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Stephen L. Nelson

MBA, CPA, MS in Taxation
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For Dummies



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by Stephen Nelson, MBA, CPA, MS
in Taxation

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QuickBooks® 2019 All-in-One For Dummies®

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Introduction

Few people read introductions to reference books, so I'll make this very brief. I just want to tell you which versions of QuickBooks this book works for, what's in the reference, what it assumes about your existing skills, and what conventions I use.

About This Book

The desktop version of QuickBooks comes in several flavors, including QuickBooks Pro, QuickBooks Premier, and QuickBooks Enterprise Solutions. This reference talks about QuickBooks 19 Enterprise Solutions, which is a superset of QuickBooks 2019 Premier and QuickBooks 2019 Pro. If you're using QuickBooks Self-Employed or QuickBooks Online, you shouldn't use this book. Sorry.

On the other hand, even though this book is written for QuickBooks Enterprise Solutions, if you're using QuickBooks Premier or QuickBooks Pro, don't worry. You're just fine with this book. And don't freak out if you're using some version of QuickBooks that's very similar to QuickBooks 2019, such as QuickBooks 2018 or QuickBooks 2020. Although this reference is about QuickBooks 2019, it also works just fine for the 2017, 2018, and probably 2020 versions of QuickBooks because QuickBooks is a very mature product at this point. The changes from one year to the next are modest. This means that if you're using QuickBooks 2018, stuff may look a little different if you closely compare the images in this book with what you see on your screen, but the information in this reference will still apply to your situation.

Note, too, that specialty versions of QuickBooks, such as QuickBooks Accountant's Edition and QuickBooks Contractor, also work almost identically to QuickBooks Premier.



TIP

If you use QuickBooks Pro and see some whistle or bell that you really want to use but that isn't available in your version of QuickBooks, you'll know that you should upgrade to the Premier or Enterprise Solutions version of QuickBooks.



REMEMBER

The bottom line? Yes, QuickBooks comes in several flavors. Yes, Intuit publishes new editions of its QuickBooks products every year. But you can use this book for any recent version of QuickBooks Pro, Premier, or Enterprise Solutions.

To make the best use of your time and energy, you should know about the conventions I use in this book:

- » When I want you to type something such as **Jennifer**, it's in bold letters.
- » By the way, except for passwords, you don't have to worry about the case of the stuff you type in QuickBooks. If I tell you to type Jennifer, you can type **JENNIFER**. Or you can follow poet e e cummings's lead and type **jennifer**.
- » Whenever I tell you to choose a command from a menu, I say something like Choose Lists ⇨ Items, which simply means to first choose the Lists menu and then choose Items. The ⇨ separates one part of the command from the next part.
- » You can choose menus and commands and select dialog-box elements with the mouse. Just click the thing that you want to select.
- » While I'm on the subject of conventions, let me also mention something about QuickBooks conventions, because it turns out that there's really no good place to point this out. QuickBooks doesn't use document windows the same way that other Windows programs do. Instead, it locks the active window into place and then displays a list of windows in its Navigator pane, which is like another little window. To move to a listed window, you click it.



TIP

You can tell QuickBooks to use windows like every other program does, however, by choosing View ⇨ Multiple Windows. You can even remove the Navigator pane by choosing View ⇨ Open Window List.

Foolish Assumptions

I'm making only three assumptions about your QuickBooks and accounting skills:

- » You have a PC with Windows 7, Windows 8, or Windows 10. (I took pictures of the QuickBooks windows and dialog boxes in Windows 10, in case you're interested.)
- » You know a little bit about how to work with your computer.
- » You have, or will buy, a copy of QuickBooks Pro, QuickBooks Premier, or QuickBooks Enterprise Solutions for each computer on which you want to run the program.

In other words, I don't assume that you're a computer genius or an MBA, or that you're super-experienced in the arcane rules of accounting. I assume that QuickBooks and accounting are new subjects to you. But I also assume that you want to understand the subjects because you need to do so for your job or your business.

Icons Used in This Book

Like many computer books, this book uses icons, or little pictures, to flag things that don't quite fit into the flow of things.



WARNING

The Warning icon tells you to watch out! It marks important information that may save you headaches when using QuickBooks 2019.



REMEMBER

Remember icons mark the information that's especially important to know. To siphon off the most important information in each chapter, skim these icons.



TIP

The Tip icon marks tips (duh!) and shortcuts that you can use to make QuickBooks easier.



TECHNICAL
STUFF

The Technical Stuff icon marks information of a highly technical nature that you normally can skip.

Beyond the Book

QuickBooks 2019 All-in-One For Dummies includes some extra content that you bought with your book but didn't get inside the book. Okay, I know that sounds bad at first blush. But don't worry. This extra, premium stuff is available online:

» The Cheat Sheet for this book is at

www.dummies.com

In the Search field, type **QuickBooks 2019 All-in-One For Dummies Cheat Sheet** to find the Cheat sheet for this book.

» Updates to this book, if there are any, are also at www.dummies.com. Search for the book's title to find the associated updates.

Where to Go from Here

This reference combines eight short books, including a minibook about accounting, one about setting up the QuickBooks system, one for bookkeepers using QuickBooks, one for accountants and managers using QuickBooks, a minibook

about small-business financial management, a minibook about business planning, a minibook about taking care of a QuickBooks accounting system, and a minibook of appendixes of further useful information.

I'm not going to go into more detail here about what's available in the book. If you have a specific question about what's covered or where some topic is covered, refer to the table of contents in the front of this reference. Also remember that the book provides an index to help you find just the pages that have the information you need.

While I'm on the subject of what's in this book and how to find information, let me make four tangential points:

- » You'll never read this book from cover to cover unless you're someone who has an obsessive-compulsive personality (like me) and many hours to devote to reading. But that's okay. This reference isn't meant to be read from cover to cover like some Val McDermid page-turner. Instead, chapters within the eight minibooks are organized into largely self-contained descriptions of how you do the things that you need to do. You just read the paragraph, page, or chapter that provides the information you want.
- » I haven't discussed in any detail how to use the QuickBooks Premier and QuickBooks Enterprise Solutions features for business planning. The wizard-based approach that QuickBooks Premier and QuickBooks Enterprise Solutions provide for business planning is not, in my humble opinion, the right way. Instead, I discuss in detail alternative, superior approaches to business planning and budgeting (using spreadsheets) in Book 6. (Just so you know: The approach I describe and recommend here is the same one that any business school teaches its students.)
- » At a few points in the book, you'll find me saying things like "Well, I really don't think you should use this part of the product." I just want to explain here, up front, where I'm coming from. First, know that I think QuickBooks is an outstanding product, but not every feature and every command is good. I've already mentioned that the new business planning tools aren't ones that I can recommend. And payroll, very frankly, is another pain-in-the-butt feature that most businesses should avoid. (I do briefly discuss payroll in Book 3, Chapter 5.) So if I think that a particular feature is one that you shouldn't use, I don't take up page space (or much page space) describing the feature. I'd rather use that space to describe other stuff that I believe is going to be valuable to you and other readers.
- » I should also mention one final thing: Accounting software programs require you to do a certain amount of preparation before you can use them to get real work done. If you haven't started to use QuickBooks yet, I recommend that you skim Book 1 and then read Book 2 to find out what you need to do first.

1

An Accounting Primer

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IN THIS CHAPTER

- » Figuring out the purpose of accounting
- » Taking a look at the common financial statements
- » Understanding the philosophy of accounting
- » Discovering income tax accounting and reporting

Chapter 1

Principles of Accounting

Any discussion of how to use QuickBooks to better manage your business begins with a discussion of the basics of accounting. For this reason, in this chapter and the next two, I attempt to provide the same information that you'd receive in an introductory college accounting course. I tailor the entire discussion, of course, to QuickBooks and the small-business environment. What you'll read about here and in the next chapters of this book pretty much describes how accounting works in a small-business setting. When you're using QuickBooks.

If you've had some experience with accounting, if you know how to read an income statement and balance sheet, or if you know how to construct a journal entry, you don't need to read this chapter or the next. But if you're new to accounting and business bookkeeping, take the time to read this chapter carefully. I start the chapter by giving you a high-level overview of the purpose of accounting. Then I review the common financial statements that any accounting system worth its salt produces. I also discuss some of the important principles of accounting and the philosophy of accounting. Finally, I talk a little bit about income tax law and tax accounting.

The Purpose of Accounting

In the movie *Creator*, Peter O'Toole plays an eccentric professor. At one point, O'Toole's character attempts to talk a young student into working as an unpaid

research assistant. When the student protests, noting that he needs 15 credit hours, O'Toole creates a special 15-credit independent-study course named "Introduction to the Big Picture." In the next section, I describe the "big picture" of accounting. At its core, accounting makes perfect, logical sense.

The big picture

The most important thing to understand about accounting is that it provides financial information to stakeholders. *Stakeholders* are the people who do business with or interact with a firm; they include managers, employees, investors, banks, vendors, government authorities, and agencies that may tax a firm. Stakeholders and their information requirements deserve a bit more discussion. Why? Because the information needs of these stakeholders determine what an accounting system must do.

Managers, investors, and entrepreneurs

The first category of stakeholders includes the firm's managers, investors, and entrepreneurs. This group needs financial information to determine whether a business is making money. This group also wants any information that gives insight into whether a business is growing or contracting and how healthy or sick it is. To fulfill its obligations and duties, this group often needs detailed information. A manager or entrepreneur may want to know which customers are particularly profitable — or unprofitable. An active investor may want to know which product lines are growing or contracting.

A related set of information requirements concerns asset and liability record keeping. An *asset* is something that the firm owns, such as cash, inventory, or equipment. A *liability* is some debt or obligation that the firm owes, such as bank loans and accounts payable.

Obviously, someone at a firm — perhaps a manager, bookkeeper, or accountant — needs to have very detailed records of the amount of cash that the firm has in its bank accounts, the inventory that the firm has in its warehouse or on its shelves, and the equipment that the firm owns and uses in its operations.

If you look over the preceding two or three paragraphs, nothing I've said is particularly surprising. It makes sense, right? Someone who works in a business, manages a business, or actively invests in a business needs good general information about the financial affairs of the firm and, in many cases, very detailed information about important assets (such as cash) and liabilities (such as bank loans).

External creditors

A second category of stakeholders includes outside firms that lend money to a business and credit-reporting agencies that supply information to these lenders. Banks want to know about the financial affairs and financial condition of a firm before lending money, for example. The accounting system needs to produce the financial information that a bank requires to consider a loan request.

What information do lenders want? Lenders want to know that a business is profitable and enjoys a positive cash flow. Profits and positive cash flows allow a business to repay debt easily. A bank or other lender also wants to see assets that could be liquidated, in a worst-case scenario, to pay a loan — and other debts that may represent a claim on the firm's assets.

Vendors also typically require financial information from a firm. A vendor often lends money to a firm by extending trade credit. What's noteworthy about this fact is that vendors sometimes require special accounting. One category of vendors that a company such as John Wiley & Sons, Inc., deals with is authors. To pay an author the royalty that he or she is entitled to, Wiley puts in a fair amount of work to calculate royalty-per-unit amounts and then reports and remits these amounts to authors.

Other firms sometimes have similar financial reporting requirements for vendors. Franchisees (such as the man or woman who owns and operates the local McDonald's) pay a franchise fee based on revenue. Retailers may perform special accounting and reporting to enjoy rebates and incentives from the manufacturers of the products that they sell.

Government agencies

Predictable stakeholders that require financial information from a business also include the federal and state government agencies with jurisdiction over the firm. Every business in the United States needs to report on its revenue, expenses, and profits so that the firm can correctly calculate income tax due to the federal government (and often the state government too) and then pay that tax.

Firms with employees must also report to the federal and state governments on wages paid to those employees and pay payroll taxes based on metrics, such as number of employees, wages paid to employees, and unemployment benefits claimed by past employees.

Providing this sort of financial information to government agencies represents a key duty of a firm's accounting system.

Business form generation

In addition to the financial reporting described in the preceding paragraphs, accounting systems typically perform a key task for businesses: producing business forms. An accounting system almost always produces the checks needed to pay vendors, for example. In addition, an accounting system prepares the invoices and payroll checks. More sophisticated accounting systems, such as those used by large firms, prepare many other business forms, including purchase orders, monthly customer statements, credit memos to customers, and sales receipts.



TIP

Every accounting function that I've described so far is performed ably by each of the versions of QuickBooks: QuickBooks Simple Start, QuickBooks Pro, QuickBooks Premier, and QuickBooks Enterprise.

Reviewing the Common Financial Statements

With the background information just provided, I'm ready to talk about some of the common financial statements or accounting reports that an accounting system like QuickBooks produces. If you understand which reports you want your accounting system to produce, you should find it much easier to collect the raw data necessary to prepare these reports.

In the following sections, I describe the three principal financial statements: the income statement, the balance sheet, and the statement of cash flows. I also briefly describe a fourth, catch-all category: accounting reports.

Don't worry — I go through this material slowly. You need to understand what financial statements your accounting systems are supposed to provide and what data these financial statements supply.

The income statement

Perhaps the most important financial statement that an accounting system produces is the income statement, also known as a profit and loss statement. An income statement summarizes a firm's revenue and expenses for a particular period. *Revenue* represents amounts that a business earns by providing goods and services to its customers. *Expenses* represent amounts that a firm spends providing those goods and services. If a business can provide goods or services to customers

for revenue that exceeds its expenses, the firm earns a profit. If expenses exceed revenue, obviously, the firm suffers a loss.

To show you how this all works — and it's really pretty simple — take a look at Tables 1-1 and 1-2. Table 1-1 summarizes the sales that an imaginary business enjoys. Table 1-2 summarizes the expenses that the same business incurs for the same period. These two tables provide all the information necessary to construct an income statement.

TABLE 1-1

A Sales Journal

Joe	\$1,000
Bob	500
Frank	1,000
Abdul	2,000
Yoshio	2,750
Marie	2,250
Jeremy	1,000
Chang	2,500
Total sales	\$13,000

TABLE 1-2

An Expenses Journal

Purchases of dogs and buns	\$3,000
Rent	1,000
Wages	4,000
Supplies	1,000
Total supplies	\$9,000

Using the information from Tables 1-1 and 1-2, you can construct the simple income statement shown in Table 1-3. Understanding the details of an income statement is key to your understanding of how accounting works and what accounting tries to do. Therefore, I want to go into some detail discussing this income statement.

TABLE 1-3

Simple Income Statement

Sales revenue	\$13,000
Less: Cost of goods sold	3,000
Gross margin	\$10,000
Operating expenses	
Rent	\$1,000
Wages	4,000
Supplies	1,000
Total operating expenses	6,000
Operating profit	\$4,000

The first thing to note about the income statement shown in Table 1-3 is the sales revenue figure of \$13,000. This figure shows the sales generated for a particular period of time. The \$13,000 figure shown in Table 1-3 comes directly from the sales journal shown in Table 1-1.

One important thing to recognize about accounting for sales revenue is that revenue gets counted when goods or services are provided, not when a customer pays for the goods or services. If you look at the list of sales shown in Table 1-1, for example, Joe (the first customer listed) may have paid \$1,000 in cash, but Bob, Frank, and Abdul (the second, third, and fourth customers) may have paid for their purchases with a credit card. Yoshio, Marie, Jeremy, and Chang (the fifth through eighth customers listed) may not have even paid for their purchases at the time the goods or services were provided. These customers may simply have promised to pay for the purchases at some later date. The timing of payment for goods or services doesn't matter, however. Accountants have figured out that you count revenue when goods or services are provided. Information about when customers pay for those goods or services, if you want that information, can come from lists of customer payments.

Cost of goods sold and *gross margins* are two other values that you commonly see in income statements. Before I discuss cost of goods sold and gross margins, however, let me add a little more detail to this example. Suppose that the financial information in Tables 1-1, 1-2, and 1-3 shows the financial results from your business: the hot dog stand that you operate for one day at the major sporting event in the city where you live. Table 1-1 describes sales to hungry customers. Table 1-2 summarizes the one-day expenses of operating your super-duper hot dog stand.

In this case, the actual items that you sell — hot dogs and buns — are shown separately in the income statement as cost of goods sold. By separately showing the cost of the goods sold, the income statement can show what is called a gross margin. The *gross margin* is the amount of revenue left over after paying for the cost of goods. In Table 1-3, the cost of goods sold equals \$3,000 for purchases of dogs and buns. The difference between the \$13,000 of sales revenue and the \$3,000 of cost of goods sold equals \$10,000, which is the gross margin.



TIP

Knowing how to calculate gross margin allows you to estimate firm break-even points and to perform profit, volume, and cost analyses. All these techniques are extremely useful for thinking about the financial affairs of your business. In fact, Book 6, Chapter 1 describes how you can perform these analyses.

The *operating expenses* portion of the simple income statement shown in Table 1-3 repeats the other information listed in the expenses journal. The \$1,000 of rent, the \$4,000 of wages, and the \$1,000 of supplies get totaled. These operating expenses are then subtracted from the gross.

Do you see, then, what an income statement does? An income statement reports on the revenue that a firm has generated. It shows the cost of goods sold and calculates the gross margin. It identifies and shows operating expenses, and finally shows the profits of the business.

One other important point: Income statements summarize revenue, expenses, and profits for a particular period. Some managers and entrepreneurs, for example, may want to prepare income statements on a daily basis. Public companies are required to prepare income statements on a quarterly and annual basis. And taxing authorities, such as the Internal Revenue Service (IRS), require tax return preparation both quarterly and annually.



TIP

Technically speaking, the quarterly statements required by the IRS don't need to report revenue. The IRS requires quarterly statements only of wages paid to employees. Only the annual income statements required by the IRS report both revenue and expenses. These income statements are produced to prepare an annual income tax return.

Balance sheet

The second most important financial statement that an accounting system produces is a balance sheet. A *balance sheet* reports on a business's assets, liabilities, and owner contributions of capital at a particular point in time:

» **The assets** shown in a balance sheet are those items that are owned by the business, which have value and for which money was paid.

- » The **liabilities** shown in a balance sheet are those amounts that a business owes to other people, businesses, and government agencies.
- » The **owner contributions of capital** are the amounts that owners, partners, or shareholders have paid into the business in the form of investment or have reinvested in the business by leaving profits inside the company.

As long as you understand what assets and liabilities are, a balance sheet is easy to understand and interpret. Table 1-4, for example, shows a simple balance sheet. Pretend that this balance sheet shows the condition of the hot dog stand at the beginning of the day, before any hot dogs have been sold. The first portion of the balance sheet shows and totals the two assets of the business: the \$1,000 cash in the cash register in a box under the counter and the \$3,000 worth of hot dogs and buns that you've purchased to sell during the day.

TABLE 1-4

A Simple Balance Sheet

Assets	
Cash	\$1,000
Inventory	3,000
Total assets	\$4,000
Liabilities	
Accounts payable	\$2,000
Loan payable	1,000
Owner's equity	
S. Nelson, capital	\$1,000
Total liabilities and owner's equity	\$4,000



TIP

Balance sheets can use several other categories to report assets: accounts receivable (amounts that customers owe), investments, fixtures, equipment, and long-term investments. In the case of a small owner-operated business, not all these asset categories show up. But if you look at the balance sheet of a very large business — say, one of the 100 largest businesses in the United States — you see these other categories.

The liabilities section of the balance sheet shows the amounts that the firm owes to other people and businesses. The balance sheet in Table 1-4 shows \$2,000 of accounts payable and a \$1,000 loan payable. Presumably, the \$2,000 of accounts payable is the money that you owe to the vendors who supplied your hot dogs and buns. The \$1,000 loan payable represents some loan you've taken out — perhaps from some well-meaning and naive relative.

The owner's equity section shows the amount that the owner, the partners, or shareholders have contributed to the business in the form of original funds invested or profits reinvested. One important point about the balance sheet shown in Table 1-4: This balance sheet shows how owner's equity looks when the business is a sole proprietorship. In the case of a sole proprietor, only one line is reported in the owner's equity section of the balance sheet. This line combines all contributions made by the proprietor — both amounts originally invested and amounts reinvested.

I talk a bit more about owner's equity accounting later in this chapter because the owner's equity sections look different for partnerships and corporations. Before I get into that discussion, however, let me make two important observations about the balance sheet shown in Table 1-4:

- » **A balance sheet needs to *balance*.** This means that the total assets must equal the total liabilities and owner's equity. In the balance sheet shown in Table 1-4, for example, total assets show as \$4,000. Total liabilities and owner's equity also show as \$4,000. This equality is no coincidence. If an accounting system works right, and the accountants and bookkeepers entering information into this system do their jobs right, the balance sheet balances.
- » **A balance sheet provides a snapshot of a business's financial condition at a particular point in time.** I mention in the introductory remarks related to Table 1-4 that the balance sheet in this table shows the financial condition of the business immediately before the day's business activities begin.



REMEMBER

You can prepare a balance sheet for any point in time. It's key that you understand that a balance sheet is prepared for a particular point in time.

By convention, businesses prepare balance sheets to show the financial condition at the end of the period of time for which an income statement is prepared. A business typically prepares an income statement on an annual basis. In this orthodox situation, a firm also prepares a balance sheet at the very end of the year.

At this point, I return to something that I allude to earlier in the chapter: the fact that the owner's equity section of a balance sheet looks different for different types of businesses.

Table 1-5 shows how the owner's equity section of a balance sheet looks for a partnership. In Table 1-5, I show how the owner's equity section of the business appears if, instead of having a sole proprietor named S. Nelson running the hot-dog stand, the business is actually owned and operated by three partners named Tom, Dick, and Harry. In this case, the partners' equity section shows the amounts originally invested and any amounts reinvested by the partners. As is the case with sole proprietorships, each partner's contributions and reinvested profits appear on a single line.

TABLE 1-5

Owner's Equity for a Partnership

Partners' equity	
Tom, capital	\$500
Dick, capital	250
Harry, capital	250
Total partner capital	\$1,000

Go ahead and take a look at Table 1-6. It shows how the owner's equity section looks for a corporation.

TABLE 1-6

Owner's Equity for a Corporation

Shareholders' equity	
Capital stock, 100 shares at \$1 par	\$100
Contributed capital in excess of par	400
Retained earnings	500
Total shareholders' equity	\$1,000

This next part is a little bit weird. For a corporation, the amounts that appear in the owner's equity or shareholders' equity section actually fall into two major categories: retained earnings and contributed capital. *Retained earnings* represent profits that the shareholders have left in the business. *Contributed capital* is the money originally contributed by the shareholders to the corporation.

The retained-earnings thing makes sense, right? That's just the money — the profits — that investors have reinvested in the business.

The contributed-capital thing is more complicated. Here's how it works. If you buy a share of stock in some new corporation — for, say, \$5 — typically, some portion of that price per share is for par value. Now, don't ask me to justify par value. It stems from business practices that were common a century or more ago. Just trust that typically, if you pay some amount — again, say \$5 — for a share, some portion of the amount that you pay — maybe 10 cents a share or \$1 a share — is for par value.

In the owner's equity section of a corporation's balance sheet, capital that's contributed by original investors is broken down into the amounts paid for this mysterious par value and the amounts paid in excess of this par value. In Table 1-6, you can see that \$100 of shareholders' equity or owner's equity represents amounts paid for par value. Another \$400 of the amounts contributed by the original investors represents amounts paid in excess of par value. The total shareholders' equity, or total corporate owner's equity, equals the sum of the capital stock par value, the contributed capital and excess of par value, and any retained earnings. So in Table 1-6, the total shareholders' equity equals \$1,000.

Statement of cash flows

Now I come to the one tricky financial statement: the statement of cash flows.

Before I begin, I have one comment to make about the statement of cash flows. As an accountant, I've worked with many bright managers and businesspeople. No matter how much hand-holding and explanation I (or other accountants) provide, some of these smart people never quite get some of the numbers on the statement of cash flows. In fact, many of the students who major in accounting never (in my opinion, at least) quite understand how a statement of cash flows really works.

For this reason, don't spend *too* much time spinning your wheels on this statement or trying to understand what it does. QuickBooks does supply a statement of cash flows, but you don't need to use it. In fact, QuickBooks produces cash basis income statements, which give you almost the same information — and in a format that's easier to understand.

I think the best way to explain what a statement of cash flows does is to ask you to look again at the balance sheet shown in Table 1-4 earlier in this chapter. This table is the balance sheet for the imaginary hot dog stand at the beginning of the day.

Now take a look at Table 1-7, which shows the balance sheet at the end of the day, after operations for the hot dog stand have ended. Notice that at the start of the day (see Table 1-4), cash equals \$1,000, and at the end of the day (see Table 1-7), cash equals \$5,000. The statement of cash flows explains why cash changes from the one number to the other number over a period of time. In other words, a statement of cash flows explains how cash goes from \$1,000 at the start of the day to \$5,000 at the end of the day.

TABLE 1-7

Another Simple Balance Sheet

Assets	
Cash	\$5,000
Inventory	0
Total assets	\$5,000
Liabilities	
Accounts payable	\$0
Loan payable	0
Owner's equity	
S. Nelson, capital	\$5,000
Total liabilities and owner's equity	\$5,000

Table 1-8, not coincidentally, shows a statement of cash flows that explains how cash flowed for your imaginary business. If you're reading this book, presumably you need to understand this statement. I start at the bottom of the statement and work up.



REMEMBER

By convention, accountants show negative numbers inside parentheses. These parentheses flag negative values more clearly than a simple minus sign can.

The last three lines of the statement of cash flows are all easy to understand. The cash balance at the end of the period, \$5,000, shows what cash the business holds at the end of the day. The cash balance at the start of the period, \$1,000, shows the cash that the business holds at the beginning of the day. Both the cash balance at the start of the period and the cash balance at the end of the period tie to the cash balance values reported in the two balance sheets. (Look at Table 1-4 and Table 1-7 to corroborate this assertion.) Clearly, if you start the period with \$1,000 and end the period with \$5,000, cash has increased by \$4,000. That's an arithmetical certainty. No question there, right?

TABLE 1-8

A Simple Statement of Cash Flows

Operating activities	
Net income	\$4,000
Decrease in accounts payable	(2,000)
Adjustment: Decrease in inventory	3,000
Net cash provided by operating activities	\$5,000
Financing activities	
Decrease in notes payable	(1,000)
Net cash provided (used) by financing activities	(1,000)
Increase in cash	\$4,000
Cash balance at start of period	1,000
Cash balance at end of period	\$5,000

The financing activities of the statement of cash flows show how firm borrowing and firm debt repayment affect the firm cash flow. If the business uses its profits to repay the \$1,000 loan payable — which is what happened — this \$1,000 cash outflow shows up in the financing activities portion of the statement of cash flows as a negative \$1,000.

The top portion of the statement of cash flows is often the trickiest to understand. Note, however, that I've talked about everything else in this statement. So with a strong push, you can fight your way through to understanding what's going on here. The operating activities portion of the statement of cash flows essentially shows the cash that comes from the profit. If you look at Table 1-8, for example, you see that the first line in the operating activities portion of the statement of cash flows is net income of \$4,000. This is the net income amount reported on the income statement for the period. The net income or operating profit reported in the business's income statement, however, isn't necessarily the same thing as cash income or cash profit. A variety of factors must be adjusted to convert this net income amount to what's essentially a cash amount of operating profit.

In the case of the hot-dog-stand business, if you use some of the profits to pay off all the accounts payable, this payoff uses up some of your cash profit. This is exactly what Table 1-8 shows. You can see that the decrease in the accounts payable from \$2,000 to \$0 over the day required, quite logically, \$2,000 of the net income. Another way to think about this is that essentially, you used up \$2,000 of your cash profits to pay off accounts payable. Remember that the accounts payable is the amount that you owed your vendors for hot dogs and buns.

Another adjustment is required for the decrease in inventory. The decrease in inventory from the start of the period to the end of the period produces cash. Basically, you're liquidating inventory. Another way to think about this is that although this inventory — the hot dogs and buns, in this example — shows up as an expense for the day's income statement, it isn't purchased during the day. It doesn't consume cash during the day; it was purchased at some point in the past.

When you combine the net income, the accounts payable adjustment, and the inventory adjustment, you get the net cash provided by the operating activities. In Table 1-8, these three amounts combine for \$5,000 of cash provided by the operations.

After you understand the details of the financing and operating activities areas of the statement of cash flows, the statement makes sense. Net cash provided by the operating activities equals \$5,000. Financing activities reduce cash by \$1,000. This means that cash actually increased over the period by \$4,000, which explains why cash starts the period at \$1,000 and ends the period at \$5,000.

Other accounting statements

You can probably come up with examples of several other popular or useful accounting reports. Not surprisingly, a good accounting system such as QuickBooks produces most of these reports. One very common report or financial statement, for example, is a list of the amounts that your customers owe you. It's a good idea to prepare and review such reports on a regular basis to make sure that you don't have customers turning into collection problems.

Table 1-9 shows how the simplest sort of accounts receivable report may look. Each customer is named along with the amount owed.

Table 1-10 shows another common accounting report: an inventory report that the hot dog stand may have at the start of the day. An inventory report like the one shown in Table 1-10 would probably name the various items held for resale, the quantity held, and the amount or value of the inventory item. A report such as this one is useful for making sure that you have the appropriate quantities of inventory in stock. (Think of how useful such a report would be if you really were planning to sell thousands of hot dogs at major sporting events in your hometown.)

TABLE 1-9

An Accounts Receivable Report at End of Day

Customer	Amount
W. Churchill	\$45.12
G. Patton	34.32
B. Montgomery	12.34
H. Petain	65.87
C. de Gaulle	43.21
Total receivables	\$200.86

TABLE 1-10

An Inventory Report at Start of Day

Item	Quantity	Amount
Kielbasa	2,000	\$900.00
Bratwurst	2,000	1,000.00
Plain buns	2,000	500.00
Sesame buns	2,000	600.00
Total inventory		\$3,000.00

Putting it all together

By now, you should understand what an accounting system does. When you boil everything down to its essence, it’s straightforward, isn’t it? Really, an accounting system just provides you the financial information that you need to run your business.

Let me add a tangential but important point: QuickBooks supplies all this accounting information. For the most part, preparing these sorts of financial statements in QuickBooks is pretty darn easy. But first, you’ll find it helpful to know a bit more about accounting and bookkeeping. I go over that information in the coming chapters. Also, note that the big-picture stuff covered in this chapter is the most important knowledge that you need. If you understand the ideas described in this chapter, the battle is more than half won.

CURIOUS ABOUT DIFFERENT BUSINESS FORMS?

Are you curious about the differences among a sole proprietorship, a partnership, and a corporation? A *sole proprietorship* is formed automatically in most states and in most industries when an individual decides to go into business. In many jurisdictions, the sole proprietor needs to acquire or apply for a business license from the state or local city government. Other than clearing that modest hurdle, sole proprietorship requires no special prerequisites.

A *partnership* is formed automatically when two or more people enter into a joint business or investment activity for the purpose of making a profit. As is the case with a sole proprietorship, partnerships typically need to acquire a business license from the state and perhaps the federal government. Partnership formation doesn't necessarily require any additional paperwork or legal maneuvering. If you do enter into a partnership, however, most attorneys (probably all attorneys) will tell you that you do so at a certain amount of risk if you don't have an attorney draw up a partnership agreement that outlines the duties, rights, and responsibilities of the partners. Also be aware that you can form a partnership simply by collaborating in business with someone. The law books are full of stories of people who inadvertently created partnerships merely by collaborating on some project, sharing office space, or working together on some activity.

By comparison, most states allow several other business forms, including *corporations*, *limited liability companies*, and *limited liability partnerships*. These other business forms sometimes require considerably more work to set up, sometimes the assistance of a good attorney or accountant, and sometimes payment of several hundred — and possibly several thousand — dollars in legal and licensing fees. The unique feature of most of these other business forms is that the corporation, limited liability company, or limited liability partnership becomes a separate legal entity. In many cases, this separate legal entity protects investors from creditors that have a claim on the assets of the business. By comparison, in a sole proprietorship or a partnership, the sole proprietor and the partners are liable for the debts and obligations of the proprietorship or the partnership.

If you have questions about the correct business form in which to operate, talk with a good local attorney or accountant. He or she can assist you in choosing the appropriate business form and in considering both the legal and tax aspects of choosing a particular form. As a general rule, more sophisticated business forms such as corporations, limited liability companies, and limited liability partnerships deliver significant legal and tax benefits to investors and managers. Unfortunately, these more sophisticated business forms also require considerably more legal and accounting fiddle-faddling.

The Philosophy of Accounting

Maybe the phrase *philosophy of accounting* is too strong, but accounting does rest on a rather small set of fundamental assumptions and principles. People often refer to these fundamentals as *generally accepted accounting principles*.

I want to quickly summarize what these principles are. I find — and I bet you'll find the same thing — that understanding the principles provides context and makes accounting practices more understandable. With this in mind, let me go through the half dozen or so key accounting principles and assumptions.

These basic accounting principles underlie business accounting. These principles and assumptions are implicit in all the discussions in this entire book. It's no exaggeration to say that they permeate almost everything related to business accounting.

Revenue principle

The *revenue principle*, also known as the *realization principle*, states that revenue is earned when the sale is made. Typically, the sale is made when goods or services are provided. A key component of the revenue principle, when it comes to the sale of goods, is that revenue is earned when legal ownership of the goods passes from seller to buyer.

Note that revenue isn't earned when you collect cash for something. It turns out, perhaps counterintuitively, that counting revenue when cash is collected doesn't give the business owner a good idea of what sales really are. Some customers may pay deposits early, before actually receiving the goods or services. Often, customers want to use trade credit, paying a firm at some point in the future for goods or services. Because cash flows can fluctuate wildly — even something like a delay in the mail can affect cash flow — you don't want to use cash collection from customers as a measure of sales. Besides, you can easily track cash collections from customers. So why not have the extra information about when sales actually occur?

Expense principle

The *expense principle* states that an expense occurs when the business uses goods or receives services. In other words, the expense principle is the flip side of the revenue principle. As is the case with the revenue principle, if you receive some goods, simply receiving the goods means that you've incurred the expense of the goods. Similarly, if you've received some service — services from your lawyer,

for example — you’ve incurred the expense. It doesn’t matter that your lawyer takes a few days or a few weeks to send you the bill. You incur an expense when goods or services are received.

Matching principle

The *matching principle* is related to the revenue and expense principles. The matching principle states that when you recognize revenue, you should match related expenses with the revenue. The best example of the matching principle concerns the case of businesses that resell inventory. In the example of the hot dog stand, you should count the expense of a hot dog and the expense of a bun on the day when you sell that hot dog and that bun. Don’t count the expense when you buy the buns and the dogs; count the expense when you sell them. In other words, match the expense of the item with the revenue of the item.



TIP

Accrual-based accounting, which is a term you’ve probably heard, is what you get when you apply the revenue principle, the expense principle, and the matching principle. In a nutshell, accrual-based accounting means that you record revenue when a sale is made and record expenses when goods are used or services are received.

Cost principle

The *cost principle* states that amounts in your accounting system should be quantified, or measured, by using historical cost. If you have a business and the business owns a building, that building — according to the cost principle — shows up on your balance sheet at its historical cost. You don’t adjust the values in an accounting system for changes in a fair market value. You use the original historical costs.



TIP

I should admit that the cost principle is occasionally violated in a couple of ways. The cost principle is adjusted through the application of depreciation, which I discuss in Book 1, Chapter 3. Also, sometimes fair market values are used to value assets, but only when assets are worth less than they cost.

Objectivity principle

The *objectivity principle* states that accounting measurements and accounting reports should use objective, factual, and verifiable data. In other words, accountants, accounting systems, and accounting reports should rely on subjectivity as little as possible.

An accountant always wants to use objective data (even if it's bad) rather than subjective data (even if the subjective data is arguably better). The idea is that objectivity provides protection from the corrupting influence that subjectivity can introduce into a firm's accounting records.

Continuity assumption

The *continuity assumption* — accountants call it an *assumption* rather than a *principle* for reasons unknown to me — states that accounting systems assume that a business will continue to operate. The importance of the continuity assumption becomes clear if you consider the ramifications of assuming that a business won't continue. If a business won't continue, it becomes very unclear how one should value assets if the assets have no resale value. This sounds like gobbledygook, but think about the implicit continuity assumption built in to the balance sheet for the hot dog stand at the beginning of the day. (This is the balance sheet that shows up in Table 1-4 earlier in this chapter.)

Implicit in that balance sheet is the assumption that hot dogs and hot dog buns have some value because they can be sold. If a business won't continue operations, no assurance exists that any of the inventory can be sold. If the inventory can't be sold, what does that say about the owner's equity value shown in the balance sheet?

You can see, I hope, the sorts of accounting problems that you get into without the assumption that the business will continue to operate.

Unit-of-measure assumption

The *unit-of-measure assumption* assumes that a business's domestic currency is the appropriate unit of measure for the business to use in its accounting. In other words, the unit-of-measure assumption states that it's okay for U.S. businesses to use US dollars in their accounting, and it's okay for UK businesses to use pounds sterling as the unit of measure in their accounting system. The unit-of-measure assumption also states, implicitly, that even though inflation and occasionally deflation change the purchasing power of the unit of measure used in the accounting system, that's still okay. Sure, inflation and deflation foul up some of the numbers in a firm's financial statements. But the unit-of-measure assumption says that's usually okay — especially in light of the fact that no better alternatives exist.

Separate-entity assumption

The *separate-entity assumption* states that a business entity, like a sole proprietorship, is a separate entity — a separate thing from its business owner. Also, the separate-entity assumption says that a partnership is a separate thing from the partners who own part of the business. This assumption, therefore, enables one to prepare financial statements just for the sole proprietorship or just for the partnership. As a result, the separate-entity assumption also relies on a business to be separate, distinct, and definable compared with its business owners.

A Few Words about Tax Accounting

I'm not going to talk much about tax accounting or tax preparation in this book, but one of the key reason why you do accounting and use a program such as QuickBooks is to make your tax accounting easier. That's obvious. So a fair question is this: How does what I've said so far relate to income tax return preparation?

This question is a tough one to answer. Tax laws typically don't map to generally accepted accounting principles. Generally accepted accounting principles aren't the same things as income tax laws. If you use good basic accounting practices as you operate QuickBooks, however, you get financial information that you can use to easily prepare your tax returns, especially if you get some help from your certified public accountant (CPA).

If you want, you can also use income tax rules to fine-tune your accounting and bookkeeping. This practice, which is technically known as an *other comprehensive basis of accounting (OCBOA)*, is generally considered to be an appropriate way to perform accounting for small and medium-size enterprises.

IN THIS CHAPTER

- » Checking out the fiddle-faddle method of accounting
- » Grasping how double-entry bookkeeping works
- » Looking at an (almost) real-life example
- » Figuring out how QuickBooks helps

Chapter 2

Double-Entry Bookkeeping

The preceding chapter describes why businesses create financial statements and how these financial statements can be used. If you've read Book 1, Chapter 1, or if you've spent much time managing a business, you probably know what you need to know about financial statements. In truth, financial statements are pretty straightforward. An income statement, for example, shows a firm's revenue, expenses, and profits. A balance sheet itemizes a firm's assets, liabilities, and owner's equity. So far, so good.

Unfortunately, preparing traditional financial statements is more complicated and tedious. The work of preparing financial statements — called *accounting* or *bookkeeping* — requires either a whole bunch of fiddle-faddling with numbers or learning how to use double-entry bookkeeping.

In this chapter, I start by describing the fiddle-faddle method. This isn't because I think you should use that method. In fact, I assume that you eventually want to use QuickBooks for your accounting and, by extension, for double-entry bookkeeping. But if you understand the fiddle-faddle method, you'll clearly see why double-entry bookkeeping is so much better.

After I describe the fiddle-faddle method, I walk you through the steps to using and understanding double-entry bookkeeping. After you see all the anguish and grief that the fiddle-faddle method causes, you should have no trouble appreciating why double-entry bookkeeping works so much better. And I hope you'll also commit to the 30 or 40 minutes necessary to learn the basics of double-entry bookkeeping.

The Fiddle-Faddle Method of Accounting

Most small businesses — or at least those small businesses whose owners aren't already trained in accounting — have used the fiddle-faddle method. Take a peek at the financial statements shown in Tables 2-1 and 2-2. If you've read or reviewed Book 1, Chapter 1, you may recognize that these financial statements stem from the imaginary hot dog stand. Table 2-1 shows the income statement for the one day a year that the imaginary business operates. Table 2-2 shows the balance sheet at the start of the first day of operation.

TABLE 2-1

A Simple Income Statement for the Hot Dog Stand

Sales revenue	\$13,000
Less: Cost of goods sold	3,000
Gross margin	\$10,000
Operating expenses	
Rent	\$1,000
Wages	4,000
Supplies	1,000
Total operating expenses	6,000
Operating profit	\$4,000

With the fiddle-faddle method of accounting, you individually calculate each number shown in the financial statement. The sales revenue figure shown in Table 2-1, for example, equals \$13,000. The fiddle-faddle method of accounting requires you to somehow come up with this sales revenue number manually. You may be able to come up with this number by remembering each of the sales that you made during the day. Or, if you prepare invoices or sales receipts, you may be

able to come up with this number by adding all the individual sales. If you have a cash register, you may be able to come up with this number by looking at the cash register tape.

TABLE 2-2

A Simple Balance Sheet for the Hot Dog Stand

Assets	
Cash	\$1,000
Inventory	3,000
Total assets	\$4,000
Liabilities	
Accounts payable	\$2,000
Loan payable	1,000
Owner's equity	
S. Nelson, capital	\$1,000
Total liabilities and owner's equity	\$4,000

Other revenue and expense numbers get calculated in the same crude manner. The \$1,000 of rent expense, for example, gets calculated by remembering what amount you paid for rent or by looking in your checkbook register and finding the check that you wrote for rent.

The balance sheet values get produced in roughly the same way. You can deduce the cash balance of \$1,000, for example, by looking at the checkbook or, in a worst-case scenario, the bank statement. You can deduce the inventory balance of \$3,000 by adding the individual inventory item values. You can calculate the liability and owner's equity amounts in similar fashion.

Some of the values shown in an income statement or on a balance sheet get *plugged* — meaning that they're calculated by using other numbers from the financial statement. You don't look up the profit amount in any particular place; instead, you calculate profit by subtracting expenses from revenue. You can also calculate balance sheet values such as total assets, owner's equity, and total liabilities, of course.

Okay, I admit it: The fiddle-faddle method of accounting works reasonably well for a very small business as long as you have a good checkbook. So for a very small business, you may be able to get away with this crude, piecemeal approach to accounting.

Unfortunately, the fiddle-faddle method suffers the three horrible weaknesses for a firm that doesn't have super-simple finances:

- » **It's not systematic enough to be automated.** Now, admittedly, you may not care that the fiddle-faddle approach isn't systematic enough for automation. But this point is an important one: A systematic approach like double-entry bookkeeping can be automated, as you can do with QuickBooks. This automation means that the task of preparing financial statements requires — oh, I don't know — maybe five mouse clicks. Because the fiddle-faddle approach can't be automated, every time you want to produce financial statements, you or some poor co-worker must do an enormous amount of work to collect the numbers and all the raw data necessary to produce information like that shown in Table 2-1 and Table 2-2. In reality, of course, with more complicated financial statements, someone does much, much more work.
- » **It's very easy to lose details.** This sounds abstract, but let me give you a good, concrete example. If you look at Table 2-1, you see that the hot dog stand incurs only three operating expenses: rent, wages, and supplies. If you know the operating expense categories that the business incurs, it's fairly easy to look through the check register and find the check or checks that pay rent, for example. You can use a similar approach with the wages and supplies expenses. But what if you also have an advertising expense category, a business license expense, or some other easy-to-forget category? If you forget a category, you miss expenses. If you forget that you spent money advertising and, thereby, forget to tally your advertising expenses, that whole category of operating expense gets omitted from your income statement.
- » **It doesn't allow rigorous error checking.** This business about error checking may seem to be nitpicky, but error checking is important with accounting and bookkeeping systems. With all the numbers and transactions floating around, errors easily creep into the system. I discuss error checking more later in this chapter, but let me give you an example of the sort of error checking an accounting system can (and should) perform. Take a look at the example of the sales transaction. If you sell an item for \$1,000, you can check that amount by comparing it with your record of what the customer paid. This makes sense, right? If you sell me an item for \$1,000, you should be able to compare that \$1,000 sale with the amount of cash that I pay you. A \$1,000 sale to me should correspond to a \$1,000 cash payment from me. The fiddle-faddle method can't make these comparisons, but double-entry bookkeeping can.

You see where I am now, right? I've admitted that you can construct financial statements by using the fiddle-faddle method. But I hope I've also convinced you that the fiddle-faddle method suffers some really debilitating weaknesses. I'm talking about something as important as how you can best manage the financial affairs of your business. These weaknesses indicate that you need a better tool. Specifically, you need double-entry bookkeeping, which I discuss next.

How Double-Entry Bookkeeping Works

After you conclude that the fiddle-faddle method is for the birds, you're ready to absorb the necessary accounting theory and learn the bookkeeping tricks required to employ double-entry bookkeeping. Essentially, you need two things to work with double-entry bookkeeping: an understanding of the accounting model and a grasp of the mechanics of debits and credits. Neither of these things is difficult. If you flip ahead a few pages, you can see that I'm going to spend only a few pages talking about this material. How difficult can anything be that can be described in just a few pages? Not very, right?

The accounting model

Here's the first thing to understand and internalize to use double-entry bookkeeping: Modern accounting uses an accounting model that says assets equal liabilities plus owner's equity. The following formula expresses this in a more conventional, algebraic form:

$$\text{assets} = \text{liabilities} + \text{owner's equity}$$

If you think about this for a moment and flip back to Table 2-2, you see that this formula summarizes the organization of a business's balance sheet. Conceptually, the formula says that a business owns stuff and that the money or the funds for that stuff comes either from creditors (such as the bank or some vendor) or the owners (either in the form of original contributed capital or perhaps in reinvested profits). If you understand the balance sheet shown in Table 2-2 and discussed here, you understand the first core principle of double-entry bookkeeping. This isn't that tough so far, is it?

Here's the second thing to understand about the basic accounting model: Revenue increases owner's equity, and expenses decrease owner's equity. Think about that for a minute. That makes intuitive sense. If you receive \$1,000 in cash from a customer, you have \$1,000 more in the business. If you write a \$1,000 check to pay a bill, you have \$1,000 less in the business.

Another way to say the same thing is that profits clearly add to owner's equity. Profits get reinvested in the business and boost owner's equity. Profits are calculated as the difference between revenue and expenses. If revenue exceeds expenses, profits exist.

Let me review where I am so far in this discussion about the basic accounting model. The basic model says that assets equal liabilities plus owner's equity. In other words, the total assets of a firm equal the total of its liabilities and owner's equity.

Furthermore, revenue increases owner's equity, and expenses decrease owner's equity.

At this point, you don't have to intuitively understand the logic of the accounting model and the way that revenue and expenses plug into the owner's equity of the model. If you do get it, that's great but not necessary. But you do need to memorize or remember (for at least the next few paragraphs) the manner in which the basic model works.



REMEMBER

This point may seem to be redundant, but note that a balance sheet is constructed by using information about a firm's assets, liabilities, and owner's equity. Similarly, note that a firm's income statement is constructed by using information about its revenue and its expenses. All this discussion — all this tediousness — is really about how you collect the information necessary to produce an income statement and a balance sheet.

Now I come to perhaps the most important point to understand to get double-entry bookkeeping. Every transaction and every economic event that occurs in the life of a firm produces two effects: an increase in some account shown in the balance sheet or income statement and a decrease in some account shown in the balance sheet or income statement. When something happens, economically speaking, that something affects at least two types of information shown in the financial statement. In the next few paragraphs, I give you some examples so that you can really understand this concept.

Suppose that in your business, you sell \$1,000 worth of an item for \$1,000 in cash. In the case of this transaction or economic event, two things occur from the perspective of your financial statements:

- » Your cash increases by \$1,000.
- » Your sales revenue increases by \$1,000.

Another way to say this same thing is that your \$1,000 cash sale affects both your balance sheet (because cash increases) and your income statement (because sales revenue is earned).

See the duality? And just a paragraph ago, you were thinking that this topic might be too complicated for you, weren't you?

Here's another common example. Suppose that you buy \$1,000 worth of inventory for cash. In this case, you decrease your cash balance by \$1,000, but you increase your inventory balance by \$1,000. Note that in this case, both effects of

the transaction appear in sort of the same area of your financial statement: the list of assets. Nevertheless, this transaction also affects two accounts.



TIP

When I use the word *account*, I simply mean some value that appears in your income statement or on your balance sheet. If you look at Tables 2-1 and 2-2, for example, any value that appears in those financial statements that isn't simply a calculation represents an account. In essence, an account tracks some group of assets, liabilities, owner's equity, contributions, revenue, or expenses. I talk more about accounts in the next section, where I get to the actual mechanics of double-entry bookkeeping.

Here's another example that shows this duality of effects in an economic event. Suppose that you spend \$1,000 in cash on advertising. In this case, this economic event reduces cash by \$1,000 and increases the advertising expense amount by \$1,000. This economic event affects both the assets portion of the balance sheet and the operating expenses portion of the income statement.

And now — believe it or not — you're ready to see how the mechanics of double-entry bookkeeping work.

Talking mechanics

Roughly 500 years ago, an Italian monk named Luca Pacioli devised a systematic approach to keeping track of the increases and decreases in account balances. He said that increases in asset and expense accounts should be called *debits*, whereas decreases in asset and expense accounts should be called *credits*. He also said that increases in liabilities, owner's equity, and revenue accounts should be called credits, whereas decreases in liabilities, owner's equity, and revenue accounts should be called debits.

Table 2-3 summarizes the information that I just shared. Unfortunately — and you can't get around this fact — you need to memorize this table or dog-ear the page so that you can refer to it easily.

In Pacioli's debits-and-credits system, any transaction can be described as a set of balancing debits and credits. This system not only works as financial shorthand, but also provides error checking. To get a better idea of how it works, look at some simple examples.

TABLE 2-3

You Must Remember This

Account	Debit	Credit
Assets	Increase	Decrease
Expenses	Increase	Decrease
Liabilities	Decrease	Increase
Owner's equity	Decrease	Increase
Revenue	Decrease	Increase

Take the case of a \$1,000 cash sale. By using Pacioli's system or by using double-entry bookkeeping, you can record this transaction as shown here:

Cash	\$1,000	Debit
Sales revenue	\$1,000	Credit

See how that works? The \$1,000 cash sale appears as both a debit to cash (which means an increase in cash) and a \$1,000 credit to sales (which means a \$1,000 increase in sales revenue). Debits equal credits, and that's no accident. The accounting model and Pacioli's assignment of debits and credits mean that any correctly recorded transaction balances. For a correctly recorded transaction, the transaction's debits equal the transaction's credits.

Although you can show transactions as I've just shown the \$1,000 cash sale, you and I may just as well use the more orthodox nomenclature. By convention, accountants and bookkeepers show transactions, or what accountants and bookkeepers call *journal entries*, like the one shown in Table 2-4.

TABLE 2-4

Journal Entry 1: Recording the Cash Sale

Account	Debit	Credit
Cash	\$1,000	
Sales revenue		\$1,000

See how that works? Each account that's affected by a transaction appears on a separate line. Debits appear in the left column. Credits appear in the right column.



TIP

You actually already understand how this account business works. You have a checkbook. You use it to keep track of both the balance in your checking account and the transactions that change the checking account balance. The rules of double-entry bookkeeping essentially say that you're going to use a similar

record-keeping system not only for your cash account, but also for every other account you need to prepare your financial statements.

Here are a couple of other examples of how this transaction recording works. In the first part of this discussion of how double-entry bookkeeping works, I describe two other transactions: purchasing \$1,000 of inventory for cash and spending \$1,000 in cash on advertising. Table 2-5 shows how the purchase of \$1,000 of inventory for cash appears. Table 2-6 shows how spending \$1,000 of cash on advertising appears.

TABLE 2-5

Journal Entry 2: Recording the Inventory Purchase

Account	Debit	Credit
Inventory	\$1,000	
Cash		\$1,000

TABLE 2-6

Journal Entry 3: Recording the Advertising Expense

Account	Debit	Credit
Advertising	\$1,000	
Cash		\$1,000

By tallying the debits and credits to an account, you can calculate the account balance. Suppose that before Journal Entries 1, 2, and 3, the cash balance equals \$2,000. Journal Entry 1 increases cash by \$1,000 (the debit). Journal Entries 2 and 3 decrease cash by \$1,000 each (the \$2,000 credits). If you combine all these entries, you get the new account balance. The following formula shows the calculation:

Beginning balance of cash	\$2,000
Plus cash debit from Journal Entry 1	\$1,000
Minus cash credit from Journal Entry 2	-\$1,000
Minus cash credit from Journal Entry 3	-\$1,000
Ending cash balance	\$1,000

THAT DARN BANK

When I learned about double-entry bookkeeping, I stumbled over the terms *debit* and *credit*. The way I'd heard the terms used before didn't agree with the way that double-entry bookkeeping seemed to describe them. This conflict caused a certain amount of confusion for me. Because I don't want you to suffer the same fate, let me quickly describe my initial confusion.

If you look at Table 2-3, you see that an increase in an asset account is a debit, and a decrease in an asset account is a credit. This means that in the case of your cash account, increases to cash are debits and decreases to cash are credits.

At some time, however, you've undoubtedly talked to the bank and heard someone refer to crediting your bank account — which meant increasing the account balance. And perhaps that someone talked about debiting your account — which meant decreasing the account balance. So what's up with that? Am I wrong, and is the bank right?

Actually, both the bank and I are right. Here's why. The bank is talking about debiting and crediting — not a cash account and not an asset account, but a *liability account*. To the bank, the money that you've placed in the account isn't cash (an asset) but a liability (money that the bank owes you). If you look at Table 2-3, you see that increases in a liability are credit amounts and decreases in a liability are debit amounts. Therefore, from the bank's perspective, when the bank increases the balance in your account, that increase is a credit.

Your assets may represent another firm's liabilities. Your liabilities will represent another firm's assets. Therefore, whenever you hear some other business talking about crediting or debiting your account, what you do is exactly the opposite. If the business credits, you debit. If the business debits, you credit.

Do you see how that works? You start with \$2,000 as the cash account balance. The first cash debit of \$1,000 increases the cash balance to \$3,000 and then the cash credit of \$1,000 in Journal Entry 2 decreases the cash balance to \$2,000. Finally, the cash credit of \$1,000 in Journal Entry 3 decreases the cash balance to \$1,000.

You can calculate the account balance for any account by taking the starting account balance and then adding the debits and credits that have occurred since then. By hand, this arithmetic is a little unwieldy. Your computer (with the help of QuickBooks) does this math easily.

Almost a Real-Life Example

To cement the concepts that I talk about in the preceding paragraphs of this chapter, I want to quickly step through the journal entries, or bookkeeping transactions, that you'd record in the case of the hot dog stand discussed in Book 1, Chapter 1. To start, you need to know that the balance sheet shown in Table 2-2 is the balance sheet at the start of the day, which means that the account balances in all the accounts appear as shown in Table 2-7. This list of account balances is called a *trial balance*. It shows the debit or credit balance for each account.

TABLE 2-7

A Trial Balance at the Start of the Day

Account	Debit	Credit
Cash	\$1,000	
Inventory	3,000	
Accounts payable		\$2,000
Loan payable		1,000
S. Nelson, capital	—	1,000
Totals	\$4,000	\$4,000



REMEMBER

I'm assuming that no year-to-date revenue or expenses exist yet for the hot dog stand. In other words, the operation is at a starting period.



TIP

You may want to take a quick peek at Table 2-1, shown earlier. It summarizes the business activities of the hot dog stand. The journal entries that follow show how the information necessary for this statement would be recorded.

Recording rent expense

Suppose that the first transaction to record is a \$1,000 check written to pay rent. In this case, the journal entry appears as shown in Table 2-8. In this example, \$1,000 is debited to rent expense, and \$1,000 is credited to cash.

TABLE 2-8

Journal Entry 4: Recording the Rent Expense

Account	Debit	Credit
Rent	\$1,000	
Cash		\$1,000

Recording wages expense

If you need to record \$4,000 of wages expense, you use the journal entry shown in Table 2-9. This journal entry debits wages expense for \$4,000 and credits cash for \$4,000. In other words, you use \$4,000 of cash to pay wages for the business.

TABLE 2-9

Journal Entry 5: Recording the Wages Expense

Account	Debit	Credit
Wages expense	\$4,000	
Cash		\$4,000

Recording supplies expense

To record \$1,000 of supplies expense paid for by writing a check, you record the journal entry shown in Table 2-10. This transaction debits supplies expense for \$1,000 and credits cash for \$1,000.

TABLE 2-10

Journal Entry 6: Recording the Supplies Expense

Account	Debit	Credit
Supplies	\$1,000	
Cash		\$1,000



TIP

Note that for each of the preceding transactions, debits equal credits. As long as debits equal credits, you know that the transaction is in balance. This balance is one of the ways that double-entry bookkeeping prevents errors.

Recording sales revenue

Suppose that you sell \$13,000 worth of hot dogs. To record this transaction in a journal entry, you debit cash for \$13,000 and credit sales revenue for \$13,000, as shown in Table 2-11. I should tell you, however, that in the case of the hot dog stand selling hot dogs for a dollar or two apiece, you wouldn't necessarily use a single journal entry to record sales revenue amounts. Though you could use a single journal entry that tallied the entire day's sales, if you're selling hot dogs at a dollar a dog, you could also record 13,000 \$1 transactions. Each of these \$1 transactions debits cash for \$1 and credits sales revenue for \$1.

TABLE 2-11

Journal Entry 7: Recording the Sales Revenue

Account	Debit	Credit
Cash	\$13,000	
Sales revenue		\$13,000

Recording cost of goods sold

You must record the expense of the hot dogs and buns that you sell. You must also record the fact that if you use up your inventory of hot dogs and buns, your inventory balance has decreased. Table 2-12 shows how you record these items. Cost of goods sold gets debited for \$3,000, and inventory gets credited for \$3,000.

TABLE 2-12

Journal Entry 8: Recording the Cost of Goods Sold

Account	Debit	Credit
Cost of goods sold	\$3,000	
Inventory		\$3,000

If you’re confused about this cost-of-goods-sold transaction — it represents the first transaction that doesn’t use cash — read Book 1, Chapter 1, where I describe the two accounting principles. In short, these two principles go like this:

- » **Expense principle:** This principle says that an expense gets counted when the item gets sold. This means that the inventory isn’t counted as cost of goods sold or as an expense when it’s purchased. Rather, the expense of each hot dog and bun you sell gets counted when the item is actually sold to somebody.
- » **Matching principle:** This principle says that expenses or cost of a sale get matched with the revenue of the sale. This means that you recognize the cost of goods sold at the same time that you recognize the sale. Typically, in fact, you can combine Journal Entries 7 and 8.



TIP

Another way to think about the information recorded in Journal Entry 8 is this: Rather than “spend” cash to provide customers hot dogs and buns, you spend inventory.

Recording the payoff of accounts payable

Suppose that one thing you do at the end of the day is write a check to pay off the accounts payable. The accounts payable are the amounts that you owe vendors — probably the suppliers from which you purchased the hot dogs and buns. To record the payoff of accounts payable, you debit accounts payable for \$2,000 and credit cash for \$2,000, as shown in Table 2-13.

TABLE 2-13

Journal Entry 9: Recording the Payoff of Accounts Payable

Account	Debit	Credit
Accounts payable	\$2,000	
Cash		\$2,000

Recording the payoff of a loan

Suppose also that you use cash profits from the day to pay off the \$1,000 loan that the balance sheet shows (see Table 2-2). To record this transaction, you debit loan payable for \$1,000 and credit cash for \$1,000, as shown in Table 2-14.

TABLE 2-14

Journal Entry 10: Recording the Payoff of the Loan

Account	Debit	Credit
Loan payable	\$1,000	
Cash		\$1,000

Calculating account balance

You may already be able to guess that if you know an account’s starting balance and have a way to add up the debits and the credits to the account, you can easily calculate the ending account balance.

Take the case of the cash account balance of the hot dog stand. If you look at the balance sheet shown in Table 2-2, you see that the beginning balance for cash is \$1,000. You can easily construct a little schedule of how the account balance changes — this schedule is called a *T-account* — that calculates the ending balance. (In case you’re wondering, a T-account is a visual aid to help in accounting.

You start by drawing a big capital T, with debits on the left side and credits on the right side.) In fact, Table 2-15 does just this. If you look closely at Table 2-15, you see that the cash beginning balance is \$1,000. Then, on the following lines of the T-account, you see the effects of Journal Entries 4, 5, 6, 7, 9, and 10. Some of these journal entries credit cash. Some of them debit cash. You can calculate the ending cash balance by combining the debit and credit amounts.

TABLE 2-15

A T-Account of the Cash Account

	Debit	Credit
Beginning balance	\$1,000	
Journal Entry 4		\$1,000
Journal Entry 5		4,000
Journal Entry 6		1,000
Journal Entry 7	13,000	
Journal Entry 9		2,000
Journal Entry 10	—	\$1,000
Ending balance	\$5,000	

The information shown in Table 2-15 should make sense to you. But in case you're still trying to memorize what debits and credits mean, I'm going to give you a bit more detail. To calculate the ending balance shown in Table 2-15, you add up the debits, add up the credits, and combine the two sums. The net amount in the cash account equals the \$5,000 debit. If you recall from the preceding paragraphs, a debit balance in an asset account, such as cash, represents a positive amount. A \$5,000 debit balance in the cash account, therefore, indicates that you have \$5,000 of cash in the account.

Cash is usually the trickiest account to analyze with a T-account because so many journal entries affect cash. In many cases, however, a T-account analysis of an account balance is much more straightforward. If you look at Table 2-16, you see a T-account analysis of the inventory account. This T-account analysis shows that the beginning inventory account balance equals \$3,000. But when Journal Entry 8 credits inventory for \$3,000 — this is the journal entry that records the cost of goods sold — the inventory balance is wiped out.

TABLE 2-16**A T-Account of the Inventory Account**

	Debit	Credit
Beginning balance	\$3,000	
Journal Entry 8	—	\$3,000
Ending balance	\$0	

Paying off the accounts payable and loan payable accounts is similarly straightforward. Table 2-17 shows the T-account analysis of the accounts payable account. Table 2-18 shows the T-account analysis of the loan payable account. In both cases, the T-account analysis shows that the liability accounts start with a credit beginning balance. (Remember that a liability account would have a credit balance if the firm really owed money.) Then, when the payments are recorded to pay off the accounts payable and loan payable in Journal Entries 9 and 10, the liability account is debited. The result, in the case of both accounts, is that the liability account balance is reduced to zero.

TABLE 2-17**A T-Account of Accounts Payable**

	Debit	Credit
Beginning balance		\$2,000
Journal Entry 9	\$2,000	
Ending balance	\$0	

TABLE 2-18**A T-Account of the Loan Payable Account**

	Debit	Credit
Beginning balance		\$1,000
Journal Entry 10	\$1,000	
Ending balance	\$0	

I'm not going to show T-account analyses of the other accounts that the preceding journal entries use. In every other case, the only debit or credit to the account comes from the journal entry, which means that the journal entry amount is the account balance. Only one journal entry affects the sales revenue account: Journal Entry 7, which credits sales revenue for \$13,000. Because the sales revenue account has no beginning balance, that \$13,000 credit equals the sales revenue account balance. The expense accounts work the same way.

Using T-account analysis results

If you construct (or your accounting program constructs) T-accounts for each balance sheet and income statement account, you can easily calculate account balances at a particular point in time by using the T-account analysis results. Table 2-19 shows a trial balance at the end of the day for the hot dog stand. You can calculate each of these account balances by using T-account analysis.

TABLE 2-19

A Trial Balance at End of Day

Account	Debit	Credit
Cash	\$5,000	
Inventory	0	
Accounts payable		\$0
Loan payable		0
S. Nelson, capital		\$1,000
Sales revenue		13,000
Cost of goods sold	3,000	
Rent	1,000	
Wages expense	4,000	
Supplies	1,000	—
Totals	\$14,000	\$14,000

The first line shown in the trial balance in Table 2-19 is the cash account, with a debit balance of \$5,000. This debit account balance comes from the T-account analysis shown in Table 2-15. The account balances for inventory, accounts payable, and loan payable also come from the T-account analyses shown previously in this chapter (Tables 2-16, 2-17, and 2-18).

As I note in the preceding section, you don't need to perform T-account analyses for the other accounts shown in the trial balance provided in Table 2-19. These other accounts show a single debit or credit.

I need to make one final and perhaps already-obvious point: The information provided in Table 2-19 is the information necessary to construct an income statement for the day and a balance sheet as of the end of the day. If you take sales revenue, cost of goods sold, rent, wages expense, and supplies expense from the

trial balance, you have all the information that you need to construct an income statement for the day. In fact, the information shown in Table 2-19 is the information used to construct the income statement shown in Table 2-1.

Similarly, the asset, liability, and owner's equity balance information shown in the trial balance provided in Table 2-19 supplies the information necessary to construct a balance sheet as of the end of the day.



TIP

The end-of-day balance sheet won't balance unless you also include the profits of the day. These profits, called *retained earnings* or lumped into the owner's capital account, equal \$4,000. You can see what this end-of-day balance sheet looks like by reading Book 1, Chapter 1. In that chapter, Table 1-9 shows the end-of-day balance sheet for the hot-dog-stand business.

A Few Words about How QuickBooks Works

Before I end this chapter, I want to make a few comments about how QuickBooks helps you. First — and this point may be the most important one — QuickBooks makes most of these journal entries for you. In Journal Entry 6, for example, I show you how to record a \$1,000 check written to pay supplies, but you'd never have to make this journal entry in QuickBooks. When you use QuickBooks to record a \$1,000 check that pays Acme Supplies for some paper products that you purchased, QuickBooks automatically debits supplies expense (as long as you indicate that the check is for supplies) and then credits cash.

Similarly, in the case of Journal Entries 7 and 8, when you produce an invoice that records a sale, QuickBooks makes these journal entries for you. If you sold \$13,000 worth of hot dogs and buns, and those hot dogs and buns actually cost you \$3,000, QuickBooks debits cash for \$13,000, credits sales revenue for \$13,000, debits cost of goods sold for \$3,000, and credits inventory for \$3,000. In other words, for most of your routine transactions, QuickBooks handles the journal entries for you behind the scenes.

This doesn't mean, however, that you can always avoid working with journal entries. Any transaction that can't be handled through a standard QuickBooks form — such as the Invoice form or the Write Checks form — must be recorded by using a journal entry. If you purchase some fixed asset by writing a check, for example, the purchase of the fixed asset gets recorded automatically by QuickBooks. But the depreciation that will be used to expense the asset over its

estimated economic life — something I talk a bit about in the next chapter — must be recorded with journal entries that you construct yourself and enter a different way.

One other really important point: I note in the preceding paragraphs that the trial balance information shown in Table 2-19 provides the raw data that you need to prepare your financial statement. I don't want to leave you with a misunderstanding, however. You don't have to use this sort of raw data to prepare your financial statements. Predictably, QuickBooks easily, quickly, and effortlessly builds your financial statements by using this trial balance information.

Just to put these comments together, then, QuickBooks automatically creates most journal entries for you, builds a trial balance by using journal entry information, and — when asked — produces financial statements. Most of the work of double-entry bookkeeping, then, goes on behind the scenes. You don't worry about many journal entries on a day-to-day basis. And if you don't want to ever see a trial balance, you don't have to. In fact, if you use QuickBooks only to produce invoices and to write checks that pay the bills, almost all the information that you need to prepare your financial statements gets collected automatically. So that's really neat.



REMEMBER

Not all the information that's necessary for producing good, accurate financial statements gets collected automatically, however. You'll encounter a handful of important cases that should be handled on a special basis through journal entries that you or your CPA must construct and enter.