

How does Accounting Software Work?

an article by sme financial systems

some of the complexities of
accounting software unravelled

SME Financial Systems,
Campus Innovation Centre,
UCD, Belfield, Dublin 4, Ireland
Phone: +3531 492 5555
Fax: +3531 492 5755

find more business resources at sme.ie

Business or Personal Use?

There is a difference between software designed to help run a business and keep track of personal finances.

Software designed for business use can be trickier to use and only provides some of the features required for management of personal finances, whilst personal finance software doesn't provide the safeguards or features required for the majority of business users.

Whilst some personal finance packages include invoicing and VAT, they are less than ideal for the majority of businesses, with the exception perhaps of clubs and associations.

Accounting Software

There is a wide variety of accounting software available today, but the common denominator is that they generally use 'double entry' principles, are of 'three ledger' design and use 'charts of accounts'. But what do these terms mean?

Three ledgers

The three ledgers are "sales", "purchases" and "nominal". In essence the "sales" and "purchases" ledgers keep a record of individual customers' and suppliers' payments including balances outstanding at any point in time.

The same information is cross referenced to and kept in the "nominal" or "general" ledger, not in the customer or supplier format but by the type of income, expense, asset or liability to which they relate.

While this categorisation in the nominal ledger produces the Profit and Loss Account (income less expenditure) and Balance Sheet (assets and liabilities or what the business owns and owes), how does the accounts package know which is which?

Chart of accounts

Data entered has to be allocated to its proper home or "account". Not unlike mail being sorted by postcode, each account has a unique number

or "account code" to which the transaction is sent by typing in the correct number (or alphanumeric in some cases).

The list of all the account codes of a business is called its "chart of accounts". Amending this list is one of the ways that accounts packages are tailored to suit the needs of individual businesses and flexibility in chart of account design is one of the things to look for in selecting a package.

Whilst the chart of accounts is usually fairly unique to a business, certain groups of accounts are normally divided into different categories. The least number of categories is four, each category often starting with a different number such as '1' for Income, '2' for Expenses, '3' for Assets and '4' for Liabilities.

For instance, buying a lead for a printer might be entered to account 2-567, 'computer supplies', an expense, or 2-569, 'office supplies', at the discretion of the user. Yet the purchase of a printer might go to account 3-567, 'computer equipment'.

In this case entering an account code starting with '2' sends the payment to an expense account and '3' to an asset account, although the subsequent numbers '567' are the same. This is how the nominal ledger produces its reports with assets in the Balance Sheet increasing if a '3' is entered or expenses in the Profit and Loss account increasing if a '2' is entered.

This isn't as daunting as it sounds. If you don't know a number, hitting a key or a mouse click brings up the list or "chart" to choose from and after a while you get to know most of the main numbers anyway. In addition, to help the user get up and running some accounts packages have chart of accounts 'templates' ready to go, requiring some but not major amendment, depending on the business.

Good chart design is crucial, though, as the more appropriate the design to the peculiar requirements of the business, the more meaningful will be the management information provided by the software.

So if you often enter only one number to an accounts package, why do you hear the term 'double entry'?

cont/d

Double entry

Venetian merchants are said to have invented 'double entry' bookkeeping. In the days of manual books and before calculators, there needed to be checks and balances built into the process. To reduce the potential for errors and ensure more accurate record keeping, all entries required a corresponding opposite entry. If both entries weren't done right the books wouldn't balance.

For instance, paying a bill increased an expense 'account' and reduced an asset account (bank) whilst a cash sale increased an income account and increased an asset account (bank).

The method chosen allowed the combination of increases and decreases to be recorded on opposite sides of a page ('debits and credits') of manual books, hence the term 'bookkeeping'!

Partly because of the safety and security element and partly because it corresponded to the manual principles people were familiar with, the double entry method continued into accounting software, although the debit and credit entries are generally produced automatically by the package and invisibly to the user.

For a variety of reasons three ledger accounting software using double entry principles best suits the business user, one of the reasons why personal finance software is less than ideal for anything but the most basic business use.