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Bookkeeping 101: The Ceterus Way

Many businesses have a bank loan. These loans require monthly payments that are split between principal and interest. You may have noticed that the loan balance is not reduced by the full payment you made. You may wonder why and what is the impact on your books. Let's walk through an example of how loan payments work and how you can ensure you know your loan balance is accurate.

We use the following loan terms in our example:

Amount - $300,000	Term - 84 payments (7 years)	Interest Rate - 4%

Using the terms above, the loan would require a monthly payment of $4,100.64. A portion of that amount would be applied to principal and the other to interest. As time goes on the amount applied to principal increases and the amount applied to interest decreases.

The first payment made on the loan would be split, $3,100.64 to principal and $1,000 to interest. How does this loan payment affect the books? Let's walk through the journal entry made to allocate this payment properly.

Account	Debit	Credit	Explanation
Bank Loan	3,100.64		Principal portion of your loan payment. This amount reduces the amount you owe the bank. You can see the reduction on the balance sheet. No impact on the profit and loss statement.
Interest Expense	1,000.00		Interest portion of your loan payment. This amount will be displayed on the profit and loss statement and reduces net income.
Operating Account		4,100.64	Cash outflow related to the total loan payment made.

As you can see, the loan payment impacts the books in multiple ways. Of course, cash is reduced by the full amount of the payment. The profit and loss statement is only affected by the portion allocated to interest expense.