

ACCOUNTING FOR YOUR BUSINESS

Knowing Your Options

Do You Already Know?

- The four basic accounting concepts and how to implement them
- The advantages and disadvantages of each legal form of business structure
- How to set up a computerized accounting system



For additional questions to assess your current knowledge of making business accounting decisions, go to www.wiley.com/college/epstein.

What You Will Find Out

1.1 How basic accounting concepts help record, classify, and report information about a business's financial transactions

1.2 The types of business structures

1.3 How the various accounting software options serve a business

What You Will Be Able To Do

- Choose a time period for tracking business finances; determine whether a cash-basis accounting system or an accrual accounting system is best for your business

- Evaluate business structures

- Choose a computerized accounting program; set up a computerized accounting system

INTRODUCTION

Accounting is called “the language of business” because it is used to communicate financial information. Like any language, accounting has its own vocabulary and structure. This chapter explores the terms and concepts used in accounting for a small business.

1.1 BASIC ACCOUNTING CONCEPTS

Bookkeeping:

The methodical way in which businesses track their financial transactions.

Accounting:

The total structure of records and procedures used to record, classify, and report information about a business’s financial transactions.

Bookkeeping is the methodical way in which businesses track their financial transactions. **Accounting** is the total structure of records and procedures used to record, classify, and report information about a business’s financial transactions. Bookkeeping involves the recording of that financial information into the accounting system while maintaining adherence to solid accounting principles.

Accurate and complete bookkeeping is crucial to any business owner, but it’s also important to others who are interested in the business, such as investors, financial institutions, and employees. People both inside (managers, owners, and employees) and outside the business (investors, lenders, and government agencies) depend on accurate recording of financial transactions.

Many small-business people who are just starting their businesses serve as their own bookkeepers until the business is large enough to hire someone dedicated to keeping the books. Few small businesses have accountants on staff; instead, they have bookkeepers on staff who serve as the outside accountant’s eyes and ears. A bookkeeper is not required to be a certified public accountant (CPA). However, most businesses do require that the outside accountant has a CPA certification.

Whether you are the business owner, bookkeeper, or CPA, you will need to apply basic accounting concepts. These concepts include the following:

- Separate entity assumption.
- Accounting period assumption.
- Cash-basis accounting and accrual accounting.
- Internal controls.

1.1.1 Separate Entity Assumption

An *entity* is something that has an independent existence. You are an entity, and your business is a different entity. The **separate entity assumption** is the concept that a business is an economic entity separate from its owner.

Separate entity assumption:

The concept that a business is an economic entity separate from its owner.

You may already know that a corporation is a separate *legal* entity. The separate entity assumption applies to all forms of business, not just corporations. In practical terms, this means that the business's financial records must be kept separate from the owner's financial records.



IN THE REAL WORLD

Organizing Your Accounts

Some people would say it's a good problem to have. When Monica started working as an event planner, the word spread about her exceptional talent. She planned every detail of an event, yet could think on her feet and make adjustments seamlessly.

The problem was Monica's success. When she wasn't working an event, she was preparing for the next one. She never seemed to have time to set up an accounting system for her business. She used her personal bank account and did not have a separate file location for business papers. At tax time she had to hire an accountant to help her sort out the mess and file her income tax return. With the accountant, Monica set up a system that included a separate bank account for the business and a location for her work files.

Accounting period assumption:

The concept that income is reported in regular time periods.

Accounting period:

The time for which financial information is being tracked.

Annual report:

A year-end summary of the company's activities and financial results.

Fiscal year:

A 12-month accounting period.

1.1.2 Accounting Period Assumption

The **accounting period assumption** is the concept that income is reported in regular time periods. An **accounting period** is the time for which financial information is being tracked. Most businesses track their financial results on a monthly basis, so each accounting period equals one month. Some businesses choose to do financial reports on a quarterly basis, so the accounting periods are three months. Other businesses only look at their results on a yearly basis, so their accounting periods are 12 months. A business that tracks its financial activities monthly usually also creates quarterly reports and an **annual report** (a year-end summary of the company's activities and financial results).

A **fiscal year** is a consecutive 12-month accounting period. The fiscal year is not always the same as the calendar year (January 1–December 31).

Small Business Accounting in Action

Choose a time period for tracking business finances.

1.1.3 Cash-Basis Accounting and Accrual Accounting

Before starting to record transactions, you must decide whether to use cash-basis accounting or accrual accounting. The key difference between these two accounting methods is the point at which you record sales and purchases in your books. Cash-basis accounting is used for service businesses only. If a business



PATHWAY TO... CHOOSING A FISCAL YEAR

- The calendar year is usually easiest, especially since the IRS requires calendar-year tax reporting for most businesses.
- Choose a different fiscal year if your company's busiest season occurs at calendar year-end. Many retail stores operate on a fiscal year of February 1 to January 31.
- If your inventory levels are high at the end of December, schedule your fiscal year-end for when levels are lower. This makes the year-end inventory count easier.

has inventory, then it must use accrual accounting. This book concentrates on the accrual accounting method. If you choose to use cash-basis accounting, don't panic: You can still find most of the bookkeeping information here useful.

Cash-basis accounting:

A system in which transactions are recorded when cash changes hands.

Cash-Basis Accounting

Cash-basis accounting is a system in which you only record transactions when cash actually changes hands. You record a sale when a cash payment is received from the customer. You record a purchase when cash is paid out. Cash receipts or payments can be in the form of cash, check, credit card, electronic transfer, or other means used to pay for an item.

Cash-basis accounting can't be used if a store sells products on store credit and bills the customer at a later date. There is no provision to record and track money due from customers at some time in the future in the cash-basis accounting method.

That's also true for purchases. With the cash-basis accounting method, the owner only records the purchase of supplies or goods that will later be sold when he or she actually pays cash. If goods are bought on credit to be paid later, the transaction isn't recorded until the cash is actually paid out.

Depending on the size of your business, you may want to start out with cash-basis accounting. Many small businesses run by an individual or a small group of partners use cash-basis accounting because it's easy. But as the business grows, the business owners find it necessary to switch to accrual accounting in order to more accurately track revenue and expenses.

Accrual accounting:

A system in which transactions are recorded when completed, even if cash doesn't change hands.

Accrual Accounting

Accrual accounting is a system in which you record a transaction when it's completed, even if cash doesn't change hands. For example, if you sell on store credit, you record the transaction immediately.

Suppose your company buys products to sell from a vendor but doesn't actually pay for those products for 30 days. If you're using cash-basis accounting, you don't record the purchase until you actually lay out the cash to the vendor. If you're using accrual accounting, you record the purchase when you receive the products, and you also use an account called accounts payable to record the future debt.

Like cash-basis accounting, accrual accounting has its drawbacks. It does a good job of matching revenue and expenses, but it does a poor job of tracking cash. Because you record revenue when the transaction occurs and not when you collect the cash, you can show a high income even if you don't have cash in the bank. For example, suppose you're running a contracting company and completing jobs on a daily basis. You can record the revenue upon completion of the job even if you haven't yet collected the cash. If your customers are slow to pay, you may end up with lots of revenue but little cash.

Small Business Accounting in Action

Determine whether a cash-basis accounting system or an accrual accounting system is best for a business.

Many companies that use the accrual accounting method monitor cash flow on a weekly basis to be sure they have enough cash on hand to operate the business. If your business is seasonal, such as a landscaping business with little to do during the winter months, you can establish short-term lines of credit through your bank to maintain cash flow through the lean times.

Making the Switch to Accrual Accounting

Changing between the cash-basis and accrual methods of accounting may not be simple, and you should check with your accountant to be sure you do it right. You may even need to get permission from the IRS, which tests whether you're seeking an unfair tax advantage when making the switch.

Keep in mind that the following types of businesses should only use accrual accounting (and never cash-basis):

- Businesses that carry an inventory.
- Businesses that incorporated as a C corporation (more on incorporation in the next section).
- Businesses with gross annual sales that exceed \$5 million.

1.1.4 Internal Controls

Every business owner needs to be concerned with keeping tight controls on company cash and how it's used. **Internal controls** are critical procedures that carry out the following:

- Protect assets.
- Provide reliable records.

Internal controls:

Procedures that protect assets and provide reliable records.

One way to institute internal controls is to place restrictions on who has the ability to enter information into your books and who has access to use that information.

You also need to carefully control who has the ability to accept cash receipts and who has the ability to disburse your business's cash. Separating duties appropriately helps you protect your business's assets from error, theft, and fraud. Chapter 8 goes into detail about controlling cash and protecting your financial records.



SELF-CHECK

1. Define the separate entity assumption.
2. List three examples of accounting periods.
3. Describe the key difference between cash-basis accounting and accrual accounting.
4. Define internal controls and list three examples.

Apply Your Knowledge You plan to start a Web site design business that caters to engineering firms. Using the four basic accounting concepts, create a “to-do” list of various items you will need to research before making decisions about your accounting system.

1.2 TYPES OF BUSINESSES

Businesses can be classified in two ways: by their type of operation and by their legal form of business structure.

1.2.1 Types of Business Operations

The term *business operation* refers to ways that businesses make money. There are three types of business operations:

- Service.
- Merchandising.
- Manufacturing.

Service business:
A business that sells services.

A **service business** is a business that sells services. Service businesses range from huge international accounting firms to walking the neighbors' dogs for a fee.

Merchandising business:

A business that buys inventory for resale.

Manufacturing business:

A business that sells goods it produces from raw materials.

A business that buys inventory for resale is a **merchandising business**. Wal-Mart Inc. is a merchandising business. So is your corner newsstand.

A **manufacturing business** is a business that sells goods it produces from raw materials. General Motors Corporation and a local bakery are examples of manufacturing businesses.

Some businesses have more than one type of operation. A styling salon is primarily a service business, but it can also sell merchandise such as specialty shampoos.

1.2.2 Legal Forms of Business Structure

Paying taxes and reporting income for your company are very important jobs, and the way in which you complete these tasks properly depends on your business's legal structure. This section discusses the main forms of legal structure:

FOR EXAMPLE

See Table 1-1 for a comparison of business structures.

- Sole proprietorship.
- Partnership.
- Corporation.
- Limited Liability Company (LLC).

Sole proprietorship:

A business that is owned by one person and is not separate from its owner for legal purposes.

Sole Proprietorship

The simplest legal structure for a business is the **sole proprietorship**, a business that's owned by one individual. Most new businesses with only one owner start out as sole proprietorships. In fact, about 75 percent of U.S. businesses do not have payroll. Most are self-employed persons who have unincorporated businesses. Although a sole proprietorship is a separate entity for business purposes, it is legally the same economic unit as the business owner. The business's profit is reported on the owner's individual income tax return.

Some sole proprietorships never change their status, but others grow by adding partners and becoming partnerships. Some add lots of staff and want to protect themselves from lawsuits, so they become Limited Liability Companies (LLCs). Those seeking the greatest protection from individual lawsuits, whether they have employees or are simply single-owner companies without employees, become corporations.

Partnership

Partnership:

A business that is owned by more than one person and is not separate from its owners for legal purposes.

A business owned by more than one person is a **partnership**. Like a sole proprietorship, a partnership is a separate *business* entity but not a separate *legal* entity. The business's profit "passes through" directly to the partners and is reported on each partner's individual tax return. The owner is also personally responsible for all business debts.

The partnership is the most flexible type of business structure involving more than one owner. Each partner in a partnership is personally liable for all the debts of the partnership. This structure is slightly more complicated than a sole proprietorship, and partners should work out certain key issues before the business opens its doors. These issues include the following:

- How the partners will divide the profits and losses.
- How each partner can sell his or her share of the business, if he or she so chooses.
- What will happen to each partner's share if a partner becomes sick or dies.
- How the partnership will be dissolved if one of the partners wants out.

Partners in a partnership don't always have to share equal risks. A partnership may have two different types of partners: general and limited. The **general partner** runs the day-to-day business and is held personally responsible for all activities of the business, no matter how much he or she has personally invested in the business. **Limited partners**, on the other hand, are passive owners of the business and are not involved in its day-to-day operations. If a claim is filed against the business, the limited partners can only be held personally liable for the amount of money that matches how much they individually invested in the business.

General partner:

A partner who runs the day-to-day business in a partnership and has unlimited legal liability.

Limited partner:

A partner who is a passive owner of a partnership and has limited legal liability.

*Small Business
Accounting in
Action* →

Evaluate business structures.

Corporation

If your business faces a great risk of being sued, the safest business structure for you is the corporation. Courts in the United States have clearly determined that a **corporation** is a separate legal entity and that its owners' personal assets are protected from claims against the corporation. Essentially, an owner or shareholder in a corporation can't be sued or face collections because of actions taken by the corporation. This veil of protection is the reason many small-business owners choose to incorporate even though it involves a lot of expenses (lawyers and accountants) and government paperwork.

In a corporation, each share of stock represents a portion of ownership, and profits must be split based on stock ownership. You don't have to sell stock on the public stock markets in order to be a corporation, though. In fact, most corporations are private entities that sell their stock privately among friends and investors.

Corporations come in two varieties, *S corporations* and *C corporations*. As you may expect, each has unique tax requirements and practices. In fact, not even all corporations pay tax on the company's profits. Some smaller corporations are designated as S corporations and pass their earnings on to the stockholders, who report that income on their individual tax returns.

Corporation:

A separate legal entity, which protects an owner's personal assets from claims against the corporation.

If you're a small-business owner who wants to incorporate, first you must form a board of directors. Boards can be made up of owners of the company as well as nonowners.

Corporations provide an umbrella of protection for company owners, but in order to maintain that protection, the owners must comply with many rules unique to corporations. The board of directors takes on the key role of complying with these rules, and it must maintain a record of meeting minutes that prove the board is following key operating procedures.



PATHWAY TO... THE RESPONSIBILITIES OF THE BOARD OF DIRECTORS

- Establishment of records of banking associations and any changes to those arrangements.
- Tracking of loans from stockholders or third parties.
- Selling or redeeming shares of stock.
- Payment of dividends.
- Authorization of salaries or bonuses for officers and key executives.
- Undertaking of any purchases, sales, or leases of corporate assets.
- Buying another company.
- Merging with another company.
- Making changes to the Articles of Incorporation or bylaws.
- Election of corporate officers and directors.

Corporate board minutes are considered official and must be available for review by the IRS, state taxing authorities, and the courts. If a company's owners want to invoke the veil of protection that corporate status provides, they must prove that the board has met its obligations and that the company operated as a corporation. In other words, you can't form a board and have no proof that it ever met and managed these key functions.

Check with your accountant to determine whether incorporating your business makes sense for you. Tax savings isn't the only issue you have to think about; operating a corporation also increases administrative, legal, and accounting costs. Be sure that you understand all the costs before incorporating.



IN THE REAL WORLD

Small Beginnings

You have probably used a FedEx Kinko's for your business, job, school projects, or personal life. Even before Kinko's became part of FedEx, the company had many stores that offered a wide variety of services.

Did you know that it all started in 1970 with a tiny storefront and a single copy machine? In addition to copy services, Paul Orfalea offered offset press, film processing, and school supplies. The space was too small to actually make copies; the copier had to be moved outside to the sidewalk.

The business expanded beyond its Santa Barbara, California, home and now has more than 1,500 locations worldwide. Kinko's remained a privately held corporation until it was acquired by FedEx in 2004.

Limited Liability Company (LLC):

A structure that provides a business owner with some protection from being held personally liable for their business's activities.

Limited Liability Company (LLC)

The **Limited Liability Company**, or LLC, is a structure that provides a business owner with some protection from being held personally liable for their business's activities. This business structure is somewhere between a sole proprietorship or partnership and a corporation. The business ownership and IRS tax rules are similar to those of a sole proprietorship or partnership, but like a corporation, if the business is sued, the owners aren't held personally liable.

LLCs are state entities, so the level of legal protection given to a company's owners depends upon the rules of the state in which the LLC was formed. Most states give LLC owners the same protection from lawsuits as the federal government gives corporation owners. However, these LLC protections haven't been fully tested in court to date, so no one knows for certain whether or not they hold up in the courtroom. An owner should seek legal and accounting advice before choosing this structure, as it has both tax benefits and limits.

LLCs are relatively new to the world of business structures. They were first established in the United States about 25 years ago, but didn't become popular until the mid-1990s, when most states approved the LLC as a business structure. They are still not adopted by all 50 states.

Many law firms and accounting firms are set up as LLCs. More and more small-business owners are choosing this structure rather than a corporation because the LLC is easier and cheaper to maintain (less government paperwork and lower legal and accounting fees), yet it still provides personal protection from legal entanglements.

Table 1-1 compares the characteristics of the different forms of business structure.

Table 1-1: Comparing Legal Forms of Business Structure

<i>Characteristic</i>	<i>Sole Proprietorship</i>	<i>Partnership</i>	<i>S Corporation</i>	<i>C Corporation</i>	<i>LLC</i>
Ease of formation and maintenance	Simple	Moderate	Complex	Complex	Moderate
Limited Liability	No	General Partner: No Limited Partner: Yes	Yes	Yes	Yes
Pass-through profits and losses	Yes	Yes	Yes	No ⁽¹⁾	Yes

⁽¹⁾ The C corporation pays taxes as a separate legal entity. If shareholders receive dividends, they also pay taxes at the individual level.



CAREER CONNECTION

Two friends form a knitting partnership with the hopes of making the world a more beautiful place—one row at a time.

When May Chao taught friend Jodi Toubes to knit in 2005, the two simply thought the hobby would be a way to take a break from their busy lives as mothers and working women in Los Angeles. Less than a year—and many scarves and blankets—later, Chao and Toubes were crafting uniquely styled tote bags for themselves, knitted in funky colors such as periwinkle and lime green. Soon after, they began taking orders from friends. It was clear to May and Jodi that they were onto something, and so “wabi-sabi knits” was born (www.wabisabiknits.biz).

Rooted in Japanese Shinto philosophy, wabi-sabi is an appreciation of beauty that is “imperfect, impermanent, and incomplete.” This idea of simplicity and natural beauty is represented in the two’s functional and environmentally friendly products. In forming a business partnership, Toubes and Chao wanted to focus on that same idea of simplicity. To do so, says Chao, “We agreed on a plan, because if we could agree on the ‘big picture’ and how to get there, there would be less room for misunderstanding or disagreements on the day-to-day running of the business.” Part of their plan included dividing up the responsibilities of the business; they also set clear goals, budgets, and objectives for growing the business.

Chao, whose strengths lie in marketing and accounting, uses QuickBooks and Excel for the business’s finances. “QuickBooks is an easy way to record sales and expenses and maintain a customer database,” she says, “and Excel allows me to format the data for specific needs, like

(continued)



CAREER CONNECTION

(continued)

annual sales tax reporting. It also serves as a backup to double-check that our numbers tie together.” Toubes, who handles sales, merchandising, and inventory, appreciates the value of having an inventory database to help keep the business on track.

Although the two have been pleased with the gradual growth of the business, they hope their new Web site will be a useful tool for customers, who can now choose designs and colors over the Internet. “We’re ready for the Web site to take us to the next level,” says Toubes.

Tips from the Professionals

- Know what financial information you need to have first, and buy or create a system to keep track of it.
- Keep diligent records of all expenses and sales, and run monthly/quarterly reports to monitor how your business is performing.
- Reevaluate your business plan vs. performance each year to see where new opportunities lie, and find ways to continually improve (for example, cut costs, find new markets).



SELF-CHECK

1. Identify and define the three types of business operations.
2. List the legal forms of business structure.
3. Which legal form of business structure is the most simple to set up? Which is the most complicated?
4. Which business structures protect the owners’ personal assets in lawsuits?

Apply Your Knowledge You and a coworker are striking out on your own to open a licensed day-care center. What type of business operation is this? What must you consider in choosing the legal form of structure for a day-care business? List the pros and cons of each business structure as it relates to your business.

1.3 ACCOUNTING SOFTWARE OPTIONS

Some small-business owners who have been around a while still do things the old-fashioned way—they keep their books using paper forms. However, in this age of technology and instant information, the majority of today’s businesses computerize their books.

Not only is computerized bookkeeping easier, it also minimizes the chance of errors, because most of the work involves using on-screen forms to input data. The forms can be understood even by someone without training in accounting or bookkeeping. The person entering the information doesn't need to know whether something is a debit or credit (Chapter 2 explains the difference), because the computerized system takes care of everything.

In addition to increasing accuracy and cutting the time it takes to do your bookkeeping, computerized accounting also makes designing reports easier. These reports can then be used to help make business decisions. Your computerized accounting system stores detailed information about every transaction, so you can group that detail in any way that may assist your decision making.

1.3.1 Overview of Software Options

More than 50 different types of accounting software programs are on the market, and all are designed to computerize your bookkeeping. The more sophisticated ones target specific industry needs, such as food services or utilities, and can cost thousands of dollars. To check out those options, visit www.findaccountingsoftware.com, where you can browse for accounting software that's grouped by industry—29 to be exact, from accommodations and food services to utilities.

Luckily, as a small businessperson, you probably don't need all the bells and whistles offered by the top-of-the-line programs. Instead, three software programs reviewed in this section can meet the needs of most small-business people:

- Simply Accounting Pro.
- Peachtree Accounting.
- QuickBooks.

Using one of these three systems, you can get started with a modest initial investment. It may not be fancy, but basic computerized accounting software can do a fine job of helping you keep your books. And you can always upgrade to a more expensive program, if needed, as your business grows.

Accounting software packages are updated almost every year. That's because tax laws and laws involving many other aspects of operating a business change so often. In addition, computer software companies are always improving their products to make computerized accounting programs more user-friendly, so be sure that you always buy the most current version of an accounting software package.

Simply Accounting Pro

Simply Accounting Pro (www.simplyaccounting.com) is a cost-effective choice for bookkeeping software if you're just starting up and don't have sophisticated bookkeeping or accounting needs. For example, you can process credit-card transactions and electronic features from inside the other two accounting software programs discussed in this section, but Simply Accounting requires you to use an add-on tool. This program caters to the bookkeeping novice and even provides an option that lets you avoid accounting jargon. The program includes more than 100 accounting templates for things like sales orders, quotes, receipts, and other basic needs for a variety of industries, including medical/dental, real estate, property management, and retail firms. Simply Accounting Pro has an integrated feature that allows you to do Employee Direct Deposit for payroll.

If you're working with another software system to manage your business data and are interesting in switching to Simply Accounting Pro, you may be able to import that data directly into Simply Accounting. (Information about how to import data is included with the program.) You can import data from software such as Microsoft Excel (a spreadsheet program) or Access (a database program). If you're converting from QuickBooks or another accounting software program called MYOB, you can easily import your data to Simply Accounting. However, data from Microsoft Money and Intuit Quicken can't be imported.

Peachtree Accounting

Peachtree Accounting (www.peachtree.com) is an excellent software package for your bookkeeping and accounting needs, but it's definitely not recommended if you're a novice. You need to be familiar with accounting jargon to use the Peachtree system.

According to CNET (www.cnet.com), a company that offers reviews of computer software and hardware, Peachtree Accounting's inventory-management tools are the best in its class. The software automatically generates purchase orders when inventory reaches a level predetermined by the user. You can also export Peachtree Accounting's customer, vendor, or employee information into Microsoft Word and use the data with Word's mail-merge feature to send emails or letters.

Peachtree Accounting offers a utility that's easy to use to convert data from Intuit's QuickBooks. You can also import files from Quicken. There's no conversion tool for Microsoft Excel data, but you can import and export Excel files into the program without problems.

If you want to be able to integrate your shipping with UPS, have more than one user, control users by screen-level security, have advanced inventory or job costing capabilities, or have an audit trail of your work, you need to start with Peachtree Complete Accounting instead of Peachtree Accounting.

***Small Business
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Action*** →

Choose a computerized accounting program.

QuickBooks

QuickBooks (www.quickbooks.intuit.com) offers the best of both worlds: an easy user interface (for the novice) and extensive bookkeeping and accounting features (for the experienced bookkeeper or accountant). More small-business owners today use QuickBooks than any other small-business accounting software package. Even CNET gives QuickBooks its highest rating for accounting software packages in this class. Many nonprofit organizations—schools, churches, and social agencies—also use QuickBooks for accounting purposes.

The QuickBooks learning center walks you through every type of key transaction with an interactive program that not only shows you how to do the function, but also explains the basics of bookkeeping. You don't have to use the tutorial, but the option pops up when you do a task for the first time, so the choice is always yours. You also can go back to the learning center to review at any time.

QuickBooks Basic can probably meet most of your bookkeeping and accounting needs. If you want to integrate your bookkeeping with a point-of-sale package, which integrates cash register sales, you need to get QuickBooks Pro. You also need QuickBooks Pro if you want to do inventory management, generate purchase orders from estimates or sales orders, do job costing and estimates, automatically create a budget, or integrate your data for use with Microsoft Word and Excel programs. This book uses QuickBooks Pro to demonstrate various bookkeeping functions.

QuickBooks is a versatile program and can share data with over 325 popular business software applications. Sales, customer, and financial data can be easily shared, so you don't have to enter that information twice.

**IN THE REAL WORLD****Show Business**

Donal wanted to combine his entrepreneurial ambition with his love of movies. Armed with a degree in accounting and knowledge from completing an internship the previous summer at a film studio, Donal launched a freelance career as a production accountant.

Donal's first job was working on the accounting team of a romantic comedy. He did not go on location to Prague and London, but he did have to deal with time differences and currency-exchange issues. He also learned about union regulations for cast and crew members. Although accounting systems such as QuickBooks were available, Donal's team chose and used accounting software that was developed for production accountants. Working with the software's industry-specific features, Donal developed a wider understanding of the film business.

1.3.2 Add-Ons and Fees

The three accounting programs discussed in this section offer add-ons and features you're likely to need, such as:

- **Tax updates:** If you have employees and want up-to-date tax information and forms to do your payroll using your accounting software, you need to buy an update each year.
- **Online credit-card processing and electronic bill paying:** Having the capabilities to perform these tasks means additional fees.
- **Point-of-sale software:** This add-on helps you integrate your sales at the cash register with your accounting software.

Before signing on for one of the add-ons, be sure you understand what the fees will be. Usually, you're advised of the additional costs whenever you try to do anything that incurs extra fees.

1.3.3 Setting Up Your Computerized Books

After you pick your software, the hard work is done because actually setting up the package will probably take you less time than researching your options and picking your software. The three packages discussed in this section have good start-up tutorials to help you set up the books.

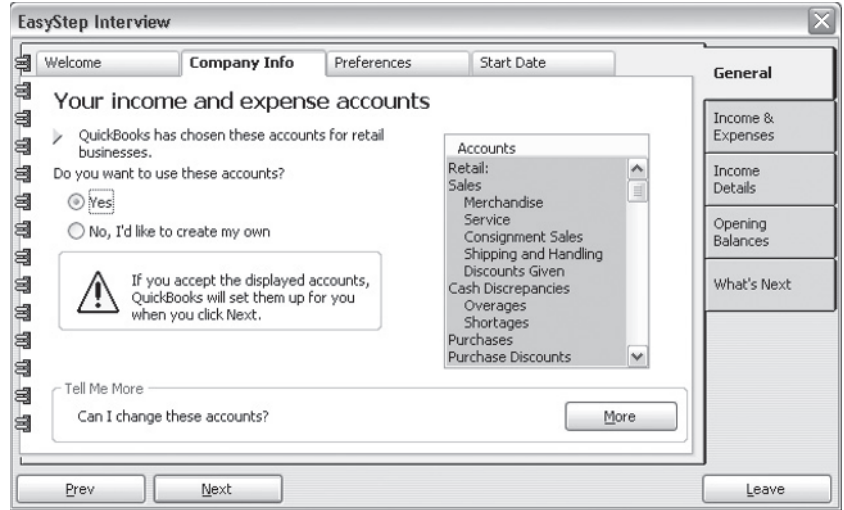
A building block of any accounting system is the chart of accounts, which is a list of the accounts used in the business. Chapter 2 discusses the chart of accounts in more detail. Simply Accounting Pro, Peachtree Accounting, and QuickBooks all produce a number of sample charts of accounts that automatically appear after you choose the type of business you plan to run and upon which industry that business falls. Start with one of the charts offered by the software, like you see in Figure 1-1, and then tweak it to your business's needs.

Once your chart of accounts appears, all three programs ask you to enter a company name, address, and tax identification number to get started. If you're operating as a sole proprietor or if your business is based on a partnership and you don't have a federal tax ID for the business, you can use your Social Security number.

You then select an accounting period (see Figure 1-2). If the calendar year is your accounting period, you don't have to change anything. But if you operate your business based on another period of 12 months, such as September 1 to August 31, you must enter that information.

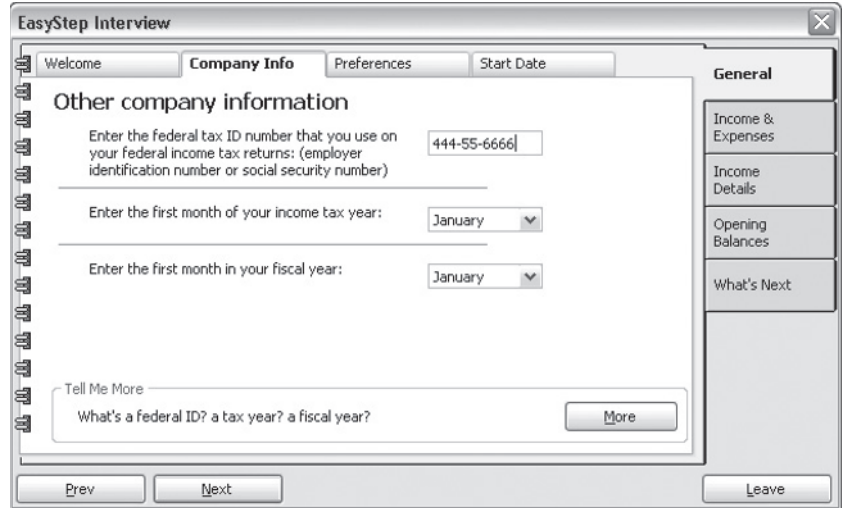
If you don't change your accounting period to match how you plan to develop your financial statements, then you have to delete the business from the system and start over.

Figure 1-1



QuickBooks generates a chart of accounts based on the type of business you have.

Figure 1-2



QuickBooks asks you to input your fiscal year.

This is also the time to input information about your bank accounts and other key financial data (see Figure 1-3). Your main business bank account is the one that should be used for Cash in Checking, the first account listed in your software's chart of accounts.

Figure 1-3

QuickBooks collects information about your bank accounts.



PATHWAY TO... SETTING UP A COMPUTERIZED ACCOUNTING SYSTEM

- Create your chart of accounts.
- Enter your company name, address, and tax identification number.
- Select your accounting period.
- Input information about your bank accounts and other key financial data.
- Enter data unique to your business, such as budget information, vendors, and customers.
- Select your accounting method: cash-basis or accrual.
- Enter sales tax rates, if appropriate.
- Pick a format for your invoices.
- Set up payroll data.
- Define how you want to pay bills.

After entering your bank and other financial information, you enter data unique to your business. If you want to use the program's budgeting features, you enter your budget information before entering other data. Then you add your vendor and customer accounts so that when you start entering transactions, the information is already in the system. If you don't have any outstanding bills or customer payments due, you can wait and enter vendor and customer information as the need arises.

**Small Business
Accounting in
Action** 

Set up a computerized accounting system.

Other information collected includes the type of accounting method you'll be using—either cash-basis or accrual accounting. You also need to enter information about whether or not you collect sales taxes from your customers and, if you do, the sales tax rates. Also, you can pick a format for your invoices, set up payroll data, and make arrangements for how you want to pay bills. The steps to set up your system are summarized in Section 1.3.3.

Don't worry about entering everything into your computerized system right away. All programs make it very easy to add customers, vendors, and employees at any time.

**SELF-CHECK**

1. Describe the advantages of using a computerized accounting system.
2. Identify three accounting software programs.
3. List the information you should have ready when you set up a computerized accounting system.

Apply Your Knowledge When you started your car-detailing business, most of your income was from providing services. Eighteen months later, you found that you were making a lot of profit from selling high-end vehicle accessories. Eventually, you opened a store and you spend most of your time managing the retail side of the business. Your employees perform the detailing work. Which software program is appropriate for each stage of your business? Explain why each program is best for a particular stage.

SUMMARY**Section 1.1**

- Bookkeeping is the methodical way in which a business tracks financial transactions. Accounting is the total structure of records and procedures used to record, classify, and report information about a business's financial transactions.
- The four main accounting concepts are separate entity assumption, accounting period assumption, cash-basis and accrual accounting, and internal controls.

Section 1.2

- Businesses can be classified by their type of operation; the three forms of business operations are service, merchandising, and manufacturing.

- Small businesses are usually organized as one of the following legal forms of business structure: sole proprietorship, partnership, corporation, or Limited Liability Company.

Section 1.3

- Although some small-business owners still keep their books using paper forms, the majority of today's businesses computerize their books. In doing so, they save time and energy—and they minimize the risk of errors.
- Popular accounting software programs for small businesses include Simply Pro Accounting, Peachtree Accounting, and QuickBooks.

ASSESS YOUR UNDERSTANDING

UNDERSTAND: WHAT HAVE YOU LEARNED?



Go to **www.wiley.com/college/epstein** to assess your knowledge of making business accounting decisions.

PRACTICE: WHAT WOULD YOU DO?

1. If you are starting a gardening business, what are three things you can do to make sure you comply with the separate entity assumption?
2. Your friend has a full-time job, but he plans to have a side-business teaching music lessons during the school year. He wants to take summers off from his music business. What would be the most useful fiscal year for his business?
3. Identify advantages and disadvantages of cash-basis accounting and accrual accounting.
4. You own a packaging business and employ three workers. What can you do to strengthen internal controls?
5. Think of a business you would like to open. Briefly describe the type of business operation. Which legal structure do you think would be best? Why?
6. Suppose you are starting a corporation. What qualities would you want in the people who serve on your board of directors? How would you go about choosing and recruiting board members?
7. Your business partner does not want to spend money on software and prefers to do the books manually. Prepare a list of talking points to convince your partner to invest in accounting software.
8. Which software features are most important to you as a potential small-business owner?

BE A SMALL BUSINESS ACCOUNTANT

You Be the Teacher

Prepare a three-minute lecture on one of the following topics. The focus of your lecture should be the needs of your audience.

- How to Be a Separate Entity
 - How to Choose an Accounting Period
 - Cash-Basis or Accrual: Which Is Best for Your Business?
 - Do Your Internal Controls Work?
-

Research Legal Forms of Business Structure

On the Web site of the Small Business Administration (www.sba.gov), go to “SMALL BUSINESS PLANNER,” “Start Your Business,” “Choose a Structure,” and “Forms of Ownership.” What is the first step in determining how to structure your company? What factors should you consider in selecting the form of ownership? Which business structure requires that the owner be paid wages if he or she works for the company and it makes a profit? Would this wage requirement affect your decision about business structure? Why or why not?

Accounting Software Wish List

List the things you want your software to do, and the types of information you want from it. Based on what you have learned so far, can accounting software deliver what you want? Check over your list periodically and compare it to what you learn about accounting software.

KEY TERMS

Accounting	The total structure of records and procedures used to record, classify, and report information about a business's financial transactions.
Accounting period	The time for which financial information is being tracked.
Accounting period assumption	The concept that income is reported in regular time periods.
Accrual accounting	A system in which transactions are recorded when completed, even if cash doesn't change hands.
Annual report	A year-end summary of the company's activities and financial results.
Bookkeeping	The methodical way in which businesses track their financial transactions.
Cash-basis accounting	A system in which transactions are recorded when cash changes hands.
Corporation	A separate legal entity, which protects an owner's personal assets from claims against the corporation.
Fiscal year	A 12-month accounting period.
General partner	A partner who runs the day-to-day business in a partnership and has unlimited legal liability.
Internal controls	Procedures that protect assets and provide reliable records.
Limited Liability Company (LLC)	A structure that provides a business owner with some protection from being held personally liable for their business's activities.
Limited partner	A partner who is a passive owner of a partnership and has limited liability.
Manufacturing business	A business that sells goods it produces from raw materials.
Merchandising business	A business that buys inventory for resale.
Partnership	A business that is owned by more than one person and is not separate from its owners for legal purposes.
Separate entity assumption	The concept that a business is an economic entity separate from its owner.
Service business	A business that sells services.
Sole proprietorship	A business that is owned by one person and is not separate from its owner for legal purposes.