LEARNING MADE EASY

3rd Edition

Bookkeeping

for dummies®

A Wiley Brand

Grasp the components of a financial cycle

Use QuickBooks® Online to manage your bookkeeping

Track and balance business transactions

Lita Epstein, MBA

Bookkeeping

3rd Edition

by Lita Epstein, MBA

for dummies®
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Bookkeeping For Dummies®, 3rd Edition

Published by: **John Wiley & Sons, Inc.,** 111 River Street, Hoboken, NJ 07030-5774, www.wiley.com

Published simultaneously in Canada

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Library of Congress Control Number: 2025936529

ISBN 978-1-394-34979-1 (pbk); ISBN 978-1-394-34981-4 (ebk); ISBN 978-1-394-34980-7 (ebk)

Contents at a Glance

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Introduction

Bookkeepers manage all the financial data for small companies. If you subscribe to the idea that information is power (which I do), you'll agree that the bookkeeper has a tremendous amount of power within a company. Information tracked in the books helps business owners make key decisions involving sales planning, hiring and product offerings and manage many other financial aspects of their business.

If it weren't for the hard work of bookkeepers, companies wouldn't have a good idea about what happens with their financial transactions. Without accurate financial bookkeeping, a company owner wouldn't know how many sales were made, how much cash was collected, or how much cash was paid for the products sold to customers during the year. They also wouldn't know how much cash was paid to employees or how much cash was spent on other business needs throughout the year. In other words, accurate and consistent bookkeeping is the most effective way to keep track of a business's cash flow.

Accurate and complete financial bookkeeping is crucial to any business owner, but it's also important to those who work with the business, such as investors, financial institutions, and employees. People both inside (managers, owners, and employees) and outside the business (investors, lenders, and government agencies) all depend on the bookkeeper's accurate recording of financial transactions.

Yes, the bookkeeper's job is critical and requires certain skills and talents. Bookkeepers must be detail-oriented, enjoy working with numbers, and be meticulous about accurately entering those numbers in the books. They must also be vigilant about keeping a paper trail and filing all needed backup information about the financial transactions entered into the books.

Whether you're a business owner keeping the books yourself or an employee keeping the books for a small business owner, your job is critical for the smooth financial operation of the company.

About This Book

In this book, I introduce you to the key aspects of bookkeeping and how to set up and use your financial books. I walk you through the basics of bookkeeping, starting with the process of setting up your company's books and developing

- A list of your company's accounts, called the Chart of Accounts.
- Your company's General Ledger, which summarizes all the activity in a company's accounts.
- Your company's journals, which give details about all your financial transactions.

Then, I take you through the process of recording all your transactions — sales, purchases, and other financial activity. I also talk about how to manage payroll, governmental reporting, and external financial reporting.

Finally, I show you how to start the yearly cycle all over again by closing out the necessary accounts for the current year and opening up any new ones for the next year.

Yes, bookkeeping is a continuous cycle starting with financial transactions, recording those transactions in journals, posting those transactions to the General Ledger, testing your books to be sure that they're in balance, making any necessary adjustments or corrections to the books to keep them in balance, preparing financial reports to understand how well the business did during the year, and finally getting ready to start the process all over again for the next year.

You find out all about this cycle, starting with Chapter 2 and following the bookkeeping journey through closing out the year and getting ready for the next year in Chapter 23.

I've included a number of examples of how to apply the basics of bookkeeping to real-life situations. If you're primarily reading this book to gain a general knowledge of the subject and don't need to delve into all the nitty-gritty, day-to-day aspects of bookkeeping, you may want to skip over the paragraphs marked with the Example icon (see the section "Icons Used in This Book" later in this Introduction). Skipping the examples shouldn't interfere with your grasp of the key aspects of how to keep the books.

I use QuickBooks Online throughout this book, so I will show you some of its advanced features where appropriate.

Conventions Used in This Book

To help you find your way around in the book, I use the following conventions:

- *Italics* are used both to emphasize a word to make a sentence clearer and to highlight a new word that's being defined.
- **Bold** highlights keywords in bulleted lists.

Foolish Assumptions

While writing this book, I made some key assumptions about who you are and why you've picked up this book to get a better understanding of bookkeeping. I assume that you are

- A business owner who wants to know how to do your own books. You have a good understanding of business and its terminology but have little or no knowledge of bookkeeping and accounting.
- A person who does bookkeeping or plans to do bookkeeping for a small business and needs to know more about how to set up and keep the books. You have some basic knowledge of business terminology but don't know much about bookkeeping or accounting.
- A staff person in a small business who's just been asked to take over the company's bookkeeping duties. You need to know more about how transactions are entered into the books, how to prove out transactions to be sure that you're making entries correctly and accurately, and how to prepare financial reports using the data you collect.

Beyond the Book

In addition to what you're reading right now, this product also comes with a free access-anywhere Cheat Sheet, where you can see the building blocks for a successful bookkeeping system, key steps for keeping the books, and tips on controlling your business cash and calculating and testing cash flow. To get this Cheat Sheet, simply go to `www.dummies.com` and enter "Bookkeeping For Dummies Cheat Sheet" in the Search box.

Icons Used in This Book

This book contains icons that point to the type of information you're reading.

TIP

Look to this icon for ideas on how to improve your bookkeeping processes and use the information in the book to manage your business.

REMEMBER

This icon marks anything I want you to recall about bookkeeping after you've finished reading this book.

TECHNICAL STUFF

Who doesn't love a little technical jargon? I've pulled out these paragraphs so you can understand the technical aspects of bookkeeping without getting overwhelmed.

WARNING

This icon points out any aspect of bookkeeping that comes with dangers or perils that may hurt the accuracy of your entries or the way in which you use your financial information in the future. I also use this icon to mark certain things that can get you into trouble with the government, your lenders, your vendors, your employees, or your investors.

Where to Go from Here

Can you feel the excitement? You're now ready to enter the world of bookkeeping! Because of the way *Bookkeeping For Dummies*, 3rd Edition is set up, you can start anywhere you like.

If you need the basics or if you're a little rusty and want to refresh your knowledge of bookkeeping, start with Part I. However, if you already know bookkeeping basics, are familiar with the key terminology, and know how to set up a Chart of Accounts, consider diving into Part II.

If you've set up your books already and feel comfortable with the basics of bookkeeping, you may want to start with Part III on how to enter various transactions. On the other hand, if your priority is using the financial information you've already collected, check out the financial reporting options in Part V.

1

Basic Bookkeeping: Why You Need It

IN THIS PART . . .

Introducing you to the world of bookkeeping

Exploring bookkeeping basics

Developing your financial road map

IN THIS CHAPTER

» Introducing bookkeeping and its basic purpose

» Maintaining a paper trail

» Managing daily business finances

» Making sure everything is accurate

» Putting on a financial show

Chapter 1

So, You Want to Do the Books

Few small business owners actually hire accountants to work full time for them. For many small businesses, that expense is probably too great, so instead, the owner hires a bookkeeper to keep track of the business's month-to-month financials. In return, the accountant helps the bookkeeper develop good bookkeeping practices and reviews their work periodically (usually monthly).

In this chapter, I provide 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.

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 sweat the small stuff, like keeping detailed records of every penny spent; you just want to quickly build a business in which you can make lots of money.

Well, slow down there — this isn't a race! 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. And keeping close track of cash flow is key to the success of small businesses.

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

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 from 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 only record transactions when cash changes hands. If you use accrual accounting, you record a transaction when it's completed, even if cash doesn't change hands.

For example, suppose your company buys products to sell from a vendor but doesn't actually pay for those products for 30 days. If you're using cash-basis accounting, you don't record the purchase until you actually 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.

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

Understanding assets, liabilities, and equity

Every business has three key financial parts that must be kept 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:

Assets = Liabilities + Equity

Because it's so important, I 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.

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

I know all this debit, credit, and double-entry stuff sounds confusing, but I promise it will become much clearer as you work through this book. I start explaining this critical yet somewhat confusing concept in Chapter 2.

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; it's essentially a list of all the accounts your business has and what types of transactions go into each one.

I talk more about the Chart of Accounts in Chapter 3.

Recognizing the Importance of an Accurate Paper Trail

Keeping the books is all about creating an accurate paper trail. You want to track all of your company's financial transactions, so if a question comes up at a later date, you can turn to the books to figure out what went wrong.

REMEMBER

An accurate paper trail is the only way to track your financial successes and review your financial failures, a task that's vitally important in order to grow your business. You need to know what works successfully so 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 different formats. Controlling who enters this financial information into your books and who can access it afterward is smart business and involves critical planning on your part. I address all these concepts in the following sections.

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 can also use these account summaries to develop internal reports that help you make key business decisions. I talk more about developing and maintaining the General Ledger in Chapter 4.

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.

For example, almost every company has a Cash Receipts Journal in which to keep the details for all incoming cash and a Cash Disbursements Journal in which to keep the details 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. I talk more about the importance of journals, the accounts commonly journalized, and the process of maintaining journals in Chapter 5.

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 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 also makes designing reports easier. These reports can then be used to help 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. I will talk more about computerized accounting systems in Chapter 6. I also discuss how to protect your financial records kept online in Chapter 8.

Instituting internal controls

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

You also need to carefully control who can accept cash receipts and who can disburse your business's cash. Separating duties appropriately helps you protect your business's assets from error, theft, and fraud. I talk more about controlling your cash and protecting your financial records in Chapter 7.

Using Bookkeeping's 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 established to manage the day-to-day operations of your business. You'll quickly see how a well-designed bookkeeping system can make your 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 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 inventory costs 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 you have enough inventory on hand to satisfy your customers' needs. I will talk more about how to use your bookkeeping system to manage inventory in Chapter 9.

Tracking sales

Everyone wants to know how well their 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 you need to offer discounts more frequently in order 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 weaknesses and figure out how to maintain your profit goals in spite of any obstacles.

While 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 is usually a sign of a problem that needs to be researched and corrected.

I talk more about how to use the bookkeeping system for tracking sales, discounts, and returns in Chapter 10.

Handling payroll

Payroll can be a huge nightmare for many companies. Payroll requires you to comply with a lot of government regulations 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.

I talk more about managing payroll and government requirements in Chapters 10 and 11. I also talk about year-end payroll obligations in Chapter 21.

Running Tests for Accuracy

All the time it takes to track your transactions isn't worth it if you don't periodically test to be sure you've entered those transactions accurately. The old adage "Garbage in, garbage out" holds very true for bookkeeping: 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 out 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 cashiers and the accuracy of your checking account. I talk about all the steps necessary to take to prove out your cash in Chapter 15.

Testing your balance

After you prove out your cash (see Chapter 15), 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 find out more about trial balances in Chapter 17.

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. In Chapter 18, I explain common adjustments that may be needed as you prove out your books at the end of an accounting period, and I also explain how to make the necessary corrections.

Finally Showing Off Your Financial Success

Proving out your books and ensuring their balance 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 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 have taken any 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, which they can 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:

Assets = Liabilities + 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 revenues, 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.

I explain how to prepare a balance sheet in Chapter 19, and I talk more about developing an income statement in Chapter 20.

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 (which I explain further in Chapter 22) — must file and pay taxes. (Partnerships and LLCs do not 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.)

I talk more about business structures and how they're taxed in Chapter 22.