



ACCOUNTING & RECORDS

FOR *Small Business*



TAXES

FILING

BOOKKEEPING

BUDGET

Keep Good Records

Recordkeeping: The orderly and disciplined practice of storing business-related documents

- A system that allows you to collect information about your business activities, access it when needed, summarize it for reporting, and analyze it for business decision making
- One of the most important responsibilities as a small business owner
- A business's success depends on creating and maintaining an effective record system
- The importance of measurement: To manage a business you must be able to measure activity
- Helps with detailed tracking of revenues and expenses, planning, legal compliance, and tax return preparation (federal, state, and local)

Audience for Your Records & Reports

- **You** so that you can carry out operations, prepare periodic reports, and file income tax returns
- **Partners or investors** so that financial statements can be prepared and financial positions and results of operations can be monitored
- **Bankers** so that loan applications can be reviewed and loan servicing can be monitored
 - **IRS and state authorities** so that tax returns and other tax-related documents can be prepared and issued

Setting Up & Organizing a Filing System

- Systems range from simple manila folder filing systems to digital systems such as document management systems
 - Must be easy to use and must provide adequate storage and fast retrieval of records
 - Must be suited to your particular business needs
- A filing system should not be a random assortment of individual files
- Start with a plan
- Create categories and subcategories (e.g., a category could be *Plant and Equipment* with subcategories such as *land, buildings, computers, printers, furniture, fixtures*, etc.)

Paper-Based Systems

- **File folder:** Holds loose papers together for organization and protection
 - Label file folders based on what is inside by writing directly on the tabs or by writing on adhesive labels that are placed on the tabs
 - Create broad categories and develop refined categories as time goes by
 - Unfold papers before filing them
 - File papers in reverse chronological order (i.e., most recent papers on top)
 - Vital documents should be filed in a fire-resistant safe or cabinet
- **Hanging folder:** Use to group several file folders together (e.g., a hanging folder might be labeled *Customers* and contain individual client file folders)
 - **Cabinet storage:** Hanging folders are often stored in a filing cabinet
 - Records contained in paper files should be managed according to business and income tax requirements
 - Documents should be filed as soon as possible after receipt or creation
 - The following principles help in maintaining an orderly filing system:
 - ◊ File the most recent document on top
 - ◊ File in order of the date on which the document was written, not the date of receipt
 - ◊ File attachments or enclosures immediately below the documents to which they relate
 - ◊ Place bulky items such as very large documents, plans, drawings, and blueprints in a pouch or pocket with the contents described on its front
 - ◊ Do not file duplicates

- **Accordion folder:** Opens like an accordion on top to reveal compartments for storing documents
 - Designed to store documents without a filing cabinet (e.g., in a closet or on a shelf)
 - Each compartment can be labeled

Tickler Systems

- Filing system for remembering upcoming events
 - **Paper system:** Collection of date-labeled file folders organized in a way that allows time-sensitive documents to be filed according to the future date on which each document needs action
 - **Computerized filing system:** Tickler system sends out text or email alerts

EX: Bills due, quarterly taxes due, and license renewals (action needed); insurance reviews and renewals

Digital Document Management Systems

- On-premises (hard drive) or cloud-hosted systems to store digital versions of business documents
- Electronic file cabinet structure with search capabilities
- **Scanning options:** Ability to utilize software or database search capabilities to locate a specific item or date
- **Security measures:** Password protected
- **Mobile access:** Able to retrieve and review documents from your laptop or phone

Spreadsheets

- Can be used for basic recordkeeping and budgeting for small businesses
- Should not be used in place of an accounting system but are great for supplemental recordkeeping and reports
- Many accounting software packages allow for the extraction of data into spreadsheet-compatible files
- Can be used as a tool to help project operating profit, develop a projected income statement, and create a balance sheet and cash flow forecast
- Help with preparing budgets
 - Excel is the most popular desktop spreadsheet program
 - Google Sheets is a cloud-based spreadsheet application

Accounting Software

- Complete financial recordkeeping system
- Allows for recording and posting all the transactions of your business, with a preset or easily adapted chart of accounts
- Automatically generate reports and graphs, such as balance sheets, profit and loss statements, and cash flow statements
- QuickBooks is most popular for small businesses
 - Desktop system with files residing on the computer's hard drive
 - User must back up and protect data
- Subscription solutions (e.g., QuickBooks Online)
 - Accounting software that is hosted on remote servers
 - Data is processed and stored in the cloud
 - Password protected with automatic backup of data
 - Access real-time data from anywhere with an Internet connection

- Access from any device, including laptops, smartphones, and tablets
- Routine maintenance and updates to the software are managed by the SaaS (Software as a Service) provider

Accounting Records

Accounting records take many forms: source documents, journals, ledgers, trial balances, and financial statements

Source Documents

- Evidence of a business transaction
- Important starting point of the audit trail
 - An audit trail can be either a paper- or digital-based trail showing a documented history of a transaction
 - An audit trail allows an auditor to follow the financial data from its original creation or source document (invoice, receipt, voucher, etc.) to the general ledger
- Examples of source documents:
 - Invoices
 - Other evidence of income, such as copies of checks, receipts, and bank statements
 - Expense documentation
 - ◊ Canceled checks that identify the payee, amount, and proof of payment/electronic funds transferred
 - ◊ Cash register tapes
 - ◊ Account statements
 - ◊ Credit card receipts and statements
 - ◊ Invoices
 - ◊ Petty cash slips for small cash payments

Record Retention Schedule

Record retention guidelines recommended by the US Small Business Administration

Accounting Records	
Invoices and receivables	5 years
Checks and payables	5 years
Auditors' reports	Permanently
Annual statements	Permanently
Inventory	4 years
Personnel	
Payroll	6 years
Contracts	5 years
Personnel files	3 years
Insurance records	5 years
Time cards	2 years
Retirement plans	Permanently
Business and Corporate	
Contracts	7 years
Copyrights	Permanently
Correspondence	3 years
Leases	6 years
Property records	Permanently
Licenses	As required
Permits	As required
Insurance policy	As required
Taxation	
Tax returns	Permanently
Employee withholding	7 years
Tax bills and statements	Permanently

Note: If there is pending or threatened litigation involving your business, discuss with your attorney the need to preserve business records for litigation purposes

- Bookkeeping is vital to properly managing your business
- Records are also needed for income tax purposes
 - **Cash-based accounting:** Revenues are recorded when received, and expenses are recorded when paid
 - **Accrual-based accounting:** Revenues are recorded when earned, and expenses are recorded when incurred

Bookkeeping vs. Accounting

- A **bookkeeper** processes transactions and performs much of the data entry/recording tasks
 - The bookkeeper records the bills from vendors, pays bills, processes payroll data, prepares sales invoices, mails statements to customers, etc.
 - The bookkeeper should take care of the “books” but not handle the cash (checks or currency)
 - Separation of duties is necessary to protect assets but is often difficult (costly) in small businesses
 - Those who do the accounting work should not have custody of access to cash
 - Accounting entries can cover embezzlements and other misappropriations of assets
 - Bank reconciliations (balancing the checking accounts) should be performed by someone who doesn’t handle the cash
- An **accountant** prepares adjusting entries and the company’s financial statements (income statement, balance sheet, and statement of cash flows) and assists management to understand the financial impact of its past and future decisions

Accounting Systems

Every small business owner should know at least the basics of their accounting system, even if the task of running this system is delegated to a bookkeeper or an accountant

- An accounting system is an information system
- Inputs are source documents (invoices, receipts, checks, and bills) and calculations such as depreciation
- Inputs → Processing → Outputs

Journals & Ledgers

- A **journal** is where every transaction is initially recorded; journal entries include the following components:
 - Date of the transaction (month, day, and year)
 - Numbers/Names (title) of accounts and the amounts debited
 - Numbers/Names (title) of accounts and the amounts credited
 - A short explanation of the transaction

Journal Entry Example

	Account Title	Debit	Credit
January 3, 2017	Cash	\$1,000	
	Sales		\$1,000
	<i>Explanation: Cash sale</i>		

- A **ledger** is another name for an account; a general ledger is a collection of accounts
- Once a transaction is journalized, it must be posted to a ledger (account)
- Posting is the process of copying information from the journal to the general ledger

Accounting Equation

- Accounting systems are based on the accounting equation: **Assets = Liabilities + Equity**
- **Assets** represent the company’s resources
 - To qualify as an asset, the following requirements apply:
 - ◊ Company must own the resource
 - ◊ Resource must be of value
 - ◊ Resource must have a quantifiable (measurable) cost
- **Liabilities** represent what the company owes to others
 - To qualify as a liability, the following requirements apply:
 - ◊ Must be quantifiable (measurable)
 - ◊ Occurrence must be probable
- **Equity** represents the owners’ investment in the company
 - **Equity = Assets – Liabilities**
 - Includes money invested in the company (shares, partner investments, sole proprietor investment) and retained earnings
 - Retained earnings is net income reinvested in the business

Income Statement Formula

- An income statement shows the net income (profits) or net loss from operating a business over a certain period of time, such as a year
- **Net income (or loss) = Revenues – Expenses**
- Revenues are inflows of cash or other assets or reductions in liabilities resulting from producing, delivering, or providing goods or services constituting an entity’s central operations (e.g., sales of goods, fees charged for services, rent earned, interest earned, royalties earned)
- Expenses are outflows of cash or other assets or incurrence of liabilities resulting from producing, delivering, or providing goods or services constituting an entity’s central operations
- Possible expenses of a small business:
 - **Cost of goods sold:** Cost of inventory sold to customers; includes acquisition price, freight and shipping costs to acquire, and in the case of manufacturing, materials, labor, and overhead
 - **Advertising:** Cost of online and print ads, business gifts, mailing lists, and other promotional expenses
 - **Car and truck expenses:** Including fuel, repairs, and maintenance of vehicles that are used in the business
 - **Commissions and fees:** Paid to consultants and salespeople
 - **Contract labor:** Amounts paid to freelancers and independent or outside contractors and subcontractors
 - **Depreciation:** The allocation of a tangible, long-life asset’s cost to expense over the period that the asset is likely to be used. For example, if a business purchases a delivery truck with a cost of \$100,000 and it is expected to be used for 5 years, the business might have a depreciation expense of \$20,000 in each of the 5 years. Depreciation is calculated on buildings, equipment, machinery, tools, office furniture, and other business assets (but not land)
 - **Employee benefits costs:** Any expenses incurred by the business to benefit the employees other than salary, wages, and pension costs. Includes such things as adoption assistance, child care, dependent care assistance, group life insurance, health insurance, and parking and transportation reimbursement
 - **Insurance:** The cost of insurance coverage on business assets and liability
 - **Interest:** The cost of borrowing for business debts such as credit card interest and loan finance charges
 - **Legal and professional services:** The cost for the use of the services of accountants, lawyers, consultants, answering services, payroll services, and security and cleaning services
 - **Office expenses:** The cost of all office supplies and other office-related expenses and bank service charges, business cards, coffee or water service, computer supplies, postage, decorations, fire extinguishers, light bulbs, software, signs, periodicals, and newspapers
 - **Rent or lease:** The cost of renting buildings, equipment, and vehicles
 - **Repairs and maintenance:** The cost of cleaning, electrical repairs, landscaping, building repairs, and plumbing repairs
 - **Supplies:** The cost of building supplies, equipment, and tools with a useful life of less than a year; replacement of consumables; and uniforms
 - **Taxes and licenses:** The cost of business licenses, employer’s taxes, inventory tax, permits, and property taxes
 - **Travel, meals, and entertainment:** The cost of lodgings, transportation, business meals, and other travel-related incidental expenses
 - **Utilities:** The cost of electricity, heating, trash and garbage removal, telephone, Internet, cable, cell phone, and sewer and water service
 - **Salary and wages:** The cost of payroll and payroll-related taxes

Accounts

- An **account** is a record showing increases and decreases and the balance of specific assets, liabilities, equity, revenues, and expenses

EX: The cash account has a beginning balance of \$1,000. You receive \$5,000 from a customer and pay \$500 for a bill. The cash account balance would be \$5,500

	Cash	
Beginning balance	\$1,000	
Receipt	\$5,000	
Balance	\$5,500	\$500 payment

- **Chart of accounts:** A list of all the accounts a company is using, organized by assets, liabilities, equity, revenues, and expenses

- | | |
|--|---|
| <ul style="list-style-type: none"> – Cash and cash equivalents – Accounts receivable – Inventory – Other current assets – Property, plant, and equipment – Accounts payable – Other current liabilities – Long-term liabilities – Mortgages – Loans – Capital – Retained earnings – Sales | <ul style="list-style-type: none"> – Fees – Rent – Royalties – Interest – Other income – Cost of sales (cost of goods sold) – Research and development – Sales and marketing – General and administrative – Depreciation – Finance costs – Income tax expense |
|--|---|

Double-Entry Accounting Systems

- Some general rules:
 - A minimum of two accounts is needed for every transaction—at least one account is debited, and at least one account is credited
 - A **debit** is an entry on the left-hand side of an account; a **credit** is an entry on the right-hand side of an account

Account Title	
Left Debit	Right Credit

- Debit and credit rules:
 - **Expense accounts** are debited to increase the account and normally have debit balances

EX: On June 30, the company incurs \$500 for rent

	Rent Expense	
Balance	\$2,500	
June 30	\$500	
Balance	\$3,000	

- **Revenue accounts** are credited to increase the account and normally have credit balances

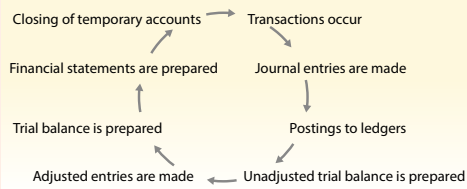
EX: The company sold \$1,000 of product on June 30

	Sales	
Balance	\$50,000	
June 30	\$1,000	
Balance	\$51,000	

- **Asset accounts** normally have debit balances
 - ◊ To increase an asset account, debit the account
 - ◊ To decrease an asset account, credit the account
- **Liability accounts** normally have credit balances
 - ◊ To increase a liability account, credit the account
 - ◊ To decrease a liability account, debit the account

Accounting Cycle

The accounting cycle is the collective process of recording and processing the business transactions of a company; the cycle begins when a transaction occurs and ends with its inclusion in the financial statements



Posting of Transactions

- Transactions are recorded in a journal
- Transactions are posted from the journal to general ledger accounts and subsidiary accounts as they occur
- Some businesses with many transactions post the transactions daily, whereas businesses with fewer transactions post them weekly

EX: Sale of \$1,000 of product for cash

Journal

	Account Title	Debit	Credit
January 3, 2017	Cash	\$1,000	
	Sales		\$1,000
	<i>Explanation: Cash sale</i>		

Posting to Ledgers

Cash		Sales	
Balance	\$10,000	Balance	\$0,000
June 30	\$1,000	June 30	\$1,000
Balance	\$11,000	Balance	\$51,000

Preparation of Trial Balances

- A trial balance is an internal report that lists the balances in each of an organization's general ledger accounts
- Steps in preparing a trial balance:
 - Enter the debit balance amounts and list them in a *Debit* column
 - Enter the credit balance amounts and list them in a *Credit* column
 - The total of each column and the sum of the two columns should be equal
 - If they are not equal, the accountant or bookkeeper must resolve the difference by reviewing general ledger postings
- Accounting software prepares trial balances automatically; however, any inequality (debits not equal to credits) must be reconciled by the bookkeeper or accountant
- Frequency of preparation: daily if the business has many daily transactions, whereas weekly could suffice if a business has a low volume of transactions

Trial Balance Example

	Debit	Credit
Cash and cash equivalents	\$10,000	
Accounts receivable	20,700	
Inventory	30,100	
Other current assets	4,200	
Property, plant, and equipment	120,000	
Accumulated depreciation		\$31,000
Accounts payable		1,000
Other current liabilities		1,200
Mortgages		70,000
Short-term note payable		4,100
Capital		
Retained earnings		78,200
Sales		250,100
Fees		3,000
Rent		10,000
Royalties		2,700
Interest		11,000
Other income		400
Cost of sales (cost of goods sold)	160,000	
Research and development	7,000	
Sales and marketing	22,000	
General and administrative	60,000	
Depreciation	20,000	
Finance costs	3,300	
Income tax expense	5,400	
	<u>\$462,700</u>	<u>\$462,700</u>

Basic Accounting Principles

- **Measurement (cost principle):** Assets are initially recorded at their cost
 - EX:** A parcel of land is acquired for \$100,000 but has an appraised value of \$120,000. Under the cost principle, the land would be recorded in the accounting records for \$100,000
- **Revenue recognition:** Accrual-based accounting requires that revenue is recognized (accounted for) at the point that it is earned
 - EX:** A customer purchases a \$1,000 product and will pay for it in 30 days. Revenue of \$1,000 is recorded in the accounting records at the point in time the sale was made
- **Expense recognition:** Report all expenses that helped generate revenue (matching principle)
 - EX:** For the month of June, a company earned \$120,000 in revenues and incurred operating costs of \$80,000. Therefore, the income before taxes and interest was \$40,000 (\$120,000 less \$80,000)
- **Full disclosure:** All information must be reported in the financial statements with notes that would impact user decision making
 - EX:** A company is being sued for an injury incurred by a customer in the company store. The probability is high that the company will be liable for some damages, but it is difficult to estimate how much the judge will award. A note should be included as a supplement to the financial statements that this contingent liability exists
- **Going concern:** An assumption that a business is going to continue to operate and will not be sold or closed in the near future
- **Business entity:** The business is an entity of itself and is not an extension of the owner
 - EX:** ABC Incorporated is owned by John Smith and Mary Jones. The company enters into contracts to purchase inventory and supplies. The company, not John and Mary, are liable for the contracts
- **Time period assumption:** A company's reporting is done in specific time periods such as a month, quarter, or year
 - EX:** Income statement for 12 months ended on December 31

Financial Statements

- **Balance sheet:** A report showing the assets, liabilities, and capital of a business at a particular point in time

Example Company Incorporated

Balance Sheet		12/31/17	
Assets			
Cash and cash equivalents	\$10,000		
Accounts receivable	20,700		
Inventory	30,100		
Other current assets	4,200		
Total current assets			\$65,000
Property, plant, and equipment	145,200		
Less: Accumulated depreciation	(31,000)		114,200
Total assets			<u>\$179,200</u>
Liabilities and Equity			
Accounts payable	\$1,000		
Other current liabilities	1,200		
Short-term note payable	4,100		
Total current liabilities			\$6,300
Mortgages			70,000
Total liabilities			<u>\$76,300</u>
Capital			25,200
Retained earnings			78,200
Total liabilities and equity			<u>\$179,700</u>

- **Income statement (P&L):** A report showing the revenues, expenses, and the net income or net loss of a business over a period of time, such as a year

Example Company Incorporated

Income Statement

For the 12 months ending 12/31/17

Sale	\$325,000	
Less: Cost of goods sold	(160,000)	
Gross profit		\$165,000
Operating expenses		
Sales and marketing	\$22,000	
General and administrative	\$60,000	
Depreciation	\$20,000	
Total expenses		102,000
Operating income		\$63,000
Finance costs		3,300
Income tax expense		5,400
Net income		<u>\$57,600</u>

- Financial statement users
 - Internal users are the operating owners, managers, and staff of a business
 - External users are the non-operating owners (i.e., limited partners or shareholders) of a business

Audited Financial Statements

- An audit consists of an evaluation of a company's financial statements to express an opinion on whether the financial statements are fairly presented
- For a "clean" audit opinion, a company must prepare their financial statements in accordance with a framework of generally accepted accounting principles (GAAP)
 - The fair presentation of financial statements is evaluated by independent auditors (a CPA firm) using a framework of generally accepted auditing standards (GAAS), which set out requirements and guidance on how to conduct an audit
- Audited financial statements are often required by banks when evaluating a commercial loan request and by investors

Balancing the Checking Account:

Reconciliation Steps

- Review of canceled checks: Compare canceled checks (or digital images) to what you recorded in the check register (or cash disbursements journal)
- Verify debits: Many payments are the result of automatic withdrawals/payments; verify that all debits are correct
- Check the deposits: Verify that the deposits shown in the bank record agree with the deposits recorded in the check register (or cash receipts journal)
- Look for any additional credits or debits to the account; fees or interest will need to be recorded in the company records in order to reconcile the accounts
- Compare the bank balance to the company balance (general ledger)
- The adjusted ending balance should equal the balance of the company's cash account in the general ledger

Ending balance shown on statement	_____
Plus deposits not shown on statement	_____
Subtotal	_____
Less total outstanding drafts	_____
Equals adjusted ending balance	_____

Basic Cash Management Rules for Small Businesses

- Pay bills by check; this creates an audit trail and an electronic record
- Deposit all income (both cash and checks) immediately; this creates an audit trail and an electronic record and safeguards the funds
- Do not commingle personal and business funds; do not use the business account for personal use; recordkeeping can become confusing, and analysis of business results can be distorted; also, tax reporting requires segregation of business activities from personal activities
- Balance (bank account reconciliation) the checking account every month and on a timely basis; frequent and timely reconciliations will uncover errors, identity thefts, and fraud
- Write checks to specific individuals or entities; don't make checks payable to "Cash"
- Bill customers promptly and offer discounts (e.g., 3/10 net 30, 3% discount if paid within 10 days with the total due no later than 30 days)

Recordkeeping for Independent Contractors

- Many small businesses utilize independent contractors instead of employees to perform tasks and projects
- According to the IRS, “The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done”
- A person is not an independent contractor if they perform services that can be controlled by an employer (what will be done and how it will be done)

Form 1099-MISC

As a general rule, you must issue a Form 1099-MISC to each person to whom you have paid at least \$600 in rents, services (including parts and materials), prizes and awards, or other income payments

Federal Requirements Recordkeeping & Reporting for Employers

To determine if a person is an employee, the IRS looks at the following factors:

- **Behavioral control** covers facts that show if the business has a right to direct and control what work is accomplished and how the work is done, through instructions, training, or other means
- **Financial control** covers facts that show if the business has a right to direct or control the financial and business aspects of the worker’s job; this includes:
 - The extent to which the worker has unreimbursed business expenses
 - The extent of the worker’s investment in the facilities or tools used in performing services
 - The extent to which the worker makes his/her services available to the relevant market
 - How the business pays the worker
 - The extent to which the worker can realize a profit or incur a loss

- **Relationship of the parties** covers facts that show the type of relationship the parties had; this includes:
 - Written contracts describing the relationship the parties intended to create
 - Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay
 - The permanency of the relationship
 - The extent to which services performed by the worker are a key aspect of the regular business of the company

A business owner can request the IRS to determine if a specific individual is an independent contractor or an employee by filing IRS Form SS-8

Employer Basic Responsibilities Regarding Income Tax & Payroll

There are many responsibilities that an employer has as a result of having employees

Obtaining an EIN

- A federal employer identification number (EIN) is a nine-digit number the IRS assigns to businesses for tax filing and reporting purposes; it is used to uniquely identify the taxpayer; EINs must be used by business entities—corporations, partnerships, and limited liability companies
- According to the IRS, you will need an EIN if you answer “yes” to any of the following questions:
 - Do you have employees?
 - Do you operate your business as a corporation or a partnership?
 - Do you file any of these tax returns: Employment; Excise; or Alcohol, Tobacco, and Firearms?
 - Do you withhold taxes on income other than wages paid to a nonresident alien?
 - Do you have a Keogh plan?

IRS Publication 15 (Circular E), Employer’s Tax Guide

This is a guide to help employers meet federal government rules for hiring, paying, and withholding taxes from employee’s paychecks

Form W-4

Used by employers to withhold the proper amount of federal income tax from an employee’s paycheck; the IRS requires that a W-4 be completed upon hire and

recommends that employees submit a new W-4 tax form each year, or anytime their personal or financial situation changes

Form I-9

Businesses must verify that each new employee is legally eligible to work in the United States; this includes completing the US Citizenship and Immigration Services (USCIS) Form I-9, Employment Eligibility Verification

Fair Labor Standards Act (FLSA)

Establishes minimum wage, overtime pay, recordkeeping, and child labor standards affecting full-time and part-time workers in the private sector and in federal, state, and local governments

Withholding of Income Taxes & FICA

Employees have federal, state, and local income taxes withheld from their paychecks, along with Social Security and Medicare (FICA); the employer is also liable for an employer’s portion of Social Security and Medicare taxes

Payroll Tax Returns

- Business owners must file payroll tax returns
- Form 944 (annually), if total employment taxes for the year are less than \$1,000
 - Form 941 (quarterly), if total employment taxes are more than \$1,000

Form W-2

- Employers must complete a Form W-2 for each employee, reporting the employee’s income (salary, wages, commissions, tips) and deductions for the year
- Every employer engaged in a trade or business who pays remuneration, including noncash payments of \$600 or more for the year for services performed by an employee, must file a Form W-2 for each employee (even if the employee is related to the employer) from whom income, Social Security, or Medicare tax was withheld

Basic Employer Responsibility Checklist

New Employees

- ✓ Verify work eligibility with Form I-9
- ✓ Record employees’ names and Social Security number from Social Security cards
- ✓ Require employee to complete Form W-4

Each Payday

- ✓ Withhold federal, state, and local income tax based on each employee’s W-4
- ✓ Withhold employee’s share of Social Security and Medicare taxes
- ✓ Make deposits for:
 - Withheld income tax
 - Withheld and employer Social Security taxes
 - Withheld and employer Medicare taxes

Quarterly

- ✓ Deposit FUTA tax if the undeposited amount is over \$500
- ✓ File Form 941 (employer’s quarterly federal tax return)

Annually

- ✓ File Form 944 (if required), which is the employer’s federal tax return and is for the smallest employers—those whose annual liability for Social Security, Medicare, and withheld federal income taxes is \$1,000 or less and will file and pay these taxes only once a year instead of every quarter
- ✓ Furnish each employee with a Form W-2
- ✓ Furnish each payee with a Form 1099
- ✓ File Forms 1099

Payroll & Personnel Recordkeeping

If you hire employees, your recordkeeping capacity needs to comply with state and federal rules and laws; payroll and personnel legal recordkeeping requirements might include:

- Hiring and evaluation documentation
- Basis on which wages are paid
- Social Security numbers
- Time sheets to record total hours worked, regular hours, and overtime hours
- Total wages paid each pay period
- Income tax withholdings
- Fair Labor Standards Act required information
- Injury reports
- Employment records
- Copy of annual performance evaluations

Income Tax on Business Earnings

Sole Proprietor

- A sole proprietor is someone who owns an unincorporated business by himself or herself
- Business profits (revenues less expenses)

- are considered personal income
- Filing taxes as a sole proprietor is relatively simple—business income or loss reported on IRS Form 1040 (personal income tax form)

Form 1040 Schedule C

- Profit and loss statement
- Revenues (income) less expenses
- IRS Publication 334, Tax Guide for Small Business, explains Schedule C

- You can deduct the costs (expenses) of operating your business; to be deductible, a business expense must be both ordinary and necessary
 - An ordinary expense is one that is

common and accepted in your field of business

- A necessary expense is one that is helpful and appropriate for your business
- An expense does not have to be indispensable to be considered necessary

Partnership Reporting

Form 1065

- Partnerships file an information return to report their income, gains, losses, deductions, credits, etc.
- A partnership does not pay tax on its income, but “passes through” any profits or losses to its partners, which is

reported on Schedule K-1

- Partners must include partnership items on their tax or information returns

Form 1065 Schedule K-1

- A partnership uses Schedule K-1 to report a partner’s share of the partnership’s income, deductions, credits, etc.

Form 1120 Corporate Taxation

- Regular corporations (also called C corporations) are artificial beings and therefore are taxpayers; one disadvantage of a C corporation is “double

taxation”—some or all of the taxable income of a corporation is taxed twice

- Income is first taxed as it’s earned by the corporation
- Income is taxed again when claimed by shareholders, such as when receiving dividends
- As of 2017, C corporations pay taxes at a rate of between 15% and 38% based on how much income they have earned
- S corporations are businesses in which taxable income “passes through” to the owners (similar to a partnership)
 - S corporation profits are taxed only at the individual level and not at the

corporate income level, avoiding double taxation

- S corporation status means that the company must be located within the United States and have no more than 100 shareholders
- A limited liability company (LLC) is a business structure allowed by state statute that can offer limited liability and the benefits of partnership taxation (pass through); an LLC with at least two members is classified as a partnership for federal income tax purposes

Income Tax Calendar

Individuals

- **Form 1040:** Due on the 15th day of the fourth month after the end of your tax year
- **Form 4868:** Used to request an extension of time to file Form 1040
- **Estimated tax payments (Form 1040-ES):** Payments are due on the 15th day of the fourth, sixth, and ninth months of your tax year and on the 15th day of the first month after your tax year ends

Partnerships

- **Form 1065:** Due on the 15th day of the third month after the end of the partnership’s tax year
- **Form 1065 and K-1:** Provide all partners with a

copy of their Schedule K-1 (Form 1065) or substitute Schedule K-1 (Form 1065) by the 15th day of the third month after the end of the partnership’s tax year

- **Form 7004:** Used to request an automatic 6-month extension of time to file Form 1065

Corporations & S Corporations

- **Form 1120:** Due on the 15th day of the fourth month after the end of the corporation’s tax year; however, a corporation with a fiscal tax year ending on June 30 must file by the 15th day of the third month after the end of its tax year
- **Form 7004:** Used to request an automatic 6-month extension of time to file Form 1120; however,

corporations with a fiscal tax year ending on June 30 or a short tax year treated as if the short year ended on June 30 will use Form 7004 to request an automatic 7-month extension of time to file Form 1120

- **Form 1120S:** Due on the 15th day of the third month after the end of the corporation’s tax year; provide each shareholder with a copy of their Schedule K-1 (Form 1120S) by the 15th day of the third month after the end of the corporation’s tax year
- **Form 7004:** Used to request an automatic 6-month extension of time to file Form 1120S
- **Estimated tax payments:** Payments are due on the 15th day of the fourth, sixth, ninth, and twelfth months of the corporation’s tax year

Self-Employment Tax Rules

- Self-employment tax consists of Social Security and Medicare taxes primarily for individuals who work for themselves
- It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners
- As of 2017, the self-employment tax rate is 15.3%
 - The rate consists of two parts: 12.4% for Social Security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance)
- You must pay self-employment tax if either of the following applies:
 - Your net earnings from self-employment (excluding church employee income) were \$400 or more
 - The self-employment tax rules apply no matter how old you are and even if you are already receiving Social Security or Medicare
- To pay self-employment tax, you must have a Social Security number (SSN) or an individual taxpayer identification number (ITIN)

Retirement Plans for Small Businesses

There are benefits to the small business and to the employees of setting up small business retirement plans

Benefits of Establishing a Retirement Plan

- Employer contributions are tax-deductible
- Assets in the plan grow tax-free
- Tax credits and other incentives for starting a plan may reduce costs
- Retirement plans can attract and retain better employees

Employee Benefits

- Employee contributions can reduce current taxable income
- Contributions and investment gains are not taxed until distributed
- Contributions can be made through payroll deductions
- Retirement assets can be carried from one employer to another

Types of Small Business Retirement Plans

Payroll Deduction IRA

- Under a Payroll Deduction IRA, an employee establishes an IRA (either a traditional IRA or a Roth IRA) with a financial institution
- The employee then authorizes a payroll

deduction for the IRA with the remainder of the employee’s pay distributed to the employee as before

Traditional IRA

- A traditional IRA is a personal savings plan that gives you tax advantages for saving for retirement
- Contributions to a traditional IRA may be tax deductible, either in whole or in part; also, the earnings on the amounts in your IRA are not taxed until they are distributed
- The portion of the contributions that was tax deductible also does not get taxed until distributed
- A traditional IRA can be established at many different financial institutions, including banks, insurance companies, and brokerage firms

Roth IRA

- A Roth IRA is also a personal savings plan, but operates somewhat in reverse compared to a traditional IRA; for instance, contributions to a Roth IRA are not tax deductible, while contributions to a traditional IRA may be deductible; however, while distributions (including earnings) from a traditional IRA may be included in income, the distributions (including earnings) from a Roth

IRA are not included in income

- For both IRA types (traditional and Roth), earnings that remain in the account are not taxed
- A Roth IRA can be established at the same types of financial institutions as a traditional IRA

Simplified Employee Pension Plan (SEP)

- A SEP provides employers a simplified method to make contributions toward their employees’ retirement and their own retirement
- Contributions are made directly to an IRA set up for each employee (a SEP-IRA)

SIMPLE IRA Plan

- A SIMPLE IRA plan is a Savings Incentive Match Plan for Employees; it gives small employers a simplified method to make contributions toward their employees’ retirement and their own retirement
- Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching contributions
- All contributions are made directly to an IRA set up for each employee (a SIMPLE IRA)

Home-Based Businesses

- Small business owners may be able to deduct expenses related to the business use of part of their home if they meet specific requirements; consult IRS rules on home-based business deductions
- Generally, to qualify to deduct expenses for business use of your home, you must use part of your home:

- Exclusively and regularly as your principal place of business
- Exclusively and regularly as a place where you meet or deal with patients, clients, or customers in the normal course of your trade or business
- In the case of a separate structure that is not attached

to your home, in connection with your trade or business

- On a regular basis for certain storage use, such as inventory or product samples
- For rental use
- As a daycare facility

Professional Help

Small business owners may need additional professional help:

- A **bookkeeper** to record business transactions, post to accounts, prepare trial balances, reconcile checking accounts, and prepare billings and invoices
- A **CPA** to prepare financial statements and other reports and analyses; prepare income tax returns and informational returns; and perform tax planning, personal financial planning, and business advisory services
- An **attorney** to provide legal advice, contract, review, and document preparation
- An **insurance agent** to perform risk analysis, provide insurance coverage, and perform annual reviews

Meeting with Your CPA or Tax Preparer for Tax Return Preparation

Preparation is key; organizing information ahead of time will make the meeting more productive and time efficient

What to Bring

- ✓ A summary of all business income and expenses and printed financial statements if books are maintained on a computer
- ✓ **Note:** If you use QuickBooks, Quicken, or the like, you may be asked to provide a backup copy of your data on a USB flash drive or CD
- ✓ A copy of last year's tax return and the depreciation schedules of company assets
- ✓ A list of any new ownership changes that might have transpired during the year
- ✓ Copies of all 1099s and 1098s received
- ✓ Copies of federal quarterly payroll tax returns
- ✓ Forms W-3 and W-2
- ✓ Detailed summary (including the date of purchase) of all assets over \$500 (vehicles, computer equipment, machinery, etc.)
- ✓ Bank statements and December bank account reconciliations
- ✓ Business loan balance confirmations and/or year-end loan statements
- ✓ Closing settlement statements on properties purchased and/or sold during the year
- ✓ Health insurance premiums paid
- ✓ SEP, SIMPLE, and IRA contribution amounts (contributions must be made by April 15 of the current year to qualify as a deduction on the prior year's tax return)
- ✓ Quarterly federal and state estimated payments made during the year and dates paid

Budgeting

Why Budget?

- Help you manage your costs
- Help you prepare for "what is coming next"
- Help manage cash flow
- Help you set profit goals and monitor progress toward those goals from month to month

Where to Start

- Project revenues (i.e., sales in units × selling price)
- Project expenses for all business costs (expenses)
 - Salary expenses
 - Payroll expenses
 - Outside services
 - Supplies (office and operating)
 - Repairs and maintenance
 - Advertising
 - Car, delivery, and travel
 - Accounting and legal expenses
 - Rent and related costs
 - Telephone
 - Utilities
 - Insurance
 - Taxes (real estate, etc.)
 - Interest
 - Depreciation
 - Other expenses
- **Projected revenues – Projected costs = Profit**
- Prepare a month-by-month budget for the next 12 months

One Month Budget Example

	Budget	Actual
Sales	\$25,000	\$21,000
Less cost of goods sold	\$8,000	\$8,100
Gross profit	\$17,000	\$12,900
Operating expenses		
Accounting	\$300	\$100
Advertising	\$5,000	\$4,500
Salaries and wages	\$3,700	\$4,000
Vehicle expenses	\$500	\$600
Bank charges	\$220	\$200
Printing	\$500	\$200
Insurance	\$850	\$800
Internet expense	\$250	\$250
Taxes	\$455	\$455
Rent	\$900	\$900
Telephone and cable	\$400	\$350
Utilities	\$225	\$250
Depreciation expense	\$500	\$500
Office expenses	\$125	\$150
Other expenses	\$700	\$600
Total	\$14,625	\$13,855
Net income or loss (cash basis)	\$2,375	(\$955)
Cash flow		
Net income (loss)	\$2,375	(\$955)
Plus depreciation	\$500	\$500
Cash from operations	\$2,875	(\$455)
Plus beginning cash	\$20,000	\$20,000
Less debt payment	\$1,000	\$1,000
Cash after debt payment	\$21,875	\$18,545

How to Use a Budget

- A budget is both a planning tool and a control tool
- Difference between budget and actual is a variance; large variances should be analyzed
- Helps you set goals and take corrective action when variances from goals occur
- Iterative process
 - Reset revenue goals and expected costs to achieve a target profit
 - Revise cash budget to take into account deficits
- Projected financial statements
 - Budget should help produce projected (pro-forma) income statement and balance sheet 12 months ahead
 - The budget helps you prepare an income statement for a future period (i.e., a projected income statement for a future 12-month period)

Business Plan

- A document disclosing a business's future objectives and strategies for achieving them; used to help plan and organize a business, to seek investment from potential owners, and to borrow funds from a bank
- Contents:
 - **Executive Summary:** A one- or two-page synopsis of the plan
 - **Company Description:** Describes the mission of the company and the vision of management
 - **Products and Services:** Describes the products and services that management plans to offer
 - **Marketing Plan:** Details how products and services will be priced and promoted and where and how they will be sold
 - **Operational Plan:** Details production, distribution, and other activities to produce and provide goods and services
 - **Management and Organization:** Provides an organization chart and the background, experience, and education of management
 - **Startup Expenses and Capitalization:** Details the expected costs to be incurred to start the business and the source and amount of funds that provide the capital to start the business
 - **Financial Plan:** Includes budgets and projected financial statements (income statement, balance sheet, and statement of cash flows)

Small Business Fraud

- Small businesses can be vulnerable to fraud because they lack the resources to implement a complete and effective system of internal controls and often cannot afford separation of duties
- Common fraud schemes in small businesses:
 - Billing fraud
 - Check tampering
 - Skimming
 - Expense reimbursement fraud

Conditions That Contribute to Fraud

- Lack of segregation of duties
- Too much trust placed in employees
- Lack of verification of transactions after they have been entered into the system
- Lack of reconciliations
- No follow-up when things appear "questionable" or "not reasonable"
- Lack of control over cash

Fraud Triangle

Helps explain why fraudulent activity occurs:

- **Opportunity:** Fraud occurs because too much trust was invested in an employee or because internal controls were lacking
- **Pressure:** Perpetrator feels stress to steal or profit illegally; could be because of financial issues, addictions, or other stressors
- **Rationalization:** Perpetrator finds a way to "justify" the act

Internal Controls

Internal controls are policies, plans, and procedures to help your company achieve goals; to operate effectively and efficiently; to produce reliable financial reports; and to comply with laws, regulations, and policies

- **Separation of duties:** Separation of authorization, custody of assets, and recordkeeping
 - Separation of duties is often difficult and too expensive in small businesses
 - It is very important that the owner/operator chooses people of integrity, but also provides sound oversight
- Reconciliation of accounts (i.e., balancing the checkbook)
- Lock up sensitive records
- Utilize passwords for important digital files
- Minimize the amount of cash on hand
- Carefully review budgeted versus actual performance and understand why variances occur
- Utilize respected and ethical advisors
- Use petty cash funds for small purchases
 - **Petty cash:** A small fund of cash kept on hand and maintained by one person (custodian of petty cash) for small purchases or small-amount reimbursements

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Disclaimer: This guide is intended for informational purposes only. Due to its condensed format, this guide cannot possibly cover every aspect of the subject. BarCharts, Inc., its writers, editors, and design staff are not responsible or liable for the use or misuse of the information contained in this guide.

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