

## Accounting 101

As the name suggests Accounting means to account for or look after something. To have a methodical accurate way of doing this will minimise confusion and increase understanding. Good accounting provides good and useful information. Remember, that the main beneficiary is the actual entity (the church) preparing the information, so they should determine what information they require, that means the most to them. Therefore, the reports should be both an all-encompassing summary and simple to understand.

Primarily there are two main Reports that Accountants, Businesses, Churches, etc, use. Whether or not your church identifies these or not, they do have them. They are:

1. Balance Sheet
2. Profit and Loss (or Income) Statement

If a stakeholder (a party that has an interest in a entity and can either affect or be affected by the business, eg. Bank) requires financial information regarding your church, they will most likely require these reports.

### Balance Sheet

The Balance Sheet is perpetual in nature, in that it exists for the life of the entity. Any given Balance Sheet is a snapshot of the financial worth of an entity at a particular date, so it includes things that the church owns (*Assets*) and things that the church owes (*Liabilities*), and the net is the value of the entity (*Equity*).

So, if a church only has a Bank account, or even a shoe box of cash, it has a Balance Sheet. It has a financial worth or Equity of the account balance. Every financial action that happens will normally affect the Balance Sheet and we call these *transactions*.

### Profit and Loss Statement

This is a statement or report showing how an entity is faring financially in a given period. It is not perpetual, but resets every twelve months. An entity decides the twelve month period, but typically it would be end of calendar year (31 December) or end of financial year (30 June).

The name tells you the nature of the report, but sometimes churches don't like the concept of making a Profit or Loss, so they rename the net result Surplus or Deficit, and call the report an Income Statement.

The Profit and Loss Statement gives a picture of how well an entity is functioning financially. It shows money coming in, called *Income* and money going out, called *Expenses*. Normally the main income for a church is *Offering* and the main expense is *Payroll*

## Transactions and Accounts

As mentioned, most transactions affect the Balance Sheet, as most will result in a reduction or increase in the Bank account.

It is common terminology to call the names of the items on the Balance Sheet and Profit and Loss *Accounts*. So far we have mentioned the Bank *account*, Offering *account* and Payroll *account*, and the entire list of these accounts is called a *Chart of Accounts*. For example, typical church Chart of Accounts might include the following:

<b>Account</b>	<b>Type</b>	<b>Report</b>
Bank account	Asset	Balance Sheet
Equipment	Asset	Balance Sheet
Tax owed	Liability	Balance Sheet
Accumulated Surpluses	Equity	Balance Sheet
Offering	Income	Profit & Loss
Interest earned	Income	Profit & Loss
Payroll	Expense	Profit & Loss
Printing and Stationery	Expense	Profit & Loss

When considering a transaction, the church may have to consider whether it relates only to the current financial year, or is more perpetual in nature. It also has to consider if the transaction creates a debt.

For example, if a church buys a computer, the *account* can either be an Asset, as it is something that will last more than one year, or an Expense, which means there is no perpetual value shown in the reports, but is also easier to account for. A church should address this treatment in a Finance or Purchasing Policy.

You may have picked up that the transactions mentioned all affect two accounts on the Chart of Accounts. If for example, you pay a Telephone bill, this will affect both the *Telephone Expense* on the Profit and Loss and the *Bank Account* on the Balance Sheet.<sup>1</sup> This is called Double Entry Accounting and any accounting software operates with this concept.

**This is probably all the theory you need!**

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<sup>1</sup> The Balance Sheet is called the Balance Sheet because it has to balance. That is Assets less Liabilities equals Equity. All transactions in the Profit and Loss net off with a Profit or Loss, which goes to Equity, ensuring the Balance sheet balances

## Finance Software

As software has been written for businesses there are a few anomalies that is handy for churches to be aware of.

### Accrual vs Cash Accounting

A lot of churches default to Cash Accounting. They record transactions when they happen. Most businesses account for transactions on an Accrual Basis, in that they want to record a transaction when it is incurred but pay it when it is due. A simple example is an entity receives an electricity bill in May, but it is not due until June. For a church they may pay it either month, but more than likely will record it in the bank account and the expense account on the date of payment.

Let's look at the transactions for Accrual Accounting. The entity want to record the expense in May, but take it out of the bank in June.

In May	Increase <i>Electricity</i> Expense	(Profit and Loss)
	Increase <i>Accounts Payable</i> Liability	(Balance Sheet)
In June	Pay from <i>Bank Account</i> Asset	(Balance Sheet)
	Decrease <i>Accounts Payable</i> Liability	(Balance Sheet)

Why do most entities use Accrual Accounting?

- It better aligns income and expenses in the period incurred, but keeps the cash in the bank until accounts are due
- It gives more accurate account of the worth of an entity. (For example a report reader can see there is an Account Payable, a real debt, even though it has not been paid)
- There are Accounting Standards that Incorporated Entities need to comply with

This is why Accounting software tends to be oriented this way. In the Settings you will find the option to choose which method, and it would not be normal to change this once the method had been decided.

The main reason for this section is that you may post a transaction, and it comes out of the Expense (or Income), but not the Bank. Here are some typical examples:

- Create Account Payable, that goes to Accounts Payable (Liability)
- Create Invoice for Income to Accounts Receivable (Asset)
- Payroll PAYG tax to PAYG Payable (Liability)
- Payroll Superannuation to Superannuation Payable (Liability)
- GST collected or paid to GST Payable (Liability)

It is important to look on the Balance Sheet periodically to make sure all the amounts make sense. A mistake, for example, is to process the pays which takes the Expense from Superannuation, and then when it is paid to the Super company, to take it from the Expense again. This has the effect of doubling the

Expense and leaving an amount accumulating in the Balance Sheet. The actual payment has to come from the Superannuation Payable (Liability).

### Suppliers and Customers

Being business oriented, accounting software uses the terms Customers and Suppliers. A church may not have any Customers per se. The software wants to attribute Income to a Customer, so it is common to create one called something like "Offering".

### Journals

Every transaction produces a *journal entry*, to complete the double entry accounting, previously mentioned. For example you pay a telephone bill, it comes from the Telephone expense and from the Bank account. In accounting language you *Debit* Telephone expense and *Credit* Bank account.

This just happens in accounting software and you don't have to think about it. Occasionally, however, you may want to do a manual journal entry, and this would usually only be to correct something. Often when you want to correct something, you Edit the original transaction.

For the point of example, though, let us say you discovered that six months ago a Telephone expense was taken from the Electricity expense, and you have a finance policy that you cannot edit transactions after Leadership reports have been prepared and accepted in the minutes. Six months ago the transaction was Debit Electricity, Credit Bank. Bank is actually correct, but Electricity and Telephone are not, so the manual journal entry in the current month is Debit Telephone and Credit Electricity, which will correct everything.

Note: depending on the materiality of the mistake to may want to mention it at Leadership, when the current month report is given.

### **Additional Reports**

The Balance Sheet and Profit and Loss Statement are documents that enables report readers to have a common platforms to understand financial information, in a summarised and logical format. They are also readily available from Accounting software.

To simplify procedures, particularly if you are using Accounting software, it is good practice to educate Leadership with regard to what these reports mean. Leadership may require more information, but start with the Balance Sheet and Profit and Loss.

Two other common reports are *Budget* and *Cash Flow Statements*

### Budget

A budget is a planning tool, to work out if an entity can afford to operate with a certain model, and if not to make plans to remain healthy. A good budget should minimise surprises. It is not bad management to make a loss, if it is planned. It is not a good strategy to plan for repeated losses.

The most common budget is one which replicates the Profit and Loss, but from a church may also have a Capital budget, for things do not go on the Profit and Loss, like a building project or possibly equipment. A budget is an estimate of what will happen, and like the Profit and Loss, and resets every year<sup>2</sup>. Some ideas to creating a budget:

- Start with current year data. You may only have six or nine months data, but you can use a formula (eg. with nine months data multiply the amounts by 12 and divide by 9) to calculate the whole year. Make sure you make allowances for annual bills like Insurance
- Ask leadership and departments whether anything will change next year
- Be aware of industry variations (e.g. if interest rates are predicted to increase, this might affect interest income, interest expense and even offerings)
- Factor in expected growth
- Make allowance for inflation. Go to <http://www.abs.gov.au/> and type "CPI" in Search to find the most recent inflation rate

Normally a budget is a process of getting information then reviewing the findings, and there maybe a few versions before the final one is approved. Reviews, decisions and assumptions are best documented. Common practice is for leadership to approve a budget and then it be presented to the church.

Once the year of budget has commenced any changes should be documented and approved by leadership and any significant variations be reported to the leadership.

Many Accounting packages allow budgets to be loaded (and even created). If it is loaded it is easy to report actual against budget and any variations.

### Cash Flow Statement

Unfortunately the have been many profitable businesses that have failed due to bad cash management. Reasons for this:

- Capital project using all the funds, so there is no money for ongoing expenses
- Income not coming in quick enough to cover expenses
- Payment for expenses that uses up the cash that should have been for liabilities (debts)

When considering a Cash Flow Statement, most of the cash items do hit the Profit and Loss, but some are delayed, such as Superannuation. There may also be capital purchases such as buildings and equipment, that will not affect the

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<sup>2</sup> A Capital Budget will go over the duration of the project

Profit and Loss, and items on the Profit and Loss such as provisions and depreciation which are not cash transactions. It is important to build a model that reflects when the money will go into or come out of the bank.

If the church has a monthly model, it can then move payments around so that there is always sufficient cash, or know when to make arrangements (e.g. Loan) to cover costs.

If for example the church plans to upgrade the kitchen in the coming year a cash flow statement should show things like the PAYG and superannuation bumps, the expected building fund income, the repayment dates, other capital items, etc, such that it determine the timing of having the cash available for the non-negotiables and the project. Identifying the cash tight periods may mean the decision to stagger the project or source additional funds, and avoid cash stress points.

### Comparison reporting

With regard to the Balance Sheet and the Profit and Loss Statement, it can be helpful to have comparison reports, for example:

- Balance Sheet: Current vs last end of year
- Balance Sheet: Current vs same time last year
- Profit and Loss: Current vs Budget
- Profit and Loss: Current vs same time last year

### Dashboard

Some organisations adopt a Dashboard approach to reporting, which utilises graphs and dot points to demonstrate reporting, as a visual representation can often be more meaningful than a page of figures. This can be fairly simply set up in Excel, and would report on a few key performance indicators. For example:

- Offerings or Income (monthly column chart)
- Breakup of Expenses (pie chart)
- Actual vs Budget P&L (line chart)
- Expected Cash Flow
- List of key performance and variations

Reporting may be a mixture of figure reports and dashboard reports. The key is to keep it meaningful to the readers and simple for the preparers.