CHAPTER 3

ACCOUNTING AND BOOKKEEPING

Most operators of a new and growing business have a flair for the environment in which the business operates. They may be a great salesperson, an outstanding mechanic, carpenter, lawyer, or inventor. Unfortunately most people don't like to keep the books. As an owner of a business you must remember that your company's books and financial statements represent a score sheet. This score sheets tells you how the is business is progressing, and functions as an early warning system, to let you know when and why the business may be going amiss. Financial statements, tax returns and the underlying records will provide the basis for many decisions made by outsiders, such as banks, landlords, potential investors, and trade creditors, as well as taxing authorities and other governing bodies. The necessity for good, well-organized financial records cannot be over-emphasized. Two of the greatest mistakes made by owners of small businesses are not keeping good financial records and then making improper or poor business decisions based on inadequate information.

Quality financial information does not necessarily translate into complicated bookkeeping or accounting systems. Far too often owners of businesses become overwhelmed by their accounting system to the point where it is of no use to them. An accounting or bookkeeping system is like any tool used in your business; it needs to be sophisticated enough to provide the information you need to run your business and simple enough for you to run it (or supervise the bookkeeper). Questions you should ask in developing an accounting and financial reporting system are:

1. Who will be the users of the financial information?
2. What questions do I need answered to manage the business?
3. What questions should be answered for government or regulatory taxing authorities?

As your business grows, you should work closely with your accountant to ensure that your accounting system is providing you with appropriate information.

Chart of Accounts

The basic road map into any accounting system is the chart of accounts. It is this chart which helps establish the information which will be captured by your accounting system, and what information will subsequently be readily retrievable by the system. While it may seem that developing a chart of accounts is not particularly high on your list of things to do as you start a new business. However, the amount of time and money saved by a well-organized accounting system can be significant, as you are able to monitor the progress of the business and generate information needed for various purposes. Also, this tool, like the rest of the accounting system, needs to be dynamic and should grow as the size and needs of your business change.

To help establish a good working chart of accounts you need to answer some questions about how your business will operate, and what is important to you. Each one of these questions can have several answers and will probably generate more questions. In conjunction with your accountant, use the information generated from this analysis to structure the chart of accounts.

Consider the following questions:

1. Will your business have inventory to account for? If so, will it be purchased in final form or will there be production costs?

2. Are fixed assets (property and equipment) a significant portion of your business?

3. Will you sell only one product or service or will there be several types of business?

4. Will you have accounts receivable from customers which you will need to track?

5. Are you going to sell in only one location or will you do business in several locations?

6. Are the products you sell subject to sales tax?

7. Do you need to track costs by department?

8. To what type of government controls or regulatory reporting are you subject?

An example of a basic chart of accounts follows this section.

Cash or Accrual Accounting

One of the decisions to be made as you start a business, is whether to keep your records on a cash or accrual basis of accounting. The cash basis of accounting has the advantage of simplicity and almost everyone understands it. Under the cash basis of accounting, you record sales when you receive the money and account for expenses when you pay the bills.

Unfortunately, as we all know, the business world is not always so easy. Sales are made to customers and you sometimes must extend credit. Your business will incur liabilities which are due even though you may not have received the invoice or have the cash available to pay them.

Most users of financial statements, such as bankers and investors, are accustomed to accrual basis statements and expect to see them. Once you become familiar with them, they provide a much better measuring device for your business operations than cash basis statements.

Whether you use the cash or accrual basis, it is usually possible to keep books for income tax purposes on a different basis than for financial statements. It may be more advantageous (less tax) for you to do so. However, not all businesses are eligible to use the cash basis of accounting for tax purposes. Your accountant can advise you on the advantages and feasibility of doing this in your particular circumstances. One of the considerations is the additional cost of keeping two sets of records.

Accounting Records and Record-Keeping

Another question which the owner of a business must answer is "Who will keep the books of the business?" Will you do it yourself, will the receptionist or a secretary double as a part-time bookkeeper, will you have a bookkeeper that comes in periodically, or will the volume of activity be such that a full-time bookkeeper will be required?

Very often the owners of a business decide to keep the books themselves and underestimate the commitment they have made to other phases of the operation and the time required to maintain a good set of financial records and books of account. As a consequence, the record-keeping is often low priority and must be caught up later. This approach, though rarely planned, can require a substantial expenditure of time and money. While it is important for the owners of a business to maintain control and stay involved in the financial operations of the enterprise, this can be achieved by maintaining close control over the check signing function and scrutinizing certain records. Your company's accountant can help develop a good program of record keeping duties for you, your employees and any outside bookkeepers you may engage.

A Word About Computers

The computer is probably the single most valuable invention for bookkeeping and accounting since the advent of double entry bookkeeping. If your business includes any of the following then a computer would be a useful tool in your business.

1. Many repetitious or routine tasks
2. Lots of paperwork; i.e., payroll checks, invoices, purchase orders, mailing labels.
3. Lots of general correspondence
4. Written reports, contracts, newsletters, catalogues or brochures.

Your accountant should understand both your business and computers so he or she can take much of the confusion out of the selection process by assisting you in the purchase and installation of your computer and software.

There are a number of very good, easy to use accounting software systems which are commercially available, but none of them will solve the problems of inaccurate or poor quality financial records. All they will do is generate bad information faster. This is one of the reasons that the computer has also probably caused more headaches for the owners of modern businesses than any other single cause. If you want to use a computer based accounting package, either in your own business, with a service bureau or through your accountant, it is imperative that you generate accurate information to be entered into the system.

The real value of the computer becomes apparent once it is running smoothly in your business. Your accountant can then function in the capacity for which he was trained not as a "number cruncher", but as your business advisor, consultant, and strategist. Both of you can focus not on producing reports for various regulatory agencies but on analyzing your business to make it more profitable.

Internal Control

What is internal control? It is the system of checks and balances within a business enterprise which helps to ensure that the company's assets are properly safeguarded and that the financial information produced by the company is accurate and reliable. When you're operating as a "one man shop" or at least handling all of the company's financial transactions, maintaining good internal accounting control is relatively straight forward.

However, when your company grows to the size where you must delegate some of the functions it becomes more difficult to ensure that all the transactions are being accounted for properly.

No matter the size of your business, you should always be able to answer "yes" to the following questions:

1. When my company provides goods or services to our customers, am I sure that the sale is recorded and the revenue is recorded in accounts receivable or the cash is collected?

2. When cash is expended by my company, am I sure we received goods or services?

The methods used to ensure that these two questions can be answered affirmatively will vary widely. The solution in your particular instance may be as simple as numbering the sales tickets and being sure **ALL TICKETS ARE ACCOUNTED FOR** or reviewing all invoices and timecards before signing company checks. These are fundamentals in a well run business. As the company grows you will need to consider concepts such as segregation of authority as well as employee fidelity bonds or controlled access storerooms. These are essential stepping stones to maintaining good control in your business.

No matter what the size of your enterprise is, you should consider how you are controlling your business and that safeguarding your hard-earned assets should be a priority from the beginning.

Illustrative Chart of Accounts

Current Assets:

1000	Cash
1120	Accounts Receivable
1125	Allowance for Uncollectibles
1130	Inventory
1140	Prepaid Rent
1150	Prepaid Expenses

Fixed Assets:

1310	Equipment
1320	Furniture and Fixtures
1330	Automobile
1340	Leasehold Improvements
1350	Accumulated Depreciation

Intangible Assets:

1410	Goodwill
1420	Organizational Costs
1430	Accumulated Amortization
1440	Deposits

Current Liabilities:

2100	Notes Payable
2110	Accounts Payable
2120	Interest Payable
2130	Salaries Payable
2140	Income Tax Payable
2150	Sales Tax Payable
2160	Federal Withholding and FICA Tax Payable
2170	State Withholding Tax Payable
2180	Federal Unemployment Tax Payable
2190	State Unemployment Tax Payable
2200	Advances from Customers

Long-Term Liabilities:

2410	Mortgage Payable
2420	Credit Line Payable

Stockholder’s Equity:

3510	Capital Stock
3650	Retained Earnings

Revenue:

4000	Sales
4100	Returns and Allowances

Cost of Goods Sold:

5100	Purchases
5110	Freight
5120	Direct Labor

Expenses:

6010	Advertising
6020	Bank Charges
6030	Contract Labor
6040	Depreciation and Amortization
6050	Dues and Subscriptions
6060	Employee Benefits
6070	Insurance
6080	Interest Expense
6090	Janitorial
6100	Professional Fees
6110	Meals and Entertainment
6120	Office Expense
6130	Payroll
6140	Postage and Shipping
6150	Rent
6160	Repairs and Maintenance
6170	Supplies
6180	Taxes - Income
6190	Taxes - Payroll
6200	Taxes - Other
6210	Telephone
6220	Travel
6230	Utilities

Other Revenue:

7010	Interest Income
7020	Other Income