

Chapter 2. The Basics

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Putting It All Together

This chapter will introduce some of the basics of using GnuCash. It is recommended that you read through this chapter, before starting to do any real work with GnuCash. Next chapters will begin to show you hands on examples.

Accounting Concepts

GnuCash is easy enough to use that you do not need to have a complete understanding of accounting principles to find it useful. However, you will find that some basic accounting knowledge will prove to be invaluable as GnuCash was designed using these principles as a template. It is highly recommended that you understand this section of the guide before proceeding.

The 5 Basic Accounts

Basic accounting rules group all finance related things into 5 fundamental types of “accounts”.

That is, everything that accounting deals with can be placed into one of these 5 accounts:

- *Assets* — things you own.
- *Liabilities* — things you owe.
- *Equity* — overall net worth.
- *Income* — increases the value of your accounts.
- *Expenses* — decreases the value of your accounts.

It is clear that it is possible to categorize your financial world into these 5 groups. For example, the cash in your bank account is an asset, your mortgage is a liability, your paycheck is income, and the cost of dinner last night is an expense.

The Accounting Equation

With the 5 basic accounts defined, what is the relationship between them? How does one type of account affect the others? Firstly, equity is defined by assets and liability. That is, your net worth is calculated by subtracting your liabilities from your assets:

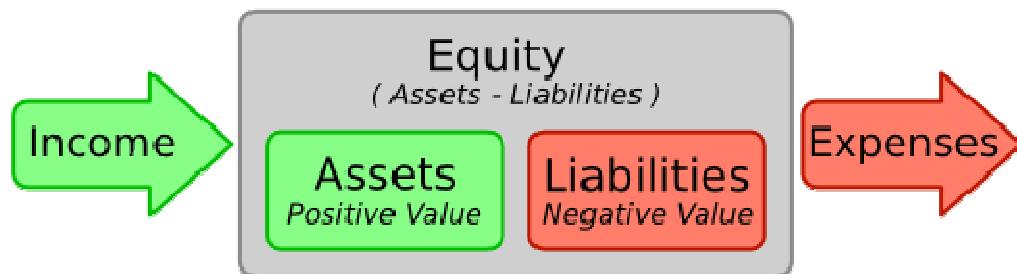
$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

Furthermore, you can increase your equity through income, and decrease equity through expenses. This makes sense of course, when you receive a paycheck you become "richer" and when you pay for dinner you become "poorer". This is expressed mathematically in what is known as the Accounting Equation:

$$\text{Assets} - \text{Liabilities} = \text{Equity} + (\text{Income} - \text{Expenses})$$

This equation must always be balanced, a condition that can only be satisfied if you enter values to multiple accounts. For example: if you receive money in the form of income you must see an equal increase in your assets. As another example, you could have an increase in assets if you have a parallel increase in liabilities.

Figure 2.1. The basic accounts relationships



A graphical view of the relationship between the 5 basic accounts. Net worth (equity) increases through income and decreases through expenses. The arrows represent the movement of

value.

Double Entry

The accounting equation is the very heart of a *double entry accounting system*. For every change in value of one account in the Accounting Equation, there must be a balancing change in another. This concept is known as the *Principle of Balance*, and is of fundamental importance for understanding GnuCash and other double entry accounting systems. When you work with GnuCash, you will always be concerned with at least 2 accounts, to keep the accounting equation balanced.

Double entry accounting serves two purposes. The first is to create an accounting trail; money always has to come from somewhere and go to somewhere. Additionally, double entry accounting historically served to double check the math of an accountant. Because the numbers are entered into multiple accounts simultaneously, there are multiple places to check to make sure the totals match. Of course, with the advent of computers, the chances of a mathematical problem are low, but it is good to know that the concept still exists!

Double entry accounting has been around since the late 15th century, when it was described by an Italian friar, Luca Pacioli. Traditional double entry accounting involves recording each transaction in a book called a ledger, then copying each part of the transaction to separate books called journals. This method is still used in businesses today as a way to avoid entry errors and to track the source of those errors. GnuCash simplifies this traditional accounting by copying part of each transaction for you, so it may not catch some of the entry errors that would show up in traditional accounting. But it will flag transactions that are not balanced, and it will let you know when an account name is missing.

Note

Calling this double-entry bookkeeping is a bit misleading; it would be somewhat more accurate to call it multiple- entry bookkeeping, since a transaction can affect more than two accounts. Unfortunately, there's 700 years of history of use of the term, which sufficiently discourages changing it.