

Chapter 1

So You Want to Do the Books

In This Chapter

- ▶ Introducing bookkeeping and its basic purpose
 - ▶ Maintaining a paper trail
 - ▶ Managing daily business finances
 - ▶ Making sure that everything's accurate
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Many small business owners, while they enjoy working in their chosen field using the skills they know and love, don't always like to perform 'bookkeeping' duties. Most company owners prefer to employ the skills of a qualified bookkeeper. Some may, perhaps, prefer to give their bagfuls of receipts to their accountant and simply hope that a useful set of accounts comes out of the end of the accounting sausage machine!

In this chapter, we help to demystify the role of a bookkeeper. It may be that you're just starting off in business and, as a result, can't afford the services of a bookkeeper just yet! Think of this chapter as a checklist of jobs that need to be done.

Delving into Bookkeeping Basics

Like most businesspeople, you probably have great ideas for running your own business and just want to get started. You don't want to be distracted by the small stuff, like keeping detailed records of every penny you spend; you just want to build a business with which you can make lots of money.

Well, slow down there – you're not in a race! If you don't carefully plan your bookkeeping system and figure out exactly how and what financial details you want to track, you've absolutely no way to measure the success (or failure, unfortunately) of your business efforts.

Bookkeeping, when done properly, gives you an excellent measure of how well you're doing and also provides lots of information throughout the year. This information allows you to test the financial success of your business strategies and make any necessary course corrections early in the year to ensure that you reach your year-end profit goals.

Looking at basic accounting methods

You can't keep books unless you know how to go about doing so. The two basic accounting methods are *cash-based accounting* and *accrual accounting*. The key difference between the two methods is the point at which you record sales and purchases in your books:

- ✓ If you choose cash-based accounting, you only record transactions when cash changes hands.
- ✓ If you use accrual accounting, you record a transaction on its completion, even if cash doesn't change hands.

For example, suppose that your business buys products to sell from a supplier but doesn't actually pay for those products for 30 days. If you're using cash-based accounting, you don't record the purchase until you actually lay out the cash to the supplier. If you're using accrual accounting, you record the purchase when you receive the products, and you also record the future debt in an account called Trade Creditors.



There are specific criteria for who can use cash-based accounting. For example, if you're a sole trader or partnership and your turnover is expected to be below £82,000, you're able to use cash-based accounting and submit your self-assessment returns on that basis. However, if you're a limited company or run a limited liability partnership, you won't be able to operate the cash-based scheme and will need to use accrual based methods. For more detailed criteria, see www.gov.uk and type 'cash basis' in the search box.

We talk about the pros and cons of each type of accounting method in Chapter 2.

Understanding assets, capital and liabilities

Every business has three key financial parts that must be kept in balance: assets, capital and liabilities. Of course, for some of you these may be alien concepts, so maybe a quick accounting primer is in order.



We use buying a house with a mortgage as an example. The house you're buying is an asset, that is, something of value that you own. In the first year of the mortgage you don't own all of it but, by the end of the mortgage period (typically 25 years), you will. The mortgage is a liability, or a debt that you owe. As the years roll on and you reduce the mortgage (liability), your capital or ownership of the asset increases. That's it in a nutshell.

- ✓ Assets include everything the business owns, such as cash, stock, buildings, equipment and vehicles.
- ✓ Capital includes the claims that owners have on the assets based on their portion of ownership in the business.
- ✓ Liabilities include everything the business owes to others, such as supplier bills, credit card balances and bank loans.



The formula for keeping your books in balance involves these three elements:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

Another way of explaining this is to say that all of the company's resources (assets) have been provided by either creditors (liabilities) or the owners (equity/capital) of the business. Because this equation is so important, we talk a lot about how to keep your books in balance throughout this book. You can find an initial introduction to this concept in Chapter 2.

The preceding equation can also be restated as follows:

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

Some people may prefer this new equation as it looks a little more like the vertical Balance Sheet format that we discuss in Chapter 14. The vertical Balance Sheet shows all the Assets minus the Liabilities at the top of the Balance Sheet followed by the Capital at the bottom of the Balance Sheet.

Introducing debits and credits

To keep the books, you need to revise your thinking about two common financial terms: debits and credits. Most non-bookkeepers and non-accountants think of debits as subtractions from their bank accounts. The opposite is true with credits – people usually see credits as additions to their accounts, in most cases in the form of refunds or corrections in favour of the account holders.

Well, forget all you think that you know about debits and credits. Debits and credits are totally different animals in the world of bookkeeping. Because keeping the books involves a method called *double-entry bookkeeping*, you

have to make at least two entries – a debit and a credit – into your bookkeeping system for every transaction. Whether that debit or credit adds to or subtracts from an account depends solely upon the type of account.

We know all this debit, credit and double-entry stuff sounds confusing, but we promise that this system is going to become much clearer as you work through this book. We start explaining this important concept in Chapter 2.

Charting your bookkeeping course

You can't just enter transactions in the books willy-nilly. You need to know exactly where those transactions fit into the larger bookkeeping system. To know where everything goes, you use your *Chart of Accounts*, which is essentially a list of all the accounts that your business has and the types of transactions that go into each one. (We talk more about the Chart of Accounts in Chapter 3.)

Discovering different business types

Before you start up in business, you're wise to sit down and have a think about the structure of your business.

For example, if you're a window cleaner, and only ever see yourself doing your own rounds and not working with anyone else, then sole trader status would be more than adequate. However, if you're planning to be much bigger and take on staff, then you need to read Chapter 5 to see how you should structure your business and what sort of advice you may need.

Planning and controlling your activities

Many businesses just start up and trade from day to day, without any real planning or control of the activities they undertake. Often, businesspeople become so busy that they're fire-fighting continually and lack any real direction. We like using checklists, as they help to organise your bookkeeping activities in a methodical and orderly manner. This level of organisation means that you can pick up and put down the accounts from day to day or even week to week. You can always start from where you left off, quickly and easily, by simply adopting some of the hints and tips contained within Chapter 6.

Keeping an accurate paper trail

Keeping the books is all about creating an accurate paper trail. A computerised accounting system would refer to this trail as the *Audit Trail*. You want to keep track of all your business's financial transactions so that if a question comes up at a later date, you can turn to the books to figure out what went wrong. We're big fans of using checklists, so you know exactly where you are in the monthly accounting cycle. While the first part of this book introduces the concept of bookkeeping, from Part II onwards we guide you through the accounting cycle in a systematic manner, in keeping with the order in which we'd approach our monthly accounts. See Chapter 6 for a monthly checklist.

All your business's financial transactions are summarised in the Nominal Ledger, and journals keep track of the tiniest details of each transaction. Information can be gathered quickly by using a computerised accounting system, which gives you access to your financial information in many different report formats. Controlling who enters this financial information into your books and who can access it afterwards is smart business practice, and involves critical planning on your part. We address all these concepts in the following sections.

Instituting internal controls

Every business owner needs to be concerned with keeping tight controls on business cash and how that cash is used. One way to institute this control is by placing internal restrictions on who can enter information into your books and who has the necessary access to use that information.

You also need to control carefully who has the ability to accept cash receipts and spend your business's cash. Separating duties appropriately helps you to protect your business's assets from error, theft and fraud. We talk more about controlling your cash and protecting your financial records in Chapter 6.

Defining and Maintaining a Ledger

You may get confused by terms such as *books*, *ledgers*, *journals* and *accounts*. Most of these words evolved from traditional bookkeeping methods, where accounts were handwritten in huge leather-bound ledgers. These looked like books, hence the name *bookkeeping* – simply, keeping financial records in the books!

The books are also known as *journals* or *ledgers* (we told you it was a bit confusing!). You'd normally have one book for your sales, one for purchases and then a general one used for everything (often known as the *General Ledger*, although in the UK it's more commonly known as the *Nominal Ledger*). Sometimes, businesses would also keep a separate cashbook, which would record cash received and cash paid.

Nowadays, most people use computers to do their accounts (anything to make our busy lives easier). The most simplistic set of accounts can be done on a spreadsheet, although we don't recommend it as mistakes can easily be made and you'll struggle to find an efficient way to make sure that the books balance.



In this book we demonstrate the use of ledgers using Sage 50 Accounts. However, it's worth pointing out at this stage that, if your budget is low and you're a micro business (for example, a one-man band), you can buy many other computer packages that will enable you to provide accurate accounts, including online accounting services, some of which we cover in Chapter 18 (where we discuss cloud accounting). For example, Sage has developed an online service called Sage One that is simple and easy to use. Refer to *Sage One For Dummies* by yours truly to find out more.



Most computerised accounting systems use the term *ledger*, so you usually find the following:

- ✓ **Sales Ledger:** A ledger that holds all the individual customer accounts and their balances. This ledger is sometimes known as the *Customer Ledger* or the *Debtors Ledger*.
- ✓ **Purchase Ledger:** A ledger that holds all the individual supplier accounts and their balances. This ledger is sometimes known as the *Supplier Ledger* or *Creditor Ledger*.
- ✓ **Nominal Ledger:** A ledger that includes balances and activities for all the Nominal accounts used to run the business. We discuss Nominal accounts in Chapter 4. This ledger is also known as the *General Ledger*.
- ✓ **Cashbook, or Bank:** For example, in Sage, you can have numerous Bank current accounts and Petty Cash accounts all under the general 'Bank' heading. Any cash received or paid is recorded in this part of the accounting system.
- ✓ **Accounts:** Simply a collective term for all the ledgers.

The pinnacle of your bookkeeping system is the *Nominal Ledger*. In this ledger, you keep a summary of all your accounts and the financial activities that took place involving those accounts throughout the year.

The sum of each Nominal Ledger account can be used to develop your financial reports on a monthly, quarterly or annual basis. You can also use these account summaries to develop internal reports that help you to make key business decisions. We talk more about developing Profit and Loss Reports and Balance Sheets in Chapter 3, when we introduce the *Chart of Accounts*.

We explain more about developing and maintaining the Nominal Ledger in Chapter 4. We also discuss the importance of journals and talk about the accounts commonly journalised in Chapter 4.

Using Bookkeeping Tools to Manage Daily Finances

After you set up your business's books and put in place your internal controls, you're ready to use the systems you've established to manage the day-to-day operations of your business. A well-designed bookkeeping system quickly makes the job of managing your business's finances much easier.

Tracking sales

Everyone wants to know how well sales are doing. If you keep your books up-to-date and accurate, you can easily get those numbers on a daily basis. You can also watch sales trends as often as you think necessary: daily, weekly or monthly.

Use the information collected by your bookkeeping system to monitor sales, review discounts offered to customers and track the return of products. All three elements are critical to monitoring the sales success of your products.



If you find that you need to offer discounts more frequently in order to increase sales, you may need to review your pricing, and you definitely need to conduct market research to determine the cause of this sales weakness. The cause may be the new activities of an aggressive competitor, or simply a slowdown in your particular market. Either way, you need to understand the problem and work out how to maintain your profit objectives in spite of any obstacles.

When sales tracking reveals an increase in the number of your products being returned, you need to find the reason for the increase. Perhaps the quality of the product you're selling is declining, and you need to find a new supplier. Whatever the reason, an increased number of product returns is usually a sign of a problem that needs to be researched and corrected.

We talk more about how to use the bookkeeping system for tracking sales, discounts and returns in Chapter 7.

Keeping stock

If your business keeps stock on hand or in warehouses, tracking the costs of the products you plan to sell is critical for managing your profit potential. When you see stock costs escalating, you may need to adjust your own prices in order to maintain your profit margin. You certainly don't want to wait until the end of the year to find out how much your stock cost you.

You also must keep a careful watch on how much stock you have on hand and how much was sold. Stock can get damaged, discarded or stolen, meaning that your physical stock counts may differ from the counts you have in your books. Do a physical count periodically – at least monthly for most businesses and possibly daily for active retail stores.

In addition to watching for signs of theft or poor handling of stock, make sure that you've enough stock on hand to satisfy your customers' needs. We explain how to use your bookkeeping system to manage stock in Chapter 8.



If you run a service-based business, you can count yourself lucky as stock isn't as significant a cost in your business. You're predominantly selling time and using stocks of materials as a part of your service. However, you can't ignore your material costs, so the same lessons on stock control apply to you.

Running Tests for Accuracy

Tracking your transactions is a waste of time if you don't periodically test to be sure that you've entered those transactions accurately. The old adage, 'Garbage in, garbage out' is particularly true for bookkeeping: if the numbers you put into your bookkeeping system are garbage, the reports you develop from those numbers are also garbage.

Checking the cash and bank

The first step in testing your books includes proving that your cash transactions are accurately recorded. This process involves checking a number of different transactions and elements, including the cash taken in on a daily

basis by your staff and the accuracy of your bank account(s). We talk about all the necessary steps you can take to prove that your cash is correct in Chapter 9.

Testing your balance

After you prove that your cash is right (see Chapter 9), you can check that you've recorded everything else in your books just as precisely. Review the accounts for any glaring errors and then test whether or not they're in balance by doing a Trial Balance. You can find out more about Trial Balances in Chapter 10.

Doing bookkeeping corrections

You may find that when you first run your Trial Balance, you need to make adjustments. In Chapter 10, we explain common adjustments that may be needed as you close your books at the end of an accounting period, and we also explain how to make the necessary corrections.

You need to complete monthly journals on a regular basis. One of these is *depreciation*, which is where you aim to spread the cost of your assets over their useful economic life. We talk more about the different types of depreciation, and how you journal it, in Chapter 11.

Understanding your VAT

For those of you who are VAT registered, you know that you need to submit a regular VAT Return, usually on a quarterly basis. In Chapter 12, we talk about how you can easily do this return using a computerised accounting system.

Preparing financial reports

Most businesses prepare at least two key financial reports: the Balance Sheet and the Profit and Loss statement. These reports can be shown to business outsiders, including the financial institutions from which the business borrows money and the business's investors.



The *Balance Sheet* is a snapshot of your business's financial health as of a particular date, and ideally it shows that your business's assets are equal to the value of your liabilities and your capital. The Balance Sheet is so-called because of its balanced formula:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

The *Profit and Loss statement* summarises your business's financial transactions for a particular time period, such as a month, quarter or year. This financial statement starts with your sales, subtracts the costs of goods sold and then subtracts any expenses incurred in operating the business. The bottom line of the Profit and Loss statement shows how much profit your business made during the accounting period. If you haven't done well, the Profit and Loss statement shows how much you've lost.

We explain how to prepare a Balance Sheet in Chapter 14, and we talk more about developing a Profit and Loss statement in Chapter 13.

Note: It's probably worth pointing out that, since 2005, some companies have been switching from domestic accounting rules to International Financial Reporting Standards. The names of the two financial statements that we have just mentioned are referred to differently by International Financial Reporting Standards. The Profit and Loss statement is referred to as the Income Statement and the Balance Sheet is called the Statement of Financial Position. That said, for the purposes of this book, we continue to use the names Profit and Loss statement and Balance Sheet.

Computers now play an important part in creating your reports. Provided that you've set up your nominal codes correctly, you can easily prepare reports at the click of a button! Having said all this, you need to understand the bookkeeping double-entry rules, which we explain in Chapter 2. So, when you need to make an adjustment to your accounts, you'll have the necessary confidence to complete journals by applying the rules of double-entry bookkeeping.

Throughout this book, we demonstrate using Sage software and you'll be pleased to know that the majority of double-entry bookkeeping is done automatically for you. For example, when you create a sales invoice on the system, Sage debits the Debtors Control account and credits the individual Sales account with the net value of the invoice. It also posts the VAT element (assuming that you're VAT registered) to the VAT Control account.

Handling payroll

Payroll can be extremely daunting for many businesses. It requires you to comply with loads of government and tax regulations and complete a lot of paperwork. You also have to worry about collecting and paying over such

things as PAYE and National Insurance. And, if you pay employee benefits, you've yet another layer of record-keeping to deal with. The past few years have seen a complete overhaul of the system, where payroll is now operated in 'real time' and automatic penalties are imposed if, say, a late submission is made.

We talk more about the recently adopted RTI (Real Time Information) system in Chapter 17.

Going up in the clouds

You may have heard the term *cloud accounting*, but what does it really mean? Fortunately for you, we investigate this bizarre sounding accounting system in Chapter 18. We look at its benefits and perceived disadvantages so that you can make up your own mind about whether it's for you!

Closing off an accounting period

You draw a metaphorical line at the end of each accounting period (month, quarter, year) and close off entries for that period. Effectively, you say 'That's it for now' and draw a line under it. In fact, in good old-fashioned manual bookkeeping, you do draw an actual line and total up entries for the period. Doing so is called *closing your books*. Nowadays, with the use of computers, this process is automated, and in Sage you run what's known as a *period end* or *year-end*. The software effectively draws that line for you and prepares the opening balances for the next period. In Chapter 16, we discuss the process of preparing your year-end accounts.

A word about non-profit-making entities

Not everyone is in business to make money. Many clubs and societies are non-profit-making organisations, and are happy to be so. However, these organisations do need to keep their books, and usually present their reports in a slightly different format, as we discuss in Chapter 15.

