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# Know How to Keep Your Books

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One of the most common mistakes that small business owners make is not understanding or carefully tracking their finances. Too many businesses use only one tool to handle their money; their checkbook. And while your business checkbook should be the heart of your bookkeeping system, it is only the start.

This chapter isn't going to make you a bookkeeper. Instead, its goal is to make you familiar with a typical bookkeeping system, so that you can either establish your own system or give you the knowledge to hire someone to help you.

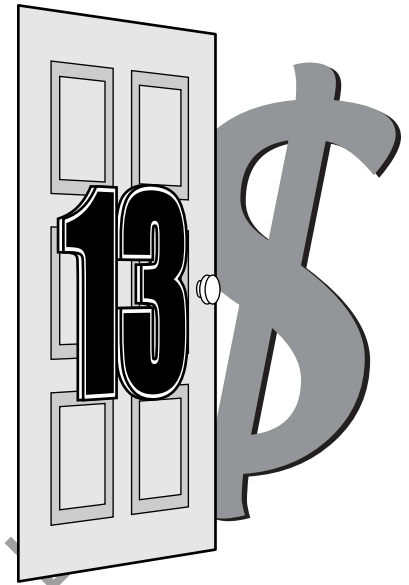
## Bookkeeping vs. Accounting

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To get a complete picture of the financial health of your business, you'll need to look at it from several different viewpoints. Just as you can't know what the inside of your house will look like by looking at the outside, you'll need several different viewpoints to get a complete picture of your business finances.

### Bookkeeping

Of course you have to keep track of all of the money that comes into and goes out of your business. Not only is that the only way you can know if you are profitable, it is also how you will determine how much you owe in taxes. Keeping track of your day-to-day finances is bookkeeping.



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Bookkeeping concentrates on the individual transactions that your business does every day, including keeping track of the paperwork that goes along with those transactions.

Think of it this way. If you were lost in the forest, you could easily see how healthy the trees were, but you would have no idea where you were in relation to the entire forest. If you were in a helicopter flying above the forest you could see where you were but would have no idea of how healthy any individual tree was. Bookkeeping is like looking at each tree; you see the details at the expense of the big picture.

## Accounting

Accounting is like being in that helicopter; you get the big picture at the expense of the details. The accounting process takes all of those daily records you generate (your bookkeeping) and distills them down into three formats that show you the financial health of your business. You need both thorough bookkeeping and accurate accounting to really know what is going on.

We'll take a look at accounting in more detail in the next chapter.

## Bookkeeping Overview

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### Dangers of not keeping a handle on finances

Imagine that you suddenly got the chance to coach your favorite sports team. But you were given little time to prepare. There you were, on the sidelines, with no clue about how much time was left in the game, who the players were and their relative strengths and weaknesses, or even the score in the game. Plus, you didn't know anything about your opponents. It would be difficult, if not impossible, to win that game, much less plan for future games, without having the required knowledge.

As ridiculous as this scenario sounds, this is the situation that many business owners find themselves in. They have no idea whether or not they have cash on hand, don't know what kind of profit they are making (or even if they have any profit at all), and don't know what the business owns and

owes. In other words, they have no idea if their business is succeeding or failing. Obviously, if you want your business to succeed, you have to have a handle on how well it is doing financially. Money may not be your only goal in running a business, but it is an essential element in any businesses' success. Money is the lifeblood of a business – lose too much and you're dead.

You don't have to get caught in this trap. By following some simple, time-tested guidelines, you can help ensure that your business works for you. There are four great reasons for you to stay on top of your finances.

## Management

One of the elements in managing your business is managing your money. You couldn't very well manage any employees you had unless you knew where they were at all times and what they were doing, so how can you manage your money unless you know how much you have, where it is, and what it is doing? Actively managing your money will allow it to work for you and reduce the inevitable stress associated with not having enough on hand at all times.

## Taxes

Here's a question for you. Who is responsible for calculating how much you owe in taxes? It isn't the government, it's you. You keep track of your income and expenses, and then use the tax law to calculate how much tax you owe at the end of the year. Obviously, you don't want to pay too much; that would be foolish. On the other hand, you don't want to pay too little; that would not only be illegal but you would be cheating those of us who do pay our fair share. Oh, and if you get audited you have to demonstrate to the IRS that your income and expenses are legitimate and the taxes you have paid are correct.

## Financial assistance

If you decide to seek financial assistance such as a loan, chances are excellent that the financial institution will ask for a copy of your financial records. If you've been in business a while, they may ask for up to the last three year's records. They do this simply to see how well you have run your busi-

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ness and to get a good feel for how well you manage your money. It's just like if you bought a used car, you would want to see the previous owner's maintenance records to verify that the car was, as they claim, well cared for. The lender wants to make sure that your business is also well cared for before they put their money at risk.

## Theft

If you read the local newspaper at all, you've undoubtedly seen articles about embezzlement from small businesses. It happens with amazing regularity. Often, a person is hired at a small business to handle the books, sometimes on a part-time basis. They are given the ability to write checks, and often, to order supplies. Over the course of months, they end up stealing business funds and siphoning off money into their own pockets.

A common method of embezzlement is for the bookkeeper to set up shell companies, which means they open checking accounts for businesses that do not exist, and whose accounts they control. Next they create phony orders from these phony companies, supposedly placed by the company that they work for (that would be your business). Since they can write checks from the business account, they pay the phony company funds from your business for these imaginary orders. The money actually goes to them.

Without proper oversight, it is surprisingly easy for this type of theft to go unnoticed, and many embezzlers never get caught. Even when they are caught, they rationalize their acts, saying they meant to pay the money back. They never do.

There are plenty of other ways that unscrupulous employees can rob you blind. You should take some common sense steps to protect yourself. First, it is always a good idea to be familiar with accepted bookkeeping practices so you can see if someone is doing something out of the ordinary. Second, you could consider making your signature a requirement on all checks, or perhaps on all checks over a given amount, rather than give someone else this power. This would help ensure that you are aware of where checks are going. Third, if you do hire a bookkeeper, be sure to check their background and references. One phone call might save your business from ruin.

# Three Rules for Brilliant Bookkeeping

For simple businesses, such as a single owner business with no employees, keeping your books can be very simple. But as soon as the business becomes more complicated, the business' finances quickly become more complex. You will certainly want to discuss your business' bookkeeping and accounting needs with an expert before you begin. But regardless of how complex your business is, the basics still apply. You must follow these rules.

## Keep all business and personal finances separate

Here's another experiment to think about. You open a new deck of cards. Which would be easier – to separate the cards by suit when they are already with one another, or to shuffle the cards, throw them up in the air, and then separate the cards by suit? Clearly, separating the cards at the beginning, when they are already with one another, is easier than when they are all mixed up. And that is the reason you want separate business and personal checking accounts.

I don't care how small your business is, you want to keep your business money and your personal money in separate pots, and that means having separate checking accounts. The checking account is the heart of any business' money management system, and it is unrealistic to think you could run a business without one. You can do it; there is no legal requirement that you have two accounts. But at the end of the year when you are searching for business-related tax deductions, you'll be going through your single checking account and trying to remember what your checks were written for. Was that check to the office supply store for business materials or construction paper for your kid's school project? Having separate accounts saves time and prevents you from making costly mistakes.

When you need to take money out of your business for personal use, you can write yourself a check from the business account to your personal account. This is the owner's draw that we'll discuss shortly. If you need to inject money into the business from your personal funds, write a personal

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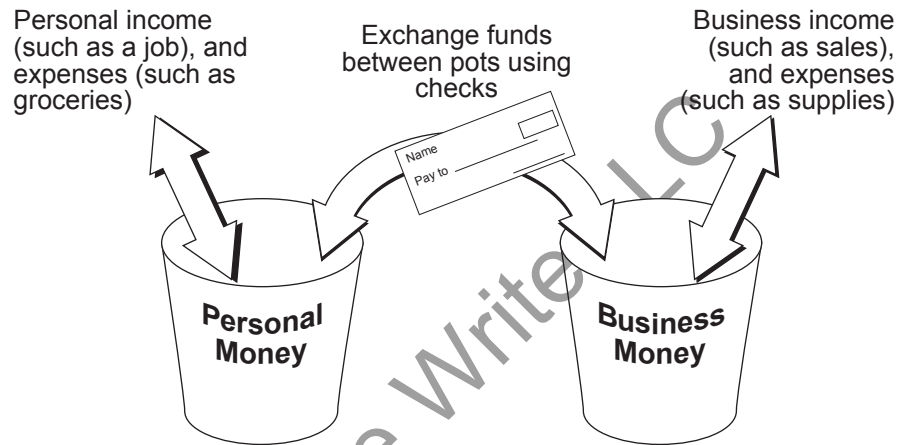
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check to the business (this is a perfectly legitimate thing to do). In each case you leave a paper trail of where the money comes from and where it goes. Without leaving such a trail, you can't be sure of where your money is going, and you can't be sure of just how much of that income and expense is tax-related. If you are ever audited, the IRS will expect to see a separate listing of personal and business finances, and keeping your books this way from the beginning is much easier than trying to separate them in a hurry.



*Keeping your personal and business funds in separate accounts lets you track your finances more efficiently*

## Maintain your books regularly

You'll need to update and maintain your books regularly. Depending on how frequently money goes into and out of your business, this may mean daily, weekly, or at the most, monthly. Few businesses, especially in the first years, can afford to ignore their books for more than a few days. For most businesses, keeping your books up-to-date means:

- Depositing checks as soon as possible and recording them in the register.
- Recording all transactions, including cash, on a regular basis (preferably daily).
- Billing customers promptly with the payment terms printed on the bill, and then tracking which customers are billed when, so that you know which bills are overdue and which have been paid.
- Recording expenses when they occur and keeping receipts for tax purposes.

A good rule of thumb is that you should have a good idea of how much money you have in your business checking account, to within a few dollars, **at all times**. This tracking of funds into and out of your checking account is your cash flow, and it is so important we'll talk about it at length in Chapter 14, *Know Accounting Basics*.

### Keep copies of all records

The paperwork that you generate in your business from daily transactions are called the general records, or source documents, and it is important that you keep them, for several reasons:

- To help manage your business. You can't tell where you are going if you don't know where you are.
- To help you prepare your financial statements, which tell you how well your business is doing throughout the year.
- To help in preparing your taxes at the end of the year. To calculate your taxes owed, you will need to know both where your money came from. To justify your business deductions you'll need to know where it went.
- Finally, if you are ever audited, these records will be required to prove to the tax agency that your tax return was correct.

The requirements for retaining your records will vary state-by-state, but a good general rule is to keep as much paperwork as you can for as long as you can. Of course, this isn't always practical, so you should consult with the IRS and your state taxing agency to get the statute of limitations for your situation. Many experts recommend that you keep your original or source documents up to seven years. But you should keep copies of your filed tax returns forever. For more information, see IRS Tax Publication 583, *Starting a Business and Keeping Records*.

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# Elements of Bookkeeping Systems

## The heart: a business checkbook

The heart of any small business bookkeeping system is the business checkbook. It is unrealistic to think that you can run a business without a checkbook. You could do it, but you wouldn't want to. You would end up wasting time and money, and your chances of making a costly error would be very high.

If you already have a personal checking account, get another account for your business. If you use the business name for the account, your bank may want to charge you more than for a personal account. Shop around – try to find a free or low cost business checking account. You will probably have to have an EIN before you get a business checking account – we'll cover those in Chapter 15:

In addition to your checkbook, you'll have to keep all records and receipts that your business generates. Try to develop a system that will let you retrieve your records quickly. Depending on how much paperwork your business generates, you might be able to get by with an accordion folder with 12 divisions. Each month you would put all of your records into that month's section. More complex business will require more complex ways of keeping track. In all cases, though, you must keep paperwork to help with taxes at the end of the year, and to justify your taxes in case of future audits. In general, you should keep records for up to seven years, more if practical.

## More sophistication

If your business is more complex, you'll need more complex accounting methods to track your progress. If you extend or receive credit, you will have to use accounts payable and accounts receivable so that you know who owes you money and who you owe money to. We'll talk more about these in Chapter 14.

If you sell merchandise, your business must track the inventory you buy and sell. You'll have to do this for tax reasons, as well as to know what you have in stock. Tracking inventory can be complex if you have lots of items.

If your business has employees, you must keep track of your payroll and payroll taxes. This again can be quite complex, and many businesses get into tax trouble because they do not pay enough attention to this essential part of their business.

If your business has more than a few employees or is doing significant business, you should probably use a more complex accounting system, including ledgers and the double-entry bookkeeping system. We'll talk more about in the next chapter.

Here is a chart showing what kinds of accounting tools you should use depending on the type of business you run.

If your business...	You should use...
Is in business	<ul style="list-style-type: none"> <li>• Checkbook (a must for any business!)</li> <li>• Records and receipts</li> <li>• Income and Expense Journals</li> </ul>
Extends or receives credit	Accounts Payable and Receivable
Sells merchandise	Inventory records
Has employees	Payroll records
Needs more control	Ledgers (double entry system)

## Paper vs. Computer

Lots of aspiring business owners think that they won't have to worry about their bookkeeping and accounting chores because they'll have the computer do all of the work. And in one sense, they're right; computers can relieve you of a lot of the grunt work involved in maintaining your books and charting your finances.

But computers, like any tool, are only useful in the hands of a person who has the knowledge and skill to operate them. To see if you are ready to use a computer in your business, think about these two questions:

- Do you have a clear understanding of general computer usage now?

For example, can you surf the web, send e-mail, and copy and paste text? If so, you probably know enough about the computer to get by.

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- Do you have a good handle on bookkeeping basics?

For example, do you currently balance your check-book regularly, tally your income and expenses monthly, and understand what a cash flow is? If so, you probably know enough about bookkeeping to go electronic.

If you couldn't answer yes to these questions, you should probably delay using the computer for your bookkeeping until down the road. Here are two reasons why.

### Time Management

If you have limited computer skills now, the time to learn isn't when you are preoccupied with starting your business. Learning how to use your bookkeeping program will take time, lots of it, probably more than you have to spare as your business gets off the ground. You will hopefully have more time in the future to learn the computer. And by delaying putting your finances on the computer, you will have the advantage of knowing exactly what you are doing.

One unfortunate consequence of rushing to computerize your finances is that the computer program that is supposed to make your life so easy will follow the standard rules of accounting, rules you may not yet understand. So if you fail to establish the correct accounts when starting up, or misunderstand an accounting term, or make an honest mistake, the computer will have no sympathy. It does what it is supposed to do and you may not realize the mistake until much later. And without understanding what the bookkeeping program is doing behind the scenes, you may not have a clue as to how to correct it. Better to stick with paper until you have a solid understanding of what you are doing.

### Paper is great

Businesses have been keeping their financial records on paper for 5,000 years (OK, maybe they were on clay tablets or papyrus for some of that time). You can certainly afford to keep your records on paper for the year or two it will take you to become familiar with the bookkeeping requirements and money flow in your business.

I would recommend that you spend some time in a business supplies store (such as Office Max, Office Depot, or Staples) and look for bookkeeping and accounting aids. DOME is a company that makes excellent guides that many business

can use to keep track of their finances. Chances are if you need to keep track of things on paper, someone sells a solution.

Once you do have your bookkeeping system established and the kinks worked out, you should have little problem jumping to the computer.

## The Three Most Important Words

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Chances are you are already confused with a lot of this money talk. Most business owners are. Nearly every business, from a simple dog-sitting business to a complex car dealership, will be more successful if they follow these three words when it comes to managing their money and keeping a handle on their financial health:

### Get expert advice

As we saw in Chapter 5, *Know Who Will Help You*, hiring outside help often ends up being cheaper than trying to do the work yourself, and of course there is no question that a bookkeeper or accountant knows more about their field than you do. (If you knew more than the expert advising you, you either have a poor expert or are in the wrong line of work yourself.) You might want to review this section and start shopping for a pro to help you.

## So, How Do I Pay Myself?

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If you have worked for someone else, you have been paid a wage, which includes your hourly pay minus whatever taxes and other deductions you owe. By law, all employees are paid wages. But when you work for yourself, you usually are not an employee of your business. This means that you do not pay yourself a wage. Instead you will withdraw money from the business' net profit for your own personal use. This is called an **owner's draw**. (In this discussion we are assuming that your business is a sole proprietor or LLC – if you have a corporation chances are you are an employee and **do** pay yourself a wage.)

If you have employees, you have to pay them; the government gets very upset when wages and taxes aren't paid (the

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employees won't be too happy either). But as a sole proprietor or LLC member, you do not have to pay yourself. An owner's draw is completely optional. You can take out whatever is in the business account for personal use, or you can leave it in. As we'll see in a minute, it doesn't matter to anyone except you how much of an owner's draw you take. But of course, if there is no net profit from which to take a draw, then you don't get one.

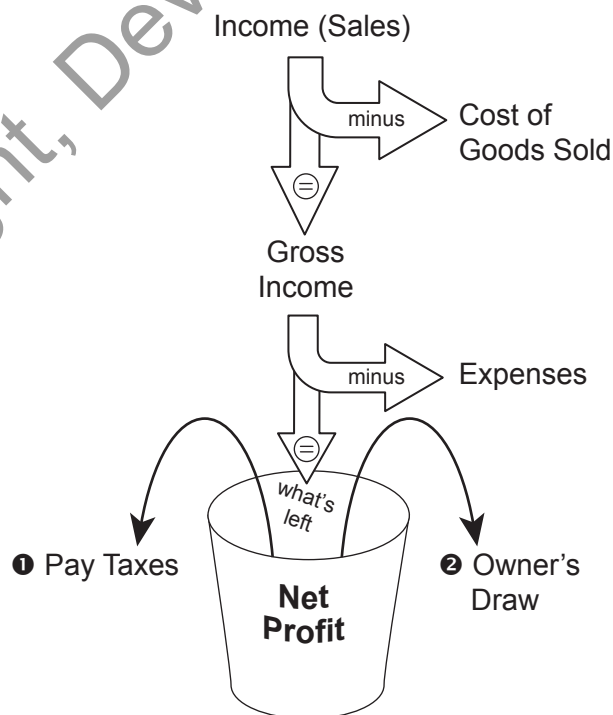
An owner's draw is the money you take from the business to spend on your personal needs, such as groceries and recreation. Here's the tricky thing to understanding an owner's draw. The money you take out of the business as an owner's draw is already your money – you are simply moving it from one pot to another. Here is how the process works.

Remember when we discussed how you figured out your net profit? We used these formulas:

Gross Income (or Sales) – Cost of Goods sold = Gross Profit

Gross Profit – Expenses = Net Profit

Looking at how your business money flows, you find your net profit like this:



*An owner's draw is money you take out of the business for personal use. Because it comes out of the net profit bucket, the money is already yours and has no tax implications.*

The net profit bucket is the total sum of what your business makes, but that doesn't mean all of the money in this bucket is yours to spend as you please. Instead, several things have to be taken care of before you go out and buy that boat you've always wanted.

First, if the level of net profit in your bucket is high enough, you will have to pay taxes out of it, such as your Self-Employment and income taxes. Many novice business owners neglect their taxes and forget to set aside some of their net profits, so that, come tax time, they don't have enough in reserve. Cheating the IRS is not a good way to build a successful business. (Taxes are complicated enough that you will want to get some expert advice on how to keep yours as low as possible.)

Second, you will want to keep a fair amount of money in your business' net profit bucket to put back into expanding your business, act as a cushion against unforeseen incidents, or to take advantage of unusual opportunities.

Finally, if there is money still left in your bucket at the end of the month or the quarter, you can take an owner's draw. You do not have to take a draw, and many business owners don't take a draw for several months, or even years, while they establish their business.

### Taxes on business income

As we'll see when we get to Chapter 15, *Know How to Minimize Your Taxes*, you will pay taxes based on your business' net profit. Because you pay taxes on net profit, what you do with this money after you pay taxes on it has no effect on your taxes. Therefore, if you take all of your remaining net profit as an owner's draw, or none of it, it has no effect on your taxes.

Lots of people find this confusing, and I can understand why; it is confusing. Here's the important point. In a sole proprietorship or single-member LLC, the dollars your business earns in net profit are taxed at the net profit stage. The business' net profit is considered your money anyway for tax purposes, so it is only taxed once. What happens to the money after that doesn't matter.

If you still have a hard time with this, just accept it as a matter of faith, and talk to your bookkeeper or accountant. If it

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helps, as we'll see when we get to taxes, the IRS never asks you to report your owner's draw – they don't care!

To summarize, here are the important points about an owner's draw:

- You do not have to take it (it's already your money).
- You do not pay taxes on it (you pay taxes on net profit, not what you take from the business for personal use).
- It is not a business expense (sorry, since it doesn't go to support your business, you cannot deduct it).

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# Nail It Down!

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Here are the key elements to remember in managing your books.

## Bookkeeping Essentials

- Keep your business and personal accounts separate.
- A business checking account is the heart of any bookkeeping system; more complex businesses require more elements to track their finances.
- Maintain your books regularly.
- Keep copies of all records.
- Keep your books on the computer only if you are really comfortable doing so. Remember that paper has worked well for thousands of years.
- Get expert advice!**

## Paying yourself

- Sole proprietors and single-member LLC owners will pay themselves through an owner's draw.
- The money from an owner's draw comes from net profit, after taxes have been paid.
- Because taxes have been paid on net profit, the owner's draw has no effect on taxes.
- Owner's draw is optional, and if there is no net profit, there is no draw.

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