PART ONE

The Basics of Bookkeeping

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CHAPTER 1

Bookkeeping Basics

What Is Bookkeeping?

Bookkeeping is how you record and report on the financial transactions of a business. The bookkeeper is responsible for initially recording basic accounting transactions, such as issuing invoices to customers, recording cash receipts, and paying employees. Bookkeeping is rarely conducted entirely on paper anymore. Instead, the bookkeeper uses a low-end accounting software package to record transactions. The software makes it easier to record transactions, and also summarizes the information into financial reports that are useful to the owners of the business to see how it is operating.

What Is the Job Description of a Bookkeeper?

The following is a detailed description of the tasks for which a bookkeeper is responsible. These line items may vary somewhat for companies located in specialized industries, but the description covers the bulk of all bookkeeper activities.

Basic Function

The bookkeeper position creates financial transactions and creates financial reports from that information. The creation of financial transactions includes posting information to accounting journals or accounting software from such source documents as invoices to customers, cash receipts, and supplier invoices. The bookkeeper also reconciles accounts to ensure their accuracy.

Principal Accountabilities

- Purchase supplies and equipment as authorized by management.
- Monitor office supply levels and reorder as necessary.
- Tag and monitor fixed assets.

- Pay supplier invoices in a timely manner.
- Take all reasonable discounts on supplier invoices.
- Pay any debt as it comes due for payment.
- Monitor debt levels and compliance with debt covenants.
- Issue invoices to customers.
- Collect sales taxes from customers and remit them to the government.
- Ensure that receivables are collected promptly.
- Record cash receipts and make bank deposits.
- Conduct a monthly reconciliation of every bank account.
- Conduct periodic reconciliations of all accounts to ensure their accuracy.
- Maintain the petty cash fund.
- Issue financial statements.
- Provide information to the external accountant who creates the company's financial statements.
- Assemble information for external auditors for the annual audit.
- Calculate and issue financial analysis of the financial statements.
- Maintain an orderly accounting filing system.
- Maintain the chart of accounts.
- Maintain the annual budget.
- Calculate variances from the budget and report significant issues to management.
- Comply with local, state, and federal government reporting requirements.
- Process payroll in a timely manner.
- Provide clerical and administrative support to management as requested.

Desired Qualifications

The bookkeeper candidate should have an associate's degree in accounting or business administration, or equivalent business experience, as well as a knowledge of bookkeeping and generally accepted accounting principles. Preference will be given to candidates with a working knowledge of the ____ accounting software package.

What Is a Certified Public Accountant?

A *certified public accountant* (CPA) is an accountant who has passed all parts of the CPA examination, as administered by the American Institute of Certified Public Accountants, and who has also completed all additional work and educational requirements of their local state accounting regulatory agencies. A CPA is authorized to render an opinion on the fairness of a client's financial statements.

A CPA has considerably more knowledge of accounting than the typical bookkeeper, and must also update this knowledge with an annual continuing professional education requirement.

How Does a Bookkeeper Interact with a CPA?

The bookkeeper should consider a CPA to be a resource who can provide assistance in a variety of areas. If a CPA is already rendering an opinion on the fairness of the financial statements issued by the bookkeeper, then ethical guidelines prevent that CPA from providing many other services to the bookkeeper's company (other than creating tax returns). However, it is entirely acceptable to hire the services of a different CPA who acts solely as an advisor in such matters as creating budgets and financial statements.

What Are Generally Accepted Accounting Principles?

Generally accepted accounting principles (GAAP) are the set of authoritative accounting standards issued by several standard-setting bodies (particularly for U.S. GAAP, the Financial Accounting Standards Board, or FASB), which entities should follow in preparing their financial statements. The standards show how to aggregate and present financial information, as well as disclose supporting information.

The FASB issues frequent updates to GAAP, which are called Accounting Standard Updates. Most of these updates relate to technical issues that are of no concern to the bookkeeper, but some may require a change in how basic transactions are recorded or reported. If so, consult with your CPA regarding how these changes apply to your business.

What Are International Financial Reporting Standards?

International Financial Reporting Standards (IFRS) are the accounting standards set by the International Accounting Standards Board, which an entity can comply with if it wishes to create financial statements that are accepted in those countries allowing the use of IFRS. International Financial Reporting Standards were previously known as International Accounting Standards (IAS).

Most companies in the United States do not yet have to comply with IFRS, which in any case are close to the standards of GAAP, which *are* required within the United States. There is a general trend in favor of adopting IFRS throughout the world, but there is not yet a specific conversion date for this in the United States.

What Is the Income Statement?

The *income statement* is a financial report that summarizes an entity's revenue, cost of goods sold, gross margin, other costs, tax expense, and net income or loss. The income statement shows an entity's financial results over a specific time period, usually a month, quarter, or year. The key parts of an income statement are:

- *Revenue*. *Revenue* is an increase in assets or decrease in liabilities, caused by the provision of services or products to customers. You typically record revenue when you issue an invoice to a customer.
- *Cost of goods sold*. *Cost of goods sold* is the accumulated total of all costs used to create a product or service that has been sold. These costs fall into the general subcategories of direct labor, materials, and overhead.
- *Gross margin*. *Gross margin* is revenues less the cost of goods sold. The gross margin reveals the amount that an entity earns from the sale of its products and services, before the deduction of any sales and administrative expenses.
- *Expenses*. An *expense* is the reduction in value of an asset as it is used to generate revenue.
- *Net income or loss*. *Net income* is the excess of revenues over expenses, including the impact of income taxes, while a net loss is the excess of expenses over revenues.

What Is the Balance Sheet?

The *balance sheet* is a report that summarizes all of an entity's assets, liabilities, and equity as of a given point in time. The key parts of a balance sheet are:

- *Assets*. An *asset* is an item of economic value that is expected to yield a benefit to the owning entity. Examples of assets are cash, investments, accounts receivable, prepaid items, land, buildings, and office equipment.
- *Liabilities*. A *liability* is a legally binding obligation payable to another entity. Examples of liabilities are accounts payable, accrued expenses, wages payable, and taxes.
- *Equity*. *Equity* is the funds contributed by an entity's owners, plus or minus accumulated retained earnings.

What Is an Accounting Period?

An accounting period is the span of time covered by a set of financial statements. For internal financial reporting, an accounting period is generally

considered to be one month. A few firms compile financial information for a 4-week period, so that they have 13 accounting periods per year.

A publicly held company must report to the Securities and Exchange Commission (SEC) on a quarterly basis, so the accounting period for its financial reports to the SEC span three months. If a set of financial statements cover the results of an entire year, then the accounting period is one year. If the accounting period is for 12 months ending on a date other than December 31, then the accounting period is called a fiscal year, as opposed to a calendar year.

Technically, an accounting period only applies to the income statement, since the balance sheet reports information as of a specific date. Thus, if an entity reports on its results for January, the header of the income statement says, "for the month ended January 31," while the header of the balance sheet reads, "as of January 31."

What Is a Transaction?

A *transaction* is a business event that has a monetary impact on an entity's financial statements and is recorded as an entry in its accounting records. Examples of transactions are acquiring property or paying supplier bills.

What Is the Accounting Cycle?

The accounting cycle is a sequential series of activities to identify and record an entity's individual transactions, which are then aggregated at the end of a reporting period into financial statements. The accounting cycle for individual transactions is:

1. Identify the event that is causing an accounting transaction.
2. Prepare the business document associated with the accounting transaction, such as a purchase order, customer invoice, or cash receipt.
3. Identify which accounts are affected by the business document.
4. Record in the appropriate accounts in the accounting database the amounts noted on the business document.

The preceding accounting cycle steps were associated with individual transactions. The following accounting cycle steps are only used at the end of the accounting period, and are associated with the aggregate amounts of the preceding transactions:

1. Prepare a preliminary trial balance, which itemizes the debit and credit totals for each account.

2. Add accrued items, record estimates, and correct errors in the preliminary trial balance with adjusting entries.
3. Prepare an adjusted trial balance, which incorporates the preliminary trial balance and all adjusting entries.
4. Prepare the financial statements from the adjusted trial balance.
5. Close the books for the reporting period.
6. Prepare and review a post-closing trial balance.

What Is the Cash Method of Accounting?

The normal method for reporting a company's financial results is the accrual basis of accounting, under which expenses are matched to revenues within a reporting period. However, for tax purposes, it is sometimes possible to report income under the cash method of accounting. Under this approach, revenue is not recognized until payment for invoices is received, while expenses are not recognized until paid.

The cash basis of accounting can result in a great deal of manipulation from the perspective of the Internal Revenue Service (IRS), which discourages its use but does not prohibit it. As an example of income manipulation, a company may realize that it will have a large amount of income to report in the current year, and will probably have less in the following year. Accordingly, it prepays a number of supplier invoices at the end of the year, so that it recognizes them at once under the cash method of accounting as expenses in the current year. The IRS prohibits this type of behavior under the rule that cash payments recognized in the current period can only relate to current-year expenses. Nonetheless, it is a difficult issue for the IRS to police. The same degree of manipulation can be applied to the recognition of revenue, simply by delaying billings to customers near the end of the tax year. Also, in situations where there is a sudden surge of business at the end of the tax year, possibly due to seasonality, the cash method of accounting will not reveal the sales until the following year, since payment on the invoices from customers will not arrive until the next year. Consequently, the cash method tends to underreport taxable income.

In order to limit the use of this method, the IRS prohibits it if a company has any inventories on hand at the end of the year. The reason for this is that expenditures for inventory can be so large and subject to manipulation at year-end that a company could theoretically alter its reported level of taxable income to an enormous extent. The cash basis is also not allowable for any C corporation, partnership that has a C corporation for a partner, or tax shelter. However, within these restrictions, it is allowable for an entity with average annual gross receipts of $5 million or less for the three tax years ending with the prior tax year, as well as for any personal service corporation that provides at least 95 percent of its activities in the services arena.

The IRS imposes some accrual accounting concepts on a cash-basis organization in order to avoid some of the more blatant forms of income avoidance. For example, if a cash-basis company receives a check at the end of its tax year, it may be tempted not to cash the check until the beginning of the next tax year, since this would push the revenue associated with that check into the next year. To avoid this problem, the IRS uses the concept of *constructive receipt*, which requires you to record the receipt when it is made available without restriction (whether or not it is actually recorded on the company's books at that time).

What Is the Accrual Method of Accounting?

Under the accrual method of accounting, you record a transaction when it occurs, even if no cash changes hands. You record such transactions with an *accrual,* which allows an entity to record expenses and revenues for which it expects to expend cash or receive cash, respectively, in a future reporting period. Examples of accruals are:

- *Revenue accrual*. A consulting company works billable hours on a project that it will eventually bill to a client for $5,000. It can record an accrual in the current period, so that its current income statement shows $5,000 of revenue, even though it has not yet billed the client.
- *Expense accrual: interest*. A company has a loan with the local bank for $1 million, and pays interest on the loan at a variable rate of interest. The invoice from the bank for $3,000 in interest expense does not arrive until the following month, so the company accrues the expense in order to show the amount on its income statement in the proper month.
- *Expense accrual: wages*. A company pays its employees at the end of each month for their hours worked through the 25th day of the month. To fully record the wage expense for the entire month, it also accrues $32,000 in additional wages, which represents the cost of wages for the remaining days of the month.

In double-entry bookkeeping, the offset to an accrued expense is an accrued liability account, which appears in the balance sheet. The offset to accrued revenue is an accrued asset account (such as unbilled consulting fees), which also appears in the balance sheet.

Most accruals are initially created as *reversing accruals*, so that the accounting software automatically cancels them in the following month. This happens when you are expecting revenue to actually be billed, or supplier invoices to actually arrive, in the next month.

What Is Double-Entry Bookkeeping?

Double-entry bookkeeping is the classic system of recording financial transactions. Its name is entirely accurate—you record all transactions twice, using a debit and a credit. A *debit* either increases an asset or expense account, or decreases a liability or equity account. It is positioned to the left in an accounting entry. A *credit* is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is positioned to the right in an accounting entry. Double-entry bookkeeping is essentially about how you use an asset or liability. For example, you buy a plane ticket for $1,000. The way to record this transaction under double-entry bookkeeping is:

	Debit	Credit
Travel expense	1,000	
Cash		1,000

In the preceding entry, you have drawn down an asset, cash, by $1,000 in order to incur an expense. Therefore, you use a credit to reduce your amount of cash on hand, and a debit to increase the amount of the expense associated with travel.

As another example, you spend $10,000 to purchase a computer, and record the purchase with the following transaction:

	Debit	Credit
Computer equipment	10,000	
Cash		10,000

In this situation, you have again drawn down the cash asset, this time by $10,000, and have acquired an asset, the computer, by doing so. Therefore, you use a credit to reduce the amount of cash on hand, and a debit to record the addition of a new asset, the computer. This entry has essentially replaced one asset (cash) with another (computer equipment).

What if you are not paying cash for an item, but rather have accepted an obligation to pay a supplier at a later date? This calls for an entry where the asset appears in the debit column, and a credit creates a liability. The following entry assumes the purchase of an automobile for $25,000, with payment due at a later date:

	Debit	Credit
Fixed assets—Vehicles	25,000	
Accounts payable		25,000

When the due date arrives for the supplier's invoice, you then pay it with cash, using the following entry:

	Debit	Credit
Accounts payable	25,000	
Cash		25,000

Thus, using a connected series of two entries, you have acquired one asset for $25,000 (the automobile), while reducing another asset account (cash) in order to pay for it.

In short, double-entry bookkeeping operates on the assumption that an increase in one type of account (such as an asset) can only occur if there is also either a decline in that same type of account, or through an increase in another type of account (such as a liability).

Should Debits and Credits Always Balance?

Yes. If the total of all the debits and credits you have recorded do not balance, then there is an error—in some transaction, either the total debits were larger than the total credits, or vice versa. You will need to review your entries to locate the imbalance, and correct it.

For Accounting Software

If you are using accounting software, then you should be entering all debits and credits through a standard journal entry format that is provided by the software. It is virtually impossible to create an unbalanced entry with accounting software, since the software will not allow you to complete a journal entry unless it is in balance.

How Do Debits and Credits Affect My Accounts?

Use the following table to determine the effect of debits and credits on your accounts:

Debit and Credit Impact on Account Types

Account Category	Debits	Credits
Assets	Increase	Decrease
Liabilities	Decrease	Increase
Equity	Decrease	Increase
Revenue	Decrease	Increase
Expenses	Increase	Decrease

What Are Accounting Principles?

A number of accounting principles govern the way in which you record transactions. More accurately, view them as guidelines to consider whenever you are contemplating how to record a transaction. Here are the 11 accounting principles:

1. *Conservatism*. Recognize expenses and liabilities as soon as possible when there is uncertainty about the outcome of an event, but only recognize revenues and assets when you are certain that they will be received. Thus, if there is uncertainty about recording a loss, you should tend toward recording the loss. Conversely, if there is uncertainty about recording a gain, you should not record the gain. If there is a choice of several equally likely outcomes to record, do so for the outcome resulting in the least amount of profit.
2. *Consistency*. Once you adopt an accounting principle or method, continue to follow it consistently in future periods. You should only change a principle or method if the new version in some way improves reported financial results.
3. *Cost*. Only record an asset, liability, or equity investment at its original cost. This principle is most justifiable for short-term assets and liabilities that you do not intend to keep for long, and least justifiable for assets and liabilities whose values may fluctuate over a number of years.
4. *Economic entity*. Keep the activities of a business entity separate from the activities of its owners and any other business entities. Therefore, do not mix the accounting transactions of multiple entities.
5. *Full disclosure*. Include in an entity's financial statements all of the information that would affect a reader's understanding of those statements. Normally, this means disclosing information about those events that are likely to have a material impact on a business entity's financial results.
6. *Going concern*. The business will remain in business for the foreseeable future. This assumption implies that you can justifiably defer the recognition of some expenses until a later period, when the entity will

presumably still be operational. If this is not the case, then you may have to record all expenses at once, and perhaps also record assets at their liquidation values.

7. *Matching*. When you record revenue, you should also record any related expenses at the same time. Thus, if there is a cause-and-effect relationship between revenue and expenses, record them in the same accounting period.
8. *Materiality*. You should record a transaction if not doing so would have influenced a person who relies on the financial statements. The exact boundaries of materiality have never been clearly defined. Certainly, you should record an item representing at least 5 percent of total assets, and should record smaller amounts if not doing so would change a profit to a loss.
9. *Monetary unit*. You should only record transactions that can be expressed in terms of currency. Thus, you cannot record such nonquantifiable items as employee skill levels or the quality of customer service. The principle also assumes that the currency in which you record transactions remains stable over time, which may not be the case if there is hyperinflation.
10. *Revenue recognition*. If you are using the accrual basis of accounting, you should only record revenue when it has been earned. However, under the cash basis of accounting, you should record revenue when you receive a cash payment.
11. *Time period*. Report the financial results of a business over a standard period of time, which is usually monthly, quarterly, or annually.

What Are Accounts Receivable and Accounts Payable?

The term *accounts receivable* describes short-term amounts due from customers who have purchased goods or services from your business on credit. Accounts receivable appear on your business' balance sheet as an asset.

Accounts payable describes a business's short-term obligation to pay suppliers for products and services, which it purchased on credit. Accounts payable appear on a business's balance sheet as a liability.

What Is Inventory?

Inventory is an asset that is held for sale in the ordinary course of business, or that is in the process of being produced for sale, or the materials or supplies intended for consumption in the production process. This can include items purchased and held for resale. In the case of services, inventory can be the costs of a service for which related revenue has not yet been recognized. Inventory is frequently subdivided by manufacturing businesses into these categories:

- *Raw materials inventory*. The total cost of all component parts currently in stock that have not yet been used in work-in-process or finished goods production.
- *Work-in-process inventory*. Inventory that has been partially converted through the production process, but for which additional work must be completed before it can be recorded as finished goods inventory.
- *Finished goods inventory*. Goods that have been completed by the manufacturing process, or purchased in a completed form, but which have not yet been sold to customers.

A retail establishment may refer to its inventory as *merchandise*.

What Is Depreciation?

Depreciation is the gradual charging to expense of an asset's cost over its expected useful life. For example, a $3,000 computer is estimated to have a three-year useful life, so you should charge $1,000 of depreciation expense against the computer asset per year. If there is a significant amount of expected salvage value at the end of an asset's useful life, then you should reduce the amount of depreciation accordingly. *Useful life* is the estimated life span of a depreciable asset, during which it can be expected to contribute to company operations, while *salvage value* is the expected proceeds to be garnered from the sale of a fixed asset at the end of its useful life.

What Is the General Ledger?

A *general ledger* is the master set of accounts that summarize all transactions occurring within a business. There may be a subsidiary set of ledgers that summarize into the general ledger. An *account* is a separate, detailed record associated with a specific asset, liability, or equity item. For example, a business usually has a separate account for each of its bank accounts, as well as for its accounts receivable and accounts payable. A *ledger* is a book or database in which double-entry accounting transactions are stored and summarized.

What Is the Trial Balance?

The trial balance is a report listing the ending debit and credit balances in all accounts at the end of a reporting period. The trial balance is used to ensure that the total of all debits equals the total of all credits, as a worksheet for making adjustments, and finally as the source document for creating the financial statements. See Chapter 11, "The Trial Balance," for more information.