Accounting 101 For Small Business Owners

A Comprehensive E-Book

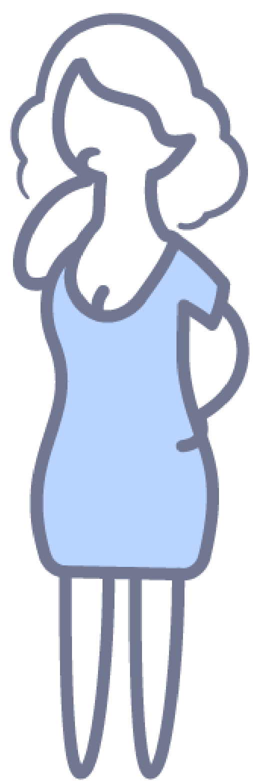
Contents

01

What is Accounting?

There are two basic categories of accounting: financial accounting and managerial accounting. Financial accounting deals with information that is made public to stockholders, customers, creditors, and regulatory bodies. Managerial accounting deals with information that is not shared with the public, such as salaries, profits, and the cost of goods produced.

The goal of managerial accounting is to help company managers and supervisors make financial decisions, whereas the goal of financial accounting is to provide important financial information about your company to those outside of the business. For most small business owners, “accounting” is managerial accounting.



What Does Accounting Allow You to Do?

Accounting is essential if you want to be able to grow your business in a way that can be measured and predicted. Having a system of tracking your business' assets, liabilities, and income lets you to make smart, informed business decisions based on the past performance and present financial health of your company. With a clear, organized accounting system you can not only analyze your company's financial data but also help it grow and profit.

Sound accounting also helps you satisfy your customers. Knowing where your company stands financially in terms of income and expenses will help you better understand what you need to do in the future to maintain that level of customer satisfaction and grow your business.

Need more evidence?

Accounting also helps you track who owes you what, what you owe to who, manage payroll records, track loan and interest repayments, attract potential investors, maintain a budget, and perhaps most importantly, sets you up with the financial data you need when it comes time to file and pay your company's taxes.

What Happens If You Don't Do Your Accounting?

You Can Lose Money

If you're a sole proprietor business, you do everything—including invoicing. And when business is good, remembering all of the instances in which you're supposed to get paid can get real hard, real fast.

In addition to losing income in big chunks as above, not having accounting for your small business can lead to slow leaks.

Tax Time Will Be a Nightmare

How many CPAs or tax prep pros do you think would be happy to have a client who has no accounting or bookkeeping system in place? Zero. Tax prep without a year's worth of
records is a nightmare.

You Won't Have Proof When You Need It

Should you get an inquiry from a local, state or federal revenue agency, the onus is generally on you to provide evidence in response.

Growth Will Be Hard

If you're business gets to the stage where it's time to expand, open a new location or build out a team, a lack of financial records will make things difficult. Would you give a loan to someone with no evidence of responsible financial practices?

You Won't Know How To Pay Yourself

At the end of the day, you're in business for yourself to make a living. If you don't have an accounting system in place, you simply cannot accurately know what to pay yourself. (The less you have to guess at anything in business, the more successful you will be.)

02

What are accounts in accounting?

In accounting, an account is simply a unique place in the general ledger that is used for recording a dollar balance along with a history of changes to that balance. This balance can be associated with a bank account or it can represent the amount of money owed to you by a client or customer. It could also represent your reported income, expenses or the value of assets that you own.

What Are The Different Accounts In Accounting?

Cash Account

A cash account is the easiest way to record cash payments, deposits and withdrawals. We would use this option in Kashoo when entering income or expenses received in cash under Terms or Payments Accounts. This will show that you were paid in cash or that you paid for something in cash.

Bank Accounts

We use this account type to refer to bank accounts that are used for the purpose of running your business. A common example would be a small business that has a checking account where money can be deposited and used for bill payments and incidental expenses.

Credit Cards

Credit cards are great for keeping track of expenses because many credit card companies will send you a statement at the end of the month with details of your business expenses.

Undeposited Funds

A common practice is for a business to collect cash and checks into an envelope and deposit them all in one lump sum. When this happens it appears on the bank statement as one transaction.

Income Accounts

Income accounts are used to track the source of income so that a business owner can track where their money is coming from.

Expense Accounts

An expense account is meant to represent a category of expenses for the business. Basically, any type of product or service that does not have a resale value is an expense.

What Are The Different Accounts In Accounting? (cont’d)

Assets
The asset account represents the value of the assets owned by the business. Only items that have a resale value should be recorded in this account.

Liabilities
A liability account represents a type of debt or upcoming cost for the business. The type of liability determines the duration of the debt.

Equity
An equity account represents the net worth and ownership of the business. Examples of these accounts include owner investments, retained earnings, common stock.

Accounts Payable
Accounts payable represents the money that the business owes. Accounts payable usually comes in the form of bills or invoices from others vendors or service providers.

Accounts Receivable
Accounts receivable represents the money that is owed to the business. Accounts receivable is usually in the form of outstanding invoices issued by the business that have not yet been paid.

Cost of Goods Sold
The cost of goods sold is the cost that goes into creating the product that the business sells. The only costs included here are those that are directly tied to the production of the products.

Gain or Loss On Foreign Exchange
This account is used to track the gains or losses caused by a change in value of foreign currencies between the time an invoice is issued and when it is paid.

03

Accrual Basis vs Cash Basis

As a freelancer, solo practitioner, or small business owner, it is important for you to understand the two basic ways to account for the income and expenses of your business: the accrual method and the cash method. You must use one or the other, and the method you choose will determine how you track your income and how you treat your expenses for tax filing purposes.

Accrual-Basis Accounting

The most common accounting method is the accrual basis method, where income is counted when your product or service is sold, not when you receive the payment.

When recording your sales, you generate accounts receivable transactions that inform you that you have a payment owed to you by a specific date. You record your expenses when you receive the goods or services from your vendor or contractor, not when you actually pay the expense. Your recorded expenses are tracked as accounts payable, so you know when and how much you must pay in upcoming bills due.

When using the accrual basis accounting method, you can run daily, weekly, or monthly reports from your Kashoo Business Dashboard to monitor your cash flow and help you to decide if you need a short-term loan from your financial institution to maintain business operations during lean or seasonal periods in your calendar year.

The accrual basis method also allows you to deduct expenses incurred in one tax year, even though you will not pay for the items until the next tax year, thereby possibly reducing your tax obligations. Of course, you will want to consult with your accountant and tax attorney to ensure that you are in compliance for your particular business situation.

Cash-Basis Accounting

The cash basis accounting method is a little easier to manage, and many new freelancers and sole proprietors start out using the cash method, where all transactions are recorded when cash is received for sales or paid for expenses.

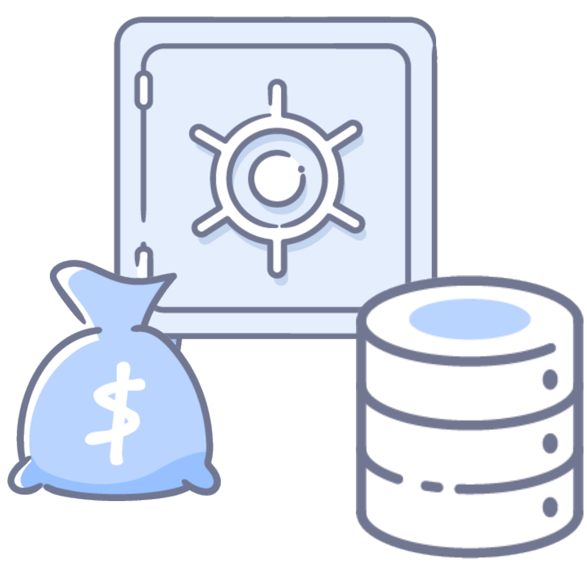
The cash method is not applicable for situations where the business owner either buys items for the company on credit or extends some type of credit to customers. Many times, a business will buy products in one month and not sell them until the next month, and with the cash basis method, there is no functionality for recording these kinds of transactions. Most business owners eventually switch to accrual-based accounting to more accurately reflect actual revenues and expenses.

04

What is an Accounting Transaction?

The simplest definition of an accounting transaction is an event that occurs that has an impact on your business' financial statements.

This event is recorded in your business' accounting records, and keeping track of the totality of these transactions allows you to analyze and predict your business' financial health. Some examples of a transaction in accounting include making a sale to a customer, purchasing supplies for your business from a supplier, or borrowing money from a lender (such as taking out a loan from the bank).



The Accounting Equation

Every transaction in accounting is part of the accounting equation, which can be expressed as:

assets = liabilities + owner's equity

We'll define these terms below, but for now you should know that any transaction that occurs within your business—whether it be a sale you've made to a customer or a loan you've taken out from the bank—must result in a balanced equation.

Example:

Let's look at taking out a bank loan: this transaction results in an increase to the amount of cash the business has (which is part of the business' assets), while on the right-hand side of the equation, it also results in an increase, this time to loans payable (part of the business' liabilities).

Now let's look at each separate part of the accounting equation and define its different terms. First off, on the left-hand side we have assets.

Assets can be defined as the resources controlled by your business which can lead to future financial gain (i.e., cash, equipment, vehicles, land, etc.).

If something is owned or controlled by your company and will provide measurable future benefits, then it can be considered an asset. In this way, anyone who owes your company money (debtors) can be considered an asset: this is known as accounts receivable ("receivable" meaning "can or will be received").

The Accounting Equation (cont'd)

The second term on the right-hand side of the equation is owner's equity, which is essentially the owner's stake in the business.

In the case of a legal corpoation, owner's equity is called shareholders' equity. When starting up a business, the owner will invest assets (capital) into the company with the goal of earning a profit.

Lastly, we have liabilities: these are debts owed to outside parties (such as a loan from the bank)

which must be paid back in the future. Until they are paid back, these outside parties have a claim on the business' assets equal to the amount of the liability.

Profits, Income, and Expenses

We mentioned earlier that business owners invest capital into their company when starting up a business in order to earn a profit. A profit is the positive amount left over when subtracting expenses from income:

profit = income – expenses

The profit being made by a for-profit organization is a good indicator of its financial performance. (Of course, there are also non-profit organizations, such as educational institutions and charities, where surplus revenues are used to advance the organization's goals rather than pay owners and/or shareholders.)

Income in accounting can be defined as an event that results in money flowing into your business.

Income is not the same as cash (which is a separate element of accounting), but rather is the event itself – making a sale, receiving interest, etc. – that leads to an increase in the business' assets, as well as the owner's equity. (Remember: both sides of the accounting equation mentioned above must remain balanced.)

Profits, Income, and Expenses (cont'd)

Expenses can be defined as events that result in money leaving, or flowing out of, your business (the opposite of income).

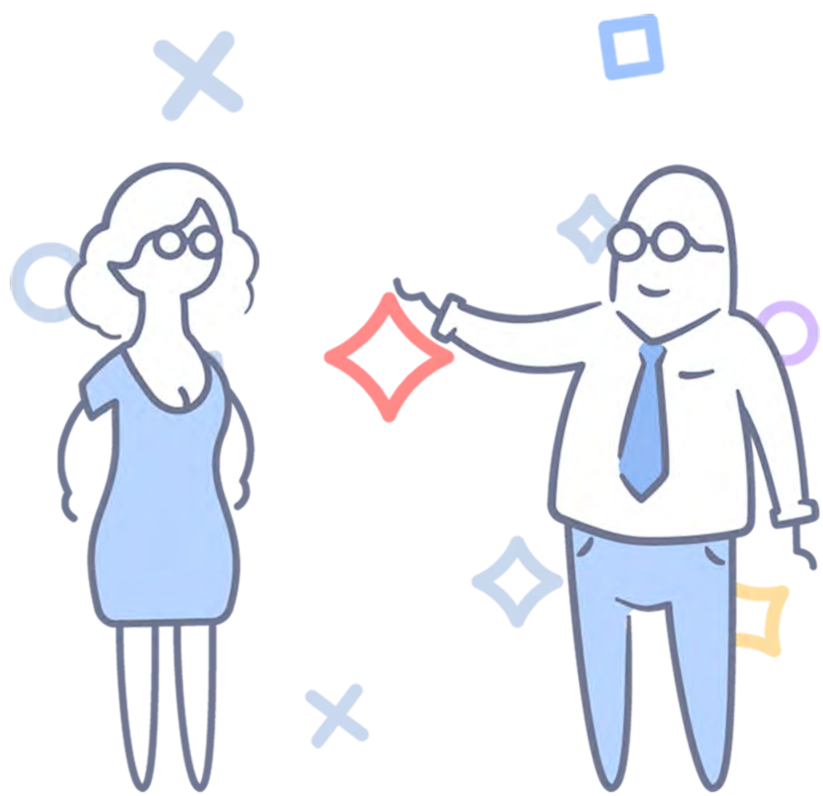
The money may be flowing out of the business immediately, or at a later date, such as with the payment of a bill at the end of a payment term. Some common examples of expenses include wages paid to employees, insurance, and loan payments. Whereas an increase in income leads to an increase in owner's equity, expenses and owner's equity are conversely related, meaning that as expenses go up, owner's equity goes down, and vice versa.

As with recording income, expenses may occur and be recorded on a cash basis (where the expense is paid right away), or on an accrual basis (where the expense will be paid at a later time). In terms of our accounting equation, expenses are added to liabilities: when the expense is paid off—whether it be a bill or a bank loan or some other expense—there will be a decrease on the assets side of the equation, as well as on the liabilities side, keeping the equation balanced.

05

What is the Difference Between a Bookkeeper and an Accountant

The roles of a bookkeeper and an accountant may overlap, but there are crucial differences between them. If you understand the differences, you can determine how these roles should be filled within your own business model. Let's have a look at what each of them do and whether you need one or the other, both, or neither!



Bookkeeper vs. Accountant

What does a bookkeeper do?

A bookkeeper carries out all of the essential clerical functions of your business' finances: recording your data and organizing it for you.

Traditionally, bookkeepers enter financial transactions into a journal, making any necessary adjustments. They enter sales into the proper accounts, record payments from clients or customers, and payments to vendors. They reconcile bank accounts, compile data for the general ledger, generate reports, and prepare financial statements.

What does an accountant do?

Accountants provide informed analysis of your bookkeeping data and, ultimately, can help you make better business decisions.

They help you interpret your reports in the context of ever-changing regulations, marketplace conditions, business and industry trends, and so on. A good accountant remains objective, providing unbiased advice. Translation: they're not afraid to tell you hard news. They make their recommendations based on one thing and one thing only: a company's overall financial picture. But perhaps most importantly, an accountant can help you prepare and file business tax returns. (If your business structure is complicated or you've grown exponentially, an accountant's tax prep services will be worth its weight in gold.)

Can I Be My Own Bookkeeper or Accountant?

The short answer is yes, but there are some caveats.

You can likely manage your own bookkeeping tasks, but with some help. Cloud accounting software, like Kashoo, allows you to quickly enter transactions, send out invoices, record payments, and download your bank and credit card statements. You can even run your own reports whenever you want them. So ultimately, it is possible to run your own bookkeeping so long as you have the right tools to ensure that you're not spending insane amounts of time doing so.

As for being your own accountant, it's probably safer to leave it to the experts. A good accountant is certified and has undergone years of education in business finance and tax. That knowledge is their value to you in both being able to help you make sound business decisions and file and pay your tax obligations appropriately. And again, you've got a business to run. Tackling your own accounting will likely result in even more time spent than trying to own your own bookkeeping. Plus, employing the services of an accountant gives you peace of mind: you've got a trusted ally who can help you should issues—like an audit—ever arise.

06

The Anatomy of an Income Statement

What is an Income Statement?

According to the Wiley Dictionary, “An income statement is a financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.”

How much income did your business bring in last year?
How many expenses did your business incur last year?

If you can answer the above questions, and can calculate your Total Income – Expenses = Profit… guess what? You have just created an income statement!

Basic Income Statement Formula

To simplify your understanding of an income statement even further, here is the basic formula that builds an income statement:

Revenues – Expenses + Other Income/Losses = Net Income

Remember that an income statement records the total activity of the business' operations throughout a certain period of time. For example, if your business' fiscal year end is December 31, then your income statement will record its business operations from January 1 to December 31.

Meaning, all sales and expenses that you incurred during January 1 to December 31 will be recorded on your Income Statement for fiscal year-end 2018.

Revenue = Your Business Operating Income

Essentially, revenue is the total sales of goods and/or services you have provided to your customers throughout the year. A great example is if you run a company that distributes bread, your revenue will include the total loaves you sold to your customers throughout the year. Plus, if your business sold different types of bread, you can break out your revenue as follows:

Total Revenue

Whole Wheat Bread Sales
Multigrain Bread Sales
Baguette Sales

Your total revenue, in the bread example, will include the sum of all 3 types of bread sales. Make sense?

Note that the revenue line is at the top of the income statement because it essentially drives the costs and the gain/losses incurred throughout the year.

Here are a few other terms that are used to describe revenue:

Sales
Net Sales
Total Revenue
Net Product Sales
Net Service Sales

Expenses = Costs Incurred

Expenses are the total purchases or costs the company has to pay for throughout the year as it relates to the normal course of business.

The income statement can show a breakout of costs per product, or keep it simple by just outlining each cost incurred for the entire business.

Here are a few alternatives to the term expenses:

Cost of Goods Sold
Cost of Sales
Total Expenses
Cost of Products Sold

Other Income/Expenses = Operations Outside Normal Course of Business

Other income and expenses are those items that don't occur during the normal course of business operation.

Here are a few items shown on the other income/expenses section of the income statement:

Interest Expense
Provision for Income Taxes (may be shown as a separate line item on the income statement)
Income from Rental Property (outside of the normal course of businesses)
Foreign Currency Exchange – Loss/Gains

Revenue - Expenses = Gross Profit

Remember the formula stated above to describe an income statement:

Revenue – Expenses + Other Income/Expenses = Net Income

Well, if you just section off the Revenue – Expenses, the total value equals what accountants call, the Gross Profit.

A company's gross profit essentially showcases the difference between the total net sales and the total costs incurred from those sales. Calculating your company's gross profit helps you to understand how profitable your products actually are, without taking into account items like depreciation, income tax, etc.

Obviously, the greater the gross profit, or gross margin is, the greater the potential is for a positive net income (or bottom line).

A few terms that are alternatives to Gross Profit includes:

Gross Income
Gross Margin (Gross Profit divided by Total Revenue)
Gross Profit Income

07 BONUS

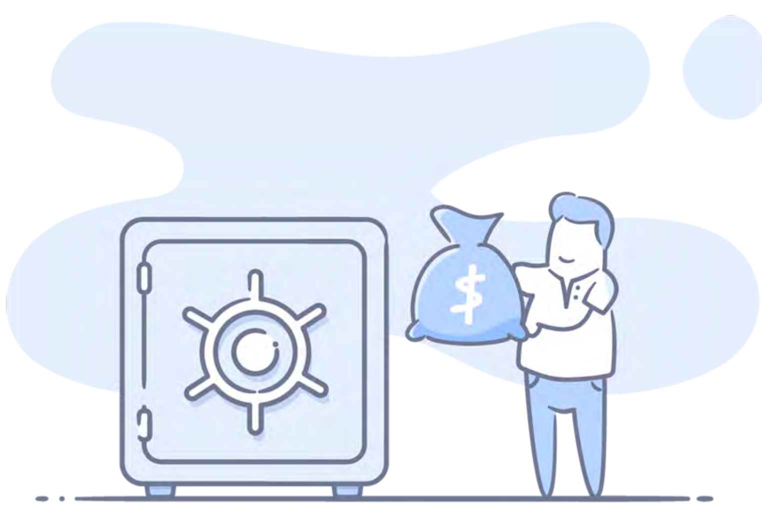
How to Manage Your Cash Flow (and Avoid Going out of Business)

Cash flow is one of the most critical components to a small business and can be the determining factor as to whether or not your business will be intact next year. Without cash, profits turn out to be meaningless.

You probably already know this, but at the end of the day, if you do not have the cash to pay payroll and business expenses, the growing revenue line won't help keep your business alive.

So what do you do to avoid going out of business? Time to get serious about cash flow management.

Here are 5 ways you can get a better handle on the cash coming in and out of your business.



Step 1: Reconcile Your Books, Every Morning

Imagine if you woke up, and the first thing you did for 10 minutes was checked your Kashoo Banking page to find out exactly how much money was coming in and out of your account, every single day.

Do you think you would have a better handle on your cash if you reconciled your books every morning? We think so!

Start off your morning, with a cup of Joe, reconciling transactions that occurred from the day before. You can start to see what is coming in and out of your account. This will relieve you from the daily stresses of not having a clue whether or not you can pay next month's payroll.

No thank you.

Fortunately, reconciling transactions is super easy in Kashoo. You might even have some fun doing it. To learn more about Banking and our Dashboard, check out Kashoo's 14-Day Free Trial here.

Step 2: Review Your Accounts Receivable Weekly

Accounts receivable can quickly become your Achilles Heel if you are not careful.

If you need a refresh on what accounts receivable stands for, it's the total balance of money owed to you by your customers. Let's say you made a sale today for $5,000, but your customer only paid you $500 for it, then you have an outstanding accounts receivable balance of $4,500.

Accounts receivable is considered an asset, but again, without keeping a close eye on it, it can seriously bring down your business.

More specifically, if you start reviewing your accounts receivable, or AR balance, each week, you will know how long it has been for outstanding payment due from your customers and whether or not you need to follow up with them for payment.

Some businesses just assume the customer will pay. Then 90 days later, they try and contact their customer and get a wrong number or an errored out email address. Don't let this happen to your business.

If you generate revenue, make sure you stay on top of collecting the cash associated with that revenue.

Step 3: Review Large Credit Card Balances/ Credit Lines

Debt is great, when it's used as an investment and you have a good handle on how it's profiting and growing your business. But as with the accounts receivable outstanding balance, you need to be careful with interest accruing on your debt balances.

If you have a line of credit, and you are constantly paying expenses with that credit, remember that interest is a partner in this deal and it gets its cut.

Don't let your debts get out of hand.

Stay on top of reviewing your credit card balances and line of credit withdrawals, whether it's weekly or monthly. This is another quick way to avoid the shock of bankruptcy.

Step 4: Save For A Rainy Day & Set Aside For Taxes

Do you have a business with uneven cash flow?

For example, are you a retailer that makes the most of your sales in December, but are completely dry in July?

If so, you need to start saving and stashing your cash away, to keep your business up and running throughout the dry seasons.

A great way to stay on top of the peaks and troughs of business, is to create cash flow projections. You need to pull prior year's Profit and Loss reports, available through Kashoo to get a handle on where the dry seasons occurs throughout each year.

Then, determine how you can save your cash when things are flowing, and how to properly portion out the cash when revenue is tighter than usual.

You also can't forget about taxes. Make sure you're setting aside amounts each month so you don't get hit with a major tax bill at the end of the year!

Step 5: Spend Next Month's Expenses on Last Month's Income

This is a concept, pulled from most personal finance budgeting recommendations that can easily be applied to your small business.

Ask yourself, how much income did you make last month? Of that income, how much did you generate in cash?

If you have an answer to how much you generated in cash last month, then that is the balance you need to spend for next month's expenses. And that's it.

Let's break this down further.

Let's say you generated $15,000 in profit last month and collected $8,000 in cash. You should be expecting or planning to have up to $8,000 in expenses total for next month. If it happens to be more, you need to create a plan on how you can generate more income and more cash to pay off your upcoming expenses.

This process keeps you one step ahead, instead of slowly bleeding cash that you don't have in the first place.

Put Your Knowledge To Use

Ready to put your new bookkeeping knowledge to use? Master your small business accounting and regain control of your finances.

If you haven't already, get started with Kashoo—and see just how easy it is to manage your own books, record invoices and expenses on the spot, reconcile your books, and get an overview of exactly how your business is doing.