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CHARTERED PROFESSIONAL ACCOUNTANTS

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Basic Bookkeeping Principles for Your Small Business

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Bookkeeping is the process of recording and tracking income and expenses in the books and records of your business. Many people fail to recognize that bookkeepers are not necessarily accountants, although all accountants know how to perform bookkeeping. As a small business owner, you may decide to do your own bookkeeping but rely on an accountant to prepare your tax return, handle tricky transactions or audit your books. Whether you do your own bookkeeping or rely on someone else, you should at least be familiar with the basic principles so that you understand why things work the way they do.

Bookkeeping Systems

The two basic systems are single-entry and double-entry bookkeeping. Single-entry is similar to a checkbook, in which you either increase or decrease the amount in your checking account. It is simple to use and tells you your account's cash balance, but it sheds no light on where the money came from or went to. To account for your income and spending, you need a double-entry system that names two or more accounts for each transaction.

Accounts

Accounts reflect the basic structure of your business. You set up account for various items, such as cash, receivables, payables, inventory, payroll expenses, taxes due, and so forth. Accounts fall into seven different categories:

1. ***Assets:*** Assets are the things your business owns, including cash, accounts receivable, inventory, prepaid expenses, property, supplies and patents.

2. ***Liabilities:*** These are the things your business owes, including borrowings, payables, unfilled subscriptions and unearned revenue.

3. ***Owner's equity:*** This is the difference between assets and liabilities, and represents the total value of your business. It includes the capital you and others paid into the company, shares you've issued, dividends paid, and the earnings you've retained from operating your business.

4. ***Expenses:*** Expense accounts track how much you spend. They arise from buying and maintaining assets, paying off liabilities, and paying yourself a salary or draw.

5. ***Income:*** This is the money your business earns by providing products and/or services. It also includes any interest you earn on your excess cash and the dividends you receive by holding the stock of other businesses.

6. ***Gains:*** You record a gain when you sell an asset, other than inventory, for more than its purchase price. An example of a gain would be the sale of equipment for more than its original cost.

7. ***Losses:*** Losses occurs when you sell a non-inventory asset for less than cost. An example would be if your company sold off a vehicle for less than its depreciated salvage value.

The Accounting Equation

The first three accounts types appear on a company's **balance sheet** such that assets equal liabilities plus owner's equity. This is the basic accounting equation, and it is meant to disclose the financial condition of a company at a specific point in time. The four remaining account types, income, gains, expenses and losses, appear on the company's **income statement**.

The Accounting Transaction

In a double-entry accounting system, each transaction is dated and composed of at least two entries. Each entry lists account name and a debit or credit such that:

- A debit increases an asset, expense or loss or decreases a liability, owner's equity, income or gain.
- A credit decreases an asset, expense or loss or increases a liability, owner's equity, income or gain.
- In an accounting transaction, *the sum of the debits must equal the sum of the credits*.

For example, if you write a $100 check to Office Depot for $70 dollars of office supplies and $30 to ship a package, the accounting entry would be a debit of $70 to the office supplies account (increases an asset), a debit of $30 for shipping expense account (increases an expense), and a credit of $100 to the cash account (decreases an asset). The two debits equal the one credit, namely $100.

For convenience, you can picture activity in an account in the form of a T-ledger, with debits on the left and credits on the right, separated by a vertical line. The debits minus the credits is the account balance. Asset accounts normally have a debit balance, whereas credit balances are normal for liability and owner's equity accounts.

Cash vs Accrual Accounting

Many small business use cash accounting, in which bookkeeping entries are made only when cash is collected or disbursed. In accrual accounting, bookkeeping entries are made when income is earned and expenses are recognized, even if cash flows at a different time.

Principles

Accrual accounting is more complex but also more accurate, because it satisfies these principles:

1. ***Matching:*** Expenses should be matched to revenues. For example, sales commissions should be recognized in the period when the sales are booked, not in the period when the sales revenue is collected.

2. ***Revenue recognition:*** You recognize revenue as soon as a service is performed or a product is sold.

3. ***Cost:*** The initial, or historical, amount spent on an item doesn't change over time, regardless of any subsequent changes to its value. ***Net value*** can change, due to events such depreciation or damage, but these are separate entries from original cost.

4. ***Time period:*** Every transaction is assigned to an established time period, such as a month or a year, and financial statements must indicate the date or date range for the information presented.

Economic entity: The business activity of the company you own must be maintained separately from your personal transactions.

Going concern: It is assumed your business will continue in operation for the foreseeable future. You must disclose if this assumption is incorrect.

Full disclosure: You must report all material economic activity, either in the standard financial statements or in the footnotes to those statements.