How to Solve Accounting Problems

Solving means finding or providing a satisfactory answer or explanation for a problem. A solution to a problem, whether in accounting or in any other discipline, involves more than just "getting the answer." This is what most of us search for, but other preliminary steps lead to the final solution.

Before you can solve any problem, you need to understand accounting fundamentals and strategies for solving problems. First, we will look at these fundamentals, then we will review problem-solving strategies.

The fundamental accounting equation (Assets = Liabilities + Owner's Equity) is the basis for double-entry accounting. Assets are things owned. Liabilities are amounts owed to creditors. Owner's equity is the financial interest of the owner in the company.

We can think of owner's equity as an umbrella that covers the Capital account. The Capital account increases with investments and revenues, and decreases with withdrawals by the owner and expenses incurred.

Revenues, expenses, and the Drawing account are considered temporary owner's equity accounts, or nominal accounts. They are open for the accounting period to keep track of changes to owner's equity due to revenue earned and expenses incurred. At the end of the accounting period, they are closed out and the difference between the revenue and expenses is transferred to the Capital account. A net profit increases Capital, and a net loss decreases it.

Our expanded fundamental accounting equation now reads:

\[ Assets = Liabilities + Owner's Equity + Revenue - Expenses \]

Both sides of any equation must balance.

The equation elements or classifications are broken down into subdivisions called accounts. Each account can be represented by a T account—a visualization of the information presented in a formal ledger account. The T account provides a structure to demonstrate the rules of debit and credit. It has two sides, a left side called the debit side and a right side called the credit side. You must clear your mind of your emotional attachment to the term credit. A credit is neither good nor bad, plus nor minus. Increases can be shown by debits or credits, depending on which account is involved.

The first accounting rule is that debits must equal credits in any entry.

Another rule is that the normal balance of an account is the plus side, which can be either the debit or credit side.

The problems at the end of the chapter provide the opportunity to apply the fundamentals that you have learned. Now let's look at some basic problem-solving techniques.

Scan the entire problem to get an overview of what is involved and what is expected. Most of the problem sets in your textbook have three sections that you must read carefully.

The first section includes a list of learning objectives, a problem number, and information about the problem and the business.

There is a list of transactions or other information providing the basis for solving the problem.

There are step-by-step instructions to guide you through the problem.

Read and follow each instruction carefully. Do them in order and do not skip any. Write down any questions you have and remember to ask your instructor to clarify them.

Most of the problems in your book include narrative transactions—sentences describing the transaction. The secret for solving this kind of problem is finding and understanding key words. Here are some translations of some of the more common words you will encounter in the problems:

- **Paid** means cash going out, cash decreased.
- **Invested** may mean cash was invested by the owner, but an investment can also mean another asset besides cash, such as personal equipment, one's law library, or other assets which are then given a fair market value.
- **Received cash** means cash coming in, cash increased.
- **Bought** means purchased something with cash or maybe on account or with a promissory note. In either of the latter two cases, a promise has been made to pay cash at a later date agreed upon by both parties.
Received and paid a bill is the same as paid. Cash went out, cash decreased.

Received a bill, without any reference to paying, means cash is not paid out at this time. The bill has been put away for payment at a later date.

Billed customers for services means no cash was received, but customers have promised to pay after they receive the bill. (The **accrual basis** of accounting allows us to book revenue when earned and expenses when incurred, the opposite of the cash basis most people use for their personal accounting.)

Another way of looking at key words in transactions is to group phrases which you can expect to see together in certain types of transactions. Here are some words and phrases that you might encounter in a problem involving a customer:

<table>
<thead>
<tr>
<th>Issued a credit memo</th>
<th>Sales Returns and Allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>Accounts Receivable</td>
</tr>
<tr>
<td>Sold</td>
<td>Accounts Receivable Ledger</td>
</tr>
<tr>
<td>Sales Discount</td>
<td></td>
</tr>
</tbody>
</table>

You will not see these customer-related key phrases mixed with phrases involving vendors and suppliers.

Here are some words and phrases associated with vendors and suppliers:

<table>
<thead>
<tr>
<th>Received a credit memo</th>
<th>Purchases Returns and Allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>Purchases Discount</td>
<td>Accounts Payable Ledger</td>
</tr>
</tbody>
</table>

We have just looked at key words in transactions described in sentences, but in real-world situations, transactions are primarily generated by **source documents**. A source document is a piece of paper that evidences a transaction—some change in the financial condition of the business—for example, an invoice or a check. However, most of the problems in your book are based on sentences describing transactions. Whether the transaction is generated by a sentence or a document, analyze the transaction to decide what accounts are debited and credited. The steps taken to analyze a transaction are:

1. Which accounts are involved?
2. Where do the accounts fall in the fundamental accounting equation: Assets, Liabilities, Owner's Equity, Revenues, or Expenses?
3. Are the accounts increased or decreased?
4. Which accounts are debited, and which accounts are credited?
5. Do total debits equal total credits?

These steps work for every transaction, no matter how complex. Analyzing each transaction using these steps is critical to your success in accounting.

In summary, you need a firm base in accounting fundamentals before you begin to journalize transactions. You need to understand the fundamental accounting equation, the rules of debiting and crediting, and how to analyze each transaction based on these rules. Next you must understand the problem posed. Scan the problem, and then read it carefully. Follow, in order, the specific instructions listed at the end of each problem.

If you follow these rules and steps, your accounting experience will be more successful and satisfying. Try them—they work.