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FUNDAMENTALS OF RECORDKEEPING AND FINANCE FOR THE SMALL BUSINESS

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Introduction by Donald M. Dible
Author of "Up Your OWN Organization!"
A Handbook on How to Start
and Finance a New Business

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INTRODUCTION

It's April 14, and a small business owner makes his way to his accountant's office. With him, he has a shoe box full of receipts, invoices, and assorted scraps of paper. "I need a tax return tomorrow. I tried doing it myself, but got bogged down. Can you help me?"

While this example is sad, it's typical. Just ask any accountant if you don't believe me. An enormous number of small business owners see recordkeeping as a government-imposed requirement created so the boogeymen from the Internal Revenue Service can bleed you dry.

Frankly, I consider the recordkeeping requirements of taxation to be one of the few good things resulting from government regulation of business. If it were not for this annual reporting requirement, many business owners would never know whether they were making a profit. And, obviously, that's important.

Now, let's assume you are making a profit--or will be soon. That's not enough! To succeed in most businesses, you must grow. This takes money. Sometimes, your invested capital--plus the profits you plow back into the business--are not enough to enable you to grow as rapidly as possible. Unless you make provision for additional money, you could find yourself in deep trouble.

Strange as it may seem, there are times when too much success can be fatal. If you run out of the cash necessary to pay your suppliers and lenders in a timely fashion, they may force you into bankruptcy in order to collect. Not everyone has the patience of Job!

Recognizing how important a knowledge of record-keeping and finance is to small business success, the writings of two eminently qualified business experts have been selected for inclusion in this book. We at The Entrepreneur Press sincerely hope you find it helpful.

Donald M. Dible
Vacaville, California

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Robert C. Ragan, CPA

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Records—For the Government Or for Yourself?

Why keep records?

If you are a typical small businessman, your answer to this question is probably, "Because the Government (and you mean the Internal Revenue Service) requires me to!" If the question comes in the middle of a busy day, you may add a few heartfelt words about the amount of time you have to spend on records—just for the Government!

Is it "just for the Government," though? It shouldn't be. True, regulations issued in recent years, not only by the Internal Revenue Service, but also by various other governmental agencies—Federal, State, and local—have greatly increased the recordkeeping requirements of business. But the fact is that this may be a good thing for the small businessman, overburdened though he usually is. Many studies have found a close relation between inadequate records and business failures.

Advantages of Keeping Good Records

A simple, well-organized system of records, regularly kept up, can actually be a timesaver by bringing order out of disorder. Furthermore, competition is very strong in today's business arena. A small businessman needs to know almost on a day-to-day basis where his business stands profitwise, which lines of merchandise or services are the most or the least profitable, what his working-capital needs are, and many other details. He can get this information with reasonable certainty only if he has a good recordkeeping system—one that gives him all the information he needs *and no more.*

Good records can also help to safeguard your assets. Accurate records of cash transactions will disclose any shortages, so that steps can be taken to find and correct the source of trouble. Accounts-receivable records disclose any shortages in the customers' balances and also help to control bad-debt losses. Inventory shortages are somewhat harder to detect, but here, again, a good system of records makes it possible to keep the shrinkage at a minimum.

Still another important use of well-organized financial records is in the preparation of financial reports showing the progress and current condition of your business. Such reports can be invaluable if you need a bank loan, or if the business must be evaluated for a sale or merger.

The Records Are for You

Think of recordkeeping, then, not as a necessary nuisance imposed by governmental regulations, but as an important tool for your own use in managing your business. Take the time, or hire an accountant, to set up a recordkeeping system that is patterned after basic accounting principles but is tailormade for *your* store. Then—grumble if you must, *but use it.* Remember, it is not just a storehouse of facts for Government use; it is a source of information that can help you increase your profits if you put it to work constructively.

Building Materials for Your Recordkeeping System

The following section of this book explains briefly some of the terms that are used over and over again in any discussion of financial records. If you are impatient, you can skip it and go directly to page 8, coming back to this section if you have trouble later with some of the terms. However, you will find the rest of the book easier going if you do read this section and make sure before going on that you understand the basic ideas involved in financial recordkeeping and the terms used.

Assets, Liabilities, and Capital

Anything a business *owns* that has a money value is an *asset* of the business. Cash, merchandise, supplies, amounts owed by customers (accounts receivable), land, buildings, furniture and fixtures, delivery equipment, and so on are assets.

Anything the business *owes* is a *liability.* Liabilities might include amounts owed to suppliers (accounts payable) or to the bank (notes payable), taxes already incurred but not yet due for payment, wages earned by employees since the last payday, and other amounts due.

The difference between what the business *owns* and what it *owes* is the amount that really belongs to the owner of the business—his *equity* or *capital* (sometimes called *proprietorship*).

The Framework for Your Records

Liabilities can be thought of as creditors' rights or claims against the assets of the business, and capital as the owner's rights. The sum of these rights to the assets, of course, will always equal the sum of the assets themselves. In other words, the total assets always equal the total liabilities (creditors' rights) plus the capital (owner's rights), or simply—

Assets=liabilities+capital.

Let's see how two typical business transactions affect this equation. Suppose that you pay a $50 bill from a supplier. One of your assets—cash—will be reduced by $50. But a liability—accounts payable—will be reduced by the same amount, so the equation will still balance.

Now suppose you buy $50 worth of supplies and pay cash for them. Again, the asset cash will be reduced by $50; but in this case, the value of another asset—supplies—will be increased by $50. So the sum of all the assets doesn't change, and the equation still holds true.

This equation is known as the *accounting equation.* It is the framework on which you will build your financial records.

The Basic Records

The financial records of a business begin with bits and pieces of paper—sales checks, credit memos, cash-register tapes, written receipts, check stubs, petty-cash slips, bank statements, and so on. These papers are important. They are the bricks from which you will build your organized, permanent records. Some sort of written record, however informal, should always be made *at the time a transaction takes place.*

The journal. The information from these various papers is first brought together in one or more *journals*—sometimes called "books of original entry." A journal is simply a record of the daily transactions of the business. Each journal entry shows (1) the date of transaction, (2) a brief description of it, (3) the amount of money involved, and (4) the assets, liabilities, capital, or type of income or expense affected by the transaction.

The ledger. To make the information recorded in the journal more usable, each item is later transferred, or *posted,* to a ledger account. An *account* is a record of the increases and decreases in *one type* of asset, liability, capital, income, or expense. A book or file in which a number of accounts are kept together is called a *ledger*. Exhibit 11 on page 66 shows typical accounts in a general ledger. A brief study of this will help you understand some of the following examples and transactions.

Sometimes the income and expense items are posted to a profit-and-loss statement and only the net profit or loss posted to a ledger account. This method is used in the recordkeeping system described in this booklet.

A business uses as many accounts as it needs for keeping track of its operations. A small firm with few pieces of equipment, for instance, may have only one account for all its equipment. A larger business will probably need an account for each type of equipment or even, in some cases, for a single piece of equipment. A business with only one owner will need only one capital account; a partnership will need a capital account for each partner.

Double-Entry Bookkeeping

Notice that each of the transactions used to illustrate the accounting equation (p. 5) had two effects. This is true of all business transactions, since a transaction is basically an exchange of one thing for another. Double-entry bookkeeping shows this twofold effect by recording every transaction twice—as a *debit* entry in one account and as a *credit* entry in another. Either or both of the entries may be broken down into several items, but the total of the amounts entered as debits must equal the total of the amounts entered as credits.

Debit and Credit Entries

One account may have both *debit (dr.)* and *credit (cr.)* entries. Then what determines whether an entry is to be a debit or a credit? It depends on the type of account and on whether the transaction to be entered will increase or decrease the account. Exhibit 1 shows the types of entries *(debit* or *credit)* and the typical balances for each class of accounts.

Thus, as a study of exhibit 1 will show, when you pay a bill, the amount paid is entered as a *debit* to accounts payable and as a *credit* to your cash account. When you buy supplies for cash, the amount paid is entered as a *debit* to the supplies account and as a *credit* to the cash account.

Each account sheet in the ledger has a column for the date, one for a brief description of the entry, one for the posting reference, and two for dollar amounts. *Debit* entries are always put in the left-hand dollar column and *credit* entries in the right-hand column. If the debit entries in an account total more than the credit entries, the account is said to have a *debit balance*. If the credit entries total more than the debit entries, the account has a *credit balance*. The total of all the credit

Exhibit 1.—Table of Debit and Credit Entries

Type of account	If the transaction will *decrease* the account, enter it as a—	If the transaction will *increase* the account, enter it as a—	Typical balance
Asset	credit	*debit*	*debit*
Liability	*debit*	credit	credit
Capital	*debit*	credit	credit
Income	*debit*	credit	credit
Expense	credit	*debit*	*debit*

The Trial Balance

To make certain that the sum of the debit balances does equal the sum of the credit balances, a *trial balance* is taken at the end of the month (or other accounting period). This is done simply by adding all debit account balances and all credit account balances. If no errors have been made, the two totals will be the same.

The trial balance ensures that any errors will be found before they are too deeply buried. It also clears the way for preparing financial statements.

Financial Statements

The journal alone would give you a complete record of all the transactions of your business—in simple chronological order. But that isn't enough. The ledger accounts are needed to organize the details from the journal into a usable form. You need to know where the business stands financially, how well it is going, and what can be done to improve it. Ledger accounts provide for this information by grouping the transactions of your business in such a way that at any time you can prepare a balance sheet and a profit-and-loss statement.

The *balance sheet* summarizes your assets, liabilities, and capital to show the condition of your business on given date—what proportion of the assets you really own. It is called a balance sheet because it shows how the two sides of the accounting equation (assets=liabilities+capital) "balance" in your business.