Accounting 101

A business is one or more individuals selling products or services for profit. Nearly 100,000 new businesses are started in Canada each year, with most of them being founded by people who want freedom from ordinary jobs, a new challenge in life, or the advantage of earning extra money.

Four topics to be discussed:

1. Business organization
2. Three main financial statements
3. The accounting equation
4. Debits and credits

1. Business organizations take one of three forms:

1. Sole proprietorship
2. Partnership
3. Corporation

Sole Proprietorship

A sole proprietorship, or single proprietorship, is a business owned by one person. No legal requirement is needed in order to start this form of business, other than to file for a business license and register the business name. While it is a separate entity for accounting purposes, it is not a separate legal entity from its owner, this means, that a court can order an owner to sell personal belongings to pay its debts. Tax authorities do not separate a proprietorship from its owner; the profits of the business are reported and taxed on the owner's personal income tax return.

Partnership

A partnership is owned by two or more personas called *partners.* As for a proprietorship, no special legal requirements must be met in order to start a partnership, other than to register the business name and get a business license. To run the business together, the partners need an oral or written agreement that usually indicates how the profits and losses are to be shared. Each partner's share of profits is reported and taxed on that partner's personal tax return. Like a proprietorship, a partnership does not have a separate legal entity from its owners.

Corporation

A Corporation is a business that has a separate legal entity and is responsible for its own acts and its own debts. It can enter into its own contracts, and it can buy, own, and sell property. Think of a corporation as a separate person, therefore, a corporation files its own tax return and pays tax on its profits. A corporation acts through its managers that hold a separate legal status and the managers are not responsible for the corporate acts and debts. Ownership, or equity, of the corporation is divided into units called **shares.** Owners of shares are called **shareholders** or in American terms *stockholders*. A shareholder can sell or transfer shares to another person without affecting the operations of a corporation.

2. Three Main Financial Statements

1. A balance sheet contains assets, liabilities, and owners equity.

Creative Interiors
Balance Sheet as at March 31, 2009

Assets			**Liabilities**		
Cash	$8,400		Accounts Payable	$6,000	
Supplies	3,600		Notes payable	200	
Office Supplies	6,000				
			Total Liabilities		$6,200
			Sally Creative Capital		11,800
Total assets		**$18,000**	**Total Liability and Owners equity**		**$18,000**

2. Income statements contain income and expenses.

Creative Interiors
Income Statement March 1 – 31, 2009

Revenue			
Consulting Revenue	$3800		
Rental Revenue	300		
Total Revenue		$4,100	
Operating Expenses			
Rent Expense	$1000		
Salaries Expense	700		
Total Operating Expenses			$1,700
Net Income			**$2,400**

4. Trial balance contains all accounts. Assets, liabilities, owner equity, income, and expenses.

Creative Interiors
Trial Balance as at March 31, 2009

	Debits	Credits
Cash	$8,400	
Supplies	3,600	
Office Furniture	6,000	
Accounts payable		$6,000
Notes Payable		200
Sally Creative Capital		11,800
Current Earnings	2,400	
Consulting Revenue		3,800
Rent Revenue		300
Rent Expense	1,000	
Salaries Expense	700	
	$22,100	**$22,100**

3. The Accounting Equation

Notice on the balance sheet the two sections are the assets on one side and liabilities and owners equity are on the other side. The total assets of $18,000 equal the total liability and owner equity of $18,000. This equality is known as accounting equation.

Assets =	Liabilities +	Owner Equity
Assets describe what an organization has invested in, such as land building, machinery, and cash on hand.	Liabilities describe debts to pay to suppliers, bank loans, and government taxes.	OE describes owner financing (investment) and owner withdrawal.

Assets =	Liabilities +	Owner Equity
$25000	$15000	$10,000
Purchase of equipment	Bank loan	Owner investment

5. Debits and Credits

Assets	
⇧	⇩
Debit for Increases	Credit for Decreases
+	-

Liabilities	
⇩	⇧
Debit for Decreases	Credit for Increases
-	+

Owner Investment	
⇩	⇧
Debit for Decreases	Credit for Increases
-	+

Revenues	
⇩	⇧
Debit for Decreases	Credit for Increases
-	+

Expenses	
⇧	⇩
Debit for Increases	Credit for Decreases
+	-

Owner Withdrawal	
⇧	⇩
Debit for Increases	Credit for Decreases
+	-

The T-accounts above are a helpful learning tool. It shows the effects of individual transactions on specific accounts. The T-account is so named because it looks like the letter T.

The left side of the T-account is always called the **debit** side often abbreviated Dr. The right side is always called the credit side, often abbreviated Cr. The difference between total debits and total credits for an account is the account balance. When the sum of debits exceeds the sum of credits, the account has a *debit balance*. It has a *credit balance* when the sum of credits exceeds the sum of debits. When the sum of debits equals the sum of credits, the account has a zero balance.

Office Supplies		
	100 300	60 200
Balance	140	

Accounts Payable		
350 500	400 600	
	150	Balance

100 + 300 = 400 total debits; 60 + 200 = 260 total credit; debits are greater than credits, so the 140 balance is a debit (400 – 260).

350 + 500 = 850 total debits; 400 + 600 = 1,000 total credits; credits are greater than debits, so the 150 balance is a credit (1,000 – 850).

Analyzing transactions - below are some transactions to show you how debits and credits rules and double-entry accounting are useful in analyzing and processing transactions.

1. Investment by owner

Dr.	Cash	Cr.
10,000		

Dr.	Sally Creative, Capital	Cr.
	10,000	

Transaction: Sally Creative invested $10,000 in Creative Interiors on January 1, 2009.

Analysis: Assets increase. Owner equity increase.

Double-entry: Debits the Cash asset account for $10,000. Credit The Sally Creative, Capital account in owner equity for $10,000.

2. Purchase supplies for cash

Dr.	Supplies	Cr.
2.500		

Dr.	Cash	Cr.
10,000		2,500

Transaction: Creative Interiors purchases supplies by paying $2,500 cash.

Analysis: Assets increase. Assets decrease. These changes the composition of assets, but does not change the total amount of assets.

Double-entry: Debit the Supplies asset account for $2500. Credit the Cash asset account for $2500.

3. Purchase furniture and supplies on credit.

Dr.	Supplies	Cr.
2,500 1,100		

Dr.	Furniture	Cr.
6,000		

Dr.	Accounts Payable	Cr.
		1,100

Dr.	Notes Payable	Cr.
		6,000

Transaction: Creative Interiors purchases $1,100 of supplies and $6,000 of furniture on credit. Creative interiors signs a promissory note for the $6,000 of furniture.

Analysis: Assets increases. Liabilities increases.

Double-entry: Debit two asset accounts: Supplies for $1,100 and furniture for $6000. Credit two liability accounts: Accounts payable for $1,100 and Notes Payable for $6000.

4. Services rendered for cash.

Dr. Cash	Cr.
10,000	2,500
2,200	

Dr. Revenue	Cr.
	2,200

Transaction: Creative Interiors provided consulting services to a Customer and immediately collected $2,200 cash.

Analysis: Assets increase.

Double-entry: Debit the Cash asset account for $2,200. Credit the Consulting Revenue account for $2,200.

5. Payment of expenses in cash.

Dr. Salaries Expense	Cr.
700	

Dr. Cash	Cr.
10,000	2,500
2,200	700

Transaction: Creative Interiors pays $700 cash for Employee's salary for the pay period ending on January 14.

Analysis: Assets decrease.

Double-entry: Debit the Salaries expense account For $700. Credit the Cash asset account for $700