Chapter 6

Accounting and Finance

Accounting is the process of recording, classifying, reporting, and analyzing money. Accountants capture and record all the transactions, operations, and activities that have financial consequences for a business. Accountants are also involved in other activities in finance that impact a business, such as weighing the costs of new ventures, participating in strategies for mergers and acquisitions, quality management, tracking financial performance, as well as tax strategy.

While the accounting requirements of businesses vary, all organizations need a way to keep track of the flow of money within them. The responsibilities of the finance and accounting functional area within an organization or of its chief financial officer (CFO) include:

- ✔ *Facilitating operations*—payroll, purchasing, cash collections, cash disbursements.
- ✔ *Management control*—measuring actual performance against goals and expectations.
- ✔ *Management decision making*—analyzing cash position to make decisions.

- ✔ *External financial reports*—financial statements prepared according to generally accepted accounting principles (GAAP) and available for audit.
- ✔ *Tax returns*—federal and state income taxes; property, sales, and payroll taxes.

Accounting and finance are not intuitive. Many small businesses hire accountants to set up and manage their books. Other companies use accounting software such as QuickBooks. Accounting involves periodic reporting of financial data and includes:

- ✔ *Business transactions.* Businesses keep a daily record of transactions in sales journals, cash-receipt journals, or cash-disbursement journals.
- ✔ *Debits and credits to a general ledger.* An up-to-date general ledger shows current information about accounts payable, accounts receivable, owners' equity, and other accounts.
- ✔ *Making adjustments to the general ledger.* General-ledger adjustments let businesses account for items that don't get recorded in daily journals, such as bad debts and accrued interest or taxes. By adjusting entries, businesses can match revenues with expenses within each accounting period.
- ✔ *Closing the books.* After all revenues and expenses are accounted for, any net profit gets posted in the owners' equity account. Revenue and expense accounts are always brought to a zero balance before a new accounting cycle begins.
- ✔ *Preparing financial statements.* At the end of a period, businesses prepare financial reports—income statements, statements of capital, balance sheets, cash-flow statements, and other reports—that summarize all the financial activity for that period.

CASH VERSUS ACCRUAL ACCOUNTING

The two principal methods of keeping track of the money that flows in and out of a business are cash and accrual accounting. Most small businesses use the cash method, in which income is reported in the year it is received, and expenses are deducted in the year they are paid. Under the accrual method, income is reported when it is earned and expenses deducted when incurred, regardless of whether money has changed hands yet.

Accrual Accounting

In an organization using the accrual method, an accountant records income and expenses when they happen, not when they are actually received or paid. In practical terms, this difference in timing is relevant if your company keeps inventory on hand or handles transactions on credit. For example, a consultant completes a project in January but isn't paid for it at the time. The business that has been serviced recognizes all expenses in relation to that contract when they were incurred, even though the consultant has not been paid. Both the income and expenses are recorded for the current tax year, even if payment is received and bills are paid the following February.

Cash Accounting

If an accountant uses the cash method, he/she counts income when it is received and expenses when they are paid. Many small businesses, especially retail businesses, use the cash basis method of accounting, which is based on real-time cash flow. On the day a check is received, it becomes a cash receipt.

DOUBLE-ENTRY BOOKKEEPING

Without a system to record and track the flow of money within a firm, a business cannot accurately conduct its operating functions or make clear operating decisions. In order to effectively operate, a business must ensure that the cash inflow from operating, financing, and investing activities is in balance with the cash outflows that are associated with expenditures. To do this, accountants use a system of double-entry accounting to debit (remove) or credit (add) money as it flows into and out of their business. Double entry requires two entries per transaction, which provides cross-checks and decreases errors. In the record of every financial transaction the following equation remains in balance at all times:

Assets = Liabilities + Owners' Equity (Capital)

Assets are what a company owns, such as equipment, buildings, and inventory. Claims on assets include liabilities and owners' (stockholders) equity. Liabilities are what a company owes, such as notes payable, trade accounts payable, and bonds. Owners' equity represents the claims of owners against the business.

The double-entry system provides checks and balances that ensure that the books are always kept in balance. Each transaction is recorded as a debit or a credit, with total assets equaling the sum total of liabilities and owners' equity.

ACCOUNTING TERMS AND CONCEPTS

There are a few accounting terms and concepts that a business manager must be familiar with in order to make setting up an accounting system easier.

Debits and Credits

An understanding of debits and credits is essential in the effective usage of any accounting system. Every accounting entry in the general ledger contains both a debit and a credit. Further, all debits must equal all credits. If they don't, the double-entry system is out of balance. Therefore, the accounting system must have a mechanism to ensure that all entries balance. Indeed, most automated accounting systems won't let you enter an out-of-balance entry; they will just beep at you until you fix your error. Depending on the type of accounting system, a debit or credit will either increase or decrease the account balance. For every increase in one account, there is an opposite (and equal) decrease in another. That's what keeps the entry in balance.

Assets and Liabilities

Balance sheet accounts are the assets and liabilities for a firm, which, as discussed, must balance.

Identifying Assets. An asset is any item of value owned by a business. A firm's assets are listed on its balance sheet, where they are set off against its liabilities. Assets may include factories, land, inventories, vehicles, and other items. Some assets (short-term assets), like cash, are easy to value and liquidate, while others (long-term assets), such as buildings and farmland, are difficult to value and take longer to liquidate. These kinds of assets are collectively known as tangible assets. Intangible assets, like a valued brand name such as BMW, don't show up on a balance sheet, but do contribute to the value of the firm. There are many other intangible assets owned by a company. Patents, the exclusive right to use a trademark, and goodwill from the acquisition of another company are such intangible assets. Generally, the value of intangible assets is whatever both parties agree to when the assets are created. In the case of a patent, the value is often linked to its development costs. Goodwill is often the difference between the purchase price of a company and the value of the assets acquired (net of accumulated depreciation). Even something that is not physically in hand, such as accounts receivable, is an asset because a company has claim to money due from a customer.

Identifying Liabilities. Liabilities are the opposite of assets. These are the obligations of one company to another. Accounts payable are liabilities and represent a company's future duty to pay a vendor. So is the loan you took from a bank. A business organizes liabilities into short-term and long-term categories on the balance sheet. Long-term debt (claims due in more than one year) and short-term debt (claims due within a year) are liabilities because they are claims against the business. If you were a bank, a customer's deposits would be a liability for accounting purposes, because they represent future claims against the bank.

Owners' Equity

Owners' equity is the difference between assets and liabilities; it increases and decreases just like they do. Owners' equity includes factors like partners' capital accounts, stock, and retained earnings. Stockholders' equity is also what would belong to the company's owners—the holders of its common stock—after selling the assets and paying off the creditors. Literally, it is paid-in capital plus retained earnings.

Retained earnings are the accumulated profits after dividends to common shareholders have been paid. At the end of one accounting year, all the income and expense accounts are compared to one another, and the difference (profit or loss for the year) is moved into the retained earnings account.

Income and Expenses

Further down in the chart of accounts (usually after the owners' equity section) come the income and expense accounts. Most companies want to keep track of just where they get income and where it goes, and these accounts provide that information.

Income Accounts. A business may want to establish an income account for different income-generating departments of a business. In that way, it can identify exactly where the income is coming from, and the income of the various departments can be added together. Different income accounts would be:

- ✔ Sales revenue.
- ✔ Interest income.
- ✔ Income from sale of assets.

Expense Accounts. Most companies have a separate account for each type of expense they incur. A company probably incurs much the same expenses month after month; thus, once they are established, the expense accounts won't vary much from month to month. Typical expense accounts include:

- ✔ Salaries and wages.
- ✔ Telephones.

- ✔ Utilities.
- ✔ Repairs.
- ✔ Maintenance.
- ✔ Depreciation.
- ✔ Amortization.
- ✔ Interest.
- ✔ Rent.

GENERAL LEDGER

The core of a company's financial records is maintained as a "general ledger." These records constitute the central "books" of all financial transactions since day one in the life of the company.

In setting up the general ledger, one must be cognizant of two points: (1) linkage to the company's financial reports and (2) establishment of opening balances.

The two primary financial documents of any company are the balance sheet and the profit and loss statement (income statement), both of which are drawn directly from the company's general ledger. The general ledger accrues the balances that make up the line items on these reports, and the changes are reflected in the profit and loss statement.

Every account that is on a chart of accounts will be included in a general ledger, which should be set up in the same order as the chart of accounts. While the general ledger does not include every single accounting entry in a given period, it does reflect a summary of all transactions made.

If a business is small and cash-based, a business can set up much of a general ledger out of a checkbook. The checkbook includes several pieces of information vital to the general ledger—cumulative cash balance, date of the entry, amount of the entry, and purpose of the entry. Even for a cash-based business, a checkbook cannot be a sole source for establishing a balance sheet.

An important component of any general ledger is source documents. Two examples of source documents are copies of invoices to customers and from suppliers. Source documents are critical in that they provide an audit trail in case you or someone else has to go back and study financial transactions made in a business. For instance, a customer might claim that he never received an invoice from you. A source document will prove otherwise. And source documents are a required component for an accountant at tax time. Other examples of source documents include canceled checks, utility bills, payroll tax records, and loan statements.

All general ledger entries are double entries. This makes sense because for every financial transaction in a business, the money (or commitment to pay) goes from one place to another. For instance, when a payroll check is written, the money flows out of a payroll account (cash) into the hands of an employee (an expense). When goods are sold on account, a record of the sale (income) is generated; but there must also be a journal entry to make sure that the funds are collected from that account later (an account receivable). As discussed earlier, the system used in recording entries on a general ledger is called a system of debits and credits.

As explained in a previous section, for every debit there should be an equal and offsetting credit. It is when the debits and credits are not equal or do not offset one another that the books don't balance. A key advantage of any automated bookkeeping system is that it polices debit and credit entries as they are made, making it far more difficult for the accounts not to balance.

COMPONENTS OF THE ACCOUNTING SYSTEM

Think of the accounting system as a wheel, and the hub as the general ledger. Feeding the hub information are the spokes of the wheel. These include:

- ✔ Payroll.
- ✔ Accounts payable.
- ✔ Fixed assets.
- ✔ Inventory control.
- ✔ Accounts receivable.

- ✔ Order entry.
- ✔ Cost accounting.

The following is an exploration of some of the important elements of the accounting system.

Payroll

Payroll accounting can be quite a challenge for the new business owner. There are many federal and state laws that regulate what must be tracked related to payroll. A business may face fines for maintaining incomplete or nonconforming records. Many small business owners outsource their payroll services and by so doing guarantee their compliance with all applicable laws.

If payroll is maintained in-house, it is advised that a business use an automated payroll system. Even if the books are done manually, an automated payroll system will save valuable time and help considerably with compliance.

Accounts Payable

Accounts payable represent bills from suppliers for goods or services purchased on credit. Generally this debt must be paid within 12 months. It is important to track accounts payable in a timely manner in order to know how much each supplier is owed and when payment is due. If a business has a timely system in place to manage accounts payable, it may often be able to take advantage of discounts that are provided for timely payments. A poorly managed supplier system can damage a relationship with a supplier and earn a business a poor credit rating.

Fixed Assets

Fixed assets are commonly recognized as long-lived property owned by a firm that is used in the production of its income. Fixed assets include real estate, facilities, and equipment. Other types of assets include intangible fixed assets, such as patents, trademarks, and customer recognition. Fixed assets are items that are for long-term use, generally five years or more. They are not bought and sold in the normal course of business operation.

In an accrual system of accounting, fixed assets are not recorded when they are purchased, but rather they are expensed over a period of time that coincides with the useful life of the item (the amount of time the asset is expected to last). This process is known as depreciation. Most businesses that own fixed assets keep subledgers for each asset category as well as for each depreciation schedule.

In most cases, depreciation is easy to compute. The cost of the asset is divided by its useful life. For instance, a $50,000 piece of equipment with a five-year useful life would be depreciated at a rate of $10,000 per year. This is known as straight-line depreciation.

There are other more complicated methods of fixed-asset depreciation that allow for accelerated depreciation on the front end, which is advantageous from a tax standpoint. You should seek the advice of a certified public accountant (CPA) before setting up depreciation schedules for fixed-asset purchases.

Inventory Control

A good inventory-control feature is an essential part of a bookkeeping system. If you are going to be manufacturing products, you will have to track raw materials, work in process, and finished goods, and separate subledgers should be established for each of these inventory categories. Even if you are a wholesaler or retailer, you will be selling many different types of inventory and will need an effective system to track each inventory item offered for sale.

Another key reason to track inventory very closely is the direct relationship to cost of goods sold. Because nearly all businesses that stock inventory are required to use the accrual method for accounting, good inventory records are a must for accurately tracking the material cost associated with each item sold. From a management standpoint, tracking inventory is also important. An effective and up-to-date inventory-control system will provide you with the following critical information:

- ✔ Which items sell well, and which items are slow moving.
- ✔ When to order more raw materials or more items.

✔ Where in the warehouse the inventory is stored when it comes time to ship it.
✔ Number of days in the production process for each item.
✔ Typical order of key customers.
✔ Minimum inventory level needed to meet daily orders.

Accounts Receivable

If you plan to sell goods or services on account in a business, you will need a method of tracking who owes you how much and when it is due, the purpose of the accounts receivable subledger. If you will be selling to a number of different customers, an automated system is a must.

A good bookkeeping software system will allow you to set up subledgers for each customer. Thus, when a sale is made on account, you can track it specifically to the customer. This is essential to ensure that billing and collection are done in a timely manner.

ORGANIZING THE ACCOUNTING AND FINANCE DEPARTMENT

Organize a small-business accounting system by function. Often there is just one person in the office to do all the transaction entries. From an internal control standpoint, this isn't desirable because it opens the door for fraud and embezzlement. Companies with more people assigned to accounting functions don't pose as much of a threat for fraud perpetrated by a single person.

Having the same person draft the checks and reconcile the checking account is not a good example of how to assign accounting duties. Small businesses often can't afford the number of people needed for an adequate separation of duties; however, setting up a smart internal control structure within a new accounting system helps mitigate that risk.

Assignment of Duties

Figure out who is going to do what in a new accounting system. A business needs to cover the following accounting responsibilities:

- ✔ Payroll. (Even if the business uses an outside payroll service, someone must be in control and be responsible.)
- ✔ Accounts payable.
- ✔ Fixed assets.
- ✔ Inventory control.
- ✔ Accounts receivable.
- ✔ Order entry.
- ✔ Cost accounting.
- ✔ Monthly reporting.
- ✔ Internal accounting control.
- ✔ Overall responsibility for the accounting system.
- ✔ Management of the computer system (if you're using one).

In many cases the same person will do many of these things. The person assigned to be in overall charge of the system should be the one who is most familiar with accounting. If you are just starting a company, you will want to think about the background of the new employees. At least one of them should have the capacity and integrity to run the accounting system. To determine someone's expertise in a field, one of the following steps would be appropriate:

- ✔ Have the applicant be interviewed by an expert. Your own CPA will probably be glad to interview a few for you.
- ✔ Carefully check references from past jobs. Ask detailed questions on exactly what the candidate did in the accounting function. Compare the reference source's answers with what the candidate said.
- ✔ Ask some accounting questions. This will allow you to assess the applicant's comfort with the language of accounting.

PRACTICAL ACCOUNTING

Though accounting serves a rather perfunctory purpose of control and assessment of the firm's financial performance, there are other, practical financial activities to consider.

Credit Checking Potential Customers

When a business extends credit, it is in effect loaning customers money, and any company wants to be reasonably sure that the money will be paid back. The best assurance of being able to collect is to check each customer's credit history before extending credit. That can be as simple as a phone call to a bank.

However a business chooses to check a customer, it will want to build a credit relationship slowly and carefully. Remember, not every customer deserves the same credit terms; thus, it's best to approach credit on a case-by-case basis. One thing to note is how long the company has been in business. Companies that have been around for at least five years are more likely to pay their bills on time—or they wouldn't be around anymore. The key ways to check a customer's credit include credit reports, credit references, financial statements, personal credit reports on the owner or CEO, and letters of credit.

Credit Reports. It's always a good idea to obtain a potential customer's credit report before you extend credit. Credit reports range in price from $15 for a one-page report to more than $1,000 for a detailed filing. The reports show historical payment data; bankruptcy records; any lawsuits, liens, or court judgments against a company; and a risk rating that predicts how likely customers are to pay their bills. Even if a prospective customer has little or no credit history, running a credit report is still worthwhile because it will reveal relevant data, including bankruptcy filings, corporate records, fictitious business name filings, court judgments, and tax liens.

Credit reporting agencies can send a credit report via mail, fax, or via the World Wide Web. Some agencies also provide reports online. If you request a considerable number of reports, you might be able to sign a contract that will reduce a per-report price.

Credit References. In addition to credit reports, or for companies not covered by commercial credit reporting agencies, you may want to check a customer's credit references yourself. These references can be informative, but they aren't foolproof. After all, a customer picks his or her own references. To gain a more realistic picture, ask a customer for a comprehensive list of suppliers. Call several and ask if a potential customer owes them money. If so, find out if payments are being made in a timely manner. Ask these suppliers for names of other suppliers and other customers and contact them as references.

You might want to call the customer's banker as well. While specific information may be inappropriate or illegal for a banker to provide, you may seek some general information. Ask how long the bank has had a relationship with the company. Has the bank given it any credit? If a loan was given, did the company meet its obligations?

Personal Credit Report of the Owner or CEO. When contemplating doing business with a new, closely held private company, it may not be possible to obtain a credit report, references, or financial statements. However, you can run a personal credit check on the owner or CEO of the business. If that person has a strong credit history, it's likely he or she will see to it that the company pays its bills on time. If the owner or CEO has a history of debt dodging or late bill payment, the company could follow suit. If a review raises concerns, schedule a meeting with management to address the issues. You may want to discuss credit issues with any investors in the firm as well.

Red Flags. In addition to the standard inquiries into a company's credit situation, you should keep your eyes open for other things that could indicate a credit problem:

Does the business engage in unusual price-cutting or discounting strategies? Such practices may hinder the company's ability to pay what it owes in a timely fashion. Does the company already have trade credit relationships with other companies? You don't want to work with a customer that is already overextended. Are any company assets already pledged as collateral? Does the company operate in a cyclical industry or in a business sector that is prone to seasonal turns? What is the general economic climate? When business is good you may be more willing to extend credit. When things are slow, however, you may want to be more tightfisted in extending credit to higher-risk customers.

Finally, pay attention to the results of research. Sometimes “no” is the right answer when it comes to extending credit, no matter how much you want the business.

Reading a Credit Report. A credit report is a snapshot of a company’s or an individual’s financial activities. Credit reports typically include historical payment data, bankruptcy records, Uniform Commercial Code (UCC) filings, bank loan information, leases, payment trends, and comparative industry data.

A typical credit report on a company contains its corporate name, address, and telephone number. It also includes the name of the chief executive officer, the company’s Standard Industrial Classification (SIC) code, a description of its line of business, and the date when the company began operations. Also included are the number of employees, sales, and a net worth figure. In many cases, a report includes a numerical credit rating.

Financial information can run the gamut from basic sales and payment data to detailed transactional analysis. The information should include a summary of any lawsuits, liens, or court judgments that are outstanding, plus any relevant bankruptcy filings. If available, there will also be information on changes in ownership, relocations, company acquisitions, and publicly reported news events, including fires or natural disasters. The amount of information depends on the stature of the company and whether it is publicly owned.

Most credit report services focus on publicly held companies. Credit rating resources for privately held and newer companies are less formalized. To check payment practices for smaller companies, try talking to their customers, suppliers, and bankers.

Remember, too, that while credit reports can be important tools, they’re not ends in themselves. Before making decisions based on credit reports, you'll want to back up the information with data gleaned from other kinds of company research, as well as from customers, employees, and personal contacts.

Preventing Overdue Accounts

The best way to prevent overdue accounts is to avoid doing business with customers who have bad credit histories. However, if you limited yourself to doing business with companies with spotless credit records, a pool of potential customers would be quite small. And unfortunately, with a growing business you often have no choice but to do business with anyone who wants to do business with you. Even then, you don't always have complete control of the terms of sales agreements. The reality is that the biggest and best clients want to be billed quarterly and then have 60 days to pay you. And you certainly don't want to cut off those clients.

While you don't want to destroy any potential or established business relationships by laying down harsh payment terms, you must take some control of accounts receivable to avoid wreaking havoc with a cash flow. You're not a bank, after all. The following five steps can help cash flow without endangering it.

1. Watch for new customers with bad credit history. You can't expect that a company or a person with a history of bouncing checks or paying their bills late will change their ways when dealing with you. If you must do business with the chronically late, lay down credit rules early and firmly and start the relationship off slowly. Keep the amount of product or services you offer a company with an iffy credit record to a minimum until they've proven themselves worthy. And no matter how much you need the business, never start doing business with another person or company until you have a signed contract clearly stating and agreeing to payment terms.
2. Once you begin doing business with someone, make sure you stamp invoices with the date that payment is due. Don't rely on the customer to look at the invoice date and add 30

days—or whatever the payment terms are—to determine the pay date.

3. Offer discounts for early payment and add interest to late payments. A typical discount is 2 to 3 percent off the total if the bill is paid within 10 days of the invoice date. The maximum amount of interest that can be charged varies by state.
4. Phone customers and start trying to collect the day after a payment is due. Never wait—let them know that you keep close track of accounts receivable.
5. Until customers pay their bills, don't do any more business with them. Do not bend on this rule—you'll only cause yourself more problems and scuttle any chance of collecting what you are owed. If you really want to keep doing business with a customer who owes you, insist that any new products or services they receive from you are COD—cash on delivery.

Collection Agencies

It's easy to extend too much credit when trying to entice companies into doing more business. Extending too much credit can lead to unpaid accounts, which can quickly and severely limit the cash you have to grow a business. If you don't stay on top of overdue accounts, the chance of collecting the money decreases over time.

One way to recover more from delinquent accounts is to hire a collection agency. A collection agency locates debtors and collects the money you are owed. If brought on board early, a collection agency can often recover a substantial portion of unpaid accounts.

In addition to increasing chances of actually getting paid, using an agency saves you time and money—two of your most valuable resources. With their custom-designed phone systems, computers, and software, collection agencies can be more effective in recovering delinquent accounts than you can. Although collection agencies charge between 15 and 50 percent of what they recover, you still end up with more than you probably could have collected on your own.

When selecting an agency, you should think about these considerations.

Find out if the collection agency is a member of the American Collection Agency or the Commercial Law League of America, which require that their members adhere to a code of ethics and are familiar with the Fair Debt Collection Practices Act.

Make sure the agency has insurance that will protect a business if the agency errs during the collections process.

Ask the agency to disclose its typical recovery rate and provide you with a list of references. Contact some of the companies on the list and find out how long it took the agency to collect on late accounts, if it collected the whole debt or a portion of what was owed, and if the companies were satisfied with the agency's collection efforts.

GAAP Accounting Rules

Generally accepted accounting principles (GAAP) is a set of nationally (United States) recognized accounting standards. Using GAAP accounting standards, costs and benefits are accounted for in a recognized way to assure consistency with other firms' accounting principles and for comparing various projects and investments with one another.

Chart of Accounts

The first step in setting up an accounting system is deciding what you want to track. A chart of accounts is simply a list and is kept by every business to record and follow specific entries. Whether you decide to use a manual system or a software program, you can customize the chart of accounts to a particular business.

Account numbers are used as an easy account identification system. The chart of accounts is the fuel for an accounting system. After the chart of accounts, you establish a general ledger system, which is the engine that actually runs an accounting system on a daily basis.

The chart of accounts is the foundation on which you will build an accounting system. Take care to set up a chart of accounts correctly the first time. Keep account descriptions as concise as possible, and leave plenty of room in a numbering system to add accounts in the future.

MANAGERIAL ACCOUNTING AND FINANCIAL MANAGEMENT

There are several concepts found in accounting systems that serve as decision-making tools for the business owner, manager, or professional.

Fixed, Variable, and Other Types of Costs

Fixed, variable, incremental, opportunity, and sunk costs describe different types of costs to the business.

Fixed costs include all costs that do not vary with activity for an accounting period. Fixed costs are the inevitable costs that must be paid at any time regardless of the level of output and of the amount of resources used. A fixed cost does not, in theory, vary with activity or sales. Such costs often include offices, factories, depreciation, and insurance or professional indemnity.

Variable costs are costs that are some function of activity. Variable costs include the obvious things such as sales commissions, raw materials, components, distribution, and deal financing.

Incremental costs are those costs (or revenues) that change due to an incremental change in activity, as compared to those that are unaffected. They are costs that would occur if a particular course of action were taken.

Opportunity costs refer to alternatives or opportunities that are sacrificed in favor of the chosen solution. Because resources are limited, any decision in favor of one project (service, goods, upgrade, etc.) means doing without something else.

Sunk costs include prior costs that cannot be recovered.

Activity-Based Costing

A financial analysis costing methodology associates specific efforts and personnel with specific tasks, allowing the tasks to be analyzed and the current costs dedicated to specific tasks to be well understood. A simple activity-based costing analysis can be an analysis of work performed by a specific employee or work unit in a year and the cost associated with each time the work is done to arrive at an annual cost for that activity. For example, a company considering outsourcing its payroll function may analyze how many people in the human resources and accounting departments are involved in processing payroll each pay period, assess the associated salaries and overhead, multiply by the number of pay periods per year, and arrive at an activity-based cost of payroll processing. This assessment may then be compared to the quote from an outsource payroll preparation company to determine the relative cost/benefit of outsourcing versus internally processing the payroll function.

TAXES

Small Business Tax Basics

Next to profits, taxes may be the most important issue facing every small business. You'll want to be sure that you are meeting all your responsibilities to the tax collector—and also seizing every opportunity to reduce taxes. Use these tax tips to make sure you're not giving Uncle Sam more than his due.

Writing It Off: Deductions

You can deduct all "ordinary and necessary" business expenses from revenues to reduce taxable income (see "Tax Deductions" subsection later in the chapter). Some deductions are obvious—expenditures in such areas as business travel, equipment, salaries, or rent. But the rules governing write-offs aren't always simple. Don't overlook the following potential deductions:

- ✔ *Business losses.* Business losses can be deducted against personal income to reduce taxes. If losses exceed personal income this year, you can use some of this year's business loss to reduce a taxable income in future years.

- *Employee taxes.* If you hire employees, you'll have to pay—or withhold from their salaries—a variety of taxes:

  Withholding. Social Security (FICA), Medicare, and federal and state income taxes must be withheld from employees' pay.

  Employer matching. You must match the FICA and Medicare taxes and pay them along with employees.

  Unemployment tax. Federal and state unemployment taxes.

Quarterly Estimated Taxes

This area of the tax code trips up many an entrepreneur and is especially vexing for home-based businesses. Failure to keep up with an estimated tax bill can create cash flow problems as well as the potential for punishing Internal Revenue Service (IRS) penalties. The antidote is simple—know your responsibilities:

- Who should pay? You probably must pay quarterly estimated taxes if you expect a total tax bill in a given year to exceed $500.
- How much should you pay? By the end of the year, you must pay either 90 percent of the tax you owe for the year or 100 percent of last year's tax amount (the figure is 110 percent if your income exceeds $150,000). An accountant can help you calculate payments. Otherwise, you can subtract expenses from your income each quarter and apply an income tax rate (and any self-employment tax rate) to the resulting figure (your quarterly profit).

Sales Taxes

Many services are under the taxable radar screen, but most products are taxable (typical exceptions are food and prescription drugs). States keep adding to the list of taxable services, however, so check with a state's department of taxation to find out if you should charge sales tax on services. If you do sell a product or service that is subject to sales tax, you must register with the state's tax department. Then you must track taxable and nontaxable sales and include that information on a sales tax return.

Deadlines

As a salaried worker, you have to remember just one or two tax-related dates: April 15 and perhaps December 31. But other dates may matter just as much or more when you are involved in your own business:

- ✔ *Annual returns.* Most annual returns are due April 15 for unincorporated companies and S corporations. A C corporation, though, must file an annual corporate return within two and a half months after the close of its fiscal year.
- ✔ **Estimated taxes.** Estimated taxes are due four times a year: April 15, June 15, September 15, and January 15.
- ✔ *Sales taxes.* Sales taxes are due quarterly or monthly, depending on the rules in a state.
- ✔ *Employee taxes.* Depending on the size of a payroll, employee taxes are due weekly, monthly, or quarterly.

Taxes and Incorporation

For federal tax purposes, it's often best for a start-up company to be an S corporation rather than a regular corporation. This is so even though recent changes in tax rates have made the decision a bit more complex. Still, to make sure an S corporation is best for you, speak to a knowledgeable accountant or tax adviser. Also keep in mind that a limited liability company (LLC) may be an even better choice.

Starting as an S corporation rather than a regular corporation may be wise for two reasons:

1. Income from an S corporation is taxed at only one level rather than two—a total tax bill will likely be less.
2. If a business operates at a loss the first year, you can pass that loss through to a personal income tax return, using it to offset

income that you (and a spouse, if you're married) may have from other sources.

Your decision to be an S corporation isn't permanent. If you later find there are tax advantages to being a regular corporation, you can easily change an S corporation status.

Employee Taxes

A business is responsible for collecting and filing some taxes on behalf of employees. The following is an overview of what you have to do to withhold and match taxes on an employee's paychecks:

- ✔ *Get an employer identification number (EIN).* A business must report employment taxes or give tax statements to employees; you need an EIN to do this. Get Form SS-4 (Application for Employer Identification Number) from the Web, or by calling 1-800-Tax-Form (1-800-829-3676).
- ✔ *Deposit employee withholdings on time.* Instead of paying the federal government directly, you deposit with an authorized financial institution such as a commercial bank (1) the income tax you have withheld and (2) both the employer portion and the employee portion of Social Security and Medicare taxes.
- ✔ *Issue Form 1099-Misc to independent contractors.* Doctors, lawyers, veterinarians, contractors, direct sellers, qualified real estate agents, and others who pursue an independent trade in which they offer their services to the public are usually not employees but independent contractors. A worker is defined as an independent contractor if he controls what he does and how the work is performed. What matters is that you have the right to control the details of how the services are performed.
- ✔ *Avoid payment penalties.* For an employer, paying and reporting employment taxes is a "fiduciary responsibility," and that responsibility is taken very seriously by Congress, the IRS,

and the judicial branch of the government. The IRS can impose deposit penalties ranging from 2 percent of the amount due (for payments that are one to five days late) to 15 percent (for amounts not paid within 10 days after receiving the first IRS notice).

Preparing for a Tax Audit

A tax audit is an experience every businessperson hopes to avoid. If the IRS does pay a business a visit, however, understanding what an auditor might look for can make the difference between a minor inconvenience and a major hardship. During a full-fledged audit, an IRS agent may look at several specific items in a tax return and business records, including:

- ✔ *Income.* The IRS will compare bank statements and deposits to the income you reported. They will also review invoices, sales records, and receipts, along with a general ledger and other formal bookkeeping records. If you received gifts of money or an inheritance, keep records to document how much you received. Without proof, the IRS may classify these as income and tax them as such. They will also classify any exchange of goods or services in lieu of cash (such as barter transactions) as taxable income.
- ✔ *Expenses and deductions.* An auditor may compare canceled checks, bills marked "paid," bank statements, credit card statements, receipts for payment or charitable gifts, and other business records to the expenses and deductions you reported on a return. They may pay special attention to reported debts or business losses; charitable gifts; and travel, meal, and entertainment expenses. Keep a log to substantiate travel, meal, and entertainment expenses and be sure to deduct only legitimate business expenses.
- ✔ *Loans and interest.* An auditor may review loan paperwork, deposits, bank statements, credit card statements, receipts, and canceled checks to verify that you used borrowed money only

to cover business expenses. This is important, because you are allowed to deduct interest on business-related loans.

✔ *Employee classifications.* The IRS will review employee classifications on a return and check this data against time cards, job descriptions, benefit plans, invoices, canceled checks, contracts, and other business records. Auditors will pay particular attention to independent contractor classifications, because many firms improperly classify regular employees as contractors.

✔ *Payroll.* Auditors will examine canceled checks, tax returns, deposits, business records, and other forms to check for completeness, accuracy, and timely filing. They will also review records documenting state, federal, and Social Security (FICA) withholding, Medicare taxes, advance earned income credit, unemployment compensation, and workers' compensation premiums. The IRS will also examine salaries and bonuses paid to owners and officers of a business to be sure they are legitimate and within industry standards.

✔ *Other records.* An auditor can also inspect records from a tax preparer or accountant, bank or other financial institution, suppliers, and customers. In addition to inspecting a business, an auditor may inspect personal finances. The IRS may compare a current lifestyle with the income presented on a tax return to determine if they are compatible. An auditor may also talk with others who are knowledgeable about you and your financial situation.

Tax Deductions

Taxes are an inevitable—and painful—part of every business owner's life. But there are ways to reduce, if not eliminate, a company's tax burden, if you know how to use business-expense tax deductions to an advantage.

Most business owners know they owe business taxes only on their net business profit—that is, their total profits after they subtract their deductions. As a result, knowing how to take full advantage of a deductible business expense can dramatically lower taxable profits. You can legally deduct a number of expenses commonly associated with a trade or business. Common deductions include:

- ✔ Employee wages and most employee benefits.
- ✔ Rent or lease payments.
- ✔ Interest on business loans.
- ✔ Real estate taxes on business property.
- ✔ State, local, and foreign income taxes assessed to a business.
- ✔ Business insurance.
- ✔ Advertising and promotion costs.
- ✔ Employee education and training.
- ✔ Education to maintain or improve required business skills.
- ✔ Legal and professional fees.
- ✔ Utilities.
- ✔ Telephone costs.
- ✔ Office repairs.

If you have a home-based business or a home office, you can also deduct a portion of residential real estate taxes, utilities, and telephone expenses as long as you can prove the legitimacy of the home-based business.

Finally, always maintain complete and accurate business records to document deposits, income, expenses, and deductions. If the Internal Revenue Service audits a business, it may require you to demonstrate that each entry on a tax return is correct.

Tax laws change annually, and they can be very complex. Always consult an accountant or tax attorney for assistance, strategies, and recommendations for an individual situation.

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