Business Records and Bookkeeping Lesson: 2206

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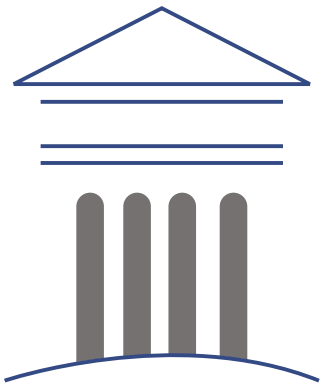
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Objectives

In this lesson, you will learn:

1. The elements of a good records system.
2. Determining your bookkeeping needs.
3. To maintain a "paper trail" so you can analyze your business progress.
4. What options are available for setting up your records system.
5. How to organize an income statement, a balance sheet, and a summary of expenses by account.
6. About software available to assist in your record keeping.

Introduction to Small Business Record Keeping

Everybody keeps business records, although they may not realize it. Take, for example, buying groceries. First you make a list of what you need. Then you go to the store and find the items on the list. At the checkout counter you pay for your groceries and record the information onto your checkbook register. Back home, you may even record the amount you spent in a budget book.

Although you may not be aware of it, these simple actions are keeping a type of business record. You are actually bookkeeping; that is, maintaining a record of certain accounts and transactions. Not only that, the bookkeeping you have been doing all your life is the same in practice and intent — if not in detail — as the bookkeeping you will do for your business.

You should begin keeping business records the first day you start your business. One reason to keep business records from the start of your business is to keep track of money. Business records also give you information for planning, preserve the data you need to get tax credit, and help you meet income tax requirements.

Business records help you chart the course of your business. Without carefully kept records, you will not know how your business is doing today. And if you do not know that, you cannot plan for tomorrow.

The best way to keep business records is to develop a useful and effective record-keeping system that tracks all of your finances. There are two things your financial record-keeping system should track: *income* and *expenses*, or what comes in and what goes out. The system you choose should be simple. Otherwise, you will not develop the habit of using it. It should also be accurate and relevant. Accurate means free from errors. Relevant means recording only what you need to record. We will get down to details later in this lesson, but here's a quick overview of income and expense records.

Cash vs. Accrual. There are two types of accounting methods: cash and accrual. The cash method records income when it is actually received — when the money is available for your use. Income is received when it is credited to your account or when it is set apart in any way that makes it available to you. You do not need to have physical possession of the cash. For example, dividends or interest credited to your account by a bank is income, even if you do not remove it in cash. Using the cash method, you deduct expenses when they are paid.

The accrual method records all income due and received and all expenses incurred whether they are paid or not. Both credit and cash transactions are recorded when made, even if you do not receive the cash.

If you have a sales and manufacturing business or a service business that sells stock, the law requires you to use the accrual method. If you have no inventory, you can choose either method. Once you choose a method, you cannot change it, except with approval from the Internal Revenue Service (IRS). We will discuss accounting methods in more detail later in this lesson.



***Figure 1**: Keeping good records can help you plan for the future growth of your business.*

INCOME RECORDS

Income records help you keep track of money that comes into your business. The types of records you need depend on the kind of *income you collect*. If you sell products, you need a Sales Journal or Cash Receipts Journal. Cash receipts are amounts you actually receive, either as cash sales or as checks paid to you by your clients. If you offer a service or extend credit, you need an Income Ledger or an Accounts Receivable Ledger. Accounts receivable are simply amounts owed to you for services or goods that you have sold. For every transaction, record the date, a description of the transaction, the client's name, and the amount received or owed.

EXPENSE RECORDS

Expenses, or disbursements, include all money that goes out of your business. In general, try to pay everything with a business check, except for small items that you can pay for out of a petty cash fund. Always list the date, check number, amount, and purpose of each disbursement. Categorize your expenses so that you will be ready for the tax season. It's easy to use a debit card to make your purchases but be sure to keep an accurate record of your spending and be sure to get a receipt for all business related purchases.

ACCOUNTING PERIODS AND METHODS

When filing your business taxes you must choose your accounting period. The accounting period is the fixed period during which you calculate yearly income. The calendar year is the natural choice of most business owners, although some business prefer to use a fiscal calendar, which sets the date on a specific day/month and goes through a 12 month cycle, for example June 1, to May 31. Fiscal years vary between businesses and countries. The fiscal year may also refer to the year used for income tax reporting.

OTHER USEFUL RECORDS

There are several other records you should consider keeping, such as records of all tax and loan payments and all merchandise you purchase for resale purposes. It is also a good idea to keep financial statements. Financial statements are not required by law or for tax purposes, but they provide a record of basic financial information that can help your business prosper.

Financial statements are simply summaries of your financial condition. The two most important summaries are the income statement and the balance sheet. The income statement, sometimes known as a profit and loss (P&L) statement, shows the sources of income, the costs and expenses, and the profit or loss.

A balance sheet, also known as a statement of assets and liabilities, is a listing of your assets, liabilities, and net worth at any given time. Assets are everything your business owns and include current and long-term assets. Current assets usually include any asset that will be used or sold in the normal course of a business year, such as accounts receivable, inventory, and cash. Long-term assets are holdings that your business intends to keep and use for a year or longer. They can be financial assets, such as stocks, bonds, and savings accounts, or capital assets, such as real estate, equipment, and cars.

Liabilities are amounts that you owe. Short-term liabilities are any notes and loans due within one year, unpaid taxes, and tax penalties. Long-term liabilities are obligations payable in more than one year. When you compare the difference between your assets and liabilities, you arrive at the net worth of, or your equity in, your business.

ELEMENTS OF A GOOD RECORDS SYSTEM

Common sense will tell you what to put in your records system. You want to spend most of your time building your business, not putting down numbers in rows. So first of all you want your records system to be simple. You want it to be easy to set up, easy to keep, and easy to understand.

Your business's financial health depends on your ability to keep it organized, up-to-date, and legal. The Small Business Administration says that "an adequate records system helps increase the chances of survival and reduces the probability of early failure." You need a records system that is accurate and consistent, one that immediately gives you the information you need.

You will sometimes need to prove that your records are correct. A good records system maintains a paper trail of invoices and receipts. It shows what money went where, so that you can substantiate tax deductions and insurance claims.

SELF-TEST QUESTIONS

Please check your answers on page 24.

1. ***True or False*. Business records are something you can worry about after you get your business going.**
2. **Name some elements of a good records system.**
3. **What is a paper trail?**
4. ***True or False*. The best records system for a small business is simple and easy to keep.**

What Records Do You Need?

By business records, most people mean bookkeeping records. In this lesson we will look at bookkeeping as it applies to you. Bookkeeping basically works the same for all businesses, large or small. For small businesses, bookkeeping is simple and straightforward.

You will also need to keep insurance records and operating records. The particular records you need to keep depend on the type and volume of business you do.

BOOKKEEPING RECORDS

Bank Account. One of the first things you need to do when you go into business is open a business bank account. If you pay all of your business expenses by check (except for petty cash) and deposit all cash receipts, your Check Register will be a valuable record (Figure 2). Check entries will show the check number, the date, who received the check and why, the amount paid, and the running bank account total. Deposit entries will show the date, who it was received from, the amount, and the running bank account total. Your deposit slips are an important part of your income paper trail.



***Figure 2:** A business checkbook can help you keep track of your expenditures if you keep accurate records.*

To avoid confusion with your personal finances, it is a good idea to use an employer identification number (EIN) instead of your social security number for the taxpayer ID required on your business account. To get your EIN, call the nearest IRS office and ask for an IRS Form SS-4, Application for Employer Identification Number. You can also apply online at https://sa2.www4.irs.gov/modiein/individual/index.jsp. You do not have to employ anyone to qualify for an EIN. Your EIN should be mailed to you within two to four weeks.

Income and Expense Ledgers. You will need ledgers for recording your income and expenses. A ledger can be a pad with the pages divided into columns, such as the one shown in Figure 3. You can buy them bound or keep them in a file folder or loose leaf notebook. They are available from any office supply store.

Income is every dollar and penny your business earns, from fees charged clients, interest on cash in the bank, and any other earnings. The key word is earnings. Funds obtained through a loan, any contributions of funds by yourself or an investor, insurance recovery for a loss, or similar funds are not business income. You should make a note of non-income funds in your Income Ledger and clearly distinguish them from income.

Expenses are incurred by your business for ordinary, necessary, and reasonable expenditures. Ordinary means that such expenses are common in your kind of business. Necessary, according to the IRS, means that "they are appropriate and helpful in developing and maintaining your trade or business." Reasonable means any expense that meets the three conditions mentioned: incurred by your business, ordinary, and necessary.

Some expenses are not considered legitimate business expenses. One example is money you take out of your business for your own use, called a personal draw. Another example is any mixed business and personal expense. Only the business part can be entered as an expense. A sample Expense Ledger is shown in Figure 4.

Accounts Receivable. Every time you send out an invoice, or bill, to a customer for payment, you need to record an account receivable. The entry should show the date sent, to whom sent (with account number if applicable), the service performed, and the payment due date. The Accounts Receivable Ledger, such as the one in Figure 5, on page 8, should also have a running total so that you can tell at a glance what money you will have coming in.

Acme Services
Income Ledger
Jan. 1, 19XX – March 31, 19XX

	Initials	Date
Prepared By		
Approved By		

	DATE		RECEIVED FROM	ACCT NO.	1 INVOICE NO.	2 AMT.	3 YTD Total
1	1	9	AGHI	43	012	4024 –	4024 –
2	1	11	J. Doe Associates	41	004	400 –	4424 –
3	1	16	DCI	44	020	175 –	4599 –
4	1	19	D. Elprin	45	501	500 –	5099 –
5	1	20	J. Doe Associates	41	005	425 –	5524 –
6	1	24	American Supplies	46	021	200 –	5724 –
7	2	10	D. Elprin	45	022	1100 –	6824 –
8							

Figure 3: *Make a note in your Income Ledger of all income.*

Acme Services
Income Ledger
Jan. 1, 19XX – March 31, 19XX

	Initials	Date
Prepared By		
Approved By		

	DATE		RECEIVED FROM	ACCT NO.	1 INVOICE NO.	2 AMT.	3 YTD Total
1	1	9	AGHI	43	012	4024 –	4024 –
2	1	11	J. Doe Associates	41	004	400 –	4424 –
3	1	16	DCI	44	020	175 –	4599 –
4	1	19	D. Elprin	45	501	500 –	5099 –
5	1	20	J. Doe Associates	41	005	425 –	5524 –
6	1	24	American Supplies	46	021	200 –	5724 –
7	2	10	D. Elprin	45	022	1100 –	6824 –
8							

Figure 4: *You should keep an Expense Ledger for ordinary, necessary, and reasonable expenses.*

Acme Services
Accts. Receivable
April 1, 19xx - June 30, 19XX

	Initials	Date
Prepared By		
Approved By		

	Invoiced		CLIENT/SERVICE	DUE	1 AMT. PAID	2 AMT. DUE	3 TOTAL OUTSTANDING
1	4	7	M. Johnson/services	5/7		300—	6016—
2	4	11	J. Doe Assoc./services	5/7		200—	6216—
3	4	13	DCI/Services	5/14		3984—	10200—
4							
5	5	16	D. Justin		1500—		8700—
6	5	16	AGHI/Services	6/30		1664—	10364—
7							
8							

Figure 5: Record an account receivable for every invoice or bill you send out.

Acme Services
Accts. Receivable
April 1, 19xx - June 30, 19XX

	Initials	Date
Prepared By		
Approved By		

	Invoiced		CLIENT/SERVICE	DUE	1 AMT. PAID	2 AMT. DUE	3 TOTAL OUTSTANDING
1	4	7	M. Johnson/services	5/7		300—	6016—
2	4	11	J. Doe Assoc./services	5/7		200—	6216—
3	4	13	DCI/Services	5/14		3984—	10200—
4							
5	5	16	D. Justin		1500—		8700—
6	5	16	AGHI/Services	6/30		1664—	10364—
7							
8							

Figure 6: An Accounts Payable ledger will help you keep track of money that you have committed to pay.

Accounts Payable. If you pay all your bills as they come in, you will have no accounts payable to record. But if you have bills you hold until their due date or until customers' payments come in, or if you have many bills to pay, you need to create an Accounts Payable Ledger, such as the one shown in Figure 6. An Accounts Payable Ledger will help you keep track of money that you have committed to pay and that is not available for spending. The Accounts Payable Ledger will list when the bill is due; to whom you owe the money, and how much you owe. This ledger also includes a block for indicating when you issued the check.

Petty Cash. For most small businesses, it is a good idea to set up a petty cash fund to pay for purchases under $25. To keep a record of petty cash withdrawals, cash a business check made out to "petty cash" at your bank. Keep a pad in a lockbox with the cash and enter each withdrawal of cash, with its purpose, on the pad. In addition, keep a cash receipt or signed petty cash voucher (these forms are available in most office supply stores) in the box for each withdrawal.

OTHER RECORDS

Insurance. If your business maintains one or more insurance policies — liability, accident, health, or casualty (fire or theft) — you should keep a list showing the insurance company, policy number, coverage, premium amount, and premium due date for each policy.

Operating Records. Operating records include files you must keep, job orders and forms, and lists of customers and prospective customers. The operating records you keep depend on what you do with your business. Follow this rule of thumb for keeping operating records: If you think you might need it down the road, keep it. A standard business journal, available at office supply stores, comes in handy for marking down miscellaneous facts and figures (Figure 7).

SELF-TEST QUESTIONS

Please check your answers on page 24.

5. ***True or False*. A loan from the bank is recorded as income when the cash is actually received.**
6. **What are the three conditions for a reasonable business expense?**
7. **What information does your check register contain?**

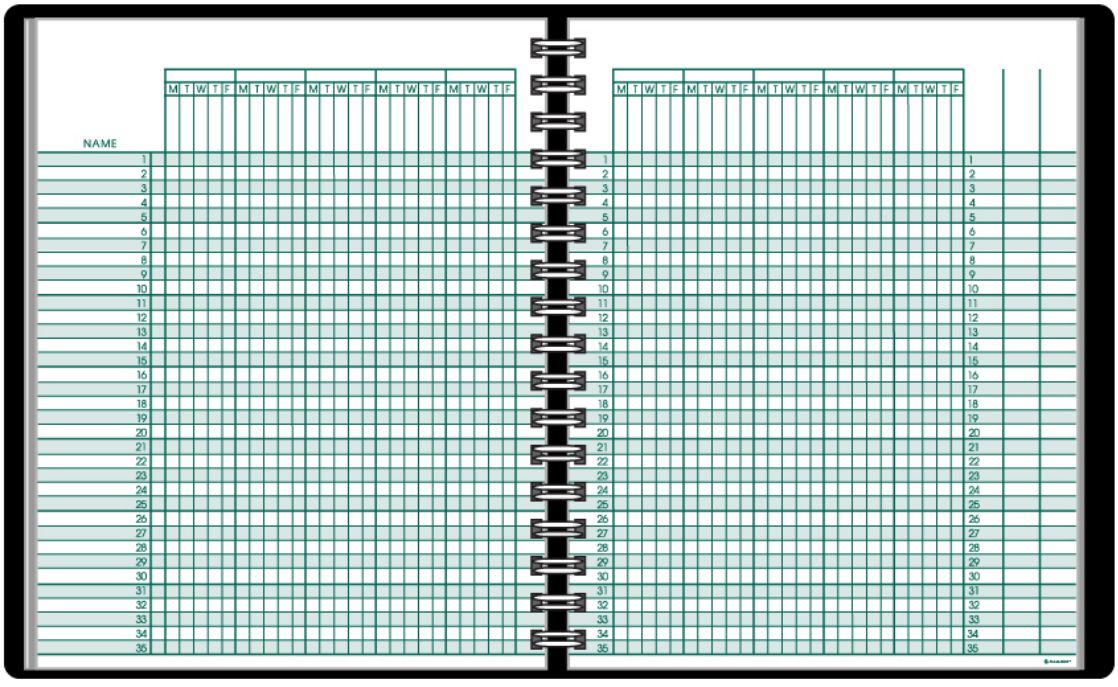


Figure 7: A standard notebook works fine to keep track of miscellaneous expenses but a 'bookkeeping records' book is better to keep your records organized.

Setting Up a Bookkeeping System

This section covers some simple bookkeeping systems you can set up for your new business. We will look at the differences between cash and accrual systems, at setting up simple charts of accounts and ledgers, and at the business reports you will need to produce for your new business.

CASH VS. ACCRUAL SYSTEMS

Many small service businesses keep cash books rather than use an accrual system. In business bookkeeping, cash means checks, checking accounts, and currency. Keeping cash books means that you record expenses when you pay them and that you record income when you receive payment. Cash accounting is the easiest bookkeeping method for small businesses that offer services instead of merchandise kept in stock.

Accrual accounting provides a more accurate financial picture for firms with a heavy cash flow. Expenses are entered in the books when they are incurred, and not necessarily when they are paid. Income is entered as it is earned, often even before the customer is billed. If you were operating a sales or manufacturing business or were keeping an inventory of merchandise for resale, IRS rules probably would require you to use the accrual method.

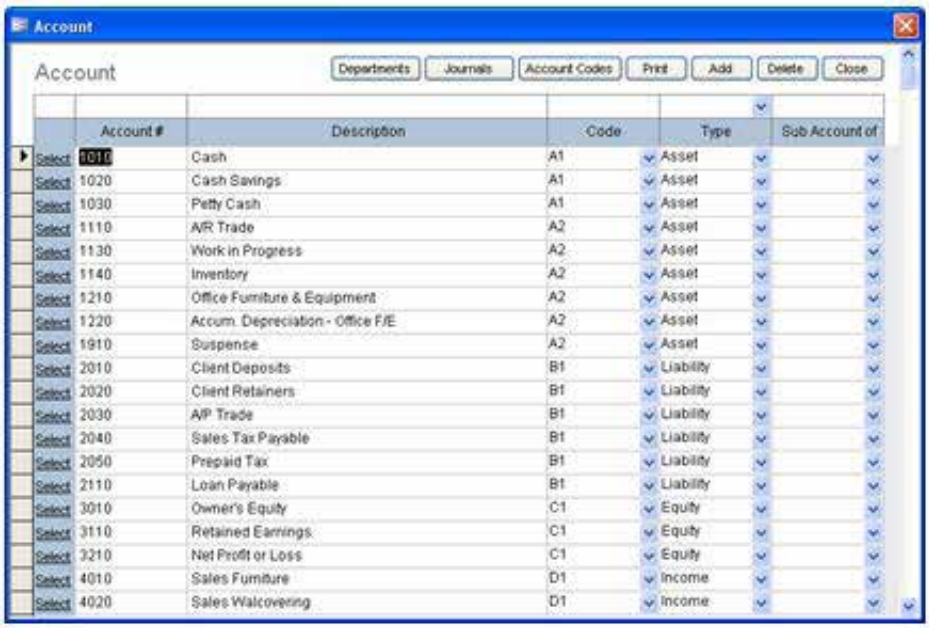
Since most small businesses use a cash accounting system rather than an accrual system, this lesson deals with cash accounting. One caution: Once you adopt a cash accounting method, you will need IRS approval to change to the accrual method.

Chart of Accounts. You will need to set up a *Chart of Accounts*, which is simply a list of account categories. Figure 8 is a sample Chart of Accounts. In cash accounting, you use the Chart of Accounts to classify expenses and income. You will set up some accounts (such as automobile expenses and entertainment) because you will need to report these expenses separately on your tax returns. You will set up other accounts (such as administrative expenses, utilities, or periodicals) so that you can keep track of business transactions and measure your progress.

The sample Chart of Accounts shown in Figure 8 on the next page probably has more expense categories than you will need. You can eliminate some categories and combine or rename others to suit your particular business.

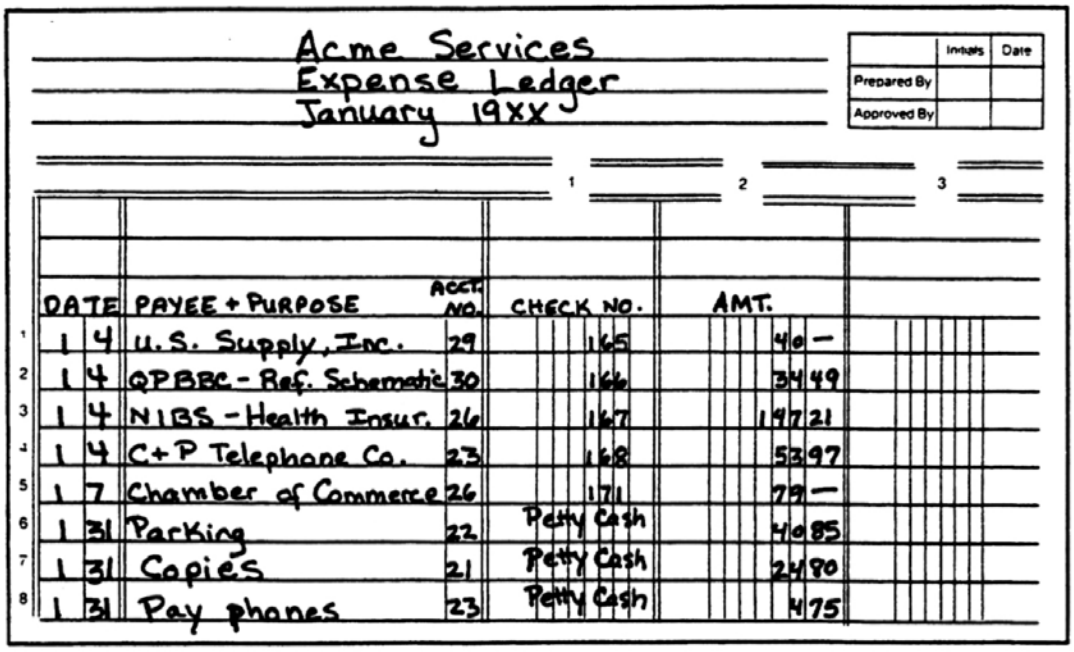
Keeping Simple Ledgers. With your Chart of Accounts set up and each account numbered, you are ready to set up your Expense and Income Ledgers. You can use a two-column pad, or you can buy simplified bookkeeping records, with ledgers already set up, at an office supply store.

If you set up your own Expense Ledger, write your business name at the top of a sheet, "Expense Ledger" on the next line, and the month and year on the next, as shown in Figure 9.



	Account #	Description	Code	Type	Sub Account of
Select	1010	Cash	A1	Asset	
Select	1020	Cash Savings	A1	Asset	
Select	1030	Petty Cash	A1	Asset	
Select	1110	A/R Trade	A2	Asset	
Select	1130	Work in Progress	A2	Asset	
Select	1140	Inventory	A2	Asset	
Select	1210	Office Furniture & Equipment	A2	Asset	
Select	1220	Accum. Depreciation - Office F/E	A2	Asset	
Select	1910	Suspense	A2	Asset	
Select	2010	Client Deposits	B1	Liability	
Select	2020	Client Retainers	B1	Liability	
Select	2030	A/P Trade	B1	Liability	
Select	2040	Sales Tax Payable	B1	Liability	
Select	2050	Prepaid Tax	B1	Liability	
Select	2110	Loan Payable	B1	Liability	
Select	3010	Owner's Equity	C1	Equity	
Select	3110	Retained Earnings	C1	Equity	
Select	3210	Net Profit or Loss	C1	Equity	
Select	4010	Sales Furniture	D1	Income	
Select	4020	Sales Walcovering	D1	Income	

Figure 8: *Sample shown is standard chart of accounts from a computerized bookkeeping program, you can easily create your own chart of accounts on ledger paper if you prefer not to use a computerized system for your record keeping.*

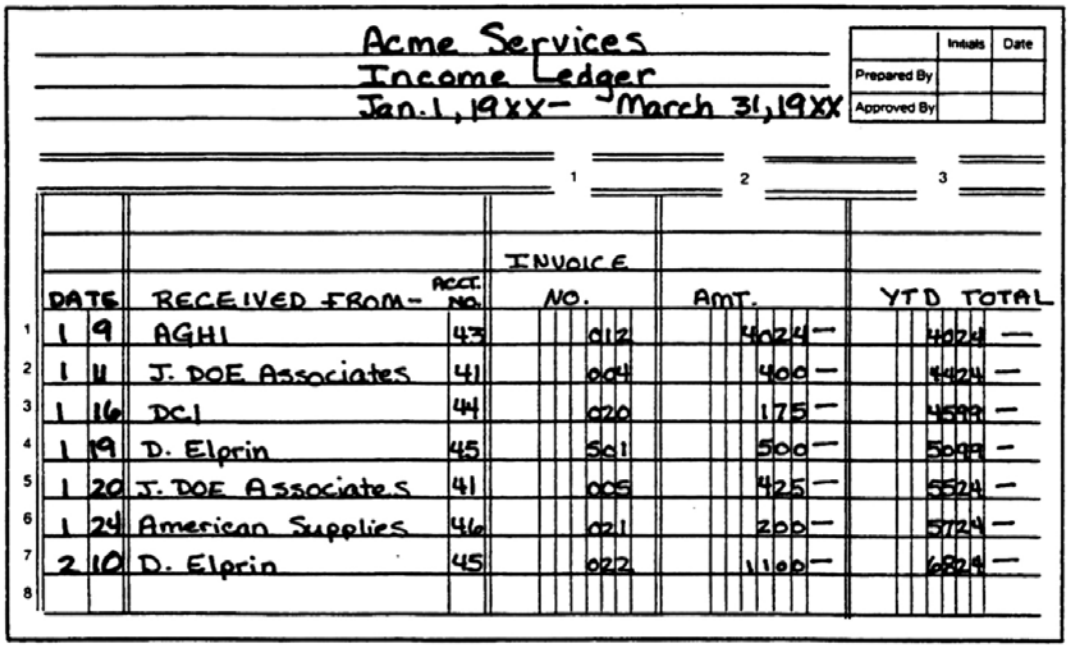


Acme Services
Expense Ledger
January 19XX

	Initials	Date
Prepared By		
Approved By		

	DATE	PAYEE + PURPOSE	ACCT. NO.	CHECK NO.	AMT.
1	1 4	U.S. Supply, Inc.	29	165	40 —
2	1 4	QPBBC - Ref. Schematic	30	166	34 49
3	1 4	NIBS - Health Insur.	26	167	197 21
4	1 4	C+P Telephone Co.	23	168	53 97
5	1 7	Chamber of Commerce	26	171	75 —
6	1 31	Parking	22	Petty Cash	4 0 85
7	1 31	Copies	21	Petty Cash	2 4 80
8	1 31	Pay phones	23	Petty Cash	4 75

Figure 9: *If you choose a cash accounting system, set up your Expense Ledger as shown here.*



Acme Services
Income Ledger
Jan. 1, 19XX – March 31, 19XX

	Initials	Date
Prepared By		
Approved By		

	DATE	RECEIVED FROM –	ACCT. NO.	INVOICE NO.	AMT.	YTD TOTAL
1	1 9	AGHI	43	012	4024 —	4024 —
2	1 11	J. DOE Associates	41	004	400 —	4424 —
3	1 16	DCI	44	020	175 —	4599 —
4	1 19	D. Elprin	45	561	500 —	5099 —
5	1 20	J. DOE Associates	41	005	425 —	5524 —
6	1 24	American Supplies	46	021	200 —	5724 —
7	2 10	D. Elprin	45	022	1100 —	6824 —
8						

Figure 10: *Set up your Income Ledger as shown here.*

Mark the first column "Date," and mark the second, extra-wide column "Payee & Purpose" and "Acct. No." Mark the next column "Check No.," and the next "Amount." Each time you pay a bill, enter the information in its column. Under "Acct. No.," put the expense category number for each expense.

On your Income Ledger, write your business name at the top, "Income Ledger" on the next line, and the current period on the third line, as shown in Figure 10.

Mark the columns "Date," "Payor" or "Received From" and "Acct. No.," "Invoice No." (you may prefer not to number your invoices), "Amount," and "Year-to-Date (YTD) Total." As each payment comes in, enter the information in the appropriate column.

You will have to decide whether to categorize your receipts by job type or by client. Whichever method you choose, each account or category should be assigned its own account number. If you choose to categorize your income by customer, put the customer's account number in the Acct. No. column. If you choose to categorize your income by job type, put the job-type account number in the Acct. No. column.

REPORTS

At the beginning of this lesson, we mentioned why it is important to keep business records: to keep track of money, to give you information for planning, to preserve the data you need to get tax credit, and to meet income tax requirements. To put the information into a usable form, you prepare reports based on the ledgers and your petty cash log. The most important bookkeeping reports you prepare will be the income statement, balance sheet, and summary of expenses by account.

An income statement, such as the one shown in Figure 11, summarizes your income and expenses for a given period. The difference between your income and expenses is called your before-tax income, before-tax profit, or loss.

A balance sheet, such as the one shown in Figure 12, lists business's assets (including equipment and real estate) and liabilities (outstanding bills and long-term debts). Assets are usually listed in the order of liquidity, or how quickly an asset can be turned into cash. The difference between assets and liabilities is owner's equity, also called capital or net worth. Both income statements and balance sheets will be important to bank loan officers or investors when you apply for credit.

A summary of expenses by account is to show where you are spending your money. This summary lets you see where you need to cut back and where you need to spend more. It also contains information you will need for preparing your income tax return.

Summary of Expenses by Category. You also need to summarize your expenses by category to check against your budget. This comparison is useful for estimating income taxes, for tracking where your money goes, and for planning your business's future. In your Expense Ledger, you should assign each

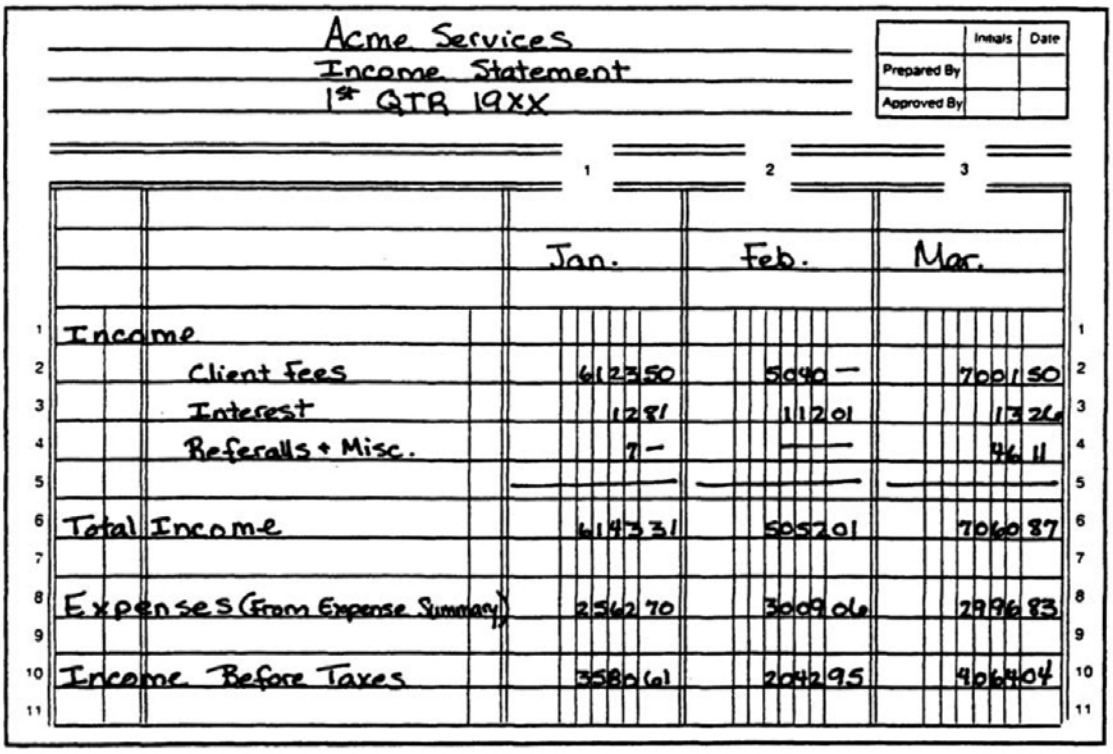


Figure 11: An income statement summarizes your income and expenses for a given time.

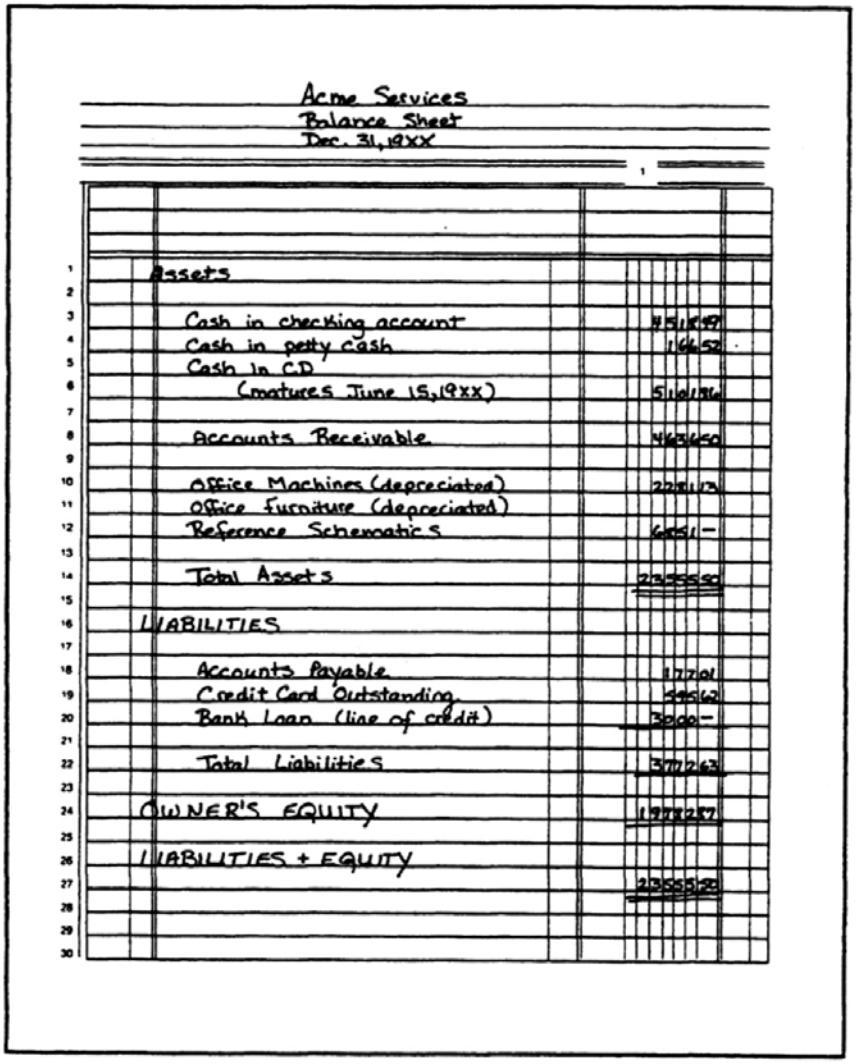


***Figure 12**: You will ordinarily prepare a balance sheet every year and whenever necessary for loan applications and investor reports.*

expenditure an account number indicating whether the expense is for administration, advertising, rent, utilities, or some other category, as shown back in Figure 4. Then, you should regularly add the expenditures for each category and record the totals in your summary of expenses by account. Details on how to keep these records are laid out later in this lesson.

SETTING UP A BOOKKEEPING SCHEDULE

Your bookkeeping schedule will include tasks you perform continuously, daily, or nearly daily. There will also be monthly, quarterly, and annual tasks.

One continuous record-keeping task for many service businesses is time-keeping, as shown in Figure 13 on the next page. If you charge for your services by the hour, you should keep precise time-use records. Many firms prepare forms for recording staff time in 15-minute increments. Some small businesses record time less formally on appointment calendar forms. For all your work, you should record the date, time of day, task or service, and customer.

Depending on the volume of your transactions, you will need to file receipts and pay bills continuously, daily, or at least often enough that they do not pile up. A receipt filing system can be as simple as a series of envelopes labeled by month.

If you do not receive many bills, you can pay them as they come in. If your business has many credit accounts, you may want to delay paying bills until they are due. One common method is to prepare a set of folders, with one folder for each day of the month, and file bills according to their due dates.

Another daily, or near daily, chore is to maintain your ledgers. Expenses paid out and income received should be entered at the time of the transaction. Monthly tasks include summarizing expenditures by account and reconciling your checking account.

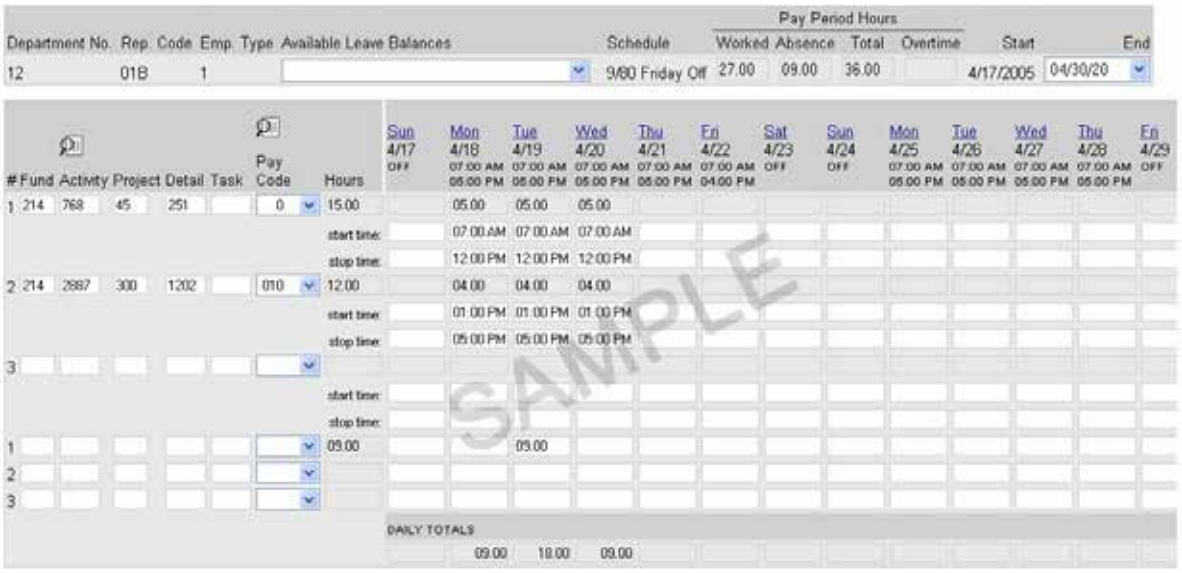


Figure 13: Keeping accurate record of your time is an important file to keep.

SUMMARY OF EXPENSES BY ACCOUNT

To summarize expenditures by account, prepare a sheet, such as the one in Figure 14, with columns headed: "Acct. No.," "Account Name," "Amount," and "Total YTD." In the " Acct. No." column, list all your expenditure accounts by number. In the "Account Name" column, list all the accounts by name. Then, for each account, add all the expenditures charged to that account from your Expense Ledger and from your petty cash log and enter the total for the month. Add each account's monthly total to its year-to-date total. The sum will be the immediate past month's year-to- date total. Enter this number for each account in the Total YTD column.

BANK RECONCILIATION

Follow these steps to reconcile your checking account statement:

1. Compare your bank statement to your check register, and check off each transaction recorded on the bank statement in the check register.

2. On a pad with columns, enter the final balance shown on the bank statement.

3. Add to this figure the amounts of all deposits or other credits shown in your check register that are not on the bank statement.

4. Subtract the amounts of all checks and other debits shown in your check register that are not on the bank statement.

5. Compare the figure with the final balance shown in your checkbook.

6. If they do not agree, check for overlooked items and mistakes in arithmetic.

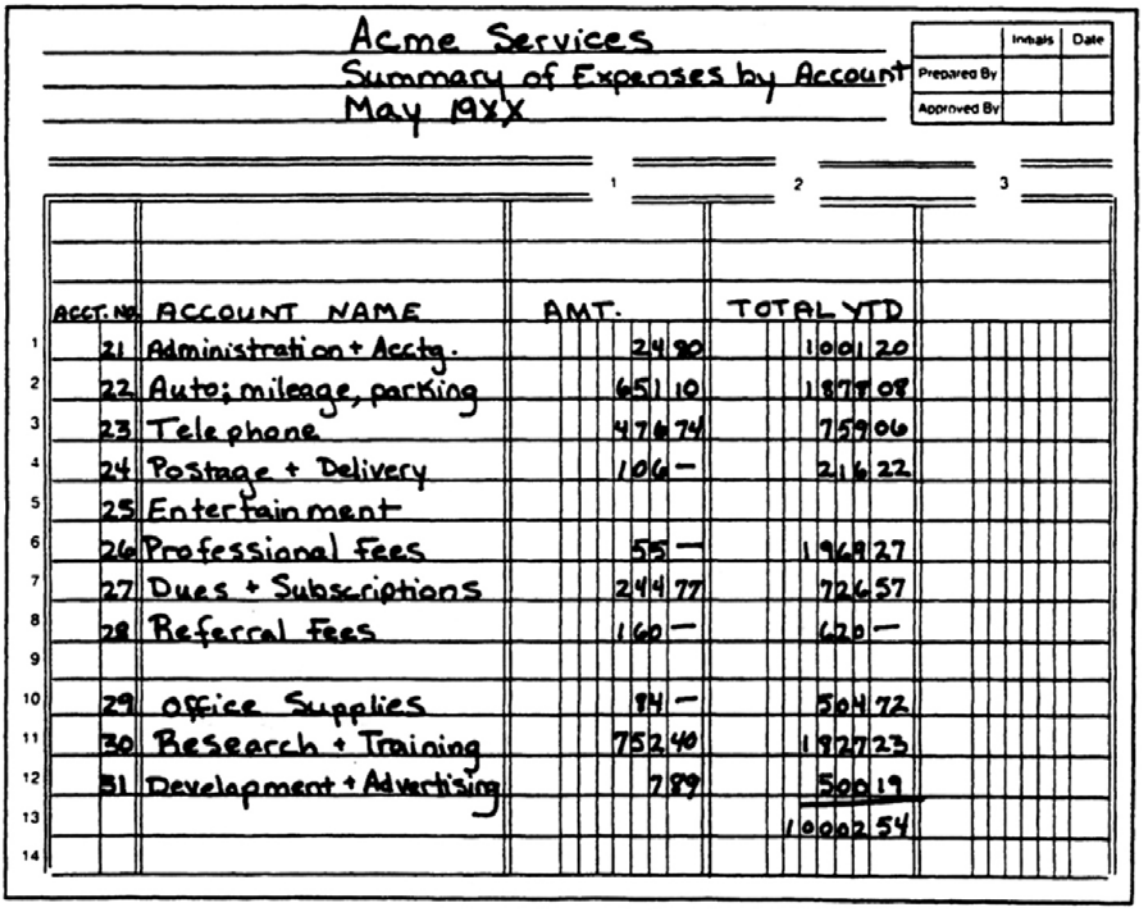
Most banks provide reconciliation worksheets on bank statements. They also offer assistance when your records and the bank's records do not agree.

INCOME STATEMENT

Depending upon the volume of your business, you will prepare an income statement quarterly or annually. For a service business with no merchandise inventory, the income statement is simple. You simply list all your income and deduct your expenses. Anything left over, after subtracting taxes, is net income. You will need the income statement, along with your balance sheet, to apply for credit or a loan at a bank or other lender.

BALANCE SHEET

A balance sheet discloses your business net worth by summarizing your assets (cash on hand, accounts receivable, investments, and property) and your liabilities (accounts payable and debts). The value of your assets minus your liabilities equals your business's net worth, or owner's equity. Your banker or prospective investors need to know your net worth to decide whether



Acme Services
Summary of Expenses by Account
May 19XX

	Initials	Date
Prepared By		
Approved By		

	ACCT. NO.	ACCOUNT NAME	AMT.	TOTAL YTD
1	21	Administration + Acctg.	24 80	1001 20
2	22	Auto; mileage, parking	651 10	1878 08
3	23	Telephone	476 74	759 06
4	24	Postage + Delivery	106 —	216 22
5	25	Entertainment		
6	26	Professional Fees	55 —	1969 27
7	27	Dues + Subscriptions	244 77	726 57
8	28	Referral Fees	160 —	620 —
9				
10	29	Office Supplies	84 —	504 72
11	30	Research + Training	752 40	1927 23
12	31	Development + Advertising	789	500 19
13				10002 54
14				

***Figure 14**: In your Expense Ledger, assign each expenditure an account number that indicates its account category and amount. Then add the expenditures for each account and record the totals in your summary of expenses by account.*

or not to loan you money or invest in your business. Ordinarily you will prepare a balance sheet every year and whenever you need one for loan applications or investor reports.

The traditional way to prepare a balance sheet is to list items on each section of the ledger — the asset section and the liability section — in order of liquidity. Thus, under assets, cash goes first, readily available investments second, long-term investments third, and personal property and real property last. Next, list liabilities in order of immediacy, from most pressing to least. List bills due tomorrow before credit payments due next month, which come before loan payments due every quarter, and so forth.

If you have used property as collateral to borrow money, the cash from that loan and the full value of that property appear on the asset side of your balance sheet. The outstanding balance of the loan appears on the liability side.

SOCIAL SECURITY AND INCOME TAX REPORTS

Most small service businesses operate as sole proprietorships. This means that you simply set yourself up as the business. When you work for someone else, your employer deducts social security payments and withholds part of your income to pay federal and state (and sometimes local) income taxes. Now that you are in business for yourself, you will need to set aside money to pay your taxes. If you need help, you can get forms for estimating your income and self-employment taxes from your local IRS office. Be sure to note that estimated taxes are due several times throughout the year. The bookkeeping method described here will provide you with all the data you need to prepare your annual income tax return.

HOW LONG SHOULD YOU KEEP RECORDS ON FILE?

You should file and keep all your accounting records and supporting documents (the paper trail) for at least five years. You will need records from the last three years if the IRS questions your returns. You will need records from the last five years to assess your business development and to plan its future.

SELF-TEST QUESTIONS

Please check your answers on page 24.

8. **Why do you need to summarize your expenses by category?**
9. **Name two bookkeeping tasks ordinarily performed monthly.**
10. **What are the five column headings for your Expense Ledger?**
11. ***True or False*. If you choose the cash method of accounting and do not like it, you can easily switch to the accrual method.**
12. **Name the three most important bookkeeping reports.**
13. **Which would come first on the asset section of your balance sheet, $500 in your checking account or a $1,000 certificate of deposit?**

Computer-Aided Bookkeeping

Small businesses usually rely on personal computers to keep their books — either their own computer or an outside bookkeeper's. A computer can perform multiple bookkeeping tasks for the small business, from keeping the general ledger to tracking inventory. A computer cannot take over the bookkeeping tasks for you, but it simplifies the process and makes it easier for the inexperienced bookkeeper.

If you plan to use a personal computer to keep the books for your business, there are a number of bookkeeping software packages on the market. It is a good idea to choose simplified bookkeeping and accounting software designed for service business bookkeeping. Software designed for non-accountants who keep their own books may be best. Some examples are Quicken or QuickBooks, both which offer all the components you need to keep accurate records. Keep in mind, just because the software says it can keep accurate records, YOU must be sure to enter accurate information for the information to be accurate.

When shopping for a bookkeeping software package, look for one that uses everyday language, rather than accounting jargon. If the program uses language and terms that you do not understand, you will not fully benefit from it. The program's displays should look like real bookkeeping forms and documents. For example, the check-writing screen should look like a regular check and the check-register screen should look like the register you keep manually. The more familiar the items in the program are to you, the quicker you can start using that program to keep your company's books.

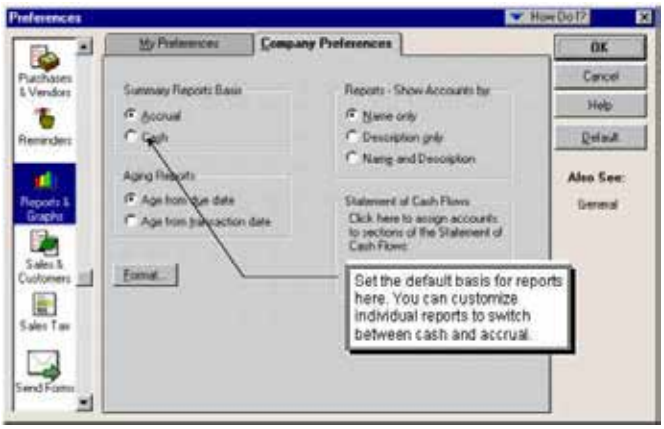


Figure 15: An example of a Quicken window where you can choose from a Cash or Accrual accounting system.

There are many simplified accounting programs on the market, and one of these is probably sufficient for your small business. However, for the more experienced bookkeeper, spreadsheets and database programs can be useful. These kinds of programs can be customized to fit your business needs, but they require a greater knowledge of accounting procedures.

DATABASE MANAGEMENT

While the term "database management" sounds technical, it is really quite simple. Database management is a fancy term for making lists. Although the word "database" did not appear in print until the 1960s, when it first made its way from the computer room into the dictionary, the idea has been around a long time. A database is information organized for rapid retrieval.

Using this definition, can you think of a database you can hold in your hand? What about the phone book? It organizes information the same way a computer database organizes information. It lists individual entries of telephone subscribers and gives information related to each entry: last name, first name, address, and phone number.

A computer database is nothing more than a set of files that stores items of information in groups. It is the principle of the telephone directory applied electronically. Of course, a database can be a lot more complicated than a simple listing, depending on how much information is stored and what the user wants to do with the information.

The telephone directory lists a few items of information for each entry, and each entry is sorted by last name. Because it is printed media, you cannot change it or add to it and you cannot use it if you do not know the last name or business name of the entry.

A database program, on the other hand, can take the same information that is listed in a telephone directory and sort it, list it, and break it up into big or little groups. Each main entry could be associated with other items, and each of those items could have items associated with it. The program can then be instructed to sort one, some, or all of the main entries by any of the associated items. You could, for instance, sort by the first name "Fred" to search for your friend's number. If you knew the town he lived in or the name of his street, you could sort by Fred and the town or street to further narrow the search.

With every electronic database, you can do certain basic things: enter information (input), change information (update), look at information (query), and print reports (output). At the telephone company, they input your name, address, and phone number in the telephone directory database when you first get

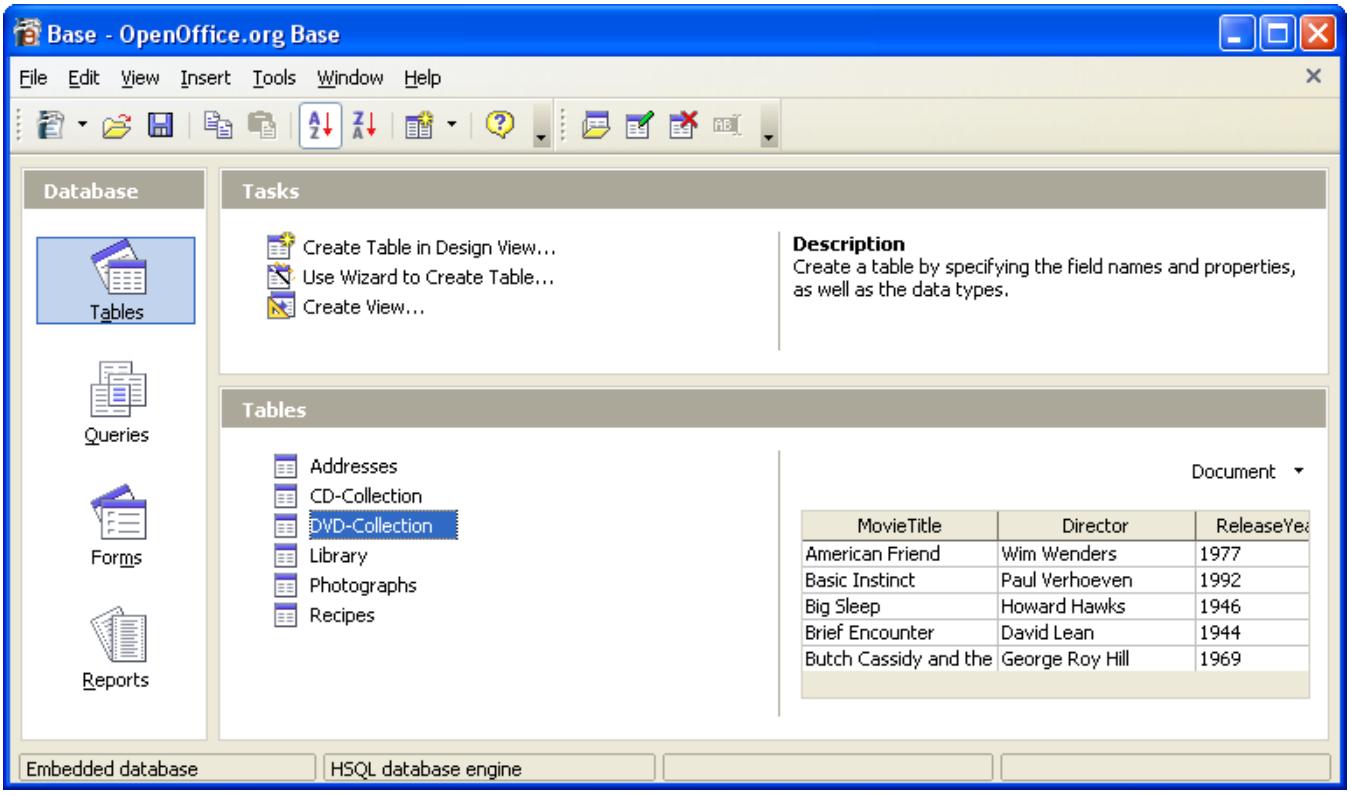


***Figure 16**: Sample of a simple database created using Open Office.*

your phone installed. When you move or change your number, the phone company updates your entry. Once a year, they output a new report and drop it on your doorstep. Although you might not think of it this way, when you look up the number for a plumber in the yellow pages, you are querying a database.

In a typical computer database, the program manipulates information stored in data files. Each file contains groups of information called records. And each record contains individual pieces of information called fields. It works like the telephone directory: the directory contains a group for each letter of the alphabet (files). Each letter group has entries for individual people (records). And each entry contains pieces of information (fields) for each person: name, address, and phone number. A simple database can keep track of who owes the business money and how much or to simply keep track of your dvd collection (Figure 16).

Businesses maintain databases to store all kinds of information. They keep mailing lists of their customers and creditors. They keep records of what, where, and when their salespeople sell. When employees travel for the company, they keep an expense record so that when they get back, they can hand in a copy to be recorded in the sales database. With all this database information, the business can analyze performance: Whom does the company do the most business with? Which day of the week is the slowest business day? What promotional campaign is getting the most new clients? How much is the business getting in return for entertainment expenses?

A computer database management program can help companies answer these questions. By manipulating information in the database, they can turn out reports that display information in different ways. Users can then interpret the information and decide what it means to the company.

Any organization with more than a few employees has to keep payroll and personnel records: hours and pay scale, annual and sick leave, health benefits, and so forth. Many businesses use database programs to maintain their inventory records. Bookstores and bakeries, hospitals and horse farms use computers to keep track of what is in stock, what has been used, and what is on order.

SPREADSHEETS

Computer spreadsheet programs are the number crunchers of the software world. They make tracking money in a business easier and more efficient. As a result, almost everyone in business uses a spreadsheet program of some sort – every manager, bookkeeper, accountant, personnel administrator, small business owner, and anyone else who must keep tabs on time, money, or inventory.

In the past, accounting departments prepared their financial analyses on paper, totaled them by hand or on an adding machine, had them typed up, and then handed the results to the boss — a time-consuming, multi-person task. Today, the average accounting department is more likely to prepare a spreadsheet on a personal computer, print it out, and hand it to the boss — a quick, one-person task.

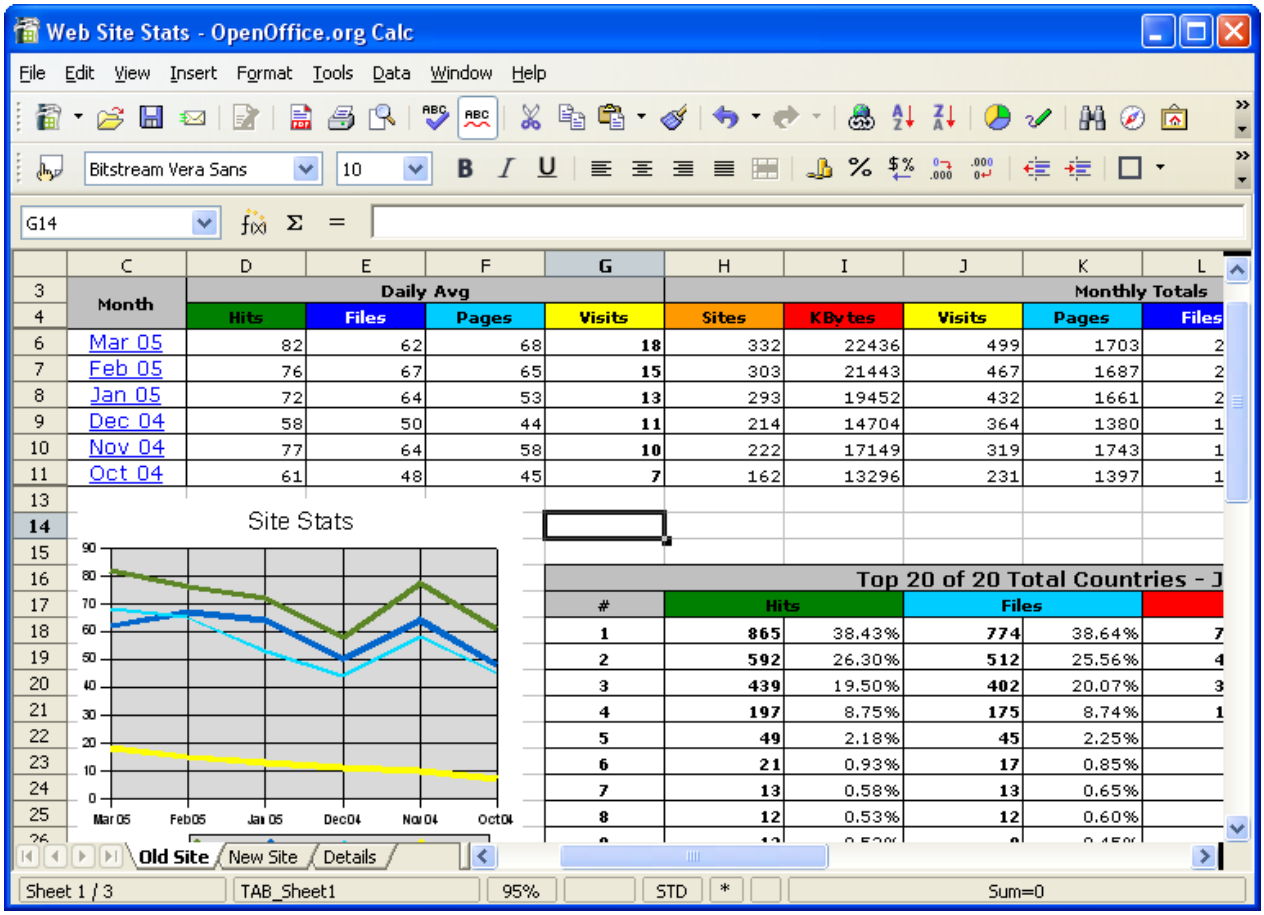
Spreadsheets are among the most popular and widely used business programs. Companies use spreadsheets to tabulate sales, count inventory in stock, project staffing needs, track accounts payable and accounts receivable, maintain the payroll, and perform many other tasks involving numbers. A spreadsheet program lets you do on computer the same things previously done on paper. A sample spreadsheet screen is shown in Figure 17.

A spreadsheet works this way: The program displays a blank grid form full of cells. A cell can contain a number, label, or formula. The cells are arranged in columns and rows. Into each cell you can enter a number to represent a sales figure, a date, a dollar amount, a number of parts in inventory, and so on. A cell can also contain identifying letters and words, called labels. For instance, you could put labels on the cells across the top and down the sides, just as if you were making a table on paper. Finally, the cells can contain a formula that performs a mathematical calculation.

The information you enter on the screen goes into a data rue, called a worksheet. The worksheet can be one or more pages long, depending on how much information you put in. The worksheet stores the information and remembers which numbers go in which cells the next time you use it. The program then sets up the spreadsheet and the data file fills it in.

Each cell is identified by its row and column. For example, cell C3 might hold the sales figure for February; D5, the advertising cost for April; and so on. If you were entering the data from written sales records, you would move around on the screen from cell to cell, typing in each entry.

After you enter the information, the program calculates the figures based on the formulas you have provided. For instance,



	C	D	E	F	G	H	I	J	K	L
3		Daily Avg				Monthly Totals				
4	Month	Hits	Files	Pages	Visits	Sites	KBytes	Visits	Pages	Files
6	Mar 05	82	62	68	18	332	22436	499	1703	2
7	Feb 05	76	67	65	15	303	21443	467	1687	2
8	Jan 05	72	64	53	13	293	19452	432	1661	2
9	Dec 04	58	50	44	11	214	14704	364	1380	1
10	Nov 04	77	64	58	10	222	17149	319	1743	1
11	Oct 04	61	48	45	7	162	13296	231	1397	1

	Top 20 of 20 Total Countries - J				
#	Hits		Files		
1	865	38.43%	774	38.64%	7
2	592	26.30%	512	25.56%	4
3	439	19.50%	402	20.07%	3
4	197	8.75%	175	8.74%	1
5	49	2.18%	45	2.25%	
6	21	0.93%	17	0.85%	
7	13	0.58%	13	0.65%	
8	12	0.53%	12	0.60%	

Figure 17: Sample of a spreadsheet created using Open Office.

you might tell the computer to add quarterly sales figures by stating that cells M3 = B3 + C3 + D3 and so on.

As you add numbers, change numbers, or move numbers around, the program recalculates the totals for you. Like the computer, the spreadsheet cannot do anything you do not tell it to do. You have to know what you want it to do, and you have to enter that as a formula. For instance, if you want the program to add the numbers in three cells in the A column, you must tell it that A4 = Al + A2 + A3.

Of course, a formula can be much more complex than this. Depending on the program's capabilities and your expertise, you can set it up to compute percentages and averages, to divide sales into categories, or to calculate the returns from a direct mailing. Once the formulas and the data are in place, you can tell the computer to calculate, which it does faster and more accurately than a person can.

The computer quickly adds and subtracts, multiplies and divides, takes percentages and square roots, and then prints out a spotless report. All you have to do is enter the data accurately and make sure there's paper in the printer.

Forecasting, Budgeting, and Scheduling. The same sales figures that described what happened last month can be used to predict the sales performance for next month, next quarter, or next year. A spreadsheet program allows you change variables and apply them to the figures to show what would happen under different circumstances. How would a 10% reduction in travel expenses affect the budget? If you offer a limited-time discount on a service, how would it affect your income for the following month? The spreadsheet functions can be much more complex than these simple examples indicate.

Similarly, a spreadsheet that maintains a company's inventory can be programmed to perform involved analyses. Which products sell best in the summer months? Which products are chronically overstocked? Which product's stock is running low?

A spreadsheet program can compile the data to answer these questions, and it can give the answers in different forms for different uses. Because accountants use numbers all day long, a spreadsheet table makes perfect sense to them. But a non-accountant may not have such an easy time making sense of long columns of figures. Fortunately, once a worksheet is complete, a spreadsheet program can convert the data into charts that communicate the same information in a more understandable form. Software graphics capabilities let the user turn a table of data into a bar graph, pie chart, or line chart to make the spreadsheet's data visually interesting as well as easier to understand.

INTEGRATED PROGRAMS

A single program that combines the functions of a spreadsheet, database, and word processor is called an integrated program. The different functions in an integrated program can "talk to each other." For instance, sales records held in the database can be transferred to the spreadsheet for calculation without retyping the information. Information from the spreadsheet can then be transferred to the word processor to print a monthly report. Microsoft Office is an integrated program but can be costly. If you don't have the money in your budget for this type of program you can use a freeware program like Apache *Open Office,* (openoffice.org) which gives you the features of a spreadsheet, database, word processing program all in one, without the expense. Fortunately both programs work seemlessly together.

SELF-TEST QUESTIONS

Please check your answers on page 24.

14. What is a database?

15. What are some possible uses for a spreadsheet?

Working with an Outside Bookkeeper

When you start your business, you will need to decide early on whether you want to keep your own books or hire a bookkeeper. The most common practice for those starting small is to keep your own books. Still, that does not apply to everyone.

HIRE A BOOKKEEPER OR KEEP YOUR OWN BOOKS?

It is important to assess your personality, skills, and business needs realistically. Do you lack the time, the willingness, and the ability to be the bookkeeper for your business? Do you expect to have so much work in your new business that you will be busy all the time? If so, the practical solution would be to stick to your specialty and hire somebody else to keep your books. Do you always put off balancing your checking account? Do you often put off little chores, letting them accumulate until you have one big job of catch- up on your hands? If your answers are yes and yes, you should seriously consider hiring a bookkeeper.

Many new business owners find they have the time to keep their own books. When you know from past experience that you can motivate yourself to do detailed work and that you are organized enough to keep up with the books, you may opt to do most or all of your bookkeeping. Many people get satisfaction from doing the books. It is like keeping score when you are winning the game.

If the business is too big for your bookkeeping ability or if it outgrows your ability, then the decision becomes easy — get outside help.

HOW MUCH SERVICE DO YOU NEED?

A small business, starting slowly, may not require any more expertise than what you learn in this lesson. But if the material discussed here sounds too intimidating, you might want to hire an accountant or bookkeeper to set up your bookkeeping system.

Report preparation is another job for which many business owners hire bookkeepers. Often, business owners maintain their own ledgers and other continuous accounts but leave the number crunching and report preparation, including tax returns, to professionals.

Still others opt for full bookkeeping services. The point is that your choices are not limited to getting professional help or not getting any help at all. You can get as little or as much professional bookkeeping help as you need. The best bet is to discuss your needs with a bookkeeper and then decide how much bookkeeping you will be comfortable doing yourself. If you decide to get outside help in setting up your bookkeeping system or in keeping all of your books, here are some tips for hiring a bookkeeper.

SOME OF THE OPTIONS

It is not necessary to take on all of the work when you decide to be your business head bookkeeper. That is just one of the options. Other options include:

1. Hiring an accountant or bookkeeper to set up your bookkeeping system, then maintaining the books yourself.

2. Hiring a bookkeeper to prepare only your monthly summaries and financial reports.

3. Retaining an accountant or tax adviser to prepare your state and federal income tax returns. You can do this in combination with one of the other two options.

WORKING WITH AN OUTSIDE BOOKKEEPER

The best credential for an accountant is the title CPA. CPA stands for *Certified Public Accountant*, a title granted only to people who have completed the required college training, worked for an accounting firm (or otherwise gained experience in the field), and passed a certification exam. The CPA title ensures that the accountant has reached a certain level of competence.

Accountants who are not certified are called Public Accountants and may or may not be licensed by the state. This does not mean they are incompetent. They may be as skilled as CPAs. Ask for references to be sure you will be satisfied with the work the CPA or PA will provide.

OTHER SOURCES OF HELP

There are other types of professional help for small businesses. Small-business consultants are neither accountants nor bookkeepers but have expertise in running small businesses. They may be professors at your local college who specialize in small businesses or they may simply be people with extensive business experience.

Your local Chamber of Commerce is a good source for small-business information. So is the Small Business Administration. Many local chambers sponsor small business seminars on the topics discussed in this lesson.

TEST YOUR BOOKKEEPING APTITUDE

- There are no right or wrong answers to this quiz. These questions should help you assess your potential success as your own bookkeeper.
- Do you usually keep effective, up-to-date personal records?
- In your new business, do you expect to have spare time between jobs?
- As you study this lesson on business record keeping, do you feel comfortable with the material?
- Do you like the idea of working with your books and keeping tabs on your business' progress?
- Do you see value in organizing your business and financial information for planning and budgeting purposes?

If most of your answers are yes, you are a strong candidate for handling your own bookkeeping and business records.

WHAT TO LOOK FOR WHEN YOU HIRE A BOOKKEEPER

Choosing professional help for your business is like choosing a doctor or dentist. You start by asking around and getting recommendations. Ask your friends and business associates. Get recommendations from other professionals, such as your insurance agent or banker. Talk to referral services run by state and local professional associations. Avoid picking names out of the yellow pages. You have no idea what kind of product you may be buying.

Here are some important things to consider when you hire an accountant or bookkeeper:

Reputation and Existing Client Base. Obviously, anyone you choose should have a good reputation among professionals and clients. If someone is recommended to you, ask for a list of his or her clients and then find out if past clients were happy with the work.

Experience and Skill in Your Area. Small businesses have special bookkeeping needs. Just because your uncle's accountant is great in big business does not mean he knows much about running a small business. Many CPAs specialize and work only with large corporations. Sit down and discuss any prospective accountant's experience with small businesses.

Time and Interest. A professional bookkeeper or accountant should be willing to take some time to get to know your business, your problems, and your future goals. If he or she does not seem interested or just wants to process your work through the firm, find someone else. Of course, a good bookkeeper is in demand and is often expensive, so do not expect hours of conversation. In fact, be suspicious if he or she has "all the time in the world" for you. It may mean he or she does not have many other clients.

Reasonable Fees. Reasonable means neither exorbitant nor suspiciously cheap. Too high may be a drain on your finances but too low might not buy the service you need. A professional bookkeeper or accountant will discuss fees willingly. Accountants usually bill by the hour. Specialized services, such as tax preparation, sometimes involve fixed estimates.

Philosophy and Style. Remember, you are dealing with a human being, not a computer program. So choose a bookkeeper or an accountant you think you can get along with and who shares your business philosophy.

Make a list of the qualities you are looking for, such as competence, good reputation, and compatible personality. Interview several bookkeepers whose backgrounds suggest they would be suitable. Then, trust your feelings and choose the one you think you can work best with.

Be open with your bookkeeper or accountant. Give him or her access to all your business information and tell him or her every relevant fact about your business. If you form a good professional relationship with your bookkeeper or accountant, you can count on reliable financial advice to help you chart the course of your expanding business in the years to come.

SELF-TEST QUESTIONS

Please check your answers on page 24.

16. **What four qualities should you look for in a bookkeeper?**
17. ***True or false*. To be guaranteed proper book- keeping, you must hire a CPA.**
18. **What information should you give your bookkeeper?**
19. **What must an accountant do to become a CPA?**

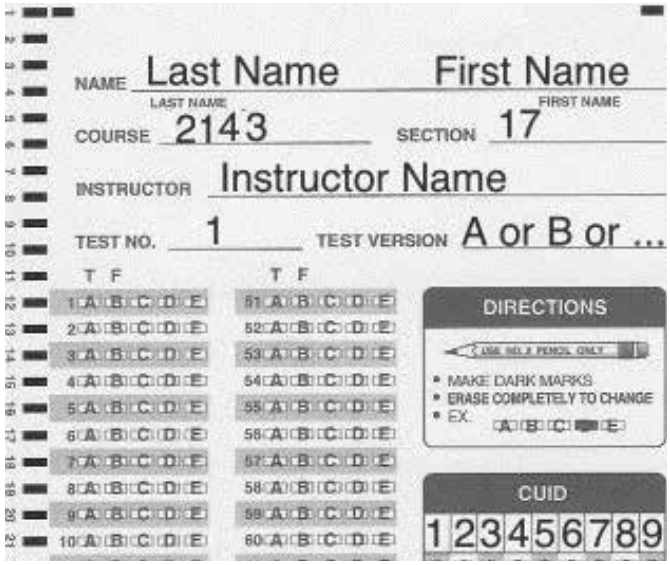
Answers to Self-Test Questions

1. False. You must maintain good business records from the outset, just as you must keep records in your everyday life.
2. A good records system is simple, easy to set up, easy to keep, and easy to understand. It is accurate and consistent, gives you the information you need, and maintains a paper trail.
3. A paper trail is a collection of records, such as invoices and receipts, that tracks money going into and out of a business.
4. True. The best records system for a small business is simple and easy to keep.
5. False. A loan provides cash but is not income, since it must be repaid. It should be recorded as a debt or liability.
6. The three conditions for a reasonable business expense are the following: the expense must be incurred by the business, it must be ordinary, and it must be necessary.
7. A properly completed Check Register contains the following information. Check entries show the check number, the date, to whom paid and why, the amount paid, and the running bank account total. Deposit entries show the date, who it was received from, the amount, and the running bank account total.
8. You need to summarize your expenses by category in order to check them against your budget, for income tax purposes, and so that you can tell where your money goes.
9. Two bookkeeping tasks performed monthly are summarizing expenditures by account and reconciling your checking account.
10. The headings for the Expense Ledger are "Date," "Payee and Purpose," "Acct. No.," "Check No.," and "Amount."
11. False. It is important to choose your accounting method for the long haul. You will need IRS per- mission to switch from cash accounting to accrual accounting or vice versa.
12. The most important bookkeeping reports are the summary of expenses by account, the balance sheet, and the income statement.
13. Regardless of the amounts involved, cash in a checking account would come before a certificate of deposit on the asset side of a balance sheet, because the checking account funds can be spent immediately.
14. A database is a collection of information organized for rapid retrieval. More and more, database is defined as a computer program that sorts and lists information in groups.
15. Spreadsheets can be used to tabulate sales, count inventory in stock, project staffing needs, track accounts payable and accounts receivable, maintain the payroll, and perform many other tasks.
16. Competence, reputation, familiarity with book- keeping for your kind of business, and compatible personality are the qualities you should look for in a bookkeeper.
17. False. A CPA title ensures competence but tells you nothing else about the accountant. In fact, the best bookkeeper for a small business might well not be a CPA.
18. You should give your bookkeeper complete information on your business and its financial status and transactions.
20. To become a CPA, an accountant must complete college training, have experience in the field, and pass an exam.

Lesson Questions

THIS IS LESSON NUMBER 2206.

Make sure you print your name, student number, and lesson number in the space provided on the Lesson Answer Form. Be sure to fill in the circles beneath your student number and lesson number.



REMINDER: A properly completed Lesson Answer Form allows us to evaluate your answers and send the results and additional study material to you. Do not hold your Lesson Answer Forms to send several at one time. You may run out of study material if you do not send your answers for evaluation promptly.

You may also complete your exam online at www.sdi.edu, click on the *online exams* tab.

1. **Two reasons for keeping business records are to keep track of money and to preserve data for credit purposes. What is another?**
   a. To avoid paying taxes and social security.
   b. For income tax purposes.
   c. To get start-up funding from friends and relatives.
   d. To avoid the need for financial planning.

2. **What proof do businesses usually have that they are keeping truthful records?**
   a. The bookkeeping entries.
   b. The individual ledgers.
   c. The paper trail of documents.
   d. The owner's income.

3. **As a business owner, you create an account receivable when you:**
   a. Bill or invoice a client.
   b. Issue a check to a supplier.
   c. Sign a contract with a client.
   d. Receive a payment from a client.

4. **In business bookkeeping, cash means:**
   a. Checks, funds in checking accounts, and currency.
   b. Credit cards and credit payments.
   c. Accounts payable outstanding.
   d. Accounts receivable outstanding.

5. **Which bookkeeping system do most small businesses use?**
   a. Chart of Accounts.
   b. Cash.
   c. Accrual.
   d. Owner's Equity.

6. **What information does your check register not contain?**
   a. Information about checks written.
   b. Information about checks deposited.
   c. Information about money owed.
   d. Running account total.

7. **The two parts of the balance sheet are:**
   a. Accounts receivable and accounts payable.
   b. The asset section and the liability section.
   c. The Income Ledger and the Expense Ledger.
   d. The Chart of Accounts and the Expense Ledger.

8. **The most important bookkeeping reports are:**
   a. Income statements, balance sheets, and summary of expenses by account.
   b. Aged Receivables report, balance sheet, and income statement.
   c. Expense Ledger and income statement.
   d. Income Ledger, balance sheet, and summary of expenses by account.

9. In a spreadsheet program, cells are arranged in:

a. Fields and records.

b. Columns and rows.

c. Rows and records.

d. Labels and columns.

10. The difference between your income and expenses is called:

a. A summary of expenses.

b. Revenue or sales.

c. Net income or loss.

d. Owner's equity or net worth.