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Chapter 1

Basic Bookkeeping

This chapter provides an overview of a bookkeeper's work. If you're just starting a business, you may be your own bookkeeper for a while until you can afford to hire one, so think of this chapter as your to-do list.

All businesses need to keep track of their financial transactions; that's why bookkeeping and bookkeepers are so important. Without accurate records, how can you tell whether your business is making a profit or taking a loss? This chapter also covers the key parts of bookkeeping by introducing you to the language of bookkeeping, familiarizing you with how bookkeepers manage the accounting cycle and showing you how to understand the most difficult type of bookkeeping: double-entry.

Bookkeeping, the methodical way in which businesses track their financial transactions, is rooted in accounting. *Accounting* is the total structure of records and procedures used to record, classify, and report information about a business's financial transactions. Bookkeeping involves the recording of that financial information into the accounting system while adhering to solid accounting principles.

Bookkeepers: The Record Keepers of the Business World

Bookkeepers are the ones who toil day in and day out to ensure that transactions are accurately recorded. Bookkeepers need to be very detail-oriented and love to work with numbers because numbers and the accounts they go into are just about all these people see all day. A bookkeeper isn't required to be a certified public accountant (CPA).

Many small-business people who are just starting their businesses serve as their own bookkeepers until the business is large enough to hire someone dedicated to keeping the books. Few small businesses have accountants on staff to check the books and prepare official financial reports; instead, they have bookkeepers on staff who serve as the outside accountants' eyes and ears. Most businesses do seek an accountant with a CPA certification to set up and review accounting processes, prepare financial reports, oversee the work of a bookkeeper, and file taxes.

In many small businesses today, a bookkeeper enters the business transactions daily while working inside the company. At the end of each month or quarter, the bookkeeper sends summary reports to the accountant, who then checks the transactions for accuracy and prepares financial statements.

In most cases, the accounting system is initially set up with the help of an accountant to ensure that it uses solid accounting principles. That accountant periodically stops by the office and reviews the system to make sure that transactions are being handled properly.



WARNING

Accurate financial reports are the only way you can know how your business is doing. These reports are developed from the information that you, as the bookkeeper, enter into your accounting system. If that information isn't accurate, your financial reports are meaningless. As the adage goes, "Garbage in, garbage out."

Delving into Bookkeeping Basics

If you don't carefully plan your bookkeeping operation and figure out exactly how and what financial detail you want to track, you'll have absolutely no way to measure the success (or failure, unfortunately) of your business efforts.

Bookkeeping, when done properly, gives you an excellent gauge of how well you're doing financially. It also provides you lots of information throughout the

year that you can use to test the financial success of your business strategies and make course corrections early in the year, if necessary, to ensure that you reach your year-end profit goals.



TIP

Bookkeeping can become your best friend for managing your financial assets and testing your business strategies, so don't shortchange it. Take the time to develop your bookkeeping system with your accountant before you even open your business's doors and make your first sale.

Picking your accounting method: cash basis versus accrual

You can't keep books unless you know how you want to go about doing so. The two basic accounting methods you have to choose between are cash-basis accounting and accrual accounting. The key difference between these two accounting methods is the point at which you record sales and purchases in your books. If you choose *cash-basis accounting*, you record transactions only when cash changes hands. If you use *accrual accounting*, you record a transaction when it's completed, even if cash doesn't change hands.

Suppose that your company buys products to sell from a vendor but doesn't pay for those products for 30 days. If you're using cash-basis accounting, you don't record the purchase until you lay out the cash to the vendor. 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 accounts payable.

Understanding assets, liabilities, and equity

Every business has three key financial parts that you must keep in balance: assets, liabilities, and equity. *Assets* include everything the company owns, such as cash, inventory, buildings, equipment, and vehicles. *Liabilities* include everything the company owes to others, such as vendor bills, credit card balances, and bank loans. *Equity* includes the claims owners have on the assets based on their portion of ownership in the company.

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

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

Much of bookkeeping involves keeping your books in balance.

Introducing debits and credits

To keep the books, you need to revise your thinking about two common financial terms: debits and credits. Most nonbookkeepers and nonaccountants think of debits as subtractions from their bank accounts. The opposite is true of credits; people usually see them as additions to their accounts, in most cases in the form of refunds or corrections in favor of the account holders.

Well, forget all you thought you knew 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 — in your bookkeeping system for every transaction. Whether that debit or credit adds to or subtracts from an account depends solely on the type of account.

Don't worry— all this debit, credit, and double-entry stuff may sound confusing, but it will become much clearer as you work through this chapter. In “Seeing Double with Double-Entry Bookkeeping” later in this chapter, I explain how it works.

Charting your bookkeeping course

You can't just enter transactions in the books willy-nilly. You need to know where exactly those transactions fit into the larger bookkeeping system. That's where your Chart of Accounts comes in. A Chart of Accounts is essentially a list of all the accounts your business has and what types of transactions go into each one. Book 1, Chapter 2 talks more about the Chart of Accounts.

Recognizing the Importance of an Accurate Paper Trail

Keeping the books is all about creating an accurate paper trail. You want to track all your company'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.



REMEMBER

Maintaining an accurate paper trail is the only way to track your financial successes and review your financial failures — a task that's vitally important for growing your business. You need to know what works so that you can repeat it in the future and build on your success. On the other hand, you need to know what failed so you can correct it and avoid making the same mistake again.

All your business's financial transactions are summarized in the General Ledger, and journals keep track of the tiniest details of each transaction. You can make your information-gathering more effective by using a computerized accounting system, which gives you access to your financial information in many formats. Controlling who enters this financial information into your books and who can access it afterward is smart business practice and involves critical planning on your part.

Maintaining a ledger

The granddaddy of your bookkeeping system is the General 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.

You draw upon the General Ledger's account summaries to develop your financial reports on a monthly, quarterly, or annual basis. You also can use these account summaries to develop internal reports that help you make key business decisions. Book 1, Chapter 3 covers developing and maintaining the General Ledger.

Keeping journals

Small companies conduct hundreds, if not thousands, of transactions each year. If every transaction were kept in the General Ledger, that record would become unwieldy and difficult to use. Instead, most companies keep a series of journals that detail activity in their most active accounts.

Almost every company, for example, has a Cash Receipts journal in which to keep the detail for all incoming cash and a Cash Disbursements journal in which to keep the detail for all outgoing cash. Other journals can detail sales, purchases, customer accounts, vendor accounts, and any other key accounts that see significant activity.

You decide which accounts you want to create journals for based on your business operation and your need for information about key financial transactions. Book 1, Chapter 4 discusses journals and the accounts that are commonly journalized.

Instituting internal controls

Every business owner needs to be concerned about keeping tight controls on company cash and how it's used. One way to institute this control is to place internal restrictions on who has access to enter information into your books and who has access to use that information.

You also need to carefully control who has the ability to accept cash receipts and who has the ability to disburse your business's cash. Separating duties appropriately helps you protect your business's assets from error, theft, and fraud. Book 1, Chapter 5 covers controlling your cash and protecting your financial records.

Computerizing

Most companies today use computerized accounting systems to keep their books. You should consider using one of these systems rather than trying to keep your books on paper. You'll find that your bookkeeping takes less time and is probably more accurate with a computerized system.



TIP

In addition to increasing accuracy and cutting the time it takes to do your bookkeeping, computerized accounting makes designing reports easier. You can use these reports to make business decisions. Your computerized accounting system stores detailed information about every transaction, so you can group that detail in any way that may assist your decision-making. Book 1, Chapter 6 is about computerized accounting systems.

Using Bookkeeping's Tools to Manage Daily Finances

After you set up your business's books and put your internal controls in place, you're ready to use the systems you established to manage the day-to-day operations of your business. You'll quickly see how a well-designed bookkeeping system can make the job of managing your business's finances much easier.

Maintaining inventory

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

You also must keep careful watch on how much inventory you have on hand and how much was sold. Inventory can get damaged, discarded, or stolen, meaning that your physical inventory 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 inventory, make sure that you have enough inventory on hand to satisfy your customers' needs. Book 3, Chapter 1 discusses how to use your bookkeeping system to manage inventory.

Tracking sales

Everyone wants to know how well sales are doing. If you keep your books up to date and accurate, you can get those numbers very easily on a daily basis. You can also watch sales trends as often as you think necessary, whether that's 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 gauging the success of the sales of your products.

If you find that you need to offer discounts more frequently to encourage sales, you may need to review your pricing, and you definitely need to research market conditions to determine the cause of this sales weakness. The cause may be new activities by an aggressive competitor or simply a slow market period. Either way, you need to understand the weakness and figure out how to maintain your profit goals in spite of any obstacles.

When sales tracking reveals an increase in the number of your products being returned, you need to research the issue and 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 usually is a sign of a problem that needs to be researched and corrected.

Book 3, Chapter 2 goes over how to use the bookkeeping system to track sales, discounts, and returns.

Handling payroll

Payroll can be a huge nightmare for many companies. Payroll requires you to comply with a lot of government regulation and fill out a lot of government paperwork. You also have to worry about collecting payroll taxes and paying employer taxes. And if you pay employee benefits, you have yet another layer of record keeping to deal with. Book 3, Chapter 3 is about managing payroll and government requirements.

Running Tests for Accuracy

All the time it takes to track your transactions isn't worthwhile if you don't periodically test to make sure that you enter those transactions accurately. If the numbers you put into your bookkeeping system are garbage, the reports you develop from those numbers will be garbage as well.

Proving out your cash

The first step in testing your books includes proving that your cash transactions are accurately recorded. This process involves checking several transactions and elements, including the cash taken in daily by your cashiers and the accuracy of your checking account. Book 4, Chapter 3 covers all the steps necessary to prove out your cash.

Testing your balance

After you prove out your cash, check whether you've recorded everything else in your books just as precisely. Review the accounts for any glaring errors and then test whether they're in balance by doing a trial balance. You can find out more about trial balances in Book 4, Chapter 5.

Doing bookkeeping corrections

You may not find your books in balance the first time you do a trial balance, but don't worry. It's rare to find your books in balance on the first try. Book 4, Chapter 6 explains common adjustments that may be necessary as you prove out your books at the end of an accounting period. It also explains how to make the necessary corrections.

Finally Showing Off Your Financial Success

Proving out your books and ensuring that they're balanced means you finally get to show what your company has accomplished financially by developing reports to present to others. It's almost like putting your business on a stage and taking a bow. (Well, at least you hope that you've done well enough to take a bow.)

If you've taken advantage of your bookkeeping information and reviewed and consulted it throughout the year, you should have a good idea of how well your business is doing. You also should make any necessary course corrections to ensure that your end-of-the-year reports look great.

Preparing financial reports

Most businesses prepare at least two key financial reports — the balance sheet and the income statement — to show to company outsiders, including the financial institutions from which the company borrows money and the company's investors.



REMEMBER

The balance sheet is a snapshot of your business's financial health as of a particular date. The balance sheet should show that your company's assets are equal to the value of your liabilities and your equity. It's called a balance sheet because it's based on a balanced formula:

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

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

Book 2, Chapter 4 covers preparing a balance sheet, and Book 2, Chapter 5 talks about developing an income statement.

Paying taxes

Most small businesses don't have to pay taxes. Instead, their profits are reported on the personal tax returns of the company owners, whether that's one person (a *sole proprietorship*) or two or more people (a *partnership*). Only companies that have incorporated — become a separate legal entity in which investors buy stock — must file and pay taxes. (Partnerships and limited liability companies don't pay taxes unless they file a special form to be taxed as a corporation, but they do have to file information returns, which detail how much the company made and how much profit each owner earned, plus any costs and expenses incurred.) Book 5, Chapter 4 covers how business structures are taxed, and Book 2, Chapter 3 goes into detail on business structures.

Wading through Bookkeeping Lingo

Before you can take on bookkeeping and start keeping the books, the first things you must get a handle on are key accounting terms. This section contains a list of terms that all bookkeepers use on a daily basis. This section is only an overview to get you more familiar with the lingo. Rest assured that all this material is covered in lots more detail throughout the book.

Accounts for the balance sheet

Here are a few terms you'll want to know:

» **Balance sheet:** The financial statement that presents a snapshot of the company's financial position (assets, liabilities, and equity) at a particular date and time. It's called a balance sheet because the things owned by the company (assets) must equal the claims against those assets (liabilities and equity).

On an ideal balance sheet, the total assets should equal the total liabilities plus the total equity. If your numbers fit this formula, the company's books are in balance.

- » **Assets:** All the things a company owns and uses to successfully run its business, such as cash, buildings, land, tools, equipment, vehicles, and furniture.
- » **Liabilities:** All the debts the company owes, such as bonds, loans, and unpaid bills.
- » **Equity:** All the money invested in the company by its owners. In a small business owned by one person or a group of people, the owner's equity is shown in a capital account. In a larger business that's incorporated, owner's equity is shown in shares of stock. Another key equity account is retained earnings, which tracks all company profits that have been reinvested in the company rather than paid out to the company's owners. Small unincorporated businesses track money paid out to owners in a drawing account, whereas incorporated businesses dole out money to owners by paying *dividends* (a portion of the company's profits paid by share of common stock for the quarter or year).

Accounts for the income statement

Here are a few terms related to income statements that you'll want to know:

- » **Income statement:** The financial statement that presents a summary of the company's financial activity over a certain period, such as a month, quarter, or year. The statement starts with revenue earned, subtracts the cost of goods sold and expenses, and ends with the bottom line: net profit or loss.
- » **Revenue:** All money collected in the process of selling the company's goods and services. Some companies also collect revenue through other means, such as selling assets that the business no longer needs or earning interest by offering short-term loans to employees or other businesses.
- » **Cost of goods sold:** All money spent to purchase or make the products or services that a company plans to sell to its customers.
- » **Expenses:** All money spent to operate the company that's not directly related to the sale of individual goods or services.

Other common terms

Some other common terms include the following:

- » **Accounting period:** The time for which financial information is being tracked. Most businesses track their financial results on a monthly basis, so each accounting period equals one month. Some businesses choose to do financial reports on a quarterly basis, so the accounting periods are three months. Other businesses look at their results on a yearly basis, so their accounting periods are 12 months. Businesses that track their financial activities monthly usually also create quarterly and annual reports (year-end summary of the company's activities and financial results) based on the information they gather.
- » **Accounts payable:** The account used to track all outstanding bills from vendors, contractors, consultants, and any other companies or people from which the company buys goods or services.
- » **Accounts receivable:** The account used to track all customer sales that are made by store credit. *Store credit* refers not to credit-card sales but to sales for which the customer is given credit directly by the store and the store needs to collect payment from the customer at a later date.
- » **Depreciation:** An accounting method used to track the aging and use of assets. If you own a car, you know that each year you use the car, its value is

reduced (unless you own one of those classic cars that goes up in value). Every major asset that a business owns ages and eventually needs replacement, including buildings, factories, equipment, and other key assets.

- » **General Ledger:** Where all the company's accounts are summarized. The General Ledger is the granddaddy of the bookkeeping system.
- » **Interest:** The money a company needs to pay if it borrows money from a bank or other company. When you buy a car with a car loan, you must pay not only the amount you borrowed, but also additional money, or interest, based on a percentage of the amount you borrowed.
- » **Inventory:** The account that tracks all products that will be sold to customers.
- » **Journals:** Where bookkeepers keep records (in chronological order) of daily company transactions. Each of the most active accounts — including Cash, Accounts Payable, and Accounts Receivable — has its own journal.
- » **Payroll:** The way that a company pays its employees. Managing payroll is a key function of the bookkeeper and involves reporting many aspects of payroll to the government, including taxes to be paid on behalf of employees, unemployment taxes, and workers' compensation.
- » **Trial balance:** How you test to ensure the books are in balance before pulling together information for the financial reports and closing the books for the accounting period.

Pedaling through the Accounting Cycle

As a bookkeeper, you complete your work by completing the tasks of the accounting cycle. It's called a cycle because the workflow is circular: entering transactions, controlling the transactions through the accounting cycle, closing the books at the end of the accounting period, and starting the entire cycle again for the next accounting period.

The accounting cycle has eight basic steps, which you can see in Figure 1-1.

1. **Transactions:** Financial transactions start the process. Transactions can include the sale or return of a product, the purchase of supplies for business activities, or any other financial activity that involves the exchange of the company's assets, the establishment or payoff of a debt, or the deposit from or payout of money to the company's owners. All sales and expenses are transactions that must be recorded. The basics of documenting business activities involve recording sales, purchases, and assets, taking on new debt, and paying off debt.

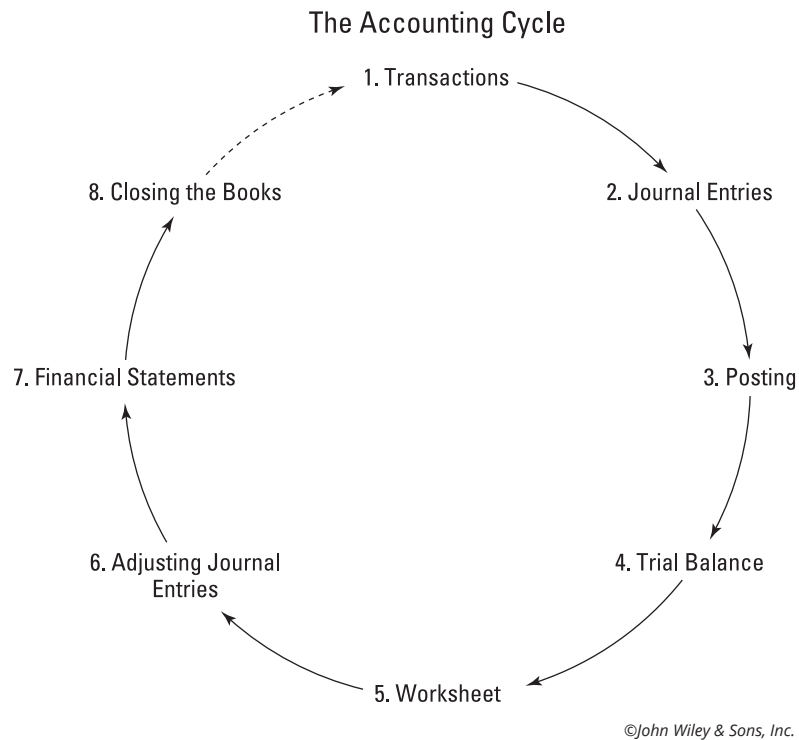


FIGURE 1-1:
The accounting cycle.

- 2. Journal entries:** The transaction is listed in the appropriate journal, maintaining the journal's chronological order of transactions. (The journal is also known as the *book of original entry* and is the first place a transaction is listed.)
- 3. Posting:** The transactions are posted to the account that it affects. These accounts are part of the General Ledger, where you can find a summary of all the business's accounts.
- 4. Trial balance:** At the end of the accounting period (which may be a month, quarter, or year, depending on your business's practices), you calculate a trial balance.
- 5. Worksheet:** Unfortunately, many times your first calculation of the trial balance shows that the books aren't in balance. If that's the case, you look for errors and make corrections called *adjustments*, which are tracked on a worksheet. Adjustments are also made to account for the depreciation of assets and to adjust for one-time payments (such as insurance) that should be allocated on a monthly basis to more accurately match monthly expenses with monthly revenue. After you make and record adjustments, you take another trial balance to be sure that the accounts are in balance.

6. **Adjusting journal entries:** Post any necessary corrections after the adjustments are made to the accounts. You don't need to make adjusting entries until the trial balance process is completed and all needed corrections and adjustments have been identified.
7. **Financial statements:** You prepare the balance sheet and income statement by using the corrected account balances.
8. **Closing the books:** You close the books for the revenue and expense accounts and then begin the entire cycle again with zero balances in those accounts.



REMEMBER

As a businessperson, you want to be able to gauge your profit or loss on month-by-month, quarter-by-quarter, and year-by-year bases, so revenue and expense accounts must start with a zero balance at the beginning of each accounting period. By contrast, you carry over asset, liability, and equity account balances from cycle to cycle because the business doesn't start each cycle by getting rid of old assets and buying new assets, paying off and then taking on new debt, or paying out all claims to owners and then collecting the money again.

Tackling the Big Decision: Cash-Basis or Accrual Accounting

Before starting to record transactions, you must decide whether to use cash-basis or accrual accounting. The crucial difference between these two processes is how you record your cash transactions.

Waiting for funds with cash-basis accounting

With *cash-basis accounting*, you record all transactions in the books when cash actually changes hands — when cash payment is received by the company from customers or paid out by the company for purchases or other services. Cash receipt or payment can be in the form of cash, check, credit card, electronic transfer, or other means used to pay for an item.

Cash-basis accounting can't be used if a store sells products on store credit and bills the customer at a later date. There is no provision to record and track money due from customers at some time in the future in the cash-basis accounting method. That's also true for purchases. With the cash-basis accounting method, the owner records only the purchase of supplies or goods that will later be sold

when he pays cash. If he buys goods on credit to be paid later, he doesn't record the transaction until he pays out the cash.



TIP

Depending on the size of your business, you may want to start with cash-basis accounting. Many small businesses run by a sole proprietor or a small group of partners use cash-basis accounting because it's easy. But as the business grows, the business owners find it necessary to switch to accrual accounting to more accurately track revenue and expenses.



WARNING

Cash-basis accounting does a good job of tracking cash flow, but it does a poor job of matching revenue earned with money laid out for expenses. This deficiency is a problem particularly when — as often happens — a company buys products in one month and sells those products in the next month. You might buy products in June with the intent to sell, and pay \$1,000 cash. You don't sell the products until July, and that's when you receive cash for the sales. When you close the books at the end of June, you have to show the \$1,000 expense with no revenue to offset it, meaning that you have a loss that month. When you sell the products for \$1,500 in July, you have a \$1,500 profit. So your monthly report for June shows a \$1,000 loss, and your monthly report for July shows a \$1,500 profit, when in actuality, you had revenue of \$500 over the two months.

For the most part, this book concentrates on the accrual accounting method. If you choose to use cash-basis accounting, don't panic: You'll still find most of the bookkeeping information here useful, but you don't need to maintain some of the accounts, such as Accounts Receivable and Accounts Payable, because you aren't recording transactions until cash changes hands. If you're using a cash-basis accounting system and sell things on credit, though, you'd better have a way to track what people owe you.

Recording right away with accrual accounting

With *accrual accounting*, you record all transactions in the books when they occur, even if no cash changes hands. If you sell on store credit, you record the transaction immediately and enter it into an Accounts Receivable account until you receive payment. If you buy goods on credit, you immediately enter the transaction into an Accounts Payable account until you pay out cash.



WARNING

Like cash-basis accounting, accrual accounting has its drawbacks. It does a good job of matching revenue and expenses, but it does a poor job of tracking cash. Because you record revenue when the transaction occurs, not when you collect the cash, your income statement can look great even if you don't have cash in the bank. Suppose that you're running a contracting company and completing jobs

on a daily basis. You can record the revenue upon completion of a job even if you haven't yet collected the cash. If your customers are slow to pay, you may end up with lots of revenue but little cash.



TIP

Many companies that use the accrual accounting method also monitor cash flow on a weekly basis to make sure that they have enough cash on hand to operate the business. If your business is seasonal, such as a landscaping business with little to do during the winter months, you can establish short-term lines of credit through your bank to maintain cash flow through the lean times.

Seeing Double with Double-Entry Bookkeeping

All businesses, whether they use the cash-basis accounting method or the accrual accounting method, use *double-entry bookkeeping* to keep their books. This practice minimizes errors and increases the chance that your books balance. Double-entry bookkeeping gets its name because you enter all transactions twice.



REMEMBER

When it comes to double-entry bookkeeping, the key formula for the balance sheet ($\text{Assets} = \text{Liabilities} + \text{Equity}$) plays a major role.

To adjust the balance of accounts in the bookkeeping world, you use a combination of debits and credits. You may think of a debit as a subtraction because you've found that debits usually mean a decrease in your bank balance. On the other hand, you've probably been excited to find unexpected credits in your bank or credit card because they mean that more money has been added to the account in your favor. Now forget all that you ever learned about debits or credits. In the world of bookkeeping, their meanings aren't so simple.

The only definite thing about debits and credits in the bookkeeping world is that a debit is on the left side of a transaction and a credit is on the right side of a transaction. Everything beyond that can get very muddled. Don't worry if you're finding this concept very difficult to grasp. You'll get plenty of practice using these concepts throughout this book.

Before I get into all the technical mumbo-jumbo of double-entry bookkeeping, here's an example of the practice in action. Suppose that you purchase a new desk for your office that costs \$1,500. This transaction has two parts. You spend an asset — cash — to buy another asset — furniture. So you must adjust two accounts in your company's books: the cash account and the furniture account. Here's what the transaction looks like in a bookkeeping entry:

Account	Debit	Credit
Furniture	\$1,500	
Cash		\$1,500

To purchase a new desk for the office

In this transaction, you record the accounts affected by the transaction. The debit increases the value of the Furniture account, and the credit decreases the value of the Cash account. For this transaction, both accounts affected are asset accounts, so when you look at how the balance sheet is affected, you can see that the only changes are on the asset side of the balance-sheet equation:

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

$$\text{Furniture increase} = \text{Cash decreases} = \text{No change to total assets}$$

In this case, the books stay in balance because the exact dollar amount that increases the value of your Furniture account decreases the value of your Cash account. At the bottom of any journal entry, you should include a brief explanation of the purpose of the entry. The first example indicates that entry was to purchase a new desk for the office.

To show you how you record a transaction if it affects both sides of the balance sheet equation, here's an example that shows how to record the purchase of inventory. Suppose that you purchase \$5,000 worth of widgets on credit. (Haven't you always wondered what widgets were? You won't find the answer here. They're commonly used in accounting examples to represent something that's purchased.) These new widgets add value to your inventory asset account and also add value to your accounts payable account.



REMEMBER

The Accounts Payable account is a liability account where you track bills that need to be paid at some point in the future.

Here's how the bookkeeping transaction for your widget purchase looks:

Account	Debit	Credit
Inventory	\$5,000	
Accounts Payable		\$5,000

To purchase widgets for sale to customers

Here's how this transaction affects the balance-sheet equation:

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

$$\text{Inventory increases} = \text{Accounts Payable increases} = \text{No change}$$

In this case, the books stay in balance because both sides of the equation increase by \$5,000.



REMEMBER

You can see from the two example transactions how double-entry bookkeeping helps you keep your books in balance — as long as you make sure that each entry in the books is balanced. Balancing your entries may look simple here, but bookkeeping entries can get very complex when more than two accounts are affected by the transaction. Don't worry; you don't have to understand now. You'll see how to enter transactions throughout the book. Again, this section is a short overview to introduce the subject.

Differentiating Debits and Credits

Because bookkeeping's debits and credits are different from the ones you're used to encountering, you're probably wondering how you're supposed to know whether a debit or credit will increase or decrease an account. Believe it or not, identifying the difference will become second nature as you start making regular bookkeeping entries. But to make things easier, Table 1-1 is a chart that bookkeepers and accountants commonly use.

TABLE 1-1

How Credits and Debits Affect Your Accounts

Account Type	Debits	Credits
Assets	Increase	Decrease
Liabilities	Decrease	Increase
Income	Decrease	Increase
Expenses	Increase	Decrease



TIP

Copy Table 1-1 and post it at your desk when you start keeping your own books to help you keep your debits and credits straight.