Woman C.P.A.

Volume 31 | Issue 3 Article 2

5-1969

Accounting for Small Business

Barbara I. Rausch

ACCOUNTING FOR SMALL BUSINESS

The author points up the major areas where the small businessman needs professional accounting help to set up his business in proper form and to operate it with a reasonable expectation of profit.

Barbara I. Rausch, CPA
Columbus, Ohio

An appropriate beginning for this paper is a definition of "small business." According to Section 1244 of the Internal Revenue Code, a small business corporation could have up to $1,000,000.00 in equity capital, which is not really small business. Traditionally, it seems, small business is thought of as the sole proprietorship, the corner grocery store, the filling station, and professional partnerships. Some employees would be quite surprised to find their employer's business referred to as a small business. It would appear most reasonable that a business would be classified as "small" either because of volume of business or because of its ownership, such as sole proprietorships, partnerships and closely held corporations.

Rumor has it that once upon a time it was possible for a man to conduct his business out of his hip pocket. His net profit was simply the cash he had left over after he paid all his bills. With the advent of income taxes, various and sundry property and franchise taxes, and with the additional burden of acting as a withholding agent for Federal, state and local taxing authorities, this method of operation is impossible today. Present competitive business conditions make record-keeping mandatory, even if the taxing authorities did not require it.

Failures

Dun & Bradstreet's 1964 statistical study, "The Failure Record through 1964," indicates that 91.9% of all failures in business are attributable to lack of management know-how and experience. One cannot help but wonder if better accounting and more current and intelligent management reports could have saved a number of these businesses.

Unfortunately, the small businessman is prone to look upon accounting as a time-consuming nuisance and inconvenience. Yet he has the greatest need for a workable accounting system that will give him promptly the necessary information to make management decisions and to avoid some of the pitfalls of business operation.

At the Beginning—Decisions

Fortunate, indeed, is the accountant who can get in at the beginning of a new business. He is in an excellent position to advise and assist the businessman in the many decisions he has to make at the outset as well as continuing with the operating of the enterprise.

Form of Entity

One of the first decisions is with regard to the form in which the business is to be conducted. Of the three choices—sole proprietorship, partnership or joint venture, and corporation—the latter is the most popular. The corporate form offers some distinct advantages, but there are also disadvantages which should be considered before making a definite decision.

The most widely recognized corporate advantages are the limited liability, free transferability of ownership and continuity of existence. But at least equally important are some of the features which the prospective new businessman may not know about, such as the choice of a natural business year and the employee status of the owner as opposed to the employer status as a sole proprietor or partner.

Even with the liberalized provisions of the "Keogh Bill," a corporate pension or retirement income plan is hard to match. With the business becoming a separate entity in the

BARBARA I. RAUSCH, CPA, is a senior staff member of the Columbus, Ohio office of Peat, Marwick, Mitchell & Co. She passed the CPA examination at her first sitting in 1961 after studying with the correspondence course of the International Accountants Society "to brush up on my accounting knowledge."

Born and educated in Berlin, Germany, she moved from her first job—budgeting and meal planning for a cafeteria (employer—the German Army) to interpreter, court reporter and claims adjuster for the American Armed Forces in West Germany after the arrival of the American troops. Upon coming to the United States in 1956, she commenced in the insurance field but switched to accounting in pursuit of more lucrative opportunity.

Miss Rausch is presently serving the Columbus Chapter of ASWA as second vice president and is a member of AICPA, AWSCPA and the Ohio Society of CPA's.

corporate form, portions of the ownership can be distributed to family, particularly children, over a period of time and be integrated with estate planning.

Of course, where there's sun, there is shadow, and operating in the corporate form has its disadvantages, too. The most immediate and obvious is that it costs money to organize a corporation and keep it alive, i.e., the annual franchise tax. The double taxation of profits, first at the corporate level and secondly at the shareholder level upon distribution of dividends, has discouraged many businessmen from forming a corporation. However, the accountant and tax practitioner can advise of means by which such double taxation can be minimized. One is for profits to be distributed to the shareholder in the form of compensation, bonuses and commissions. This has its limitations, however, since the test that must be met is the "reasonableness" of compensation of officer-shareholders in closely-held corporations.

Another method of avoiding double-taxation of profits and dividends is through the election to be taxed under Subchapter S of the Revenue Code. Here the question of whether or not the owner's compensation is reasonable has no significance, since he is taxed on the total profits. Where the corporation has several stockholders rendering various degrees of actual services, the Internal Revenue Service has authority to establish "reasonable compensation" in the determination of profits allocable to each stockholder. Subchapter S election would permit the distribution of cash, whereas in a corporation not electing Subchapter S, the cash available is not as readily distributable due to the taxation feature.

There are some limitations on Subchapter S, i.e., some types of operations are precluded from the election, especially those with "passive" income; capital losses are still the loss of the corporation and do not "flow through" to the shareholders; and the election puts some limitation on the free transferability of the shares of stock.

Cash or Accrual Basis

Whatever form of business is chosen for the new enterprise, the owner has many more decisions to make. Before filing the first income tax return, the basis for reporting income must be established, whether it be cash basis or accrual basis. In certain instances, such as where inventories are a factor, the decision is academic, for he is required to use the accrual basis, at least down to gross profit.

The Internal Revenue Code now recognizes "hybrid" methods, under which operating and other expenses could still be handled on the cash basis, even though cost of sales must be on the accrual method because of inventories required in the business. Where the intention is to be on the accrual basis eventually, it would be well to begin with this method. Aside from the fact that the Tax Commissioner's consent is required for a change in accounting methods, the year of change may prove to be a costly one and can invite an IRS examination.

Capital Requirements

One of the most important questions deals with the capital requirements of the new enterprise. A careful appraisal must be made of starting expenses and working capital requirements to cover the period in which the business can generate capital out of current earnings. Lack of liquid working capital is one of the most common causes of small business failures.

In cases where the initial capital requirements are high the question arises: How much of this money should be permanent capital and how much should be loaned to the corporation and repaid as soon as the business is on its feet? A loan should of course be a bona fide, arms-length transaction and the business should pay a reasonable interest for the loan. Immediately two other questions come up: Can the business afford to pay the interest? Does it need the expense? In some cases it might be better to have a second class of stock, such as cumulative preferred stock, rather than long-term debt, with redemption provisions much the same as the repayment of long-term debt. However, caution must be used in the redemption of preferred stock in a closely-held corporation, since such redemptions could be viewed as a dividend where the redemption does not result in a substantial change in ownership ratios.

The Internal Revenue Service is also interested in this area with the varied definitions of "thin" corporations. The effect of having the "thin" corporation questioned is that the purported interest payments on shareholder loans may be disallowed and reclassified as dividend distributions, if the loans are too large in proportion to equity capital. In such cases, the purported loans may be classified as equity investment, and any repayments are considered dividend distributions until retained earnings are exhausted.

Investment in Equipment

Also in the area of capital, and cash requirements, is the matter of the investment in equipment. The business needs to make a realistic estimate of its requirements, since overinvestment in equipment is a major cause

INDIVIDUAL INCOME TAX BILL OF 1944—This bill is an answer to the universal demand of the citizens of the Nation to simplify the methods which the government uses to collect Income Taxes. That the proposed bill is the right answer is open to question. The bill is only an amendment to the Internal Revenue Code, and like most amendments only further complicates and confuses. It was rushed through in such haste to satisfy the demands of the voters at home, that there was not sufficient time to make a study of the entire tax structure, and give it the thorough overhauling it was in need of. The voters at home may learn that what seemed to them to be a step toward simplification involves more computations than in former years.

The writer is inclined to agree with a recent article in *Taxes*, a Commerce Clearing House publication, that there can be no real simplification of collecting income taxes unless the taxpayer is willing to forego many of his constitutional and legal deductions. If we are to expect the government to figure our taxes for us, then we must pay for the privilege. The less we do for ourselves and throw upon government employees, the more controlled we shall become. When people cease to act and think for themselves, the opportunity to do so shall be withdrawn from them. It is surely not asking too much of the law makers to prepare a tax bill which would be comprehensible to the average man or woman, that would provide a form that would ask for the gross income, ordinary deductions, and provide a graduated percentage, one figure not two or three, to use to arrive at the amount of the tax due.

From "TAX NEWS" by Alberta R. Crary, Whittier, California
June, 1944

---

of cash shortage. The possibilities of leasing equipment rather than purchasing it should be investigated. The lease expense will usually be higher but one would not have to contend with obsolescence or idle equipment with a flexible and well-planned lease arrangement. The technical aspects of equipping the new enterprise must be left to others to advise, but accountants can assist the new business with cash flow and profit and loss projections.

Location

Oftentimes the location of a new business is a major factor in success or failure of a new business. The market, the availability of labor, the labor climate, and, last but not least, the various state, county and municipal taxes must be considered.

Accounting System

In addition to the decisions made to this point, the decision for a good accounting system is still required. There are three factors for a good accounting system.

(a) It must be simple. A cumbersome system invites short-cuts and by-passing of the controls that are basic to an effective system.
(b) It must be workable with the quantity and quality of the company personnel.
(c) It must be understood by the persons working with it on a day-to-day basis and by management through the reports produced. Only if these conditions are met will the accounting system serve its purpose.

Business Climate

Properly used, the balance sheet and the profit and loss statement are like a barometer. They tell the business climate very accurately and indicate fair weather ahead as well as storms in the making. Let's look at some of the potential trouble spots and danger signals where a good accounting system can help management make the right decisions.

Cash

First, and of singular importance, is cash. Even though the business is on the accrual basis, are bills being paid currently? Are discounts taken? Discounts take a direct route into net profit, and there are many businesses where discounts make the difference between making a profit, breaking even or losing money.

Is the cash being collected as it should or are receivables slow or sales falling off? There is no definite yardstick, but depending on the type and size of the business, cash equivalent of one to three months' operating expenses might be required as working capital.

Receivables

Accounts receivable assume an increasingly prominent position on the balance sheet in our modern credit-minded economy. Periodic aging of accounts receivable is one of the greatest helps to management, and the businessman should not begrudge the time it takes to prepare an aged list of accounts.

Accounts that are getting old, aside from affecting his cash position, can tell a businessman a great deal. The customer may be dissatisfied. He may have switched suppliers. Follow-up and service to the customer may not only speed up collection but also retain the customer.

If lag in collections is coupled with a reduction of sales volume, the businessman would be well advised to take a close look at his product line, his customer service and the type and quality of his contact with his customers. Accounts receivable records are quite simple to keep, from handposted customer cards to machine accounting, and the time spent in maintaining the records is well worth it.

Inventories

Like overinvestment in equipment, excessive quantities of inventory can spell trouble for any business, and especially for the new business. Although the accountants cannot advise the businessman what is excessive, he can assist with cost comparisons and cash flow projections showing small-quantity purchases with possible discounting versus large-quantity buying where the unit price might be less and where quantity discounts are offered.

As far as the recording of inventories is concerned, there are two choices. All purchases may be charged to inventory and cost of sales handled either by individual item or on the percentage-of-sales method by product lines. Another method is to charge all purchases to cost of sales with periodic adjustments for actual inventory on hand.

Regardless of which method of recording purchases is used, inventories should be verified by actual count as frequently as possible. Physical inventories not only disclose shortages, if any should exist, but they also show which product lines are moving well and which merchandise is just taking up space, becoming shop-worn and obsolete.

Where practical, the businessman should be encouraged to keep perpetual inventory cards. But even where this is not feasible, some type of inventory control should be established to protect this investment.

Liabilities

On the liability side of the balance sheet we have already touched on the long-term debt. Accounts payable should be controlled to avoid the loss of discounts, duplicate payments and overpayments. Vendors' cards are very handy, not only to indicate current balances but for comparison between sources of supply, prices, terms and volume of business done with various vendors. Accrued expenses should receive careful attention to assure matching of income and expense as closely as possible.

Revenues and Expenses

The outstanding points on the profit and loss statement are sales volume, gross profit, operating expenses and net profit. The businessman should compare his operation with published industry figures to see that he is getting his share of the market, and that his costs are in line. Where there are wide seasonal fluctuations in the sales volume, a supplemental line of products may be considered. Comparative statements for at least two years can be very enlightening.

Operating expenses can usually be classified into two categories, i.e., fixed and variable. Ordinarily, the businessman pays close attention to the operating expenses that he can control, but oftentimes the fixed expenses are the ones that cause trouble, and a close examination of these may indicate some possibility of controlling and cutting to increase profits.

In Summary

To summarize, the small businessman needs a good accounting system to provide him with reliable information on the results of doing business. It would appear that any business, however small, should seek professional assistance and advice for the initial set-up of a workable, understandable and useful set of accounting records. There are many systems available, from the hand-posted journals and general ledger to data processing equipment. There are many variations in between, such as write-it-once systems and hybrid methods of part hand-posting and part data processing.

The accounting system, regardless of type or size, must be informative, up-to-date and geared to the specific needs of the business and compliance with governmental reporting requirements. It must produce the information in such a manner that the businessman can understand it, use it, benefit from it and still be able to afford it.