BASICS OF BOOKKEEPING

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Basics of Bookkeeping

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Introductions

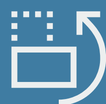
Hello!

Name

Business name and type of business

Bookkeeping knowledge (scale of 1 to 10)

Are you currently using accounting software and if so which one?


What are you hoping to take away from this class?

Class Guidelines

1. Please ask questions as they arise – don’t wait otherwise you will forget!
2. Please let me know if I don’t cover something in enough detail or miss something you are expecting to learn – *I am here to make sure you each get the most out of this class!*

The four basic steps for small business bookkeeping

1. Set up and manage accounts
2. Record financial transactions
3. Balance and close the books
4. Prepare financial statements

1. Set Up and Manage Accounts

Set up and Manage Accounts

- Chart of Accounts – A listing of accounts that a company has identified and made available for recording transactions in its general ledger (commonly referred to as the “books”).
- Each account falls under one of five types:

1. Assets – Cash and resources owned by the business (bank accounts, accounts receivable, equipment, vehicles, inventory)
2. Liabilities – Obligations and debts owed by the business (accounts payable, loans, credit cards, income tax or sales tax payable)
3. Equity – Assets minus liabilities and represents the owners interest in the business (stock, retained earnings or net income, owners draw)
4. Revenue or Income - Money earned by the business through sales of products or services (cash, sales, interest)
5. Expenses – Cash that flows out from the business to pay for some item or service (office supplies, advertising, utilities, rent, salaries, depreciation)

- Bookkeeping begins with setting up each necessary account so you can record transactions in the appropriate categories.
- Accounting software will create these accounts for you but it is important to understand each account type to correctly record transactions. You may need to add accounts depending on your business.

Frequently used accounts and their types

Account	Account type
Accounts payable	Liability
Accounts receivable	Asset
Cash	Asset
Dividends	Equity
Equipment	Asset
Insurance expense	Expense
Interest expense	Expense
Interest income	Revenue
Interest payable	Liability
Inventory	Asset
Owner’s capital	Equity
Real estate	Asset
Rent expense	Expense
Rental income	Revenue
Retained earnings	Equity
Salaries and wages	Expense
Sales income	Revenue
Supplies	Asset
Supplies expense	Expense
Utilities expense	Expense

Set up and Manage Accounts Quiz!

What account type is Cash?

Asset

What account type is rent?

Expense

What account type is loan payable?

Liability

What account type is an owner’s draw?

Equity

2. Record Financial Transactions

Record Financial Transactions

Once your accounts are set up it is now time to record what's happening with your money. There are two different methods used to record transactions - Cash basis vs. Accrual basis. The difference between the two methods is in the timing of recording the transactions.

Cash:

- Income is recorded when cash is received.
- Expense is recorded when paid.

- Accrual:
- Income is recorded when the service is provided or earned, the goods are shipped or order is placed.
- Expense is recorded when you actually receive the goods or service.

Cash vs. Accrual Basis Example

Revenue Recognition:

- A company sells $10,000 of widgets to a customer in March, which pays the invoice in April. Under the cash basis, the company records the $10,000 sale in April, when the cash is received from the customer. Under the accrual basis, the company records the $10,000 sale in March when it issued the invoice to the customer.

Expense Recognition:

- A company buys $500 of office supplies in May, which it pays for in June. Under the cash basis, the company records the expense in June when it pays the bill. Under the accrual basis, the company records the expense in May when it receives the supplier's invoice.

Why does Cash or Accrual basis matter?

Imagine you perform the following transactions in a month of business:

- 1. Sent out an invoice for $5,000 for a web design project completed this month
- 2. Received a bill for $1,000 in developer fees for work done this month
- 3. Paid $75 in fees for a bill you received last month
- 4. Received $1,000 from a client for a project that was invoiced last month

<u>The effect on cash flow:</u>

- Cash basis – profit for this month would be $925 ($1,000 in income minus $75 in fees paid)
- Accrual basis – profit for this month would be $4,000 ($5,000 in income minus $1,000 in fees)

<u>The effect on taxes:</u>

- If these transactions happened in November and December one of the differences between cash and accrual is that they affect which tax year the income and expenses are recorded in. If using accrual method you would include $4,000 of income for the current tax year if you invoiced the client in December even if you don’t receive the payment until January of the next year. With cash basis you would only be including $925 of income for the current tax year.

Why does Cash or Accrual basis matter?

Advantages and Disadvantages of both methods:

- Cash Method Advantages – It is simple and only accounts for cash paid or received which makes tracking cash flow easier to record and maintain. It can have the effect of deferring some taxes because it recognizes revenue more slowly and expenses more quickly than the accrual method.
- Cash Method Disadvantages – It might not be as accurate and may be misleading as to the profitability of your business.
- Accrual Method Advantages – It is more accurate on the profitability of your business especially long-term because it includes all revenues when they are earned and all expenses when they are incurred.
- Accrual Method Disadvantages – It is more complicated to implement and maintain since you have to also account for unearned revenue and prepaid expenses. It does not track cash flow and might not account for a cash shortage short term. Also you pay income taxes on revenue before you actually receive it.
- Most small businesses use cash basis
- Some businesses are required to use the accrual method (if gross annual revenue exceed $5 million or businesses with inventory)
- If you already filed your first tax return you must use same method consistently otherwise you may need to get approval from IRS to change methods.

Record Financial Transactions

- Double-entry bookkeeping – any transaction in one account requires an equal and opposite entry in another account.
- Two entries for each transaction – Debit (Dr) and a Credit (Cr)
- A debit is made on the left side of an account and a credit is made on the right side of an account.
- Every transaction must debit at least one account and credit at least one account and total debits must always equal total credits.

Date	Account	Debit	Credit
XX/XX/XXXX	Account Opposite Account	X	 X

Debit and Credit Examples

- On July 1st your company sells a product to a customer for $1,000 in cash. This results in sales of $1,000 and cash of $1,000. You must record an increase of the cash (asset) account with a debit and an increase of sales account with a credit:

Date	Account	Debit	Credit
07/01/2019	Cash	$1,000	
	Sales		$1,000

- On July 1st your company also buys equipment for $15,000 on credit. This results in an addition to the asset account with a debit and an increase in the accounts payable (liability) account with a credit.

Date	Account	Debit	Credit
07/01/2019	Equipment	$15,000	
	Accounts Payable		$15,000

Debits = Credits

Left = Right

Debits and credits affect each account differently

Account type	Debit recorded for	Credit recorded for
Asset	Increase	Decrease
Liability	Decrease	Increase
Revenue	Decrease	Increase
Expense	Increase	Decrease
Equity	Decrease	Increase

Record Financial Transactions - T accounts

- A T account is a graphic representation of a double entry accounting recorded transaction. Debit entries are on the left and credits on the right.

Assets

Debits	Credits
Increase	Decrease
Normal Balance	

Expenses

Debits	Credits
Increase	Decrease
Normal Balance	

Owner's Drawing

Debits	Credits
Increase	Decrease
Normal Balance	

Liabilities

Debits	Credits
Decrease	Increase
	Normal Balance

Revenues

Debits	Credits
Decrease	Increase
	Normal Balance

Owner's Capital

Debits	Credits
Decrease	Increase
	Normal Balance

Record Financial Transactions - T accounts

What would T accounts look like for each of the following examples of a cash basis company?

-Received $300 in sales.

-Paid $1,500 in rent.

-Purchased $20,000 in equipment with a loan.

-Owner paid themselves $2,000.

-Owner puts in $5,000 investment to start company.

-A transfer of $3,000 from the business savings account to the business checking account.

Record Financial Transactions

Accounting software automatically does these entries for us “behind the scenes”

But it is important for you to have a general understanding to help you identify errors. An example would be a credit balance in the Accounts Receivable account.

- Accounts that typically have a debit balance:
  - Assets
    - Cash
    - Inventory
    - Accounts Receivable
    - Equipment
  - Expenses
  - Owner Draws/Distributions

- Accounts that typically have a credit balance:
  - Liabilities
    - Accounts Payable
    - Taxes Payable
    - Loans
    - Customer Deposits
  - Income
  - Owner Contributions

3. Balance & Close The Books

Balance and Close the Books

- The last step in basic bookkeeping is to balance and close the books. When you total up account debits and credits, often at the end of the year, the totals should match. This means your books are "balanced."
- You may have to adjust or add transactions or journal entries to get everything balanced.
- **Assets = Liabilities + Equity**
- If the two sides of the equation don't match then you need to continue to find errors or post corrected entries again until the accounts are balanced.
- Once accounts are balanced then you are ready to close the books and prepare financial statements.

Reconciliations

- Monthly bank and credit card reconciliations will help to ensure that records are in agreement and the book accounts match the actual money made and spent.
- Reconciliations need to be made in order to close the books and prepare accurate financial statements.

4. Prepare Financial Statements

Prepare Financial Statements

Income Statement:

- This report is also called the Profit and Loss (P&L) statement. It breaks down business revenues, costs, and expenses over a period of time (i.e. yearly or quarterly). The difference between income and expenses is the profit or loss for a period. It measures the profitability of a company.

Balance Sheet:

- This report summarizes business assets, liabilities, and equity at a single point in time. Your total assets should equal the sum of all liabilities and equity accounts. It measures the ability of your company to pay its bills.

Prepare Financial Statements

- Balance Sheet Accounts

Assets

Liabilities

Owner’s Equity

- Income Statement Accounts

Revenue

Expenses

Sample Products Co.
Income Statement
For the Five Months Ended May 31, 2018

Sales		$100,000
Cost of goods sold		75,000
Gross profit		25,000
Operating expenses		
Selling expenses		
Advertising expense	2,000	
Commissions expense	5,000	7,000
Administrative expenses		
Office supplies expense	3,500	
Office equipment expense	2,500	6,000
Total operating expenses		13,000
Operating income		12,000
Non-Operating or other		
Interest revenues		5,000
Gain on sale of investments		3,000
Interest expense		(500)
Loss from lawsuit		(1,500)
Total non-operating		6,000
Net Income		$ 18,000

Example Company
Balance Sheet
December 31, 2018

ASSETS		LIABILITIES	
Current assets		Current liabilities	
Cash	$ 2,100	Notes payable	$ 5,000
Petty cash	100	Accounts payable	35,900
Temporary investments	10,000	Wages payable	8,500
Accounts receivable - net	40,500	Interest payable	2,900
Inventory	31,000	Taxes payable	6,100
Supplies	3,800	Warranty liability	1,100
Prepaid insurance	1,500	Unearned revenues	1,500
Total current assets	89,000	Total current liabilities	61,000
Investments	36,000	Long-term liabilities	
		Notes payable	20,000
Property, plant & equipment		Bonds payable	400,000
Land	5,500	Total long-term liabilities	420,000
Land improvements	6,500		
Buildings	180,000		
Equipment	201,000	Total liabilities	481,000
Less: accum depreciation	(56,000)		
Prop, plant & equip - net	337,000		
Intangible assets		STOCKHOLDERS' EQUITY	
Goodwill	105,000	Common stock	110,000
Trade names	200,000	Retained earnings	220,000
Total intangible assets	305,000	Accum other comprehensive income	9,000
		Less: Treasury stock	(50,000)
Other assets	3,000	Total stockholders' equity	289,000
Total assets	$ 770,000	Total liabilities & stockholders' equity	$ 770,000

The notes to the sample balance sheet have been omitted.

Prepare Financial Statements

Determine what type of account these are and if they are one the Income Statement or Balance Sheet:

- Equipment
- Sales Revenue
- Credit Card Payable
- Office Supplies
- Owner Draw
- Inventory
- Sales Tax Payable
- Depreciation Expense
- Accounts Receivable
- Loan Payable
- Cost of Goods Sold

- Asset – Balance Sheet
- Income – Income Statement
- Liability – Balance Sheet
- Expense – Income Statement
- Equity – Balance Sheet
- Asset – Balance Sheet
- Liability - Balance Sheet
- Expense – Income Statement
- Asset – Balance Sheet
- Liability – Balance Sheet
- Expense – Income Statement

Prepare Financial Statements

- Why do we care about having financial statements?
  - Software creates these financial statements for you even in real-time. This can be a lifeline when you need to make quick financial decisions based on the health of your business.
  - Financial statements are needed to secure business loans, lines of credit or business credit cards.
  - Financial statements are needed to file your tax returns.
  - Financial statements are needed if you ever want to sell your business or want investors.

The four basic steps for small business bookkeeping

1. Set up and manage accounts
2. Record financial transactions
3. Balance and close the books
4. Prepare financial statements

Why bookkeeping matters

1. Helps you catch banking errors
2. Ensures you don’t miss out on deductions come tax time
3. Gives you a clear picture of where your money is going
4. Makes it easy to prepare financial statements so you can file your taxes on time and secure business loans
5. Enables you to plan, budget and make good decisions in order to be successful and grow
6. Keeps you out of trouble with the IRS and state governments!

Top bookkeeping *mistakes* made by small businesses

1. Putting it off
2. Mixing business and personal expenses
3. Throwing away your receipts
4. Recording payments to yourself as an expense
5. Reporting transfers as income
6. Writing off major purchases as immediate expenses
7. Not classifying employees correctly (employee vs. independent contractor)
8. Neglecting sales tax
9. Trying to do it all yourself without help

What is Depreciation?

- Depreciation lets you deduct the cost of an asset you bought for your business. Instead of expensing the entire cost of the asset all in one tax year, you can write off parts of it over time. The number of years you depreciate something is determined by its useful life.
- What is an asset?
- Assets are property that can either be tangible or intangible. A tangible asset can be touched such as an office building, vehicles, equipment, furniture or a computer. An intangible asset can’t be touched such as intellectual property like a patent or copyright. Both tangible and intangible assets can be depreciated. Depreciation for intangible assets is called amortization.
- What kind of assets can you depreciate?
- The IRS has guidelines (IRS Publication 946) for what type of assets you can depreciate. To be depreciable, the property must meet all of the following requirements:
  - It must be property you own.
  - It must be used in your business or income-producing activity.
  - It must have a determinable useful life.
  - It must be expected to last more than one year.

How to figure out your asset’s useful life?

- The IRS has guidelines that sets the useful life for different types of assets (IRS Publication 946 Appendix B).
  - 5 year property – Vehicles, computers, office equipment.
  - 7 year property - Office Furniture
  - 27.5 year property – Residential rental property
  - 39 year property – Office Buildings or commercial property
  - How to calculate depreciation?
  - You will need the total price paid for the asset and the useful life determined by the IRS.

Types of Depreciation

- Straight Line - splits an asset's value evenly over multiple years.
- Double Declining - lets you write off more of an asset's value immediately after you buy it and less later on.
- Example: Your business purchases office equipment for $5,000. It has a useful life of 5 years.
- Straight Line Formula – asset cost / useful life
  - $5,000 / 5 = $1,000
- You will write off $1,000 in depreciation expense from the office equipment each year for 5 years.

Double Declining Formula

(2 x single line depreciation rate) x (book value at beginning of year)

- You will need to do the straight line depreciation calculation first to determine the depreciation rate. The depreciation rate is the percentage the asset depreciates each year.
- Using the same example since the office equipment is depreciated over 5 years it's depreciation rate is 20%. Keep in mind that the book value will change each year, as money is deducted.
- (2 x 0.20) x (5,000) = $2,000
- You will write off $2,000 in depreciation expense from the office equipment for year one. Keep in mind, though, that you deduct that $2,000 from the book value. That means, going into next year, the book value is $3,000.
- So, the equation for year two looks like:
- (2 x 0.20) x (5,000 – 2,000) = $1,200
- So, even though you wrote off $2,000 in the first year, by the second year, you write off $1,200.
- By the final year of depreciation, you'll be writing off just $259.

Business Mileage

- Must keep a log with date, destination, distance and business purpose.
- Record as incurred – difficult to reconstruct after the fact.
- Record mileage on vehicle on Jan 1st and Dec 31st every year. Must also know total mileage driven. Business miles/ total miles to figure out business percentage of expenses.
- IRS standard mileage rates for 2019 is 58 cents per mile.
- Deduct either auto expenses or mileage whichever is higher but not both.

Meals & Entertainment Expenses

- Tax deduction limited to 50%.
- Must document who, when, where and business purpose!!
- Record as incurred – difficult to reconstruct after the fact.

Home Office Deduction

- Regular and exclusive use. You must regularly use part of your home exclusively for conducting business.
- Limited to net income (cannot deduct if reporting a loss).
- Allocated based on square footage. Square footage of space used for home office and total square footage of home.
- Simplified option ($5 per SF up to a maximum of 300 SF).
- Regular method. Actual expenses (total expenses x SF% of the home office).

Sales Tax

- If you are selling tangible property you will have to charge and remit sales tax.
- You do not have to charge sales tax on services or labor.
- Please check with the Colorado Department of Revenue and your local city for sales tax licenses and rates.
- If you are located in a home rule city you will have to remit city sales tax separately from the state sales tax.
- Most cities and State of CO have sales tax classes.

QUESTIONS?

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