So, you want to learn

Bookkeeping!

by Bean Counter's Dave Marshall

Hello my name is Dave and yes I'm a bean counter. No I didn't say alcoholic, that's a soft drink not a beer in my hand, and this is not a meeting of Alcoholics Anonymous. For those of you that don't know a bean counter is slang sometimes used to refer to a bookkeeper.

I've searched the web for good free bookkeeping and accounting tutorials and courses and came to the conclusion that they're hard to find so this is my attempt to try and fill the void. What qualifies me to attempt this task ? I guess you can tell it's not my fancy dress code. I have over 30 years experience in business and even taught at a small business college for a couple of years. My method of passing on knowledge is to make the subject easy to understand and to use simple examples and terminology to illustrate the concepts being presented. If you're anything like me I learn a lot easier when I can see an example of what we're talking about. Tell me and show me too.

This free bookkeeping tutorial and course is geared to business owners, managers, and individuals who have not had any formal bookkeeping training or on the job experience and need or want to learn the basics of bookkeeping. In other words, this tutorial is for beginners (newbies) or those needing a quick refresher and is only an introduction into the world of accounting. They say a little knowledge is a dangerous thing. Well my goal is to make you dangerous.

Watch My Site Tour Video to quickly determine if my site and tutorials might provide the accounting and bookkeeping help you're looking for.

Tutorial Navigation

A menu of all the bookkeeping lessons is presented at the top and bottom of all the lessons. A back and next arrow also allow you to go back to the prior lesson or on to the next lesson. In addition, some Lessons contain Interactive Tables, Forms, and Lists. These sections include Navigation Instructions. The Lessons also include Links to additional learning materials and quizzes.

Additional Needs

- My bookkeeping and accounting quizzes and games require Adobe's Free Macromedia Flash Player which is normally already installed on your computer.
  Get Adobe's Free Flash Player.
- My Skill Tests require Javascript to be enabled in your browser. Most computers also already have this feature enabled.

What's Covered ?

This **Introduction** discusses the types of business organizations, types of business activities, users of financial information, bookkeeping systems, accounting rules, and the cash and accrual basis of accounting.

Lesson 1 The Bookkeeping Language introduces you to some of the terminology and definitions used in the accounting and bookkeeping language.

Lesson 2 Property and Property Rights explains Property & Property Rights, the Accounting Equation, double entry bookkeeping, and how business transactions affect the equation.

Lesson 3 Debits and Credits introduces and explains Debits and Credits and how they affect the Accounting Equation and are used to record business transactions.

Lesson 4 Recording Business Transactions explains and uses examples to illustrate how business transactions are properly analyzed, recorded, and summarized.

Lesson 5 The General Ledger and Journals explains what General Ledger and Journals are, how they're used, and what bookkeeping purposes they serve.

Lesson 6 Financial Statements explains what financial statements are, how they're created, and how they're used.

Lesson 7 Review of Major Concepts reviews the major definitions, concepts, and bookkeeping records previously discussed and necessary for an understanding of bookkeeping.

Introduction

Why Learn Bookkeeping ?
Why would you want to learn bookkeeping and keep up to date financial records anyway ? Can't you hire an accountant to come after the end of the year and get your check book and shoe box and do your taxes ? Sure you can ! And yes you will have adequately fulfilled your taxpayer obligations. But in order to run a business and know what, where, and when to take corrective actions requires business information. How do you get and where do you find this information ? You don't if you don't keep accurate and current records about your business financial activities (bookkeeping).

Users of Financial Information
Who needs financial information about a business besides the owner(s) ?

Users can be grouped into two broad categories namely internal users and external users. Internal users are the managers and the owners and employees who actually work for the business. External users include lenders and other creditors (suppliers), investors, customers, and governmental regulatory and taxing agencies.

Why do they need financial information ?
Users need this information to make knowledgeable decisions. Lenders and other creditors want to make sure that they will be paid back for the credit that they have extended to a business. By analyzing financial information, they at least have something to base their lending or credit decision on. The days of the "friendly" banker are gone. You need to provide them with financial information as a basis for their loan decisions. A "good ole boy" handshake won't cut it now. Similarly, customers want to make sure that the business they're buying products or services from is going to be around and not be in such a poor financial position as to have to close its doors. Other users have their own reasons for using this financial information.

Since users require financial information to base their decisions on, let's determine what is required to fill this need.

Let's begin with a definition for accounting.
Accounting is the art of analyzing, recording, summarizing, reporting, reviewing, and interpreting financial information.

Let's also define what bookkeeping is and is not. I hate to admit this but I'm going to tell a true story about myself in high school. I thought I was fairly smart back in my high school days and took all the college prep classes. My high school offered bookkeeping classes but I had no clue as to what that course was about. I thought bookkeeping was a course on how to properly organize and stack the reading books in the proper place and shelves in the library using that Dewey decimal code. That is keeping the books isn't it ? Well kinda, but that's not the bookkeeping you're going to learn here. Bookkeeping is one of the components of accounting. Think of accounting as the mom and bookkeeping as one of her children.

Bookkeeping is the process of recording and classifying business financial transactions (activities). In simple language-maintaining the records of the financial activities of a business or an individual. Bookkeeping's objective is simply to record and summarize financial transactions into a usable form that provides financial information about a business or an individual.

Accountants normally plan and set up the accounting and bookkeeping system for a business and turn over the day to day record keeping to the owner or one of his/her employees. In this age of computers, more and more of the daily bookkeeping is being done using bookkeeping software and computers although some businesses still maintain manual records. Due to the reasonable cost of computers and software, I recommend an automated (computer) bookkeeping system. In order to illustrate and understand what is actually being recorded and summarized by a computer bookkeeping system (behind the scenes) my lessons will illustrate the manual method of recording a company's financial information.

Before we start our formal training, I need to present some preliminary information that you should be familiar with. The objective is to give you a little business background information before we dive right in to the lessons.

Types Of Business Organization
One of the first decisions that a person(s) needs to make is how the company should be structured. The four basic legal forms of ownership for small businesses are a Sole Proprietorship, Partnership, Corporation, and Limited Liability Company. There are advantages and disadvantages as well as income tax ramifications

associated with each type of organization. We aren't going to delve in to this area but a brief description of the different types of organization and what they are is needed.

- **Sole Proprietorship**
  Most small business start out as sole proprietorships. These firms are owned by one person who is normally active in running and managing the business.
- **Partnership**
  A partnership is two or more people who share the ownership of a single business. In order to avoid misunderstandings about how profits/losses are shared , who's responsible for what, and other management, ownership, and operating decisions the partners normally have a formal legal partnership agreement.
- **Corporation**
  A corporation is an organization that is made up of many owners who normally are not active in the decision making and operations of the business. These owners are called shareholders or stockholders. Their ownership interest is represented by certificates of ownership (stock) issued by the corporation. Two types of corporations:

- Regular or "C" Corporation
  Earnings are taxed to the corporation. Shareholders not personally liable for income taxes unless dividends are paid.
- Subchapter-S
  A special type of corporation allowed by the Internal Revenue Service (IRS) that passes or transfers its earnings to the individual shareholders who personally pay the income taxes.

- **Limited Liability Company (LLC)**
  The LLC is a relatively new type of business structure that combines the benefits of a partnership and corporation.

Factors To Consider
Some Factors and a brief description of what to consider when choosing a type of organization:

- Tax Consequences - Federal and State
  what taxes do you have to pay to the federal and state taxing authorities?
  Is the business organization a pass-through (income only taxed once) or is the income taxed twice?
- Ease and cost of formation and recurring registration fees
  What documents do you need to file and what are the initial and recurring costs for the type of organization?
- Degree of control
  Do you want to call all the "shots" ?
  As a sole owner you get to.
- Liability (personal)
  Do your personal assets need protection from legal liability ?
  Are you willing to be liable for others (partners) ?
- Ability to get money (capital)
  Do you need other investors to get your business "off the ground" ?
- Type of Business
  If your type of profession requires a special license, is it limited to what type of organization that can be selected ?

All the different types of organizations listed above have some unique methods and rules for accounting for their transactions associated with their equity (ownership) accounts. This tutorial in order to keep it simple and since many small businesses start out organized as sole proprietorships will focus on bookkeeping for a **sole proprietorship**.

Types Of Business Activity
Our society is made up of all kinds of different types of businesses. Some sell products directly to the consumer and are known as retailers. Other businesses called wholesalers warehouse and sell large quantities of products to the retailers who in turn sell it to us (consumer). Businesses like myself provide and sell services to other businesses and individuals. Some businesses even tackle the task of actually producing (make) the products and are called manufacturers.

Many of these businesses are required to maintain and account for inventories of the products that they stock or have on hand. Again this being an introductory tutorial we are not going to cover the practices and procedures used in accounting for inventories. Those wanting to learn about inventories need to refer to my **So, you want to learn Bookkeeping! - Merchandise Inventory Tutorial**. That being the case, the examples in this tutorial will deal with a **service type of business**.

Accounting Period
Believe it or not, a business needs to select an annual tax year. Your two main choices are a **calendar** or **fiscal** tax year. A Calendar Tax Year is 12 consecutive months beginning January 1 and ending December 31. A Fiscal Tax Year is 12 consecutive months ending on the last day of any month except December 31. The calendar tax year is used by most businesses.

A reason a business might choose a fiscal tax year is that they could select an ending month for their fiscal year when business activity is low. This makes the process of what is called closing the books a little easier. Also if a business has inventories, there would be less they would have to count.

For us yanks, our Internal Revenue Service (IRS) has guidelines for what accounting periods can be used based on the types of business organizations such as a corporation, sole proprietorship, partnership, etc. Normally, choosing a calendar year is a safe choice.

Types Of Bookkeeping Systems
A business also needs to determine the type of bookkeeping system that will be used for recording their business transactions. Many small businesses start out using the single entry system.

- **Single Entry System**
  The single entry system is an "informal" accounting/bookkeeping system where a user of this system makes only **one entry** to enter a business financial transaction. It generally includes a daily summary of cash receipts and a monthly record of receipts and disbursements (worksheets).

A checkbook, for example, is a single entry bookkeeping system where one entry is made for each deposit or check written. Receipts are entered as a deposit and a source of revenue. Checks and withdrawals are entered as expenses. If a manual system is used, in order to determine your revenues and expenses you have to prepare worksheets to summarize your income and categorize and summarize your different types of expenses. Bookkeeping software and spreadsheets are also available to do this for you.

The emphasis of this system is placed on determining the profit or loss of a business.

It got its name because you record each transaction only once as either revenue (deposit) or as an expense (check). Since each entry is recorded only once, **debits and credits** (recording method required for the double entry system) **are not used** to record a financial event.

For those interested, the Internal Revenue Service's Publication 583 - "Starting a Business and Keeping Records" has a detailed example of a single entry type of system.

While the single entry system may be acceptable for tax purposes, it **does not provide** a business with all the financial information **needed to adequately report** the financial affairs of a business. In the near future, we'll probably see the single entry system follow the same path as the dinosaur - extinction.

- **Double Entry System**
  The double entry system is the **standard system** used by businesses and other organizations to record financial transactions. Since all business transactions consist of an exchange of one thing for another, double entry bookkeeping **using debits and credits**, is used to show this two-fold effect. Debits and credits are the device that provide the ability to record the entries twice and are explained in more detail later in this tutorial.

The double entry system also has built-in checks and balances. Due to the use of debits and credits, the double-entry system is self-balancing. The total of the debit values recorded must equal the total of the credit values recorded.

This system, when used along with the accrual method of accounting, is a **complete accounting system** and focuses on the income statement and balance sheet. This system has worldwide support as the system to use by businesses for recording their financial transactions.

It got its name because each transaction is recorded in at least two places (accounts) using debits and credits.

Accounting Methods
Another decision faced by a new business is what accounting/bookkeeping method is going to be used to track revenues and expenses. An accounting method is just a set of rules used to determine when and how income and expenses are reported.

If inventories are a major part of a business, the decision is made for the business owner by the Internal Revenue Service (IRS). Some business will be required to use the accrual method of accounting while others may be granted an exception and allowed to use the cash basis along with some special rules.

You're more than likely to encounter both the term **method** and **basis** used when this topic is discussed. In some cases you'll see the term **cash method** used and other cases see the term **cash basis** used. Likewise you'll see the term **accrual method** used and the term **accrual basis** used. They both refer to the same concept and are used interchangeably.

- **Cash Method**
  The cash **method** or **basis** of accounting recognizes revenues (earnings) in the period the cash is received and expenses in the period when the cash payments are made. Actually, two types of cash methods (basis) of accounting exist:

- **strict** cash method (basis)

- **modified** cash method (basis)

A strict cash method follows the cash flow exactly. A modified cash method includes some elements from the accrual method of accounting and provides special methods for handling items such as inventory and cost of goods sold, payroll tax expenses and liabilities, and recording and depreciating property and equipment.

Many small businesses, whether they know it or not, are actually using a **modified** cash method.

By concentrating on recording revenues and expenses, the purpose of the cash or modified cash method of accounting is on determining the net income or loss for a period based on the cash received and the cash spent.

Information, such as the amounts billed to customers for products and/or services and not paid, and the amounts billed by suppliers for their products and/or services and not paid **is not normally recorded and maintained** in the "books" using the cash method.

Many small businesses start out using the cash basis rather than the accrual basis of accounting.

Use of the cash basis generally is not considered to be in conformity with generally accepted accounting principles (GAAP). Is this necessarily bad ? No, if no need is foreseen for what are called audited financial statements there's no need for concern. In most cases, audited statements are only required for the "big boys" (companies whose ownership interests are publicly traded). The "little guys" like the ma and pa shops don't need to worry. Still, when possible, a business should strongly consider using the accrual method of accounting.

- **Accrual Method**
  The accrual **method** or **basis** of accounting records income in the period earned and records expenses and capital expenditures such as buildings, land, equipment, and vehicles in the period incurred.

The purpose of the accrual method of accounting is to properly match income and expenses in the correct period.

In order to accomplish this, the accrual method of accounting records revenue as earned when the product and/or service is shipped or rendered and invoiced (billed) to customers. Likewise, expenses and capital expenditures are recorded as incurred when the product and or service is shipped or rendered and invoiced (billed) by the supplier.

Information, such as the amounts billed to customers for products and/or services and not paid, and the amounts billed by suppliers for their products and/or services and not paid **is recorded and maintained** in the "books" using the accrual method. This is the accounting method that is required to be used in order to conform to generally accepted accounting principles (GAAP) in preparing financial statements for external users.

Difference Between The Two Methods
The difference between the two methods used for recording revenues and expenses results from when the business transaction is recorded in the "books" (**timing**). A business using the accrual method will record revenues and expenses in their "books" before a business using the cash method. In other words, **unlike** the **cash method**, they don't wait until they get paid by the customer or wait until they pay a supplier to record the transaction.

Comment: I've heard that "forewarned is fore armed" so here goes. **Cash Flow** and **Profits** are two different "animals". Due to the timing difference as to when revenue and expenses are recorded and when the cash resulting from the revenue and expenses is actually received or paid out , a business using the accrual method of accounting and reporting a "hefty" profit does not necessarily mean that they have the cash to pay their bills.

Even though the accrual method provides a better measure of profit and loss, many small businesses still use the cash basis of accounting. I think with the advent of easier to use computer accounting and bookkeeping software, we'll see more businesses adopting the accrual basis of accounting.

Relationship Between the Type of Bookkeeping System Used and the Accounting Method Used
What if any is the relationship between the type of bookkeeping system used and the method of accounting ?

The **Single Entry** bookkeeping system is used along with the **Cash Method** of accounting.
Debits and Credits **are not used** to record financial events.

The **Double Entry** bookkeeping system can be used with **both** the **Cash and Accrual** methods of accounting.
Debits and Credits **are used** to record financial events.

So You Know
You can use a **different** accounting method, the cash method or the accrual method, for each business that you set up.

Also, you can keep two sets of books, one on the cash basis and the other on the accrual basis, for the same business. You do; however, have to select one of the methods for tax purposes and continue to use it in the future. This is perfectly legal. It's when you keep two sets of books to hide your true earnings when the trouble begins.

Accounting and Bookkeeping Software
Let's muddy the water about the single and double entry accounting method at least as to how it relates to using bookkeeping and accounting software.

Single or Double Entry ?
Accounting and bookkeeping software programs actually allow the user to make a single (one) entry and the software handles creating the debit and credit entries "behind the scenes". The double-entry system is still there, but it's hidden from the user. The one exception is the general journal where the user does enter debits and credits.

Let's look at a sample transaction of invoicing (billing) a customer to illustrate what I'm talking about.. An invoice to a customer is created and printed and the resulting transaction is **automatically recorded** in the "books" as an increase to the amounts owed by customers and an increase to revenues (sales) using debits and credits.

Wow, since its automatic, does that mean we don't need to learn about debits and credits later? Only in your dreams. Although an airplane can be flown on auto-pilot, would you want to be on that plane without a trained pilot? The same applies to using accounting and bookkeeping software. You need a properly trained bookkeeper or accountant that is also familiar with the software product in order to properly use the software. That ole saying "GIGO" (Garbage In - Garbage Out) definitely applies here.

Let's also muddy the water regarding the cash method and accrual method of accounting.
Some accounting software allows you to convert data back and forth between a cash basis and accrual basis of

accounting. As I stated earlier, you do have to select one of the methods for tax purposes and continue to use it in the future.

What's the Recommended Type of Bookkeeping System and Accounting Method ?

Most accountants when asked will recommend that a business use the double entry bookkeeping system and the accrual basis or method of accounting which is based on the **revenue realization principle** and a principle called the **matching concept**. The revenue realization principle states that revenue should be recorded when actually earned.

Don't tell me accountants actually play matchmakers or promote a dating service! No the **matching principle** is recording the revenues earned during a period using the revenue realization principle and matching (offsetting) the revenues with the expenses incurred in generating this revenue. Why is this so important ? All businesses small and large need information to determine how well or badly they are performing; however, if this information is misleading it could lead to false conclusions and unnecessary actions. Show me what you mean.

The following sample business transactions for a mowing and landscaping company will be used to illustrate the accrual basis of accounting/matching concept and the cash basis of accounting.

January xxxx Billed $30,000 To Customers For Services Performed & Completed In January XXXX
January xxxx Received Payments From Customers of $15,000
January xxxx Billed $12,000 by Outside Contractors For Services Performed & Completed In January XXXX
January xxxx Paid Outside Contractors $8,000

February xxxx Received Payments From Customers of $15,000
February xxxx Paid Outside Contractors $4,000

	Cash Basis			Accrual Basis		
	Jan xxxx	Feb xxxx	Total	Jan xxxx	Feb xxxx	Total
Revenue	$15,000	$15,000	$30,000	$30,000	0	$30,000
Expenses	$8,000	$4,000	$12,000	$12,000	0	$12,000
Profit/Loss	$7,000	$11,000	$18,000	$18,000	0	$18,000

Possible Conclusions From The Cash Method

- Made money in January and February.
- Our company is making more profit on the same amount of revenues. We had revenues of $15,000 in both January & February but made a bigger profit in February.
- In February, we must have implemented some expense saving measures or got cheaper prices on our contracted services.

Are any of these conclusions valid ? **No not a one !** The "real" world as illustrated by the **accrual method** shows we had a great January and made $18,000 but February was terrible. We celebrated our great January and sat on our "you know what" and didn't go out and get additional business and mow some more yards and do some more landscaping.

Rules of The Accounting "Game"
In addition to the revenue realization and matching principles or concepts, accounting and bookkeeping is guided by some additional underlying rules.

Why Have Rules ?
All games such as football, baseball, basketball, etc. have rules. Why ? So that everyone plays the game the same way. Playing the Accounting "Game" is no different. What if owners and managers could prepare their business's financial statements the way they felt like ?

If a business was wanting a loan or credit, they would have a tendency to overstate the value of their assets and the value of their business. If it came to taxes (we don't like to have to pay them), let's expense and write off everything. As for measuring performance (profitability) and comparing businesses in the same industry, you'd have no idea as to who was actually doing well and who wasn't. You couldn't even compare your own business from year to year. As to coming up with a reasonable value for what a business was worth, your guess would be as good as mine.

So, to put all businesses on the same playing field, the accounting profession has established some rules and guidelines.

Two notable accounting rule making and standards setting organizations are the United States' Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The current accounting rules and standards are continually reviewed, studied, changed, and added to in order to make financial presentations more consistent, comparable, meaningful, and informative.

The following are some of the rules used to "play" the Accounting "Game":

- Accrual Concept (discussed earlier)
  Supports the idea that income and expenses should be measured and recorded at the time major efforts or accomplishments occur rather than when cash is received or paid.

- Revenue Realization Concept (discussed earlier)
  The revenue recognition principle requires companies to record revenue when it is realized or realizable and actually earned. In other words, at the time the goods are actually sold or the services are rendered.

- Matching Concept (discussed earlier)
  The Matching Principle goes hand in hand with the Revenue Realization Principle. The matching principle is recording the revenues earned during a period using the revenue realization principle and matching (offsetting) the revenues with the expenses incurred in generating this revenue.

- Accounting Period Concept
  This assumption assumes that business operations can be recorded and separated into different time periods such as months, quarters, and years. This is required in order to provide timely information that is used to compare present and past performance.

- Money Measurement Concept
  This assumption assumes accounting measures transactions and events in money and only transactions that can be monetized (stated in a monetary unit such as the dollar) are recorded and presented in financial statements. Simply stated, money is the common denominator (measurement unit) used for reporting financial information.

- Business Entity Concept
  This assumption requires every business to be accounted for separately from the owner. Personal and business-related transactions are kept apart from each other. In other words, the separate personal transactions of owners and others are not commingled with the reporting of the economic activity of the business. One of the first recommendations almost all accountants tell a client is to at least establish a business checking account and to use it to only record their business transactions.

- Going Concern Concept
  This assumption assumes that a business will continue operating and will not close or be sold. It assumes that a business will be in operation for a long time. Based on this assumption, actual costs instead of liquidation values are used for presenting financial information. This assumption is abandoned in the event that a business is actually going out of business.

- Cost Concept
  This principle requires that most assets are recorded at their original acquisition cost and except for a relatively few exceptions (marketable securities) no adjustment is made for increases in market value. In other words, the value of an asset is never "written up" even though the asset may actually be worth more than its cost. On the other hand, the cost is sometimes "written down" for example marketable securities and inventory. See Conservatism Concept.

- Conservatism Concept
  Revenues and gains are recognized slower and expenses and losses are recognized quicker. Accountants have a tendency to stray away from painting too rosy a picture. In other words, if in doubt, err to the side of caution. While accountants don't want to misinform users of financial information, they also don't want to be sued.

- Consistency Concept
  The same accounting methods should be applied from period to period and all changes to more acceptable methods should be well explained and justified. Deviations in measured outcomes from period to period should be the result of deviations in performance not changes in methods.

- Comparable
  Information must be measured and reported in a similar manner by all types of businesses. This allows comparison of the financial statements of different entities (businesses) or comparisons for the same entity (business) over different periods.

- Materiality Concept
  The significance and importance of an item should be considered in order to determine what is reported. Insignificant events need not be measured and recorded.

- Cost-Benefit Convention
  The benefit of providing the financial information should also be weighed against the cost of providing it.

- Industry Practices Convention
  When customary industry practices exists they should be followed and used for financial reporting.

Want a more in depth discussion concerning the rules of accounting and Generally Accepted Accounting Principles ? More About Rules

All lessons and examples in the remainder of this tutorial are all based on the **accrual method of accounting**, the **double entry method** of bookkeeping, and the **sole proprietor** type of business organization.

Let's see if you learned a few terms and anything about the rules for playing the accounting "game". Nothing difficult here, just a few matching exercises that review the rules of accounting and some basic bookkeeping questions.

True/False - Accounting Basics
Matching Quiz - Accounting Rules
Matching Quiz - Accounting Rules II

I'm not going to ring the bell on you, but when you're ready feel free to move on to the next lesson where we "watch the grass grow" and learn some accounting terms.

NEXT-->