Chapter 1

Deciphering the Basics

In This Chapter

- Cash vs. accrual
- Understanding assets, liabilities, and equity
- Putting it all on paper
- Managing transactions daily
- Introducing the financial statements
- Proving out the books

Bookkeepers are the accountant's eyes and ears. Few accountants actually take the time to enter the numbers into the accounting books. That job instead goes to the bookkeepers. Bookkeeping, when done properly, gives a business owener an excellent gauge of how well his business is doing financially.

In this chapter, you will get an overview of a bookkeeper's work and introduction to some of the key accounting concepts.

Using Cash or Accrual Method

When setting up a business, the first major accounting decision that must be made is whether to keep the books using the cash-basis accounting method or the accrual accounting method. If you decide to use the cash-basis accounting method, you record all transactions only when cash actually changes hands. Cash can include payment by cash, check credit card, electronic transfer, or any other means you pay for something you buy. If you decide to use the accrual accounting method, you record a transaction when the transaction is completed, even if cash has not yet changed hands.

For example, if your company purchases the products it plans to sell from vendors on credit and doesn't pay for them until 30 days later, you would record this transaction differently depending upon which method you choose to use. If you are using the cash-basis accounting method, you would not record the purchase in your books until you actually pay for the products with cash. If you are using the accrual method, you would record the purchase immediately. You would record the purchase in an account called Purchases and you would record the liability to the vendor in an account called Accounts Payable on the day you get the bill for the goods, which allows you to track all pending obligations to vendors.

Many small businesses run by a sole proprietor (single owner) or partnership group choose to use cash-basis accounting at first because it's easier, but as the business grows and there are many more transactions to keep track of a business usually will switch to the accrual method of accounting.

EXAMPLE

Q. You buy products for sale on June 15 on credit with the vendor and get a bill with the purchase. You don't have to pay that bill until July 1. How would you record this transaction in your books if you are using cash-basis accounting and also how would you would record it using accrual accounting?

A. For cash-basis accounting, you would not record anything in the books until you pay for the products with cash on July 1. For accrual accounting you would record the purchase on June 15 in Accounts Payable, as well as in the account where you record purchases.

1. You buy products you plan to sell paying cash on delivery on June 15. How and when would you record this transaction in your books if you are using cash-basis accounting and how would you record it using accrual accounting?

Solve It

2. You contract with a painter to paint your store front on June 15 and he completes the work on July 1 and gives you a bill for the work. You pay for the work with cash on July 5. How and when would you record this transaction in your books if you are using cash-basis accounting and how would you record it using accrual accounting?

Solve It

3. You order office supplies on credit on June 15 and receive them on June 16. You are billed for them on July 1, but don't pay for them with cash until July 15. How and when would you first record this transaction in your books if you are using cash-basis accounting and how would you record it using accrual accounting?

Solve It

4. You sell your products to a customer on store credit on June 15. You send a bill to the customer on July 1. You receive payment in cash from the customer on July 15. How and when would you first record this transaction in your books if you are using cash-basis accounting and how would you record it using accrual accounting?

Solve It

So which accounting method is better? The cash-basis accounting method does a good job of tracking the flow of cash, but it does a poor job of matching your revenues to your expenses. The accrual accounting method does a good job of matching revenues and expenses, but does a poor job of tracking the use of cash. Companies that use accrual accounting also set up a system to monitor cash flow.

The biggest difference between these two methods shows up with transactions that occur at the end of one year and the beginning of the next year. As you work through these problems you will see how differently the transactions are handled at the end of a year for each accounting method and how the way they are handled can impact the profits and expenses you show on your financial statements, as well as the taxes you may have to pay on any profits at the end of the year.

There is a big difference between cash and accrual accounting. While cash accounting is easier, it does make it more difficult to keep track of money due from customers who buy on store credit, as well as payments due to vendors, suppliers, contractors, and others for purchases and other expenses. You should never choose to use the cash-basis accounting method if:

- Your business carries over inventory month-to-month and year-to-year. It is more difficult to match costs for the inventory with the profits made from the sale of that inventory using the cash-basis method.
- Your business allows customers to buy on store credit. Your books will not show the revenue until the customers pay in cash. Also, you will have a more difficult time tracking how much is due from customers.

You decide to incorporate your business. Read chapter 17 for more on business types.

You have gross annual sales of more than $5 million.

If you do start keeping your books using the cash-basis accounting method, you can convert to the accrual accounting method, but you must file a form with the IRS called the Change in Accounting Method (Form 3115) within 180 days before the end of the tax year you want to make that change. You can find out more about the instructions for changing account method by downloading them at `www.irs.gov/pub/irs-pdf/i3115.pdf`.

EXAMPLE

Q. For example, suppose you are keeping the books for a carpenter who contracted to do a job on December 15 for $15,000 and received 50 percent up front or $7,500. He spent $5,000 in cash on materials December 16 and paid his workers $5,000 in cash on December 31 when the work was completed. The contractor did not meet with the customer for final approval of the work and final payment until January 3. How would you record these transactions using the cash-basis accounting method and how would you record them using the accrual accounting method?

A. If you were keeping the books using the cash-basis accrual method, you would record the cash received on December 15 of $7,500. You would record the $5,000 cash spent on materials on December 16 and you would record the payment to workers of $5,000 cash on December 31. When you closed your books for the year on December 31, this job would show revenues of $7,500 and expenses of $10,000 or a loss of $2,500. You would then record the $7,500 cash received on January 3 and have no corresponding expenses, so at the end of that year you would have an additional $7,500 in profits for work performed for the previous year with the expenses for the work recorded in the previous year.

If you were using the accrual method, you would record the receipt of $7,500 revenue on December 15; you would record the $5,000 cash spent on materials on December 16. You would record the payment to your workers of $5,000 in revenue on December 31. You would also record the final payment of $7,500 due in an account called Accounts Receivables, which tracks customer payments due. When you close your books at the end of the year, you would show a $5,000 profit on this job.

5. Suppose you are keeping the books for a carpenter who contracted to do a job on December 15 for $15,000 and received 50 percent up front or $7,500. He bought $5,000 of materials on store credit on December 16 and paid his workers $5,000 in cash on December 31 when the work was completed. He will not be billed for the materials until December 31 and won't pay for them with cash until January 10. While the contractor submitted a bill for the completed work on December 31, he did not meet with the customer for final approval of the work and final payment until January 3. How would you record these transactions using the cash-basis accounting method and how would you record them using the accrual accounting method? Would the job show a profit or a loss on December 31?

Solve It

6. Suppose you purchased $1,500 in products using cash on December 15 that you intend to sell to your customers. These products were completely sold out by December 25 and your total revenue for these products was $2,500, but not all of that revenue was in cash. You sold $1,500 of products and were paid with cash and $1,000 of products were sold using store credit. The customers would not be billed for that credit until January 2 and you won't receive payment until mid-January. How would you record these transactions using the cash-basis accounting method and how would you record them using the accrual accounting method? How would your revenues and expenses differ between these methods when you close the books on December 31?

Solve It

7. Suppose you purchased $1,500 in products on credit with the vendor on December 15 that you intend to sell to your customers. You won't be billed for these products until December 31 and won't have to pay for them with cash until January 10. These products were completely sold out by December 25 and your total revenue for these products was $2,500 in cash. How would you record these transactions using the cash-basis accounting method and how would you record them using the accrual accounting method? How would your revenues and expenses differ between these methods when you close the books on December 31?

Solve It

Sorting Out Assets, Liabilities, and Equity

Once you choose your accounting method, you'll next need to sort out whether items in your books are assets, liabilities, or equity. Assets include anything the company owns. Liabilities include anything the company owes. Equity reflects the money the owners have put in or taken out of the company.

In order to keep your books in balance, you need to carefully track all these different items in the right place. The key formula used in accounting for balancing the books is

Assets = Liabilities + Equity

In other words everything your business owns is balanced against claims against those items owned. Vendors and lenders, who account for most of your liabilities, have claims against the assets for the money you owe them. Owners of the business have claims against the remaining assets.

So which items fall into each of these categories? In the assets category you would find cash, marketable securities (including stocks, bonds, and money market accounts), inventory, buildings, land, equipment, and vehicles. These are all tangible assets (assets you can touch and feel). In addition to tangible assets there are intangible assets — assets that you can't touch and feel. Patents and copyrights are good examples of intangible assets. In both cases these are items a company owns based on governmental guarantees that the business has the exclusive rights to produce products based on these copyrights or patents. Another common intangible asset is organization costs, which include the initial start-up expenses of a business.

In the liabilities category you'll find bills due to vendors or suppliers, payments due to consultants, credit card bills, and bank loans. You would also find any accruals of taxes owed. There are two types of tax payments that you may accrue in a business. When you sell products to customers you collect sales taxes. When you pay your employees you collect taxes the employee owes the government including federal and state taxes, Social Security taxes, and Medicare taxes. Most small companies pay these taxes on a quarterly basis, but accrue them in a liability account until the tax is due to track future payment obligations.

In the equity category, you would find all claims that owners have against the company. If the company is incorporated, owner's claims would be reflected in a Stock account. Money paid out to stockholders would be found in a dividend expense account. If the company is privately owned, the owners claims would be reflected in a Capital account, which tracks money put into the business, and a Drawing account would track money taken out of the business by the owners. Any profits kept in the business and not paid out to owners, would be shown in a Retained Earnings account.

EXAMPLE

Q. Where in the books would you find cars owned by the company?

A. In an asset account that tracks vehicles owned by the company.

8. Where in the books would you find bills due to vendors?

Solve It

9. Where in the books would you find inventory you have on hand to sell to customers?

Solve It

10. Where in the books would you find money put into the company when the owners first started the business?

Solve It

11. Where in the books would you find the mortgage for the store that your company owns that you must pay off?

Solve It

Tracking the Daily Finances

A bookkeeper also needs to keep accurate day-to day records of business activities. These activities include maintaining inventory, tracking sales, and handling payroll.

It's critically important for any business to know what inventory it has on hand and how much that Inventory costs. The tracking of those details falls to the bookkeeper. I talk more about the bookkeeper's responsibilities in this area in Chapter 7.

Every business owner enjoys finding out how much he took in from sales of his products or services. You need to keep that data up-to-date, so the owner of the business can quickly see how well the business is doing and find trends that may indicate either an upswing or downswing in sales. If there is an upswing, the owner may need to bring in more products to sell. If there is a downswing, the owner may need to slow down his ordering to avoid having too much inventory on hand. I talk more about the bookkeeper's responsibility for tracking sales in Chapter 8.

The third critical responsibility is making sure the employees are paid accurately. You also have to be sure the government gets any taxes due related to the payroll. I talk more about managing payroll in Chapter 9.

Testing Your Work

At the end of an accounting period, you need to test to find out if you entered all the transactions in the books accurately and if your books are in balance. You start the process of testing for accuracy by proving out your cash to be sure your cash balance is accurate.

Once you know your cash is right, then you test whether your books are in balance using a trial balance. If they're not in balance you'll need to do a worksheet to find the errors and prepare journal entries to correct them. I talk more about how to test your work and make any necessary corrections at the end of an accounting period in Chapters 13 and 14.

Naming the Financial Statements

After you take the time to put all your transactions into the books, you need to have a way to summarize the financial results of all these transactions. You do that by preparing financial reports about the business's activity. Two key reports that are prepared include the Balance Sheet and Income Statement.

The Balance Sheet, which is based on the formula Assets equals Liabilities and Equity, shows a business's overall financial health at a particular date in time. The financial statement includes two columns. One lists all the assets and the second, which must be equal to the first, lists all the liabilities and equity. I show you how to prepare this statement in Chapter 15.

The Income Statement, which summarizes the activity of a business during an accounting period, shows whether the business made a profit or took a loss. The accounting period can be a month, a quarter or a year. This statement starts with the Revenues, subtracts the costs of purchasing the goods or services you sell, then subtracts the expenses incurred operating the business. The bottom line of an income statement is whether or not the company made a profit. I show you how to prepare this statement in Chapter 16.

EXAMPLE

Q. On which statement and where in that statement would you find the value of the buildings owned by the company?

A. The Asset section of the Balance Sheet in an account called Buildings.

12. On which statement and where in that statement would you find the value of the mortgages due to be paid to lenders?

Solve It

13. On which statement and where in that statement would you find a business's total sales for the year?

Solve It

14. On which statement and where in that statement would you find the total amount a business spent to purchase the products it planned to sell?

Solve It

15. On which statement and where in that statement would you find the value of the inventory the company had on hand to sell to its customers?

Solve It

Keeping a Paper Trail

In addition to recording all your company's transactions in the books, you also need to keep an accurate paper trail about those transactions so if a question comes up later you have all the detail you need to provide an answer about a particular expense or revenue. It's the only way that you can track both the company's financial successes and its failures.

A company owner needs to know what succeeded, so he can repeat that success in the future and also needs to know what failed, so you can avoid repeating those errors in the future. Your books and the supporting paper trail help the business owner to do that.

There are several types of books that you keep. The granddaddy of them all is the General Ledger. This summarizes all your accounts during the year. You can imagine that there would be thousands of transactions for most businesses (large corporations have millions), so it would be unwieldy to have the details of all transactions in just one book. Instead the most active accounts are detailed in a series of journals. The monthly summary totals from the journals are then posted to the General Ledger. I talk more about how General Ledgers are used in Chapter 4 and how journals are used in Chapter 5.

Many companies use computerized accounting today. In these cases the journals are kept electronically rather than on paper.

In addition to keeping the books, you also need to keep copies of the paper that was used to back up the transaction. For example, when you purchase products you intend to sell, you would get an invoice that shows how much you paid for those products. You should keep copies of all those invoices in case a question arises later. I talk more about what paperwork you need to keep and for how long you need to keep it in Chapter 6. I also talk about how to set up a filing system in that chapter, so you will be able to find everything when you need to do so.

Answers to Problems on Deciphering the Basics

1 You would record the transaction the same way using cash-basis or accrual accounting. Cash was paid on June 15, so the transaction would be recorded as a cash transaction in cash-basis accounting. The transaction was completed on June 15, so the transaction would be recorded in accrual accounting as well.

2 You would record the money due the painter on July 1 when the work is completed in the Accounts Payable account to reflect the money that is due if you are using accrual accounting. You would not record the transaction until July 5 when you pay the painter in cash using cash-basis accounting.

3 You would record the payment on July 15 when you pay with cash if you are using cash-basis accounting. If you are using accrual accounting, you would record the bill on July 1 in the Accounts Payable account if you are using accrual accounting.

4 You would record the transaction on July 15 if you are using cash-basis accounting. You would record the transaction on June 15 when you first make the sale in the Accounts Receivables account, where you track sales to customers who buy on store credit if you are using accrual accounting.

5 If you were keeping the books using cash-basis accounting, you would record the cash revenue of $7,500 on December 15. You would record the cash payment to the workers on December 31. You would record the cash revenue on January 3 and you would record the payment for materials on January 10. At the end of the year the job would show a profit of $2,500 because only $5,000 had been paid to workers and the materials were not yet paid. If you were keeping the books using accrual accounting, you would record the cash revenue of $7,500 on December 15. You would record the cash payments to workers of $5,000 on December 31. You would record the bill for materials of $5,000 on December 31, and you would also record the revenue for the completed job now due from the customer of $7,500 on December 31 in the Accounts Receivable account on December 31. At the end of the year the job would show a profit of $5,000.

6 If you were keeping the books using cash-basis accounting, you would record the $1,500 purchase of the products on December 15. You would record the cash sales of $1,500 as they were received. You would not record the sales to customers who you sold to on store credit until the money was received in mid-January. You would show $0 profit on these product sales on December 31. If you were keeping the books using an accrual accounting method, you would record the $1,500 purchase of the products on December 15. You would record the sales on the days they were made, but you would have recorded the total revenue of $2,500 by December 25. Cash sales would be recorded in the Cash account and store credit sales would be recorded in the Accounts Receivable account. You would show a profit on these product sales of $1,000 on December 31. The accrual method of accounting would show a $1,000 profit, while the cash-method would show a $0 profit.

7 If you were keeping the books using cash-basis accounting, you would record the cash sales as they were made but would total $2,500 by December 25. You would not record the cash payment of $1,500 for the products bought until you pay that bill with cash on January 10. Your revenues for these sales would total $2,500 and you wouldn't show any costs on December 31. If you were keeping the books using the accrual accounting method, you would record the sales as they were made, but would total $2,500 by December 25. You would record the bill to cover the costs of the goods on December 31 in Accounts Payable. Your revenues for these sales would total $2,500 and the costs of goods sold would total $1,500 on December 31.

8 In a liability account where you track bills called Accounts Payable.

9 In an asset account called Inventory.

10 In an equity account called Capital.

11 In a liability account called Mortgages Payable.

12 In the liability section of the Balance Sheet in a line item called Mortgages Payable.

13 In the revenues section of the Income Statement in a line item called Sales.

14 In the cost of goods sold section of the Income Statement in a line item called Purchases.

15 In the assets section of the Balance Sheet in a line item called Inventory.