

Express Video Transcript

Recording Entries with Balance-Sheet Equation Approach

Topics

- Six-step process for balance-sheet-equation (BSE) entries:
 1. What happened?
 2. Identify accounts
 3. Determine account signs
 4. Determine entry signs
 5. Record entry
 6. Check quality
- Take-aways

Transcript

This video describes a six-step process for recording entries using the balance sheet equation approach. Entries are absolutely foundational to accounting, regardless of whether you become a preparer of reports or a user of reports who wants to get behind the numbers. If accounting is the language of business, then entries are the grammar. And just as the grammar doesn't define writing, neither do entries define accounting, yet they're essential, just as grammar is to writing.

Learning how to record entries is a skill, just like grammar is a skill, and by that I mean, you have to practice, and it has to be precise and it requires discipline. So the way we're going to break it down for you is we're going to give you six steps. Think of these as like a lesson from a coach, say for tennis or golf or some other sport. They're going to tell exactly what to do, but after they tell you what to do, even if you know what to do, it doesn't mean you can do it. There are subtle nuances that you have to learn and things have to become almost muscle memory. Well, the same is true for accounting entries. You have to do them over and over and you have to get good at them. People often think of accounting as mathematical. It's really not mathematical in the sense that it's difficult math, but it's mathematical in the sense that it requires discipline. If you get behind early on, and you start skipping steps, you're going to be in trouble. So let's learn the steps and get on with it.

1. What happened?

The first thing you want to ask yourself is “What happened?” And here what you’re trying to do is connect what happened in the business to the primary elements. We start with assets. Was an asset affected by this entry? Well, the question you want to ask yourself, and again, discipline yourself to do this, even if you don’t think an asset was involved, ask the question “Did the company get something with a future benefit or give up or use up something that would otherwise have provided a benefit?” If the answer is yes, then you’ve got an asset involved.

Then you can go about finding the specific asset. What we’ve discovered over the years is students start jumping on their accounts over a here before they think of the primary elements, and that just causes confusion. It’s pretty easy when there’re only few accounts, but when you get up to about 80 accounts, which we ultimately will, or even thousands of accounts when you go work for a company, that doesn’t work. So be sure to start at the primary element level.

Now, what about liabilities? “Did the company take on an obligation or did it reduce an obligation?” That’s a simple question to ask. Ask it every time.

Next question, owners’ equity: “Did the company give something to the shareholders, get something back from the shareholders, or otherwise change the value of their claims?” These are the critical questions to ask to determine what happened.

Here’s an example that we can use to figure out what happened. So we’re going to look at the first event for Bischoff: E1-issuing share capital for cash. During 2013, BGS issued common stock to its owners in exchange for \$10 million of cash. So what happened? Well, what accountants often do is they draw a picture of what happened. Now here the picture’s simple, but sometimes it can actually be quite complex. So let’s look at what happened. Over here we have Bischoff and over here we have the shareholders, and Bischoff gave stock to the shareholders and Bischoff got back cash. This is an external transaction, meaning there’s a transaction with external stakeholders. So when we have a transaction that’s like this, we always have the company giving something up and getting something back in return.

2. Identify accounts

The second step is to determine what accounts were affected, and here’s where we connect the accounting to the business. We know what happened now. We got it in the picture. How does that connect over to the primary classes first of all? Was there an asset involved? Did the company get something? Well, they got my favorite asset, cash, and that tells us what the account is. Again, we start with the primary element. Was there a liability? Did the company take on an obligation or reduce an obligation? No. No obligations here at all. Now, how about owner’s equity? Did they have a transaction with...? Oh, yes, of course they had transactions with owners. Then, we know there has to be an owners’ equity account and we only have one account at this point under owners’ equity and that’s share capital, and so we know that the company gave up stock, which is referred to as share capital.

3. Determine account signs

The third step is to determine the account signs. Now first of all, we need to introduce the concept of an account sign. If we look down here at the BSE matrix, we see what an account sign is. We have all the accounts in the matrix, and in front of every account, there's a sign and that sign acts like an adjective. We call that the adjective sign. Now, what do we mean by that? It describes the account as opposed to what happened to the account.

So let's see why the account is positive. Well, to determine the sign of the account, you ask "How does the account affect its primary class?" Cash increases assets. Because it increases assets, it has a positive sign. Share capital increases owners' equity. Because it increases owners' equity, it too has a positive sign. And you're probably thinking, "Well, look, they all have positive signs, every one of them. What's the big deal here?" Well, this is early on in the book. We're going to have negatively signed accounts. As a matter of fact, they'll come in the chapter when we start studying the income statement. Over here under owners' equity, we're going to have accounts called expenses, and expenses are going to have a negative sign.

This is common sense even if you don't know what an expense is. They don't sound like they're good for owners, right? So if you increase the expenses, owners' equity is going to go down, so the sign of the account is negative. Now, the important thing to realize about the sign of the account is it doesn't change as we go through the entries. It's always positive, or in the case of an expense always negative, and that's because it's not related to the entries. It's a feature of the account for all entries.

4. Determine entry signs

The fourth step is to determine the entry signs. If the account signs are adjectives that describe the account, then the entry signs are like verbs. That is, they determine how this particular entry is going to affect the account.

So let's look at an example. How did issuing shares affect cash? Well, it made cash go up, so that's a positive entry sign on cash. What about share capital? How did issuing shares affect share capital? Well, it's going to make share capital go up. Now, entry signs, unlike account signs, do vary as we go through the entries. So if we think about the cash account, if we were to pay a bill, then cash would go down. That would be a negative entry sign on cash. So the entry sign can fluctuate as we move through the entries. That's why it's called the entry sign; it's specific to the entry, as opposed to the account sign, which never changes across the entries.

5. Record entry

The fifth step is record the entry. Because we've figured everything out up to now, all we've got to do is figure out how much shares did we issue. Well, we issued \$10 million worth so we simply put the measure into the cell and now the entry is completed.

Now, we're going to introduce the concept of a mini matrix. We're not going to be recording entries into the balance sheet equation for very long. We'll do it up front when we just have a few entries. We're going to have to come up with a short cut and that's called the mini matrix.

And before we go any further, let me explain the role of the mini matrix versus the balance sheet equation matrix and why we need the mini matrix.

Now, if you think about the balance sheet equation matrix down here, the big one, there is going to be for every account a separate column and for every entry a separate row. Now, if you take a company like Siemens or Wal-Mart, or any one of the big global companies, they will have literally thousands of accounts and they have upwards of billions of events every year. So that's a big, big matrix that obviously wouldn't fit on a page. What's so neat is that every concept you're learning on a very simple matrix, like the one we're starting with right now and the one we'll expand in the next couple of chapters, those simple, simple concepts scale up perfectly; meaning you can in your mind's eye see a matrix that's got billions of rows and thousands of columns and still understand the concepts that are going on.

So the balance sheet equation matrix provides a wonderful conceptual foundation. We can use that matrix to trace entries, at least in a general big picture perspective into the financial statements, even when the matrix gets very, very big. We'll start seeing in our mind's eye how things move through the matrix. So it's a fundamentally important concept, the balance sheet equation matrix, but when we're doing entries day to day as we get into the later chapters, we're going to be using the mini matrix. So let's describe what the mini matrix is and how it relates to the big matrix and this picture tells the whole story.

Essentially, what you do is you color out everything that you don't want to include and just pick up what you want to include that's relevant to this particular entry. So, we need to know that this is entry 1, E1, and that it issued share capital for cash. So, here we have a description of the event and here we have a description of the event [in the mini matrix], and we have to know the primary elements that are involved. So, here's the primary elements: assets and owners' equity, [and in the mini matrix] assets, owners' equity. We have to have an equal sign. Otherwise, it's not going to be called a balance sheet equation method; because there won't be an equation. We have to pick up our accounts, which are cash and share capital, and our account signs. There's our accounts and we also have to pick up the entry signs, down here, and of course finally, the measures.

All we're doing with the mini matrix is extracting from the bigger matrix. And as you create a mini matrix, try to visualize how it fits into the bigger matrix because that's going to be important for understanding how this entry is going to flow into the financial statements.

The BSE is great for determining how entries flow into the balance sheet, or the other financial statements, and it's also great for figuring out how to prepare statements from all the entries. What it's not good for is recording individual entries and seeing the specific details that we've been talking about here once we get a big matrix.

6. Check quality

Well, we come to the last step and this is what students always want to skip. This is called the quality check. Check your work. And again, this won't take long and you'll get to do it almost by second nature. So let's see what the steps are and what are the questions.

- First of all, does the entry reflect what happened? Well, yeah, it does down here, right, because we see that the company gave out common stock and they got back cash.

- Does each number have two signs? Yup, each number up here has two signs.
- Does each account sign, that is, the first sign, reflect how the accounts affects its primary class? Yes, cash increases assets so it's got a positive sign and the same is true for share capital.
- Does the entry sign reflect what happened to the account because of this entry? Yes, in this entry you increase cash and increase share capital.
- Does the equation balance mathematically? You might think, well, that's obvious. Well, you'd be surprised how often students mess up here. There's got to be an equation first of all all the way down, and you've got to have that equation balanced in the end. So a ++ is a +10 mathematically and a ++ is a +10. Yes, it balances mathematically. Perfect.

Take-aways

What do I want you to know from all this? Well, first of all, this is a nice outline of everything we just taught you in this particular module. We could go through and read it for you, but we're not going to. Instead, we're going to tell you that it's always available. For most pages in Navigating Accounting, you just look at the resources on the right, and you're going to find it under Record Keeping Quick Reference, and you can go look at the step. Just click on this and it will open up. It will tell you exactly what that step is and what you have to do.

The more important thing is where are we heading? In a nutshell, practice, practice, practice. This is a skill. You have to practice entries and you can't get behind. Practice is essential to learn the nuances. There're just little things that you're going to overlook if you're not practicing. So try an entry. Check your answer against the solutions. Go very slow at first. Don't skip steps. I know that some of the steps are going to seem mundane early on, but they will only become second nature if you practice them upfront. Don't worry about going slow. It can take a long time to record an entry early on, but after a while, you'll have the entry very quickly. Recording entries is absolutely foundational to accounting. You need to learn how to do them whether you're a preparer or a user.

I hope you have enjoyed this video. We'll see you in the next one.