

**BK.1**

# Bookkeeping Basics

Very small businesses are not required to keep their financial records using formal bookkeeping practices, but as a business grows in number of financial transactions per month and in the complexity of the business operations, it becomes increasingly important to use a formal bookkeeping system.

## Who should keep the books?

The owner of a small business may choose to be their own bookkeeper, or to hire a trained bookkeeper. As a business grows in size and complexity it becomes necessary for the owner to hire a bookkeeper. The bookkeeper's job is to accurately enter past financial transactions into a formal bookkeeping system. The owner needs to be able to focus on how to take historic information from the bookkeeping system and use it to analyze past performance and make decisions about the future direction of the business.

Bookkeepers may have formal or informal training, and vary greatly in experience and competence. If a business owner does not have a basic understanding of what to expect from a bookkeeper and how to supervise a bookkeeper, they can end up paying a lot of money for bookkeeping that is not actually useful, or worse, they may become victims of embezzlement. Doing your own bookkeeping during the early stages of your business may be a great way to learn basic bookkeeping and prepare yourself to later hire and supervise a bookkeeper.

## Bookkeeping is Entering Data According to a Set of Standard Rules

It is easy to be intimidated by the complexity of bookkeeping - people get two-year degrees in bookkeeping and four-year degrees in accounting - but the basics are actually very simple to understand.

All of bookkeeping and accounting comes down to a few principles and definitions, and these are employed everywhere in the world. If you understand these basics, you will quickly be able to use most bookkeeping programs.

## Foundational principles

**Accounting Entity** One of the most fundamental accounting principles is that an accounting is for a single entity only. This means that you cannot have a bookkeeping system that accounts for two businesses that have different ownership, and you cannot have a bookkeeping system that accounts for household income and expenses and business income and expenses in the same accounting. This is one of the reasons it is important to have separate business and personal bank accounts.

**Reporting Period / Accounting Period** Another basic accounting principle is that income and expenses are reported for standard periods of time, usually a month, a quarter, and a year. At the end of each accounting year, the income and expenses are re-set to zero. Reports should always be run for standard accounting periods, a month, quarter, or year.

**Double Entry** A third foundational principle is that there are two aspects to every transaction; this is called double-entry accounting, because each entry in the system must have two sides. The entire bookkeeping system is tied together with one simple mathematical formula, and the way mathematical formulas work is that if you do something to one side of the equation you have to do something of equal value to the other side of the equation or the equation will not be in balance. You will see the term “balance” used over and over again in double-entry bookkeeping. Think of a see-saw. Every transaction in your bookkeeping system first affects one side of the see-saw and then an equal amount must go on the other side of the see-saw to re-balance it. Everything you enter into your bookkeeping system must have two sides. Usually you will know one of the effects immediately - cash went up or down, that is the first entry - then you have to figure out the second entry - that second entry tells you why cash went up or down. For that you need to know a few basic definitions.

## Basic Definitions

Most bookkeeping entries are explained by six definitions. Five of them are really easy, and two take a little effort to understand. Here they are:

### Assets

There are a few different types of assets:

1. Cash;
2. Amounts owed to the business;
3. Property used in the business, and expected to benefit the business beyond the current accounting period. There are a few different types of property.
  - a. Supplies and Inventory are expected to be used up entirely in the near future – 6-18 months.

- b. Depreciable property is expected to last two or more years and to gradually decline in value over time.
- c. Non-depreciable property, like land, is considered eternal.

Depreciable assets are things that have lasting value to the business and have an “ascertainable useful life in excess of one year.”

Assets are not expensed (deducted) when purchased. Instead you take a “depreciation deduction” using special forms that are part of your tax return.

## **Liabilities**

Liabilities are amounts owed by the business, if the obligation to pay is certain, and the amount owed is known or can be reasonably estimated. This means that you do not report liabilities if it is not a certain legal fact that you owe the sum, or if you cannot reasonably estimate the amount owed.

## **Income**

There are three types of business income:

1. Ordinary income from sales of goods and services in the ordinary course of business;
2. Capital gains income from the occasional sale of property that has been used in the business;
3. Extraordinary income paid to the business for events unrelated to its normal activities or asset sales - this is usually insurance proceeds or the settlement of a lawsuit.

## **Expenses**

There are two types of business expenses:

1. Ordinary expenses incurred to conduct the regular activities of the business;
2. Extraordinary expenses or losses incurred due to events unrelated to normal business activities, these may be unusual fines or penalties, or amounts to settle a lawsuit, or losses associated with a disaster.

## **Net Income (or Loss)**

Total income less total expenses for the accounting period (a month, a quarter, or a year). If the amount is positive it is called Net Income. If it is negative it is called Net Loss.

## Equity

Equity is the net total value of the owner's interest in the business. If there is only one owner then all of the equity in the business belongs to the one owner. If there is more than one owner, then the total equity is the sum of each of their total interests in the business.

Equity can be calculated two ways:

1. The difference between assets and liabilities. Equity is positive if assets are greater than liabilities and it is negative if liabilities are greater than assets.
2. The sum, for the entire history of the business, of all the investments the owners have made into the business, less all of the draws they have taken from the business, plus or minus the net income or loss from every year of the business.

For most people, the most difficult thing to understand when learning basic bookkeeping is how to record amounts that owners contribute to or withdraw from the business. That is because those amounts directly affect equity, and equity is the hardest of the six definitions to understand.

The second hardest thing for most people to understand is when something is an asset and when it is an expense, and why the difference matters. The easy examples: a tractor is an asset, and tractor fuel is an expense. The harder examples take up volumes of accounting textbooks and Internal Revenue Code. It matters because if you treat assets as expenses then you will not have a permanent list of the assets that are used in your business year after year. This will make it hard to comply with income and property tax filing requirements, obtain credit, or plan for maintenance and future purchases.