

# What is a Chart of Accounts

The purpose of this article is to provide small to medium sized business owners with an understanding of the Chart of Accounts. It is best suited for owners who are starting up their first business. The author is a small business owner and not an accountant and the information provided here should not be considered accounting advice, which probably makes for a more interesting read.

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## ***i. Chart of Accounts in North America***

A chart of accounts is simply a list of accounts sorted by type that are used by businesses to record the movement of funds, either received or disbursed.

The list can be numeric, alphabetic or alpha-numeric, for identification. However there are suggested standards for the order of account types in North America that are different from the rest of the world. In the USA the order of the different account types is recommended by the GAAP (General Accepted Accounting Principles) and in Canada by the GIFI (General Index of Financial Information).

Although there are various examples on the web, for account designations, descriptions and coding, by industry or type of business, for both countries, they are just that, examples and not necessarily gospel. The generally accepted order and number sequence for accounts is similar in both countries.

USA		Canada	
1000 to 1999	Asset Accounts	1000 to 1699	Current Assets
2000 to 2999	Liability Accounts	1700 to 1999	Fixed/Capital Assets
3000 to 3999	Equity Accounts	2000 to 2599	Current Liabilities
4000 to 4999	Revenue Accounts	2600 to 2999	Term Liabilities
5000 to 5999	Cost of Goods Sold Accounts	3000 to 3999	Equity accounts
6000 to 7999	Expense accounts	4000 to 4999	Income accounts
		5000 to 5999	Cost of Goods Sold
		6000 to 7999	Expenses

Note: Although you could alternatively run a 5, 6 or more, character numbering system as some software manufacturers set as default e.g.10000 to 19999 for Asset Accounts, or create shorter numbered codes, or for that matter use letters, it is the order of the account types that is important and what distinguishes North American charts from the rest of the world.

## ***ii. Definition of Account Types***

Whether creating your own Chart of Accounts from scratch or using a template provided by your accounting software, it is probably a good idea as a business owner or the person assigned to do the bookkeeping, to understand what the different account types represent.

### ***i. Current Assets:***

Current Assets are assets that represent a value to a business, specifically assets that are reasonably expected to be converted to cash within 12 months, in the normal course of business e.g. cash in a bank account, cash on hand, accounts receivable (money owed to your business from customers), inventory you keep on hand for resale, prepaid expenses etc. or in other words liquid assets, that can be readily converted to cash.

### ***ii. Fixed Assets:***

Fixed Assets (also known as Capital Assets) are somewhat trickier to understand and ultimately manage. They are assets that the business owns or purchased for its own use and have not been purchased to resell in the day to day activity of the business. These would include land, buildings, manufacturing equipment, computer equipment, furnishings, leasehold improvements (e.g. new walls, rugs, paint, a sign) and/or vehicles etc.

Even if you own a small business that is renting space or running one from your home, your business will most likely have computers, printers, specific furnishings etc. that would be classified as a fixed asset and should be tracked as such.

Although a fixed asset account is obviously on the plus side of the Balance Sheet when evaluating the net worth of your business (assets are good things right), the positive feature about fixed assets is that their stated value can and in some cases must be depreciated (reduced) each year or over multiple years.

Simply put the depreciation of a fixed asset is the expense generated by the use of the asset, the magical “Well you are a business owner, you can always write off that expense” that salespeople always tell you when trying to sell you a new computer or a new piece of accounting software.

Writing down fixed assets, typically called the depreciation and now in Canada called the amortization of fixed assets happens at the end of each financial year, regardless of when you purchased the asset. Hence why many businesses buy or lease new equipment, vehicles etc. at the end of their financial year, especially if the company has excess profit in that financial year.

You reduce the value of the various fixed assets by increasing the value of the fixed asset depreciation accounts (one for each type/descriptions of a fixed asset). The depreciation amount sits in the depreciation accounts until you decide to expense them (e.g. move the balance from the depreciation accounts to an operating expense account for a given year), so there is some leeway in the timeline you have to expense the depreciation.

In other words you set aside a depreciation value each year based on the accounting rules for percentage of depreciation by fixed asset type and the rules are different in each country at different periods of time e.g. the Canadian government allowed 100% annual depreciation of new computer equipment in 2010. However, you do not necessarily have to move the depreciated value to your expense accounts until it is beneficial for your business to do so (again various localization rules apply to that period of time).

The ultimate benefit is that expensing the calculated depreciation in a given year, can and will reduce the profit earned in that year and therefore the business will owe less corporate tax. Of course the caveat is that reducing your retained earnings and/or reducing your operating profit in a given year, might not be beneficial to your business, e.g. if you need to show a higher operating profit to be reported in order to justify a loan or hungry profit sharing stakeholders.

Determining how much you can depreciate, when you can depreciate and whether it is beneficial to depreciate is one of the reasons that you want to hire an accountant. You hire them to do the magical year end depreciations and analysis of other considerations that can affect your business and in many cases your personal tax obligations. The accountants know the specific rules of depreciation for your locale, or at least they should.

### iii. Current Liabilities

Similar to current assets, current liabilities represent funds owed by your business that in the normal course of operation would be expected to be paid within a period of 12 months. A prime example of a current liability is your accounts payables, outstanding funds that you owe to suppliers or vendors that have already supplied the business with the goods or services and have given the business a period of time (under twelve months) to pay those obligations (typically via invoices).

Do not confuse current liabilities or specifically accounts payables with monthly operating expenses, e.g. even though you probably receive a telephone bill every month, it is not an accounts

payable. Meaning that in the normal course of business, you just pay the phone bill every month and enter the details to the telephone expense account. Creating an invoice or payables for monthly operating expenses is just a waste of time, not necessary and based on all the definitions this non accountant could find, are not considered accounts payables and therefore not current liabilities.

The only time these monthly or regular unpaid expenses would have to be considered as a liability is at the end of the financial year and the accountants have created a catch all account, that you have probably seen on their prepared statements, named Accrued Liabilities, to record those not yet paid operating expenses, at the end of the year. So don't mess up your payables or liabilities during the year.

Other current liabilities are the sales taxes that you collect when selling your products or services and have to periodically remit to the government, or payroll withholdings and deductions that you have collected upon the government's behalf when you pay your employees.

Customer deposits are current liabilities in that you still owe the customer for the goods or services that you have received funds in advance for. Likewise unredeemed gift certificates are treated as a current liability, unless of course your business is just selling gift certificates.

Short term loans that you have received from a bank, investor, or relative that are going to be repaid within a current or twelve month timeframe are current liabilities. Longer term loans with repayment terms of over a year are considered Term Liabilities (also called Long Term Liabilities).

#### iv. Term Liabilities

Or Long Term Liabilities are funds that a business owes with an expected repayment period of over 12 months. The most often used examples being a bank loan with the repayment term being over twelve months, or a mortgage for property, or long term loans from other lenders or a lease for a new vehicle. If any of the above obligations are expected to be paid off within twelve months, they are considered short term liabilities or as we now know to call them Current Liabilities.

Term Liabilities raise a few more eyebrows amongst the people who raise eyebrows when looking at a balance sheet, (where assets and liabilities get reported) because you are stating that your business owes creditors more money that it cannot reasonably expect to repay within a year.

Hence when creating a term liability (applying for and receiving of the funds) it is important to record the details, somewhere where you will not lose them, e.g. the purpose for taking on the debt, the terms of repayment, the interest rate(s) charged etc, plus keep any loan agreements or obligations that have been signed by the company for the term liability. These details typically are added as "Notes" that your accountant creates and adds as an addendum to your financial statements.

#### v. Owner's Equity

The most confusing of the Balance Sheet accounts is also defined as simply as Equity accounts. Simply put, your business and every other business is owned by somebody or in the case of public companies a lot of somebodies (shareholders) and the Equity accounts are used to record the activities affecting that ownership.

Equity accounts record the owners contributions (funds and/or assets) provided to the business by the owners, as well as the owners share of ownership. For larger corporations, percentage of ownership is tracked by the sale or assignment of individual shares of stock. In smaller companies

with fewer owners, equity is tracked using a Capital account (or Shareholder Funds introduced account) and a Drawings Accounts (Shareholder Funds Withdrawn).

There are differences in the required Equity accounts between incorporated and unincorporated companies, but for the small to medium sized business, here is a list and description of usage for the basic equity accounts:

#### i. Common Stock Account:

Also known as Outstanding Shares, are only mandatory for corporations, they reflect the value of issued or outstanding shares sold to investors. The value of the shares is calculated by multiplying the number of shares issued by the value of each share of stock.

For small to medium sized corporations this is typically the 1 or 100 shares that your accountant or bookkeeper told you to set up at a value of a dollar each, so that you minimally met the mandatory requirement of being incorporated.

If you are a larger business with partners each owning shares you could create Common stock account for each shareholder. However, similar to Term Liabilities keep the formal details outlining the stock disbursements for the year end notes.

#### ii. Retained Earnings Account:

The infamously mandatory Retained Earnings account, simply put, records the resulting profit or loss from the previous years of operation, all the way back to the date that your business first started.

At the end of each financial year, the Retained Earnings account is increased by the profit calculated from the closing Income Statement or P&L. If at the closing of the year, the Income Statement reported a loss, the Retained Earnings account going forward into the next year would be reduced.

Obviously having a higher retained earnings is positive thing, however do not confuse the Retained Earning with your Profit from the current operations. Having a big loss in the current year of operations which is reported via your P&Ls or Income Statements might create a much more negative impression than what the business historically did in the past.

#### iii. Shareholder Funds Introduced Account:

The Shareholder Funds account, also known as the Capital Account is generally used by small to medium, owner operated, businesses. This account represents the funds that the owner or owners contributed (each shareholder must have their own account) to start the business as well as any additional funds they may add over time to keep the business going.

Capital also includes fixed assets that the owner or owners gave to the business e.g. assigning ownership of computer equipment or furnishings etc..

Some owners record every dollar they spend on the company's behalf to the Capital account e.g. buying photocopy paper from Staples on the way to work. However the overall effect of entering these numerous miscellaneous operating expenses as shareholders contributions has very little effect on the resulting Balance Sheet or the owners taxable income and is really more of a hassle that it is worth.

In most cases these owners would be better served to treat these miscellaneous expenses as simply that, reimbursable day to day expenses. The same way they would reimburse their administrator who bought coffee for the office, reimburse the expense from petty cash or issue a check/cheque for the reported expenses. In both cases, for the administrator or owner, the reimbursement is not considered taxable income for the recipient, as long as the expense can be justified as an business operating expense. Just a suggestion.

#### iv. Drawings Account:

Also known as Shareholder Funds Withdrawn Account. As described this account records the funds that each shareholder withdraws from the company and therefore each shareholder must have an individual Drawings account. This is generally non taxable income to the owner, if they withdraw an equal or lesser amount than they have introduced (Capital account above) in a given year.

However some caution is required as the two countries and certain jurisdictions within the countries have different rules regarding shareholders withdrawals e.g. a few years back shareholders in Canada could withdraw more funds than they contributed with the balance being treated and recorded as a repayable shareholder's loan. Then the government closed that loophole and now if you draw out more than you introduced, the balance must be reported as taxable personal income for the calendar year in which the withdrawal occurred. Check with your accountant, that is their expertise.

#### vi. Other Equity Accounts

The Equity Accounts listed above are the basic equity accounts for the majority of small to medium businesses. However there are other types of equity accounts or descriptions for equity accounts that you might want to be aware of, if for no other reason than to avoid confusion or to sound more knowledgeable when talking to an accountant. They are typically used by larger corporations or certain business or organizational types.

##### i. Capital Reserve Account

Capital reserve accounts are used by larger corporations, institutions, municipalities or governments to record funds that have been set aside for long term capital investment projects or an extraordinarily large, expense that is anticipated to occur in the future.

The funds recorded as capital reserves can come from external sources, government subsidies, grants, private donations etc. or from an existing shareholder or simply from the accumulated cash generated by your business.

However once an amount is recorded to a Capital Reserve equity account on the Balance Sheet, the funds can only be used for the project or anticipated occurrence for which they were set aside. If you set up a capital reserve account for some reason, you will need to supply those details and any documentation regarding external sources of funds to your accountant for their Notes.

##### ii. Authorised Capital

Purposely spelt the US way without a "z", is also referred to as Authorised Share Capital or Nominal Capital. Authorised capital is used by corporations who issue shares to employees as incentives, performance bonuses, or as part of the employees compensation or severance

package. They also can represent share values set aside for other purposes such as acquisitions.

The maximum amount of Authorised Capital that a corporation is allowed to set aside is governed by the corporations own recorded constitutional documents, board meeting minutes etc. Portions of the funds set aside for these purposes are often left unused, while the portions that are dispensed to shareholders are then referred as and recorded to an issued share capital account.

Authorised capital accounts are highly governed and documented and have been removed as an option in some countries such as the UK.

### *iii. The Balance Sheet*

The Assets, Liabilities and Equity accounts or the top section of your Chart of Accounts in North America, that we have described so far, are reported on the Balance Sheet. The Balance Sheet will always show the current financial position or health of your business and is therefore also referred to as a Statement of Financial Position.

It is called a Balance Sheet because it is always in balance where  $\text{Assets} = \text{Liabilities} + \text{Equity}$ .

This is sort of common sense, as the business has to pay or has already paid for all the things that it has acquired (the current assets and the fixed assets listed above) and it has done that by either borrowing the funds (the current liability and/or the term liabilities) or it is getting the money from the owners or Owners Equity which we now know the Equity accounts are also called.

There are financial ratios that have been established to analyze your business that relate specifically to the balance sheet.

The **Working Capital Ratio** (Current Assets minus Current Liabilities = Working Capital), which will indicate whether your business will be able to meet its current obligations.

The **Current Ratio** (Current Assets divided by Current Liabilities) which equals the relationship between the two, where a result or ratio of 3 to 1 is better than 2 to 1 and a where 1:1 means you have no working capital.

The **Quick Ratio**, also called the **Acid Test** that is similar to the Current Ratio except that it excludes inventory on hand and any prepaid expenses from the Current Asset total, in other words it only considers what can reasonably be turned into immediate cash to pay current liabilities. Again 1:1 or less than 1 to 1 means you will have a problem meeting your current liabilities.

However in the end these Financial Ratios and others have been developed by and for the banks which as small to medium sized, business owners, in the middle of or waiting for the next, recession know, are looking for any excuse to not loan us money or in some cases to take back what they have already lent to us, so don't fixate on them if you are just starting your new company.

Alternatively if your company is large enough to regularly apply these calculated ratios, you already have people on staff, like the CFO who will drive you nuts with the results.

If you are small to medium sized business, ratios are usually not important unless you are preparing to apply for financing, in which case get an accountant to look at the Balance Sheet first, they know the ratios and the rules and how to, in many cases, make your balance sheet more appealing.

*So we are half way through the chart of accounts and you are most likely, either bored or have a headache. Take a break and then restart here, at the Income Statement. This is where all the fun is, as it deals the section of the chart of accounts that you already know and are more concerned about. The day to day activities of buying and selling or collecting money and spending money.*

#### **iv. The Income Statement**

This section will cover the accounts in the chart of accounts that are reported on the Income Statement which is also known as the P&L or Profit And Loss Statement. The accounting definitions available on the web actually make understanding what a P & L report is and how to use it, much more confusing that it should be, since, next to possibly your bank ledger, the P&L is the bible for any new small to medium business owner. The P&L provides the information required to make changes in your day to day operation.

Let's go through the account types.

##### **i. Income Accounts;**

Also referred to as Sales Accounts or Revenue accounts, record the net amount (before sales tax) of the sales of your items or services.

Typically businesses have multiple sales accounts, because they sell items from different locations or they have different types of sales categories e.g. items, services, support etc or different distinct markets that they sell to such as a manufacturer that has retail sales to the public, reseller sales (resellers that sell the product to the public) and/or distributor or wholesale sales.

Another typical sales account many businesses include is a Freight Recovered account, an account that records the shipping charges that you charge the customer when shipping goods to them and most businesses also create a miscellaneous sales account to cover the odd or one time only sources of income for the company e.g. your neighboring business buys some photocopy paper from you because they ran out and you had an extra case in your office supplies.

In other words all income generated by the sale of something is recorded into a sales account.

##### **ii. Other Income Accounts:**

By definition other income accounts record revenue that the business receives from sources other than those generated by day to day sale of goods and services. Traditional other income would be interest income from deposits in your savings accounts or interest and dividends earned from other sources, such as investments or outstanding loans to third parties, where they are paying interest. I guess it could alternatively include the sale of the photocopy paper above to an Other Income Income Account. Your choice.

##### **iii. Cost of Goods Sold:**

COGS is also known as the Cost of Sales. These are accounts that record the direct costs related to the production or acquisition of goods and/or services sold by the company. The only costs recorded in cost of sales accounts are those costs directly tied to the the production and /acquisition of the products or services provided.

In a manufacturing environment the COGS would include the cost of the materials for parts that go into the finished product along with an account for the labour costs to assemble the finished product. The cost of shipping the goods or the labour costs in selling or marketing the goods would not be included in the Cost of Sales, they are operating expenses.

Or if your business was using third party contractors to install your products or provide your services, the costs of those third party contractors would be included in the COGS.

### Calculating the Cost Of Goods

The exact costs included in the calculation of the COGS e.g. the accounts you are creating, differ from one business type of to another and typically, the cost of goods attributed to a company's products are calculated or expensed as the company sells these goods.

However if your accounting software is not tracking inventory movement or you are more service based, there is an accepted way to calculate COGS. You start with the opening inventory for the period (or the beginning of the financial quarter or year if doing stock takes quarterly or annually) and add the total amount of purchases made during the period, then deducting the value of ending inventory (physical count). This calculation gives the total amount of inventory or, more specifically, the cost of this inventory, sold by the company during the period. Subtract that amount from the total revenue for the period and you have the Gross Profit and Gross Margin percentage.

For example, if a company starts with \$10 thousand in inventory, makes \$2 thousand in purchases and ends the period being measured with \$9 thousand in inventory, the company's actual cost of goods for that period would be \$3,000 ( $\$10,000 + \$2,000 - \$9,000$ ).

So if you are using an accounting software package that does not track inventory on hand, that is the calculation that you or your accountant uses at the end of the year or at any time during the year to determine your exact cost of goods sold for the year or that period of time. In fact even if you are using accounting software that tracks inventory your accountant would do the same calculation and probably then make adjustments, because there is always shrinkage or overages when dealing with inventory items and stock value changes that might have to be accounted for

### iv. Operating Expense Accounts

Generally referred to as Operating Expenses record the expenses incurred in carrying out the day to day operations. However, because the affect of an Expense account on the P & L is the same as that of the Cost of Sales accounts above, some small business owners often confuse cost of sales to operating expenses or vise versa.

The rule, at least from every web page found is that an Operating Expense is: An expense incurred in carrying out an organization's day to day activities, *but not those expenses that are directly related* with the production of goods that are sold, e.g. as described above in the Cost of Sales description.

Typical Operating expenses include such things as payroll, sales commissions, employee benefits and pension contributions, freight and shipping costs (to bring your goods in), advertising and marketing costs, travel & accommodation (related to business trips), meal and entertainment, vehicle fuel, licensing and maintenance costs, rent, telephone, fax, cell phones, internet fees, utilities, office supplies, shipping supplies, property taxes, insurance, professional fees (legal, accounting, consultation) and repairs and maintenance which could include fixing a sign, pest control. lawn care, snow removal, waste removal, janitorial services.

The number of accounts you use or create really depends upon how much detail is important to you in analyzing where you have spent the money you have received from your sales. A rule of thumb at least one that this author has always followed in to group expenses by type or category and then

start listing them numerically from the largest expense category to the smallest expense category. In other words the more expensive items or category is usually the first one I as an owner would want to review every month.

So typically if you have employees the largest category of expenses will be Employee Cost, Payroll Costs or whatever you want to call the category. So the lower numbers in the 7000 range, using the recommended GAAP or GIFL accounts would be Payroll, Sales Commissions, Benefits, Pensions, or the Employer's share of any deductions made to employees wages (typically a Canadian thing).

This might be followed by an Advertising & Marketing category, if those expenses are the next highest category and could include trade shows that you display at and the costs related to attending those shows, booth cost, travel & accommodation, meals entertainment as well as the usual print, radio or web advertising.

Or in many cases the Administrative Costs are higher and they would be the next category, which would include Rent, Telephone, Fax, Cell Phones, the utilities (hydro, water, gas etc.) and the office supplies which could include coffee and donuts, I guess as well as the repairs and maintenance fees. The freight in expense could also be included in this category if they did not represent an overpowering amount each month or they could be treated separately.

If your business owns vehicles they might be listed next, where you record the costs of operating the vehicles, fuel, maintenance, insurance & licensing, not the leasing cost, since as we now know reduces the Term Liability for the vehicle lease(s). The vehicle category could be broken down by vehicle if the company also owned many vehicles or delivery trucks, especially if monitoring the operating expense of each or aging vehicles was important. Or you could just have one account that recorded all operating expenses, fuel, maintenance etc. for multiple vehicles. It all depends upon what is important for you the owner to review and analyze.

Professional fees the lawyers and accountants etc. might be next. Note in some jurisdictions keeping a separate account for legal or accountancy is required depending upon the type of business designation e.g corporation, sole proprietorship etc. In any case it does not hurt to be separate.

Bank and/or credit fees are also typically listed as a separate expenses and the placement based on the size of the expense would usually place them near the bottom if you are following my rule of thumb.

#### **iv.v Depreciation Expense accounts**

There are a few additional expense accounts that the small to medium sized business should create. These are the depreciation expense accounts that were related to in the Fixed Assets section, which we now know are part of the Balance Sheet. When you write off the depreciation of the fixed assets that seemed to be described in great detail, you record that write off as an entry to Depreciation Expense, also known as an Asset disposal account. You could have an account for each type of asset being depreciated or typically just one.

This account is numbered or coded so that it appears at the bottom of the list of expenses and thus the P&L and could be numbered in the high 7000s range or more often in an 8000 range of numbers.

### ***v Assignment of Expense Account Numbers and Categories***

To clarify and probably cover any personal liability here, there are recommended numbering of the different expense accounts (in fact all accounts) for different types of businesses by both the GAAP and GIFL for both

countries and for those that are anal about such things you can access those codings on the web and number your accounts accordingly.

However, speaking as an old business owner, and a person who has viewed over a 1,000 different chart of accounts from small to medium businesses, over the last four years, no one uses them, close but not exact.

The bigger influence on the coding and resulting order of accounts has been the Intuit or Sage bookkeepers, who, depending upon which one you end up with, believe that either the Intuit categories or the Sage accounts list, that they were taught is the bible.

Which brings us to categories and Intuit specifically for a moment. The dumbing down of the accounting process by Intuit has left many Intuit Bookkeepers and Intuit customers believing that they do not have a chart of accounts, everything is categories, "it is just so much easier". And I do not mean any offense to Intuit or their followers, as Intuit is the most successful accounting software developer in the world with the highest volume of sales and the largest number of customers.

However Intuit does have a chart of accounts and it can be exported, in fact all accounting systems, including hand written ledgers have a chart of accounts and the more serious ones including Intuit follow a similar alignment of account types in North America (the rest of the world is less formal) as described by the GAAP and GIFL.

Category headers on the other hand can usually be added to any serious accounting software and the best part is that the Categories then allow you to print the lined up Expense Accounts (or for that matter any account type in your Chart of Accounts, where you decide to use or assign categories) as condensed or summarized reports by that category.

For example if the person responsible for the day to day accounting entries needs to see all expenses individually stated which they most likely prefer, they can produce a P & L report, that lists those accounts individually. However maybe you as the owner, are more concerned about the monthly or quarterly expenses by Category e.g. how much on Total Employee costs versus the Total Advertising & Marketing costs versus Office Admin etc. and you can run categorized P & Ls that display that summarized information as opposed to the minutiae of individualized expensed accounts.

In other words categorizing your expense accounts not only assists you in creating an ordered list, it can also give you the ability to look at your financial reports in various and possibly more relevant ways.

## ***vi. The importance of the P&L***

As mentioned earlier, this old author, considers the monthly, quarterly and annual P&L reports to be as important to a new or small business owner as the bank register is. The reason for this is that the P & L is the only financial report that is not limited to a precise moment in time. It can be reported over a period time.

Where the Balance Sheet or top half of the Chart of Accounts shows the health of business at one point in time, because the P & L (or bottom half of the Chart of Accounts) reports on a range of periods (months) it allows you to better analyze the potential growth in profit or possibly looming losses and you can then see where you either need to increase certain expenses to accommodate that growth or cut certain expenses to reduce the approaching losses.

Simply put the P&L calculates the profit or loss for the current year's operation, where Income less Cost of Sales equals the Gross Margin earned on sales, Gross Margin less Operating Expenses equals the Profit or Loss before taxes.

To round out the accounting piece of this ode to the P & L the resulting profit or loss at the end of the operating year is then added to the Retained Earnings (Equity Account in the Balance Sheet) to start the new financial year and the P&L starts back at zero on day one, of the new year.

### vii. Understanding the Debits & Credits

If you have set your chart accounts up (Balance Sheet & P & L accounts) using the account types listed above, when you print a report that shows all the current balances for all the accounts, a report known as the Trial Balance report, all the account types whose balances are increased with Debits will balance with all the accounts types whose balances are increased with Credits and show a total for all Debits that equals the total for all Credits.

In fact even if you have have chosen the wrong accounts when entering a transaction, the Trial Balance will still be in balance between the total of the debits and the total of the credits. If you are a novice to accounting, and have this unquenchable desire to know the definitive explanation of a Debit and a Credit, look it up on Wikipedia. The definition is not important. However if you are a business owner the important things to know about Debits & Credits is how the account type balances are affected by Debits & Credits...

#### For Assets (Current & Fixed)

To increase the balance of a Asset Account you Debit that account with an amount. To decrease the balance of a Asset Account you Credit that account with an amount.

#### For Liabilities (Current & Term)

To increase the balance of a Liability Account you Credit that account with an amount. To decrease the balance of a Liability Account you Debit that account with an amount.

#### For Equity Accounts

To increase the balance of a Equity Account you Credit that account with an amount. To decrease the balance of a Equity Account you Debit that account with an amount.

#### For Income Accounts (Sales & Other Income)

To increase the balance of an Income Account you Credit that account with an amount. To decrease the balance of an Income Account you Debit that account with an amount.

#### For Cost of Sales Accounts

To increase the balance of a Cost of Sales Account you Debit that account with an amount. To decrease the balance of a Cost of Sales Account you Credit that account with an amount.

#### For Expense Accounts

To increase the balance of a Expense Account you Debit that account with an amount. To decrease the balance of a Expense Account you Credit that account with an amount.

Account Type	Debit	Credit
Current Assets	+	-
Fixed Assets	+	-
Current Liabilities	-	+
Term Liabilities	-	+
Equity	-	+
Income	-	+
COGS	+	-
Expenses	+	-

So the Golden Rule goes something like this: For every accounting transaction (deposit, withdrawal, sale or purchase, invoice or credit note etc,) the total being debited to the accounts in the transaction are equal to the total being credited to other other accounts. In other words Debits always equal Credits and that is what "true double entry" accounting software applications do.

Here's an example for the sceptic:

Sell a Widget that you purchased for \$50.00 to a customer for \$100.00 plus tax (HST \$13.00) where the customer paid by cash, cheque or credit card.

The resulting transaction will debit the Bank Account (a current asset) \$113.00 and it will credit the Sales Account \$100.00 as well as, credit the tax collected account (a current liability) \$13.00.

At the same time if you are tracking inventory on hand the transaction will Credit the Inventory On Hand account (current asset) \$50.00 and debit the COGS account \$50.00, so that your profit is \$50.00 and your Gross margin is 50%.

If the Customer was a terms customer where you invoice them for the \$100 Widget, the Transaction would debit the Accounts Receivable account (current asset) \$113.00, Credit the Sales account (current liability) \$100.00 and the Tax Collected account \$13.00. Plus the Inventory On Hand & COGS as above.

Then when the customer pays the invoice, the resulting receipt credits the Accounts Receivable (thus zeroing out the receivable asset) and debits the Bank account (also a current asset).

The effect of negative credits & debits.

Because of the so-called golden rule and the way that some accounting software print reports, many people believe that debits are always positive and credits are always negative. However from the chart you can see that you can increase the balance in accounts by crediting them with a positive number, e.g. sales accounts.

Or as in this example you can have negative amounts entered as debits or credits.

A refund entered as a negative receipt is in fact debiting the Bank Account a negative \$113.00 when you give the customer their refund and also credits the Sales account a negative \$100.00 and credits the tax collected a negative \$13.00.

In other words when you apply a negative amount as a debit it acts like a credit to an asset, cogs or expense account or conversely a negative credit amount acts like a debit to those account types, which is somewhat counter to the golden rule and makes It is somewhat confusing if you think of debits as positive amounts and credits as negative amounts.

So if you instead learn your chart accounts, the different account types and then memorize how to increase or decrease the balances in the different account types (from the chart above), I guarantee that a light will eventually go off and you will be able to figure out how to enter any type of business transaction that you will ever have to do, including those pesky Journal entries, regardless of which accounting software you use.

About the author:

Al Hayward is the president and CEO of The Loman Group, a professional sales agency that represents manufacturers in Canada. From the spring of 2007 to the fall of 2011, Al provided customer support for MoneyWorks accounting software in North America.

As iterated throughout the article, the author is not an accountant and nor should the information provided be considered accounting advice. Every business should hire the services of an accountant who understands the rules for their country, region and/or industry. It just makes sense.