Accounting DIY.

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Introduction

Most people are startled or even appalled when you mention accounting or bookkeeping. No thanks!

Although this reaction is totally uncalled for, it is probably just one of those things. Like fear of the dentist. Once you have a decent toothache, you are happy to find a dentist that will see and help you. Previous checkups might have saved you a lot of pain, misery and money, but that is not helping much now that the pain kicks in and nobody answers the phone.

The same phenomena occurs in bookkeeping. Only when the taxman knocks, a fight with the business partner starts to get ugly or when bankruptcy is around the corner, professional help from an accountant is wanted. Professional help goes along with professional fees, and the accountant will have to reconstruct all financial and fiscal data, mostly from scratch or worse. Some simple bookkeeping measures could have prevented most of the problems and most of the costs. An apple a day keeps the doctor away. Prevention is the best cure.
Any bookkeeper will agree that they would rather keep too much records then pay too much taxes.

In my career as a bookkeeper I came across some funny cases. Time after time it turns out that people, although they have been in business for years, do not have a ***clue*** as to what bookkeeping is. Until they are overtaken by circumstances somehow. That moment is painful and at that stage a steep learning curve is needed.

Why this book?

Look at the last annual report your accountant made for you, and search for terms like administration fee, accountant fee or external advisors. When you find that, look to the right and see what figures are behind those words. Or (if you still have to start with your own business), phone an accountant and ask what a year of accounting, including annual report and tax filings, would cost you. A possible ***big*** reduction on that kind of money should be all the motivation you need to keep reading.

Bookkeeping? Do it yourself!
Of course, you can always hire someone else to do it for you, but that will be more expensive. And hey, it is no rocket science.

Having commercial skills or being an entrepreneur does not automatically include a feeling for order, receipt collecting or regular filing. When I ask people in business about it, I hear a lot of ´that is what I have a bookkeeper for´. Well, take it from me, that is most certainly **not** what you have a bookkeeper for!
That is not their job, and they will only do it when they

1. get paid and
2. there is no other solution.

The hourly rates for a bookkeeper (or worse an accountant) are quite a lot higher than the wages of anyone with reading skills that can enter invoices and receipts in numerical order into an accounting system just as well. There is the first saving to be made, pay an administrative clerk to do administrative work. You would not hire a brain surgeon to give a flue shot, would you?. Nurses are cheaper and most of the time better looking.

With a little bit of education anybody with a working set of brains can do their own bookkeeping.
Or a big part of it anyway. That is another possible saving: you do not even have to pay anyone if you sort out bills, bank statements and invoices yourself. No time consuming external training required there.
Just filing them in numerical or alphabetical order (instead of in a shoebox) will help. Maybe even put it in a spreadsheet. The invoice from your external accountant will be a lot less frightening. (Sorting out receipts and invoices is most definitive a 'billable activity”as far as the bookkeeper is concerned. Just like the brain surgeon would invoice you for the flue shot.)

An accountant for the whole range from shoebox to annual report is expansive and only realistic for millionaires and major companies. Since they have bean counters on the payroll already, they are not part of this book.

Debit and Credit.

In bookkeeping we talk about debit and credit. This is a historical fact, it could just as well have been plus and minus or left and right. Every profession has its own slang, there is no easy way around that. See it like learning vocabulaire at school. Once you have hammered it into your brain, you can use it the rest of your life.

The thing is, amounts end up on two sides of the line, according to their origin and meaning. As a rule of thumb you can say that

Debit is what you have **Credit is what you owe**

Just hammer into your head, Debit is left, Credit Right. So, there you have it. The first two difficult words are dealt with. Just to be complete it can be said that Debit and Credit should always balance. So if I record debit 100, I have to record credit 100 as well.

Lean back, relax and realise that technically you can do your own accounting now. It is not getting any harder than this, and you know almost everything now. The rest is mainly repetition and more of the same.

Balance Sheet

The ultimate goal of bookkeeping is to record and show the financial state of the company.
There is a very simple formula: ***A – L = E*** ***Assets minus Liabilities = Equity.***

Assets and Liabilities are on the Balance Sheet. Assets on the left, Liabilities on the right to be precise.
So, on the Balance Sheet, Assets (what you have) go DEBIT, Liabilities (what you owe) go CREDIT.
Since we just stated that Equity is the difference between Assets and Liabilities, and normally we want to have more possessions than liabilities, the Equity part will have to end up on the right to balance everything out.

As an example and to get the feel of things here the Balance Sheet per 31 december 2004 of a common company: the private household.

Balance Sheet as per 31 december 2004:

Assets – Debit	€	**Liabilities– Credit**	€
House	200000	Mortgage	140000
Car	15000	Credit Card	7000
Bank Account	2000	Equity	
Cash	1000	*(218000 -/- 147000 =)*	71000
Total Assets	**218000**	**Total Liabilities**	**218000**

Maybe it looks a little strange at first, but Debit (left) we see what this family has (Assets), and Credit (right) we see what this family owes to others. The remainder is also Credit (right) and is called Capital or Equity. That may sound chique, it is not as terrible as it may seem. It just means that if the company (Family) would stop at this moment, after selling of all Assets and paying off all it owes to the Mortgage and Credit Card companies, 71.000 euro 'remains' . That amount (that capital) can be seen as an amount the family owes to itself. It is the net worth of this family. Note, you always look at the situation from the standpoint of the company (family).

Capital or Equity can be split up further: Owners Equity and Third Party Equity or Stockholders Equity. Here, the Equity is *Owners* Equity. The other liabilities like Credit Card debt would be Third Party Equity. The mortgage bank is in fact a stockholder in the household, the house to be more precise, so the term Stockholders Equity could also be used. (Technically, no stock was issued, but you get the idea).

Most households are not used to preparing annual Balance Sheets, but it is not really a lot of work..
One fine day it will have to be done anyway, when your wife want a divorce or at the latest when you die, to record the value of the estate. If no records of the family household are available, a local solicitor will be glad to help out, invoicing the normal fee for their profession. As stated before, prevention is cheaper and quite simple.

Equity changes

The situation shown above is, as we mentioned, the state of affairs as per December 31 2004.
In bookkeeping it is common practice to update and close the books every now and then. This is done at least once a year.

In 'normal' life we see a lot of similar terms. we evaluate the situation, we put everything on a list, find the pro´s and cons. This evaluation every now and then helps to get a grip or to keep perspective. Never hurt anyone, and not only in accounting.
Suppose that for the same company (family) at the end of 2005 the Balance Sheet looks like this:

Balance Sheet as per December 31 2005:

Assets – Debit	**€**	**Liabilities– Credit**	**€**
House	220000	Mortgage	140000
Car	10000	Credit Card	9000
Bank Account	1000	Equity	
Cash	1000	*(232000 -/- 149000 =)*	83000
Total Assets	**232000**	**Total Liabilities**	**232000**

When you compare this Balance Sheet per December 2005 with the Balance Sheet per December 2004 you can see if you are better of now, or maybe worse of then last year. This is one way to calculate the profit (or loss) for a given period. Beancounters call this *Calculating Result trough Equity Movement*.

The only thing that really interests me, is the movement in Equity, Owner´s Equity to be more precise.
In other words, if I was to sell everything now, what is left for **me**? And is that more or less then last year?
Can I retire on a tropical island yet, or will I have to keep working for another year?

I can see in one sweep that in December 2005 I have 83.000 Equity, as opposed to the 71.000 I had in December 2004. I am 12.000 better of than a year before now, but early retirement is not an option yet.

If I want to know what ***caused*** this favourable movement in Equity, I will have to look at expenses, revenu and any special effects that might have taken place. In bookkeeping, all that kind of things are recorded in the Profit & Loss Account, also known as Income Statement..

Profit & Loss or Income Statement

As mentioned during the Balance Sheet explanation, in bookkeeping the books are closed periodically.
At that moment, any change in Equity appears automatically.

This change is not the result of magic or a communist complot. This change mirrors the results of the company Or, to stay with the example, the result of this household.

Just as with overbalance Sheet, there is a rule of thumb for the Profit & Loss Account:

Costs and Expenses go Debit, **Income and revenu go Credit.**

Easy way to remember this: You will always have Costs! Guaranteed! And what you have goes .... debit!
Weather there will be any income remains to be seen. No sale, no revenue.
Now if costs go Debit, where would Income go? Guess what?

To top it of, a formula as well:

I – C = R ***Income minus Costs = Result***

We close the books every now and then, but at least once a year.
At that moment we move This Years Result to the Balance Sheet, so as to have a clean slate to start next year. And every year gets to keep it's own Result that way. If the income is greater than the expenses, we have made a profit. Just to be on the safe side: that is the normal and desired situation! If, for one reason or another, we have more expenses than income, we call that loss or negative profit. Try to avoid that.

If we would *not* move the Result to the Balance Sheet once a year with a Journal Entry, we would end up with one enormous overview of **all** expenses and revenues during **all** years together. That would be of little use and would not help anyone. It would also make comparing various years tricky at best.

Here is an example of the Profit & Loss Account of the Family Household for 2005:

Profit & Loss Account for the year 2005:

Costs – Debit	**€**	**Income – Credit**	**€**
Groceries	4000	Salary husband	7700
Medical expenses	2000	Salary wife	1200
School fees	500		
Clothing	1000	Result on Investment Stock	500
Car expenses	2400	Result on Investment House	20000
Mortgage intrest	7000		
Intrest on Credit Card	500		
Subtotal expenses	17400	Subtotal income	29400
Result Year (29400 – 17400)	**12000**		
	29400		**29400**

The annual Journal Entry to move the result to the Balance Sheet can be booked to Owners Equity at once.
But it can just as well be journalised via a special Balance Sheet account “This Year´s Result”.
That may seem complicated, but can be easier after all. For example when a year-end bonus is to be calculated as a fixed percentage of the Year's Result. Having that Result visible separately and at once can be very handy.

In this Profit & Loss account the one half of the yearly Journal Entry is **bold.** Since this amount is Debit, the other half of the Journal Entry must go Credit. The other half of the Journal Entry is as we discussed previously to Equity.

We see that the Equity as per December 31 is indeed 12.000 higher, therefore this Journal Entry has been made.

Analysing the Result

If you look quickly and only consider the bottom line (as most managers and directors will do) everything looks marvelous. We have Profit, Positive Profit! I am 12.000 better off than last year, life is great!

When we consider the figures in some more detail, we see some small problems and snakes in the grass .

The Income from Investment together total 20.500. Apparently some stock was bought and sold with a profit in 2005, and the value of the house went up with 20.000.

That sounds nice, 20.500 profit from investments. And most of the time the prise of houses will rise.
That money **is not there** however, apart from the 500 we cashed at the stock deal.
Unless you are planning to sell the house, that value change does not do you any good. You can not use it to buy groceries or pay bills.

If you look at the other items, you see that against 9.400 income from wages and stock, there is 17.400 expenses on groceries, car and what not. A big fat minus of 8.000!

If this pattern of spending versus income is continued for a few more years, the house will **have** to be sold because all Equity will be gone.

You can not spend more money then you earn for a longer period of time. Money has to come from somewhere. That can be your bank account, your Creditcard, or your Capital (Equity). But at the end of the day, somebody has to pay the bill. The first person to come up with a way to spend more then they earn on a *long term* basis can collect a bottle of 12 year old whisky and a statue at my place.

It is the (sad' duty of the bookkeeper to sober up the company management and remove any champagne bottles. And to advise them not to declare any end/of/year bonus yet.

The management will probably not like that, but somebody will have to warn them. Otherwise the 8.000 minus might be joined by another 12.000 minus extra for say a new car. After all, `I worked hard for it´ and ´we made a profit, so I see no problem´.

Cash Register

In an old fashioned cash register we keep track of the amount of money we have in the cash box, what comes in and what goes out during the day. To make sure we did not forget anything we can do a financial cash check at the beginning and the end of the day.

That may sound difficult, it is just a way to say "count all money in the cash box" and compare that to the calculated amount. As a simple example we take a family household again. The cash box in an average family will be a wallet, but for the theory of bookkeeping that does not matter.

In 2005, January 1st I start with an amount of 1.000 euro. I can know that in two ways:

1) I can see it on the Balance Sheet as per December 31st 2004. It says there I have 1.000 cash .
2) I can do a **cash count** January 1st to see how much money I have. Normally that should be the same amount as was recorded in the cash register on December 31st of last year. The physical check by cash count to make sure this is indeed the case is called Cash Check or Cash Control.

If the amount recorded (theoretical cash at hand) is not the same as the money counted, we call that a Cash Difference. Such a difference can be caused by a number of things. Think about receiving the wrong amount of change. If you pay with a 20 note but receive change from 10, you will be 10 short at the end of the day.

Gotcha: Cash is a Balance Sheet item. That means the rule of thumb applies. What we have goes Debit, what we owe goes Credit. Since i can never have say minus hundred euro in my wallet, the Balance Sheet item Cash will always be positive (i have money in my wallet) or in the worst case scenario null (I am broke).

Formula for Cash:

O+ I – E = C ***Opening amount + Income – Expenses = Closing amount***

So Opening amount as per January 1st (should be same as Closing amount as per December 31st) plus any income or ATM withdrawals minus receipts for expenses gives the Closing amount as per January 1st.
Note, that is the *theoretical amount*, what *should be* the amount of cash at hand.

To check this, we simply count the money in the wallet. If some trick like being short changed has occurred, we will soon know about it. In that case the theoretical amount will not be the same as the physical amount. Suppose we count 820 euro in stead of 830. The ten euro short has been explained: we received change from a tenner instead of 20 euro

Cash Register as per January 1st 2005:

Income – Plus (Debit)	**€**	**Expenses – Minus (Credit)**	**€**
Opening Amount Jan 1st 2005	**1000**	Groceries	150
		Hairdresser	40
Cash from ATM	200	Jeans	80
		Petrol	100
Subtotal Income	**200**	Subtotal expenses	**370**
		Closing Amnount January 1st (1000 + 200 – 370)	*830*
Total	**1200**	**Total**	**1200**

Trust is cool, Control is better.

To make sure the employee that starts with the Cash Register the following day is not seen as the guilty party for the Cash Difference we just encountered, an extra entry in the Cash Register has to be made. In a business environment or any other professional situation, the person "taking over " the Cash Register should consider to do a cash count *before starting*. Any difference would surface there and then as well, and what is more important, *before* any further use of Cash has occurred.

In that case the person who was in charge of the Cash Register the previous day will make a dubious impression at best. Maybe even a suspicion of grabbing the cash box would arise. All that while a simple extra entry could have demonstrated the real state of affairs.

Apart from the benefits of Fraud Prevention, there is also a time element to be considered. When you do a cash count the same evening, anything that happened during the day will be fresh in your memory. A possible solution or explanation for a Cash Difference will be relatively easy to find or remember. Oh, I must have been short changed, forgot to ask for a receipt for the flowers or lost the receipt for McDonalds altogether.
Loads of possibilities. If you get used to do the Cash register at the end of the week, or even worse once a month, you will never be able to remember what you did when.

If after three weeks you find a Cash Difference of 200 euro, you can never be sure on what day it occurred. Therefore, you do not even know who was handling the wallet at that moment. Was somebody just careless, are receipts missing, or did somebody pay out some unofficial income ? You will never know. Control is better.

In the Column for expenses an extra 10 euro will have to be entered stating it is a Cash Difference so that the Closing amount is corrected to the 820 that is actually at hand.

Corrected Cash Register per January 1st 2005:

Income – Plus (Debit)	**€**	**Expenses – Minus (Credit)**	**€**
Opening Amount Jan 1st 2005	**1000**	Groceries	150
		Hairdresser	40
Cash from ATM	200	Jeans	80
		Petrol	100
		Cash Difference	10
Subtotal Income	**200**	Subtotal expenses	**380**
		Closing Amnount January 1st (1000 + 200 – 380)	**820**
Total	**1200**	**Total**	**1200**
Opening amount January 2nd 2005	820		

Of course, from a family standpoint, this is quite far fetched. Nowadays, when the wallet is empty, we go the nearest ATM and refill. If you would ask people at the ATM what happened to the money from the previous refill, you would probably get an answer like "Oh, that's gone".

For good measure: In the old days, (think 1940's , 1950's) it was common practice for the lady of the house (housewife) to keep a Cash Register where all groceries and other household expenses were recorded exactly and to the cent. At the end of the week or month, she took that register to her husband to ask him to hand over the household money for the next period.

The husband could check that the previous household budget was not gambled away at bingo-nights or spent on sherry or other unwanted items. This form of domestic control was somehow sadly lost.
I do not have to ask about it at home. My girlfriend does not have a Cash Register. Let alone she would want to keep track of shopping frenzies. Indeed, the answer: "Oh, that´s gone" is her copyright.