The Ultimate Guide to Small Business Accounting

sas

Specialty Answering Service

Disclaimer

Specialty Answering Service's Ultimate guide to Small Business Accounting eBook is intended as general guidance only and may not apply to your business or situation based on your individual circumstances. Specialty Answering Service makes no claims or guarantees regarding the accuracy of this information and material. The content of this eBook is not designed to provide professional or authoritative advice in accounting. If expert accounting assistance is needed, please seek the help of an accounting professional.

Most small business owners

are likely flying solo from the get-go, managing every aspect of the business themselves – be it sales, marketing, after-sales service or even bookkeeping. Once you reach a certain scale, it makes sense to bring in professional accountants. Bookkeeping is a nightmare, so small business owners will often opt to hire a per diem accountant to handle this chore. This ensures that tasks are efficiently addressed, compliance requirements are met, and accounting data is reviewed for useful metrics.

Per diem accountants can do any number of things for you such as payroll, tax preparation, and bank reconciliation. They can also help you identify and liaise with sources of financial and technical assistance for your small business. Several resources are listed below:

- The Small Business Administration (SBA)
- SBA-guaranteed loans from banks
- Trade organizations
- Tax incentives available for hiring minority employees
- Federal government-funded loans from local community banks
- Service Corps of Retired Executives (SCORE), a nonprofit organization

Having the right bookkeeper on your team will definitely take some weight off your shoulders, but you still need to be on top of things to run a profitable business. That includes creating and managing your budgets, recording your transactions accurately (a key element for tax season), reviewing your financial health, and initiating corrective actions when necessary. To get started, you'll need to have a basic understanding of business financing concepts, a list of must-do activities, and a monitoring process to periodically evaluate your business.

> “Per diem accountants can do any number of things for you such as payroll, tax preparation, and bank reconciliation.”

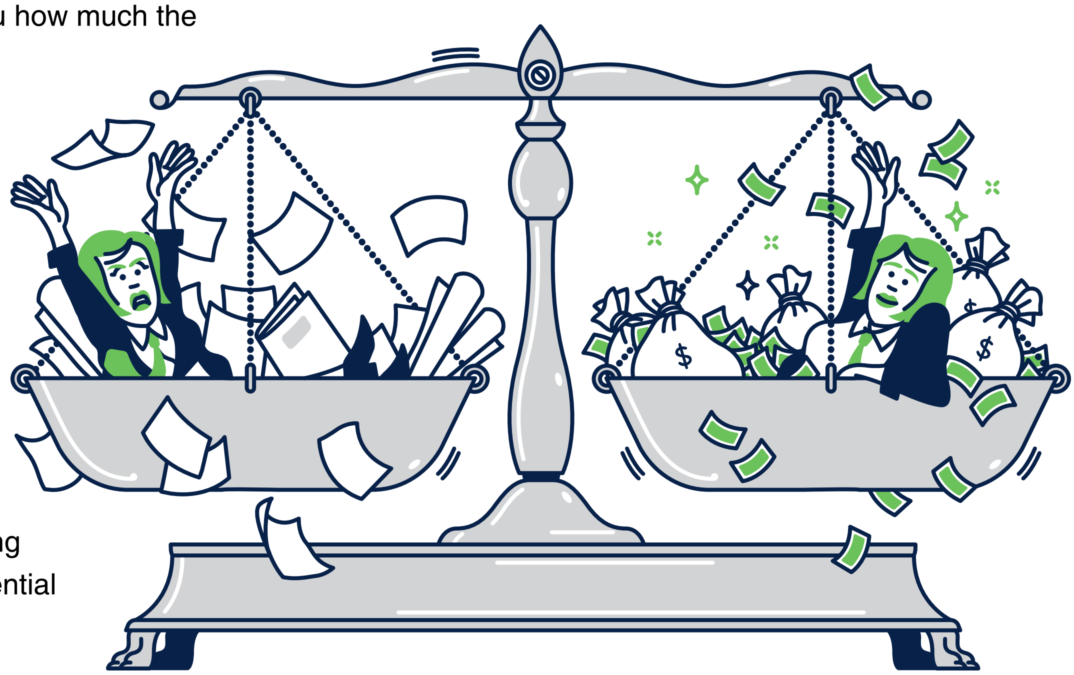
The financial health

of any business – large or small – can be judged by three classic financial measures: the Balance Sheet, the Profit and Loss Statement, and the Cash Flow Statement. As a business owner, understanding what each of these portrays will give you the information you need to strategically deploy your funds, and make the right operational choices from a financial perspective.

☑ **The Balance Sheet**, or "Statement of Financial Position," is a snapshot of your business at any given point in time and will show you the ratio of what you have vs. what you owe. In other words, it tells you how much the business is worth.

☑ **The Profit and Loss Statement**, also known as an "Income Statement" or "Earnings Statement," tells you whether the business is profitable or not. It is required by the IRS in order to assess taxes on your earnings.

☑ **The Cash Flow Statement** predicts your future cash balances by showing you cash in vs. cash out. Knowing where your money is going can help you identify potential areas for cost savings.



These items should also be included in your business plan, which is essential if you're trying to secure a bank loan. Your accountant can establish a strong relationship with your banker and assist you with:

- **Making your business plan "banker-friendly."**
- **Providing estimates of your future cash needs by preparing cash flow control statements.**
- **Preparing a personal financial statement, including your personal balance sheet (personal assets and liabilities), profit and loss, and cash flow statements, which may need to be submitted as a guarantee for acquiring a business or bank loan.**

> **"Every business owner should have an understanding of the three classic measures that judge the financial health of a business."**

If you are a new business owner,

then you will need to determine which method of accounting is right for you: cash basis or accrual basis. Give this considerable thought, as once you choose, you'll need to stick to it.

☑ **Cash Basis:** With the cash method, income is when you receive cash, and expenses are when you pay the bills. Most small businesses operate on a cash basis, as it is easier to understand.

☑ **Accrual Basis:** With the accrual method, revenues and expenses are recorded when the transaction is made, regardless of whether cash is exchanged or not. So, when a product is sold, it is recorded in Accounts Receivable and then moved to the Cash account when payment is received. And when an expense is incurred, it is recorded in Accounts Payable until the payment is made. The IRS mandates accrual-based accounting if you hold inventory.

If your business has inventory, you could opt for a hybrid of both methods. For example, the cash method would be used to track income and expenses, and the accrual method would track inventory. Each method has it's pros and cons, and your accountant can work with you to determine which is the best fit for your small business.

"Your accountant can work with you to determine which method of accounting is best for your small business."

When it comes to accounting,

small business owners are generally at a loss as to what to do and when to do it. In order to keep your accounting practices streamlined, you'll need a timeline of tax-related activities that you will manage separately as daily tasks, weekly tasks, monthly tasks, quarterly tasks, and annual tasks.

DAILY TASKS

Cash Verification

The key ingredient to keeping your business running is cash. Make it a daily practice to verify your cash position, and take a look at your payables and receivables each day, as well. This way, you'll know exactly what you have on hand.

Record Transactions

When working with your accountant, you'll need to provide well-maintained records of your business transactions. These include customer invoices, receipts, vendor payments, etc. If your transaction volume is small, you may record them manually or using Excel sheets. However, accounting software such as QuickBooks has several advantages, and the benefits often outweigh the costs.

> "Make it a daily practice to verify your cash position."

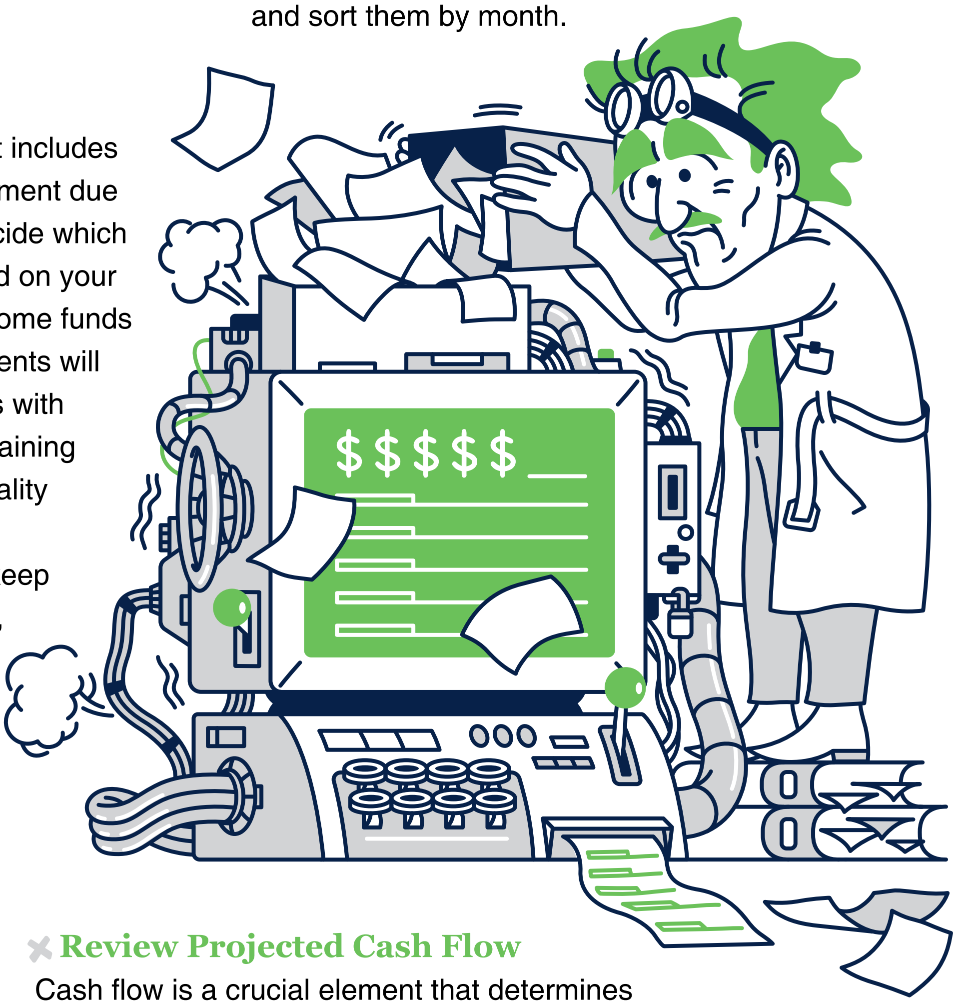
WEEKLY TASKS

Documentation & Filing

Most small businesses keep all paper receipts in a box and only sort them at tax time. A much easier approach would be to have separate files for different receipts, and sort them as they are generated. If you use accounting software, you can scan paper receipts and invoices, and file them electronically.

Be sure to retain copies of all invoices, receipts, and payments (be it cash, check or credit card). In addition, the following files need to be maintained:

- ☑ **Vendor File:** If you rely on multiple vendors, like an answering service, it's a good idea to have an alphabetical vendor file.
- ☑ **Payroll File:** Keep a payroll file, and sort it by payroll date.
- ☑ **Bank File:** Organize your bank statements and sort them by month.



Vendor Management

Create an "Unpaid Vendors" file that includes billing dates, amounts due, and payment due dates, and review this regularly. Decide which payments to make each week based on your cash flow position. Then, earmark some funds for supplier payments. Timely payments will help you develop great relationships with vendors, and this can give you bargaining power for more discounts, better quality products, and an extension of credit during a lean phase. Make sure to keep copies of all invoices and payments, even if they are made online.

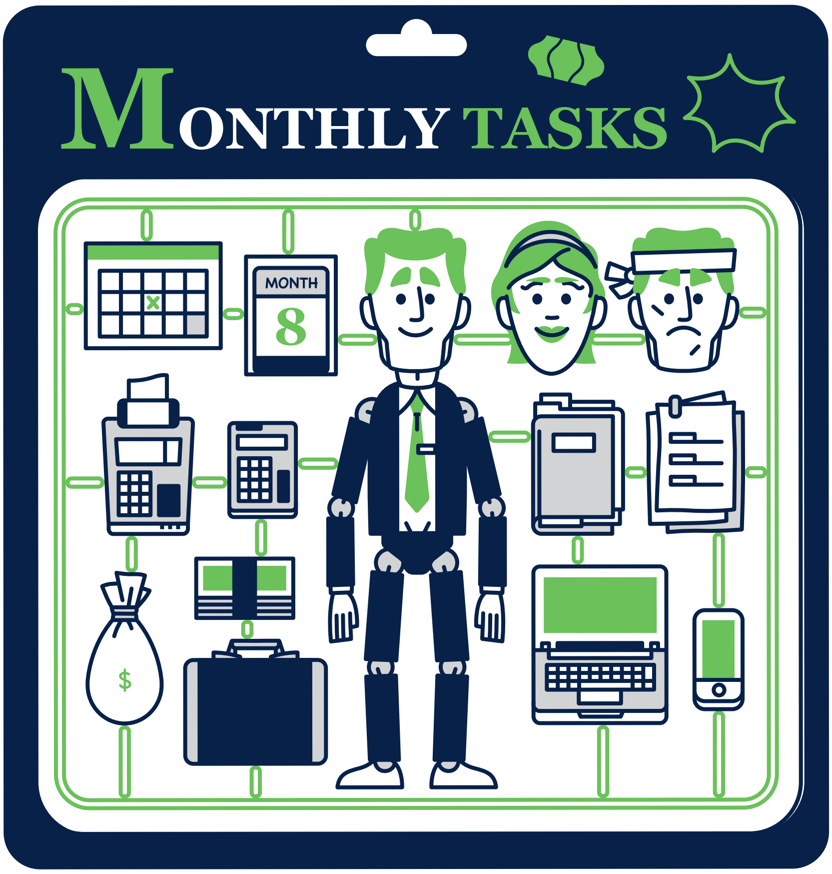
Invoice Management

On a weekly basis, prepare all invoices for clients that you have been servicing and any upfront billing that you may want to do. Don't forget to include payment terms in your invoices – most invoices are "Net 30," which means they are due within thirty days. You can also consider offering incentives for early payments.

Review Projected Cash Flow

Cash flow is a crucial element that determines the survival of your business in its initial years. Review your projected cash flow, and set aside enough cash for paying suppliers and employees. You don't need an accountant's help to maintain a simple statement that shows your current cash in hand, expected receipts, and expected payments during the next week.

> "Don't wait until tax time to sort paper receipts."



Business Checkbook Reconciliation

To ensure that you're working with the correct cash position, balance your business checkbook on a monthly basis to verify that all transaction entries are accurate, and that any errors or omissions, either by you or by the bank, can be corrected in a timely fashion. For more information on bank reconciliation, including step-by-step instructions, skip ahead to page 13.

Receivables Aging

While maintaining records of open invoices, include details of "aging" – the number of days a bill is past-due. This will help you quickly identify customers who are defaulting so that you can take the necessary actions, such as sending reminder statements, making phone calls, and in extreme cases, discontinuing their service. At the end of the year, the aging details will help you determine which debts should be written off and which should be carried over into the next year.

Analyze Inventory Status

If your business has inventory, then you need to manage inventory levels at least on a monthly basis. Reorder products and raw materials that are being consumed at a fast pace, and take a look at the stragglers that may have to be marked down, bundled with other fast-moving products, or written off. Reviewing inventory monthly ensures that you are not short on products or overloaded with dead stock.

Payroll & Tax Management

While employees are typically paid once every two weeks, there are different timelines for payroll tax requirements based on federal, state and local laws. As a small business owner, you will need to sit down with your accountant to structure payroll such that the applicable taxes are appropriately withheld. Prepare a calendar of activities, and set reminders to follow up with your accountant to ensure that the pertinent taxes and dues – income, social security, Medicare, disability, etc. – are paid and reported in a timely manner.

Review Financial Performance Against Budgets & Prior Periods

Preparing a budget before the year begins is essential. Then, compare your income statement against your budget, both for the month and for the year to date. Looking at actual performance vs. target numbers will help you determine where your dollars have been going so that you can make corrections as needed. You can also compare this year's and last year's income statements to see how much better or worse you are performing on a year-to-year basis.

You should also generate a monthly balance sheet to compare against prior periods. Your accountant or basic accounting software can do this for you. If your business is cyclical, compare the numbers against the same timeframe during the previous year. Otherwise, compare them against the previous month. Balance sheet reviews helps improve asset and liability management. For example, if accounts payables are up, it may be because you don't have the cash to pay your suppliers, or you may have increased orders anticipating sales growth.

> **“Compare this year's and last year's income statements to see how much better or worse you are performing on a year-to-year basis.”**

QUARTERLY TASKS

Review & Modify Your Income Statement Estimates

Every quarter, meet with your accountant to review and revise your income statement estimates for the year. In addition, this is a good time to do a root cause analysis on variances in your income statement, and decide on any changes you may need to make in your business approach. Are you burning cash faster than expected? Would it be beneficial to drop customers who are too expensive to serve, with no corresponding results? Should you arrange for another line of credit? These and other questions are best answered by you, your accountant, and your sales director.

Review Your Tax Returns

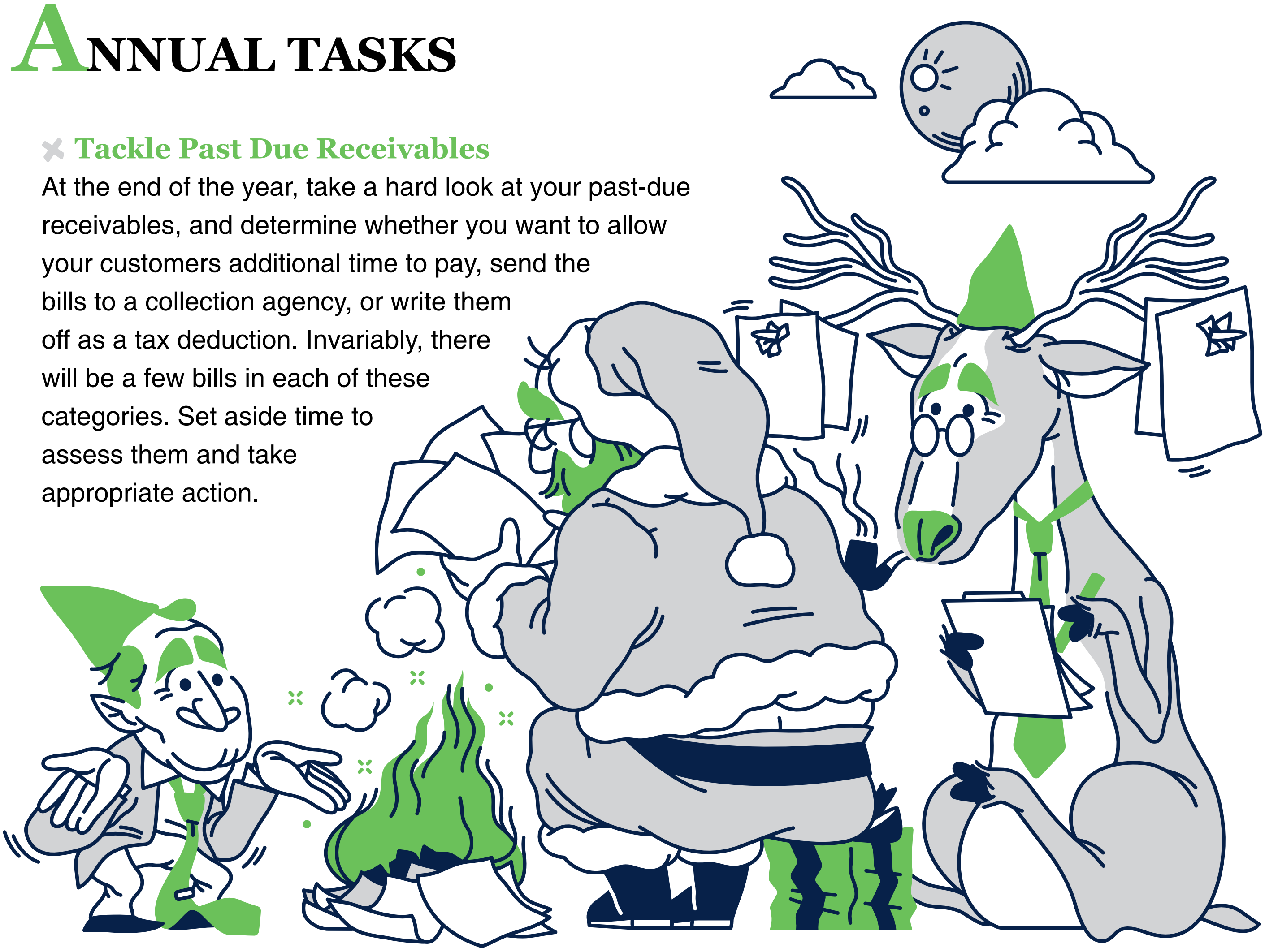
While your accountant and payroll service provider will work on preparing the payroll tax, income tax, and sales tax returns, you will still need to review these reports to make sure they have the correct figures.

> “Every quarter, meet with your accountant to review and revise your income statement estimates for the year.”

Annual Tasks

Tackle Past Due Receivables

At the end of the year, take a hard look at your past-due receivables, and determine whether you want to allow your customers additional time to pay, send the bills to a collection agency, or write them off as a tax deduction. Invariably, there will be a few bills in each of these categories. Set aside time to assess them and take appropriate action.



Manage Inventory

Be bold when you review your current inventory. Determine the value of the unsold items, and remember that any write-down of inventory translates to a tax deduction. If you do not think your inventory can be sold, then you need to write it down to avoid paying additional taxes for overstating stock.

File IRS Forms

File IRS forms for your full-time employees (W-2s) and independent contractors (1099s). Be sure to report their annual earnings to the IRS, and mail copies of the tax forms to each employee before the January 31st deadline. Your accountant can help you with these filings.

Review & Approve Financial Statements & Tax Returns

While your accountant will help you prepare your annual financial statements and tax returns, it is your responsibility to review them for accuracy. Before you sign off, sit down and discuss any items that you do not understand. In the event that your taxes are underpaid, the IRS will penalize you, and not your accountant.

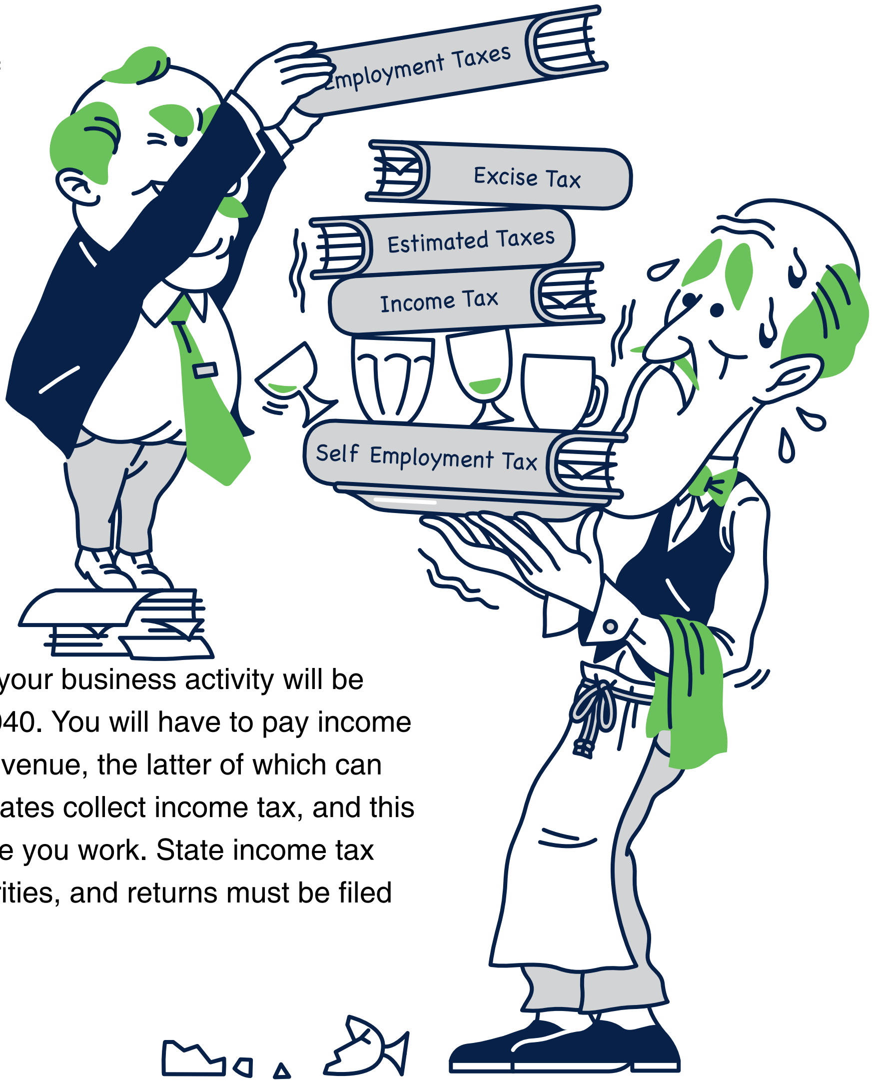
> “In the event that your taxes are underpaid, the IRS will penalize you, and not your accountant.”

Sales Tax

The federal government levies five types of business taxes:

- ☑ Income Tax
- ☑ Estimated Taxes
- ☑ Self-Employment Tax
- ☑ Employment Taxes
- ☑ Excise Tax

Of those, you'll primarily encounter Income Tax and Employment Taxes, which are also assessed at the state level.



Income Tax

If you are starting out as a sole proprietor, your business activity will be reported in Schedule C of your IRS form 1040. You will have to pay income tax as well as FICA tax on your business revenue, the latter of which can take away 15% of your net income. Most states collect income tax, and this will vary based on where you live and where you work. State income tax needs to be deposited with the state authorities, and returns must be filed quarterly.

Employment Tax

Federal and state payroll numbers are required to file employment tax returns, so enlist your accountant's help to get all tax identification numbers in place. As the business and regulatory environment becomes more complex, payroll accounting and reporting is best outsourced to a "Payroll Accounting Service" provider. Your accountant may double as your payroll accounting provider, or they may be able to recommend a trusted service.

Employers pay the following taxes on a quarterly basis:

Federal income tax, withheld from employees' pay, and deposited with the federal tax authorities

FICA taxes (social security and Medicare), withheld from employees' pay with a matching contribution by the employer, and deposited with the federal tax authorities

Federal and state unemployment taxes, solely paid by the employer, and deposited with the federal and state tax authorities

State and local income taxes (where applicable), withheld from employees' pay, and deposited with the state and local tax authorities

Sales Tax

Businesses must also pay sales tax and file returns quarterly, just as with other state taxes. If your sales volume is large, you may need to deposit sales tax on a monthly basis in addition to your quarterly returns.

Federal Forms

Federal tax forms depend on the business structure that you choose. Here is a list of resources for various business structures:

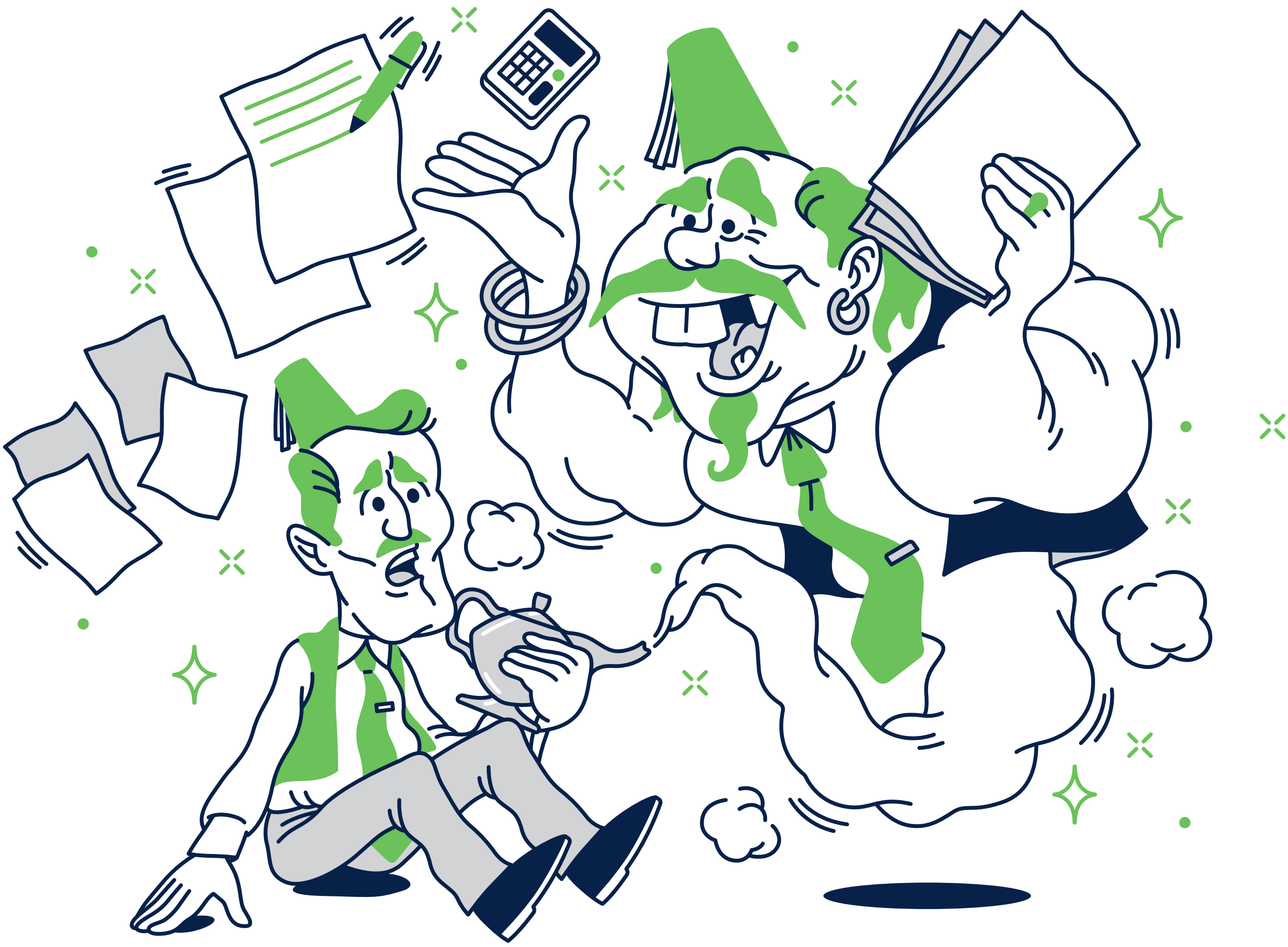
- ☑ **Sole Proprietorship**
- ☑ **Partnership**
- ☑ **Corporation**
- ☑ **S Corporation**
- ☑ **Limited Liability Company (LLC)**

If you are hiring an accountant, make sure that he or she prepares and adheres to a timeline for tax payments and return filing, as per regulatory requirements. If you are strapped for cash, there may be a temptation to avoid timely tax payment. However, for the long-term success of your business, it is best to plan in advance and set aside money for regulatory obligations so that you can avoid being penalized for late payments. If you absolutely cannot pay your taxes on time, then contact the IRS and set up a flat-rate payment plan. This is better than the 0.5% to 1% per month penalty that you'll be charged if you default on payments.

> **“For the long-term success of your business, set aside money for regulatory obligations so that you can avoid being penalized for late tax payments.”**

Required Documents for Tax Preparation

Good record keeping is essential for effective small business accounting. Adhering to the daily, weekly, and monthly activities mentioned earlier will ensure that tax time isn't a mad rush of collating your receipts and summarizing your business activities. While your accountant can certainly help you with those chores, it's much easier if you do this regularly, and rely on him or her solely for tax filing.



For tax preparation, your accountant will require:

☑ Basic Financial Statements:

Have a balance sheet, income statement, and cash-flow statement as the basis for your tax preparation.

☑ Activities around Capital Assets:

If you have bought or sold any capital assets (land, building, machinery, etc.), then it has to be accounted for in your tax returns. If you are using accounting software, you can easily get a print out of all asset activity for the year that can be handed over to your accountant. Otherwise, you would need to maintain an Excel-based or manual tracker that can be given to your accountant along with related supporting evidence (title deeds, sale deeds, etc.).

In addition, some of the easiest tax deductions can be found in your daily expenses:

☑ Travel Logs
If you use a vehicle for business purposes (even if it is your personal vehicle), maintain a mileage log (dates, miles driven, and purpose of travel) as well as a log of operating expenses such as loan interest, lease costs, gas, repairs, maintenance, and insurance. You accountant will be able to tell you which of these can be claimed as tax deductions. This can be kept in a notebook or in an Excel sheet.

☑ Home Office Expenses:
For those who are running a business out of your home, a percentage of your utilities, rent or mortgage, repairs and maintenance, home insurance, etc. can be claimed as business expenses. It is usually calculated based on the percentage of square-foot area that your home office is situated in or the number of rooms used for your home office. In either case, provide all original receipts and a summary of the expenses incurred to your accountant. For claiming deductions on mortgage interest and property tax payments, you will need a 1098 form from your mortgage company for all mortgaged properties.

☑ Health Insurance:
With the Affordable Care Act in place, self-employed business owners can deduct health insurance costs for themselves in addition to dependent family members.There are rules to be aware of, though. For example, if your dependent spouse is eligible for insurance through his or her employer, then you cannot claim the deduction.

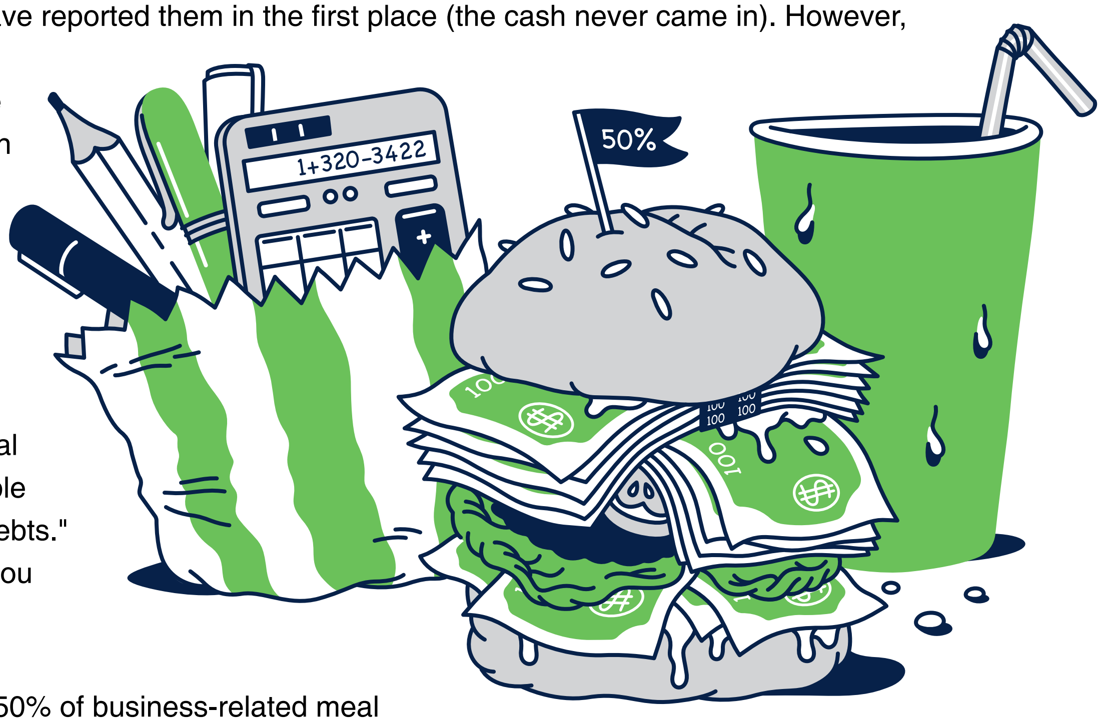
☑ Other Insurance:
There are additional types of deductible business insurance, and your accountant will be able to guide you through the nuances of all potential insurance-related deductions such as:

- Credit insurance
- Liability insurance
- Insurance against fire, theft, flood, etc.
- Malpractice insurance
- Worker’s Compensation insurance
- Vehicle insurance for vehicles used for business purposes

> “Good record keeping is essential for effective small business accounting.”

Required Documents for Tax Preparation, Cont'd

☑ **Bad Debts:** Depending on the accounting method you follow (cash or accrual basis), you can deduct bad debts from your reported gross income. Bad debts are losses that result from extending credit to your customers, employees or distributors, and in some cases, even your suppliers (if you pay in advance for supplies). Typically, with a cash-based accounting system, you will not have a provision to deduct bad debts, as you will not have reported them in the first place (the cash never came in). However, with an accrual-based system, you would have reported income as soon as you made the sale. If you are unable to collect it later, you can deduct it as a bad debt.



☑ **Capital Losses:** Certain short-term capital losses are also deductible as "non-business bad debts." Ask your accountant if you are eligible for this.

☑ **Meal Expenses:** 50% of business-related meal expenses are tax deductible by the IRS, with some qualifications. Keep notes on the actual business discussions that happened during the meal, as you would have to provide them in the event of an IRS audit. Alternately, for local travel, you can take a per diem rate as a meal travel expense.

With a little frontend work in the form of record keeping, your small business can benefit from expense deductions that you would otherwise miss. Visit the IRS site for a comprehensive list of business expenses that impact your tax calculations, and how to handle them.

> **"With a little frontend work in the form of record keeping, your small business can benefit from business expense deductions that you would otherwise miss."**

Tax Mistakes to Avoid

Selecting the Wrong Business Structure

If you are in the planning phase of starting a new business, then you'll want to talk with your accountant about developing a tax-friendly business structure. In order to avoid double taxation (at the corporation level and as tax on dividends), it may be better for a small business to set up as an S Corporation rather than a C Corporation.

Including Unqualified Deductions

IRS laws regarding what expenses qualify for tax deductions and the associated limits and timelines are varied and complex. For example, you cannot deduct startup costs as a business expense until you have made your first sale, and the deductions are to be spread out over a period of 15 years. In addition, if your startup costs are below $50,000, you can deduct $5,000 in the first year of business as startup costs, and another $5,000 as organizational costs (e.g., cost of incorporating your business entity, legal and other professional fees).

Unless you keep up with all of the changes, it is best to let your accountant figure out what qualifies as a tax-deductible expense. From your side, though, make sure that you maintain receipts of all your startup costs including the purchase of computers, office space rental, and so on.

Not Maximizing Available Deductions

Your accountant will be able to guide you on all legally-viable ways of claiming tax deductions. For example, as discussed earlier, if your spouse is working for your small business, classifying him or her as an employee will offer several benefits such as using a Medical Expense Reimbursement Plan to deduct health insurance premiums and medical expenses not covered by insurance. In fact, even your children's medical expenses can be tax-deductible. Should something unforeseen happen to your family members, this can be a big advantage. In order to treat your spouse as an employee, make sure that you have some evidence of him or her spending time for the company – such as timesheets. Speak to your accountant about what additional documentation should be maintained.

Combining Personal & Business Expenses

When running a small business, especially if it is home-based, you may inadvertently combine personal and business expenses, and this can become a sore point with the IRS. To avoid this issue, have a separate business account and credit card, and do not use money from the business account for any personal expenses. For expenses that are both personal and business, such as rent, maintain clear records of which area of your house is being earmarked as a home office.

> **"When running a home-based business, it is best to have separate accounts for business and personal use."**

Bank Reconciliation

Reconciliation refers to matching the balance in your checkbook with the balance in your bank statement. This needs to be done on a monthly basis. Your accountant can do this for you, but you should know the basics to at least perform a review. In fact, if you can do the bank reconciliation yourself, you can avoid the cost of assigning this task to your accountant.

While reconciling the books, don't forget to include any checks that you have written that have not yet been cleared by the bank. In such a case, your checkbook balance will be lower than your bank balance. Once you subtract the outstanding check amount from the bank balance, the result should match the number in your checkbook. If it matches, then you have successfully reconciled your bank balance.

Performing a bank reconciliation will help you to better understand your cash flow position and will alert you to any erroneous or missing entries in your bank statement so that they can be quickly corrected. Here is a step-by-step process on how to do a bank reconciliation:

Compare your book balance to your bank balance.

Your accounting balance (book balance) and your bank statement balance (bank balance) should be compared side by side to verify transactions until both cash balances match. If you are using accounting software, you can make use of the reconciliation feature that most accounting software has. Otherwise, make a printout of your monthly transactions, and compare them.

Include bank-only transactions to your book balance, and book-only transactions to your bank balance.

Usually, your bank statement will have some debits and credits that will not be present in your accounting books. These include positive transactions, such as interest payments from the bank, and negative transactions, such as bank charges. You will need to add the positive transactions and subtract the negative transactions from your book balance. Similarly, you will need to adjust for book-only entries – checks that you have written but have not been cashed (negative transactions), and deposits that are in transit (positive transactions). Add the positive transactions to your bank balance and subtract the negative transactions. This is a difficult step, as it may not be clear which transactions are not accounted for in your bank statement. However, if you address your bank reconciliations on a monthly basis, there may only be a few such entries to adjust for.

> **“Performing a bank reconciliation will help you to better understand your cash flow position.”**

Bank Reconciliation, Cont'd

Compare the balances.

Your adjusted book balance and adjusted bank balance should match. If they don't, here are a few things that you can check:

Recording error:

If your reconciliation difference is divisible by 9, then you most likely made a transposition error in your books. For example, you wrote a check for $45 and recorded it as $54.

Wrong opening balance:

If your opening cash balance is not accurate, then your bank account will not reconcile. This can happen when you are doing a bank reconciliation for the first time.

Unrecorded transactions:

You may have forgotten to record a check payment or a deposit. Look through the bank transactions that don't match up, and if you can remember that such a transaction did occur, then include the details in your books.

Wrong journal entries:

Any mistake in journal entries that impact the bank balance can cause your reconciliation to fail. Correct these and reconcile again.

> "Your adjusted book balance and adjusted bank balance should match."

Before we end this

small business accounting primer, here is a list of the Top 5 Do's and Don'ts for new business owners.

THE TOP FIVE DOs

1. Understand basic accounting and financial ratios, even if you have completely outsourced the process.
2. Hire an accountant who has worked in your industry before. Accounting and tax laws differ from industry to industry, and having an experienced person handle your financials will not only help from an accounting perspective but also from a networking perspective. Your accountant will be able to introduce you to bankers and sometimes even potential clients.
3. Have internal controls and documented policies in place to prevent fraud.
4. Perform bank reconciliation and cash flow control diligently on a monthly basis.
5. Research which accounting software will work best for you and your business.

THE TOP FIVE DON'Ts

1. Do not use money set aside for taxes for other business purposes.
2. Do not be optimistic in sales projections or conservative in expense projections, and don't wait to establish lines of credit until you have a need for financing.
3. Do not pay any invoice without matching it against your purchase order and goods or services received.
4. Do not delegate the authority to sign checks to anyone but yourself.
5. Do not mix business with pleasure. Maintain separate records and separate accounts.

Specialty Answering Service

https://www.specialtyansweringservice.net