

Bulletin #3010, Record Keeping for Profit

Home-Based Business Fact Sheet

Record Keeping for Profit

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Would you believe you could save nearly \$100 an hour by keeping good records? Suppose you had a \$20 business expense that you forgot to record. This oversight, in effect, raises your business' net income by \$20. Overstating net income by \$20 causes (1) your Social Security tax to go up by \$3.06 (\$20 times 15.3 percent for a self-employed person); (2) your federal income tax to go up \$4 (assuming you were in the 20 percent federal income tax bracket); and (3) your state income tax to go up \$1 (assuming you were in the five percent state tax bracket).

The \$20 expense not recorded will cost you \$8.06 more in Social Security, federal income tax and state income tax. If you had recorded this expense in five minutes or 1/12 of an hour, you would have saved \$8.06 in 1/12 of an hour, or \$96.72 per hour. That is a pretty good use of your time.

In addition, good records serve as an important management tool for every business by providing:

1. An accurate reflection of financial performance;
2. The ability to monitor performance in specific areas;
3. Complete and accurate income data; and
4. The basis for sound planning for the future.

Getting started

The key to an effective, efficient bookkeeping system is to get set up right in the first place. Your system should be adequate to meet your current needs and be expandable as your business grows. However, you do not need an elaborate system for a small business. There are no easy guidelines on what your system should be. But you must have a system.

The simplest system is just to use your business checkbook. Record on each check and deposit slip the details of the transaction. **All transactions must go through the checkbook, and you need to reconcile it monthly.** At the end of the year, you can summarize your profit picture. This system is suitable only if you have a few transactions.

A more complete system uses the checkbook plus a cash receipts journal and a cash disbursements journal. All transactions are recorded in one of the journals. The cash receipts journal has two columns for various categories of receipts with a line for each receipt including date, source of cash and total amount. The column categories may be departments or types of merchandise or types of service or whatever classification makes sense in your business.

The cash disbursements journal has columns for various categories of expenditures with a line for each expenditure, including date, check number, payee, description of expense and total amount. The column categories may be merchandise for resale, supplies, interest, occupancy costs, owner's draw, salaries, or whatever classifications make sense in your business.

The choice of column or account categories is critical to future analysis. Think ahead to what analysis you want and need when establishing categories.

All columns in both the cash receipts and cash disbursements journal should be totaled each month with year-to-date totals after each month. You can then quickly determine your financial status at the end of any month and make your annual income statement.

There are a number of one-write, duplicate check and pegboard systems commercially available that reduce entry time and errors. The process is simplified and standardized for analysis by accounting firms.

The double-entry bookkeeping system is the standard system of the accounting profession. The double-entry system combines the single-entry system described above with additional information to provide a broader, more complete picture of your business. For example, not only income but cash on hand, accounts receivable inventory, and equity in building and equipment are considered as well as accounts payable, mortgages and loans.

When do you need to have a double-entry system? You should have a double-entry system if you have significant accounts receivable, accounts payable, depreciable equipment or inventory. An outside investor will likely insist on a double-entry system. If you envision your business growing rapidly, it would be to your advantage to set up a double-entry bookkeeping system at the start.

With double-entry bookkeeping, you use journals and ledgers to record information in various accounts established to reflect the needs of your business. Each transaction is recorded twice so the system is self-balancing. Since net worth of the business is a central feature of double entry, it makes sense that each transaction has a plus and a minus side.

To illustrate, when a check is written for an operating expense — for example a utility bill — you would decrease the cash account and increase the utility expense account. If the total amounts recorded as credits do not equal the totals recorded as debits, you know there is a mistake that must be corrected.

Further explanations of the double-entry system may quickly confuse people who do not have accounting expertise. If you do not have the time or inclination to learn double-entry bookkeeping, work with a competent professional at least when setting up your system. It will be money well spent. You may be able to maintain the system once it is established.

If you want to learn more about bookkeeping, consider an accounting or bookkeeping class at night school or from your community college. Investment in a good system will pay big dividends in reduced frustration, increased accuracy and more good information for managing your business.

Who keeps the books?

Your bookkeeper should be good with numbers, careful with details and able to be interrupted without introducing errors. The books should be easily accessible and, perhaps, should get in your way so that you will remember to keep them current. Frequently, the individual business operator will keep the books. That gives a better appreciation of what is happening in the business and keeps you current. Also, you become very familiar with the system. However, this takes time that may be better used elsewhere in the business. This is a time management question that each individual must resolve.

Often, a spouse or other family member will do the record keeping. This is usually satisfactory if the individual is qualified, keeps you informed and keeps the books current. The business operator must review the books periodically to know what is going on and how the business is doing. When record keeping gets to be a hassle, takes valuable time from your business, includes a lot of errors or raises your level of frustration, it is time to hire someone to do the bookkeeping.

Regardless of who keeps the books, the responsibility for understanding and interpreting the records remains with the business owner and cannot be transferred to anyone else. If you own or operate the business, you must know your financial records.

What an accountant can do for you

Before you start to operate your business, an accountant can help you evaluate the profitability of your plans by projecting income and expenses as well as setting up a record keeping system. A business accountant can tell you what licenses and permits you will need. If these are overlooked, you may face mushrooming penalty charges.

Accountants may also help you:

1. Analyze how your business is doing, how you could do better and where you may cut costs.
2. Set up your books in a double-entry system and do the work for you or train you or your bookkeeper to keep them up-to-date.
3. Prepare your tax returns and, if audited by the IRS, go with you to explain your return.
4. Decide on the method of accounting (cash or accrual) that may be most helpful to you for tax purposes and understanding actual costs of doing business.

Choosing an accountant

Many bookkeeping and accounting services are available. As with all professional services, ask other business owners for their recommendations. Select someone who knows your type of business so you do not have to pay them to learn your business. Before you begin your search, have in mind what services you need — complete or partial bookkeeping, tax form preparation, or financial analysis and advice. The more you ask the service to perform, the more it will cost you.

If you decide to hire a professional, should you hire a bookkeeper, accountant or certified public accountant (CPA)? That depends on how specialized you need your records to be, what expertise you require and the professional's background. If you need certified audits performed, you will need a CPA.

Certified audits are required by law for publicly owned corporations. For the protection of investors, a company's annual financial statement is audited by an outside accountant certified to do this work. Certified audits are not required for privately owned companies since the audit results are solely for use within the company. However, your lender may want a certified audit.

If you are looking for management advice and analysis, a CPA or an accountant, depending on his or her experience, may be able to help you. A bookkeeper will keep the records and provide summaries as requested.

Record keeping cost of employees

Record keeping expands significantly when you hire employees — and that is an understatement. Federal and state employment taxes must be paid and reports submitted on a regular schedule. Failure to do so can lead to significant penalties.

There are three federal employment taxes:

1. Federal income tax that you withhold from employees' wages;
2. Social security (FICA) tax, both the amount you pay and the amount you withhold from employees' wages;
3. and Federal unemployment (FUTA) tax.

Before you file a federal tax return or make a payment, you must have an employer identification number (EIN). Use Form SS-4, available from an Internal Revenue Service Center. An excellent publication from the IRS, Employer's Tax Guide, Publication 15, Circular E, explains federal employee taxes in detail and includes tables to help you figure employee withholding.

State income tax must also be withheld from an employee's wages, and state unemployment taxes must be paid. You must make an application to the Maine Department of Finance and Administration, Bureau of Taxation, to set up your withholding account.

All payroll deductions must be accurately calculated, the payroll checks made out and all data recorded for each employee. The payroll and associated tax forms are not only added paperwork, but an added expense if you don't prepare them yourself.

Using your records

All too often, the sole motivation for keeping records is to pay taxes. But your records should be used to increase profits and to make sound business decisions, such as for expansion or purchases of new equipment. Record keeping is a positive experience when you can quickly get needed and reliable information. In fact, the few minutes spent each day on the books could be your most profitable investment.

Records are no substitute for good management. They can only tell you **what has happened**, not **why** it happened. With analysis, you may discover why. Your records cannot predict what will happen, but they can provide direction and show the results of changes you make in pricing, scheduling and other activities.

Good records can tell you when cash was received and when expenses were paid to help project future cash flows. Accounts receivable records will show which accounts are past due so you know where to concentrate collection activities and whose credit status needs reviewing. By tracking overhead expenses, you will know whether utility bills are out of line or repair costs are unusually high. You can also be sure that you are taking full tax advantage of building and equipment depreciation.

When you have an income statement (or profit and loss sheet) and a balance sheet, you can use business ratios as simple tests to see how efficiently you are operating. An income statement and balance sheet may be prepared from your checkbook, daily receipts and cash disbursement records. Compare your ratios to those for your type of business published in "Selected Key Business Ratios" from Dun & Bradstreet to see if you are "on target" or if adjustments should be made. "Selected Key Business Ratios" is available at many banks and libraries.

Business ratios can show the following things:

1. **The return on your investment:** If you are a sole proprietor, including a salary for yourself in your business income statement will provide a truer picture of the return on your investment. Return on investment is also called the “net profits to net worth ratio.”
2. **Inventory turnover:** Your money may be tied up too long in inventory so that you do not realize sufficient income from it.
3. **Operating efficiency:** These measures vary by the type of business. By analyzing these measures, along with labor cost, you can see whether you may be employing too many people for the amount of production achieved or total amount sold.
4. **Theft problems:** The ratio of receipts to inventory purchases may show if you have problems with theft of merchandise or raw materials inventory. Comparing actual inventory to “book” inventory will indicate shrinkage or possible theft.

Record keeping for income taxes

A good record keeping system that is maintained on a regular basis vastly reduces the time and work involved in preparing income taxes. IRS Publication 334, “Tax Guide for Small Businesses,” is comprehensive and contains completed sample forms.

Another good source of information is IRS Publication 583, “Tax Payers Starting a Business.” In addition to tax information, this publication shows a typical record keeping system for a small business, including filled in sample forms. It is a good review of a simple bookkeeping system.

Checklist for good records

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- _____ **Open a business checking account.** Don't use your personal checking account for your business. The cost of another account is minimal compared to the confusion of business matters in your personal account. Get a business-type checkbook with stubs to record information.
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- _____ **Pay all bills by check.** On each check, note what was purchased with that check. This is your record of having paid bills and facilitates analysis of expenditures.
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- _____ **Use petty cash sparingly.** Only when absolutely necessary should you make payments from petty cash, and then be sure to have a receipt including the purpose of each expenditure. Then write a check to petty cash to keep the checkbook complete.
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- _____ **Record all sales.** Use sales tickets, duplicate receipts, copies of invoices, cash register tape or some other system that itemizes each sale. This facilitates analysis of sales and provides a record of who has paid or not paid, including a date for your accounts receivable records.
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- _____ **Endorse all checks immediately.** Endorse checks "for deposit only" to your account in your bank. Such a restrictive endorsement stamp would be a good investment.
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- _____ **Deposit receipts daily.** Don't keep cash or checks around your place of business. They invite theft, they can get lost and the money should be put to work for you immediately.
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- _____ **Label bank deposit slips completely.** They provide a good record of sources of income and back up sales records.
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- _____ **Balance the cash drawer daily.** Errors compound. The possibility of theft, losses and errors is reduced with regular systematic balancing of all monies.
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- _____ **Balance bank account monthly.** Do it when the checks come back from the bank. Errors compound here, too.
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- _____ **Use work-order forms.** Keep a record on each job, including details of the job, when promised, prices quoted, expense items and time spent. Keep work order forms handy so you will record items immediately. Analyze each job for profitability.
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- _____ **Inventory all items regularly.** Count all items in inventory and include the purchase cost of each item. Always take inventory once a year. A good business practice is to take inventory twice a year, and a better practice is quarterly inventory. Monitoring the inventory process is the responsibility of the owner. If you own it, you count it.
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- _____ **Practice good record hygiene.** Keep clean, neat and regular records
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The Home-Based Business Fact Sheet Series

This is one of a series of publications designed for the person entering or considering a new business operation. See the University of Maine Cooperative Extension Online Publications Catalog for the complete [Home-Based Business fact sheet series](#).

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