

# Basic Accounting

## Chapter 8

## Unit 3

### Performance Objectives:

You will read information about start-up costs and use a start-up calculator to calculate your start-up costs. You will then carry out whatever additional research is needed to complete a chart of the start-up costs for your business. You will read about the two accounting methods and then decide which accounting method you will use for your business. You will create your charts of accounts in Microsoft® Excel. You will read about the three basic financial statements needed by small businesses.

### Evaluation Criteria:

Successful completion of this chapter requires you to:

- § Read information about start-up costs.
- § Calculate the start-up costs for your business using an online calculator.
- § Read about accounting methods and decide which accounting method your business will use.
- § Read the information below and then create your chart of accounts in Microsoft® Excel.
- § Read information about three basic financial statements.

You will incur specific costs when starting a new business venture. How do you determine these start-up costs? You will find a list of some basic start-up costs on the following page. It will take some research to find the accurate amounts for start-up costs. There are many places to look for answers:

- You can use the Internet (some links follow this section).
- Go to the local or university library.

*Use the people in your support network:*

- Talk to other business owners in a related field.
- Talk to business owner in the same industry, in a similar geographic, but different market area.
- Talk to business counselors.
- Call people at the bank or other appropriate institutions.
- Talk with people at the local SBDC (Small Business Development Center).

### **Task 1: Start-Up Costs Calculator**

Go to [Bplans.com](http://www.bplans.com)<sup>1</sup> and click on Biz Calculators from the navigation bar on the left hand side of the page. Choose [Starting Costs Calculator](http://www.bplans.com/business_calculators/startup_costs_calculator.cfm)<sup>2</sup>. Write your results below.

<sup>1</sup>Bplans.com: <http://www.bplans.com/>

<sup>2</sup>Starting Costs Calculator: [http://www.bplans.com/business\\_calculators/startup\\_costs\\_calculator.cfm](http://www.bplans.com/business_calculators/startup_costs_calculator.cfm)

## Task 2: Start-Up Costs

Do some basic research to fill in the tables with the start-up costs for your business. See how close your numbers are to what you figured at [Bplans.com](http://Bplans.com). Fill in the charts below.

### One-Time Costs

|                                  |  |
|----------------------------------|--|
| Licenses                         |  |
| Permits                          |  |
| Legal Fees                       |  |
| Letterhead, Business Cards, etc. |  |
| Deposits with Public Utilities   |  |
| Starting Inventory               |  |
| Remodeling                       |  |
| Equipment                        |  |
| Furniture and Fixtures           |  |
| Installation of Fixtures         |  |
| Real Estate                      |  |
| New Construction                 |  |
| Supplies                         |  |
| Cash                             |  |
| <b>SUBTOTAL</b>                  |  |

### Monthly Expenses

|                             |  |
|-----------------------------|--|
| Rent                        |  |
| Owner's Salary              |  |
| Employee Salaries           |  |
| Advertising                 |  |
| Telephone                   |  |
| Internet                    |  |
| Utilities                   |  |
| Insurance                   |  |
| Shipping and Delivery       |  |
| Legal Fees                  |  |
| Taxes                       |  |
| <b>SUBTOTAL</b>             |  |
| <b>Total Start-Up Costs</b> |  |

### Task 3: Accounting Methods

Read though the methods below.

If your business makes a sale on January 23 but isn't paid for that sale until February 11, when do you record the sale as income?

For some businesses the answer is January and for some others it is February. It all depends on which accounting method your business uses. Ideally, before you make your first sale and certainly before you file your first business tax return, you need to decide which accounting method you will use.

There are two basic methods:

- **Cash Basis:**  
Some small businesses record income as cash comes in and expenses when they pay bills. They do not record money owed to them by customers or bills they owe to suppliers as expenses until money changes hands. Using this accounting method, the business owner in the example above would record the sale as income in February when he received payment.
- **Accrual Basis:**  
Business owners who record income at the time of the sale (instead of the time they receive payment) are using the accrual method of accounting. Using this accounting method, the business owner in the example above would record the sale as income in January, when the transaction occurred.



#### Tax Tip

NOTE: The IRS requires that you file your taxes using the same method from year to year.

Many small business owners find the option of cash basis accounting to be an easier and less costly way of bookkeeping as it closely reflects your cash flow. The cash basis method allows deductions for expenses to be taken in the year paid and reporting of income in the year received whereas the accrual method recognizes income and expenses at the time they occur (at the time of the sale for income and at the time of your purchase for expenses). The accrual method is a more accurate measure of your operation and is recommended by accountants even though it may be more difficult. Some types of businesses must use the accrual method.

## Task 4: Cash Versus Accrual: The IRS

Go to the IRS Web site and click on [IRS Accounting Methods](#)<sup>3</sup>. Read the information in [Choosing an Accounting Method](#)<sup>4</sup> to determine which accounting method you should use.

My business should use the \_\_\_\_\_ accounting method.

**Before making this decision final, consult your tax accountant or business advisor. Changing your accounting method can incur heavy costs and penalties.**

## Task 5: Chart of Accounts

Read the information below and then create your chart of accounts in Microsoft® Excel.

The next step in preparation for constructing your business financial statements is to create your **chart of accounts**. This is a list of where your income comes from, where you put it, what your expenses are for, and what you use to pay for them. Here is a sample list of items in a chart of accounts:

1. **Assets** (what you own)
  - 101 Cash
  - 102 Supplies
  - 103 Accounts Receivable (what people owe you)
  - 106 Prepaid Insurance
2. **Liabilities**
  - 201 Accounts Payable (what you owe to others)
  - 202 Salaries Payable
3. **Equity** (the net worth of your business)
4. **Income**
  - 401 Sales
  - 402 Interest
5. **Expenses**
  - 501 Utilities
  - 502 Rent
  - 503 Advertising
  - 504 Supplies

<sup>3</sup>IRS Accounting Methods: <http://www.irs.gov/businesses/small/article/0,,id=98680,00.html>

<sup>4</sup>Choosing an Accounting Method: <http://www.nolo.com/legal-encyclopedia/article-29513.html>

## Task 6: Financial Statements

Read the information below.

There are three basic financial statements that business owners need to understand. They are the income statement, the balance sheet, and the cash flow statement. Each statement serves different purposes, which are outlined below. *You will complete each of these statements for your business in the following chapters.*

### Income Statement

This financial statement shows your income and expenses over a period of time.

**How often?** Annually, over a tax year, often completed in conjunction with the balance sheet for income tax purposes; monthly, for owner review and management purposes.

**Shows:** A company's profit or loss

**Measures:** Profitability

| Jack N' Jill's Lawn Care        |                                  |         |                |
|---------------------------------|----------------------------------|---------|----------------|
| Income Statement                |                                  |         |                |
| For Month Ended July 31, 2001   |                                  |         |                |
| <b>Sales</b>                    | Lawn Mowing                      | \$1,645 |                |
|                                 | Edging                           | 210     |                |
|                                 | Mulching                         | 1,040   |                |
|                                 | Fertilizer Application           | 720     |                |
|                                 | Tree Trimming                    | 350     |                |
|                                 | Landscaping                      | 2,420   |                |
| <b>Total Sales</b>              |                                  |         | <u>\$6,385</u> |
| <b>Operating Expenses</b>       |                                  |         |                |
|                                 | Salaries                         | \$4,080 |                |
|                                 | Insurance Expense                | 100     |                |
|                                 | Equipment Maintenance            | 50      |                |
|                                 | Phone                            | 35      |                |
|                                 | Supplies                         | 1,525   |                |
|                                 | Depreciation Expense - Equipment | (81)    |                |
| <b>Total Operating Expenses</b> |                                  |         | <u>\$5,709</u> |
| <b>Other Expenses</b>           |                                  | \$0     |                |
| <b>Total Other Expenses</b>     |                                  |         | <u>\$0</u>     |
| <b>Total Expenses</b>           |                                  |         | <u>\$5,709</u> |
| <b>Profit (Loss) Pretax</b>     |                                  |         | <u>\$676</u>   |

(Income Statement in Microsoft® Excel)

| <b>Jack N' Jill's Lawn Care</b>          |                        |
|--|------------------------|
| <b>Profit &amp; Loss</b>                 |                        |
| <b>January 1 through August 19, 2002</b> |                        |
| ◊ <u>Jan 1 - Aug 19, 02</u> ◊            |                        |
| <b>Ordinary Income/Expense</b>           |                        |
| <b>Income</b>                            |                        |
| <b>Sales</b>                             | 1,930.00               |
| <b>Services</b>                          | <u>3,360.00</u>        |
| <b>Total Income</b>                      | 5,290.00               |
| <br>                                     |                        |
| <b>Cost of Goods Sold</b>                |                        |
| <b>Cost of Goods Sold</b>                | <u>575.00</u>          |
| <b>Total COGS</b>                        | <u>575.00</u>          |
| <br>                                     |                        |
| <b>Gross Profit</b>                      | <u>4,715.00</u>        |
| <br>                                     |                        |
| <b>Net Ordinary Income</b>               | <u>4,715.00</u>        |
| <br>                                     |                        |
| <b>Net Income</b>                        | <u><b>4,715.00</b></u> |

(Profit and Loss Statement in QuickBooks Basic 2002®)

## Balance Sheet

The balance sheet is a snapshot of the performance of the company on one date. This statement is used when applying for a loan or at the end of a year to account for your company's assets, liabilities, and equity. Total assets equal total liabilities and equity, hence the name, balance sheet.

**How often?** Annually for tax purposes, more often for owner review and management purposes; at the close of the most recent accounting period for review prior to applying for financing.

**Shows:** What the company owns and owes

**Measures:** How well a business manages its assets and liabilities

| Jack N' Jill's Lawn Care<br>Balance Sheet<br>For Month Ended July 31, 2001 |                 |                                     |                 |
|--|-----------------|-------------------------------------|-----------------|
| Assets   |                 | Liabilities                         |                 |
| <b>CURRENT ASSETS</b>  |                 | <b>CURRENT LIABILITIES</b>          |                 |
| Cash   | \$5,460         | Accounts Payable                    | \$650           |
| Accounts Receivable  | 0               | Current Portion Long-Term Debt      | 150             |
| Inventory  | 50              | Accrued Expenses                    | 408             |
| Prepaid Expenses   | 900             | Notes Payable                       | 0               |
| <b>Total Current Assets</b>  | <b>\$6,410</b>  | <b>Total Current Liabilities</b>    | <b>\$1,208</b>  |
| <b>FIXED ASSETS</b>  |                 | <b>LONG-TERM LIABILITIES</b>        |                 |
|  |                 | Equipment Loan                      | \$1,950         |
| Fixtures and<br>Leasehold Improvements                                     | \$0             | <b>Total Long-Term Liabilities</b>  | <b>\$1,950</b>  |
| Building   | 0               | <b>Total Liabilities</b>            | <b>\$3,158</b>  |
| Trucks   | 1,500           | <b>EQUITY</b>                       |                 |
| Machinery and Equipment  | 3,725           | <b>Total Equity</b>                 | <b>\$7,705</b>  |
| Depreciation - Equipment   | (772)           |                                     |                 |
| <b>Total Fixed Assets</b>  | <b>\$4,453</b>  |                                     |                 |
| <b>Total Assets</b>  | <b>\$10,863</b> | <b>Total Liabilities and Equity</b> | <b>\$10,863</b> |

(Balance sheet in Microsoft® Excel)

**Jack N' Jill's Lawn Care  
Balance Sheet  
As of August 19, 2002**

◊ Aug 19, 02 ◊

|                                       |                        |
|---------------------------------------|------------------------|
| <b>ASSETS</b>                         |                        |
| <b>Current Assets</b>                 |                        |
| Checking/Savings                      |                        |
| Checking Account                      | ▶ 50.00 ◀              |
| Total Checking/Savings                | 50.00                  |
| <br><b>Accounts Receivable</b>        |                        |
| Accounts Receivable                   | 2,367.19               |
| Total Accounts Receivable             | 2,367.19               |
| <br><b>Other Current Assets</b>       |                        |
| Inventory Asset                       | -574.00                |
| Undeposited Funds                     | 3,204.34               |
| Total Other Current Assets            | 2,630.34               |
| Total Current Assets                  | 5,047.53               |
| <br><b>Fixed Assets</b>               |                        |
| 1991 Ford F150 Truck                  | 1,500.00               |
| Craftsman Rear Bag 6.75 hp mowe       | 350.00                 |
| Craftsman Rear Bag 7.0 Hp mower       | 375.00                 |
| Total Fixed Assets                    | 2,225.00               |
| <b>TOTAL ASSETS</b>                   | <b><u>7,272.53</u></b> |
| <br><b>LIABILITIES &amp; EQUITY</b>   |                        |
| <b>Liabilities</b>                    |                        |
| <b>Current Liabilities</b>            |                        |
| Other Current Liabilities             |                        |
| Sales Tax Payable                     | 281.53                 |
| Total Other Current Liabilities       | 281.53                 |
| Total Current Liabilities             | 281.53                 |
| <br><b>Long Term Liabilities</b>      |                        |
| Equipment Loan                        | 1,950.00               |
| White's Landscaping Supplies          | 650.00                 |
| Total Long Term Liabilities           | 2,600.00               |
| Total Liabilities                     | 2,881.53               |
| <br><b>Equity</b>                     |                        |
| Opening Bal Equity                    | -324.00                |
| Net Income                            | 4,715.00               |
| Total Equity                          | 4,391.00               |
| <b>TOTAL LIABILITIES &amp; EQUITY</b> | <b><u>7,272.53</u></b> |

(Balance sheet in QuickBooks Basic 2002®)

## Statement of Cash Flows

This statement summarizes your inflow and outflow of cash. It is like a budget in that it shows when cash will be coming in and going out of a business over the year. An income statement doesn't show this. Since depreciation is not a cash expense, it is not shown in the cash flow. You can use this report to analyze your cash position over a period of time. It shows either actual or projected ("pro forma") figures.

The cash flow statement could be considered the most important financial statement. One third or more of today's businesses fail due to lack of cash flow (p. 76 Keeping the Books, Pinson, L. © 2001). You can avoid this by carefully keeping track of your cash expenditures.

- How often?** Monthly and annually
- Shows:**
- How much cash your business will need
  - When it will be needed
  - Where cash will come from
  - How the cash has been used
- Measures:** Cash in bank; cash flow in and out of business

| <b>Larry's Landscaping &amp; Garden Supply</b>                             |                         |
|--|-------------------------|
| <b>Statement of Cash Flows</b>   |                         |
| October 1 through December 15, 2003  |                         |
| ◊ <u>Oct 1 - Dec 15, 03</u> ◊  |                         |
| <b>OPERATING ACTIVITIES</b>  |                         |
| Net Income   | ▶ 24,111.06 ◀           |
| Adjustments to reconcile Net Income<br>to net cash provided by operations: |                         |
| Accounts Receivable  | -31,278.08              |
| Inventory Asset  | -323.91                 |
| Accounts Payable   | 1,498.25                |
| CalOil Card  | 48.50                   |
| QuickBooks Credit Card:QBCC Field Office                                   | 45.00                   |
| QuickBooks Credit Card:QBCC Home Office                                    | 25.00                   |
| Payroll Liabilities  | 1,769.96                |
| Sales Tax Payable  | <u>885.20</u>           |
| Net cash provided by Operating Activities                                  | -3,219.02               |
| <b>FINANCING ACTIVITIES</b>  |                         |
| Bank Loan  | -1,270.50               |
| Owner's Equity:Owner's Draw  | <u>-5,000.00</u>        |
| Net cash provided by Financing Activities                                  | <u>-6,270.50</u>        |
| Net cash increase for period   | -9,489.52               |
| Cash at beginning of period  | <u>51,013.31</u>        |
| Cash at end of period  | <u><u>41,523.79</u></u> |

(Statement of Cash Flows in QuickBooks Basic 2002®)

## Importance of Financial Reports

From the outline for each of the three basic financial statements, you can see how they have distinct purposes. They can also serve many purposes. They allow you to get an overall picture of your company and bring together the many pieces of information that you create as a result of your day-to-day operation. They are also tools used by financial institutions and potential investors. When combined, they tell financial institutions and those who may invest money in your company a great deal of information. They also can bring potential problems to your attention so that you can take corrective measures before it is too late.

You will want to learn how you can use your financial statements for management purposes to increase the profitability of your business. We will provide a general overall view of how your basic financial reports relate to each other. We will also show you a few ways you can use the information they provide. You will need to take the time to learn about business ratios and compare your reports for different periods of time to see in what direction your business is heading. You will want to address this information with your business counselor.

## Balance Sheet

As a general rule a balance sheet is just a snapshot in time but can be used to analyze trends such as:

- Are your customers paying regularly?
- Are your customers charging more, taking longer to pay?
- Are your vendors being paid regularly?
- Are you charging more, taking longer to pay, or taking out loans (creating more debt)?
- Is there cash available?

Information that can be obtained from your balance sheet:

- Can you meet your financial obligations? (Can you pay off your debts with what you own? Are you too far in debt, which affects your ability to get additional working capital (loans)?)
- Adequate cash level? Do you have cash flow problems? (Cash flow is also referred to as liquidity.)
- How much has been invested?
- How that money has been invested. (What assets do you own?)
- Do you have the right percentages of current assets to current liabilities?
- How old your assets are and what you paid for them.

Ways you can improve your balance sheet:

- Follow up on collecting from customers
- Pay cash for purchases or delay purchasing
- Increase cash flow by paying vendors later (but you risk the loss of a good credit rating which provides you the ability to borrow money)

The balance sheet shows you the distribution of assets, liabilities and equity at a specified time. You can use ratios such as liquidity (current ratio, quick ratio), working capital, and leverage to help analyze your balance sheet. These ratios are formulas using the data from your report. For example, to calculate a current ratio you use the following formula:  $\text{Current assets} \div \text{current liabilities} = \text{current ratio}$ . Each type of business has guidelines for acceptable ratios.

## Income Statement

As a general rule, an income statement is a summary for the period of time stated in the report. It shows the revenues (income) and expenses for that time period and the amount of depreciation your assets have used, and the difference between them.

It can be used to:

- Compare your budget for that time period against actual income and expenses
- Pinpoint unexpected expenditures or unexpectedly high costs
- Determine income tax liability.

Information that can be obtained from your income statement:

- Is your gross profit decreasing? (Sign of potential problems.)
- Are you depreciating your assets? (Depreciation (a system of cost recovery) allows you to reduce your taxable income without spending money to do so, which increases cash flow.)
- Are you making money or losing it? If you keep showing losses you are heading for trouble; if you are showing a profit, it doesn't mean you are actually making money and your next step is to analyze whether you are actually making money. (See Cash Flow)
- Are sales going up or down?
- Are expenses going up or down?
- How much depreciation expense for the period.

Income statement analysis shows the effectiveness of your management. Again, you can use ratios to help, such as interest coverage (the ability to make loan payments), profitability (gross margin, operating margin, net margin to measure your earnings or bottom line).

## Cash Flow

As a general rule, your cash flow shows how the money goes in and out of your business. It flows in from sales, payments by customers on their charges (accounts receivable), and from loans. It flows out by paying expenses, purchasing materials, buying fixed assets, paying on loans, and paying on the bills you charged (accounts payable).

Note: If you are using the accrual method of accounting, be sure to convert your accrual profit to cash flow profit. Your business counselor can give you the formula and show you how this is done.

**REMEMBER – profit and cash flow are not the same thing!** You can have profit without cash and loss with cash. For example: If you allow your customers to charge their purchases, you can show sales but your cash does not reflect it since the sales were recorded as accounts receivable because you do not have the money yet. Alternatively, you could generate a net profit but when you take into account your accounts receivable, inventory, accounts payable, and notes payable, you can find that you have a negative net cash flow. How much you owe and how much your customers owe you has a great impact on your business and its operation.

Ways to improve your cash flow:

- Offer incentives such as discounts for customers to pay their bills on time
- Delay payment of your bills to vendors (BE CAREFUL! This can cause you greater problems.)
- Delay purchases of assets
- Purchase materials as needed
- Negotiate better pricing for materials

### **How the Reports Relate to Each Other**

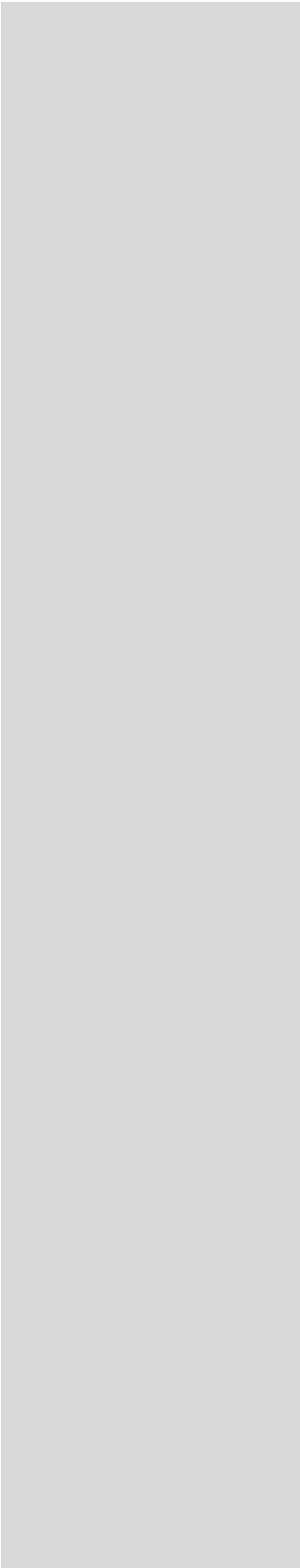
To know what happened during the time period covered by the balance sheet, you refer to your income statement for that period of time. It shows the income earned during that period, the costs (expenses) involved and the difference between the two.

The accounting equation of **Assets = Liabilities + Owner's Equity** is the foundation of all reporting. It is possible to use your liabilities and equity to create or increase assets (collecting on your accounts receivable, disposing of materials on hand, keeping profits in the business, cutting costs). By monitoring and controlling your fixed and variable costs, using business and financial ratios, you can make major changes in the profitability of your business, which in turn affects the equity, or value of it.

You need to understand cash flow and how inflows and outflows affect assets, liabilities and equity categories on the balance sheet. You will address these concepts with your business counselor.

Liabilities and equity can be used to create assets. For example, by investing equity in your company, you will increase your assets. You can also create assets by making purchases of equipment (fixed assets). These are usually done by taking out a loan or a note, which increases your liabilities.

Liabilities, equity and assets work to create profit. You can become more profitable by using your assets well. Reducing liabilities, holding on to retained earnings, selling assets no longer needed; all can work to create profit for your company.



When your business generates a profit, you have two options: paying it out (owner's equity) or keeping it in (retained earnings) the company to be used to grow the business. When it is kept in the business, it will show up on your balance sheet in the equity section under Retained Earnings.

When you prepare your reports you will find that your accounts will go on either your balance sheet or your income statement. If you are to be successful, you will have to have a basic understanding of accounting systems. There are several free resources that you can use to acquire this information.