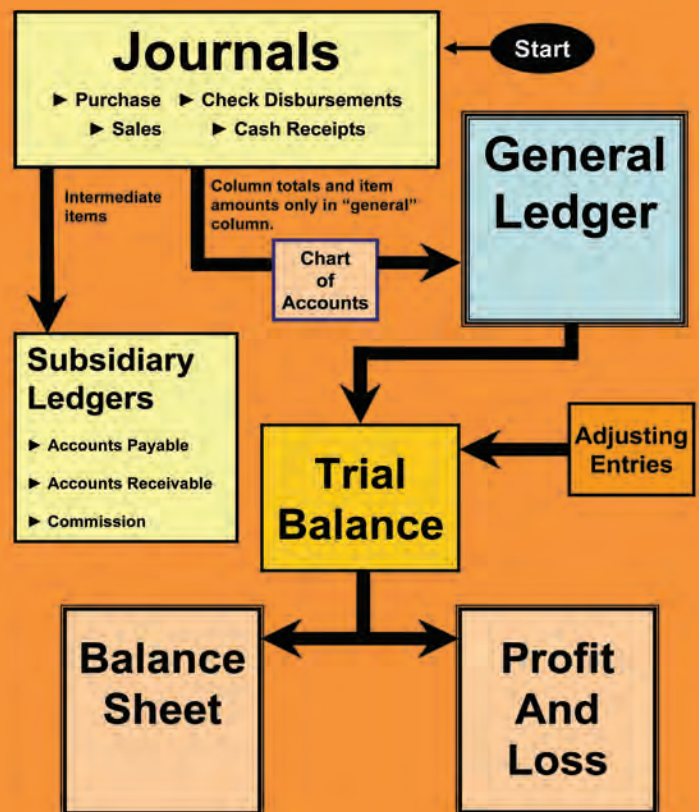


BASIC ACCOUNTING SIMPLIFIED

A PRIMER FOR BEGINNING AND STRUGGLING ACCOUNTING STUDENTS

An Illustrated Guide
to Understanding:

- *Journal Entries*
- *Ledgers and Journals*
- *The Trial Balance and Balance Sheet*
- *Financial Statement Preparation*



Alvin L. Lesser, PA and Gary S. Lesser, JD

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BASIC ACCOUNTING SIMPLIFIED

Alvin L. Lesser, PA and Gary S. Lesser, JD

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Printed in the United States of America

ISBN 978-0-578-07632-4

2 3 4 5 6 7 8 9 0

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Introduction

When the basics are understood, the more advanced aspects of accounting are easier to understand. By simplifying complex concepts, *Basic Accounting Simplified* helps students of accounting to think through, understand, and master the more difficult issues that will be taught as their accounting education progresses.

Basic Accounting Simplified also provides a practical approach to solving problems. Straightforward instructions will guide the student through this process and will engage the student every step of the way.

The objective of this book is to impart *an in-depth understanding of the fundamentals of accounting* to the beginning or struggling accounting student. It presents an easy-to-grasp technique that can be mastered in a short time. This book:

- Uses a unique teaching method that takes the stress out of learning the basics in order to make it easier to learn more complex accounting principles
- Explains journal entries and their relation to the trial balance
- Displays and explains the journals and ledgers and all postings
- Exhibits a full set of accounting books
- Covers the steps necessary to make financial statements

Basic Accounting Simplified is the “safety net” every accounting student should have in order to be successful in this field.

Overview

► Chapter 1 The Method

The basics of accounting, including the trial balance, are discussed and thoroughly explained in this chapter.

- Learning the basics of accounting
- The large scope of double-entry accounting
- Journal entries and how to make them
- Examples of journal entries
- Journal entries and posting to the Trial Balance
- A completed trial balance made by journal entry

► Chapter 2 Ledgers, Journals, and the Trial Balance

The various books of account are discussed and explained in this chapter. The relationship between journals and ledgers and the trial balance are analyzed and examined in this chapter. The following ledgers and journals are included:

- The General Ledger
- The Subsidiary Ledgers
- The Check Disbursement Journal
- The Cash Receipts Journal
- The Purchase Journal and Accounts Payable Ledger
- The Sales Journal and Accounts Receivable Ledger
- The Commission Ledger and Petty Cash Book

► Chapter 3 Combining Journals and Ledgers

The books of account will be combined and provide a thorough overview of accounting. Making postings, journals, and ledgers, are explained in this chapter.

► Chapter 4 Student Practice Session: Posting From Journals to Ledgers

The student will complete the posting from completed journals to ledgers. The posting from the Check Disbursement Journal, the Cash Receipts Journal, the Purchase Journal, and the Sales Journal are examined in this chapter.

► Appendices

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1. Introduction

The practice or profession of accounting is more of a science than an art. The double-entry system of accounting provides assurance errors have not been made. Business transactions are recorded in journals in a well-defined manner. The recordation into the general ledger provides a pathway to the Trial Balance and ultimately to the Balance Sheet and Profit and Loss statement.

This book employs a unique method of instruction in that it starts with the first phase of the accounting process, the journal entry, and skips to the last phase, the trial balance, completely omitting journals and ledgers. This will facilitate the understanding of journals and ledgers as they are later explained in Chapter 2. Slowly and gradually, a complete set of accounting books will be created. The steps involved in making a financial record of business transactions and in the preparation of statements concerning the Balance Sheet and income are fully discussed and explained.

2. Chapter Objective

To learn the basics of accounting up to and including the trial balance. When the basics are understood, the more advanced aspects of accounting will be more easily understood. The following figure is an important illustration. It should be kept in mind now and throughout your accounting career (see also, Figure 1-3 located below in Section 5A).

The following diagram is illustrative of one of the most basic concepts in accounting. Debits and credits can be good or bad for the business. Simply knowing whether an item is good or bad for the business and whether it is a balance sheet or profit and loss item can be used to determine whether the item is posted as a debit or credit.

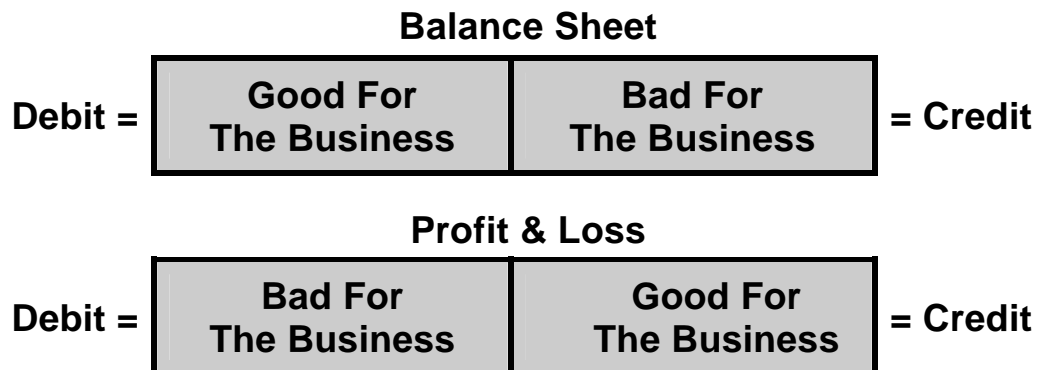


Figure 1-1

The illustration shows that:

- A balance sheet item that is *good* for the business is a *debit*.
- A balance sheet item that is *bad* for the business is a *credit*.
- A profit and loss item that is *good* for the business is a *credit*.
- A profit and loss item that is *bad* for the business is a *debit*.

3. The Journal Entry

A journal entry is the method used in accounting to record business transactions. The journal entry could be very simple by having just one debit and one credit. It could also have one debit and ten credits. It does not matter how many debits or credits a journal entry has, but the cardinal rule is *the total of the debits must equal the total of the credits* in every journal entry. All areas of accounting utilize journal entries. When information is recorded in any book of account it is done by journal entry, for example.

- When data is posted to the general ledger it is posted by journal entry
- When the numbers in the general ledger are netted, a journal entry is formed in the balance column
- When the netted amounts are placed on the trial balance it is a journal entry

Helpful Tip. A *debit* is always on the left side and a *credit* is always on the right side. There is an “r” in *credit* and *right*.

4. The Trial Balance

In the system of instruction (“The Method”) used in Chapter 1, all journal entries will be posted directly to the trial balance. In figure 1-2, below, in the first two columns following the “Item” column is an illustration of the Trial Balance to which all the journal entries that follow later in this chapter will be posted. The adjusting entries and the financial statements are made after the trial balance has been entered in those columns.

Helpful Tip. As will be discussed later in this book, transactions are recorded using journal entries and the trial balance. At the end of each accounting period and after all the preparatory work has been done, the results are recorded in the general ledger. The net amounts contained in the general ledger are then recorded onto the trial balance.

For instructional purposes, all the journal entries in Chapter 1 will be posted directly to the trial balance. Journal entry items that affect the balance sheet are placed under the caption balance sheet items, and those that affect profit and loss are placed in that designated area on the trial balance. Since they are separated in name only, a journal entry that affects both the balance sheet and profit and loss are placed in their respective areas.

<i>Item</i>	Trial Balance		Adjusting Entries		Balance Sheet	
	<i>Debit</i>	<i>Credit</i>	<i>Debit</i>	<i>Credit</i>	<i>Debit</i>	<i>Credit</i>
	Profit & Loss Items				Profit & Loss	

Figure 1-2

5. The Balance Sheet

The balance sheet maintains a permanent, but ever changing record, of the financial matters that affect a business. It shows the financial position of a business at any specific moment in time. The balance sheet is comprised of assets (shown as debits) and liabilities (shown as credits). As shown in Figure 1-3, assets are represented by the word **Good**. All the good items a business possesses, such as money in the bank, accounts receivable, and so on, are assets and are *good*. The liabilities are the opposite and are represented by the word **Bad**. To put it simply *good* in the balance sheet minus *bad* equals the Owner's Equity which, as shown, is on the credit side, but nevertheless is shown as *good*. The reason it is shown as *good* is explained later.

Examples of some of the items carried on the balance sheet are:

- *Accounts Payable* maintains a *record* of the total amount owed to the vendors when merchandise or services are purchased on credit.
- *Accounts Receivable* maintains a *record* of the total amount owed by purchasers when merchandise or services are sold on credit.

- *Inventory* maintains a *record* of the relative value of the merchandise on hand at the beginning and at the end of the accounting period.
- *Loans Payable* maintains a *record* of who is owed money and how much is owed.
- *Equipment* maintains a record of trucks, cars, and other equipment owned by the Star Company.
- *Petty Cash* maintains a record of the cash available for reimbursement of miscellaneous expenditures made on behalf of the Star Company.
- Bank keeps a record of the amount of cash in the bank.

Balance sheet items are those items that maintain a record as long as the business is in existence. The balance sheet items that exist at the end of an older accounting period also exist on the first day of the next (new) accounting period.

A. Assets

Assets are all the items in the possession of a business that are good for the business. Having more money in the bank, larger accounts receivable, more inventory and equipment, and so on, reflect a thriving business. All assets are debits and placed in the first quadrant of Figure 1-3.

TRIAL BALANCE WITH QUADRANTS				
Debits		Balance Sheet		Credits
GOOD	Quadrant 1		BAD	Quadrant 2
Assets			Liabilities	
			Owner's Equity Good	
Debits		Profit & Loss		Credits
BAD	Quadrant 3		GOOD	Quadrant 4
Losses			Profits	

Figure 1-3

B. Liabilities

Liabilities are all the items in the possession of a business that are bad for the business. Being overdrawn at the bank, large accounts payable, too many loans and notes payable, etc., may be indications of a business in dire straits. Balance sheet items that are bad for the business are displayed as credits in the second quadrant of Figure 1-3.

6. Profit and Loss Items

Profit and loss items are the normal income and expense items associated with a business. At the end of the accounting period, the expenses are subtracted from sales and other income items and the profit or loss is determined. This profit or loss is transferred by journal entry to the owner's equity account (discussed in chapter 4). The closing entry is such that all the profit and loss items become zero at the beginning of the new accounting period. As the new accounting period progresses, the new income and expense amounts build up and, at the end of the new accounting period they are, once again, transferred to *owner's equity*. Thus, this process is repeated for each accounting period.

Examples of items that appear in the balance sheet area or in the profit and loss area on the trial balance are shown in Table 1-1, below.

Table 1-1. Balance Sheet and Profit and Loss Items

Balance Sheet Items	Profit & Loss Items
<ul style="list-style-type: none"> • Accounts Payable • Accounts Receivable • Bank • Deposits • Equipment • Furniture & Fixtures ("F&F") • Equipment • Inventory • Loans Payable • Owner Equity • Petty Cash 	<ul style="list-style-type: none"> • Advertising • Auto Expense • Commission • Electric • Food and Lodging • Purchases • Rent • Sales • Telephone

Table 1-1

Note. Throughout the book there will be many references to the word "account." When this word is used, reference is being made to one of the items listed in the *chart of accounts* shown in Section 7.

7. Chart of Accounts

The *chart of accounts* serves the same function in accounting as the table of contents found at the beginning of a book. The chart, provided by the accountant, provides the bookkeeper with the means of determining the accounts included in the *general ledger* and their page numbers within the general ledger. The *chart of accounts* for the Star Company, a small manufacturing business, is shown below.

Chart of Accounts	
General Ledger	GL #
Balance Sheet Items*	
Accounts Payable (Control)	7
Accounts Receivable (Control)	3
Bank	1
Deposits	4
Inventory	10
Loans Payable	8
Owner's Equity	9
Equipment	5
Petty Cash	2
Reserve for Depreciation	6
Profit and Loss Items*	
Auto Expense	53
Commission	54
Food and Lodging	55
Depreciation	58
Profit & Loss	59
Purchases	52
Rent	56
Telephone	57
Sales	51

* The word "item" is used, at times, when referring to a specific item in the chart of accounts. It is primarily used when referring to the balance sheet or the profit and loss statement. For example, a balance sheet item means that it belongs in the balance sheet portion of the trial balance. Conversely, a profit and loss item means it belongs in the profit and loss portion of the trial balance.

8. The Wide Scope of Double-Entry Accounting

All of accounting is primarily a journal entry. A journal entry is, first and foremost, an example of double-entry accounting. It doesn't seem logical to be able to record one transaction using the same number two times. No other area in mathematics uses the same number twice. Why doesn't using the same number twice lead to duplications and erroneous answers? Why does double-entry accounting work?

A journal entry consists of two parts, a debit and a credit. For example, in the case of a sale, one of the journal entry parts is entered on the balance sheet and the other half is entered on the profit and loss. The fact the same number is entered two times works in accounting because the part put on the balance sheet keeps a record of what has transpired in the profit and loss portion. The point to remember is that each half of a journal entry performs a different function. There are exceptions to this rule that will be discussed later.

Example. Assume the following:

- A. A cash sale for \$100 was made; the money is deposited into the bank.
- B. A \$200 sale was made and the money is placed in the cash register.
- C. A \$300 sale was made on credit.

TRIAL BALANCE			
Debits	Balance Sheet	Credits	
(A) <i>Bank</i>	100		
(B) <i>Cash</i>	200		
(C) <i>Accounts Receivable</i>	300		
Profit & Loss			
		(A) <i>Sale</i>	100
		(B) <i>Sale</i>	200
		(C) <i>Sale</i>	300

Figure 1-4

In the above example, the amount of sales (\$100, \$200, and \$300) is known. But, equally important, there is a record of what was acquired as a result of the sales (bank, cash, and a receivable). As additional transactions are recorded, the principle remains the same: the items that keep a record are placed in the balance sheet and the items that describe the sales and expenses are placed in the profit and loss sections.

- Each time part of a journal entry is placed on the balance sheet a record is being kept
- Each time part of a journal entry is placed in the profit and loss, income or loss is affected

Helpful Tip. The double-entry accounting system serves as an error-detection system: if at any point the debits do not equal the corresponding credits, an error has occurred.

9. Types of Journal Entries

A. The Diagonal Journal Entry

A diagonal journal entry going from quadrant 1 to quadrant 4 is good for the business since it increases the probability of making a profit. A diagonal journal entry going from quadrant 3 to quadrant 2 is bad for the business since it increases the probability of suffering a loss, see Figure 1-5.

Diagonal journal entries are the most prevalent types of journal entry; more than 95 percent of all journal entries are *diagonal*. For example, depositing money in the bank as a result of a sale (quadrant 1 to 4) is a common occurrence. Withdrawing money from the bank for a purchase (quadrant 3 to 2) is also a common occurrence.

Trial Balance			
Debits	Balance Sheet		Credits
QUADRANT 1		QUADRANT 2	
GOOD		BAD	
Debit	Profit & Loss		Credit
QUADRANT 3		QUADRANT 4	
BAD		GOOD	

Figure 1-5

For centuries the books of account have been set up recognizing the great frequency of these types of transactions. It is the very foundation of double entry accounting. When a sale is made, profit is affected, and the bank account is increased by the extent of the sale. When a purchase is made, loss is affected, and the bank account is decreased to the extent of the purchase.

Items that affect income adversely are placed in quadrant 3. Many of the same expenses that an individual has in operating a household would be in quadrant 3. Items that have a negative impact on income include cleaning, rent, purchases, auto expenses, utilities, telephone, etc. If an entry is made to quadrant 3, the other half of that entry must go to quadrant 2, which keeps a record of how quadrant 2 is adversely affected (e.g., a reduction in the bank account or an increase in accounts payable).

B. The Horizontal Journal Entry

Horizontal journal entries go from quadrant 1 to quadrant 2 or from quadrant 3 to quadrant 4. For example, purchasing equipment (quadrant 1), with funds withdrawn from the bank (quadrant 2), is an example of a horizontal journal entry.

Horizontal journal entries that go from quadrant 1 (assets) to quadrant 2 (liabilities) only affect the balance sheet. Income is not affected when horizontal journal entries are placed in the balance sheet. Following are examples of horizontal type balance sheet journal entries. It should be noted the total of the assets and the liabilities remain the same after a horizontal entry is made to the balance sheet.

- When an error has been committed.

To record an overcharge to B Co. that should have been charge to A Co.

	<u>Debit</u>	<u>Credit</u>
Accounts Receivable—A Co.	10	
Accounts Receivable—B Co.		10

- When equipment has been purchased.

To record purchase of an automobile.

	<u>Debit</u>	<u>Credit</u>
Automobile	30,000	
Bank		30,000

- When the owner invests money in the business.

To record owner's investment.

	<u>Debit</u>	<u>Credit</u>
Bank	10,000	
Owner's Equity		10,000

- When money is borrowed.

Money is borrowed from the bank.

	<u>Debit</u>	<u>Credit</u>
Bank	5,000	
Loan Payable-Smith Bank		5,000

- Petty Cash fund is established.

Establishment of a petty cash fund.	<u>Debit</u>	<u>Credit</u>
Petty Cash Fund	30	
Bank		30

Note. There are very few journals entries that go horizontally from quadrant 3 (expense) to quadrant 4 (income). Horizontal journal entries that go from quadrant 3 to quadrant 4 are used mainly to correct errors.

C. Section Summary

- In general, there are two types of diagonal journal entries. One type goes from the asset side of the balance sheet to the income side of the profit and loss. The other type goes from the expense side of the profit and loss to the liability side of the balance sheet.
- There are two types of horizontal journal entries. One type goes from the asset side of the balance sheet to the liability side of the balance sheet. The other type goes from the expense side of the profit and loss to the income side of the profit and loss. Horizontal journal entries are primarily used to rectify an error, to make an adjustment, or to record the purchase of a capital asset (and have no affect on profit and loss).

TRIAL BALANCE				
DEBITS		Balance Sheet		CREDITS
GOOD	Quadrant 1.		BAD	Quadrant 2.
Assets			Liabilities	
			Owner's equity Good	
DEBITS		Profit & Loss		CREDITS
BAD	Quadrant 3.		GOOD	Quadrant 4.
Loss			Profit	

More than 95 percent of all journal entries are *diagonal*. They are either:

- A debit to quadrant 1 and a credit to quadrant 4
 - This is an entry that increases profit, or
- A debit to quadrant 3 and a credit to quadrant 2
 - This is an entry that decreases profit.

"Now, when I teach my classes in individual and corporate income tax to law students, I will assign sections and assignments from this book to make sure that everyone has a solid understanding of what the accountants do, and why and how they do it."

—**Barry Kozak, The John Marshall Law School, Chicago, IL**

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—**Benjamin Botwick, CPA, Fairlawn, NJ**

"Basic Accounting Simplified" helps the accounting student or novice to unlock the secrets of the mechanics of accounting fundamentals in the first few chapters. Accounting teachers attempt from the first day of class to teach their students accounting theory without a solid foundation of the mechanics of accounting leaving many intelligent students with quizzical looks. "Basic Accounting Simplified" bridges the accounting knowledge gap between accounting theory and the mechanics of accounting."

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