

THEME: DEBITS & CREDITS

By John W. Day, MBA

ACCOUNTING TERM: Double-Entry Method

Double-entry is a method of accounting that uses two sides of a ledger page to keep track of transactions. The accounting equation, $Assets = Liabilities + Equity$ is the foundation for this system. All entries on the left (debit) side must equal all entries on the right (credit) side of the ledger. When both sides are equal, the books are said to be "in balance".

FEATURE ARTICLE: Two QuickBooks Traps - Watch Out!

Trap #1 - The Black Hole

There are now over two million users of Quicken and QuickBooks. It's a great accounting software program, but a source of frustration can be the dreaded "Black Hole". What is this "Black Hole", you may ask? There are times when you need to fix a mistake or record an item such as a refund, bank charge, voided check, etc. In these cases, you have to tell the computer where to record the transactions. If you do not know how to communicate this information to the computer, you may get a message that says, "Do you want the program to balance this transaction for you?" Naturally, you say, "By all means" and go on your merry way.

Arrgg! What you have just done is to allow the computer to record an amount into an account called "Opening Balance Equity". I refer to it as a "Black Hole in Space" because, unless you reclassify the amount and record it to its proper account, it will stay there forever and your books will not be complete or accurate. I will never forget the time a new client gave me a QuickBooks floppy disk that supposedly had his latest financial statement on it. The client's business was very small. When I reviewed his financial statement I noticed several hundred thousand dollars posted to his "Opening Balance Equity" account. His response to my obvious question was, "Hey, I just said yes when the computer program asked me if I wanted my books to balance." Watch out for this trap, computers still can't think like humans.

Trap #2 - The Year End Dilemma!

As you may already know, each year all the Revenue and Expense accounts found on your Income Statement have to be "closed out" so that you can begin with a clean slate for the new year's activity. QuickBooks does it for you. It is date sensitive and knows when your old year ends and the new year begins. You don't have to do anything. Right? Wrong! Let's see why. Assume you are a sole proprietor and have an Owner's Draw account in the

Equity section of your Balance Sheet. Let's say you have taken a draw of \$50,000 during the year. If you don't do something with that account balance, what is going to happen? You will be recording another year's draw amount on top the previous year.

Uh Oh! It's going to look like you have been taking a lot of money out of the business in one year. This might be hard to explain to your local banker or perhaps your spouse. More important, it will be confusing to sort out how much personal funds you have drawn from the company during the year. What you must do is close the Draw account into an account called Owner's Equity. Owner's Equity is an account that accumulates all the prior year's Net Profit or Losses, Owner's Draws, and Owner's Capital Contributions.

Normally, your accounting software will automatically close the year's Net Profit or Loss into an accumulated equity account. However, what it won't do is distribute those Net Profit or Losses into other accounts. For instance, in a Partnership the Net Profit or Loss for the year has to be distributed into the Partner's Capital accounts, and, in a Non-Profit Organization, the Net Excess Revenue or Expense may have to be distributed into various Fund Balances that were set up.

No accounting software program can do this for you because choices are required that only you can make. For example, perhaps there is a special agreement that one partner gets a distribution of profit that is unequal to the other partners. How would the computer know that information unless you told it? What then are the solutions? Either learn how to write journal entries yourself, or pay someone else to do it for you.

Owners of QuickBooks accounting software should take caution, because the QuickBooks Company claims no accounting knowledge is needed to make their system work. Those that believe this claim may assume that these necessary transactions are being done for them.

QUESTION: Why does a Balance Sheet Balance?

This is a good question because the answer is fundamental to the double-entry accounting method. The answer is very simple but often overlooked due to its simplicity. Confusion reigns until this one is figured out. Here it is:

You just bought a house priced at \$200,000. You made a \$50,000 down payment and mortgaged the difference of \$150,000. The accounting formula says:

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

Or

$$\$200,000 = \$150,000 + \$50,000$$

I can just hear you saying, “Duh, John”, but now, let’s view this idea in a slightly different context. It is amazing how this simple concept slips by so many people when seen in the context of an accounting Balance Sheet. The key to remember is that *whatever* the difference between the Assets of your business and the amount of Liabilities owed by the business is *your* Equity.

The house example is easy to understand because the Liability is directly related to the Asset. In a business, you must look at the aggregate of all the Assets and all the Liabilities to determine your Equity. This is the concept I want you to understand. Double-entry says the Assets are on the debit side of the ledger and Liabilities and Equity have to make up the same amount on the credit side of the ledger. Let’s see how it looks in journal entry form:

DESCRIPTION	DEBIT	CREDIT
Cash	200,000	
Notes Payable		150,000
Capital Contribution		50,000

These three entries represent an increase to each account. To verify this statement, use the “Accounting Model” tool, found in the following link:

http://www.reallifeaccounting.com/accounting_model.asp

Why does a Balance Sheet “balance”? Because, a Balance Sheet, by its very nature, *has to*.

TIP: Cash As A Reference

Once one side of the journal entry is known, you automatically know what the other side has to be. In other words, if you know what the debit is, then you know the other side will be a credit entry, and vice versa. The following is a useful technique that is great for beginners or people who have to write journal entries infrequently. Essentially, it works for those who haven’t memorized the Accounting Model:

The general ledger account, Cash, is involved in many transactions, therefore, it can be used as a reference. Memorize that a debit to Cash is an increase and a credit to Cash is a decrease. When you figure out whether Cash should be increased or decreased, you will know on what side of the ledger to record the transaction.

Increase in Cash

DESCRIPTION	DEBIT	CREDIT
Cash	50.00	
?		?

Decrease in Cash

DESCRIPTION	DEBIT	CREDIT
?	?	
Cash		50.00

You will also know what side of the ledger the rest of your transaction will be on. This way you quickly resolve half of the transaction. Here is an example:

You are recording entries from your bank reconciliation. One of the entries is a NSF (non-sufficient funds) check amount from one of your customers for \$75.00. Think about what happened: A customer paid you and you recorded it as a deposit when it came in. That increased your bank account. Now the bank is saying the check is no good. Therefore, you have to decrease your cash by this check amount.

DESCRIPTION	DEBIT	CREDIT
?	75.00	
Cash		75.00

Look at the Accounting Model. A decrease to Cash is going to require a credit entry. This means, automatically, that you are going to have to *debit* some other entry for \$75.00. What's it going to be? You have to ask this question in your mind to start formulating the answer. Go back to the original transaction. You sold something to this customer and they paid you. When that happened, you increased Sales and increased Cash.

Keep looking at the Accounting Model. An increase to Sales is what? Yes, it's a credit. The sale turned out to be no good, so you have to negate it. You do that by decreasing Sales and you do that by debiting that account.

DESCRIPTION	DEBIT	CREDIT
Sales	75.00	
Cash		75.00

Weren't you looking for a debit? See how this works, it's kind of fun. See how important it is to memorize the Accounting Model!

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.

