

THEME: WRITING JOURNAL ENTRIES

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ACCOUNTING TERMS: Financial Transaction vs. Accounting Transaction

A financial transaction occurs in a business when an actual physical event takes place. Some examples are: when money is deposited in a bank; when a customer pays for a good or service; when a check is written to pay for a good or service, etc. An accounting transaction occurs when a financial transaction is recorded onto the proper ledgers and journals of a company, written as debits and credits.

FEATURE ARTICLE: Writing General Journals Entries – A Six-Step Method.

I've always said that the key to understanding accounting is learning how debits and credits work. However, that is only part of the equation. One must learn how to "think out" the process of translating financial transactions into accounting transactions to be effective. The trick is to not get ahead of yourself before understanding what you are doing. The temptation is to take shortcuts prematurely.

If your situation requires that you only have to write a journal entry once in a while, it could prove difficult to remember the process of figuring out which side of the ledger to record an entry. You may have to re-remember the steps each time. If you have to record entries regularly, then it's time to bite the bullet and memorize the Accounting Model.

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

You will also need to memorize the "six-step method" for learning how to write general journal entries as developed in my "The Heart of Accounting" workbook. Obviously, I don't have room in this article to take you through the entire process of creating a financial statement as I do in the workbook. But, I can give you a general idea of what's involved.

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

I will assume that you have downloaded the "accounting model" and have it by your side, or better yet, that you have memorized it. It's much easier if it is in your head. You can download a blank general journal entry form from my web site if you need one at your place of work:

<http://www.reallifeaccounting.com/forms.asp>

Before we get started, you're going to need a Chart of Accounts. This is simplified one:

1000 ASSETS:

Current Assets:

1010 Cash-in-Bank

1020 Petty Cash-on-hand

1310 Inventory

Fixed Assets:

1530 Equipment

1540 Furniture & Fixtures

1560 Leasehold Improvements

1610 Accumulated Depreciation

Other Assets

1810 Deposits

1820 Miscellaneous Suspense

2000 LIABILITIES:

Current Liabilities:

2010 Accounts Payable

2070 Sales Tax Payable

Long-Term Liabilities:

2510 Notes Payable (L/T)

3000 EQUITY:

- 3010 Capital Contributions - Current Year**
- 3050 Owner's Draw**
- 3060 Owner's Equity**
- 4000 REVENUE:**
 - 4010 Taxable Sales**
 - 4020 Services Rendered**
- 5000 COST OF SALES:**
 - 5050 Purchases (Inventory)**
- 6000 OPERATING EXPENSES:**
 - 6010 Accounting & Legal**
 - 6020 Advertising**
 - 6080 Bank Charges**
 - 6220 Dues & Subscriptions**
 - 6480 Meals & Entertainment**
 - 6540 Miscellaneous**
 - 6580 Office Expense**
 - 6820 Rent**
 - 6860 Repairs & Maintenance**
 - 6980 Supplies**
 - 7110 Utilities**

Now we are ready to do a transaction. Here is a list of the six steps:

Step 1 Review the physical events that took place.

- Step 2** Identify the appropriate GL accounts to be used and which of the five sections of the accounting model they fall within.
- Step 3** Convert what happened into terms of increases and decreases.
- Step 4** Determine what side of the ledger each GL account in the transaction requires, i.e., debit or credit.
- Step 5** Write the General Journal entry.
- Step 6** Verify that the debit entries equal the credit entries of the transaction.

Our first transaction will be a simple one and straight out of my, “The Heart of Accounting” workbook. We will assume that you have decided to start your own business with the \$5,000 your grandmother left you when she passed away.

- Step 1** Review the physical events that took place:

You walked in the door of the bank, strolled up to the new accounts desk and plunked down \$5,000. The bank clerk set up your new account, deposited the money, gave you the starter checkbook, and you got up and walked out the door.

- Step 2** Identify the appropriate GL accounts to be used and which of the five sections of the Accounting Model they fall within.

Your second step will be to identify the appropriate General Ledger (GL) accounts for the transaction. Right off the bat, you know that you are working with Cash and Equity. Look at the Chart of Accounts. Do you see a GL account called Cash? It is number 1010 – Cash-in-Bank. Notice that the Cash-in-Bank GL account falls within the Assets section of GL accounts. Therefore, Cash-in-Bank is an asset. But, for the other part of the transaction you have only identified the Equity GL section. You haven’t yet identified the actual GL account. Once again, think about the physical event. You contributed money to the business. Therefore, number 3010 Capital (meaning money or property) Contributions would be the likely choice.

- Step 3** Convert what happened into terms of increases and decreases.

In this step you will need to convert what happened into terms of **increases** and **decreases**. At this point, it is important to remember the rule of double-entry accounting.

The Left side of the ledger must always equal the Right side of the ledger.

For instance, you deposited \$5,000 into the bank, therefore, the cash balance in your bank account was increased. At the same time, the equity in your business was also increased. Note that there are two increases. I point this out, because some people jump to the conclusion that there must be an increase and a decrease. This makes no sense when applying the rules of the Accounting Model.

Step 4 Determine what side of the ledger each GL account in the transaction requires, i.e., debit or credit.

After identifying the GL accounts of the transaction, you can go to step four which is to determine whether to record the two increases on the debit (left) or credit (right) side of the ledger. You accomplish this step by using the Accounting Model. First, there is the increase in Cash-in-Bank which is an asset. The Accounting Model indicates that an increase in an asset requires that the entry be recorded on the debit side of the ledger. Second, there is the increase in Capital Contributions which is found in the Equity section. The Accounting Model indicates that an increase in an equity account requires that the entry be recorded on the credit side of the ledger. Be sure to verify what I have just said with the Accounting Model before continuing on.

Step 5 Write the General Journal entry.

DESCRIPTION	ACCOUNT #	DEBIT	CREDIT
Cash-in-Bank	1010	5,000	
Capital Contribution	3010		5,000

Make sure the journal is formatted properly as mentioned above.

Step 6 Verify that the debit entries equal the credit entries of the transaction.

It looks like the debit of \$5,000 equals the credit of \$5,000.

You're done!

QUESTION: What Shortcuts Are Used When Writing Journal Entries?

As you become more familiar with the process you can take shortcuts. The shortcuts I am referring to are the ability to combine certain steps. Begin by combining steps 2, 3 & 4. In other words, you identify what GL account is appropriate and whether an increase or a decrease occurred. In our example, you would say there was “an increase to Cash requiring a debit entry” and a “increase to Capital Contributions requiring a credit entry.”

As you become more comfortable knowing that an increase to cash is a debit entry, you can shorten the process even further by simply stating that you are going to “debit Cash” by \$5,000 and “credit Capital Contributions” by \$5,000. Debit Cash automatically means that there is an increase to Cash. If you said, “Credit Cash,” that would automatically mean a decrease to Cash had Occurred.

So what is happening with this shortcut is that, depending on the GL account being used, saying debit or credit automatically defines whether there is an increase or a decrease and whether the ledger entry goes on the right or left side. In addition, identifying the GL account itself automatically indicates in which of the five sections it belongs. For instance, Cash = Asset; Accounts Payable = Liability; Owner’s Draw = Equity; Taxable Sales = Income; and Bank Charges = Expense.

Had you not learned the individual steps first before learning the shortcuts, you could easily get confused. If you do get mixed up, go back the original six steps and trace your way back through the steps again.

Pretty soon, as you work with this, you will become fluent in using the short-hand language all accountants use.

TIP: Use A Protocol When Writing Journal Entries.

There is a protocol to follow when writing journal entries. It is important to use the protocol because it keeps your entries organized and easier to read. Your mind becomes accustomed to seeing a particular layout and will alert you if it sees something different. This will often be a result of an error or an omission.

Notice in the example below, that the debit entry general ledger account “Cash” is written to the far left of the description column and the credit entry general ledger accounts, “Notes Payable” and Capital Contribution” are indented three spaces. This gives the eye a special recognition of what is a debit and what is a credit. Always, the debits are written first, then the credits. Keep the numbers in line with each other in the column. This prevents a jumbled-up look.

Correct:

DESCRIPTION	ACCOUNT	DEBIT	CREDIT
Cash	1010	200,000	
Notes Payable	2510		150,000
Capital Contribution	3010		50,000
To record cash deposit on 2/1/XX; record notes payable with Pacific Bank; and contribution from JH Jones, owner.			

Incorrect:

DESCRIPTION	ACCOUNT #	DEBIT	CREDIT
Notes Payable	2510		150,000
Cash	1010	200,000	
Capital Contribution	3010		50,000

It should be clear that it is less work for the eye to see what is going on with the first group than the second. In addition, a general rule is that each journal must stand on its own. This means that if a stranger were to read the journal entry explanation, there would be no confusion as to the purpose of the journal entry and what it was related to.

If the journal entry is obvious, such as this one:

DESCRIPTION	ACCOUNT #	DEBIT	CREDIT
Rent	6820	2,000	
Cash	1010		2,000

No description is necessary.

Following this protocol is a technique accountants use to make their work go smoother with fewer mistakes. The little time it takes to develop this habit is well worth it.

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.