THE **TRUE** BASICS OF ACCOUNTING

The purpose of this article is to highlight the **true** basics of accounting. Why the emphasis on **true**? It is because of the various *formulas, rules, recipes,* etc., used in the elementary teaching of accounting. They do a lot of harm as learners are *not guided to discover, reason* and *understand* but are *taught or drilled to do.* Learners are not guided to discover the *why* (reasons why certain things are done) – they are *taught* the *what-to-do,* whether they understand it or not.

The end result of the accounting process is in the form of reports and financial statements. These show how a business or organisation has performed and provide the information required to plan for the future. The Balance sheet (Statement of financial position) is one of the relevant statements and shows the financial position of a business on a specific date. It shows what the business owns (assets), what they owe (liabilities) and the difference, known as equity or owner's equity. If we write these three items in equation form, we get: Assets – Liabilities = Owner's equity. However, we usually work with positive amounts in accounting. So the equation known as the **basic accounting equation** is written as: Assets = Owner's equity + Liabilities.

This basic accounting equation is the TRUE basics of accounting. Everything done in accounting is a **result** of *the effect that transactions have on one, two or all three of the elements of the basic accounting equation.* Note that reference to this will be made further on in the article.

The following ten transactions of Rufus Plumbers can serve as an example to support this statement:
1. Rufus started his business, Rufus Plumbers, by depositing a capital contribution of R80 000 in the current bank account of the business; receipt 001 was issued.
2. Bought a vehicle from Bingo Motors and paid by cheque 001, R25 000.
3. Issued cheque 002 for R15 000 to Coastal Stores for equipment.
4. Paid the local newspaper, *Daily News*, for advertising, cheque 003, R400.
5. Rented a storeroom from First Street Properties; paid rent by cheque 004, R900.
6. Cash received for services rendered, cash register roll, R3 300.
7. Rufus Plumbers bought a vehicle on credit from Oxford Motors, R90 000.
8. Services rendered on credit to J. Mapaka, invoice A01 issued, R6 000.
9. Rufus Plumbers paid Oxford Motors R20 000 by cheque 005 as part payment of debt.
10. Received R4 000 from J. Mapaka as part payment of his account, receipt B01.

If we record the effect of each of the above transactions on the accounting equation and prepare a cumulative summary after each transaction, we will arrive at the following solution:

Effect on the accounting equation (The *reason* given is *important* and must *make sense.*)

	Assets		Equity		Liabilities	
	Effect	Reason	Effect	Reason	Effect	Reason
1.	+80 000	Cash increases	+80 000	Owner's capital contribution		
2.	−25 000	Cash decreases				
	+25 000	Vehicles increases				
3.	−15 000	Cash decreases				
	+15 000	Equipment increases				
4.	−400	Cash decreases	−400	Advertising – expense		
5.	−900	Cash decreases	−900	Rent – expense		
6.	+3 300	Cash increases	+3 300	Income earned		
7.	+90 000	Vehicles increases			+90 000	Creditors increases
8.	+6 000	Debtors increases	+6 000	Income earned		
9.	−20 000	Cash decreases			−20 000	Creditors decreases
10.	+4 000	Cash increases				
	−4 000	Debtors decreases				

Cumulative summary after each transaction

No.	Assets		Owner's equity + Liabilities	
1.	Cash	R80 000	Capital contribution	R80 000
2.	Cash	55 000	Capital contribution	80 000
	Vehicles	25 000		
		R80 000		R80 000
3.	Cash	40 000	Capital contribution	80 000
	Vehicles	25 000		
	Equipment	15 000		
		R80 000		R80 000
4.	Cash	39 600	Owner's equity	79 600
	Vehicles	25 000		
	Equipment	15 000		
		R79 600		R79 600
5.	Cash	38 700	Owner's equity	78 700
	Vehicles	25 000		
	Equipment	15 000		
		R78 700		R78 700
6.	Cash	42 000	Owner's equity	82 000
	Vehicles	25 000		
	Equipment	15 000		
		R82 000		R82 000
7.	Cash	42 000	Owner's equity	82 000
	Vehicles	115 000	Creditors	90 000
	Equipment	15 000		
		R172 000		R172 000
8.	Cash	42 000	Owner's equity	88 000
	Vehicles	115 000	Creditors	90 000
	Equipment	15 000		
	Debtors	6 000		
		R178 000		R178 000
9.	Cash	22 000	Owner's equity	88 000
	Vehicles	115 000	Creditors	70 000
	Equipment	15 000		
	Debtors	6 000		
		R158 000		R158 000
10.	Cash	26 000	Owner's equity	88 000
	Vehicles	115 000	Creditors	70 000
	Equipment	15 000		
	Debtors	2 000		
		R158 000		R158 000

Using the cumulative summary of the effect of the ten transactions on the accounting equation, we can report to management as follows:

Assets	
Cash in the bank	26 000
Vehicles with total cost price	115 000
Equipment costing	15 000
Debtors owe the business	2 000
Total assets therefore	158 000
Less Liabilities	
Owing to creditors	70 000
Owner's equity	88 000

Owner's equity after the transactions	88 000
Owner's contribution was	80 000
Net income/Profit	8 000

However, the cumulative summary does not tell us:
• What the total income amounted to.
• What expenses were incurred.
• Any other information that management might like to know.

The main aim of accounting is to provide information in the form of reports or financial statements to allow managers to make decisions. To achieve this, a systematic method of recording in accounts is essential. This is where ledger accounts come in handy. Ledger accounts are used as an aid to make more information available. For instance, one can open a separate ledger account for each asset, liability and expense as well as one (or more) to record the business income. However, this does **not** make ledger accounts part of the **true** basics of Accounting. Ledger accounts are an **aid** – and that's all!

The effect of the ten transactions in the example on the accounting equation shows clearly that assets, owner's equity and liabilities can increase or decrease, depending on the relevant transaction. Ledger accounts are in the form of a capital T and are called T-accounts. Increases are recorded on the one side of the account and decreases on the other side. The name of the account is written at the top in the middle. The left side of the account is called the *debit side* and the right side the *credit side*. Accounts are kept in a book called the *General ledger*.

Each T-account is identified by the name which is written at the top in the middle. There are rules which *allow us to apply logical reasoning* in deciding which account to debit and which account to credit. These rules are applicable to all transactions and are *the only rules* that learners need to know.

They are:

Dr.	ASSETS	Cr.	=	Dr.	OWNER'S EQUITY	Cr.	+	Dr.	LIABILITIES	Cr.
Increase with a debit entry		Decrease with a credit entry		Decreases with a debit entry		Increases with a credit entry		Decrease with a debit entry		Increase with a credit entry

INCOME ACCOUNTS	
	Are credited *because* income increases owner's equity

EXPENSE ACCOUNTS	
Are debited *because* expenses decrease owner's equity	

If we draw up simplified ledger T-accounts of the effect of the ten transactions in the example on the accounting equation, we will arrive at the following solution:

General ledger of Rufus Plumbers
Asset accounts

Dr.		BANK				Cr.
1.	Capital	80 000	2.	Vehicles		25 000
6.	Current income	3 300	3.	Equipment		15 000
10.	Debtors	4 000	4.	Advertising		400
			5.	Rent expense		900
			9.	Creditors		20 000

Dr.		VEHICLES			Cr.
2.	Bank	25 000			
7.	Creditors	90 000			

Dr.		EQUIPMENT			Cr.
3.	Bank	15 000			

Dr.		DEBTORS			Cr.
8.	Current income	6 000	10.	Bank	4 000

Accounts that affect owner's equity

Dr.		CAPITAL			Cr.
			1.	Bank	80 000

Dr.		ADVERTISING			Cr.
4.	Bank	400			

Dr.		RENT EXPENSE			Cr.
5.	Bank	900			

Dr.		CURRENT INCOME			Cr.
			6.	Bank	3 300
			8.	Debtors	6 000

Dr.		CREDITORS			Cr.
9.	Bank	20 000	7.	Vehicles	90 000

Although ledger accounts are not part of the true basics of accounting, they do supply more information than the cumulative summary we prepared. The Current income account shows us that the total income amounted to R9 300 (services rendered for cash R3 300 and services rendered on credit R6 000). The expense accounts (Advertising and Rent expense) show us that the expenses incurred were R400 for advertising and R900 for rent. Total expenses thus R1 300. The net income (profit) therefore can be calculated as R(9 300 – 1 300) = R8 000. This calculation is normally done by preparing an Income statement.

The Bank account shows us how much money was received R(80 000 + 3 300 + 4 000) = R87 300 and how much money was paid out R(25 000 + 15 000 + 400 + 900 + 20 000) = R61 300. Therefore, there must still be R(87 300 – 61 300) = R26 000 in the bank.

The Vehicles account shows us that two vehicles were bought. One for cash (R25 000) and one on credit (R90 000). The total cost of the two vehicles is thus R115 000.

The Equipment account shows us that equipment costing R15 000 was bought for cash.

The Debtors account shows us that services costing R6 000 were rendered on credit and that R4 000 of this amount has been paid by the debtor. Therefore debtors still owe Rufus Plumbers R2 000 (6 000 – 4 000).

The Creditors account shows us that a vehicle costing R90 000 was bought on credit and that R20 000 has been paid to the creditor. Therefore Rufus Plumbers still owe creditors R70 000.

The accounting equation should balance if our calculations are correct:

Bank	26 000	Capital contribution	80 000	Creditors	70 000
Vehicles	115 000	Net income/Profit	8 000		
Equipment	15 000				
Debtors	2 000				
Assets	158 000 **=**	**Owner's equity**	88 000 **+**	**Liabilities**	70 000

Back to the statement: Everything done in accounting is a **result** of *the effect that transactions have on one, two or all three of the elements of the basic accounting equation*.

The effect on the accounting equation shows clearly that assets, owner's equity and liabilities can increase or decrease, depending on the relevant transaction. When we apply the rules which *allow us to apply logical reasoning* in deciding which account to debit and which account to credit, we find that one account *will be* debited and another account *will be* credited with the *same amount*. This has resulted in what is known as the double entry principle or double entry system. However, it is not a principle in its own right – the double entry principal/system is a *result* of the *effect of transactions* on the elements of the accounting equation.

We used ten transactions in the example discussed above. However, in most businesses large numbers of transactions take place every day. Entering each of these transactions in ledger accounts would be an impossible task. This is where subsidiary journals come in handy. Subsidiary journals are used as an aid to summarise similar transactions before posting them to the ledger. This does NOT make subsidiary journals part of the TRUE basics of accounting. Subsidiary journals are an AID – and that's all!

For the sake of completeness the **recording procedure of accounting** is set out schematically below:

Transaction	
Basics of accounting: Effect on A, O and L ("What happened?")	Subsidiary journals/books (Books of first entry) They **do not form part** of the 'basics of accounting'.
↓ ↓ ↓ ↓ ↓ ↓ ↓ ↓ ↓ ↓ ↓ ↓	Cash receipts journal (summarises all cash received) Cash payments journal (summarises all cheque payments) Petty cash journal (summarises petty cash payments) Debtors journal (summarises the credit sales of trading goods) Creditors journal (summarises all credit purchases) Debtors allowances journal (summarises returns by debtors) Creditors allowances journal (summarises returns to creditors) (The **sole purpose** of the above *subsidiary journals* is to summarise similar transactions. Each one summarises one type of transaction.) In addition to the above *specialised subsidiary journals*, a General journal is used to record transactions that do not belong in any of the other subsidiary journals.)
↓ ↓ Ledger entries: Acc to debit Acc to credit	Subsidiary journals are posted to the General ledger at month-end. Learners need to understand *what the totals* of the various analysis columns in the relevant subsidiary journal *mean* and should then apply the rules which *allow us to apply logical reasoning* in deciding which account to debit and which account to credit.

Back to the statement: Everything done in accounting is a **result** of *the effect that transactions have on one, two or all three of the elements of the basic accounting equation*.

Subsidiary books are posted to the General ledger at month-end. Learners need to understand *what the totals* of the various analysis columns in the relevant subsidiary book *mean* and should then apply the rules which *allow us to apply logical reasoning* in deciding which account to debit and which account to credit. The *same logical reasoning* applies throughout when recording transactions in ledger accounts or posting subsidiary journals to ledger accounts.

It makes sense to use the TRUE basics as a starting point for the elementary teaching of accounting. However, the methodology discussed does not end here. Be consistent *throughout all the grades*. Then you will find that it will not be necessary for the learners to use a formula to identify income and expense accounts when they have to prepare an Income statement. So let learners first consider the effect of *all new transactions* on the accounting equation and then reason what entry should be made to record the relevant effect. By doing this, you will **enable the learners to think and reason for themselves** and soon they will be able to work on their own.

You can read more about the methodology in the article *Accounting: Do you guide or do you just teach?* and its follow-up: *Accounting: How to guide – not just teach!* Both these articles can be downloaded from Via Afrika's website, http://www.viaafrika.com/downloads-page/

The articles are also available in Afrikaans (*Rekeningkunde: Begelei jy of onderrig jy net?* and *Rekeningkunde: Hoe om te begelei – nie net te onderrig nie!*) on the same website.