



Bookkeeping & Accounting Issues

A business that is either just starting out or undergoing a significant growth stage must deal with four main issues in regard to recordkeeping: the use of the most appropriate "tax year;" whether to use a cash vs accrual method of accounting; maintaining a good recordkeeping/bookkeeping system; and, having a working knowledge of the major IRS reporting requirements for various payments.

The right decisions in these matters help increase the chance of business survival and of maximizing business profits. In addition, it can make matters much easier in dealing with such groups as the IRS, your state tax authority, an insurance carrier, outside investors, and accountants. This can save you time, aggravation, and money.

The Use Of The Most Appropriate Business Tax Year

A business may be required to choose between two different tax year periods: a Calendar Year or a Fiscal Year. A calendar year is one which ends on December 31. A normal fiscal year consists of 12 consecutive months ending in a month other than December. The business must establish which of these two options it will use for its operational life.

Why would a fiscal year be chosen? Many businesses use a fiscal year to match the business cycle—take advantage of the highs or lows. Others do it for convenience of recordkeeping. Getting information ready for doing taxes or financial reports can be time consuming, so a fiscal year that ends during a lull period gives the owners a more efficient time frame to do the recordkeeping activities. Businesses where inventory (and inventory-taking) is a big factor frequently elect fiscal years.

Similarly, businesses where the cash flow may differ from a calendar year period may decide on a fiscal year so money will be available to pay any required income taxes. In brief, a fiscal year may be more beneficial than a calendar year for a business where the preferred operating or income cycles end other than December 31.

From an income tax reporting standpoint, there are some business types that are either limited in the choice, or must make a special application to get permission to use a specific choice. This is due to the so-called "default" issues related to certain types of entities in which they are restricted in their selection.

In this regard, businesses that are either sole proprietorships, partnerships, or special subchapter S corporations must generally use a calendar year for income tax filing purposes. Regular C-type corporations can usually elect either calendar or fiscal without any restrictions, unless they fall under the classification of a "personal service corporation." In that case, a calendar year would also become the required default choice. A personal service corporation is one in which the principal activity consists of personal services done by owner/employees.

There are ways in which a business may still be able to qualify for a fiscal year selection instead of a required calendar year. The IRS may grant special permission to use other than the required tax year if the business can prove it has a definite "Business purpose" for another tax period.



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For instance, a business that is highly "seasonal" in nature where the main activities have monthly "peaks and valleys" that do not end on December 31 would be a good candidate. A tax preparation business where April is the dominant month is a good example; certain farming related businesses also fall into this category.

Other determining areas might be such things as the use of a fiscal year due to employee hiring patterns, consumer buying patterns (swimming pools, boats, etc.), regulatory purposes, or model year changes, to name a few. Reasons that CANNOT be used to get out of using a required tax year revolve around a business purpose that causes a significant shift in income or deductions such that it reduces potential tax liability.

Another way for certain business types to use a tax year different from a required tax year is to make a Section 444 Election. This is done by filing IRS Form 8716, "Election To Have A Tax Year Other Than A Required Tax Year." This may work for partnerships, personal service corporations, and subchapter S corporations where the "business purpose" test doesn't apply. This involves meeting various deferral period requirements and possibly making a payment if there are any calculated tax benefits from this deferral into a fiscal year.

Change In Tax Year: If you decide to try to change an existing tax year, an IRS Form 1128, "Application To Adopt, Change, Or Retain A Tax Year" must be filed. This is due before the 15th day of the second calendar month following the close of the prior tax year.

Cash Vs Accrual Accounting Methods

Under IRS definition, an accounting method is a set of rules used to determine when and how income and expenses are reported. Normally for IRS purposes, the accounting method—cash vs accrual—is chosen before you file the first business income tax return. It must then be used on a consistent basis for the life of the business, unless changes in the business occur that statutorily necessitate a change in the accounting method. If you wish to change methods for particular reasons of your own, you must get written permission from the IRS.

Normally, you calculate your income and expenses by using three major methods: 1) Cash Method; 2) Accrual Method; or, 3) Hybrid Method in which select elements of cash and accrual are combined.

Cash Method

This is used by most sole proprietorships, and many businesses where inventory is not a major factor. In this method, income is reported when actually (or constructively) received, and expenses are deducted when paid or legally charged (like with a credit card).

Constructive receipt means the money is made available to you without restriction. It doesn't always mean you have to have it in your possession. If it is credited to you, or given to your agent, it is still considered constructively received by you.

Expenses that you pay for are generally deducted in that particular year, unless you have substantially prepaid expenses that actually were for another year. As an example, if you prepay a three year service contract you cannot deduct the full three years of expense in one year. You would have to allocate the cost instead.



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Note that there are restrictions on which type of business can and cannot use the cash method. Generally, this method can be used by sole proprietors, corporations with less than \$5 million dollars in gross receipts (current 2000 year rules), most general partnerships (unless a C Corporation is one of the partners), and farm businesses with less than \$25 million dollars in gross receipts.

Tax planning opportunities exist with the cash method if you can time your constructive receipt of the income in such a way as to push it into another tax year. When you bill the client, when you actually receive the money and bank it, and when the job and its guarantees reach completion can each define when you have to report the income.

As to taking expense deductions, buying and placing into use such things as business equipment and supplies can be equally timed. Advertising, marketing, and employee bonuses can also be timed to best suit you for tax planning purposes.

Accrual Method

Using an accrual method, income is reported in the year it is earned, not necessarily received, and expenses are deducted in the year they are incurred, not necessarily when paid. From the gross receipts perspective, an accrual method generally means you report the income when the client is billed and/or has received your service or product. So if you finish a job and bill the client this December 2000, but don't get paid until January 2001, the income is reported in 2000 under the accrual method. Note that there are certain exceptions to this if the business transactions involve "related persons, entities, and controlled groups" but this is relatively rare for the scope of this discourse.

Unlike the cash method of accounting, accrual methodology can also involve making adjustments to reported income for bad debt allowances. If you report income when billed, but do not end up collecting all that is due you, you then may be able to write off the non-collectible portion as a business bad debt.

In regard to business expenses, you deduct or capitalize these when you become liable for them. This liability issue involves meeting the "events and economic performance" rules. Before taking the deduction, all necessary events that create the liability must have happened, and the economic performance of the action must have occurred. Thus, if the expense is for materials, property, or services you incur in the production of income for your trade or business, economic performance occurs as you provide your service or product.

Tax planning avenues that may be open to accrual type operations involve the attempt to defer income into a future year, and accelerate expense deductions into the current year. In this way, the net income from the business may be lowered for the current year at the expense of the next year. This may be possible by arranging it so the job you are doing is not fully completed before the close of the year, in which case the receipts collected don't necessarily have to be posted as taxable income at that point. You get the cash, but defer paying taxes on it until a later date.



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Similarly on the expense side, you would attempt to accelerate expenses into the current year so the bill you receive can be written off even though you haven't paid for it yet. This type of tax deferring can be beneficial in two ways. First, from a "use of funds" perspective it may make sense since you will have an extra year's use of the tax money you have delayed. Second, if your business experiences relatively large swings in taxable income from year to year, this is a way of "levelling off" the taxable income, thus possibly lowering the marginal tax bracket and actually saving taxes overall.

So if you are billed for office equipment placed into use in December 2000, but don't pay for it until January 2001, the deduction is taken in 2000 under an accrual method.

While the use of an accrual method may be elective for most, a business that maintains inventory as a significant part of the production of income (stores, manufacturers, wholesalers) must use some form of accrual based accounting for the purchases and sales of the particular products in question. The full cash method is generally not allowed in this case.

Hybrid Method

This combination of cash and accrual may be allowable if you can clearly show income and expenses in a consistent methodology. If you have two distinctly different businesses, you may use a cash method for one, and an accrual method for the other. If inventory is a significant part of your business, you could use accrual for purchases of inventory and sales of these items, but you may use cash methods for all other income and expense items.

However, there are limitations. If you elect the cash method for income, you must generally use the cash method for expenses. Conversely, if you elect accrual for expenses, you must use accrual for income.

Within this hybrid method there may be different elections as to how income will be reported. As an example, a completed contracts method may be elected for income. This may apply to a construction-type business where the projects take more than one year to complete.

Minimum Bookkeeping System Requirements

Maintaining a good, acceptable bookkeeping/recordkeeping system should not be solely to satisfy the government. There's no question that the more successful businesses also have more efficient bookkeeping systems in place. This is because a good bookkeeping system can give a business the timely information it needs to increase profit-making opportunities.

A good bookkeeping system can help the business answer many important questions such as:

- How much business is being done?
- How much cash is on hand?
- How much is tied up in receivables, and how old are these receivables?
- Should credit continue to be extended?
- Should collection action be taken?
- What are the expenses by categories?
- What are the important business ratios that should be analyzed?
- Are sales, expenses, capital, and profits showing improvement over previous periods?
- Where is the break-even point?
- How does this business compare with others of its size and industry?



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What is the projected income tax bill going to be, and how can this be minimized?
Is payroll at its optimum level, and is there enough cash coming in to meet payroll?

A good bookkeeping system allows the business owner and accountant to create and review important business ratios, profit and loss statements, balance sheets, customized management reports, reconciled bank statements, and required tax return information.

Requirements Of A Good System

For most businesses, especially privately-owned ones, an adequate recordkeeping system should be relatively simple to use and understand, accurate, designed to provide timely information, consistent in its treatment of income and expenses, reliable, and exportable in its context. The last feature refers to how easy it is for others besides the one recording the information to be able to understand, compile, and make adjustments to the information for their own purposes. Tax accountants, bankers, outside investors, shareholders, and actual business owners fall into this group.

Single Vs Double Entry: There is sometimes a choice between these two types. A single-entry system is the easier to keep, and also the more limiting for information, auditing, and accuracy-checking purposes. In single entry, an income or expense item is posted once with no other account offsets. For simple, one-person sole proprietorships where the owner also pays the bills, collects the income, does the bookkeeping, and where managerial reports are secondary, this system is easier to use and understand. A single-entry system tends to concentrate primarily on the profit and loss statement and not the balance sheet side, so it is really only a partial system.

The double entry system involves the use of journals and ledgers to track profit and loss and balance sheet items. Transactions are entered into a journal, then summarized in ledger accounts. These include income and expenses, assets, liability, and capital accounts. Unlike the single-entry, the double entry system is designed to be self-balancing. Every entry involves both a debit and credit in which the ultimate sum of the debits equal the sum of the credits.

At given periods(usually monthly, quarterly, annually), financial statements can be prepared which usually center around the Income Statement and the Balance Sheet. The income statement is similar to a profit and loss statement in that it reflects the income and expenses for the period. The Balance Sheet shows the business financial position at a given point in time in regard to assets, liabilities, and capital. While more complicated to maintain, double-entry systems allow for much more flexibility and standardization. They help to minimize errors, and possible embezzlement problems. Further, for businesses that may require audited, compiled, or certified financials (for investors, or lenders, etc.) double-entry systems are definitely the preferred way to go.



Features Of An Adequate Bookkeeping System

Whether single entry or double entry is selected, a bookkeeping system should have as a minimum the following component parts:

- 1) **Income Register:** This records and details money received by the business. It's especially important from a tax audit standpoint to be able to track the nature of the business deposits and differentiate between taxable and nontaxable sources. This income should be in balance with your bank statements, and supported by sales slips, invoices, register tapes or any documents used in the sales process which are stored separately.
- 2) **Disbursements Record:** This classifies, categorizes, and summarizes the expenses paid out for the business. Reimbursements and cash payments are handled the same way as checks. These expenses are recorded according to the date, check number, amount, and expense category. Further, all expenses should be backed up with an invoice or cash receipt which are stored separately.
- 3) **Petty Cash Vouchers:** For minor, incidental expenses where writing a check would be a nuisance (such as for office coffee, stamps, etc.), the use of a petty cash system is recommended. A check is written to fund the petty cash box for a designated amount. Money is taken out to pay for these small items (usually under \$5), and the receipts are recorded on petty cash vouchers. Periodically, another check is written to replenish the petty cash fund.
- 4) **Travel & Entertainment Reports:** For tax purposes, contemporaneous records must be kept for such expenses as food and entertaining, use of vehicle, outside travel, and other employee paid business expenses to be reimbursed. This T & E log breaks down the expenses per employee, and per category. In addition, back-up receipts where required for these expenses must be stored in case of audit.
- 5) **Equipment Register:** This records all assets/equipment bought or disposed of by the business. It shows the dates involved, purchase amounts, check number, supplier's names, and disposition details. For calculating depreciation, and any tax consequences upon disposition, this register is highly recommended.
- 6) **Payroll Register:** A separate, detailed record is in order for controlling various aspects of payroll. Records verifying the accuracy of how payroll is calculated, taxes are credited and deposited, overtime is calculated, etc., are mandatory.
- 7) **Insurance Log:** Business insurance policies are identified and detailed as to the type of coverage, premium costs, policy numbers, name of insurer, effective policy dates, and expiration dates (to avoid unwanted loss of coverage).
- 8) **Accounts Receivable Control Ledger:** This helps you keep track of who owes the businesses, how much is owed, and for how long it has been owed. It is essential to maximize your cash flow situation, and to minimize business bad debts. Accounts receivable are usually tracked according to their "age" using 30 day, 60 day, 90 day, and 180 day cycles.

Please understand that these eight features represent the minimum for an adequate bookkeeping system. The nature and type of business dictates what other features or customization should occur. In fact, many business types customize their systems; restaurants, automotive businesses, manufacturing, and others have their own particular nuances that need to be considered in setting up a system.



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IRS Reporting Requirements For Payments

Businesses may be required to send notification to the IRS and state tax authorities for payments made in diverse areas. These are usually called "information returns" in which the business discloses to the government the nature of the payment, the amount, and to whom the payment was made.

Generally, these forms are required to be distributed to the recipient of the payments as well as to the government. For IRS purposes, they are usually due on or before February 28 of the year following the year of payment. There may be penalties charged to any business that fails to file these information returns. Some of the most common filings are:

- Form 1099 Misc:** Payments in excess of \$600 per individual for services rendered (such as subcontractors, landlords, other nonemployee compensation).
- Form 1098:** For payments of mortgage interest in excess of \$600 to individuals on loans owed by the business.
- Form 1099 DIV:** Payments in excess of \$10 per recipient for dividends, and stock dividends.
- Form 1099 INT:** For payments in excess of \$10 to recipients of interest income.
- Form 8300:** Report of cash payments received by a business in excess of \$10,000 per transaction or related transactions.
- Form W-2:** Payments to employees for wages, tips, and other compensation. No dollar limitation.

There are many other possible information returns that may be required for different business activities and business types. However, these are the main ones that tend to impact most average businesses. When in doubt as to the ones required in your business, check with the appropriate professional before the year ends.

A Word On Computerized Systems

With today's explosion of the use of data processing systems, more and more businesses of all sizes are using computerized recordkeeping systems. There are no government restrictions or limitations on these systems as long as they meet the same tests and requirements as manual ones do.

The IRS position is that you must be able to show records that provide the necessary information to determine correct tax liability in a way that the auditors can track. The documentation must show the applications performed, the procedures used in each application, and the controls at hand. In other words, the computerized system must provide an adequate audit trail back to the original source of entry.

Using Outside Accounting Services

Many firms elect to use outside bookkeeping and accounting services to handle the major aspects of the recordkeeping—especially as it relates to government tax filings.



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This may be the most efficient use of a business owner's time. To try to be an expert in accounting, and to try to keep up with the changes that occur in the field can be prohibitive for a business owner. So the use of a professional to help design, change, and implement the necessary bookkeeping systems is certainly a viable option.

Conclusion

Decisions on accounting and bookkeeping issues are important for businesses, especially in the early stages. The purpose is twofold:

- 1) To meet government requirements, AND,
- 2) To increase the business chance for success by providing timely, efficient, and informative data with which to make comparative choices.

While it is usually easier to make these choices at the start of the business operation, this is not always possible. Businesses change along the way. In fact, running a business is not a static event; rather, it is a dynamic. These changes may necessitate corresponding changes in the accounting method, year, or bookkeeping system being used.

With few exceptions, it is strongly recommended that a business owner consider using an outside professional for at least some of the decision-making process here. The expeditious use of this type of assistance in the earlier stages of development can go a long way toward achieving the maximum business success possible.