THE UNIVERSITY OF MAINE
Cooperative Extension

Keeping Your Business on Track, Part I

Home-Based Business Fact Sheet

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RECORDS

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Small business managers use information from their record systems to make informed decisions for the business operation. Many small businesses fail because managers did not keep adequate records and could not make timely and important management decisions.

The objective of this fact sheet is to describe good record systems for small and home-based businesses as the first part of a three-part fact sheet series. The second and third parts of the series will cover how record information is used in business analysis and in making business management decisions.

Why Do You Need to Keep Business Records?

- **To accurately assess the economic health of your business.** Records are necessary to understand the cash flow of a business and make good business decisions.
- **To allow for financial projections based on past history.** Financial statements and record analysis inform the business owner/manager of the financial health of the business.
- **To ensure there are no errors in invoice payments or in requests for payment from customers.**
- **To ensure that you pay only the taxes that you owe—and no more.**
- **To help determine what you should charge for your products and/or services.**

Legally, you must keep records on all business transactions. The Internal Revenue Service (IRS) mandates that business transactions be reported and records of paid bills, cancelled checks and duplicate deposit slips be kept to support the business's profit and loss report.

Requirements of a Good Record-Keeping System

Your record keeping system should be

- **as simple as possible.** You don't want to spend more time keeping records than you do running your business.
- **understandable.** You need to know what you are doing. Your record-keeping system should also be understandable to others, in case someone else needs to take it over temporarily or permanently.
- **reliable and accurate.** It should give you systematic and essential information and provide mathematical checks for errors.
- **efficient.** You must be able to provide or find information when you need it. Someone might be waiting!
- **comparable to similar businesses.** Outside or third parties might want to know how your business compares with others. If you have a similar system, you can compare percentages of gross profit, volume and payroll, for example.

What Records Should Be Kept?

The IRS does not require any particular type of bookkeeping and accounting system as long as your records are permanent, accurate, and complete and clearly establish income, expense deductions, credits, employee data and any other relevant information.

When you are starting a business, establish the books and records with the method that is most suitable for your business. An accountant can help you with this.

Use a checkbook. All dollars or funds that pass in or out of your business should go through a checking account that you set up solely for your business. The checkbook shows how much money was handled and what amounts are deductible business expenses for income tax reports, so you can prove how much income is taxable. You should balance the bank statement for your checking account monthly, using proof totals from your receipts and disbursements journal to check your work.

The IRS requires you to track five aspects of your business: income, expenses, assets, liabilities and equity. Also, all asset accounts, such as buildings, equipment and motor vehicles, must include the date of acquisition, cost, depreciation and/or depletion.

If you have more than one business, you must keep a complete and separate set of books and records for each business.

What Kind of Accounting Method and Bookkeeping System Should You Use?

Accounting Methods

There are two accounting methods to choose from: *accrual* and *cash.* Which method you choose may depend on whether or not you extend credit to customers and the amount of inventory you require. If you need inventory to show income correctly, you must generally use an accrual method of accounting.

1. **Accrual:** Most businesses use the accrual method of accounting. With this method of recording, report income in the tax year you earn it, even if the cash payment has not yet been received. Similarly, you deduct or capitalize expenses in the tax year you incur them, even if the cash payment has not been made.
2. **Cash:** Under the cash method, you report income in the tax year you receive it. Similarly, you usually deduct or capitalize expenses in the tax year you pay them.

When you file your first tax return, you choose the method of accounting most appropriate for your business. After that, you must obtain the consent of the (IRS) before making a change in methods.

Bookkeeping Systems

There are two types of bookkeeping systems: *single entry* and *double entry.*

1. **Single Entry:** The simplest bookkeeping system is single entry. Each transaction is recorded once. This system may be sufficient if you are just starting a business, or have a very small and simple business with a limited number of transactions. A daily summary of receipts and a monthly disbursement journal will help you use a single entry system to record income and expenses adequately for tax purposes.

   The New England Farm Account Book, which is available in county Extension offices, is an example of a single entry system. This account book is very useful for small-scale businesspeople. The columnar headings are left blank for the bookkeeper to set up a workable system that provides information for the profit and loss and cash flow statements.

2.. **Double Entry:** The double entry system has the advantage of built-in checks and balances, which ensure accuracy. Each transaction is recorded twice. You use journals and ledgers in this system.

   First, all the daily transactions of the business are entered in the journal. Journal entries show the date, a description of the transaction, the money involved and the type of income and expense affected by the transaction.

   Later, summary totals are posted to ledger accounts, and they show income, expenses, assets, liabilities and net worth. Income and expense accounts are closed out at the end of each accounting period, whereas asset, liability and net worth accounts are kept open and maintained on a permanent basis.

   An important feature of this system is that it is self-balancing. Every business transaction has two sides. For example, a product sale is both a delivery of goods and a receipt of payment. On your Balance Sheet (statement of assets, liabilities and net worth), the delivery of goods is recorded as a credit (reduction of assets), while the receipt of payment would be counted as a debit (increase in assets). Therefore, when you compare ledger accounts the totals of debit and credit amounts should be the same. If no errors have been made, the accounts balance.

After the accounts are balanced, financial statements—the income statement, cash flow statement and balance sheet-may be easily prepared.

Other Records

Depending on your business needs, some of these other records may be useful:

- **A petty cash fund** is used for making small payments without having to write checks. Every time you make a payment using petty cash funds, you should make out a petty cash slip and attach it to your receipt as proof of payment. You need to set a fixed amount in your fund, such as $50, and the unspent cash plus the petty cash slips should always equal that amount. When the total of petty cash slips nears the fixed amount, you bring the cash back to the fixed amount by writing a check to "petty cash" for the amount of the outstanding slips. Then you can summarize the slips and enter them in the proper columns in your cash disbursement journal.
- **Taxes, permits and licenses.** Keep files of documents and correspondence to and from taxing, licensing and regulating agencies. These files should include the following information: your federal employer identification number; federal use tax; FICA (social security) and Medicare taxes; federal income tax (estimated return, quarterly estimate payment, annual return, payment dates); state income tax; federal unemployment tax; state unemployment tax; federal excise taxes; state excise taxes; Workers Compensation insurance fees; state licenses; state sales tax number; local business taxes; and local licenses and permits.
- **Time cards or books on individual employees** for accurate payment of wages.
- **Social security** payroll records showing social security tax deductions and employee earnings to date.
- **Accounts payable and accounts receivable records.**
- **Capital and depreciation records** listing all major depreciable assets and showing current values and depreciation.
- **Annual inventories** of items and their values.
- **Production and shrinkage records.**
- **Records of expenses associated with business use of your home.**
- **Mileage log and travel records.**
- **Records of automobile or other vehicle expenses.**
- **Business documents,** such as bills, vouchers, sales slips, cancelled checks, business notes and contracts or agreements.
- **Payroll records.** Yearly and quarterly reports of individual payroll payments must be made to the state and federal governments. Each individual employee receives a W-2 form at the year's end showing total withholding payments made for the employee during the calendar year.

An employment card or file should be kept for each employee showing, among other things, their social security number; name; address; telephone number; W-4 form; name, address and phone number of next of kin; job description; application for employment; and correspondence to and from the employee.

A summary payroll should be made each payday showing names; employee numbers; rates of pay; hours worked; overtime hours; total pay and amount of deductions for Federal Insurance Compensation Act (FICA: social security tax); withholding taxes and deductions for insurance; pension and/or savings plans.

How Long Should You Keep Records?

It may seem premature to worry about holding records during the start-up phase of your business. However, once records are discarded, it is unlikely they can ever be replaced. You must keep your records as long as they may be needed for the administration of any provision of the IRS Tax Code. Generally, this means you must keep all records that support an income item or deduction on your tax return until the period of limitations for that particular return runs out. See IRS publication #583, *Starting a Business and Keeping Records,* for more information about IRS regulations.

Record keeping is the first step to successful business decision-making. How records are used to assess the financial status of your business is described in *Keeping Your Business On Track Part II: Financial Statements*. *Part III, Ratio Analysis* describes analytical methods.

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