

COMMON-SENSE TAX ACCOUNTING 101
FOR SMALL BUSINESS

By

Tom Post CPA

In Tomball

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Your accounting system is a living, breathing, talking, and reporting organism. It consists of the Accounts Receivable Person, the Accounts Payable Person, the Inventory Person, and the Internal Auditor or Controller.

Accounts Receivable/Income

It all begins with your customers or clients. You have no business if you don't have customers or clients who are willing to pay for your goods and services.

"Bring me my ticket please." The first and most important small business document is the ticket, invoice or statement of fees for services rendered.

The invoice starts the ball rolling. It asks the customer or client to pay you for goods and services rendered. How many invoices or tickets will you have in a day, a week, a month, a year? Who prepares the invoice or ticket? How will you keep track and summarize these documents? Enter the Accounts Receivable Person.

The Accounts Receivable Person stands up and accounts for invoices. This accounting is used to project how much cash will be coming in to the business. It is also used to prepare sales tax reports and to complete the revenue portion of the annual income tax return.

The Accounts Receivable Person has primary responsibility for the ever-important customer service.

Accounts Payable

Expenses/Cost of Goods Sold/Assets/Wages and Salaries

The people who provide goods and services to your business are very important members of your small business team. A chain is only as strong as its weakest link. Vendor/Employee Services are almost as important as customer service.

The Accounts Payable Person stands up and accounts for all money flowing out of the business. This includes cost of goods sold (inventory), supplies, business expenses, meals and entertainment expense, transportation expense, assets purchased, and wages and salaries. It is very important that the Accounts Payable Person coordinates with the Accounts Receivable Person and the Controller because the business cannot spend money that it does not have in the bank.

The Accounts Payable Person is responsible for knowing how much money the business needs to operate this week, month and year. This person also plays a very important role in the budgeting process and in the tax reporting process.

Inventory

Inventory is the stock of material needed to complete the jobs that your business does for its customers. The Inventory Person is responsible for ordering purchases of materials and for keeping track of inventory on hand. The Inventory Person also needs to coordinate with the other members of the team.

Controller/Internal Auditor

The Controller/Internal Auditor should be the most sophisticated/educated/knowledgeable member of the accounting team. This Person is responsible for training and supervising the accounting aspects of the other team members' job duties. The Controller also reconciles the bank statement each month. If items are discovered in the bank statement that were not recorded, the Controller corrects the error and takes steps to make sure that similar items will be recorded properly in the future.

The Controller also has primary responsibility for any loans that the business makes.

Initially the Controller is active in preparing the loan requests when funds are needed to keep the business going and growing. The Controller monitors repayments on the loans and keeps track of the outstanding balances.

Mark Up/Profit Margin

The profit margin is the difference between the price that a small business pays for a product and the sales price of that product. To achieve a 20% profit margin, you must mark up the cost by 25%. Here's the formula:

$$\frac{\text{Profit Margin/Markup}}{\text{Cost}} = \frac{20}{80} = 25\%$$

This formula can be used to determine the right mark up percentage in all cases. This may well be the only math you need to know in small business tax accounting other than addition and subtraction.

The Budgeting Process

A small business lives or dies based on its ability to accurately project cash flow.

It is my suggestion that the people defined in this living accounting system be empowered to actively participate in the budgeting process.

You should have monthly budget meetings where the members of your accounting team literally stand up and report verbally and in writing on this prediction of cash flow for the next month. I suggest that your banker and your CPA be invited to these meetings.

It seems to me that the small business world has an aversion to its employees being aware or knowledgeable about what is going on financially in the business. I believe that this is a big mistake.

Record Your Income

When income is earned by your business, it should be recorded. When it comes time to file your business tax return you need to report to your tax return preparer how much income was earned for the 365 days of the year. Some people like to record their income on a spreadsheet; others use a comprehensive accounting program like QuickBooks. Either method can work. The important thing is to keep contemporaneous books records that are adequate for tax purposes.

Document Your Expenses

When it comes time to file your tax return, we need a summary of the business expenses incurred for the 365 days of the year. Many folks like to record these expenses daily, weekly, monthly or even quarterly. For tax purposes, we need for the summary to run totals for the entire taxable year.

Just like with income, you can use a spreadsheet or a comprehensive accounting program like QuickBooks. Please remember that on the tax return we need totals for the entire year.

While you are compiling expenses, you should also compile a list of any fixed assets purchased for the business during the year.

What do we mean when we use the word document? Assume for a minute that you have responsibility to approve expenditures for the business. You would not approve the purchase of a swimming pool at the owner's home from business funds, would you? Often small business owners dump volumes (boxes) of records on a bookkeeper which include many personal expenses as business expenses. When this is done, the business owner (taxpayer) is ultimately responsible for taxes, interest, negligence, and fraud penalties that might result from such faulty business practices.

Choosing a Tax Return Preparer

My son Eric, who has worked for me for years, believes there should be a law that says you must hire a licensed tax return preparer to complete your small business tax return. Eric believes this regulation should be similar to the regulations that apply to trades like electricians and plumbers. I think Eric is right about that.

In the world it turns out that most of the “franchised” tax preparers do not have a license to practice before the internal Revenue Service. There are three major ways to qualify to practice before the Internal Revenue Service:

- A. Attorney
- B. Certified Public Accountant
- C. Enrolled Agent

Almost anyone can take the test to become an enrolled agent and qualify to practice before the IRS. It has always mystified me why the franchised tax preparers don't require their staff to become enrolled agents. At the same time these franchised shops refer to CPA's as mom and pop CPA firms. This is a pet peeve of mine.

I am not saying that there are no franchised tax preparer offices that are conscientious about their work. I am just saying that most of them do not have a license to practice before the IRS. One final note – most of the franchised tax preparers concentrate on personal rather than business tax returns.

Wrap Up

When it comes to small business tax accounting, it seems that integrity and honesty are more important than IQ. This pamphlet has outlined a simple approach to an accounting system that has internal control. The essence of internal control is segregation of duties and checks and balances.

A small business owner can use a living, breathing, talking accounting system as outlined in this booklet to manage his or her business and have a lot of fun doing it.

Business vs. Charity

Generally speaking, business rewards production. We all know that it is better to teach someone to be productive than to give them a hand-out. Most of us seem to have forgotten that if you want to be good in business, all you have to do is follow good ethical business practices.

Charities have rules against competing with businesses. The rule imposes a tax on unrelated trade or business income of the charity. Businesses have rules against competing with charities. This is why there are limitations on charitable deductions of businesses. There are no such limitations on ordinary and necessary business expenses. Just like separation of church and state, I believe we should practice separation of Charity and Business.

I have a suspicion that some of these folks who obsess on charities have a guilty conscience about ill-gotten gains and that they are trying to compensate for their misdeeds (more on this under Good/Evil).

Regulation

There are those who say that deregulation of the savings and loan industry caused the savings and loan crisis. I agree with these folks. Likewise, deregulation of the financial markets may have caused our recent financial crises. It seems to me that although free enterprise is a wonderful concept, in these virtual monopolies, human beings are not capable of regulating ourselves. Many of my friends are benefiting from deregulation of the energy industry. I myself fail to see the wisdom of transferring so much profit from the productive people to the so-called middle-man salespeople.

Good/Evil – Con a Con

Some people say that you can't con a con. Is that really true? I don't think so. If one con is a better con than the other – he can con the lesser con – my opinion.

How many people have gotten rich by being dishonest? How many people are good, honest people who have simply been blessed with an abundant life? The jury is out on this one. I still have hope that the abundant lifers will win out.

Recently our president spoke about a justified war. He said that pacifist policies would not have stopped Adolph Hitler. Sometime we have this on a personal level also. How often do you see situations where one person shares honestly and other person takes advantage of what that person shared for personal material gain?

I used to think of myself as a hypocrite buster. Later I decided that being a hypocrite buster was, as they say, “negative”. I am beginning to think that it is my calling to be a hypocrite buster. Hypocrites are bad for society. Someone has to do it. On a larger scale – isn't that what regulations are all about?

Retirement Plans

A successful small business probably should have a Retirement Plan. Retirement Plans run from an Individual Retirement Plan to a Simple IRA, a SEP, a 401(k) Plan, a profit sharing plan, a safe harbor profit sharing plan, and finally a Defined Benefit Pension Plan. The Safe Harbor 401(k) Profit Sharing Plan can be a lot of fun. The fun comes at year-end when we compute the matching, safe-harbor, and profit-sharing contributions/deductions.

I find that these plans produce a lot of good will and solidarity between members of the small business team.

Succession Plan

A successful small business needs a Succession Plan. Simply stated, a Succession Plan is a plan to replace the management in case of emergency. I am sure you have heard the stories of the management teams that died in a plane crash. These things really happen and you need to prepare for them. There is nothing worse in small business than seeing a small business fail because of a failure to plan for this type of emergency. The most exciting Succession Plan is the ESOP – the Employee Stock Ownership Plan. These came into being in 1974 with ERISA – The Employee Retirement Income Security Act. For some strange reason they have not caught on. It's a shame, really, because an ESOP is a good concept.