

The Definitive Guide to

Small Business Expenses



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Introduction

One of the first things that you'll discover when you start a small business is just how much everything costs. From paying bills to stocking product or funding services, the expenses of running a business can be endless – and a little shocking. Fortunately (or not), not everything that you pay for is considered an “expense” in the world of finance. And those that are, can help you cut down your tax bill considerably if accounted correctly. Since every business owner knows that the number one rule of owning a business is not to mess with the IRS, it's important to understand expenses and how to account them early on.

This guide to small business expenses will walk you through what you should expense, what you shouldn't, and how to track them so that tax time is easier. You'll also learn what depreciation and amortization are, and why they matter, as well as what and how to deduct so that your tax burden isn't quite so hefty. By the time this guide is done, you should be confident in your ability to accurately track your expenses, deduct them from your taxes, and ensure that your books are in good shape.

Before we get started, though, let's define what an “expense” is. In the world of accounting, the word expense is actually a verb, and “an expense” is simply short hand for “an item that has been expensed”. Expense means to record an economic cost that was incurred in order to earn revenue. If a cost does not directly relate to earning revenue for your business, it often either cannot be expensed, or it is better to not expense it. There are many categories of costs related to business that fall in the gray zone, and we'll attempt to offer examples in this guide that can help you make the final call when you inevitably run into these types of costs.

Now that you understand what we mean by expense, let's get started.

What Should I Expense?



The first, and most important, question that small business owners have to ask is what they should be expensing. Imagine this: last year, you opened that business that you've always dreamed of. After years of planning, saving, and false starts, you finally have everything up and running. In the hustle and bustle of making a buck, you did your best with the books, but most of your records are focused on what you earned – you know that the IRS will shut you down in a heartbeat if you don't report everything the business made.

And now it's tax time. You fill out the paperwork, send it off on time, and pat yourself on the back for doing a great job – only to find a tax bill worth more than your first born child in the mail in the following weeks. What went wrong? More than likely, you didn't cash in as many deductibles as you could have, which would have saved you the pain of selling off a body part to afford the bill. This is only one example of a situation in which you need to have your expenses recorded. There are many other reasons why it's important to know your expenses. Potential investors will want to know how profitable the business really is, which requires a comparison of revenue and expenses. Auditors will need that information to ensure your books are being kept properly. If you ever need to sell your business, potential buyers will need that information to make you the best offer. The reasons go on and on.

But as we said earlier, not everything that comes out of the business bank account should be expensed. This chapter will cover the categories of business expenses that should always be recorded as such, and why these categories are important.

Rule of Thumb



When it comes to understanding what should be expensed, the general rule of thumb is: expense a cost when it has no future economic value, or when it has been used up. A great example is a single month's salaries. The economic value that you received for last month's salaries (AKA the work your employees did last month) has already been received. You will never again receive last month's work, therefore that economic value has expired, or been totally used up. The money you exchanged for that value, therefore, is an expense.

This can get a little bit murky when you think about costs relating to things like vehicles or building rent, but it's best to think of everything in terms of when you used up the item or service paid for. If you paid rent for last month, you can't re-use last month's rent; you'll have to pay again for the following month. So last month's rent is an expense.

However, if you pay your rent a year in advance, then the amount that you have paid for future months is not an

expense, because it will still bring you economic value, in the form of a building to operate from, in the future.

We'll discuss how future payments like that example will become expenses over time in a future chapter, but for now, this basic rule of thumb can help you understand the categories of expenses.

Advertising

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Advertising costs that include business cards, brochures, giveaway items, posters, web site design and maintenance, mailing lists, and any other tangible item can be expensed and deducted on taxes. You can also expense the costs of goodwill advertising, such as sponsoring a local sports team.

Licenses, Fees, and Interest

There is a wide variety of fees or license costs you may need, depending on your industry. In addition to business licenses, bank fees, loan interest, credit card fees, professional dues and franchise fees, you may also have legal fees, accountant's fees, consultant's fees, and other professional costs. All of these can be expensed and deducted after the service has been received.

Education and Training

Any professional education you or your employees undergo, including seminars or development courses, can be expensed. You can usually deduct the cost of entry and supplies as well as the cost of transportation or travel. However, it's important to note that you cannot deduct these expenses unless the education or training took place after the business was legally launched.



Equipment and Supplies

Equipment can be a tricky area when it comes to expensing costs in small business accounting. Any equipment that will be useful for your business for longer than one year should be accounted as an asset, rather than an expense. Assets are deducted differently, based on depreciation, which we'll discuss in a later chapter. However, you can expense and deduct supplies that are used up in the operation of your business. This may mean office supplies, cleaning supplies, software, or production materials, but it can also include things like your security system and the coffee and water you provide for customers. Uniforms and protective clothing that are not considered street wear can also be expensed and deducted.

Payroll and Insurance

Employee wages can be expensed and deducted, but it's important to check with an accountant before you account for the amount paid to independent contractors. There are different tax laws in this situation. Additionally, you can only deduct the amount paid for the current tax year. If an independent contractor is paid in advance for a multi-year project, their future pay cannot be deducted. All premiums that you pay for business-related insurance should be expensed and deducted, except car insurance if you expense your auto costs separately.

Location Costs



The costs related to building rent, utilities, furnishing and so forth, can be expensed in certain areas. Rent payments for an office space or for equipment that you do not own are generally considered expenses, but be careful to record transactions if the rent is paid to a relative. If you use part of your home for your business, there are some things you can expensed and deduct; however, be aware that the IRS scrutinizes this very carefully. Most business owners use a deduction ratio, in which they calculate the costs of mortgage or rent, utilities, upkeep, etc., per square foot of the residence, and expense only what applies to the square foot of the area used for business.

Repairs or Maintenance

Repairs or equipment maintenance can be another gray area in accounting. If the repairs or maintenance adds value to the equipment, location, or item in question, that could be considered an improvement, and should be considered an asset rather than an expense. The only time you can expense this cost is if the repairs or maintenance only keeps the item at its normal operating condition. Any type of improvement must be depreciated over time instead.

Travel Costs

Employee wages can be expensed and deducted, but it's important to check with an accountant before you account for the amount paid to independent contractors. There are different tax laws in this situation. Additionally, you can only deduct the amount paid for the current tax year. If an independent contractor is paid in advance for a multi-year project, their future pay cannot be deducted. All premiums that you pay for business-related insurance should be expensed and deducted, except car insurance if you expense your auto costs separately.

Charity Contributions

There are several other categories of costs that may be expensed, including casualty losses, gifts, bad debts, meals, mailing costs, publication costs, research costs, and charity contributions. Charitable contributions are the most complex to expense and deduct, and probably require help from a tax professional. The charity that you support must be qualified by the IRS as tax exempt, and the amount that you should expense and deduct is very specific. Owners of businesses that fall under the category of sole proprietorship, partnership, LLC, or S corporation, should not expense charitable contributions, but should rather consider them personal deductions.

A Note on Start-Up Expenses

If this is your first year of launching and operating your business, you can expense and deduct the first \$5,000 of costs. Anything relating to forming an entity, including research and analysis, pre-launch advertising, accounting and legal fees, and all other aspects of the business, can be expensed and deducted. Any costs that are accrued in the formation of forming the business that exceed \$5,000 are generally considered an asset and depreciated over following years.

However, it's important to note that you cannot deduct the costs of research and analysis if you decide not to launch the business after investigation. If you incur costs related to attempting to purchase a business, and the deal doesn't happen for some reason, then you can deduct those investigative costs.

The best thing to do is to launch your business quickly – once you have reached the point of launch, all of these costs will be expensed and can be deducted normally, rather than having to keep everything under that \$5,000 limit to ensure that they can be deducted.

What Shouldn't I Expense?



In the last chapter, we looked at the standard categories that most business owners need to know about in order to properly expense costs. But what kinds of costs shouldn't be expensed? There are many that the IRS will not allow to be deducted, but there are other reasons for not expensing certain costs as well. Imagine this scenario:

You have been operating a successful business for five years, and are considering approaching investors to help you grow to the next level. In order to attract great investors, you need to present a picture of a great business, one that is thriving and growing every month. Your books, which show all of your revenue compared to all of your expenses, will help investors understand just how successful you have been.

However, at the same time, you need to purchase a very expensive piece of equipment to help you with the growth of the business. While you know that this equipment is going to add revenue in the future, all the books will show is one giant negative compared to your revenue right at this moment. This could make investors hesitant to jump in, when it appears that your costs are much higher than they should be. What should you do?

This is why accountants use a technique called capitalizing. This means that a cost will be recorded as an asset, rather than an expense. Only the cost of what you've used in the past year should be expensed. This is found by dividing the cost of the equipment by its expected lifespan and allotting only one year's worth of the cost to the current year.

As you can see, there are sometimes advantages to not expensing items, even if it does mean that you won't be able to deduct as much on the taxes for that year. So what items shouldn't you expense?

Items That Depreciate

For the most part, you'll be dealing with items that depreciate when it comes to items that shouldn't be expensed. The IRS has very specific guidelines for depreciating property. The item has to be owned by you or the business, or you must make capital improvements on the item – in the second case, you may only depreciate the value of the improvements.

You must be using this item to make revenue. Again, if it's something at your home, or something you also use for personal use, you must only depreciate the value of the portion used for business purposes. Finally, the item must have a useful life of more than one year. If the item won't be making you revenue in the following year, you must expense it instead.

Here are some common examples of depreciable items:



Machinery

- Equipment of any other sort



Office Buildings



Computers and Technology



Vehicles

- Pre-paid expenses (For example: Insurance that is paid a year in advance, or advanced pay for an independent contractor.)



Buildings that you own and rent out

In addition to the actual cost of the item, you also need to factor in costs of things like sales tax, installation fees, service fees, etc., when depreciating the item.

There is one notable exception on this list that we discussed earlier: improvements that you made to a property. Whether you own a property or not, if you make improvements to it that result in earned revenue, you should depreciate the value of the improvements. If you own a property that is already being depreciated, and make improvements, the improvements should be considered an entirely new depreciated property within your books. There is a fine line between a repair, which is usually expensed, and an improvement, which must be depreciated, so be sure to check with a tax professional before attempting to deduct repairs.

A great example of the situation outlined above is that of a computer that was purchased for a business, and is currently on the books as an asset being depreciated. Imagine the computer gets a virus, and the technician can either repair the computer, restoring it to its normal state, or upgrade the computer to a newer version, making it run far better and increasing its lifespan. In the first case, the repair is an expense that should be deducted. In the second case, the cost of the upgrade should be accounted as a brand new asset that is depreciated.

While there are some grey areas that may need the attention of a tax professional, these are some common examples of things that you should not depreciate:

- Collectibles
- Land
- Stock or bond investments
- Anything that will be used for less than one year
- Buildings that are not being rented out or used for income
- Anything that is being used for personal purposes

Items That Amortize

When you speak to a tax professional, you may also hear the term “amortize” come up. Amortization is very similar to depreciation, except that it deals with items that aren’t tangible. Where depreciation describes how the cost of a tangible item will add value to the company over many years, amortization describes how the cost of an intangible asset will add value to the company over many years. The best example of an intangible asset is a patent. Companies must record the development cost of their patented item over the entirety of the patent. So if a company has a 5-year patent, and the development costs of the item are 10 million dollars, that 10 million dollars is amortized as an asset of two million dollars every year for 5 years. Amortization also applies to loan repayments.

There are certain deductions that can be taken for amortized items, particularly in research and development, natural gas exploration, forestation, and pollution control. If your business deals with many amortized items, it is best to speak to a tax professional regarding deductions.



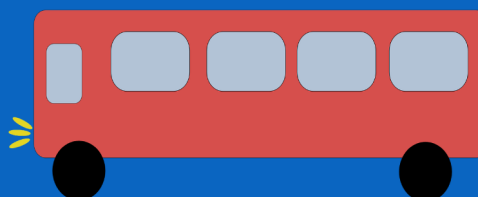
Non-Deductible Expenses

Throughout this book so far, we've mostly focused on expenses that can be deducted when tax time comes around. However, there are certain things that you might consider expenses that can never be deducted on taxes. While these still may show up on your books as expenses (and should, if you want to show a clear picture of your business' growth and avoid an audit), it's still good to know what things cannot help you lower your tax bill. These include things like political donations, government fines, and estate taxes. If it is directly tied to the government, chances are it cannot be deducted.

Other things that can't be deducted include:



Business clothing that can be worn outside of work. Famously, a member of Rod Stewart's band tried to deduct silk and leather costume wear from performances, but was denied because he could technically wear them outside of work. The only clothing that can be deducted is something you truly could not wear outside of work, such as a hazmat suit.



The cost of commuting. Only travel that takes you away from your place of business overnight counts for deductions.



Traffic tickets. Even if you are on a business trip, you can't deduct a ticket.



Technology. Unless your computer, phone, or tablet is an essential part of running your business, it can't be deducted.

Effective Expense and Deduction Tracking



So now you know what expensing is, what you can expense, and what items should be considered assets instead. As they say, knowledge is power, so you're well on your way to ensuring that your small business is keeping good books. The next step is putting your knowledge to work and actually tracking expenses.

In this chapter, we'll go through some of our best tips for effectively tracking your expenses and deductible items. Not only will that make your life easier at tax time, it will also mean that you can be sure you don't overpay when the tax bill comes due.

Automate

The most important thing you can do for yourself as you dive into the process of business accounting is get automated. Even great accountants would have a difficult time keeping perfect books and running a business. Using an automated bookkeeping software helps you streamline the entire process, and, if you choose the right software, usually has all the formulas and categories you need programmed in. All you have to do is input data, and the software does the rest.

After learning about depreciation, amortization, expensing, capitalizing, and the IRS, that should sound like your new best friend. One of the ways that botkeeper goes a step further is to include the services of a dedicated accountant in addition to automated bookkeeping. That way, if you ever have any questions about what data goes where, or you need assistance with payroll or other reports, you have a live helper available as well.

When it comes to your expenses, botkeeper can help with paying bills, managing your cash flow, collecting and categorizing receipts, tracking your accounts payable, reconciling the books and creating expense reports any time, any where. The software can also assist with payroll entry and tracking, benefits setup, and compliance tracking. Automation is truly the best thing you can do for your business accounting right away.

Create a Dedicated Bank Account

If your business is small, you may be tempted to use your own bank account, particularly when you've likely been using it up till now to cover expenses out of pocket. However, this set up is a recipe for disaster when it comes time to create an expense report or do your taxes. In some cases, it can also lead to tricky legal situations that would make it difficult to get out from under debts accrued by the business.

The best plan of action is to create a business account, where all of the revenue is deposited. From there, either used a dedicated business credit card for expenses and pay it off from the business account, or pay all expenses from the revenue in the account. You can connect the accounts to make moving money to your personal account easier, but having a clear distinction between your personal expenses and your business expenses makes it much easier.

The #1 Paper Trail You Need to Have



When using an automated bookkeeping system, you may be tempted to do away with a paper trail altogether. In some cases, this may work just fine. You may not need to have a paper ledger if you have a backed-up electronic ledger. However, there is one type of paper you should always keep, and no, it's not cash: receipts.

Any time you get receipts for a business-related cost, keep it stored and organized chronologically. You may have a fancy filing system or shoebox, either way works. Not only do you need these to help deduct expenses, they are vital in the case of an audit. Most businesses are required to keep all receipts that are over \$75; however, if you are a small business where the majority of your single purchases are under this amount, it may be best to keep all receipts.

Additionally, you should be sure that each receipt is notated in a way that allows you to remember what it was for. If you collected several meal receipts while on a business trip, staple them together with a note that says "Business Trip, August 2015" or something similar. Use names and places, as specific as you can, so that you'll remember in a year what this receipt was for.

Another important paper trail that you may want to consider if you use your home as an office is a yearly photograph of your office space. Think of this like your own version of a receipt. It shows exactly what area of your home you are accounting for as an expense, and makes it easier to justify your yearly

Don't Just Track

Running a business takes a lot of time, and you are probably feeling pretty good about yourself if you manage to stay on top of the tracking. But even if it's just you running the show, you should take the time to evaluate the company's performance by analyzing the books. There are many ways you can analyze financial statements to get a good picture of how you are really doing.

Most automated software can create reports that show you trends, for example. These trends can show any number of things – how much revenue you earned per month, how much income you made per month (revenue minus expenses is your income), how many new leads you attracted per month, and so on. These are great tools to help you identify what things you may be doing right, what things you may be doing wrong, and where you can improve.



Go Mobile to Stay on Top of It

One of the benefits of a good accounting software is that it should allow you to enter expenses and other accounting data anywhere, even from your mobile device. This is important because the best way to keep your books in order is to stay on top of it. Always enter an expense as soon as you can after it is accrued, and always file receipts as soon as you can after receiving them. Once you allow accounting tasks to pile up, it becomes harder to get an accurate picture of what has happened in your finances.

Another great tool for mobile accounting is your calendar app. Entering a reoccurring reminder for ongoing bills, marking what you paid when if you can't get to your accounting software, etc., can ensure that you at least have a written record that includes a date stamp, to look back on.



A powerful mobile app is one of the things that we focused on when developing botkeeper. Our app allows you to continuously stay updated 24/7 on the overall health of your business, and also allows you to input data right where you are. It's easy to open the portal on your device, make a few entries after paying some bills, and then go about your errands. You won't have to schedule in extra time to deal with paperwork, and botkeeper will take care of creating reports, categorizing expenses, and even paying reoccurring bills for you. Going mobile with your automated software, or with the tools you do use, is second only to using an automated software in the first place for usefulness.

Common Mistakes Beginners Make

So now you have our best tips for tracking expenses, but that doesn't mean you're not human. There are some very common mistakes that beginners make when it comes to business accounting, particularly when it comes to expenses, that you can avoid.

4 Incorrectly Classifying Expenses

In the first part of this book, we discussed what makes something an expense or an asset that needs to be depreciated. However, once you've identified a cost as an expense, there are still more categories that you need to keep in mind. The biggest problem that this can cause is a mistake in your deductibles, leading to an audit or a hefty tax bill. However, it can also paint a poor picture of the workings of the business.

Imagine that you're about to head into that all-important meeting with the investors that has kept you up at night reading this book. You've made sure to capitalize those big costs so that your revenue and expense ratio looks right. But when you head into the meeting, the investors specifically ask you why the company seems to be bleeding so much money in product development. A product that costs this much to make should surely be priced higher, they reason. But if you price the product higher, then your competitor may take your business.



Suddenly what seemed like a great business looks like a bigger risk. But when you get home from the meeting that night, you realize that the expense they were seeing for production cost had mistakenly also included payroll costs for the past year as well. That's a major change that could completely redefine their idea of the value of the product.

This is why expenses are further categorized beyond just "expense" and "asset". By separating out your expenses, you can get an in-depth look at where you may be able to save money, how much it truly costs to produce your service or product, and where you should consider changes. Additionally, many accounting systems group like expenses into a single lump sum on end-of-the-year reports, rather than listing every single purchase in that category individually. This helps streamline reports.

Every single industry has its own standards for expense categories, and that's something you need to know when you set up your accounting. If your company is in manufacturing, the cost of goods sold (AKA how much it costs to sell your product) will include everything from factory overhead to storage. Tech companies will classify more expenses as research and development than other industries.

If you run into an expense that doesn't seem to match up to any industry standard category, your next best bet is to categorize it the way it would be categorized by the IRS on a tax return. This will simply make it easier for you when it comes time to report.

Finally, most accounting programs will include many classifications and can suggest categories for each expense as you enter it.

Failing to Note Tiny Transactions

In every business, there are always at least a handful of those insignificant transactions that you can easily brush off, or not even think to record in the first place. Paying a few bucks to send a certified letter, buying a potential client a cup of coffee at a meeting, picking up dry cleaning when you're on a business trip – all of these are not only expenses, but deductible expenses at that.

The big reason that it's a mistake to miss recording these is that it creates the habit of recording transactions. As your company grows, both in the size of transactions and in the number, you'll already be used to automatically recording everything that happens.



Failing to Reconcile Expenses with Bank Reports

While you're busy taking care of your own accounting, the bank is also keeping their version of your books. Every time you swipe your card, write a check, or withdraw cash, the bank makes a note. This can be extremely helpful when it comes time to make sure your books are correct – but it can also cause major problems if you don't make a regular habit of reconciling your records with theirs.

Mistakes in your own records can happen, and mistakes on the bank's end can happen as well. Make a habit of reconciling the bank records with yours regularly to ensure that no mistakes are being recorded long-term on either end.

Failing to Correctly Categorize Employees

We briefly touched on the differences between employees and independent contractors in an early chapter. However, not knowing the difference can create a significant problem for your company, particularly if you record employees as contractors by mistake.

When you have an employee, you are responsible for not only paying their payroll, but also for deducting taxes from their payroll and sending it to the government. In addition, you must match certain taxes and send to the government as well for each employee. These taxes are for social security and Medicaid, but the amounts you must remove, as well as any other tax that must be removed, vary from state to state.



The basic differences between an employee and a contractor are:

Contractors

- Pay their own employment taxes.
- Provide their own tools, training, and materials.
- Are hired on a project-to-project basis.

Employees

- Must work for a specific amount of time, at a specific time of day, in a specific location.
- Receive benefits and their work is required for the day-to-day operation of the business.

Always be sure you have a clear definition of an employee's status in their work contract when they are hired.

Failure to Keep Your Accountant in the Loop

Even if you use an automated accountant like botkeeper, you still need to be sure that the information you are giving the software (or your human accountant) is up-to-date and reliable. Simple things like making purchases without reporting it, setting up reoccurring costs without reporting it, or failing to keep receipts filed, can become a major headache later on when it's time to reconcile the books.

Not Keeping Updated on IRS and Industry Changes

Tax laws change every year. Rates go up and down in every industry, for nearly every type of expense. Additionally, industries frequently change their reporting standards and best practices to reflect evolving methods of business. This is why having a dedicated accountant is so important – this person is paid to keep on top of new changes, and to ensure that you are always compliant.



However, if you keep your books yourself, you'll need to ensure compliance on your own. This means regularly checking in with industry accounting professionals to be sure your reporting is on par with industry standards. It also means regularly checking in with IRS tax rates to be sure you are accounting correctly and doing payroll correctly. There are many ways to keep yourself up to date, but a quarterly check with industry professionals and IRS updates is the safest method if you don't use an accountant.

Failing to Recognize a Deduction



The last mistake that most new business owners make is failing to report every deduction they can. In their fear that they might not pay enough taxes, they err on the side of paying too much. That's just as bad for your business as paying too much in any other expense category.

The problem with guides to all the deductions you can possibly take is that every single industry, and even every single business within an industry, has specific and unique situations that could lead to a deduction. Custom recommendations for getting the most out of your expenses can only be gotten from a licensed tax professional. If you have never worked with one before, we can recommend one from our network of partners to help you lower your tax bill and ensure that your expense accounting is accurate.



Conclusion

Business accounting is no small field, and within a few brief pages, we've covered a lot. Expenses, assets, and tax deductions may not seem like what you set out to accomplish as a business owner, but they're a necessary part of ensuring that your business runs smoothly.

To sum up everything that you've learned into bite-sized takeaways, expenses are costs that will not provide any further value to your company. When you record these expenses, they need to be carefully categorized to ensure that your books are correct. Some kinds of expenses can significantly affect your tax bill, so you should be sure to get the most out of what you can deduct. Tracking your expenses and paying attention to the reports from your accounting software are the best ways to keep up with your company's financial health.

Obviously, we covered much more than this, of course. Knowing what you can deduct, and what you can't, knowing what shouldn't even be expensed at all, understanding the major pitfalls that most beginners make, and collecting our top tips for tracking your expenses are all important parts of ensuring your books are in order.

Now that you've got this knowledge, the next thing you have to do is set up your accounting system and get to work! Contact botkeeper today to find out how our automated bookkeeping system can help you get started in just minutes, and how we'll make sure that your expenses, revenue, reporting, administration, and payroll are always managed and tracked correctly. Talk to one of our live accountants, get in touch with tax and payroll professionals, and use the automated bookkeeping bot to stay on top of your books wherever you are.

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