ACCOUNTING

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Accounting

- **Accounting and financial record keeping are necessary because, among many reasons, they can prevent the failure of a business.**
  - Many business fail due to the owner's lack of understanding of their business's financial situation.
  - Accounting and record keeping help a business owner to understand if their business is succeeding or failing and why.
  - The purpose of any financial record-keeping system is to provide a picture of the well-being of a business.
  - In addition to determining the well-being of a business, financial record keeping is also necessary for income taxes, loan applications, and to sell a business for a profit.
- ***Accounting* is the design, preparation, and interpretation of the recordkeeping system that a business uses.**
  - *Book-keeping* is the actual input of financial information into this recordkeeping system.
  - Accounting and book-keeping are usually standardized into one of two kinds of standard reports: balance sheet or a profit/loss statement.

Balance Sheet

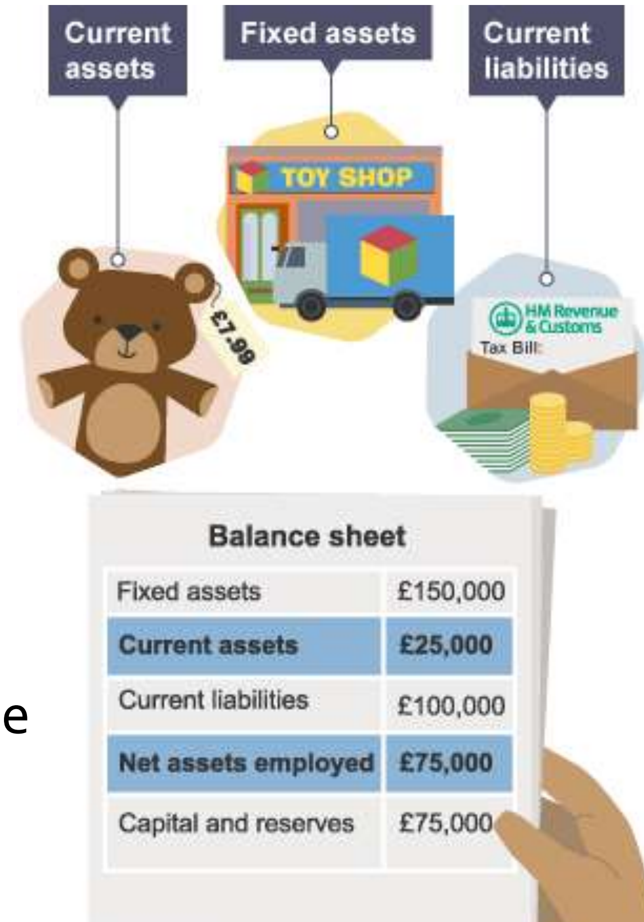
- **A <u>balance sheet</u> is a method of accounting that shows what a business owes and owns at a specific point in time.**
  - This allows anyone who looks at this sheet to be able to determine the relative financial health of the business at any point in time.
  - If the business owns more than it owes, it is in a healthy financial position.
    - *Vice versa, if the business owes more than it owns, it is in potential financial trouble.*
  - A balance sheet is usually prepared on the last day of a month, quarter, or year.
  - A balance sheet lists the amounts of business assets (what is owned) and liabilities (what is owed) in a standardized format for that particular point in time.

Balance Sheet		
As of Dec. 31, 2004 (000's)		
Assets	*2004*	*2003*
Cash and Equivalents	52,000	57,600
Accounts Receivable	402,000	351,200
Inventory	836,000	715,200
Total Current Assets	*1,290,000*	*1,124,000*
Plant & Equipment	527,000	491,000
Accumulated Depreciation	166,200	146,200
Net Fixed Assets	*360,800*	*344,800*
Total Assets	***1,650,800***	***1,468,800***
Liabilities and Owner's Equity		
Accounts Payable	175,200	145,600
Short-term Notes Payable	225,000	200,000
Other Current Liabilities	140,000	136,000
Total Current Liabilities	*540,200*	*481,600*
Long-term Debt	424,612	323,432
Total Liabilities	*964,812*	*805,032*
Common Stock	460,000	460,000
Retained Earnings	225,988	203,768
Total Shareholder's Equity	*685,988*	*663,768*
Total Liabilities and Owner's Equity	***1,650,800***	***1,468,800***

Source: http://figures.boundless.com/11029/full/balance-sheet.png

Assets

- **What a business owns is known as an __asset__.**
  - Examples of assets include cash on hand or in a bank, personal property such as equipment, vehicles, tools, or supplies, inventory (materials that will be sold to customers), real estate, buildings, land, and money that is owed to the business.
- **Money that is owed to the business is called its __accounts receivable__.**
  - *__Accounts receivable__ is basically the money that a company hopes to eventually receive.*
- **Assets are usually broken into two categories: current assets and fixed assets.**
  - __Current assets__ consist of cash, accounts receivable, and inventory.
    - *Current assets are usually considered anything that could be converted to cash within one year.*
  - __Fixed assets__ are more permanent and include vehicles, equipment, machinery, land, and buildings.



Source: www.bbc.co.uk304

Liabilities

- **What a business owes is called its <u>liabilities</u>.**
  - Examples of liabilities include long-term debts (mortgages on real-estate or a business loan) or short-term debts (such as inventory purchased with a credit card or taxes).
- **Money that is owed to others is called the <u>accounts payable</u>.**
  - Accounts payable is basically the money a company hopes to eventually be able to pay.
- **The <u>equity</u> of a business is also considered a liability.**
  - <u>Equity</u> is the value of the ownership of the business.
  - Equity is basically the value that would be left over if all the debts of the business were paid off.
  - For partnerships and sole proprietorships, the business equity is the net worth of the business.
  - If the business is a corporation, the business equity is called the capital surplus.
- **In sum, the liabilities of the business are all debts (short- and long-term), as well as the equity of the business.**

Liabilities

- **Three kinds of liabilities exist in accounting.**
  - <u>Current liabilities</u> are those that a business must completely pay within one year. These include accounts payable and taxes.
  - <u>Long-term liabilities</u> are those that a business must pay off over time, such as a mortgage or a loan.
  - <u>Owner's equity</u> is whatever is left after debts are subtracted from assets.
- **If a business's books are <u>balanced</u>, this means that the total value of all assets are equal to the total value of all liabilities.**
  - Another way to consider this: Assets = Debts + Equity.
  - Rearranging this equation would provide us with: Equity = Assets – Debts.

Source: www.iexpats.com

Profit & Loss Statement

- **A <u>profit & loss statement</u> is the other kind of business report (the first being the balance sheet).**
  - A profit/loss statement is a summary of the income and expenses of the business during a certain period.
  - Profit/loss statements are usually prepared monthly, quarterly, or annually.
  - Profit/loss statements are sometimes referred to as income statements or operating statements.
- **Typically a profit/loss statement will be organized so that all the income for a specific period is together and all the expenses for that same period are also together.**
  - All the income and all the expenses will be totaled beneath each category.
  - At the bottom, the total expenses will be subtracted from the total income to provide the <u>net profit</u> (the income left after expenses).
- **<u>Income</u> is any money that a business will receive during a certain period.**
  - <u>Expenses</u> are any money that the business has paid or will pay during a certain period.
  - <u>Profit</u> occurs when income exceeds expenses.
  - <u>Loss</u> occurs when expenses exceed income.

Profit Loss Statement

INCOME

For Dates Submitted Between: 05/01/03 and 05/31/03

Category	
	$579.00
Car Rental	$243.00
Electric	$200.27
Food	$27.00
Lodging	$550.50
Mailing	$45.00
TOTAL INCOME	$1,644.77

Expenses

Category	
Electric	$210.00
Entertainment	$55.23
Food	$34.27
Lodging	$115.00
Travel	$455.00
TOTAL EXPENSES	$869.50
OVERALL TOTAL	$775.27

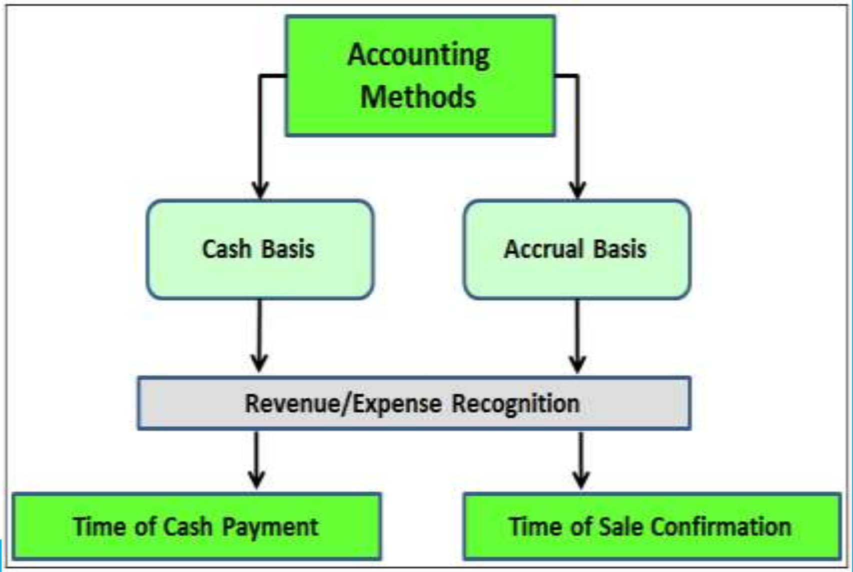
Source: http://www.bookkeeping-basics.net/images/profit-and-loss.gif

Income

- **Income can be broken into two types: service and sales.**
  - <u>Service income</u> comes from providing a service for someone.
    - *Profit can be determined simply by deducting the expenses of making the income from the income itself.*
    - *E.g. if you received $20 for cutting a friend's hair and you spent $5 on gas, your profit would be $15.*
  - <u>Sales income</u> comes from selling a product.
    - *Profit from sales income is determined by subtracting both the cost of producing the product as well as the cost of the materials of the product from the income of that product.*
    - *For example, if you are selling cookies, you would have to subtract the cost of the flour, eggs, milk, and sugar as well as the cost of the electricity and gas from the total income of selling the cookies.*
    - *For sales income, the actual income from selling a product is the sale income minus the cost of the product to the seller.*

Cash vs. Accrual

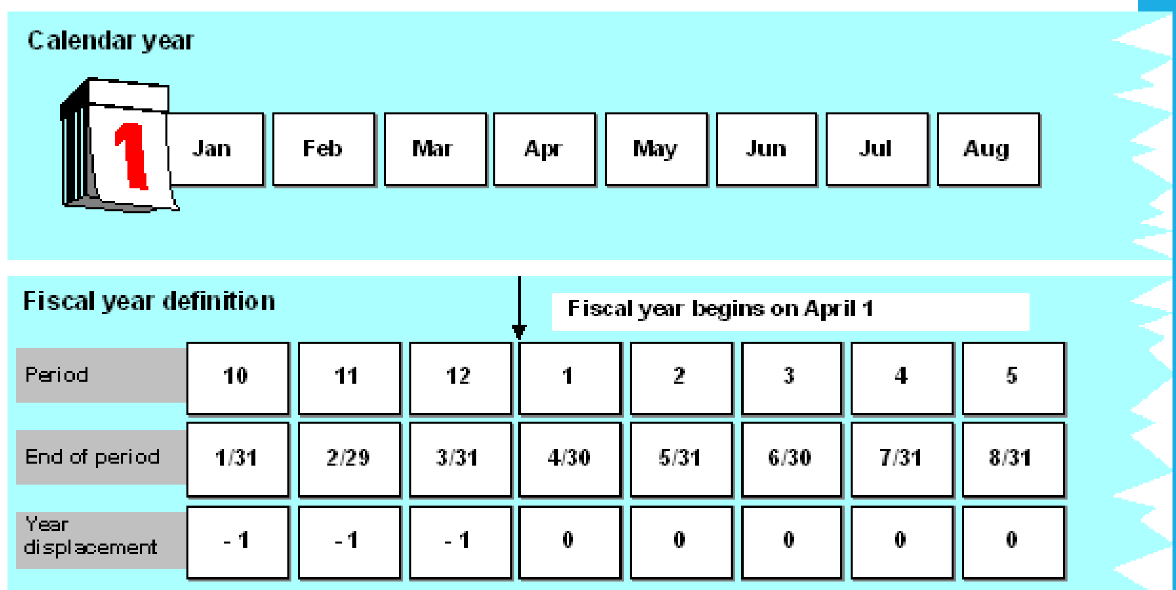
- **There are two basic methods for measuring the transactions of a business: cash method and accrual method.**
  - The <u>cash method</u> of accounting is a system that records income when it is received and records expenses when they are paid.
    - *This method is legal for your business if it has an annual gross revenue of less than $1 million for three⁺ years.*
  - The <u>accrual method</u> of accounting counts income and expenses when they are due to the business.
    - *Income is recorded when the due date for the payment has been reached (even if the payment was not received).*
    - *Expenses are recorded when they are due (even if they have not been paid).*
    - *If a business has inventory, it is wise to use the accrual method in order to accurately track inventory.*



Source: http://campbellpropertymanagement.com/blog/wp-content/uploads/2014/04/Accounting-Methods.png

Fiscal vs. Calendar Years

- **A business is allowed to choose between a fiscal year accounting period and a calendar year period.**
  - A <u>fiscal year</u> consists of 12 consecutive months that do not end on December 31st.
  - A <u>calendar year</u> consists of 12 consecutive months that always end on December 31st.
  - If a sole-proprietorship reports income on a fiscal year, then all non-business income must also be reported on the same fiscal year.
  - This can complicate tax reporting and should be avoided.
- **Partnerships and corporations would only choose to use a fiscal year if there is a valid business purpose that supports the use of a fiscal year (such as a growing season or tourist season that continues through December and January).**
  - If a fiscal year is used, a tax accounting professional should be consulted.
  - For most small businesses, the choice of a calendar year period is sufficient and will simplify tax purposes.



Source: http://help.sap.com/static/saphelp_46c/en/96/8b2fc843ce11d189ee0000e81ddfac/Image387.gif

Chart of Accounts

- **Once you know the specific needs of your business, you can set up an array of specific accounts to handle your financial records.**
  - The set of general accounts for your business are called the <u>chart of accounts</u>.
  - A <u>chart of accounts</u> will list all the categories of financial transactions which you need to track.
- **It is possible to run a business and merely keep track of your income and expenses without any itemization.**
  - The downside of this approach is that you wouldn't be able to analyze how the business is performing in regards to each of its components.
  - You would also be unable to properly complete the necessary information for business income tax returns.
- **A chart of accounts should also include the different types of income your business will receive.**
  - Creating these accounts is simply a matter of determining the categories under which each kind of expense and income would fall under and selecting a name and number for that category.

Chart of Accounts

As at July 17, 2008

Fisher-Fleming & Company

Account No.	Description
1011	Seattle Savings & Loan - General
1031	First National Bank - General
1041	SeaFirst Bank - General
1111	Seattle Savings & Loan - Trust
1131	First National - Trust
1141	SeaFirst Bank - Trust
1201	Accounts Receivable
1205	Allowance for Doubtful Accounts
1301	Value Added Tax Refundable
1351	Prepaid Expenses
1511	Furniture & Equipment
1521	Library
1531	Leasehold Improvements
1541	Computer Equipment
1551	Office Equipment
1611	Acc Dep - Furniture & Equipment
1621	Acc Dep - Library
1631	Acc Dep - Leasehold Improvements
1641	Acc Dep - Computer Equipment
1651	Acc Dep - Office Equipment
1701	Goodwill
2001	Accounts Payable
2042	State Tax Payable
2111	Seattle Savings & Loan - Trust Liability
2131	First National Bank - Trust Liability
2141	SeaFirst Bank - Trust Liability
2191	General Reserve - Trust Liability
2301	Value Added Tax Remittable
2341	Due to IRS
2501	Loans Payable
3011	Capital - Smith
3041	Capital - Jones
3071	Capital - Burwell
3111	Drawings - Smith
3141	Drawings - Jones
3171	Drawings - Burwell
3999	Retained Earnings
4001	Client Fees
4101	State Tax Commission Income
4501	Disburse Recover
4701	Other Charges Recovered
5001	Client Disburse
6001	Accounting
6005	Advertizing & Promotion
6007	Amortization of Goodwill

Chart of Accounts

- **The main reason for creating a chart of accounts is separate and itemize the amount spent in each category so that you have the information that you will need to determine the health of your business and for filing taxes.**
  - For example, by itemizing expenses and income you can determine if the extra business from offering a sale offset the lost income of that sale.
  - In addition to allowing you to analyze the likelihood of success of your business, this will also ensure that your business can take the maximum allowed deductions and minimize your tax bill.
- **Typically income categories are assigned a number between 10-29.**
  - For example, sale income could be assigned the number 11, service the number 12, interest the number 13, etc.
  - Expenses may be assigned numbers 30-79.
  - Balance sheet accounts for assets and liabilities can be assigned numbers 80-99.
- **If your business needs more categories than allowed by a 2-digit system, expand to three.**
  - For example, if you have multiple kinds of sales income, you could use 110-119 as the codes for these accounts.

Asset Types

- **Once you have set up your chart of accounts, you will need to open a bank account for your business.**
  - Once an account has been set up, you will need to prepare a method to keep track of the assets of the business.
  - These assets will then need to be separated into current (could be converted into cash within a year) and fixed (long-term assets).
- **Current assets typically consist of at least the following (some businesses may have other accounts as well):**
  - Business bank checking account.
  - Business bank savings account.
  - Petty cash (cash on hand for miscellaneous needs).
  - Accounts receivable (money owed to the business).
  - Inventory.
- **At minimum, these accounts must be updated at the end of the year for tax purposes; a business owner may wish to do this quarterly or monthly for more accurate analysis of their financial standing.**

Current Asset Account Record

- **Assets can be tracked using a <u>Current Asset Account Record</u>.**
  - On this form, a business owner will periodically track the value for all assets except inventory.
    - *Inventory should be tracked using specialized inventory records.*
- **Any business which sells an item of merchandise to a customer must have a system to keep track of inventory.**
  - <u>Inventory</u> is considered any merchandise or materials which are held for sale during the normal course of your business.
  - Inventory includes the cost of the merchandise or products that will be sold as well as the costs of the materials and paid labor which were used to create the finished product.
    - *Inventory does not include the costs of equipment or machinery needed to create the product (these are fixed assets, not current assets).*

Inventory Control

- **An effective system of inventory control is needed because…**
  - You will need to keep track of what you have ordered, what is in stock, and when you will need to reorder.
  - You need to keep track of the cost of your inventory for tax purposes.
    - *The only portion of your inventory costs that reduce your gross profit for tax purposes are the actual cost of goods which you have sold during the tax year.*
- **For the purposes of filing taxes, you will need to know how much inventory is on hand at the beginning of the year, add any inventory purchased over the course of the year, and subtract whatever is left at the end of the year.**
  - [value of inventory on Jan 1] + [inventory purchased Jan-Dec] = Cost of Inventory
  - [cost of inventory for that year] – [inventory left Dec 31] = Cost of Goods Sold for that year
- **Cost of goods sold for that year is needed to determine your tax obligations.**
  - For example, if you had \$500 of inventory at the start of the year, purchased \$400 more inventory from Jan-Dec, and had \$600 of inventory left on Dec 31st, your cost of goods sold would be [\$500 + \$400] - \$600 = \$300

Janis' Correct Cost of Goods Sold	
Beginning Inventory	$0
Purchases	37,500
Less: ending inventory	(12,500)
Cost of sales	$ 25,000

Source: http://www.understand-accounting.net/images/cgs1.jpg

Bibliography

- *All information in this presentation was based on the book Sole Proprietorship Small Business Start-up Kit by Daniel Sitarz (2011 Nova Publishing Company, Carbondale IL).*

- *The author of this presentation claims no ownership of this text or the ideas claimed within.*

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