

# Accounting

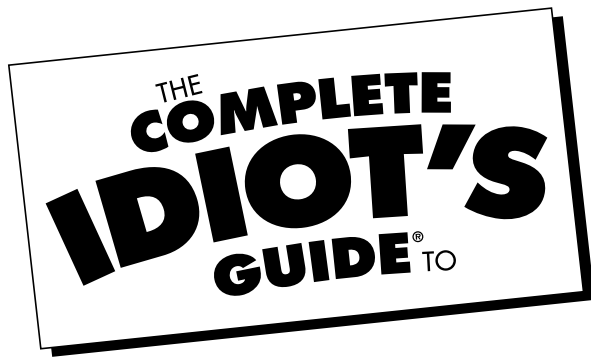
**Second Edition**

*by Lita Epstein, MBA, and Shellie Moore, CPA*



A member of Penguin Group (USA) Inc.





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## Foreword

Today we live in a world with financial demands on our time and our thinking. Never has it been more important to you and to your family to understand “where you stand” in your finances. What do you hope will be your financial future? At last there is a book that shows you how to “set the record straight.” How are you doing, dollars and cents-wise? You *have* to understand your finances in today’s constantly changing money world, much more than your parents did (or didn’t). With companies “outsourcing” jobs to foreign countries, where do you find a job? More and more of us are setting up our own small businesses and/or consulting enterprises to make a living. Our motto should be “keep the books!”

Doing business requires a vision of what you are contributing to the services and/or the products for your customers and your community. To achieve that vision requires a detailed plan including your financial goals and the resources you will need (human and financial), what geographical area you will serve, as well as what human and fixed assets are required. Now plan your sources of funding, both equity and debt. You know you must hire employees and motivate them to achieve the goals you have set. Payrolls and benefits have their own measures, which are described in this book. Another section of this book will walk you through the process of leading, motivating, and measuring your “associates” productivities, the records required, and how to file their reports. (Never call them “employees” anymore.)

It was my privilege to co-author a book about the Federal Reserve, our nation’s central bank, with Lita Epstein: *The Complete Idiot’s Guide to the Federal Reserve* (Alpha Books, 2003). We translated “fedspeak” that we all see in our newspapers into English. Lita’s accounting expertise was very contributory to our communicating what all that accounting jargon and data about the money supply and interest rates really means. Once again, in this book, *The Complete Idiot’s Guide to Accounting*, Lita Epstein, along with her co-author Shellie Moore, make a potentially confusing topic accessible to everyone.

Wherever you go and whomever you deal with, the question will inevitably be asked, “How are you doing?” Your sales, profits, costs, and tax liabilities will be reported and projected in many ways, as explained in this book. In this “information age,” many of us are getting used to measuring, checking, and evaluating our companies, our investments, and our many obligations, private and public. No, you don’t have to file “everything” with each of your regulators and the “taxman,” but it certainly seems like it. You really need the understanding of the results measurement. I can still remember how the financial institution startups my partners and I did in California required all those records and reports, and this was three decades ago. And more is demanded today!

Today's business world is marked by the scandals (and the alleged missteps) in business reporting. Yes, the stories are about the large entities, the Enrons, the Worldcoms, and "Freddie" (The Federal Home Loan Mortgage Company). However, those stories just make it more important today for each of us to gear up our understanding of accounting, reporting, and financial planning.

In this book, Epstein and Moore walk you through the process of comprehending the measurement of assets, liabilities, income, and expenses. When that accounting language begins to sound confusing, flip to the glossary in the back of their book!

Let me sum up by confessing that I wish I had possessed a copy of *The Complete Idiot's Guide to Accounting* when I was investing my time and my resources in banks, insurance companies, and financial service entities. I strongly recommend this book to you for the family, business, and governmental dealings you will have in this ever-changing world in which we live!

Preston Martin, Ph.D.

Former vice chairman, Federal Reserve Board of Governors

Former chairman, Federal Home Loan Bank Board

Former chairman, Serraco Enterprises Corporation, Sears Roebuck



# Introduction

As we all know, information is power. Many of you may not think of accounting as a means to get key information and to stay in control of your business operation.

You probably think of the world of accounting as a place with a language you don't understand. You view it as a necessary evil that you must have around in order to present the necessary reports to your investors and supporting financial institutions.

We'll show you how much power you can have if you learn the language of accounting and use the information it generates to manage your business and control your assets and liabilities. In order to harness that power, you need to set up the proper roadmap for your accounts, enter your transactions into that roadmap in a logical way, and then use it to develop the routes for your business success.

## How We've Organized The Book

You'll start your trip in the world of accounting by learning how to design that roadmap. Then we'll take you on a tour of how to use your accounting system as part of regular business operations. We'll review how to close your books and develop your reports. Finally we'll show you how to restart the cycle and begin a new year.

We've organized the book into six parts:

**Part 1, "Charting the Books,"** shows you how to structure your accounting system so you can manage your assets, liabilities, income, and expenses.

**Part 2, "Doing Business,"** teaches you how to use your newly minted accounting system as part of an effective and efficient tool to run your business.

**Part 3, "Keeping Employees Happy,"** discusses how to set up your employee records and maintain those records so you can prepare the required governmental reports and pay the necessary taxes. We also explore tax rules relating to employee benefits.

**Part 4, "Closing Out the Books,"** will show you how to close the books at the end of each month and test your work.

**Part 5, "Putting On a Show,"** will describe the reports you'll need and want to produce at the end of each month, both for internal use and to show your bank or investors.

**Part 6, "Closing the Books at Year-End,"** reviews the process for closing the books at the end of the year and getting ready to restart the process again for a new year. We also discuss computerizing your accounting system.

## Extras

We have developed a few helpers you'll find in little boxes throughout the book.

### def•i•ni•tion

These will help you learn the language of accounting.

### Accounting Answers

These will help you explore additional information about key accounting topics.



### Biz Tips

These will give you ideas for how to set up your accounting system and how to find the resources you need.



### Audit Alarms

These will give you warnings about things you need to avoid.



### Business Bites

These are for fun, some well-known jokes about the world of accounting.

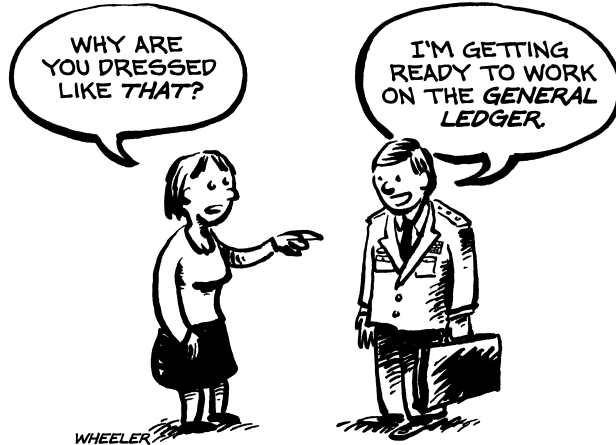
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# Part 1

## Charting the Books

Before you can even start keeping tabs on your business numbers, you have to set up the structure you will use to manage your assets, liabilities, income, and expenses. You'll learn the basics of how to develop the road-map for your accounts and how to revise or update that roadmap as needed.





# Chapter

# 1

## Structuring Your Business

### In This Chapter

- ◆ Counting cash
- ◆ Recording accruals
- ◆ Making a choice
- ◆ Satisfying the IRS
- ◆ Marking time

Have you heard this classic accounting joke?

Question: What's the definition of an accountant?

Answer: Someone who solves a problem you didn't know you had in a way you don't understand.

That is how many people think of accounting—a necessary evil to satisfy banks or other financial institutions, shareholders, and the Internal Revenue Service (IRS). As you take this journey into the depths of accounting, you learn why accounting is so much more than that and how it can help you make key business decisions. But before you can start learning about accounting's usefulness, you need to make some important decisions about how to set up your business with an efficient accounting system.

## Accounting for the Cash

The first decision a small business owner must make before setting up an accounting system is whether to operate the business on a *cash-basis* or *accrual* basis. Basically, these methods affect how you record your transactions as well as when you add transactions to your accounts.

### def•i•ni•tion

**Cash-basis accounting** is based on cash flow. You report expenses when you lay out the cash. You report income when cash is received. In addition to hard cash, income is counted as received when you get a check, credit card payment, or any other method common in your business. The same is true for expenses whether you pay them by cash, check, credit card, or other method. Essentially, cash has changed hands when you control the money. **Accrual accounting** is based on when the transaction happens, regardless of whether cash changes hands. So income is counted when it is earned, and expenses are counted when goods or services are received, even if cash has not been exchanged.

To see how these two types of accounting systems work, suppose that Tom has his own painting contracting business. He finishes a paint job on December 20, 2005, but he is not paid until January 3, 2006. How would he account for his income under the two accounting scenarios?

Under cash-basis accounting, Tom would not record the payment for the job until January 3, 2006, and therefore would not have to report the income on his 2005 taxes. He probably had expenses related to the job for which he paid cash. Those expenses would be written off in 2005.

### def•i•ni•tion

**Accounts receivable** is where a business records income due on sales or services that will be collected at a later date. **Depreciation** reduces the value of an asset over a set number of years and records an expense for that asset as it depreciates.

If Tom used the accrual accounting method, he would record his payment when the job was completed in December 2005 and indicate in his records that a payment was due from the customer in *accounts receivable*. Tom would report both his income and expenses for the job in 2005.

As you can see from this example, your choice of accounting method not only affects how you figure out your profit and losses for any given time period, but it can also affect when you pay taxes on income

and report expenses. If all your transactions are paid in cash as soon as they are completed, including both your sales and any related purchases or expenses, then your books for both types of accounting will look the same.

In reality few businesses work totally on a cash basis. Even if you do get paid in cash upon completion of each job, you probably have expenses prior to the completion of that job. Also, you are likely to purchase equipment and supplies in your business that are used over a number of months or years or make major purchases on credit and pay for them later.

Many small businesses use what is called a modified cash-basis accounting method. These businesses record most transactions when cash is exchanged, but account for certain transactions, such as the purchase and use of equipment, over time using a method called *depreciation*.

## Choosing a Method

You may wonder which accounting method is better. The truth is that both methods give you only a partial view of how your business is doing. The accrual method more accurately matches your income and expenses, but if this method is not managed carefully, you could lose track of your actual cash flow. For example, you could be recording lots of income for jobs completed, but not receiving payments on a timely basis. In other words, your bank account could be empty, but you wouldn't notice this lack of cash by just looking at your income statements. Yikes! What happens when that next check bounces? Don't worry. We talk about how to manage cash flow when using accrual accounting when we talk about cash receipts and disbursements in Chapters 7 to 10.

The cash-basis method gives you a clearer picture of your cash flow, but it does not give you a good idea of the business's long-term profitability because you don't record income when it is actually earned and expenses when they are actually incurred. Many businesses earn income or incur expenses in one month and are not paid for the job or do not lay out the cash for expenses until many months later. Cash-basis accounting does not do a good job of matching income with the expenses incurred to earn that income.

Accountants recommend the accrual method for most small businesses, but if your business is truly a cash business, you may want to use the simpler cash-basis method. Even though this book focuses primarily on the accrual method, you will find plenty of information about setting up your accounting system if you have chosen to use the

cash method. If you haven't already done so, discuss this choice with your accountant to sort out what is best for your business.



### Audit Alarms

After you choose your accounting method, you need to report that choice on the first tax return you file with the IRS. If you want to change accounting methods, you will need to file Form 3115, "Change in Accounting Method." To change methods, you need to justify the change and prove to the IRS that it will provide a better method for reporting income.

The IRS requires you to use the accrual method if your business meets one or more of the following conditions.

- ◆ Your business has inventory.
- ◆ Your business is a C corporation.
- ◆ Your gross sales exceed \$5 million. (Some exceptions to this rule include sole proprietors, personal service companies, and farming businesses.)

Now we get into the next key decision you need to make if you haven't already done so. What type of organizational structure should you choose: sole proprietor, partnership, or corporation?

## Getting Organized

Let's briefly review what each organizational structure means for your business and what types of reporting your accounting system needs to provide for you, your shareholders, your partners, and the IRS.



### Audit Alarms

Although running your business as a sole proprietor is the simplest form of organizational structure, there is a big downside. Your business is not a separate legal entity; therefore, all debts and claims are made against your individual property. You should definitely consider business liability insurance if you are a sole proprietor, especially if you are in the type of business where you could get sued.

## Sole Proprietor

If you are operating the business as a single owner, sole proprietor is definitely the easiest designation to choose. In fact, the IRS assumes you are a sole proprietor if your business has only one owner unless you have incorporated the business under state law.



The sole proprietor is not a taxable entity in the IRS's eyes. All your business assets and liabilities belong to you and are reported to the IRS as part of your individual tax return on Schedule C, "Profit or Loss from Business," or Schedule C-EZ, "Net Profit from Business." Any net profit or loss from the business then becomes part of your income on the first page of your 1040, and you pay any taxes based on your current income tax rate.

You'll also have to fill out another form, the Schedule SE, "Self-Employment Tax." The form is used to calculate your Social Security and Medicare taxes, which total 15.3 percent. When you were working for someone, your employer paid half of those taxes. Unfortunately, now you have to pay it all, but you can use half of the amount to adjust your total income downward in the adjustment section on the first page of the 1040. We discuss more about personal taxes in Chapter 24.

Two other forms may come into play for sole proprietors in specialized businesses. Farmers use Schedule F, "Profit and Loss from Farming." People who own rental property, but otherwise don't operate a real estate business, use Schedule E, "Supplemental Income and Loss." Farming income is subject to self-employment tax, but rental income is not.

## **Partnerships**

When more than one person starts a business, it is usually started as a partnership. Just like a sole proprietorship, the IRS considers a business started by two or more people a partnership unless they incorporate under state law. Partners can also elect to be taxed as a corporation by filing IRS Form 8832, "Entity Classification Election." The next section covers corporations.

A partnership files its own tax return on IRS Form 1065, "Partnership Return," but this form is only for information purposes. The return shows income, deductions, and other tax-related business information, but the partnership pays no taxes. The return also lists all the partners and each partner's share of the taxable income. Form 1065 only has to be filed if the partnership receives income or incurs expenses.

If there is no activity in any one year, the return does not need to be filed, but you may want to file anyway. You could eventually receive a notice from the IRS assessing a nonfiling penalty (\$50 times the number of months late). If so, you would have to prove that there was no need to file a return. To be safe, you may find it easier to just file every year and show zero income.



**Biz Tips**

Partnerships have many more legal issues to solve than sole proprietorships. In addition to being personally liable for debts and claims, partners also must determine how to deal with other key issues, such as how the business will be sold, what happens if one of the partners dies, and how to handle the sale if one of the partners wants out of the business. If you are considering setting up a partnership, be sure to discuss the legal ramifications with an attorney and a financial advisor.

The partnership Form 1065 includes a Schedule K-1, “Shareholder’s Share of Income, Credits, Deductions, etc.” for each partner. The partners use this form to report their income and expenses on their individual tax returns. Like a sole proprietorship, the partnership is not a taxable entity.

**Accounting Answers**

Many accounting firms set themselves up as limited liability partnerships, but the limits of their liability have not yet been tested in court. The partners of the now almost-defunct Arthur Andersen firm may soon find out just how limited their liability is as suits filed by Enron shareholders and creditors make their way through the courtroom. Many of the suits are seeking to collect damages for losses incurred when Enron collapsed. The firm’s criminal conviction on obstruction of justice was overturned by the Supreme Court in May 2005. Only 200 of the 28,000 people who worked at Arthur Anderson are left at the firm. Shareholder lawsuits were still pending at the time this book was written.

**Limited Liability Companies**

You can limit your liability as a sole proprietor or a partnership by establishing your company as a limited liability company or LLC. This designation falls somewhere between a corporation and a partnership or sole proprietorship. An LLC is a state entity organized under state laws. How limited your liability is under this organizational structure depends on the laws in your state. Most states give LLCs the same protection from liability as they give corporations.

The IRS can treat LLCs as sole proprietorships or partnerships, but you can ask to have them treated as a corporation for tax purposes if you file Form 8832. LLCs do enjoy limited liability when it comes to claims, but frequently owners have to take on debt by giving personal guarantees to financial institutions that make loans to the LLC, especially if the business is new. Owners of a new corporation could be faced with the same problem when debt is needed for the new business.

## Corporations

A corporation offers you the greatest liability protection because it is a separate legal entity. As an individual, you are protected from getting sued or facing collections because of actions taken by the corporation. This may sound attractive to you, and if you are in a business that has a high risk of getting sued, your attorney will probably recommend you set up the business as a corporation.

You must form a board of directors when you start a corporation, even if you include only your spouse and children. (Imagine what those family meetings will be like!) The board of directors can be made up of owners and nonowners. The board members who are not owners may receive director's fees for serving on the board.

You also must divvy out ownership shares in the form of stock. You don't have to sell that stock on the stock exchange though. Most small businesses do not trade their stock on an open exchange.

Corporations are a separate tax entity and must file tax returns. For tax purposes, the two types of corporate structures are C and S. You can avoid corporate taxation by filing with the IRS as an S corporation. The S corporation is purely an IRS designation that does not affect the legal status of the corporation. S corporations do not pay taxes. For tax purposes, they are treated primarily as a partnership with profits and losses passed through to the owners. All income and expenses are passed through to the owners/shareholders, even if they include you, your spouse, and your children.



### Audit Alarms

Your biggest disadvantage of establishing your business as a C corporation is that you must pay taxes on your dividend income twice: once at the corporate level and again at an individual level for any distributions to the company's stockholders. In other words, as a small business owner you could end up paying taxes twice on the same money. Congress reduced the tax bite on dividends from a high of 38.6 percent (the maximum individual tax rate in 2002) to 15 percent in 2003.

A big disadvantage of an S corporation is that you have less flexibility in how you pass through the profit and losses. Whereas a partnership can determine its own distribution formula, an S corporation must distribute its profit and losses based on percentage of corporate ownership of each of its shareholders. This arrangement can create an imbalance if, for example, one owner has a lot of cash to get the business started

and the other owner contributes unique knowledge. A partnership can more easily adjust for these differences than an S corporation.

C corporation dividends are taxed twice—once at the corporate level and once at the individual level—at least for now. This situation could change if President Bush is successful in killing the tax on dividends. Business owners can avoid the corporate level tax on this money by paying themselves and their employees (even if the employees are their spouse and children) a reasonable salary.

We're not going to delve deeply into C corporation tax issues. They are very complicated, but we do want to share corporate tax rates with you:

### **2005 C Corporation Tax Rates**

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<b>Taxable Income Over</b>	<b>But Not Over</b>	<b>Tax Rate</b>
\$0	\$50,000	15%
\$50,000	\$75,000	25%
\$75,000	\$100,000	34%
\$100,000	\$335,000	39%
\$335,000	\$10,000,000	34%
\$10,000,000	\$15,000,000	35%
\$15,000,000	\$18,333,333	38%
\$18,333,333	—	35%

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## **Choosing Your Organization**

As you can see, choosing your organizational structure is a complicated process. You should definitely seek professional advice from both your attorney and your accountant before making this decision. This chapter mentions these structures to give you an idea of the options and the type of information you need to gather using your newly minted accounting system when it comes time to do reports.

You can find excellent information about these choices at the Small Business Administration website ([www.sba.gov](http://www.sba.gov)). Women get special attention at [www.sba.gov/onlinewbc](http://www.sba.gov/onlinewbc).

## Picking Your Year

Before you start setting up your accounts, you need to make one more decision. You need to pick a tax year. As a business, you can operate on a 12-month basis that is different from the calendar year, which begins in January and ends in December. If you think it makes business sense, you may want to operate under a different 12-month period. For example, many colleges operate from September 1 to August 31 because this time period is a better match to their actual operations. This kind of setup is called operating on a *fiscal year* basis. However, a partnership's tax year must match the tax year of its partners, which is generally a calendar year if the partners are individuals.

### def•i•ni•tion

A **fiscal year** is a twelve-month period for a business that decides not to operate on a calendar year. For example, many private schools operate on a fiscal year of September 1 to August 31 because it more accurately matches their school-year schedule.

Whatever you choose to do, your accounting system should match this decision. Otherwise you will have to keep two sets of books. Just as you do when choosing the cash or accrual basis for your business, you set up your tax year when you file your first tax return for the business.

Once you have made the important decisions discussed in this chapter, you are ready to determine what key accounts you want to track. The first step is the chart of accounts, which is described in the next chapter.

## The Least You Need to Know

- ◆ You can choose to operate your company on a cash or accrual basis. The key difference is how and when you record your transactions.
- ◆ Accrual accounting gives you a good handle on your profitability, and cash-basis accounting does a better job of tracking your actual cash flow.
- ◆ You can set up as a sole proprietorship, partnership, limited liability company, or corporation. Your choice affects your personal liability as well as what reports you need to generate and how you have to file your tax returns.
- ◆ You can choose to operate on a calendar year or on a fiscal year, depending on what best matches your business cycle.



# Chapter 2

## Mapping Your Accounts

### In This Chapter

- ◆ Charting your course
- ◆ Getting in balance
- ◆ Paying your debts
- ◆ Calculating your net

**Question:** How do you drive an accountant completely insane?

**Answer:** Tie him to a chair, stand in front of him, and fold up a road map the wrong way.

Whenever you take a trip, one of the first things you consult is a map to chart your course. Operating a business isn't much different from taking a trip: you need a map to reach your goal. If you don't have a good idea of where your money is going, you have no way of knowing whether your business is profitable.

In business, this roadmap is known as the general ledger, which is the centerpiece of any accounting system. The general ledger is the place where all your accounts can be examined and adjusted, if needed, before you prepare your financial reports. (After you learn more about the details of what goes into the general ledger in Chapter 4, read Chapter 19 to learn more about the general ledger and how you balance the accounts in it.)

The chart of accounts is like the routes or information on the general ledger map that you use to figure out whether your business is on the right course. This chart serves as an index to all the places you file away financial information in your accounting system. Developing a chart of accounts gives you a chance to think about how your business operates and what activities you want to track.

Not all businesses use the same chart of accounts. As the chapter describes possibilities, you'll probably think, "I don't need that account." That's not a problem. The chart of accounts should be customized to your business needs. For example, if you are a service business that does not sell products, you don't need an inventory account.

As you design your chart of accounts, don't think only about your current business operation; think about where you would like your business to be in 5 to 10 years. Will you have employees? Do you plan to build a factory? Whatever your dreams are for your business, make room for them in your chart of accounts so your accounting system will be ready for your business's growth.

## Creating Reports

The primary purpose of any accounting system is to gauge the financial health of your business. Putting data in appropriately is important, but the way you make that data useful is to pull together information using a series of financial reports. These reports serve as a communication tool for you and your managers to use to make

key decisions. They are also needed to report your financial condition to banks (so you can get loans), to shareholders, to vendors, and to the federal government in the form of tax reports.

The two most important reports are the balance sheet and the profit and loss statement. The balance sheet is made up of *assets*, *liabilities*, and *equity*. The profit and loss statement includes *income*, *cost of sales*, and *expenses*. These reports are the ultimate goal of your accounting system, so you build the chart of accounts based on what you need in the way of information to produce these reports.

### def•i•ni•tion

**Assets** are things owned by the business. **Liabilities** are debts owed by the business. **Equity** is the value of the business after accounting for liabilities. **Income** represents the earnings of the business. **Cost of sales** tracks the money spent in order to sell products. **Expenses** are the costs of operating the business.



## Balancing the Business

Many view the balance sheet as the most important report because it provides a view of the net worth of the company. Critical financial decisions concerning bank loans or credit ratings are often based entirely on the information found in the balance sheet. The following equations sum up the essence of the balance sheet:

$$\text{assets} = \text{liabilities} + \text{owner's equity}$$

or

$$\text{owner's equity (net worth)} = \text{assets} - \text{liabilities}$$

Basically, developing a balance sheet for a business is not much different from developing a statement of personal net worth for a bank to apply for a personal loan.

The chart of accounts is usually set up in the order that the accounts appear on the balance sheet followed by how they appear on the profit and loss statement. The rest of this chapter describes how to set up the balance sheet accounts; the next chapter describes the profit and loss accounts.

The next few chapters review accounts for both a service business, which sells no products, and a sales business that does sell products. When setting up your chart of accounts, choose only the accounts that are relevant for your type of business.

In the following sections, each type of account is assigned a number as part of the brief description of its purpose in the accounting system. Each category of accounts has a range of numbers that you can use for that type of account. Leave room between account types so that you can add new accounts as your business grows, but still maintain the order of accounts that you need for your financial statements.



### Biz Tips

You don't have to assign a number to each of your accounts, but a four-digit number is required if you want to use a computer to manage your accounting system. Even if you are not now using a computer, numbering your accounts is a good idea in case you want to convert to a computer system later. Chapter 26 talks more about computerized accounting.

## Counting Assets

The first category of accounts in the chart of accounts is your company's assets. The two types of assets are *current assets* and *long-term assets*. Computer programs for

accounting use a range of numbers between 1000 and 1999 for assets. Both the chart of accounts and the balance sheet start with your most liquid asset: cash.

**Cash in Checking (1000)** This account is always the first account and is the primary operating account in which you deposit your revenue and pay expenses. Leave room after this account (and between all other accounts) in case you want to have more than one type of account within this grouping.

**Cash in Savings (1010)** This account is where you put money that is surplus cash or profits until you decide how you want to use it. You can make this account another checking account, but putting this money in a savings account that can earn interest makes more sense.

## def·i·ni·tion

**Current assets** are things you own that you can easily use or liquidate. Cash is an obvious example. **Long-term assets** are things you own that are not easily used for immediate needs. A building is an example of a long-term asset. **Petty cash** is the amount of cash kept on hand for incidental expenses.

**Cash on Hand (1020)** This account is where you track cash kept at the business. A retail business uses the accounts in this section to track what is in the registers. Other businesses commonly use this account to track *petty cash*.

**Accounts Receivable (1100)** This account is where you track money owed to the business by people who have bought your products or used your service on credit. You need this account only if you are operating on an accrual basis.

**Inventory (1200)** This account is where you keep track of the products you have purchased for sale. You add up all the costs of product purchases in this account. As you sell your products, you deduct the cost of each item sold from the inventory account. This account helps you keep track of the products you still have available for sale. To be sure your actual inventory matches what is on paper, you need to conduct periodic physical accounts of inventory. How frequently you do these checks depends on the type and size of your business.

### Biz Tips

Physically counting inventory can be a time-consuming task, but it is the best way to be sure that your products are being handled appropriately and that you are not losing money because of carelessness or theft.

Now that you've set up the accounts for tracking your current assets, it's time to move on to the accounts for your long-term assets. Most of the assets in this section are depreciable assets. That means the value of these assets depreciates over the years as they lose value from age, use, or normal wear and tear.

**Land (1300)** This account is one of the few long-term assets that is not depreciated. Because land doesn't depreciate, its cost is separated from the cost of the buildings or other structures on it.

**Building (1350)** This account is where you list the value of any buildings the business owns. This number is always a positive number.

**Accumulated Depreciation—Building (1351)** Because buildings are a depreciable asset, you need to add a line to track that depreciation. This account is always a negative number because it is used to gradually depreciate or reduce the value of the building.

In this case we don't leave room for additional accounts between the building and depreciation accounts, because you want these two accounts to stay next to each other on the balance sheet. This is how these two accounts would look on the balance sheet:

Building	\$500,000
Accumulated Depreciation	(\$50,000)

Placing a depreciation account right next to the asset being depreciated makes it easy for everyone reading the balance sheet to quickly determine the true value of your assets. In this example, the building still has a depreciable value of \$450,000.

**Leasehold Improvements (1400)** This account is where you keep track of the facilities your company leases rather than buys. In most cases, when you lease retail or warehouse space you need to pay the costs of improving the property for your unique business use. Funds spent on these improvements would be shown in this account.

**Accumulated Depreciation—Leasehold Improvements (1401)** This account is where you note the depreciation of any improvements you make to leased property.

**Vehicles (1450)** This account is where you keep track of all the cars, trucks, and other vehicles that the business owns. The initial value added to this account is the value of the vehicle when it is put into service. For example, if you are starting a new



#### Biz Tips

Depreciation may seem like a numbers game that you play to create tax write-offs. Yet depreciation can be a valuable business management tool because it allows you to easily track the life span of your assets. You can use the knowledge to determine the remaining useful life of your assets and budget for their replacement or repairs.

business but designating a personal car as a business asset, the value added to this account for that vehicle would be based on its current market value, not what you originally paid for the car.

**Accumulated Depreciation—Vehicles (1451)** This account is where you track the depreciation of all company-owned vehicles.

**Furniture and Fixtures (1500)** This account includes all the desks, chairs, and other fixtures you have in your offices, warehouses, and retail stores.

**Accumulated Depreciation—Furniture and Fixtures (1501)** Yes, furniture and fixtures depreciate as well, and this account is where you record that depreciation.

**Equipment (1550)** This account is where you track any equipment that you expect to use for your business for more than one year. This equipment includes computers, copiers, and cash registers.

**Accumulated Depreciation—Equipment (1551)** This account is where you record any depreciation for your business equipment.

## def·i·ni·tion

**Intangible assets** are things of value that are not physical objects, such as licenses, patents, trademarks, and brand names. **Amortization** is the method used to write off intangible assets in a way similar to depreciation.

**Organization Costs (1570)** This account is where you track your initial start-up expenses for the business. These are expenses associated with starting a new business that cannot be written off all in one year, such as special licenses and legal fees. These expenses are *intangible assets* rather than objects that depreciate. *Amortization* is another term that reflects their use and allows you to write off these costs over time. The amount of time depends on the type of expense. Your tax advisor can help determine how to write off your amortization expenses.

**Amortization—Organization Costs (1571)** You decrease the value of intangible assets related to organization costs in this account.

**Deposits (1580)** This account is where you keep track of deposits you had to make for rental property, to open utility accounts, and to take care of other business needs. You may not think of these deposits as long-term assets, but they are a perfect example. This money will eventually be returned to the business, but you have no way to access it at the current time. When the money is returned, the amount is subtracted from this account and added to one of your cash accounts.

**Other Assets (1600)** This section is a catchall for any asset not already named, but for which you do not want to establish a special account even though it has significant business value.

You're now finished with the primary asset accounts, but not necessarily with the asset portion of the chart of accounts. As you learn more about what you need to track for your business, you will probably find other things you want to add to your asset accounts. Remember that the chart of accounts is not cast in stone. You've left plenty of room for growth.

## Determining Liabilities

The liabilities section of the balance sheet is where you keep track of the company's debts. The range of numbers for liabilities is 2000 to 2999 in computerized accounting programs.

Liabilities are also classified as short- or long-term. Short-term liabilities are debts you need to pay in one year or less. Long-term liabilities are debts that you pay over the course of more than one year. The short-term liabilities appear first in the liability section of the balance sheet.

**Accounts Payable (2000)** This account is used to track all the money you owe to suppliers, vendors, contractors, and consultants who must be paid in less than one year. Most of these debts are due in one or two months.

**Sales Tax Collected (2100)** This account tracks taxes collected on merchandise you sold. Not all businesses must charge taxes, but most do. Usually you collect this money throughout the month and pay it to the local, state, or federal government at the end of the month.

**Accrued Payroll Taxes (2300)** This account tracks the payroll taxes you have to pay to the state or federal government based on the taxes withheld from employee paychecks. These taxes are usually paid on either a monthly or quarterly basis.

**Credit Cards Payable (2400)** The accounts in this section are used to track credit card accounts. These accounts can be short- or long-term debt, depending on how you handle your payoffs. Most businesses pay credit cards off as short-term debt and get some other form of credit line with better interest rates. These accounts should be set up with the name of the credit card in the account name. For example, a Visa credit



### Biz Tips

If you are setting up a payroll for the first time or even if you've done it before, a good place to find out more about payroll taxes is Payroll-Taxes.com ([www.payroll-taxes.com](http://www.payroll-taxes.com)). The site has an excellent reference library. Chapters 13 and 14 take a closer look at payroll issues.

card account would be named Credit Cards Payable-Visa (2400), and an American Express card account would be Credit Cards Payable-American Express (2450).

**Loans Payable (2500)** This section is where you keep track of your long-term debts. Generally you set up a series of loans payable accounts with the name of the payee in the account title. For example, your mortgage loan at State Bank would be Loans Payable-State Bank (2500). Your car loan at Citizens Bank would be Loans Payable-Citizens Bank (2550).

**Other Liabilities (2600)** You can use this section for any miscellaneous debts that don't fit in one of the other sections, but for which you do not want to set up a new account.

## Recording Equities

The accounts that reflect the net worth of the business are the equity accounts. Essentially the accounts in the equity section of the balance sheet track the value of things owned by the shareholders. These accounts appear after the liability section on the balance sheet. A computerized program will number these accounts in the range of 3000 to 3999.



### Business Bites

Old accountants never die. They just lose their balance.

**Common Stock (3100)** This account reflects the value of outstanding shares of stock. Each share of stock represents a portion of ownership. The number of shares issued is multiplied by the value of each share to calculate this number. You may not currently have common stock, but it's a good idea to leave room for the category.

**Retained Earnings (3200)** This account tracks your profit or loss, either on a monthly or yearly basis. An outsider to the company can look at the information in this account and see the success or failure of your business operations.

**Capital (3300)** This account is where you record the initial money you put into the business to get it started or contributions you made later. This account may not only reflect cash, but could also include the value of equipment, vehicles, or even buildings that you put into the business. If you have partners, each partner would have his or her own named capital account.

**Drawing (3400)** This account is where you record any money that the owner takes out of the business. If you have partners, each partner should have his or her own named drawing account.

## Your Chart of Accounts Balance Sheet

That's it! You're finished with the initial chart of accounts related to the balance sheet. Here's what the finished product would look like:

<b>Assets</b>	
1000	Cash in Checking
1010	Cash in Savings
1020	Cash on Hand
1100	Accounts Receivable
1200	Inventory
1300	Land
1350	Building
1351	Accumulated Depreciation—Building
1400	Leasehold Improvements
1401	Accumulated Depreciation—Leasehold Improvements
1450	Vehicles
1451	Accumulated Depreciation—Vehicles
1500	Furniture and Fixtures
1501	Accumulated Depreciation—Furniture and Fixtures
1550	Equipment
1551	Accumulated Depreciation—Equipment
1570	Organization Costs
1571	Amortization—Organization Costs
1580	Deposits
1600	Other Assets
<b>Liabilities</b>	
2000	Accounts Payable
2100	Sales Tax Collected
2300	Accrued Payroll Taxes
2400	Credit Cards Payable—Visa
2450	Credit Cards Payable—American Express

*continues*

*continued*

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<b>Liabilities</b>	
2500	Loans Payable—State Bank
2550	Loans Payable—Citizens Bank
2600	Other Liabilities

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<b>Equities</b>	
3100	Common Stock
3200	Retained Earnings
3300	Capital
3400	Drawing

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That wasn't so bad, was it? You're about halfway done with the development of the chart of accounts. Chapter 3 explains how to complete the chart of accounts with accounts related to the profit and loss statement.

## **The Least You Need to Know**

- ◆ The general ledger is a roadmap for the financial progress of your business; the data used to develop the general ledger come from the chart of accounts, which you can think of as the routes on a map.
- ◆ You should develop the chart of accounts in a way that enables you to easily produce two critical financial reports: the balance sheet and the profit and loss statement.
- ◆ The assets section of the chart of accounts includes accounts that track cash, inventory, equipment, and depreciation.
- ◆ The liabilities section of the chart of accounts lists a company's debts and the equities section reflects the company's net worth.



# Chapter 3

## Getting the Number News

### In This Chapter

- ◆ Creating good or bad news statements
- ◆ Finding income
- ◆ Accepting costs
- ◆ Recording expenses

In Chapter 2, we concentrated on the first group of accounts in the chart of accounts, which feed the balance sheet—that provides you with a good idea of the company's net worth. In this chapter, we concentrate on the next group of accounts, which feed the Profit and Loss (P&L) Statement—that helps you determine how much money you are making (good news) or losing (bad news—unless, of course, you want the loss to have a tax write-off) in a given period. You need the balance sheet to get loans. You need the P&L Statement to help manage your daily business operations. This chapter lists the information you need in your chart of accounts in order to create an effective P&L Statement.

## Developing Profit and Loss Statements

The P&L Statement summarizes your financial transactions during any given period, whether monthly or yearly. By looking at this statement, you can quickly tell whether the business is operating at a profit or a loss. Also, most of the information you need to file tax returns for local, state, and federal government entities is collected in the same accounts as those earmarked for the P&L Statement. Clearly the data collected for the P&L Statement provides the fuel you need to run the business.

There are three parts to a P&L Statement: income, cost of sales, and expenses. Just like the balance sheet accounts in Chapter 2, the accounts in this part of the chart of accounts are listed based on how they appear on the P&L Statement. Again, your business may not need all the accounts that are mentioned. Pick and choose the ones that match your type of business.

You may think you don't need a certain account now, but then you later find out that you do need to use that account. No problem. We'll be leaving plenty of room for you to add accounts to the chart of accounts later.

## Tracking Income

We all like to know we are making money, and the income accounts are where you collect this good news. A computerized accounting system assigns numbers 4000 to 4299 to income accounts.

**Sales of Goods or Services (4000)** This account, which starts off every P&L Statement, is where you track the company's primary source of income from sales or services or both.



### **Biz Tips**

Although you might think of returns or allowances as expenses, they are tracked in this part of the P&L Statement as negative sales because they directly impact the income numbers.

**Sales Discounts (4010)** You probably need this account only if you sell merchandise, but if you have some form of discounting for your services then you might need the account as well. For example, a consulting business may offer a discount to a customer who uses more than one of its services.

**Sales Returns and Allowances (4020)** This account is where you track returns or allowances from unhappy customers.

**Other Income (4100)** This account is used when a company generates income that is not part of its normal business operations. One example could be money earned by recycling paper or damaged boxes and containers.

**Interest Income (4150)** This account is where you keep track of any interest earnings from the company's savings accounts.

**Sale of Fixed Assets (4200)** This account is where you track any proceeds from the sale of a fixed asset. You should record revenue realized after considering depreciation.

## Determining Sales Costs

You may think you don't have any cost of sales if you are not selling products. This is not true. Even a service business has costs directly related to the services. For example, a marketing consulting firm may have to hire a market research firm in order to fulfill its contract. A law firm has court costs and may have investigator fees as part of its work for a client. The costs of sales accounts are in the 4000 number range of a computerized accounting system with the income accounts because they directly impact sales.

**Purchases (4300)** This account is where you record the cost of goods that you intend to sell. This account is directly related to the inventory account on the balance sheet. Chapter 8 takes a closer look at that relationship.

**Purchase Discounts (4310)** This account is used to track any discounts you get from vendors. For example, a vendor may give you a 10 percent discount if you pay within 10 days rather than the allowed 30 days.

**Purchase Returns and Allowances (4330)** This account is where you record your returns for unsatisfactory products or allowances for services for which you were not happy.

**Freight Charges (4350)** This account is used to track the cost of shipping the goods you sell.

**Other Sales Costs (4400)** This account is the miscellaneous account for the cost of sales section.



### Biz Tips

Managing accounts payable well can help cut costs. Vendors frequently offer an incentive for companies that pay their bills early. This incentive helps vendors receive their money more quickly and helps companies reduce their cost of sales.

After the information for sales and costs of sales is gathered on the P&L Statement, a summary total is taken that shows the gross profits of the business. This very useful number gives the business owner and the business managers a good idea of what it costs to sell their products or services. This number does not reflect the full cost of running the business, though. The accounts in the expense section of the P&L Statement do that.

## Calculating Expenses

Now that you know how to track income and costs specifically related to generating that income, you also need to make room in your chart of accounts for the other expenses related to running a business. After you calculate these expenses, you subtract that amount from the gross profit to find the company's net profit.



### Business Bites

Question: How is your daughter doing in accounting class?

Answer: Great. Now instead of asking us for her allowance, she bills us for it.

Most of these expenses are tax-deductible and are grouped here in categories you need to figure those deductions. However, you may find that your business needs to separate out accounts in even more detailed ways for management purposes. For example, a common category is vehicle expenses, but if you decide for management purposes that you need to separately track gas, repairs, licenses, and related taxes, then you may want to set up several vehicle expense categories.

Computerized accounting systems number these expense accounts in the range of 5000 to 6999. You can list the accounts in several different ways. Some businesses like to list the ones they expect to be the largest expenses first; others like to list them alphabetically. We list them alphabetically in this section because this method makes it easier for you to find accounts. You can set up the order of these accounts in whatever way makes the most sense to you, but remember that your employees need to use the chart, too, so don't make it too confusing.

**Advertising (5100)** This account is used to track anything that involves promoting your business or your products. These expenses can include newspaper, Internet, television, magazine, and radio advertising, as well as printed flyers and direct mail. If you participate in community events, such as walks/runs for fundraising or craft fairs, you can also write off costs related to promoting your business at these events, so make sure you track these promotional costs in this account.

**Amortization Expense (5150)** This account is a companion account for the accumulated amortization account on the balance sheet. This account is where you track expenses related to amortization.

**Bank Service Charges (5200)** This account is where you record any fees charged by the bank to service your accounts.

**Depreciation Expense (5250)** This account is a companion account for the accumulated depreciation account on the balance sheet. This account is where you track expenses related to depreciation.

**Dues and Subscriptions (5300)** This account is used to track your membership costs in professional or business organizations related to your business operations, as well as any subscriptions to business-related publications.

**Equipment Rental (5350)** This account gathers information about expenses paid for rented equipment such as copiers, computers, and any other machinery needed for your business.

**Insurance—Employees Group (5400)** This account tracks the costs of payments made to cover your employee group insurance.

**Insurance—General (5450)** This account tracks the costs related to business insurance policies, such as fire, theft, liability, or loss of income.

**Insurance—Officers' Life (5500)** This account is used to track life insurance you take out on your officers or other key personnel. Life insurance coverage on key personnel is important because their loss will definitely cause business interruption, and you will incur costs to replace these employees. For example, in a partnership the surviving partner can use this insurance to buy out the deceased partner.

**Interest Expense (5550)** This account is where you track any interest you pay on business debts.

**Income Taxes (5600)** This account is where you track any business expense related to your income taxes.

**Legal and Accounting (5650)** This account is used to keep track of legal and accounting costs.



#### **Biz Tips**

Any interest you pay on business debts is deductible, but debt carried for personal purpose is not always deductible. For example, interest on credit cards carried for personal reasons is not deductible, but interest on business credit cards is deductible.

**Meals and Entertainment (5700)** This account tracks expenses related to meals and events, whether you take someone to lunch for business purposes or buy a meal for your employees as a reward for hard work or working overtime. Remember, both meals and entertainment are only 50 percent deductible (unless it's an employee party or dinner), so it makes sense to lump them together.

**Miscellaneous Expense (5750)** This account is a catchall for expenses that don't fit elsewhere. You may start recording a periodic expense here and then realize you do want to track it separately. You would then need to adjust this category and subtract the expenses that you want to move to their own category.

**Office Expense (5800)** This account is where you track expenses related to running the office that are not being individually tracked, such as office supplies, paper, and other general items.

**Other Taxes (5850)** This account is where you would track items such as license taxes and other business-related taxes that are not income taxes.



#### **Audit Alarms**

Be sure you keep careful track of the purpose of the meal and who was involved. Meals and travel expenses are two red flags for the IRS. If your expenses are high in either of these areas, you need to keep careful records. By doing so you have much less risk of losing deductions related to these expenses if the IRS audits your business.

**Payroll Taxes (5900)** Use this account to track payroll tax expenses.

**Penalties (5950)** This account is one that you hope you will never have to use; it's where you track penalties for unpaid or late taxes.

**Postage (6000)** This account tracks money spent on mailing products to your customers, as well as postal expenses related to the business. This account can include U.S. Postal Service expenses, as well as expenses for express services such as Federal Express or UPS. For management purposes, you may want to track each of these types of mailing services separately by setting up specially named postage accounts, such as Postage-Federal Express.

**Rent Expense (6050)** This account is where you keep records about rent you pay on office, warehouse, or retail space needed for the business.

**Repairs and Maintenance (6100)** This account is where you track repair and maintenance costs.

**Salaries and Wages (6200)** Use this account to track money paid to your employees. Even if you don't have employees right now, it's a good idea to set up this account in case you do hire employees in the future.

**Supplies (6250)** This account is where you track supplies needed for the business.

**Travel (6300)** Use this account to track business travel costs. Be sure you keep careful records about the purpose of the travel and who went on the trip.

**Telephone Expense (6350)** Use this account to track local and long-distance telephone expenses.

**Utilities (6400)** This account is where you track payments for electricity, gas, water, or other utilities related to your business.



**Biz Tips**

We've separated out telephone expenses because most companies prefer to track this expense separately. You can also separate out any of the utility expenses for which you think a separate account will give you better information for management purposes, depending upon your type of business. For example, if you manage rental property, you may want to track all utilities separately so you can quickly find a major increase in costs and be able to investigate whether some problem exists at the rental property that could explain that increase.

**Vehicle Expenses (6450)** This account tracks expenses for the company's vehicles. You can also use this account to track reimbursement to employees for use of their personal vehicles. You may want to separate out company vehicles and employee vehicles by establishing two accounts: Vehicle Expenses—Company (6450) and Vehicle Expenses—Employee Reimbursement (6460).

## Your Chart of Accounts Profit and Loss Statement

You've now built your chart of accounts for the P&L Statement. Here's what this part of the chart of accounts looks like:

Income	
4000	Sales of Goods or Services
4010	Sales Discounts
4020	Sales Returns and Allowances
4100	Other Income

*continues*

*continued*

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<b>Income</b>	
4150	Interest Income
4200	Sale of Fixed Assets

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<b>Cost of Sales</b>	
4300	Purchases
4310	Purchase Discounts
4330	Purchase Returns and Allowances
4350	Freight Charges
4400	Other Sales Costs

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<b>Expenses</b>	
5100	Advertising
5150	Amortization Expense
5200	Bank Service Charges
5250	Depreciation Expense
5300	Dues and Subscriptions
5350	Equipment Rental
5400	Insurance—Employees Group
5450	Insurance—General
5500	Insurance—Officers' Life
5550	Interest Expense
5600	Income Taxes
5650	Legal and Accounting
5700	Meals and Entertainment
5750	Miscellaneous Expense
5800	Office Expense
5850	Other Taxes
5900	Payroll Taxes
5950	Penalties
6000	Postage
6050	Rent Expense



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Expenses	
6100	Repairs and Maintenance
6200	Salaries and Wages
6250	Supplies
6300	Travel
6350	Telephone Expense
6400	Utilities
6450	Vehicle Expenses—Company
6460	Vehicle Expenses—Employee Reimbursement

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Add this to your balance sheet portion of the chart of accounts and you are ready to go. Now we'll look at how this becomes the general ledger and how you work with both the chart of accounts and the ledger.

### The Least You Need to Know

- ◆ Income minus cost of sales is equal to gross profit.
- ◆ Expenses are subtracted from gross profit to calculate net profit.
- ◆ The expenses section of the chart of accounts can be lengthy. How detailed you want to make this section is dependent on what type of expenses you need to track and how detailed your records need to be.



# Chapter 4

## Developing the General Ledger

### In This Chapter

- ◆ Knowing your debits
- ◆ Accepting your credits
- ◆ Entering the numbers
- ◆ Creating the posts

Now that you know the accounts you need to set up to get the business started, it's time to find out how to use these accounts to build an accounting system. In this chapter, you learn how to use the chart of accounts you've built in the previous two chapters to build the core of the accounting system: the general ledger.

First, you have to learn the somewhat difficult concept of debits and credits. Sometimes a debit adds to an account, and sometimes it subtracts. (Yikes!) Same thing happens with credits. Yes, it can be confusing, but don't fret. We're here to help you through the confusion. The next step is to learn how to use debits and credits to develop entries. The last part of

the chapter shows what the general ledger should look like when you pull all this information together.

## Working With Debits and Credits

The sometimes confusing world of *debits* and *credits* is called a double-entry or dual-entry accounting system. Basically, every transaction, whether it involves using a company's resources or buying a new resource, has two sides. For example, when you buy new inventory for \$8,000, you have to use cash or credit to pay for that inventory.

### def·i·ni·tion

Debits and credits are opposites. **Debits** are always an increase to an asset or expense account and a decrease to a liabilities and income account. They are always on the left side of an accounting entry. **Credits** are always an increase to a liabilities or income account, and a decrease to an asset or expense account. They are always on the right side of an accounting entry.

Let's see how this transaction would look in the debit and credit world. Inventory bought with cash appears as follows.

	Debit	Credit
Inventory	\$8,000	
Cash in Checking		\$8,000

If you remember, Inventory is a balance sheet account in the assets section, as is Cash in Checking. So in this example the assets section of the balance sheet would have the same total because we're adding to one asset and subtracting from another asset.

Inventory bought using credit is recorded this way.

	Debit	Credit
Inventory	\$8,000	
Accounts Payable		\$8,000

When you buy on credit, you are making changes to both sides of the balance sheet. There is an increase in your assets (Inventory) as well as an increase in your liabilities (Accounts Payable). In this case, both the assets section and the liabilities section totals on the balance sheet would increase.

This table shows how debits and credits affect your accounts.

Account	Debit	Credit
Assets	Increases	Decreases
Liabilities	Decreases	Increases
Income	Decreases	Increases
Expenses	Increases	Decreases

For double-entry accounting to work, you must always make entries that are equally balanced. Whatever dollar amount you add to one side of the debit/credit equation, you must add an equal dollar amount to the other side of the equation.



**Business Bites**

A very successful partner in a Big Four accounting firm had a peculiar habit. He would go to his desk, open a locked drawer, look inside, lock the drawer again, and start his work. His subordinates knew that he hid the secret of his success in the drawer; they waited for the opportunity to find out what that was. One day when the partner had to travel out of the city, the juniors decided to make a break. They broke into the drawer, breathlessly, and looked inside. There was one small piece of paper inside. It said, "Left is debit, and right is credit."

This system may seem complicated, but when you do it correctly, all your accounts will balance. No doubt, it takes time to learn, but ultimately you will find that this system does make it easy to draw up your financial reports and see how the company is doing.

## Creating Entries

To practice creating entries in the general ledger, let's build the first month of operation for a fictitious company called Lisa's Candle Shop. In this section, you'll develop a series of entries and then learn how to post these entries to the general ledger.

To make things easier, start the company on January 1 as a new business and use the chart of accounts that you created in Chapters 2 and 3. Suppose that you, as the owner, started the business with \$15,000 that you had saved. You also needed to borrow an additional \$5,000 from Citizens Bank to get the business started.

Next you need to buy some things for the business. You buy a used desk and chair for \$500, store fixtures for \$1,200, candles to sell for \$8,000, and a used cash register for \$600. You get lucky and find a small sublet of retail space, so you need to spend only \$800 a month for rent. All these expenses total \$11,100, and this leaves you with \$8,900 in the bank. The following table shows the entries for the initial cash deposits.

	Debit	Credit
Cash in Checking	\$15,000	
Capital		\$15,000
Cash in Checking	\$5,000	
Loan Payable-Citizens Bank		\$5,000

This set of entries records the initial cash deposit from the owner and the bank loan. Cash in Checking is in the assets section of the balance sheet, and Capital is in the equities section. The Loan Payable-Citizens Bank account is in the liabilities section of the balance sheet. Both transactions increase the total of the assets section, and one increases the total of the liabilities section while the other increases the total of the equities section.

The purchases of the desk and chair and the fixtures for the retail store are recorded as follows.

	Debit	Credit
Furniture and Fixtures	\$500	
Cash in Checking		\$500
Furniture and Fixtures	\$1,200	
Cash in Checking		\$1,200

In this case, the Furniture and Fixtures account increases, and the Cash in Checking account decreases. Both accounts are in the assets section of the balance sheet, so the total for the assets section does not change.

The following shows how to record the purchase of the cash register for \$600.

	Debit	Credit
Equipment	\$600	
Cash in Checking		\$600

In this case, the increase is in the Equipment account, and the decrease is in the Cash in Checking account. Again, both accounts are in the assets section of the balance sheet, which means the amount of total assets does not change.

Then you record the purchase of inventory, which is candles in this case, for \$8,000.

	Debit	Credit
Inventory	\$8,000	
Cash in Checking		\$8,000

Notice that the Inventory account increases and the Cash in Checking account decreases. Once again, both accounts are on the balance sheet in the assets section, so the amount of total assets does not change.



**Biz Tips**

Never forget that your debits must always equal your credits.

To keep your accounts balanced, always keep this formula in mind:

$$\text{assets} = \text{liabilities} + \text{equity}$$

As you try to learn this concept, think about how your entry will impact this balance.

The transactions presented so far have affected only the balance sheet. The payment for rent of \$800, however, affects the P&L Statement.

	Debit	Credit
Rent Expense	\$800	
Cash in Checking		\$800

In this case, the amount in the Rent Expense account increases, and the amount in Cash in Checking decreases. You may wonder what happens to the balance sheet, because it now appears to be out of balance. Cash in Checking has been reduced, but no other account on the balance sheet has been touched.

The key thing to remember is that when you figure out your profit and loss at the end of the month, the accounts will balance in the balance sheet because that's when the net loss or profit will be recorded in the Retained Earnings account. What you are balancing as you make your balanced entries are the accounts in the general ledger. This accounting process will all seem much clearer as you work through it in this book. We promise.

## Posting to the Ledger

The accounts you built in Chapters 2 and 3 for the chart of accounts are now in the general ledger in the same order that you built them. Every account in the ledger should have a separate page, if you are building the ledger manually. (A computerized system will manage this setup for you.) If you are building a manual general ledger, buy a pad of ledger sheets. (See the example that follows.)

The ledger should have five columns: date, reference number, description, debit, and credit. The date is the date of the transaction. The reference number is a numbering system you should develop for your entries. Numbering each entry is very helpful. If an error occurs and you suspect a particular entry may be the problem, finding the problem is much easier when the entries are numbered. For example, you could number transactions using the date, such as 01010301 (first transaction on January 1, 2005) and 01050302 (second transaction of January 5, 2005). The description column includes the account(s) affected. The debit column includes the dollar amount for the debit part of a transaction, and the credit column includes the credit amount for the credit part of a transaction.

To see how information comes together in the general ledger, look at the way the opening transactions for Lisa's Candle Shop are posted in the tables that follow.





**1000 Cash in Checking**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010301	Deposit from owner	\$15,000.00	
1-1-05	01010302	Loan from Citizens Bank		\$5,000.00
1-1-05	01010303	Purchase chair/desk		\$500.00
1-1-05	01010304	Purchase fixtures		\$1,200.00
1-1-05	01010305	Purchase cash register		\$600.00
1-1-05	01010306	Purchase candles		\$8,000.00
1-1-05	01010307	Pay rent expense		\$800.00
		Ending balance	\$8,900.00	

**1200 Inventory**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010306	Purchase candles	\$8,000.00	
		Ending balance	\$8,000.00	

**1500 Furniture and Fixtures**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010303	Purchase chair/desk	\$500.00	
1-1-05	01010304	Purchase fixtures	\$1,200.00	
		Ending balance	\$1,700.00	

**1550 Equipment**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010305	Purchase cash register	\$600.00	
		Ending balance	\$600.00	

**2550 Loans Payable—Citizens Bank**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010302	Loan payable-Citizens Bank		\$5,000.00
		Ending balance	\$5,000.00	

**3300 Capital**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010301	Owner contribution		\$15,000.00
		Ending balance		\$15,000.00

**6050 Rent Expense**

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010307	Paid rent expense	\$800.00	
		Ending balance	\$800.00	

You can see that we added a beginning balance at the top of each of the general ledger accounts. Because this month is the first month of the ledger, all the beginning balances are \$0.00. If you had closed the ledger for the month of January, your beginning balances for February would be January's ending balances. Each month your beginning balance is the previous month's ending balance. We take a detailed look at the closing process in Part 4 after you've learned how to use all these accounts.

You may be wondering which accounts normally carry a credit balance and which accounts normally have a debit balance. To give you an idea of the answer, the following list uses the chart of accounts developed in Chapters 2 and 3:

**Debit Accounts**

Cash in Checking  
Cash in Savings  
Cash on Hand  
Accounts Receivable  
Inventory  
Land  
Building  
Leasehold Improvements  
Vehicles  
Furniture and Fixtures  
Equipment  
Organization Costs  
Deposits  
Other Assets  
Drawing  
Sales Discounts  
Sales Returns and Allowances  
Freight Charges  
Other Sales Costs  
Advertising  
Amortization Expense  
Bank Service Charges  
Depreciation Expense

**Credit Accounts**

Accumulated Depreciation  
Accumulated Amortization  
Accounts Payable  
Sales Tax Collected  
Accrued Payroll Taxes  
Credit Cards Payable  
Loans Payable  
Other Liabilities  
Common Stock  
Retained Earnings  
Capital  
Sales of Goods/Services  
Other Income  
Interest Income  
Sale of Fixed Assets  
Purchase Discounts  
Purchase Returns

**Debit Accounts**

Dues and Subscriptions  
Equipment Rental  
Insurance  
Interest Expense  
Income Taxes  
Legal and Accounting  
Meals and Entertainment  
Miscellaneous Expense  
Office Expense  
Other Taxes  
Payroll Taxes  
Penalties  
Postage  
Rent Expense  
Repairs and Maintenance  
Salaries and Wages  
Supplies  
Telephone Expense  
Travel  
Utilities  
Vehicle Expenses

**Credit Accounts**

You can see that there are more debit accounts than credit accounts. That's because all the expense accounts usually carry a debit balance. We didn't list each of the individual groupings such as insurance, accumulated depreciation, loans payable, and other similarly named accounts that had more than one listing, but each of these separate accounts is normally a debit or credit as indicated in the previous list for that type of grouping.

Information about balancing the general ledger is in Chapter 19. The next chapter explains how to adjust the accounts in the general ledger.

### **The Least You Need to Know**

- ◆ Debits and credits are used to keep track of all your business transactions. When you enter a transaction, your debits and credits should be in balance. This system of accounting is called double-entry or dual-entry accounting.
- ◆ Sometimes debits increase an account's balance, and sometimes they decrease it. The same is true with credits. A key task in learning accounting is figuring out whether something is a credit or debit.
- ◆ After you figure out your balanced entries, you then post them to the general ledger, which includes a separate page for each account on the chart of accounts.

# Chapter 5

## Changing the General Ledger

### In This Chapter

- ◆ Making adjustments
- ◆ Recording depreciation
- ◆ Dividing expenses
- ◆ Adding accounts
- ◆ Eliminating dead weight

All right! You've set up the general ledger. Now you can get down to running the business and not have to worry about your accounting system. Wouldn't that be nice if it were true?

Both the chart of accounts and the general ledger are works in progress that can be changed as needed to fit your business. They are not cast in stone; you can change both the accounts and what is in them in many different ways. This chapter shows some key examples of how you can make these changes, such as how to depreciate assets and how to account for prepaid expenses. Then the chapter shows how to add and subtract accounts from the general ledger and chart of accounts.

## Adjusting Accounts

The good news about adjusting accounts is that if you make a mistake, it's correctable. The bad news is that you have to make sure that when you make an adjustment you do so with balanced entries so that you don't throw off your entire accounting system and have to spend hours or sometimes days to figure out where the error occurred.



### Business Bites

An accountant is having a hard time sleeping and goes to see his doctor. "Doctor, I just can't get to sleep at night." The doctor asks, "Have you tried counting sheep?" "That's the problem," the accountant replies. "I make a mistake and then spend three hours trying to find it."

The most common type of adjustment is one to depreciate assets. Another common adjustment is to spread out a lump-sum payment over several months. For example, if you pay for annual insurance all at once at the beginning of the year, you need to account for that expense on a monthly basis. If you listed the payment for a major insurance policy as an expense in one month, your business would look as though it's operating at a loss, and the ledger wouldn't provide a true picture of your monthly costs of running that business.

Another reason to adjust accounts could be, for example, moving items you have been recording as an expense in a miscellaneous category to an individual account for that expense to better track the related costs. In this situation, you would want to add a new account, subtract the expenses from the old location, and add them to the new account. You also may want to eliminate an account that you no longer need.

## Depreciating Assets

When you set up the chart of accounts, you set up accounts for accumulating depreciation. Now it's time to put them to use. Depreciation plays two roles: one as an expense and the second as a deduction on your taxes. Most businesses adjust for depreciation only once a year because it's easier, after taxes have been filed, but some businesses prefer to match the expense with income on a monthly basis. Both methods are acceptable.

Many businesses use two different methods of depreciation: one for tax purposes and a second for business statements. Tax incentives enable you to write off your assets more quickly, but the information on assets that you track to take advantage of this tax benefit is different from how you track depreciation of assets for accounting purposes. For accounting purposes, only one type of depreciation is used: straight-line



depreciation. This type is the easiest type to calculate. An asset is assumed to have a certain number of years of expected use. You then divide that number into the cost of the asset to figure the amount of depreciation each year.



**Biz Tips**

For tax purposes you can write off assets the quickest using what is called Section 179, which allows you to deduct up to 100 percent of what you spend on new equipment. The maximum dollar amount allowed is \$105,000 for 2005, and it will be adjusted for inflation beginning in 2006. Speedier depreciation methods are called declining-balance methods, which permit you to write off a larger portion of the asset in the first few years that you use the equipment. If you do have a lot of equipment to write off, your best bet is to talk with your financial advisor about what makes the most sense tax-wise.

The chart of accounts has separate accounts for each major asset: buildings, vehicles, fixtures and furniture, and equipment. You need to track depreciation separately for each type of asset. Businesses can determine what they consider the normal life span for an asset based on its business use. For example, a trucking company may consider its trucks useful for only three years given their demanding use by the company, yet a flower shop that owns a truck for occasional deliveries may find that it can use the same truck for five years.

The IRS has a standard chart for depreciation recovery periods for business equipment under the straight-line depreciation method. These recovery periods are listed in the following table. You can use these or decide on other time periods if they make sense for your business. Whatever you decide to use should be recorded in your general ledger, so depreciation will be consistently handled throughout your business.

**Depreciation Recovery Periods for Business Equipment**

Property Class Recovery Period	Business Equipment
3-year property	Tractor units and horses over two years old
5-year property	Cars, taxis, buses, trucks, computers, office machines (faxes, copiers, calculators, and so on), research equipment, and cattle
7-year property	Office furniture and fixtures

*continues*

**Depreciation Recovery Periods for Business Equipment (continued)**

Property Class Recovery Period	Business Equipment
10-year property	Water transportation equipment, single-purpose agricultural or horticultural structures, and fruit- or nut-bearing vines and trees
15-year property	Land improvements, such as shrubbery, fences, roads, and bridges
20-year property	Farm buildings that are not agricultural or horticultural structures
27.5-year property	Residential rental property
39-year property	Nonresidential real estate, including a home office but not including the value of the land

Let's use these IRS recovery periods to practice writing off the assets in the fictitious Lisa's Candle Shop. Remember that she bought a desk and chair for \$500 and store fixtures for \$1,200. She also bought a cash register for \$600. The desk, chair, and cash register were all used equipment, so for the purpose of this example, assume that they are all one year old.

Based on the IRS chart, the \$500 desk and chair would have six years of life left (seven-year property minus one year of use), so the amount to be depreciated each year would be \$83 (\$300 divided by 6). The cash register fits in the five-year property category, so it has four years of use left and depreciates yearly by \$150 (\$600 divided by 4). The fixtures for the store were new, so they have seven years left as part of the seven-year property category. Their yearly depreciation would be \$171.

At the end of the year, the entry in the chart of accounts would look like the following.

	Debit	Credit
Depreciation Expense	\$404	
Accumulated Depreciation—Furniture and Fixtures		\$254
Accumulated Depreciation—Equipment		\$150

In addition to adding these numbers to the accounts in the general ledger, you also need to create a depreciation schedule for Lisa's Candle Shop. This schedule keeps track of all of your assets. Each asset should be tracked separately so you know how much value is remaining. Also, if you sell or replace an item, this schedule provides the information you need on the asset's current value. This schedule lists the date an item is placed in service, the item's description, initial cost, life span, and yearly depreciation amount, as shown in the following example.

### Depreciation Schedule for Lisa's Candle Shop

In-Service Date	Description	Cost	Recovery Period	Annual Depreciation
<b>Furniture &amp; Fixtures</b>				
1/1/05	Desk/Chair	\$500	6	\$83
1/1/05	Fixtures	\$1,200	7	\$171
				\$254
<b>Equipment</b>				
1/1/05	Cash Register	\$600	4	\$150
				\$150

If you use a different method of depreciation for tax purposes, you need to keep the details for that method on a separate depreciation schedule so you will have the needed tax information as well.



#### Biz Tips

Carefully tracking depreciation of your assets is an excellent way to help yourself plan repair and replacement budgets. A depreciation schedule provides you with a good idea of the age of all assets and how many more years you can plan to use them. You can even build a fund for replacement based on your depreciation records in order to have funds available when you need them to buy new items for your business.

Whether you need to write off your assets on a yearly or monthly basis is a business decision. If your depreciation expense is a significant number that could impact the picture of your business's profitability, you may want to depreciate assets monthly in order to have a better idea of the month-by-month profitability of your business.

## Booking Prepaid Expenses

Some expenses must be paid prior to the business using the paid-for item. One common prepaid expense is insurance. Most insurance companies require you to pay for insurance 6 to 12 months in advance. Another common prepaid expense is rent. Some retail stores are expected to pay rent quarterly rather than monthly.

	Debit	Credit
Prepaid Expense	\$1,200	
Cash in Checking		\$1,200
Prepaid Expense	\$2,400	
Cash in Checking		\$2,400

The prepaid expense account is shown in the asset section of the balance sheet. Because this prepaid expense is a short-term asset that is used in less than 12 months, you would place it before the land account. Give it a number of 1250 to make it appear after the inventory account on the balance sheet. The total for assets is reduced as the insurance expense is allocated monthly through the year.

The prepaid expense account would appear as follows in the general ledger.

### 1250 Prepaid Expenses

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010307	Paid first quarter rent	\$2,400.00	
1-15-05	01150308	Paid business insurance premium	\$1,200.00	
		Ending balance	\$3,600.00	

At the end of the month, you would record the actual expenses by reducing the amount in the prepaid expense account and recording the expense that should be allocated to that month. For example, at the end of January you would make this adjustment to the chart of accounts.

	Debit	Credit
Rent Expense	\$800	
Insurance—General	\$100	
Prepaid Expenses		\$900

After the adjustment at the end of the month, the prepaid expense account in the general ledger would look like the following.

### 1250 Prepaid Expenses

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-1-05	01010307	Paid first quarter rent	\$2,400.00	
1-15-05	01150308	Paid business insurance premium	\$1,200.00	
1-31-05	01310309	Record expenses for rent and insurance	\$700.00	
		Ending balance	\$2,900.00	

Making this adjustment matches the expenses for rent and insurance that should be allocated to the costs of operating the business in January. If you were using the cash-basis accounting method, you would not have a prepaid expense account, and the month of January would have large expenses that would offset any profit.

You can develop a schedule similar to the one you used for depreciation to keep track of prepaid expenses. This kind of schedule is a quick and easy way to know what needs to be recorded each month; it helps you remember to do the adjustments and reminds you when another annual or quarterly payment is due.



#### Audit Alarms

A large prepaid expense, such as a 12-month insurance bill paid in July, would not be fully deductible in that tax year for a business using the cash-basis method. For example, a \$1,000 insurance premium paid on July 1, 2005, could not be fully deducted in 2005. The cash-basis taxpayer would only be able to deduct \$500 in 2005 and \$500 in 2006.

## Adding Accounts

Sometimes you may decide you want to split one account into multiple accounts to more closely track certain kinds of information. Suppose that the owner of Lisa's Candle Shop decides that she needs to track her candle inventory a little differently to more quickly see what types of inventory are selling well. The increased detail would also help her more easily see what she has left in inventory. To meet these needs, she decides to add three new inventory accounts:

1201 Inventory—Candlesticks

1202 Inventory—Scented Candles

1203 Inventory—Unscented Candles

She adds these accounts to the chart of accounts and the general ledger using numbers immediately following the inventory account so that these accounts stay together on the balance sheet.

As Lisa purchases new inventory, she can record the new purchases into these accounts. If she wants to break out the inventory already on hand, then she would have to adjust previous entries. Suppose that of the \$8,000 in original inventory, Lisa has \$7,000 left. Of that amount, \$1,000 is in cards, candle supplies, and other miscellaneous inventory that she plans to leave in the inventory account. She also has \$3,000 in candlesticks, \$1,500 in scented candles, and \$1,500 in unscented candles. In this case she would adjust the inventory by recording the change this way.

---

	<b>Debit</b>	<b>Credit</b>
Inventory—Candlesticks	\$3,000	
Inventory—Scented Candles	\$1,500	
Inventory—Unscented Candles	\$1,500	
Inventory		\$6,000

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You can see that making changes as your business expands or as you want to track information differently is not difficult. Just be careful to keep things in balance when you make adjusting entries to transfer information from one account to another.

## Deleting Accounts

Sometimes you may want to eliminate an account that is not being used. You should only do that at the end of an accounting year after you have closed the books.

Eliminating an account midyear that already has transactions posted to it is never a good idea.

If you are working with a computerized accounting system, you sometimes will find that you are not allowed to delete or eliminate an account. When a computer system doesn't allow you to delete an account from the chart of accounts, the reason is because that account is a *control account*.

### def•i•ni•tion

A **control account** shows the total of accounts entered in a subsidiary ledger. For example, the accounts receivable and accounts payable accounts are managed using a separate ledger, and their totals are transferred to the general ledger at the end of each month when you close the books for the month. Chapters 7 to 10 explain more about subsidiary ledgers as they discuss how to track sales and credit purchases.

Two examples of control accounts are accounts payable and accounts receivable. Even if you don't operate your business using credit sales or credit purchases, the computerized system will not let you eliminate these accounts. Leaving a control account with a zero balance in the chart of accounts of your computerized accounting program doesn't affect your reports because such programs typically do not include any account that has a zero balance when they prepare reports. (How zero balance accounts show up depends on the preferences chosen when you set up the program.)

Now that you understand how to set up accounts and make entries to the general ledger, the next chapter explains how to organize this information to run your company using proper accounting procedures.

## The Least You Need to Know

- ◆ A number of methods are used to depreciate assets. Many businesses use one type for their accounting systems and a second type for writing off depreciation for tax purposes. However, straight-line depreciation is the only type of depreciation that can be used in the accounting system.

- ◆ To figure out annual depreciation amounts, you must know how long an asset can be expected to last before it needs to be replaced or repaired. You can determine the useful life of an asset by using a standard IRS chart or by using what you know about the asset's expected useful life in a business.
- ◆ Expenses for items that cover an entire year's costs, such as insurance, would be placed in the Prepaid Expense account and adjusted monthly to more accurately match income and expenses.
- ◆ You can add accounts to the chart of accounts as needed through the year, but if you decide you want to eliminate an account, you should wait until you close the books at the end of a year.



# Part 2

## Doing Business

Once you've designed your roadmap, you need to establish basic operating procedures to make your plans work effectively and efficiently. You'll learn how to track sales, determine costs, and manage your cash safely. We'll also talk about ways to avoid fraud and embezzlement by setting up proper separation of duties. Finally, we'll explore what records you need to keep and how long to keep them.





# Chapter 6

## Getting Organized

### In This Chapter

- ◆ Banking for your business
- ◆ Filing fun
- ◆ Controlling cash and other assets
- ◆ Assigning staff

Now that you have the initial roadmap for the accounting system in place, you need figure out how to work with that system on a day-to-day basis. You certainly want to be sure that the accounting system you set up works efficiently by helping you to manage your day-to-day business activities and giving you a clear picture of your long- and short-term profitability. The key to maintaining an efficient accounting system is to establish clear procedures for such daily tasks as handling cash and filing financial records. Also important is to set up internal accounting controls to prevent the loss or misuse of company assets.

### Setting Up Cash-Operating Procedures

Before you open the doors of your new business, you need to set up a bank account for the business. Certainly, you hope to be adding to that

account daily with all your new business. You definitely want to select a bank conveniently located to your business and one that operates at times when you need to use it. (Of course, banking hours are not necessarily designed for your business.)

Visit your area banks and find out what type of business services they offer. Find out if you will have the personal attention you need to handle questions and deal with problems that could arise. Of course, check on the fees for services. Fees vary greatly for business accounts. It never hurts to shop around, but don't necessarily choose a bank based on the fact that it has the lowest fees, because the services offered may not meet your business needs.

Some banks today are even charging if you go to a teller for individual service rather than use the automated teller machines or drop boxes. Others require you to call a centralized office rather than work with people at your local branch. Some banks charge for every transaction regardless of whether it's a deposit, a withdrawal, or a check. Others have standard monthly fees, and some banks waive these fees if you maintain a certain amount on deposit or carry a certain level of credit. Many banks offer Internet services, which certainly can make managing your accounts easier.

After you've selected your bank, your next choice is what type of account or accounts you want to establish. Your primary account, Cash in Checking (account 1000), should be operated using business voucher checks. Business voucher checks offer you excellent control over your cash accounts. As you see in the picture from Expresschecks.com, there are three checks to a page and a check stub on which to record all the critical information for journal entries: date, business or person paid, and purpose of the check. Checks are numbered by the bank, and you can quickly see whether any checks are missing or not properly used. Most banks will also give you printed deposit slips and a stamp for check endorsement that has all the proper account information included for deposits.

*Expresschecks.com shows an example of what you can order if your bank doesn't provide you with business voucher checks.*



Before taking a deposit to the bank, make a copy of all checks being deposited. Attach these copies to the receipt the teller gives you for the deposit and file them. Be sure the deposit receipt from the bank matches the total you put on the deposit slip. If not, question the difference at the bank immediately. Following these procedures will give you excellent backup if any problems occur with the deposit later.



### Biz Tips

You should assume that the cash is used as soon as you send out a check to make a payment. Never send a check with the anticipation that funds will be deposited in a day or two. Checks are clearing much more quickly today, and you certainly don't want to get socked with hefty charges for a returned check. Most times, you'll not only be forced to pay fees to your bank for a returned check, you will also be asked to pay the fees incurred by your vendor for the bad check.

This voucher check system can give you up-to-date information about your available cash provided that you total each page and carry that total forward to the next. If you do make a mistake, totaling accounts on each page will help you to quickly figure out where the mistake was made.

## Designing Filing Systems

Now that you have an operating account, you need a filing system so you can keep track of all your transactions. Chapter 4 talked about using ledger paper for accounting entries, but you'll also need file folders, three-ring notebooks or binders, file cabinets, and alphabetical and 12-month expanding files.

The chart of accounts, general ledger, and other subsidiary ledgers (such as the accounts receivable ledger, which is discussed Chapter 7) should be kept in three-ring notebooks or binders. Ledger paper has holes for these binders. Using binders makes it easy to keep track of the ledgers and to use them daily. You can keep them in files instead of binders, but then you risk that the pages could fall out of the files and become completely disorganized or land in one of those piles on your desk.

Expanding files are a good way to keep track of current vendor activity and bills. For example, you can use the alphabetical expanding files to track open purchase orders by vendor. After the order is completed, you can file all shipping information and other related materials in the vendor's individual file. A 12-month expanding file comes in handy for bills that need to be paid. That way you can file the bill based on

the month that payment is due. Within each month, you can order the bills by date to be paid. That way you not only have a quick visual reference of bills due, you also can be sure you pay them on time. In some cases, you may even want to pay them early to take advantage of discounts for paying quickly. (Discounts are covered in greater detail in Chapter 8.)



### Business Bites

Question: Why did the auditor cross the road?

Answer: Because he looked in the file and that's what they did last year.

You also should keep a file of any monthly accounting reports that you develop and print, so you can review them whenever necessary. The type of filing related to each aspect of accounting, such as accounts receivable, accounts payable, sales, and inventory, is covered in later chapters focused on each of these critical functions.



### Biz Tips

Someone could write a book on how to best organize a good filing system, and, in fact, someone has. We recommend *Taming the Paper Tiger* by Barbara Hemphill and *File ... Don't Pile: A Proven Filing System for Personal and Professional Use* by Pat Dorff.

You also need to set up files for each vendor, contractor, and employee. You will want files for each major customer. If you are a small retail store, you may want to set up your files by day rather than customer. A doctor's office needs files for each patient. A lawyer's office needs files for each client, as well as each case. The filing system you design should be one that works best for your business. No one enjoys filing, but an efficient system that quickly gives you access to the information you need is certainly worth the pain.

Even if you track everything by computer, you will still have paper that needs to be filed. Also, you do want to have paper copies of what is on your computer in case the system goes down. And, of course, you want to digitally back up any computer data in case a system crashes.

How many times have you called a company or walked into a store just to be told that the computer system is down and you'll have to call back or come back later? How angry do you get when that happens? You definitely want to set up your systems to avoid frustrating customers, vendors, and employees.

## Implementing Controls

Even more important than keeping all your paper under control is setting up an internal accounting control system that helps you avoid loss. If you are running the

business as a sole proprietor and handling all the funds yourself, you don't need internal controls. (Unless, of course, you don't trust yourself.) Otherwise, you should carefully design your accounting system as a deterrent for fraud and embezzlement. A dishonest person can find a way around almost any system, but a good internal control system keeps honest people honest.

Without good controls in place, a small business risks the following:

- ◆ Unauthorized use of assets
- ◆ Inaccurate reporting of transactions
- ◆ Loss or theft of key documents
- ◆ False entries into the accounting system to disguise theft, fraud, or embezzlement

Controls and respect for the controls start at the top and trickle down through management. Not only do you need to take the time to design good controls, you must also take the lead in following them and be sure all your managers do as well. Controls not only protect you from acts of theft or embezzlement, they also make sure your business gets all the money it's due. Common errors caused by lack of control, such as those in the following list, can cost a lot, too.

- ◆ Invoices are paid twice because you didn't have proof of payment or a system to properly track payments.
- ◆ The business is not paid for sales of products because no one recorded the sale in accounts receivable, and the unpaid account went unnoticed.
- ◆ Loss of goods (whether from theft or breakage) goes undetected because you lack regular inventory counts.
- ◆ Lax reporting or tracking of cash deposits makes it easy for someone to pocket some cash.

In addition to designing the internal accounting controls, you also must assign people to be responsible for maintaining and monitoring the system you set up. The key to a successful internal control system is proper separation of duties.

For example, you should have at least two people responsible for paying bills: one who researches and writes the checks to pay vendors and a second who reviews the payments, signs the checks, and sends them out. The person who prepares the payroll should be different than the one who has the right to sign and release the checks.

**Accounting Answers**

The Institute for Financial Crime Prevention states, "The largest single component of white-collar crime is internal theft by employees." Employee theft and embezzlement is a problem of major proportions. Annual employee theft losses in the United States are estimated at \$200 billion per year or over \$500 million per day. This estimate is more than 10 times the amount lost through all other crimes combined. In banks, for example, 95 percent of theft losses are from employees while only 5 percent are from robberies and customer theft. According to the Institute of Financial Crime Prevention, four conditions in the workplace provide opportunities for theft: poor internal controls, too much control limited to certain individuals, lax management, and failure to adequately pre-screen employees.

## Separating Duties Properly

Small businesses with small staffs sometimes have a difficult time dividing duties to maintain good accounting controls. Unfortunately, you must think like an embezzler to figure out ways someone could take advantage of a system with poor controls.

A properly organized internal control system involves several important jobs. You may have more than one person doing any of these jobs, but you shouldn't have the same person doing more than one of them.

- ◆ **Accounting.** This job involves reviewing all the transactions for accuracy, validity, appropriateness, and proper authorization. This job also involves consolidating and reviewing all cash receipts from cashiers and the bank deposits. Any person who handles payments to or from external parties should never have the responsibility of recording those transactions. Another role for the accountant or someone he or she supervises would be entering the transactions in the ledger and other financial systems. Finally, the person doing this job would review and reconcile the general ledger at the end of every month to identify errors and discrepancies and either resolve them or bring them to the attention of people who need to resolve them.
- ◆ **Authorization.** This job could be designated to a number of managers who have the right to authorize expenditures for their department. In some cases, depending on the size of the transaction, you may decide that more than one person should approve a transaction. For example, you could set a rule that the manager and an officer of the board must approve any transaction over \$20,000. Authorization levels should be clearly defined depending on what works best in your business.



- ◆ **Money Handler(s).** People who handle money directly should not be responsible for preparing the bank deposits or recording the transactions. You always want at least two people involved in any cash, check, or credit transactions. This includes people accepting payment for your products or services as well as people writing checks to pay your company's bills. For example, in a retail store the cashiers will prove out their register at the end of the day to be sure the cash in the register accurately reflects the day's activities. The entire process starts when the cashiers open at the beginning of the day with a set amount of cash. At the end of the day the cashier adds up the sales and then calculates the amount of cash or credit receipts that should match what is recorded in the register at the end of the sales day. Usually some money is left in the register for the next day, and the rest is consolidated with other cash receipts of the day. The cash is then passed on to someone in the accounting function to record transaction details and deposit the cash. A manager usually checks the cashier's work to be sure it is accurate and all transactions are included.
- ◆ **Financial Reports and Analysis.** Although the accountant can do this job, another person should review the financial transactions and prepare the reports for management and staff.

As you are setting your internal controls, consider these guiding principles.

- ◆ Separate the custody of assets (cash, credit, and check handling) from the person who records the transactions.
- ◆ Separate the right to authorize transactions from the people who actually disperse the cash.
- ◆ Separate the duties within an accounting function to provide for a good system of checks and balances.
- ◆ Separate operational responsibility from record-keeping responsibility.

## Balancing the Costs of Duty Separation

Small businesses are always trying to balance the cost of proper separation of duties with the risks of not having adequate separation of duties. You may be wondering how you can assess the risks and determine what you can do given your resource limitations.

Keep in mind that the cost of accounting controls is not always a staff cost. Generating a report or pulling together all the documentation costs time. For example, your salespeople want to satisfy customers and respond to their needs as quickly as possible and may balk at the inventory controls you put in place. The general rule is that whatever control you put in place should never cost more than the asset you are trying to protect.

Ask yourself these key questions whenever you are designing an internal control program for your business.

- ◆ What are you trying to prevent or detect—errors, sloppiness, theft, fraud, or embezzlement?
- ◆ How often do you expect to face a loss for which you are implementing the control?
- ◆ What do you expect the loss to cost?
- ◆ What will it cost to implement the prevention or detection system?

Don't try to answer these questions in a vacuum. Talk with your managers, salespeople, and any others who will be affected by the change. You might not know about all of the costs in time or money. Carefully consider everyone's concerns and design the system to be cost-effective, as well as to provide the protections you are seeking.



**Biz Tips**

A good business practice is to write up an internal control procedure when the control is first established that includes a summary of why the control is necessary, the anticipated costs of implementing the control, the assets you are trying to protect, and the estimated losses without protection. This information is in addition to the actual procedures to be implemented. That way, if a procedure is later questioned, you have the initial details of why it was established and can assess its success or failure and more easily design any changes.

You could design the best internal controls in the world, but they won't mean a thing if you don't hire competent employees with the proper training to carry them out. Staff must fully understand their roles and the importance of those roles. As the owner, your responsibility is to be certain you lead by example and reward those who follow your rules.

You also should be sure that you cross-train people so that a backup person is always available to handle a task if someone is out. In selecting backups, be careful to maintain the key principles of the separation of duties.

Never forget to constantly encourage feedback on how things could be done differently. People working with your system on a daily basis will come up with ideas for streamlining and improving the operation. Keep an open mind, but always be mindful of why controls were put in place and whether the changes being recommended will still provide the protections for which the controls were initially designed.

## Bonding Your Employees

If your business will handle a lot of cash or will possibly be exposed to the risk of employees stealing from others, you may want to consider bonding your employees using *fidelity bonds*. By carrying this type of insurance policy, you can protect your business against theft, negligence, or other situations that could result in financial loss.

Internal control systems are covered in greater detail in later chapters that discuss how to set up your accounting system to handle receipts, disbursements, and inventory. The next chapter talks about how to handle your sales and set up the appropriate accounting procedures.

### def•i•ni•tion

**Fidelity bonds** are a type of insurance that covers losses sustained from dishonest acts committed by employees. This insurance can include coverage for losses by a client because of an employee's act, as well as legal damages or court defenses resulting from an employee's dishonest act. Many times fidelity bonding is part of an overall business insurance package.

## The Least You Need to Know

- ◆ Finding the right bank that offers you the convenience you want at a reasonable cost is your first step in setting up your cash account.
- ◆ No one likes to file, but setting up an efficient and effective filing system can provide your company with needed information quickly.
- ◆ Internal theft can cost your business dearly. Separating employee duties is the most important step in implementing a strong internal control system.



# Chapter 7

## Tracking Sales

### In This Chapter

- ◆ Rolling in dough
- ◆ Giving credit
- ◆ Knowing your receipts
- ◆ Controlling the take

All businesspeople enjoy selling their products and taking in the money. But along with that fun come some necessary accounting tasks. These tasks include practicing good money collection methods, carefully filing records related to the sales, and following through on proper procedures to be sure sales are accurately recorded.

Cash sales are the easiest to record and monitor, but few businesses operate solely by cash. You also need to know how to handle credit sales and accounts receivable and establish internal control procedures to be sure you get all the money your sales have earned. This chapter gives you the information you need to handle these tasks.

## Taking In Cash

Most businesses take in some form of cash. Whether you are operating a retail store with a *point of sale* location, an in-home service business that collects money for services rendered in the home, or a consulting firm that collects money from clients, you probably have some cash transactions.

At the time of sale, a sales slip is generated by hand or by cash register that includes information about the date of the purchase, a description of the merchandise purchased, the price of the merchandise, and, if applicable, the sales tax charged. This sales slip is important to both the customer and the merchant. The slip gives the customer proof that the item was purchased in the store on a particular date, which is

### def·i·ni·tion

**Point of sale** is usually a location in a store that includes the cash register, a service counter, or any place that your customers can go to pay for and pick up merchandise.

important if the customer wants to return or exchange the merchandise. Most stores require a sales slip to accept merchandise for return or exchange. The sales slip gives the retailer the information needed to record the sale accurately and plays an important role in assuring that sales are reported. This second role is part of the discussion about internal controls in the “Controlling the Cash” section later in this chapter.

A sample cash register receipt for our fictitious company, Lisa’s Candle Shop, shows a lot of helpful information about the transaction:

### Lisa's Candle Shop, 2-15-2005

Item	No.	Price	Total
1201 Candlesticks	2	\$20	\$40.00
1202 Scented Candles	12	\$1	\$12.00
			\$52.00
Sales Tax @ 5%			\$2.60
			\$54.60
Cash Paid			\$55.00
Change			\$ .40

You can quickly see that this sales slip, which was most likely generated automatically by a cash register, gives you a wealth of information you can use to record the

transaction in your accounting system. You know the amount of cash collected, the number of items sold, the type of items that were sold, and the sales tax paid.

For the purposes of this chapter, let's focus on the sales side of the transaction. (The next chapter takes a closer look at recording the information for the cost of sales and inventory.) Assuming that the cash is deposited into the checking account, the general ledger entry for this transaction would look something like the following.

	Debit	Credit
1000 Cash in Checking	\$54.60	
2100 Sales Tax Collected		\$2.60
4000 Sales of Goods		\$52.00

You can see that just recording the sales side of the transaction affects three different accounts in the general ledger. Cash in Checking is an asset account on the balance sheet. The balance in this account is increased with the debit. Sales Tax Collected is a liability account on the balance sheet. Remember, you'll have to pay sales taxes to the state and local governments, if any, at the end of the month, so you want to keep track of this liability. Tax reporting is covered in greater detail in Chapter 11. Sales of Goods is a P&L account, and its balance is increased by the credit. Note that the journal entry is balanced.

You probably would not record each sale individually in these accounts. This single transaction is just an example to show you how things work. Most retailers add up their sales at the end of the day and just do one entry for that day.

## Selling on Credit

Few stores can operate today without selling on credit. Although credit card sales receipts look much the same as cash receipts, the retailer does not net the same amount of cash when a customer uses a credit card. Retailers have to pay a certain percentage of their sales to the credit card companies. These percentages are negotiated with the bank at the time arrangements are made to accept credit cards. In addition, the store usually needs to pay certain start-up charges to accept credit cards, including costs for the machines to be used to read the cards and generate the sales receipts. These costs vary greatly depending on a store's volume. Chapter 8 discusses the adjustments you need to make to sales to record credit card costs.

Another type of credit sale is a store charge account. Many stores allow this kind of account to avoid having to pay credit card companies and to provide convenience for regular customers. This type of sale requires additional information on the sales slip.

**Lisa's Candle Shop, 2-15-2005, Purchase on Account by Jane Smith, Account #350**

Item	No.	Price	Total
1201 Candlesticks	4	\$20.00	\$80.00
1203 Unscented Candles	24	\$ .50	\$12.00
			\$92.00
Sales Tax @ 5%			\$4.60
			\$96.60
Charged to Account #350			
Signed by _____ (Jane Smith's signature)			

In this case you need to record not only the sale but also the detail in Accounts Receivable. The entry in the ledger looks very similar to a cash transaction, but the sale is recorded in the Accounts Receivable account rather than the Cash in Checking account.

	Debit	Credit
1100 Accounts Receivable	\$96.60	
2100 Sales Tax Collected		\$4.60
4000 Sales of Goods		\$92.00

In addition to this entry, you also need to add the amount to the customer's (Jane Smith's in this case) ledger card or account file. The necessary information looks similar to the following.

Account #350  
 Jane Smith  
 100 Cedar Lane  
 Chicago, IL 33333

Date	Invoice No.	Amount	Payments	Balance
2/15/05	(if used)	\$96.60		\$96.60



At the end of the month the store sends a bill to Jane Smith. When Jane Smith pays the \$96.60, you need to enter these transactions.

	Debit	Credit
1000 Cash in Checking	\$96.60	
1100 Accounts Receivable		\$96.60

Note that the Cash in Checking account is debited, which increases that account and the Accounts Receivable account is credited, which decreases that account. Both are asset accounts, so the entry is balanced. Usually an accounting department records all the payments received at one time in these accounts rather than making an individual entry in the general ledger for each payment.

You also need to make an entry in Jane Smith’s account to reflect the payment.

Account #350  
 Jane Smith  
 100 Cedar Lane  
 Chicago, IL 33333

Date	Invoice No.	Amount	Payments	Balance
2/15/05	(if used)	\$96.60		\$96.60
3/15/05			\$96.60	\$0.00



**Biz Tips**

If you are using a computerized accounting system, the system will automatically update the customer’s account file and the general ledger accounts when you record the payment. However, you should still keep a file of invoices that have been sent requesting payment and copies of checks showing payment has been received. This paper backup gives you the detail you need in case the customer later questions his or her account.

Now that you know the basics of recording cash and credit transactions, let’s look at how these transactions are combined at the end of a sales day.

## Combining Cash and Credit

Let's work through the process of a day's sales transactions. Each day a cashier starts out with a certain amount of cash in the register. This amount is usually left over from the night before. The cash in the register is shown as part of the 1020 Cash on Hand account.

At the end of the day the cashier totals the sales at her register and counts the remaining money, including cash, checks, credit card receipts, and store charge account purchases. Usually a cashier then completes a form that tallies the day's activities. Here's a sample for Lisa's Candle Shop.

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**Date: 2/15/2005**  
**Cashier: Sally Smith**

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Beginning Cash		\$50.00
Cash Sales	\$200.00	
Credit Card Sales	\$400.00	
Store Charge Sales	\$350.00	
Total Sales		\$950.00
Sales on Credit		\$750.00
Cash Received		\$200.00
Total Cash in Register		\$250.00

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A manager reviews Sally's sales totals, checks her cash, and reconciles the register records to these totals. The manager runs a report from the cash register that provides a review of the day's transactions. This breakdown includes a total of sales and sales taxes. The manager then counts the cash left in the register to verify the cashier's work and reviews the credit receipts. Once everything is verified, the manager takes some portion of the cash to be deposited in the checking account and leaves some cash. The cash that's left becomes the beginning cash figure for the next day. Let's assume the manager took \$200 in cash and left \$50.

The manager then consolidates the reports from all the cashiers that day, makes the bank deposit (or assigns someone under him or her to do so), and gives the information to accounting so the appropriate entries can be made. To keep the example simple, assume Lisa's Candle Shop only has one cashier.

The entry for February 15, 2005, is as follows.

	Debit	Credit
1000 Cash in Checking	\$600.00	
1100 Accounts Receivable	\$350.00	
2100 Sales Tax Collected (assume 5%)		\$45.24
4000 Sales of Goods		\$904.76

In this example, the assumption is that the bank automatically deposits the credit card sales in the store’s checking account. Chapter 8 explains how to adjust the credit card sales deposit to reflect the costs of selling on credit.



**Biz Tips**

Make sure your staff takes the time to enter the daily sales receipts in the general ledger, record the bank deposit in the check register, and total each. This information gives you a good way to double-check that your general ledger Cash in Checking account matches the amount in your checkbook. If you are separating duties properly, usually the person preparing and making the bank deposits is a different person from the one who is preparing and recording the journal entries. This separation of duties is one way to both prevent errors in your books and give you good internal controls over your business’s money. In the candle shop example, the store manager handled the cash and prepared the summary. Someone outside accounting received external cash, which is another good internal control practice.

After the day’s cash receipts are counted and proven and the bank deposit is made, the person handling accounts receivable needs to record all the in-store charges to the individual account records of everyone who charged to their account that day. The next chapter explains how to handle the recording of information related to cost of sales and inventory. Chapter 9 reviews adjustments to the sales figures, such as discounts, returns and allowances, and credit card sale costs.

## Prepaying Accounts

In some businesses, Accounts Receivable accounts not only track money because of the business, but they also track money paid in advance for services. Law firms,

accounting firms, consulting firms, and other professional service organizations frequently ask clients to pay a monthly fee on retainer for services to be rendered. Usually this fee is an estimate of the services anticipated for the month.

When the money is received, an employee makes a journal entry to reflect the payment. Assume Lisa's Candle Shop has an accountant on retainer to review its monthly transactions and prepare its year-end reports and tax returns. The shop pays \$500 per month for accounting services. The accounting firm records the retainer fee in this way.

	Debit	Credit
Cash in Checking	\$500	
Accounts Receivable		\$500

The firm debits the Cash in Checking account, which increases that account, but it credits the Accounts Receivable account, which reduces the amount in that account. When the fees are actually earned and billed, the credit to the Accounts Receivable account will be reversed to show the receipt of cash and the payoff of the credit given the customer.

The firm also needs to record the receipt of funds in Lisa's Candle Shop's account.

Date	Invoice No.	Amount	Payment Rec'd	Balance
2/1/05			\$500.00	(\$ 500.00)

Note that the balance in Lisa's account shows as a negative because the fees are not yet earned.

Assume the accountant billed \$400 for services in the month of February. The accountant would then make these entries in his records.

	Debit	Credit
Accounts Receivable	\$400	
Fees Billed		\$400

Note that the Accounts Receivable account is increased with a debit entry now that the fees are earned, and the Fees Billed income account is increased with a credit entry.

The Lisa's Candle Shop account would also be updated to reflect the billed services.

Date	Invoice No.	Amount	Payment Rec'd	Balance
2/1/05			\$500.00	\$500.00
2/28/05	200	\$400.00		\$100.00

As you can see, the way you record the receipt of funds can vary greatly depending on the type of business you are running and how you collect your fees or record your sales. Some people working on contract require 50 percent up front and 50 percent upon completion. Accounting for these situations would be similar to professional fees. In these types of contract arrangements, the customer's account is adjusted as costs are incurred. Companies that work on large construction projects usually have a construction account specific to each project to manage the costs and record the payments.



#### Biz Tips

Some stores use mystery shoppers if they suspect some of their salespeople are not recording sales. Mystery shoppers are paid to pose as regular customers. Many times shoppers are used not only to check for accuracy of sales reporting, but also to test the customer service skills of the employees. You can find out more details about the type of services offered at Service Intelligence ([www.serviceintelligence.com](http://www.serviceintelligence.com)), one example of a mystery shopping service.

## Controlling the Cash

Whenever cash is changing hands, you must put controls in place as a deterrent to theft or embezzlement. Regarding sales, there are three ways employees can pocket some cash:

1. They don't record the sale.
2. They don't provide a sales receipt.
3. They record a false credit voucher.

Store owners are constantly worried that cashiers will pocket the money instead of recording a sale. The best deterrent to this type of theft is good supervision. Another way to put controls in place is to have numbered sales tickets that match the cash

register receipts. That way, if a number is missing, the cashier would have to show what happened to that sales ticket, usually by having a voided ticket that becomes part of the daily record when the cashier reconciles her register's transactions at the end of the day.

Another trick that a crooked salesperson could use is not to provide a customer with a sales receipt. The next customer is given the unused sales receipt, but the sale is not recorded. The customer has a valid sales receipt, and the cashier can pocket the money. In the company's records the sale never took place. The customer doesn't know there is a problem because he or she has a receipt. Your best defense against this tactic is to clearly remind customers (by posting signs at your store, for example) that company policy is to provide a sales receipt and that without a sales receipt no refunds or returns will be possible. This kind of reminder will reduce the possibility that someone would walk out without a sales receipt. Numbered sales receipts with duplicates can help to prevent this problem.

Another reason to have numbered sales receipts and carefully monitor their use is to prevent shoplifters from getting money for merchandise they never bought. Sometimes a shoplifter gets ahold of blank sales receipts. Shoplifters can then take goods from your store and return them for a refund using one of these sales receipts. A store could end up exchanging or refunding merchandise for which it was never paid. If someone comes in with a numbered sales receipt that is part of a missing batch, you would know they did not pay for the goods.

Credit vouchers can also provide opportunity for theft. Most stores control the problem by requiring approval from a supervisor or manager for a credit voucher to be issued. Also, numbering credit vouchers and carefully monitoring their use can protect you from misuse or theft.

## **Monitoring Accounts Receivable**

In addition to establishing controls for the sales side of your business, you also need to establish controls on the recording side, particularly regarding accounts receivable. You must be sure that you separate the duties, so that the person who receives the payment for store charge accounts is not the same as the person who records the payment.

Many companies have a lock box at the bank where payments are sent and the money is deposited. You probably will have to pay your bank a fee for this service. A summary of deposits with copies of checks is sent to the company. The accounts receivable clerks then update customer accounts based on this summary. This practice

ensures that the company's money is deposited, and it also decreases the time needed to get money into the company's account.

### Accounting Answers

Even with all these controls in place on the receipt of funds, an accounts receivable (A/R) clerk can still find ways to pocket some cash, such as the process called check lapping or kiting. In this process, an A/R clerk takes the money received from Jane Doe. When payment is received from John Doe, the clerk credits Jane Doe with payment. When payment is received from Michael Doe, the clerk records payment in John Doe's account, and so on. The only way to protect your company in this instance is to do periodic checks on people whose payment you know was received. Sometimes this practice is caught when a person who has made payment is billed a second time for a payment he or she already made. Sometimes it is caught when the dishonest employee is on vacation or out with an illness and someone else sees what has been happening.

Another common way to check accounts is to periodically send out a notice to a sampling of your accounts asking for people to verify their account balances. If you get too many people writing back that their account is in error, you know you have some kind of internal control problem. It may not be theft or embezzlement; someone in accounts receivable could just be making a lot of errors that are not being caught because of lack of internal controls.

In addition to tracking that payments are accurately reported, your Accounts Receivable account should be carefully monitored for timely payments. Otherwise you may think your business is doing incredibly well with sales rapidly increasing while in reality you are not collecting the money due.

To track payments, run a monthly report based on the Accounts Receivable account that tracks the aging of accounts. Account aging relates to the number of days an account is past due. Aging reports usually track accounts that are 30 days, 60 days, 90 days, and over 90 days past due. Part of this tracking process is to decide when you will stop trying to collect in-house and consider sending an account to an outside company for collections. You also need to decide how quickly you want to cut off a customer who has not paid. Your business can operate only with cash in hand. A customer who charges and doesn't pay is not worth having.

This chapter has shown how proper accounting and controls can help make sure your sales turn into profits for the company. The next chapter explains how to calculate the cost of those sales.

## **The Least You Need to Know**

- ◆ Record cash and credit sales daily in both the general ledger and any related customer accounts.
- ◆ Separate the handling of cash so that the person who receives the cash or other type of payment is not the same person who records that payment in your accounting system.
- ◆ Accounts Receivable is a useful tool not only for tracking sales and payments by customers, but also for tracking people who don't pay on time or at all. Careful monitoring of Accounts Receivable gives you the information that you need quickly so you can cut off a customer who doesn't pay his or her bills.



# Chapter 8

## Determining Costs

### In This Chapter

- ◆ Buying goods
- ◆ Counting inventory
- ◆ Figuring costs
- ◆ Paying payables

Making sales is the fun part of business, but understanding the costs of the products you are selling and monitoring any changes in those costs are critical to the success of your business. You could have what appears to be a very successful sales month when you add up your sales totals, but if you haven't properly priced what you are selling you could still be operating at a loss. This chapter takes you behind the sales floor to look at how to record purchases of the products you plan to sell, manage inventory, and pay for that inventory. This chapter also explains how to set up a system to pay the bills.

### Recording Purchases

We all know the impact on our monthly budgets when prices go up for items we need. When gas prices shoot up or the cost of basic foods

increases, we notice and set aside more money for gas and grocery shopping. If you are running a small business, you need to watch for any change in the prices of the products you sell and adjust your prices accordingly.

The first step in the process is to record the purchase of new inventory accurately and quickly. If you are operating a retail outlet, your inventory consists of finished goods ready for sale. The recording process involves two accounts in the chart of accounts: the Purchases account, which is on the P&L Statement directly after the sales accounts, and the Inventory account, which is on the balance sheet.

**Accounting Answers**

If you are making the products you sell, inventory control and pricing is much more complicated. A manufacturing company divides its inventory into three categories: raw materials, work in progress, and finished goods. The raw materials are all the items the company needs to buy in order to make its product. In some cases these materials may include subassemblies, which are partially built pieces. For example, a car has many parts that come to the assembly plant from different areas of the United States or around the world that are put together in its assembly plant. During the building process, the raw materials then become part of the work-in-progress inventory. At this stage, labor costs for building the product are added to the cost. When the product is built and ready for sale, the costs are transferred to the finished goods inventory. Inventory management and proper pricing for a manufacturing environment is beyond the scope of this book, but if you are interested in learning more about these concepts, one classic book is *Inventory Management and Production Planning and Scheduling, 3rd Edition* by Edward Silver (John Wiley & Sons, 1998).

The Purchases account is where you track the ongoing costs of goods to be sold. When you first buy items for sale, you record the initial purchase in this account. Assume that Lisa’s Candle Shop bought \$8,000 in new items for sale. Lisa records the purchase using this type of entry.

	Debit	Credit
4300 Purchases	\$8,000	
2000 Accounts Payable		\$8,000

Take note that the Purchases account is debited, which appears as a negative on the P&L Statement. Remember that income accounts usually carry a credit balance. The Purchases account is a cost-of-sales item that reduces the income from the Sales of Goods or Services income account. The credit to the Accounts Payable account

increases the liabilities section of the balance sheet. (Accounts Payable management is discussed later in this chapter.)

The Inventory account tracks the inventory on hand, which is an asset to the company. The Inventory account in most businesses is not adjusted with each purchase, but instead is adjusted based on the methods chosen for managing inventory.

## Managing Inventory

Companies track changes or additions to inventory in one of two ways: a *periodic inventory method* or a *perpetual inventory method*. You need to decide which method is best and most cost-effective for your business.

For the periodic inventory method, you need to decide how frequently you want to do a physical count of your inventory. Assume that Lisa's Candle Shop follows a monthly periodic inventory method. Each month she starts calculations using the beginning inventory amount, which is the ending inventory amount for the prior period. (A new business would have a beginning inventory amount of \$0 in the first month.) She then adds any purchases made during the month to that number and gets a total of goods that were available for sale. At the end of the month she physically counts what is left in inventory and subtracts that amount. The remaining number is the number of items sold. The calculation looks like this.

Beginning inventory	100
Purchases	<u>200</u>
Goods available for sale	300
Ending inventory	<u>50</u>
Items sold	250

If the items sold number does not match the actual number of sales, then you know there is a problem. There could be misplaced items, items that were damaged and discarded, or items that were stolen. Either way, the cost of goods sold is calculated using the items-sold number. Even if the items were lost or stolen, they still impact the cost of goods you sell.

### def·i·ni·tion

The **periodic inventory method** is a method that requires a physical count on a periodic basis. This count can be daily, monthly, or yearly or any other time period that meets your business needs. The **perpetual inventory method** is a method in which inventory counts are adjusted with each transaction. You definitely need a computerized inventory control system to manage inventory using this method.

You certainly want to track any differences between the items-sold number and the actual number of sales for several reasons. You need to know what is causing the differences because every item you don't sell negatively impacts your profit. You may be able to write off losses due to theft or damage, but you need to document those losses.

A perpetual inventory method is calculated based on actual transactions. You must be using a computer to be able to track things this precisely. Many major retailers link their cash register sales to their inventory control system. That's why you sometimes go to a store and find a cashier can't even record sales when the system is down. You may even see expensive cash registers sitting in the check-out area while cashiers are writing down every transaction for later input. You also might get quite frustrated when a cashier can't input an item because he or she can't locate the proper inventory number on the item you want to buy. Yup, they do call this progress.

## Tracking the Cost of Each Item

Tracking the number of items sold is just one part of the equation. You also have to track the cost of each item. You can track costs in five ways: *last in, first out (LIFO)*; *first in, first out (FIFO)*; *average costing*; *specific identification*; and *lower of cost or market (LCM)*.

### def·i·ni·tion

There are five ways to track inventory. The **last in, first out (LIFO)** system assumes that the last items put onto the shelf are the first items that are sold. The **first in, first out (FIFO)** system assumes that the first items put onto the shelf are the first items that are sold. Rather than track which items were first in and first out, the **average costing** system calculates an average cost per unit sold. The **specific identification** system tracks the actual items sold and their individual costs. The **lower of cost or market (LCM)** system sets inventory costs by whichever amount is lower: the actual cost of the inventory or the current market value.

Companies that sell big-ticket items, such as cars or computers, often use the specific identification system. Frequently the way the item is built can greatly impact the price charged. For example, a car's price can vary greatly depending on how many extras you want, such as stereo system, automatic locks and windows, automatic or manual transmission, and so on. Computers are priced by the extras as well. For example, price can vary greatly depending on storage capacity, processing speed, software

upgrades, and drives. Each item is assigned an inventory identification number, and when sold, the sale is tracked by that number.

Companies whose inventory can face rapid price changes use the lower of cost or market system. For example, companies dealing in precious metals, commodities, or publicly traded securities commonly use this method.

For the purposes of this book, we will delve into the three most common inventory systems to small businesses: FIFO, LIFO, and average costing. You can choose any of the three. Before getting into the specifics of how these systems work, you first need to understand their impact on your bottom line.

**Business Bites**

An accountant is someone who knows the cost of everything and the value of nothing.

The FIFO system assumes your oldest goods are sold first. This order can be very important if you are selling goods that spoil quickly or become obsolete. If prices go up, the FIFO method gives you a lower cost of goods sold because you are using the costs associated with older, cheaper products. This system makes your bottom line look better, but it also increases your tax bill because you have higher income.

LIFO assumes your newest inventory is sold first. If you are selling items that don't spoil or become obsolete, this system will work. When prices rise, the higher-priced goods are sold first, leaving lower-priced goods in inventory. This system increases the costs of goods sold and decreases net income, which means a lower tax liability.

Average costing give you the best picture of inventory cost trends rather than the actual ups and downs of prices. This method can level out the peaks and valleys of your inventory costs through the year. If you are selling a product that has many ups and downs through the year, this system might be your best choice.

Let's practice using these three methods so you can see the impact of each one. Assume Lisa's Candle Shop purchased candlesticks three times during the month of February. On February 1, Lisa bought 100 candlesticks for \$10.00, which was the same amount as she paid in January. On February 15, Lisa bought 100 candlesticks for \$15.00. Realizing her supplier had dramatically increased the cost of candlesticks, Lisa found a new supplier. On February 26, Lisa bought 100 candlesticks for \$12.50.

As this example illustrates, knowing your purchase costs and being able to quickly calculate their impact on your costs of goods sold is important. The accounting process collects critical information, but you must ensure that that information is shared quickly and with the right people in your business in order to be successful.



**Biz Tips**

You can see how important it was that Lisa realized her costs of goods sold had risen dramatically. She needed to find a new supplier. As Lisa's Candle Shop is a small shop, the person who paid the bill for the candlesticks probably notified Lisa of the price change immediately. In a larger business, the purchasing department, working with the accounts payable department, tracks its contract prices and quickly changes suppliers or renegotiates contracts when prices rise. Cost-accounting folks need to look at increasing costs of goods to be sold and adjust prices for their products accordingly. A company may find that it cannot charge the full costs of the increase and still sell the product, so its net income will drop.

**Practicing Inventory Costing**

To practice the inventory-costing methods, let's calculate the cost of goods sold using each method. First, you need to know what you have on hand. Assume Lisa's Candle Shop has a beginning inventory of 50 candlesticks at \$10 each for a value of \$500. As described in the last section, Lisa also made several candlestick purchases in February at different prices.

Date	Quantity	Unit Price
February 1	100	\$10
February 15	100	\$15
February 26	100	\$12.50

At the close of business on February 28, Lisa's employees did a physical count of all inventory to provide information for February's inventory calculation.

Beginning inventory	50
Purchases	300
Goods available for sale	350
Ending inventory	(90)
Items sold	260

You use these numbers to calculate the cost of goods sold. Your result differs depending on which inventory system you use (LIFO, FIFO, or average costing).

The following table shows the results of these calculations using the data from Lisa's Candle Shop.

	FIFO	LIFO	Average Costing
Beginning inventory	\$500	\$500	\$500
Cost of goods sold	\$3125	\$3350	\$3157
Ending inventory	\$1125	\$900	\$1093

Each of these inventory calculations results in a different number. FIFO has the highest value in its ending inventory, and LIFO has the lowest value. In all three cases, we started with the same beginning inventory: 50 units at \$10. The differences occurred when we calculated which units were sold.

The average costing system is easiest. To use it, you first need to calculate the average cost of each item:

150 units at \$10	= \$1,500 (50 beginning inventory plus 100 purchased on February 1)
100 units at \$15	= \$1,500
100 units at \$12.50	= \$1,250
Total costs	= \$4,250
Average cost per unit	= \$12.143 (\$4,250 divided by 350 units)

We know 260 units were sold at an average price of \$12.143, which equals \$3,157.18. The ending inventory of 90 units is \$1,092.87. (We rounded these numbers so we wouldn't have to track cents.)

So if you were using the average-costing system, you would need to adjust the Inventory account on the balance sheet to show the change in the value of the inventory, which you calculate by subtracting the beginning inventory value (\$500 in this case) from the ending inventory value (\$1,093 in this case). The entry would look something like the following.

	Debit	Credit
1201 Inventory	\$593	
4300 Purchases		\$593

Note that the Inventory account is debited to show the increase in the value of ending inventory for February, which becomes the beginning inventory number for March. The amount in the Purchase account is also decreased to reflect the inventory that is still on hand. This adjustment lowers the Cost of Goods Sold account amount on the P&L Statement, which now reflects the actual purchase costs for the goods sold that month. Lisa made purchases that totaled \$3,750 plus had \$500 in beginning inventory. As a result of adjusting for the ending inventory, the Purchase account now has a balance of \$3,157 (\$3,750 minus \$593), which matches the cost of goods calculation. The Inventory account increases from \$500 (\$500 plus \$593) to \$1,093, which matches the ending inventory number.

When we calculated FIFO, we assumed that the first items sold were the 150 candlesticks at \$10, which included the candlesticks in beginning inventory plus the ones purchased on February 1. Next to be sold were the 100 candlesticks at \$15, which were purchased on February 15. Finally, the last 10 sold were bought for \$12.50 on February 26. The remaining 90 candlesticks cost \$12.50 each, for an ending inventory value of \$1125. The adjusting entry for FIFO would look like the following.

	<b>Debit</b>	<b>Credit</b>
1201 Inventory	\$625	
4300 Purchases		\$625

When we calculated LIFO, we assumed the first items sold were the 100 candlesticks at \$12.50, next were the 100 candlesticks at \$15, and finally the 60 candlesticks at \$10. You're probably thinking, "But we didn't even have the candlesticks bought for \$12.50 until the end of the month!" That's true, but if you're using LIFO, you calculate the value within the inventory bought in that period, whether you are physically counting inventory monthly, yearly, or for some other time period that suits your business. The inventory costs are based on the prices you paid for inventory during the period involved. You don't worry about the exact dates purchased within a given period. In order to match monthly costs with monthly sales, you need to calculate the costs of goods sold and inventory value monthly.

You may remember setting up an overall Inventory account and three subaccounts to track candlesticks, scented candles, and unscented candles separately. In this case, Lisa would need to do a similar calculation for each of the inventory accounts.



**Biz Tips**

In addition to costs, you also can use these calculations to see whether you are stocking too many items or too few. Looking at Lisa's Candle Shop's balance sheet, you may be concerned about the increase in inventory on hand and wonder whether sales had slowed. You would have to look deeper into the numbers to find out that the last purchase was on February 26, which was needed because she ran short of inventory. Normally she buys inventory on the first and fifteenth of the month. So you can see that accounting for inventory and costs of goods sold not only helps you track your costs, but also helps you to monitor how quickly your inventory is selling. With this information, you can adjust your future orders to match your store's stocking needs in order to satisfy your customers.

## Paying Bills

Purchases of new inventory are just one small part of the bills that a company has to pay during the month. Your Accounts Payable account can be almost as active as your Cash in Checking account. All costs related to sales plus expenses flow through this account. There are four main functions related to the Accounts Payable account.

- ◆ Entering the payables into the accounting system
- ◆ Signing checks to pay bills
- ◆ Sending out the checks to vendors
- ◆ Reconciling the checking account

As a small company, you probably don't have four people assigned to just handle these functions, and it's not necessary. You should have a different person responsible for each of these functions, though. You never want the person who enters the bills to be paid into the system to be the same one who signs checks to pay those bills or sends out those checks. Likewise, you never want the person who signs checks to be the one who mails them out or inputs the billing data. Finally, the checking account should be reconciled by someone who is not responsible for entering bills, signing checks, or sending out checks. As we discussed in Chapter 6, separation of duties is the best way to protect the company's money internally.

Disbursement of company funds must be properly organized and monitored. Many companies use a purchase-order system to be certain that all purchases have proper approval and that items ordered are paid for only once. After you pay an invoice, be

sure to stamp it paid, so you don't risk paying it a second time. After all items on a purchase order have been received and invoices have been entered into the system, the order is closed and a new purchase order must be approved before more items can be bought.

A well-managed Accounts Payable account not only ensures that the bills are paid, but it can also monitor payments to ensure that the company takes advantage of all available discounts offered for timely payment. Also, you want to be sure bills are paid on time so you don't end up with interest charges or other penalties for late payment. The next chapter provides more information about purchase discounts.

## **The Least You Need to Know**

- ◆ You can track inventory in two different ways: the periodic inventory method or the perpetual inventory method.
- ◆ You have five options to use to calculate inventory costs: FIFO, LIFO, average costing, specific identification, or LCM.
- ◆ Proper inventory control not only helps you to monitor costs, but it also helps you to be certain you have the goods on hand when you need them.
- ◆ To maintain good internal control of the disbursement of your business's money, you need to properly organize the payment for inventory or any other bills by separating the key payment functions.

# Chapter 9

## Adjusting Sales

### In This Chapter

- ◆ Giving discounts
- ◆ Taking returns
- ◆ Getting credit
- ◆ Writing off bad debt

We've discussed how you record sales and manage the accounting for products you sell. Everything we've talked about so far is when things go exactly as planned with no need for adjustments.

But business never works that smoothly; you always need to make adjustments. You could decide to offer sales discounts to generate more business or get rid of out-of-season merchandise. You'll most likely have people return purchases or need to make allowances for damaged goods.

Goods you purchase for resale also may require adjustments. You may get a purchase discount based on the volume you buy or the timeliness in which you pay the bill. You may receive damaged or nonworking goods that you return for refund.

One other adjustment, an adjustment for bad debt, unfortunately is part of any business that sells on credit. This chapter explains how you record all of these adjustments and how they impact calculations on the P&L Statement.

## Sales Discounts

Most retail outlets offer sales at some time during the year, whether it's to bring additional traffic into the store or to get rid of leftover merchandise when the prime season is over, such as after-Christmas sales. To know how well your business is doing during prime retail time, you need to carefully track items for which you offered a discount.

When you run a sale, you should record the sale at full retail price and then record the sales discount separately. You can easily do this recording by using a standard cash register receipt. Assume Lisa's Candle Shop is offering a 20 percent discount on Christmas merchandise in January. During this sale the cash register receipts have an extra line of information.

### Lisa's Candle Shop, 1-15-2005

Item	No.	Price	Total
1201 Candlesticks	2	\$20	\$40.00
1202 Scented Candles	12	\$1	<u>\$12.00</u>
			\$52.00
4010 Sales Discounts @ 20%			<u>(\$10.40)</u>
			\$41.60
Sales Tax @ 5%			<u>\$ 2.08</u>
			\$43.68
Cash Paid			<u>\$50.00</u>
Change			<u>\$ 6.32</u>

If the money were deposited in the bank, the journal entry for this transaction would look like the following.

	Debit	Credit
1000 Cash in Checking	\$43.68	
4010 Sales Discounts	\$10.40	
4000 Sales of Goods		\$52.00
2100 Sales Tax Collected		\$2.08

When Lisa's Candle Shop prepares its P&L Statement for January, the Sales of Goods line shows the full retail value of \$52.00, but the Sales Discounts line reduces this amount by \$10.40. The Cash in Checking line reflects the amount that was actually received. Sales Tax Collected, a liability account, tracks the sales tax that has to be paid to government entities. Note that the entry is balanced with \$54.08 for both debits and credits.

## Sales Returns and Allowances

You could set up your store with a no-return policy, but few retailers do. A store's reputation for good customer service is dependent on satisfying customers, and sometimes customers decide to return an item because the item is damaged, doesn't work, or isn't what they want anymore.



### Biz Tips

You need to set your return policy and be sure that all your customer-service people understand what that policy is. You also should post your return policy near your cash registers, so your customers are aware of that policy even before they purchase an item. As mentioned in Chapter 7, requiring a receipt for all return merchandise is an important part of a good internal control system.

A number of options exist for returns. Some stores allow cash back; others permit only a credit for use in the store on another item. Let's look at how you would record two possible scenarios: one in which Lisa's Candle Shop allows cash back and one in which the store allows the customer to return the item for a store credit. In this example, the customer returns half of the candles and one of the candlesticks she purchased in the transaction shown on the previous sales receipt.

The credit slip looks like the following if cash is returned.

**Lisa's Candle Shop, 1-17-2005**

Item	No.	Price	Total
1201 Candlesticks	1	\$20	(\$20.00)
1202 Scented Candles	6	\$1	(\$6.00)
			(\$26.00)
4010 Sales Discounts @ 20%			\$5.20
			(\$20.80)
Sales Tax @ 5%			(\$1.04)
Cash Paid for Sales Return		(\$21.84)	

This cash refund is recorded in the following journal entry.

	Debit	Credit
4020 Sales Returns and Allowances	\$26.00	
2100 Sales Taxes Collected	\$1.04	
1000 Cash in Checking		\$21.84
4010 Sales Discounts		\$5.20



**Audit Alarms**

You should establish an approval procedure whereby a manager would have to approve the return of funds after verifying the merchandise has been returned and a receipt for the original purchase has been shown as well.

Recording the return involves debiting the Sales Returns and Allowances account, which shows as a negative account on the P&L Statement to be subtracted from Sales of Goods Sold account. To reverse the sales discount offered on the returned items, you credit the Sales Discounts account. You also reverse the appropriate amount from Sales Taxes Collected by debiting that Liability account because those taxes are no longer due, and finally you credit the Cash in Checking account to show the disbursal of funds.

Suppose Lisa's Candle Shop allows customers to receive only a store credit for returned goods. The credit slip for a store credit looks like the following.

**Lisa's Candle Shop, 1-17-2005**

Item	No.	Price	Total
1201 Candlesticks	1	\$20	(\$20.00)
1202 Scented Candles	6	\$1	(\$6.00)
			(\$26.00)
4010 Sales Discounts @ 20%			\$5.20
			(\$20.80)
Sales Tax @ 5%			(\$1.04)
Store Credit			(\$21.84)

The following journal entry is a record of the store credit.

	Debit	Credit
4020 Sales Returns and Allowances	\$26.00	
2100 Sales Taxes Collected	\$1.04	
2000 Accounts Payable		\$21.84
4010 Sales Discounts		\$5.20

In this case, the entries are similar to a cash refund, but instead of crediting the Cash in Checking account, Lisa's Candle Shop credits the Accounts Payable account. A store credit is a liability that should be tracked. Lisa's accounting staff also notes a store credit on the customer's ledger card. When the customer buys merchandise in the future and uses the store credit, the Accounts Payable account will be debited to reverse the store credit.

## Purchase Discounts

Just as Lisa's Candle Shop must sometimes offer purchase discounts to sell items, suppliers also face similar situations. The two most common types of discounts are ones offered for purchasing a large volume of goods or ones offered to encourage early payment of invoices.



**Biz Tips**

Your accounts payable manager should be certain the department has a process in place to take advantage of purchase discounts. For example, if there is a 2 percent discount for a 30-day invoice paid in 10 days, the accounts payable manager is the one responsible for being certain the invoice is paid in time to take advantage of that discount. Frequently the accounts payable clerk responsible for that vendor's bills has an accordion folder on his or her desk that has one slot for each day of the month. The clerk then files the invoice on the day of the month the bill should be paid in order to get the maximum discounts allowed.

The accounting for Lisa's Candle Shop is the same no matter when the discount is received. Assume Lisa's Candle Shop is offered a 2/10 discount for the purchase of \$8,000 of merchandise. This translates to a 2 percent discount if the invoice is paid by the tenth of the month. When the bill is paid early to take advantage of that discount, the transaction is recorded in the following manner (assuming that the original purchase was debited to the Purchases account and credited to the Accounts Payable account).

	Debit	Credit
2000 Accounts Payable	\$8,000	
4310 Purchase Discounts		\$160
1000 Cash in Checking		\$7,840

This journal entry reduces the Accounts Payable account liability by the full amount of the invoice. The credit to the Purchase Discounts account shows as a positive number on the P&L Statement that offsets the amount recorded to the Purchases account, which is part of the cost of goods sold. The Cash in Checking account is reduced by the amount of the invoice that needs to be paid after the discount is taken. Chapter 22 details how all this information appears on the P&L Statement.

## Purchase Refunds and Allowances

As a customer, Lisa's Candle Shop sometimes has reasons to return merchandise purchased for a refund or credit allowance. These transactions are relatively simple to record. Assume that \$1,000 of the \$8,000 in merchandise was returned before the invoice was paid. The invoice was recorded when the goods were received, so Lisa needs to adjust the amount to be paid. The transaction is recorded in this way.



	Debit	Credit
2000 Accounts Payable	\$1,000	
4330 Purchase Returns		\$1,000

This entry reverses \$1,000 of liability to the Accounts Payable account, and the credit is a positive number in the cost of goods sold section of the P&L Statement that reduces the Purchases account. The accounts payable clerk also notes on the vendor account that a return was made so that the accounting staff can be certain the amount is subtracted from a future invoice.

When inventory is counted at the end of the month, the ending inventory count reflects the amount of inventory actually left in the store. Any purchases are added to the beginning inventory, and any amount in the Purchase Returns and Allowances account is subtracted from the beginning inventory. Any costs for freight (account 4350) or other miscellaneous sales costs (account 4400) are recorded as invoices are paid.

## Bad Debt

Any business that allows customers to buy on credit is likely to end up with some customers who don't pay their bills. To minimize losses from delinquent customers, you need to monitor your Accounts Receivable account closely and cut off any customer who does not pay within a reasonable amount of time. Most businesses block future charges to any account more than 60 or 90 days late.

Even if you've acted quickly to block future charges, you still must find a way to get your money or decide that the money is uncollectible. Remember that you have to pay taxes on profits the business makes, and you certainly don't want to pay taxes on money the company will never receive.

You have to decide how long you want to wait until you determine an account is uncollectible. That amount of time could be 90 days, 120 days, or any number of days you determine is realistic for your business. Many companies review their accounts to search for ones that are uncollectible once or twice a year.

You need to add an account to track bad debt in your chart of accounts. You should place this account at the bottom of your existing chart of accounts and give it the number 6500.

For practice in recording bad debt, assume Lisa's Candle Shop has a total of \$1,500 that Lisa doesn't expect she will ever collect from unpaid accounts in 2005. She records the loss in this way.

	<b>Debit</b>	<b>Credit</b>
6500 Bad Debts	\$1,500	
1100 Accounts Receivable		\$1,500

The Bad Debts account appears in the expense section of the P&L Statement, and the Accounts Receivable account is reduced by the credit. In addition to this journal entry, the accounts receivable clerk needs to update the individual customer ledgers to show that the debt has been written off.

If at some time in the future the customer does repay the debt, you can reverse the entry very easily. Most likely the customer would pay in cash. Assume a customer who owed \$100 came in to make the payment. You would record this payment of a bad debt as follows.

	<b>Debit</b>	<b>Credit</b>
1000 Cash in Checking	\$100	
6500 Bad Debts		\$100

Even if the bad debt were written off in one year and paid in the next, the entry would be made in the year paid, and the P&L Statement for the year paid would be the one adjusted because of this payment. After a customer pays his or her debt, you have to decide whether to allow him or her to use the store charge once again. You may decide to allow the account to be reopened, but with a red flag that blocks future charges as soon as the account is late 15 or 30 days so you don't risk building another large bad-debt write-off. You also most likely would lower the customer's allowable credit limit until he or she proves that payments will be made on time by maintaining timely payments for six months to a year.

The next chapter explains how to manage other types of expense accounts not related to sales activity.

### **The Least You Need to Know**

- ◆ Most businesses discount their merchandise or services at some time during the year to generate more sales. Carefully tracking how much of your business is discounted is important because it could impact future pricing policies and the long-term profitability of your company.
- ◆ Management should carefully monitor returns to be certain store policies are being followed. You also need to track return levels because they can negatively impact your bottom line.
- ◆ Always try to take advantage of any purchase discounts offered for paying your bill a bit early. Also, don't forget to track credits and adjust invoice payments for any items you return for refund or credit.



# Chapter 10

## Cashing Out

### In This Chapter

- ◆ Paying bills
- ◆ Managing payables
- ◆ Introducing subledgers
- ◆ Making posts

The last few chapters have explained how to track the income and costs of sales for your primary product or service, but running a business involves a lot more expenses than just those related to inventory. This chapter explains how to record general operating expenses and costs related to your liabilities, such as interest payments.

Your general ledger would be enormous and probably unwieldy if you recorded every single transaction directly to it. Instead, most businesses have subledgers for various key accounts, such as Accounts Payable and Accounts Receivable. This chapter explains how to manage these subledgers and their relationship to the general ledger.

## Tracking General Expenses

When we first designed the chart of accounts, the greatest number of individual accounts was in the expense category. This category included accounts for things such as rent, utilities, interest expenses, insurance, office expenses, and supplies and vehicles, as well as expenses related to employees, contractors, and professional advisors. (Part 3 of this book covers employee-related expenses in much greater detail.)

First, let's look at the operating expenses and how you should record them. When your staff members pay bills for the business, they will code each bill for the account or account numbers that will be charged for the expense. For example, you may need to pay a bill from Office Depot that includes office supplies for several different departments. To track how much each department is spending on office supplies, you need to record portions of the bill in several different expense accounts.

Whereas accounts in accounts receivable have sales slips that already show the accounts and their codes, you need to come up with a system to code expense accounts. Many companies have a stamp that indicates the date the bill was paid, the check number, and blank lines to fill in the account code and amount. The stamp might look something like the following.

Date: \_\_\_\_\_

Check #: \_\_\_\_\_

Account

Amount Paid

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Let's practice using this type of system with a bill from Office Depot for office supplies that includes \$200 for the accounting department, \$100 for the sales department, and \$100 for the administrative offices. The sales taxes are 5 percent, or \$20 for a total bill of \$420. You need to allocate these expenses to the departments. The Supplies account number on the general ledger is 6250. You then need to assign numbers to each department. For example, give the Administrative Offices account number 6251, Accounting 6252, and Sales 6253. With the stamp, the Office Depot bill would be coded this way.

Date: 2/15/2005

Check #: 1315

Account	Amount Paid
<u>6251 Supplies-ADMIN</u>	<u>\$105</u>
<u>6252 Supplies-ACCT</u>	<u>\$210</u>
<u>6253 Supplies-Sales</u>	<u>\$105</u>

You can see that not only were the costs of the actual supplies allocated to each of the departments, but the taxes were also allocated based on the expenses. If the bill had included delivery or other charges, those, too, would have been allocated to the receiving departments.

With the information collected on this stamp, the person responsible for entering the information into the accounting system would have all he or she needs to develop the journal entry. The journal entry to record the payment of this bill would look like the following.

	Debit	Credit
6251 Supplies—Admin.	\$105	
6252 Supplies—Acct.	\$210	
6253 Supplies—Sales	\$105	
1000 Cash in Checking		\$420

You decide how detailed you want to be when tracking your general expenses. Some businesses have one supply closet and assign one or two people the responsibility of managing the use of those supplies. These businesses probably do not have a separate account tracking each department's supply use. Other businesses decide they don't want to keep that kind of detail and just have one office supplies account and code.

If postage or shipping is a major expense of your business, you may want to track those expenses by department, or you could just have one expense account. Some businesses, such as construction, code every utility bill to the individual job site, but most businesses don't bother to break down that bill at all.

In addition to allocating the expenses of bills paid, an accounts payable manager's key responsibility is to be sure the bills are paid on time to avoid any penalties or interest charges. Also a well-managed accounts payable department can save the company a lot of money by being certain that bills are paid in time to receive any discounts offered for prompt payment.

A good way to manage bill payment is to have accordion files in which bills are placed as received. One file includes the months of the year, and a second has slots for days 1 to 31. As bills are opened, they are stamped on the day received and filed according to the month in which they must be paid.



**Biz Tips**

If approval is needed before payment, a copy of the bill should be put in the file to remind the staff a bill is due, and the original should be circulated for approval. Generally, to avoid the possibility of paying a bill twice, it is a good practice to only pay bills based on originals.

At the beginning of the month, all the bills to be paid in that particular month are transferred to the second accordion folder based on the day within the month those bills should be paid. Each morning the accounts payable clerk or clerks pulls the bills from that day's folder in order to pay them on time. For example, if you have determined it takes five days from the time a check is sent for it to be recorded by your vendor as paid, then you would put something due on the tenth of the month in the day 5 folder.

If you use a computer system, your staff enters the bill into the system on the day it is received using the appropriate accounts to be charged and indicating the date the bill should be paid. If you use a purchase order (PO) system, the accounts payable person matches the invoice or bill to the appropriate PO. If the totals billed do not match the PO, the accounts payable person needs to send the bill through the appropriate approval channels before paying the bill.

Each morning someone is responsible for printing a report of the bills due for payment that day. Checks are written or computer-generated to pay those bills. The checks are then passed to the person responsible for reviewing the payments to be sure they have full approval and match the amount due and then signing the checks. Signed checks are then passed to the person who sends them out. (Remember that having more than one person involved in the process of cash being disbursed from your business helps to prevent theft and embezzlement.)

## Interest Payments

One of the most complicated types of payments made by accounts payable is loan payments in which interest expenses must be recorded. Calculating those interest expenses is what can make recording loan payments a bit complicated.

The two ways to calculate interest payments are *simple interest* and *compound interest*. Simple interest computes the interest costs of a loan based solely on the loan principal. Compound interest is calculated based on both the loan principal and accumulated interest.



A mortgage loan on your house is probably the type of compound interest loan with which you are most familiar. You know that in the early years of the loan most of your mortgage payments go toward interest on the loan and only a small portion is used to pay down the principal.

When calculating loan repayment in a business situation, you must separate the payment allocated to the principal portion to pay down the loan account, which is a liability, and the interest portion to track the expenses related to the loan in the Interest Expense account. A payoff of loan principal reduces the liability section of the balance sheet, and a payment of interest increases the expense section of the P&L Statement. Companies want to accurately record the expenses for carrying the loan each month that the loan is still on the books.

Remember that Lisa started Lisa's Candle Shop with a \$5,000 loan. Each month the shop needs to make payments on that loan. If the loan is a simple-interest loan, the total interest is based solely on the principal balance. Assume the loan was made for 5 years (60 months) at 7 percent simple interest for a total of \$350 in interest. The total to be repaid to the bank is \$5,350 or \$89 per month. Each month \$83 of principal is paid and \$6 of interest is paid. Lisa records each payment she makes with the following entry.

## def•i•n•i•t•i•o•n

**Simple interest** is calculated on a principal sum, not compounded on earned interest. **Compound interest** is calculated not only on the initial principal but also on the accumulated interest of prior periods.

	Debit	Credit
2550 Loan Payable—Citizens Bank	\$83	
5550 Interest Expense	\$6	
1000 Cash in Checking		\$89

If the loan were a compounded-interest loan, the format of the entry would be the same, but the amount allocated to principal and interest would be different. Some banks send a monthly statement that breaks down the amount of the payment that is credited to loan principal and the amount that is credited toward interest expenses provided that the loan is paid on time. If the loan payment is late, then additional interest charges could be assessed on the loan.

## def·i·ni·tion

An **amortization schedule** is a breakdown of how much of each loan payment is used to pay down a loan and how much is used to pay interest expenses.

If a monthly loan statement is not sent, a bank usually provides an *amortization schedule* that indicates the amount of each payment that goes toward paying down principal and the amount that is interest expense. Banks also provide a year-end statement that summarizes how much you paid in principal and how much you paid in interest each year. A company can review its entries to be certain the amounts are accurately reflected in the records.

Let's look at what the amortization schedule would be for Lisa's Candle Shop's \$5,000 loan if it were a compound-interest loan. To figure out this schedule, we used a financial calculator online ([www.bankrate.com/goocan/mortgage-calculator.asp](http://www.bankrate.com/goocan/mortgage-calculator.asp)). You can see in the amortization schedule that the monthly payment is \$99.01 rather than \$89, as it was with a simple interest loan. Total interest is much higher: \$940.60.

### Amortization Schedule

- Principal borrowed: \$5,000.00
- Annual payments: 12
- Total payments: 60
- Annual interest rate: 7.00%
- Periodic interest rate: 0.5833%
- Regular payment amount: \$99.01
- Final balloon payment: \$0.00
- Total repaid: \$5,940.60
- Total interest paid: \$940.60
- Interest as percentage of principal: 18.812%

Payment	Principal	Interest	Cumulated Principal	Cumulated Interest	Principal Balance
1	\$69.84	\$29.17	\$69.84	\$29.17	\$4,930.16
2	\$70.25	\$28.76	\$140.09	\$57.93	\$4,859.91
3	\$70.66	\$28.35	\$210.75	\$86.28	\$4,789.25
4	\$71.07	\$27.94	\$281.82	\$114.22	\$4,718.18
5	\$71.49	\$27.52	\$353.31	\$141.74	\$4,646.69
6	\$71.90	\$27.11	\$425.21	\$168.85	\$4,574.79
7	\$72.32	\$26.69	\$497.53	\$195.54	\$4,502.47

Payment	Principal	Interest	Cumulated Principal	Cumulated Interest	Principal Balance
8	\$72.75	\$26.26	\$570.28	\$221.80	\$4,429.72
9	\$73.17	\$25.84	\$643.45	\$247.64	\$4,356.55
10	\$73.60	\$25.41	\$717.05	\$273.05	\$4,282.95
11	\$74.03	\$24.98	\$791.08	\$298.03	\$4,208.92
12	\$74.46	\$24.55	\$865.54	\$322.58	\$4,134.46
13	\$74.89	\$24.12	\$940.43	\$346.70	\$4,059.57
14	\$75.33	\$23.68	\$1,015.76	\$370.38	\$3,984.24
15	\$75.77	\$23.24	\$1,091.53	\$393.62	\$3,908.47
16	\$76.21	\$22.80	\$1,167.74	\$416.42	\$3,832.26
17	\$76.66	\$22.35	\$1,244.40	\$438.77	\$3,755.60
18	\$77.10	\$21.91	\$1,321.50	\$460.68	\$3,678.50
19	\$77.55	\$21.46	\$1,399.05	\$482.14	\$3,600.95
20	\$78.00	\$21.01	\$1,477.05	\$503.15	\$3,522.95
21	\$78.46	\$20.55	\$1,555.51	\$523.70	\$3,444.49
22	\$78.92	\$20.09	\$1,634.43	\$543.79	\$3,365.57
23	\$79.38	\$19.63	\$1,713.81	\$563.42	\$3,286.19
24	\$79.84	\$19.17	\$1,793.65	\$582.59	\$3,206.35
25	\$80.31	\$18.70	\$1,873.96	\$601.29	\$3,126.04
26	\$80.77	\$18.24	\$1,954.73	\$619.53	\$3,045.27
27	\$81.25	\$17.76	\$2,035.98	\$637.29	\$2,964.02
28	\$81.72	\$17.29	\$2,117.70	\$654.58	\$2,882.30
29	\$82.20	\$16.81	\$2,199.90	\$671.39	\$2,800.10
30	\$82.68	\$16.33	\$2,282.58	\$687.72	\$2,717.42
31	\$83.16	\$15.85	\$2,365.74	\$703.57	\$2,634.26
32	\$83.64	\$15.37	\$2,449.38	\$718.94	\$2,550.62
33	\$84.13	\$14.88	\$2,533.51	\$733.82	\$2,466.49
34	\$84.62	\$14.39	\$2,618.13	\$748.21	\$2,381.87
35	\$85.12	\$13.89	\$2,703.25	\$762.10	\$2,296.75
36	\$85.61	\$13.40	\$2,788.86	\$775.50	\$2,211.14
37	\$86.11	\$12.90	\$2,874.97	\$788.40	\$2,125.03
38	\$86.61	\$12.40	\$2,961.58	\$800.80	\$2,038.42

*continues*

*continued*

Payment	Principal	Interest	Cumulated Principal	Cumulated Interest	Principal Balance
39	\$87.12	\$11.89	\$3,048.70	\$812.69	\$1,951.30
40	\$87.63	\$11.38	\$3,136.33	\$824.07	\$1,863.67
41	\$88.14	\$10.87	\$3,224.47	\$834.94	\$1,775.53
42	\$88.65	\$10.36	\$3,313.12	\$845.30	\$1,686.88
43	\$89.17	\$9.84	\$3,402.29	\$855.14	\$1,597.71
44	\$89.69	\$9.32	\$3,491.98	\$864.46	\$1,508.02
45	\$90.21	\$8.80	\$3,582.19	\$873.26	\$1,417.81
46	\$90.74	\$8.27	\$3,672.93	\$881.53	\$1,327.07
47	\$91.27	\$7.74	\$3,764.20	\$889.27	\$1,235.80
48	\$91.80	\$7.21	\$3,856.00	\$896.48	\$1,144.00
49	\$92.34	\$6.67	\$3,948.34	\$903.15	\$1,051.66
50	\$92.88	\$6.13	\$4,041.22	\$909.28	\$958.78
51	\$93.42	\$5.59	\$4,134.64	\$914.87	\$865.36
52	\$93.96	\$5.05	\$4,228.60	\$919.92	\$771.40
53	\$94.51	\$4.50	\$4,323.11	\$924.42	\$676.89
54	\$95.06	\$3.95	\$4,418.17	\$928.37	\$581.83
55	\$95.62	\$3.39	\$4,513.79	\$931.76	\$486.21
56	\$96.17	\$2.84	\$4,609.96	\$934.60	\$390.04
57	\$96.73	\$2.28	\$4,706.69	\$936.88	\$293.31
58	\$97.30	\$1.71	\$4,803.99	\$938.59	\$196.01
59	\$97.87	\$1.14	\$4,901.86	\$939.73	\$98.14
60	\$98.14*	\$0.57	\$5,000.00	\$940.30	\$0.00

*\*The final payment has been adjusted to account for payments having been rounded to the nearest cent.*

Based on this amortization schedule, the first payment would reduce principal by only \$69.84 while the interest expense is \$29.17. Not until the last year of payments does the interest expense drop to \$6.13, which is closest to the amount used for interest expense in the simple interest calculation.

If you want to pay the loan early, let's say after just 30 months, you can then look at payment 30 and see how much of the principal balance is left to be paid. After you make payment 30, the balance remaining to be paid is \$2,717.42 You could pay that amount plus any daily interest charged between the day you made payment 30 and

the day you pay off the loan. You would need to call the lender for the actual payoff figure that includes the additional interest due. There also may be prepayment penalties on the loan, so be sure you ask about those as well.

To give you an idea of how much interest you may owe in addition to the \$2,717.42 principal balance, you can calculate a daily interest figure. Since the interest due in month 31 is only \$15.85, the additional amount of interest you would have to pay would be less than that. To find a daily interest rate you would divide \$15.85 by 30 to get 52.8 cents. So if you payoff the loan 10 days after you made the 30<sup>th</sup> payment, the additional interest due would be \$5.28. To estimate a final payoff figure you would add the principal balance remaining to the interest due and get an estimated payoff figure of \$2,722.70.



### Audit Alarms

In reality, a simple interest loan is rare today. Many people reduce their interest expenses by paying down the principal early. If you want to pay down a loan early, be sure that you don't have a prepayment penalty on the loan. That can negate most of your advantage of paying early.

## Using Subledgers

Few businesses record each individual expense payment or each individual sale in the general ledger. Instead businesses have subledgers for key accounts, known as control accounts, including the Accounts Payable and Accounts Receivable accounts.

Working with control accounts has a number of advantages:

- ◆ The general ledger reflects a summary of transactions between the business and debtors and creditors rather than being bogged down in detail, making it a better tool for decisions concerning issues that impact all company operations.
- ◆ Control accounts can serve as an accuracy test for the calculations and postings to the individual ledger accounts.
- ◆ Control accounts help to limit the number of accounts in the general ledger.
- ◆ You can separate duties based on your control accounts, having one person responsible for all accounts in the debtor's subledger (accounts receivable) and another person responsible for all accounts in the creditor's subledger (accounts payable).

- ◆ Your accounting clerks make entries in two places: the vendor card or customer card on which the purchase or invoice is recorded and in the accounts payable or accounts receivable subledger. If you are using a computer system, these accounts are electronic files on your computer. This gives you more ways to be sure your cash receipts and disbursements are accurately recorded. If there are differences when closing out the vendor accounts or customer accounts with what is posted in the ledgers, you know you have a problem that needs to be found.

## Posting to the General Ledger

At the end of the business day, a clerk totals the accounts receivable or accounts payable entries and gives a summary report of all the entries that were made each day to the person who makes the entries in the general ledger.

For example, a summary of the day's accounts payable transactions would look something like this.

	Debit	Credit
5800 Office Expenses	\$250	
6000 Postage	\$125	
6250 Supplies	\$700	
6400 Utilities	\$300	
6350 Telephone	\$150	
1000 Cash in Checking		\$1,525
To record in Accounts Payable for 2/15/2005		

If you were using the accrual method of accounting, you would have already recorded these expenses with a credit to the Accounts Payable account. When the bills are paid, the entry would be a debit to the Accounts Payable account to reduce that liability balance and a credit to the Cash in Checking account to reduce the cash.

Each of the expense accounts may contain numerous transactions. Postage bills, for example, may be paid to UPS and Federal Express. Utility bills may include both the electric and gas companies. Supplies may include invoices from Office Depot, Lowe's, and other vendors. If questions come up about the summary entry, someone would have to research the bills paid by going back to the accounts payable subledger and possibly pulling the actual invoices paid for the date in question.

The person responsible for the general ledger then adds the entry with the summary totals to the general ledger. The general ledger only shows a total of the day's transactions, whether it is a total of sales for the Accounts Receivable account or a total of payables for the Accounts Payable account.

When the books are closed at the end of the month, the monthly totals for the accounts payable and accounts receivable subledgers are compared to the amount in the general ledger accounts for Accounts Receivable and Accounts Payable. If these numbers don't match, an employee needs to research the entries to find out why there is a difference. Part 4 talks more about month-end closes.

The next chapter takes a look at the paperwork you need to keep in order to prove out your books as well as generate the needed reports for local, state, and federal government entities.

## **The Least You Need to Know**

- ◆ Expenses are items that need to be paid toward the general operations of the business that are not directly related to sales.
- ◆ Interest expenses are incurred each month. If your payment coupon does not include the breakdown of interest and principal payment, you should calculate that in order to properly allocate the payment.
- ◆ When it comes to disbursing cash from the business, be certain you have a good separation of duties to avoid theft and embezzlement.
- ◆ Accounts Payable and Accounts Receivable are both control accounts that usually have their own subledgers to record transaction details. Daily summaries from these accounts are then passed on to the person handling the general ledger.





## Chapter

# 11

# Keeping Records and Paying Taxes

## In This Chapter

- ◆ Creating paper trails
- ◆ Being a pack rat
- ◆ Managing statements
- ◆ Taxing sales

By this point in the book, you probably have realized you'll be generating lots of paper as your business grows and transactions increase. Unless you are a pack rat who likes to keep everything, at some point you need to decide what information is critical to keep and how long you need to keep it.

Many business tasks involve significant amounts of record keeping to be done properly. For example, paying bills for major vendors is not as simple as paying each invoice when it arrives. You also need to reconcile monthly statements and manage errors in invoicing. The records you keep help you avoid overpaying or underpaying your vendors.

Finally the day will come when you'll have to pay the tax entities the sales taxes you've collected over the month. This chapter reviews the record keeping and reporting you need to do in order to satisfy local and state sales tax requirements.

## What to Keep

The following are some of the most important reasons to keep paperwork on your business activities:

- ◆ To back up your financial statements if you are questioned by the government or by your investors
- ◆ To back up your tax deductions if you are audited by the government
- ◆ To report your sales and the amount of sales tax due
- ◆ To prove that you paid a vendor or contractor for its goods and services
- ◆ To track employee compensation and benefits
- ◆ To respond to any legal disputes that arise from your business transactions

Each type of business has even more reasons specific to its activities. If you are a government contractor, record-retention requirements are usually specified in the contract. Other types of contract work have similar requirements.



### **Biz Tips**

Any time you need to calculate how to record a transaction or numerous transactions, you'll most likely have work papers that you used to figure out that entry. Keep those papers along with related copies of the transactions so that you can easily remember how you developed the entry in case it is questioned in the future.

Whenever you are preparing a report, whether it is for use inside the company or to report to a government entity, be sure you keep the work papers involved in developing that report. Your best bet is to staple the work papers to your copy of the report and file it with the report.

When you reconcile bank accounts, you'll likely have work papers as you review any differences. Keep those work papers with the reconciled bank statement. Canceled checks should be kept in numerical order, so you can quickly pull them if there is a question. Of course, as we noted in the last chapter when talking about accounts payable, you should record the check number on the invoice when the invoice is paid.

Invoices should be filed by vendor or alphabetically, whichever works best for your company. Most likely you'll end up doing a combination of the two by having individual files for major vendors and a miscellaneous alphabetical file for vendors you use occasionally.

You need to maintain sales records very carefully. You could be asked to provide them to several different government entities. Local and state entities could require proof of your sales tax reporting. The local, state, or federal government could certainly audit the sales numbers you report on your income tax returns.

Careful retention of payroll records is important not only for tax purposes, but it also can be critical if legal questions arise involving an employee. Discrimination lawsuits, employee injury lawsuits involving *workers' compensation*, unemployment claims, and other legal claims could be made that would require good record keeping.

If you have a computer system, you might think you don't need to keep all this paper around. However, if you are questioned by any government entity or become involved in a legal matter, entries on a computer are not sufficient proof. You need the paperwork that backs up what is on your computer system.

The accounting department can be called into disputes not only involving taxes and financial reports, but also all legal claims, contract disputes, and any other dispute that involves the transactions of the company.



### Audit Alarms

You should have a piece of paper, such as a sales receipt or invoice, for every penny that comes into or goes out of your business. Keep these papers filed in some type of logical order so you can find them when you need them. Even proof of how much petty cash is used is necessary as you develop your tax returns.

### def•i•n•i•t•i•o•n

**Workers' compensation** is a state-mandated protection for employees who are injured on the job. Chapter 15 explains how this protection works and how you record and track expenses for it.

## How Long to Keep It

Generally companies keep the current year's records in filing cabinets in the office. If they have enough space, they may also keep the prior year's records in a separate filing cabinet or cabinets. Otherwise, older records are in other on-site or off-site storage.

How long you need to keep the records varies by the type of record. If you are keeping the records solely to have what you need for an IRS audit, then you can destroy any records once they are four years old (that includes the current year and three years before that). The IRS has agreed not to go back further than three years to audit an individual or business. Other agencies and auditors have adopted the same policy.

All bets are off, though, if questions of fraud or embezzlement are raised. Then it would depend on the statute of limitations in the state where your business is located. We reviewed retention policies for numerous colleges and universities and found that most financial records are retained for a minimum of six or seven years and in some cases kept permanently.

Personnel files fall in a different category. These records should be kept for the entire time the person is employed plus three years after the person leaves the company. If the former employee has rights to a retirement plan, you need to save their records for as long as the company has an obligation to the employee, but you may not need to save information that is not related to retirement for more than three years after the employee leaves. You need to save all compensation information because that could be questioned when calculations are made for the distribution of retirement funds.

**Biz Tips**

Major companies, banks, newspapers, and libraries keep their records on microfilm. This storage method can certainly help you minimize the space needed to store your records. Digital scanning has also become a popular storage method for many businesses, especially now that scanners are so widely available. Many copiers can double as a scanner or even serve quadruple duty as a copier, scanner, printer, and fax machine. Storing the information digitally makes it easier to retrieve, search, and then e-mail the information to people who need it.

However you decide to store your records, be sure the critical information is well protected from fire, flood, or other catastrophe. Rebuilding a business after a catastrophic event is difficult, but trying to do it without your needed records makes it much harder.

## Reconciling Accounts

The last chapter covered paying invoices, but it didn't describe the more complicated process of managing statements from vendors or contractors. Most companies have a general policy to pay vendors or contractors based only on invoice originals to avoid

duplication. Yet even with this policy in place, you'll still get statements listing outstanding invoices for which you have no record. Reviewing these statements and knowing the status of each invoice on the statement is important. During the year, you'll probably find on these statements invoices that have already been paid, invoices for which you have no records, and invoices for which the total differs from your records.

Good record keeping will enable you to quickly find any differences and talk with the vendor to resolve them. You certainly don't want to avoid solving problems on a vendor's statement just to end up with a bad credit rating or to be cut off from goods you need in your business. If poor accounts-payable management is responsible for the sales force not having necessary goods, the accounting department will be in lots of trouble.

Sometimes differences are caused by errors on the part of the vendor or contractor, and sometimes differences are problems inside your own company. The approval process within your company might break down because invoices that need to be paid are sitting on someone's desk waiting for approval. The accounting department needs cooperation from other department managers to be certain invoices are quickly reviewed and approved or disapproved with reasons for disapproval noted. That way the accounts payable clerk handling invoices for the vendor or contractor involved will have the ammunition needed to resolve statement differences.

The last chapter discussed the use of subledgers and vendor cards or ledgers to track invoices. These vendor cards or ledgers, if kept up to date, give you an excellent snapshot of the current status of a vendor's account. For example, the following table shows a vendor ledger for Lisa's Candle Shop for its candlestick supplier.

**John's Silver Inc.,**  
**555 Silver Drive**      **Term: 30 days**  
**Silver, NY Discount: 2/10**

Date	Invoice No.	Amount	Discount	Paid/Ck #	Balance Due
1/15/05	105	\$1,000		-\$1,000/1010	
1/20/05			\$20	\$980	-0-
1/30/05	106	\$5,000		-\$5,000/1020	
2/05/05			\$100	\$4,900	-0-
2/15/05	107	\$5,000		-\$5,000/1030	
2/20/05			\$100	\$4,900	-0-
2/28/05	108	\$5,000		-\$5,000/1040	-0-

You can see how these vendor ledgers (provided they are kept up daily) make it very easy for the accounts-payable clerk to review monthly statements from the vendor and quickly know if they are accurate. Any differences between the vendor ledger and the vendor statement would need further research to find out the reason for the difference.



### Audit Alarms

Avoiding differences in vendor statements and company records doesn't make the problem go away. Instead the differences are compounded and more difficult to correct the longer they are ignored. Reconciling a difference that is one month old with numerous people who have knowledge of why the numbers differ is not that difficult. A year later most people will have forgotten what caused the difference, and you'll be unable to resolve it and more likely to end up overpaying your vendor just to close the books.

Also note that payment terms are kept at the top of the vendor ledger. In this case, if bills are paid within 10 days, a 2 percent discount can be taken. By tracking discounts on the ledger you can quickly see what money has been saved and whether the invoices are being paid in time to get the discount. The accounts payable department is usually not well-respected in a company because it is responsible for using company resources rather than bringing money into the company. However, a good accounts-payable manager knows how to show the cost savings his team is providing the company.

## Reporting to the Taxman

You probably don't have to worry about sales taxes if you are not selling a tangible good or product, but you should know your state's rules on sales taxes anyway. In some states, certain services are taxable. You do need to get a tax identification number, which is usually assigned when you get a state license. When you buy products that you intend to sell from a vendor, you won't be charged sales taxes, but you will need to provide the vendor with your resale tax number.

Every city, county, and state government has different tax rules. In the past, most small businesses had to worry only about the tax rules within their individual states, but now that many small businesses are starting to sell on the Internet there is a push

to collect sales taxes for Internet-based sales. This push has created a greater need for some sales tax uniformity. Most states passed legislation or have legislation pending to streamline sales tax rules. The only states that do not have legislation pending on this topic are Arizona, Colorado, Rhode Island, and South Carolina. In addition, Delaware and New Hampshire have no state tax, and legislation to establish a state sales tax system is pending in Oregon. The system will meet the uniformity guidelines. For more information on the Streamlined Sales Tax Project go to [www.streamlinedsalestax.org](http://www.streamlinedsalestax.org).

**Biz Tips**

Sales taxes vary greatly state by state. You can find a chart of 2005 state sales tax rates at the Federation of Tax Administrators—([www.taxadmin.org/fta/rate/sales.html](http://www.taxadmin.org/fta/rate/sales.html)). There may also be local city or county taxes depending on where your businesses are located, so be sure to discuss state and local taxes with your state tax office.

Even if you are operating only in one state, sales tax reporting can get very complicated.

- ◆ Depending on the state in which you operate your business you may need to file a sales tax return for multiple county sales.
- ◆ You may be obligated to pay taxes for transportation, fuel, local options, education, town, county, and special-purpose taxes.
- ◆ You need to calculate total receipts, total sales, and total taxes.
- ◆ You need to prepare County Tax Schedules, Exemption Worksheets, and Vendor Worksheets in most states.
- ◆ You need regular updates that provide you with current tax rates and forms.

Just looking at this list, you can see how complicated sales tax reporting can be. Not only does a company operating in numerous counties have to worry about how each county taxes sales, it also must understand numerous different types of taxes based on the products being sold.

Many times a business is collecting sales taxes for two or three entities: city, county, and state. Tax software that is regularly updated can be critical in this process because taxing authorities make changes frequently at different times of the year. For example, city or county governments can change the sales tax rate at a monthly meeting, but a state government is likely to make changes only once a year during its legislative session.



**Biz Tips**

Numerous companies offer databases or software packages to help you complete your sales tax forms. Although we don't have any recommendations for you, one of these services, the Sales Tax Clearinghouse, provides an excellent chart of state sales taxes with links to each of the states' Department of Revenue ([www.thestc.com/ta.cgi?STRates](http://www.thestc.com/ta.cgi?STRates)). The Tax and Accounting Sites Directory ([www.taxsites.com/software.html#sales](http://www.taxsites.com/software.html#sales)) gives you links to the various database and software packages available. Talk with your accountant or other business owners to find out which packages they recommend.

Although you need to have only one Sales Tax Collected Liability account on your chart of accounts, you may need to make several payments from that account based on the sales tax rules in your state. For example, the city could tax all sales at 1 percent, the county could take its cut at 1 percent, and the state may get the remaining 3 percent. You would need to report the amount of sales taxes collected and the total sales of goods or services sold to each entity collecting taxes.

Each state has a different form or set of forms for reporting sales. As you can see in the previous list, Georgia has one form (ST-3) and two possible worksheets, the Exemption Worksheet and the Vendor/Penalty Worksheet, that may need to be filed monthly. Georgia's ST-3 form comes with a seven-page booklet. Yikes! If you want to see what it looks like, go to the Sales Tax and Use page ([www.etax.dor.ga.gov/salestax/st3forms/st3\\_indx.shtml](http://www.etax.dor.ga.gov/salestax/st3forms/st3_indx.shtml)) at the Georgia Department of Revenue and click on the first ST-3. (Even the Internet hyperlink looks confusing!) Each state has a different collection of forms, so we won't show them here, but all government entities want to see this basic information:

1. Gross sales
2. Tax rate used
3. Tax rate collected

After filing your state forms, you need to enter the amount of sales tax paid in the general ledger. Assume Lisa's Candle Shop paid \$225 in sales taxes to the state and \$100 in sales taxes to the city in which the store operates. This entry is recorded as follows.



	Debit	Credit
2100 Sales Tax Collected	\$325	
1000 Cash in Checking		\$325
To pay \$225 in state sales tax and \$100 in city sales tax.		

The general ledger lists the sales taxes that have been paid (to simplify this example, we’re entering sales weekly, but most businesses would enter them daily):

### 2100 Sales Tax Collected

Date	Ref. No.	Description	Debit	Credit
1-1-05		Beginning balance	\$0.00	
1-8-05	01080307	Sales tax		\$25
1-15-05	01150309	Sales tax		\$50
1-22-05	01220308	Sales tax		\$75
1-29-05	01290307	Sales tax		\$135
1-31-05	01310303	Sales tax		\$40
1-31-05	01310304	State tax paid	\$225	
1-31-05	01310304	City tax paid	\$100	

After the taxes are paid, be sure to attach any work papers, a copy of the forms filed with the government entities, and a copy of the tax check in your sales tax files. If there is any question, you will need to prove your numbers to the government entity. Also, you must be sure to file tax forms on time in order to avoid paying late fees that include interest and penalties.

Now that we’ve stepped you through the sales process and introduced you to general operating expenses, we’ll move on to the area that can generate the greatest level of expenses: keeping your employees happy.

## **The Least You Need to Know**

- ◆ You may feel like a pack rat with all the papers you need to keep on file in your accounting system, but you will be happy you kept these papers if you are audited or face some type of legal action.
- ◆ Regular updating of your vendor accounts simplifies the process of reconciling vendor statements at the end of the month.
- ◆ Tracking and paying sales taxes is a quagmire of paperwork and forms. However, you need to pay these taxes on time and accurately to avoid paying interest and penalties.

# Part 3

## Keeping Employees Happy

Employees keep your business operating smoothly. Keeping them satisfied is important to your business's success. We'll talk about the basics of maintaining a payroll system, the rules related to taxes and benefits, and what records you need keep, as well as reports you need to file.





# Chapter 12

## Hiring and Paying Employees

### In This Chapter

- ◆ Staffing needs
- ◆ Reporting hires
- ◆ Setting wages
- ◆ Choosing a pay period

Before an employee steps through the door of your business, you need to put some key procedures in place. Even if you have a person designated to handle employees, the human resources staff and accounting staff need to coordinate the hiring process to be certain that all procedures meet both staffs' needs.

Deciphering complex payroll and staffing rules is no picnic. The accounting department needs to be certain that requirements are met for reporting to government entities and that all the required government tax forms are filled out relating to a new hire. Wage guidelines and pay periods also need to be established. This chapter walks you through the accounting process you need to complete before you hire employees.

## Taking a Number

All businesses that hire staff must have an Employer Identification Number (EIN). If you decided to incorporate, you already have this number. The number the IRS gave you when you applied for corporate status is the same number as the EIN. Otherwise

you should contact the federal and state tax agencies to get the forms you need to apply for the EIN before you start hiring.

The IRS uses the EIN to track your employees, the wages you pay them, and any taxes that have been paid on their behalf. These EIN numbers are part of a tax-matching program that the IRS uses to be sure taxpayers report all their income. (Bet you didn't know you were going to be Uncle Sam's first line of defense in finding tax fraud.)



### Biz Tips

State tax authorities use the federal EIN as a reference, so you need to set up your federal EIN before applying to the state. You can download the federal form online at [www.irs.gov/pub/irs-pdf/fss4.pdf](http://www.irs.gov/pub/irs-pdf/fss4.pdf).

If the state your business is located in has an income tax, you'll also become part of the tax-monitoring efforts at the state level. You'll need to get an employer identification number in the state as well.

In addition to income taxes, the states may also track the payment of unemployment taxes based on the EIN, or you may need to apply for an ID number for your state unemployment agency, too. Employers have to pay taxes to help fund unemployment benefits. Unemployment funds that your employees collect if you reduce your workforce and lay off employees are partially paid out of the money you pay into that fund. Your business's unemployment tax contribution is based on your company's employment history and how many past employees have collected unemployment compensation.

In addition to state unemployment taxes, a company also pays unemployment taxes at the federal level. You can get a credit for some of the federal tax based on the state taxes paid. Chapter 13 provides more information about the forms and payment details.

**Accounting Answers**

Each state calculates how much a company has to pay into unemployment compensation based on an “experience rating.” Usually it takes two years of business history to determine what an individual company should pay. Before that time the state sets a rate based on averages for the type of business you plan to run. This experience rating system provides employers with an incentive to maintain a stabilized workforce, because the fewer people who tap unemployment compensation from a particular company, the lower the unemployment taxes will be for that company after its experience rating has been established historically. Each state sets its own unemployment tax rates, which can be a percentage of a certain portion of each employee’s salary or based on total company payroll. Be sure you understand the unemployment rules in your state and how they impact your bottom line. You can find out more details about your state’s unemployment taxes at [www.toolkit.cch.com/text/P07\\_1294.asp](http://www.toolkit.cch.com/text/P07_1294.asp).

## Hiring Employees

After you have your tax numbers in place, you can start hiring employees. Along with your newly minted federal and state EINs, you’ll also get the official government publications that describe your duties as an employer and the rules for employees.

There are strict definitions about whether someone is an employee or a contractor. For employees, you need to pay benefits as well as part of the employee’s Social Security and Medicare taxes. Independent contractors must pay for their own benefits as well as all of their Social Security and Medicare taxes.

If you are a small business and plan to hire both employees and independent contractors, be sure you understand the rules for both. Whether the IRS determines that your workers are employees or independent contractors can have a major impact on your taxes and benefit costs. The IRS uses the following 20-question test to determine whether the people who work for you are employees or independent contractors:

1. **Is the individual’s work vital to the company’s core business?** For employees, the answer to this question is yes. A contractor’s services are usually limited to nonessential business activities.
2. **Did you train the individual to perform tasks in a specific way?** Employees are trained by the employer. Contractors are skilled professionals who require no training to adequately perform services.

3. **Do you (or can you) instruct the individual as to when, where, and how the work is performed?** For employees, the answer to this question is yes. In contrast, the company does not establish how, when, and where the contractor must work. Instead, the contractor performs work based on independently established procedures or industry specifications.
4. **Do you (or can you) control the sequence or order of the work performed?** For employees, the answer to this question is yes as well. On the other hand, contractors are typically held accountable only for outcomes, not the way in which they complete their work.
5. **Do you (or can you) set the hours of work for the individual?** Employees are scheduled to work certain hours. Contractors set their own work hours as long as they meet agreed-upon deadlines.
6. **Do you (or can you) require the individual to perform the work personally?** Employees are required to do the work personally. Contractors can delegate work to their own staff or subcontract the work to others.
7. **Do you (or can you) prohibit the individual from hiring, supervising, and paying assistants?** The company decides whether assistants can be hired for employees and pays those assistants. Contractors make the choice to hire assistants for themselves. The contractor also pays the costs of assistants who perform all or part of the project.
8. **Does the individual perform regular and continuous services for you?** Even if the work is not full-time, employees have established work expectations. Contractors work on a project-by-project basis with new contracts drawn up for each new project.
9. **Does the individual provide services on a substantially full-time basis to your company?** Employers can control whether full-time employees work for others. However, contractors usually do not spend their full time working for one company and are not restricted from doing projects for others provided that they accomplish what is needed by an established date.
10. **Is your company the sole or major source of income for the individual?** For employees, the answer to this question is yes. Contractors usually work for multiple clients concurrently.
11. **Is the work performed on your premises?** Employees usually work on-site unless telecommuting has been approved. Contractors have the choice to work on-site (if space is available) or at an office of their choosing.



12. **Do you (or can you) require the individual to submit regular reports, either written or oral?** You can ask employees to provide status or activity reports on a regular basis. Contractors are responsible to deliver their product on time. You cannot require interim reports from contractors unless those reports are part of the initial contract agreement.
13. **Do you pay the individual by the hour, week, or month?** Employees are paid at fixed intervals. Compensation for contractors is determined by project or is based on a fixed fee.
14. **Do you pay the individual's travel and business expenses?** Employees who incur work-related expenses are usually reimbursed for those expenses. Contractors normally include out-of-pocket expenses as part of their project fee rather than being reimbursed for them as they occur.
15. **Do you furnish tools or equipment for the individual?** Employees generally use company-provided supplies. Contractors usually provide their own equipment and supplies, unless otherwise specified in the contract.
16. **Does the individual have a significant investment in facilities, tools, or equipment?** Employees typically use the company's facilities, tools, and equipment. Contractors usually pay their own expenses related to workspace, equipment, and other needs.
17. **Can the individual realize a profit or loss from his or her services to your company?** For employees, the answer to this question is no, because employees can usually expect steady paychecks. Contractors, on the other hand, run the risk of nonpayment if a project is not completed according to contract specifications.
18. **Does the individual make his or her services available to the general public?** Employees do not sell their services to the public. Contractors publicize their services to a wide range of potential clients using direct mail, advertising, and other means.
19. **Can the individual terminate the relationship without liability?** Employees can quit at any time. Contractors are legally obligated to complete projects according to contract provisions, or they may face penalties for noncompletion as set forth in the contract.
20. **Do you have the right to discharge the individual at any time?** Employees can usually be let go "at will" by their employer. Contractors can be discharged only if they fail to perform contracted services.

If you have any question about whether the people you intend to hire fit the category of an employee or an independent contractor, be sure to seek legal advice.

## Filing Government Forms

Your first responsibility as an employer in the United States is to be sure the person is a United States citizen or has the right to work in the United States and has a Social Security number. You can use a driver's license or birth certificate in addition to the Social Security card as proof of citizenship. Be sure to make a copy of these two items and put them in the employee's file. That's just the beginning of the paperwork for new employees. You also need to make sure that a W-4, an I-9, and possibly a W-5 form are filled out. You can find many of these forms in Appendix B.

### Completing a W-4

All employees must fill out a W-4 or "Employee's Withholding Allowance Certificate." You've probably filled out many of these forms as an employee in the past. These forms indicate whether the employee is married or single and how many dependents he or she has. Employees can also indicate if they want to have extra taxes taken out or if they want to take additional withholding allowances to reduce the amount of tax to be taken out. You use the information you collect on the W-4 to figure out the reductions in the employee's salary for federal, state, and local taxes. You can download the current form at [www.irs.gov/pub/irs-pdf/fw4.pdf](http://www.irs.gov/pub/irs-pdf/fw4.pdf).

You normally are required to just file this form in the employee's personnel file, but in two instances you have to send the information immediately to the IRS:

1. The employee wants to claim more than 10 withholding allowances.
2. The employee will earn more than \$200 per week, but claims to be totally exempt from withholding tax. This situation is most likely to occur if you hire a student or a part-time worker.

### Completing an I-9

All U.S. employers are responsible for verifying the employment eligibility and identity of employees hired to work in the United States after November 6, 1986, after the passage of the Immigration Reform and Control Act. Form I-9 is the tool employers use to prove they have met this obligation. The copies you made of the employee's Social Security card and driver's license or birth certificate should be

attached to this form and filed in the personnel record. You can download the Form I-9 and its instructions at <http://uscis.gov/graphics/formsfee/forms/files/i-9.pdf>.

## Completing a W-5

If you hire employees who are eligible for the Earned Income Credit (EIC), they need to fill out the W-5 ([www.irs.gov/pub/irs-pdf/fw5.pdf](http://www.irs.gov/pub/irs-pdf/fw5.pdf)) or “Earned Income Credit Advance Payment Certificate” if they want to receive advance payments on the EIC each pay period. An employee must have a qualifying child and expect to meet income and other requirements of the EIC in order to get the EIC advance.

The EIC is a refundable tax credit that helps lower-income people offset increases in living expenses and Social Security taxes. The credit reduces the amount of tax owed. If your employees are eligible, they can receive part of the EIC in their paychecks rather than waiting until they file that year’s tax return. A new W-5 must be filed for each tax year. If the employee’s situation changes and he or she is no longer entitled to the EIC, then he or she must notify you immediately.

As an employer, you add the amount of the EIC to the employee’s net pay for the pay period. This amount is not considered wages, and you do not withhold any income, Social Security, or Medicare taxes from the payment amount. Generally, you make the advance payments from withheld income, Social Security, or Medicare taxes, but the credit advance does not change the amount of employment taxes you would usually withhold from the employee’s pay.

You report EIC advance payments you make to your employees by showing the total payments on the advance EIC line of your employment tax return, employer’s quarterly return (Form 941), or other form you use to report employees’ taxes due. You subtract the amount of any EIC credits from the total that you owe in employment taxes. Chapter 13 takes a closer look at how to calculate and file employer taxes.



### **Biz Tips**

Publication 15, “Employer’s Tax Guide” ([www.irs.gov/pub/irs-pdf/p15.pdf](http://www.irs.gov/pub/irs-pdf/p15.pdf)), explains how the EIC advance works. This guide shows how all employer taxes are calculated and filed.

## Picking Pay Periods

You need to designate how frequently you plan to pay your employees. Four pay periods are generally used today:

- ◆ Weekly: Employees are paid 52 times per year.
- ◆ Biweekly: Employees are paid 26 times per year or every two weeks.
- ◆ Semimonthly: Employees are paid 24 times per year or twice per month.
- ◆ Monthly: Employees are paid 12 times per year or once per month.

You can choose to use any of these pay periods and may even choose to pay some employees weekly and others monthly. Whatever you determine should be a clearly stated policy. The accounting department is responsible for carrying out that policy and calculating each employee's check based on that employee's pay period and wage category.

## Determining Wage Types

Employers have a lot of control over the decision of how much to pay their employees, but federal and state labor laws also must be followed. Be sure you understand these laws before you start hiring employees.

The most widely known labor law is the minimum wage law. As of October 1, 1997, the minimum wage is \$5.15 per hour. (Previously the minimum was \$4.75 per hour.) This rate must be paid to all nonexempt employees for each hour worked up to and including 40 hours in a calendar workweek. Any time beyond 40 hours must be paid as time-and-a-half overtime, which works out to a current minimum of \$7.725 per hour.

Keep in mind that the \$5.15 minimum wage is a wage that large employers pay. A large employer is any employer with a gross sales volume over \$500,000 per year. A small employer who has a gross sales volume of less than \$500,000 per year can pay \$4.90 as a minimum wage. In addition, an employer can pay new employees who are under the age of 20 a training wage of \$4.25 during their first 90 days. You cannot displace permanent or current employees with new employees using the training wage.

The following is a list of employee types.

- ◆ An exempt employee is an employee who is exempt from the Fair Labor Standards Act (FLSA). The employee is therefore not entitled to the minimum wage, equal pay, overtime pay, and child labor provision protections of the FLSA, and an employer is not subject to FLSA rules for that employee.

Normally exempt employees include executives, administrative personnel, managers, professionals, and outside salespeople who are salaried rather than hourly employees. An employer cannot set the specific hours that an exempt employee works.

- ◆ A nonexempt employee is an employee who does get the protections of the FLSA. Minimum wage, overtime pay, equal pay for equal work, and child labor protection laws are all protections of the FLSA. If you hire children under the age of 18, be certain you understand the special protections in place at both the state and federal level.
- ◆ Salaried employees are paid a certain amount per pay period, which is not based on the number of hours worked. Salaried employees, who are also exempt employees, commonly work over 40 hours per week without additional pay.
- ◆ Hourly employees are paid a certain amount per hour. After an hourly employee works more than 40 hours per week, that employee is entitled to overtime pay.



**Biz Tips**

For more information on the FLSA and how it affects your hiring and pay policies, you can visit the Department of Labor website at [www.dol.gov/compliance](http://www.dol.gov/compliance).

Many companies use either a time clock or time sheets to track the number of hours an employee works. Managers usually review these hourly reports, approve them, and send them to the accounting department. Accounting then calculates the wages or salary due and prepares the payroll.

Calculating pay for hourly employees is relatively simple. If you pay weekly and the employee works 40 hours, then multiply the number of hours by the employee's hourly wage. If the employee works over 40 hours, multiply the hours over 40 by the hourly wage times 1.5. The following calculation is for an employee who earns \$10 per hour and worked 45 hours:

40 hours × \$10	= \$400
5 hours × \$10 × 1.5	= \$75
Total gross pay	= \$475

If your normal pay period is once every two weeks, then the calculation is based on 80 hours, but you still determine whether the employee is eligible for overtime based on a 40-hour week. So an employee who works 45 hours one week and 35 hours the

next, would still get 5 hours of overtime for the week that he or she worked 45 hours. To figure out that employee's pay, you would use the following calculation.

$$\begin{array}{r} 75 \text{ hours} \times \$10 \qquad \qquad \qquad = \$750 \\ 5 \text{ hours} \times \$10 \times 1.5 \qquad \qquad \qquad = \$75 \\ \hline \text{Total gross pay} \qquad \qquad \qquad = \$825 \end{array}$$

Things get a bit more confusing when you are figuring the gross pay for a salaried person who is paid a monthly salary but is also eligible for overtime pay. Assume the employee earns \$3,000 per month and is paid twice per month at \$1,500 per pay period. In order to calculate overtime for this person, you would need to calculate an hourly wage. There are 2,080 work hours in a year (40 hours per week multiplied by 52 weeks). A person earning \$3,000 per month would have a yearly salary of \$36,000 and an hourly wage of \$17.31 (\$36,000 divided by 2,080).

After you know the hourly wage, you can calculate overtime by multiplying that wage by 1.5, which in this case equals \$25.96. Whenever that employee works more than 40 hours in a week, you would multiply the number of overtime hours worked by \$25.96. For example, if the salaried employee is entitled to overtime of 5 hours, the bimonthly check is figured as follows.

$$\begin{array}{r} \text{Salary} \qquad \qquad \qquad = \$1,500.00 \\ \text{Overtime } (\$25.96 \times 5) \qquad \qquad \qquad = \$129.80 \\ \hline \text{Gross pay} \qquad \qquad \qquad = \$1,629.80 \end{array}$$

You also may have some people who are paid on a commission basis. They can either be paid on a straight commission basis or paid a salary plus commission. Things can get even more confusing if the salary is an advance on commissions. Let's look at how you would calculate the check under all three scenarios for a salesperson who sold \$50,000 of products during the month.

First, calculate the check by a straight commission of 10 percent.

$$\$50,000 \times .10 = \$5,000 \text{ in gross wages}$$

Next, calculate the check for a salesperson with a salary of \$2,500 plus 5 percent commission.

$$\begin{array}{r} \text{Salary} \qquad \qquad \qquad = \$2,500 \\ \$50,000 \times .05 \qquad \qquad \qquad = \$2,500 \\ \hline \text{Gross pay} \qquad \qquad \qquad = \$5,000 \end{array}$$

You can see that the check amount is the same. The big difference for the employee is having a set salary to count on even if he or she has a slow sales month. Although the salesperson on straight commission has a higher earning potential at a 10 percent commission rate, the salaried salesperson has a greater level of security.

You need to decide what works better for your business and the type of salespeople you want to hire. Salespeople on straight commission do tend to be more aggressive, but they may or may not service your customers the way you want them serviced. You can have more control of a salesperson's activities if you pay a salary.

A third way to reward salespeople is to give them an advance on commissions to guarantee them a monthly income they can count on, but still pay based on straight commission. For a salesperson who sold \$50,000 at 10 percent commission, but gets a monthly advance of \$2,500 paid on the first of the month, the calculation would be as follows:

$\$50,000 \times .10$	$= \$5,000$
Advance on commissions	$= -\$2,500$
	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
Pay at end of month	$= \$2,500$

If the employee doesn't meet his or her monthly advance, the negative is usually carried forward to the next month. Some companies require employees to repay the advance; others allow the negative to build up over a number of months. Salespeople who regularly do not earn their advance are usually quickly let go and sometimes left with a sizeable debt to be paid based on the advances.

Your company also may give salespeople an incentive to earn more each month with what is called a graduated commission schedule. For example, suppose the straight commission salesperson earns 5 percent on the first \$10,000 in sales, 7 percent on the next \$15,000, and 10 percent on all sales over \$25,000. You would figure that salesperson's commissions with a \$50,000 sales volume by using this calculation:

$\$10,000 \times .05$	$= \$500$
$\$15,000 \times .07$	$= \$1,050$
$\$25,000 \times .10$	$= \$2,500$
	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
Gross wages	$= \$4,050$

You adjust a salesperson's gross wages by any refunds, returns, or allowances. You not only need to keep track of a salesperson's initial sales, but also any changes to those sales made later in the month.

If you are running the type of business where tips are common, you need to keep records of the tips. If your company considers tips as part of total compensation to meet minimum wage obligations (such as waitresses in a restaurant), you must carefully maintain records of these tips to prove you are meeting minimum wage standards. As the employer you need to calculate an employee's gross taxable wages using both the employee's hourly wage plus tips reported. Here's an example of how you would calculate gross wages for an employee earning \$4 per hour plus \$200 in tips for the week.

Base wages ( $\$4 \times 40$ )	= \$160
Tips	= \$200
Gross taxable wages	= \$360



**Biz Tips**

Employees report their tips to their employer on IRS Form 4070, "Employee's Report of Tips to Employer." IRS Publication 1244, "Employees Daily Record of Tips and Report to Employer," provides more details about how this reporting works. You can download it at [www.irs.gov/pub/irs-pdf/p1244.pdf](http://www.irs.gov/pub/irs-pdf/p1244.pdf).

The check you write to the employee is calculated on the base wages minus any taxes or benefits. You can pay employees less than minimum wage as their base wage provided that tips increase their earnings above the minimum wage.

So far, we've been talking only about gross pay. As we are all painfully aware, our paychecks are much lower than our gross pay. The check we receive is gross pay minus all deductions, whether for taxes, benefits, or retirement savings. The next two chapters look at reductions to paychecks and how they work. Chapter 13 reviews payroll taxes, and Chapter 14 looks at benefits.

**The Least You Need to Know**

- ◆ Employers face myriad rules and regulations even before they start to hire employees. The accounting department works with human resources to be certain the company complies with federal and state labor laws both before hiring and during the term of employment.
- ◆ Employers have control over when they pay their employees, but they must establish set pay periods.
- ◆ Employers have a lot of flexibility when it comes to setting wage classifications and determining an employee's pay, but they must meet the requirements of the Fair Labor Standards Act (FLSA).



# Chapter 13

## Taxing Times

### In This Chapter

- ◆ Tax bites
- ◆ Taxing calculations
- ◆ Unemployment issues
- ◆ The payroll process

As an employee, you probably always hated to open up that paycheck and see all the deductions taken out. As an employer, you're responsible for figuring out those deductions and may be shocked to learn how much more you need to pay over and above what is shown on your employee's checks.

The accounting department is responsible for managing payroll. You'll need to decide whether you want to handle payroll in-house or use a payroll specialty company to handle that task for you. After reviewing the tax calculations, this chapter discusses options for handling your company's payroll.

## Employer and Employee Taxes

Basically, as an employer you become an arm of the government to help collect taxes. You're responsible for paying Social Security tax, Medicare tax, federal withholding tax, and state withholding tax for your employees. There could also be local withholding tax for the city in which the business is located or the school district where the employee lives. In addition, you pay the employer's side of Social Security and Medicare taxes, as well as taxes for the unemployment fund in your state.

This section explains each type of tax and how it's calculated, then reviews how all this information is put together to calculate an employee's paycheck. All taxes collected from your employees are deposited in the Accrued Payroll Taxes account in the liability section of the balance sheet. Just as with the Sales Taxes Collected account, the money sits in that account until you need to pay the government entities, which can be monthly or quarterly depending on the tax and the size of your payroll.

The employer's portion of taxes is posted to the Payroll Taxes expense account on the P&L. Only the employer's portion of the payroll tax bill is a business expense. The employee portion that was withheld has been expensed as part of gross pay.

### Social Security Tax

The employer and employee share the Social Security tax equally. Both pay 6.2 percent of an employee's compensation up to \$90,000 for 2005 for a total of 12.4 percent. The maximum level of compensation to be taxed is adjusted each year by the federal government to reflect increased salary levels.

#### Accounting Answers

Social Security taxes are used to pay Social Security benefits for retirees, survivor benefits, and disability benefits, as well as provide funds for the Social Security trust fund. Approximately 85 percent of the taxes collected is used for current beneficiaries, and only about 15 percent is deposited in the trust fund for future beneficiaries. Social Security is primarily a pay-as-you-go system.

The calculation for the Social Security tax is relatively simple. For example, you would calculate the Social Security taxes for an employee who earns \$2,000 per month in this way.

$$\$2,000 \times .062 = \$124$$

$$\text{Employee's share of Social Security tax} = \$124$$

$$\text{Employer's share of Social Security tax} = \$124$$

If the employee earns over the \$90,000 cap in 2005, the employer still calculates the Social Security tax the same way. After the \$90,000 cap is reached

during the year, no more Social Security taxes are taken out. For example, a person who is earning \$180,000 would meet his or her Social Security obligation by the end of June. He or she would see an increase of 6.2 percent in his or her paycheck beginning in July.

## Medicare Tax

Employer and employee also share Medicare taxes equally—both pay 1.45 percent. The key difference between Social Security and Medicare taxes is that there are no income caps, so this percentage is taken out of the entire earnings for the year.

You would calculate the Medicare tax bite for the employee earning \$2,000 per month in this way.

$$\$2,000 \times .0145 = \$29$$

$$\text{Employee's share of Medicare tax} = \$29$$

$$\text{Employer's share of Medicare tax} = \$29$$



### Biz Tips

Each year the government mails all employers a copy of the “Employer’s Tax Guide” with updated tax information. In addition, you can always access it online at [www.irs.gov/pub/irs-pdf/p15.pdf](http://www.irs.gov/pub/irs-pdf/p15.pdf).

## Federal Withholding Tax

Now that you understand the easy calculations of Social Security and Medicare, let’s move on to the complicated world of federal withholding tax. As an employer, you have one of two methods you can use to calculate taxes. One is as a percentage of earnings, and the second is to use the tax tables in Publication 15, “Employer’s Tax Guide.”

First, let’s review tax rates for the year 2005. The following table shows tax rates for single individuals and people filing as head of household in 2005.

If taxable income is over ...	But not over ...	The tax is ...
\$0	\$10,450	10% of the amount over \$0
\$10,450	\$39,800	\$1,045 plus 15% of the amount over \$10,450
\$39,800	\$102,800	\$5,447.50 plus 25% of the amount over \$39,800
\$102,800	\$166,450	\$21,197.50 plus 28% of the amount over \$102,800
\$166,450	\$326,450	\$39,019.50 plus 33% of the amount over \$166,450
\$326,450	No limit	\$91,819.50 plus 35% of the amount over \$326,450

For married individuals filing jointly and surviving spouses, the 2005 tax rates are shown in the following table.

<b>If taxable income is over ...</b>	<b>But not over ...</b>	<b>The tax is ...</b>
\$0	\$14,600	10% of the amount over \$0
\$14,600	\$59,400	\$1,460.00 plus 15% of the amount over \$14,600
\$59,400	\$119,950	\$8,180 plus 25% of the amount over \$59,400
\$119,950	\$182,800	\$23,317.50 plus 28% of the amount over \$119,950
\$182,800	\$326,450	\$40,915.50 plus 33% of the amount over \$182,800
\$326,450	no limit	\$88,320.00 plus 35% of the amount over \$326,450

In addition to calculating taxes based on an employee's income and tax rate, an employer must also take into consideration the number of exemptions the employee claims on his or her W-4. So there isn't a simple formula for calculating federal withholding taxes. Publication 15 does give you a chart that breaks down these percentage calculations by weekly, biweekly, semimonthly, monthly, quarterly, semiannual, and annual payroll periods. You can use a different chart in the publication to adjust an employee's salary based on the number of withholding allowances. For 2005, here is the adjustment per withholding allowance.

### **2005 Withholding Allowance Adjustments**

<b>Pay Period</b>	<b>Amount</b>
Weekly payroll	\$61.54
Biweekly payroll	\$123.08
Semimonthly payroll	\$133.33
Monthly payroll	\$266.67
Quarterly	\$800.00
Semiannual	\$1,600.00
Annual	\$3,200.00

In addition to the withholding chart, percentage charts are developed based on single taxpayers or married taxpayers filing jointly for each of the payroll period types. Just as an example, here's the weekly payroll chart from Publication 15 for a married person filing jointly in 2005.

<b>If the amount of wages (after subtracting withholding allowances) is:</b>	<b>The amount of income tax to be withheld is:</b>
Not over \$154	\$0
Over \$154 but not over \$435	10% of excess over \$154
Over \$435 but not over \$1,273	\$28.10 + 15% of excess over \$435
Over \$1,273 but not over \$2,322	\$153.8 + 25% of excess over \$1,273
Over \$2,322 but not over \$3,646	\$416.05 + 28% of excess over \$2,322
Over \$3,646 but not over \$6,409	\$786.77 + 33% of excess over \$3,646
Over \$6,409	\$1,698.56 + 35% of excess over \$6,409

To practice calculating federal withholding tax, assume that Jack earns \$1,300 per week, is married, and has two children. He claims four withholding allowances for himself, his wife, and two children plus an additional three withholding allowances for the itemized deductions he expects to claim, such as home mortgage, property taxes, and charitable deductions.

Here's how you would calculate his federal withholding taxes.

1. Multiply 7 withholding allowances by \$61.54 (weekly amount from chart on preceding page) to get \$430.78.
2. Subtract \$430.78 from \$1,300 to find his taxable income, which is \$869.22
3. Jack's taxable income is over \$435 but below \$1273, so his tax would be calculated using \$28.10 plus 15 percent of \$434.22 (\$869.22-\$435) or \$65.13. The grand total is \$93.23.

So the federal tax to be deducted from Jack's weekly check is \$93.23, which totals \$4,847.96 for the year.

You can imagine how time-consuming doing this calculation for each employee would be. For this reason most employers use either the tables in Publication 15, use a payroll computer program that is updated each year for current tax rates, or use an outside contractor to handle payroll. Payroll computer programs and outsourcing are covered later in the chapter.

For now, assume you decide to use the tax tables. Using Jack as an example, we'll show you a small segment of those tax tables for that weekly salary range. (Note: The tax tables in Publication 15 go up to 10 allowances, but we're just using the segment up to 7 to save space.)

If wages are:		And the number of allowances claimed is:						
At Least	But Less Than	1	2	3	4	5	6	7
\$1,290	\$1,300	\$159	\$148	\$139	\$129	\$120	\$111	\$102
\$1,300	\$1,310	\$162	\$149	\$140	\$131	\$122	\$112	\$103
\$1,310	\$1,320	\$164	\$151	\$142	\$132	\$123	\$114	\$105

You can see these numbers are different than the calculation we did using the percentage method. Using the \$103 from the preceding table rather than the \$93.23 we calculated as part of the percentage method would result in an additional \$9.77 taken out of the check weekly or \$508.04 for the year. Even though \$1,300 appears on two lines, the top of the chart says “If wages are at least \$1,290 but less than \$1,300,” so you would use the higher number on the middle line.



**Biz Tips**

PayrollTaxes.com has an excellent summary of taxes by state at [www.payrolltaxes.com/PayrollTaxes/00000104.htm](http://www.payrolltaxes.com/PayrollTaxes/00000104.htm).

## State Withholding Tax

Most states have income taxes as well. If your business is located in a state with income taxes, you'll play tax collector for the state as well.

Some states base their income tax on a percentage of the federal withholding amount; other states use tables or percentage methods similar to the federal withholding. In addition to the W-4 at the federal level, the employee may also need to complete a similar form to declare state withholding allowances.

## Calculating Payroll Taxes

After you've calculated the taxes for each employee, your next step is to build a spreadsheet that summarizes your payroll. You should include the employee's name plus a code that indicates the filing type and number of withholding allowances being claimed. For example, Jack would be an M-7; married filing joint with seven allowances. Judy, who is single claiming one allowance, would be S-1. Jane, who is married claiming three allowances, would be M-3.

To avoid any trouble over pay levels, suppose all these employees are making the same amount. Using the tables, you determine that federal withholding for Jane would be \$140. The single tables only go up to \$1,250, so you have to use the percentage method for Judy. Her federal tax bite is \$250. Assume that the state withholding is 15 percent of the federal amount.

Here's what a portion of the payroll spreadsheet would look like.

Name	Gross Wages	SS	Med.	Fed WH	State WH	Net Check
Jack (M-7)	\$1,300	\$80.60	\$18.85	\$103	\$15.45	\$1,082.10
Judy (S-1)	\$1,300	\$80.60	\$18.85	\$250	\$37.50	\$913.05
Jane (M-3)	\$1,300	\$80.60	\$18.85	\$140	\$21.00	\$1,039.55

So far, we've discussed taking only taxes out of the paycheck. You may also offer benefits that reduce the net check as well. The next chapter talks more about benefits.

## Paying Unemployment Taxes

In addition to the employer's portion of the Social Security and Medicare taxes, one other employer's tax is partially based on employees' salaries. As the last chapter mentioned, employers also pay into an unemployment fund known as the Federal Unemployment Tax (FUTA).

Taxes are charged at both the federal and state level, but you get a credit toward the federal amount based on the amount you pay to the state. FUTA is 6.2 percent on the first \$7,000 per employee (less a credit for contributions to state funds up to a maximum of 5.4 percent).

Each state sets its own unemployment tax rates. In addition to the unemployment taxes, many states have charges for administrative costs and job-training programs. Just to give you an idea of the variations, the following table shows the unemployment tax rates in five states.



### Biz Tips

You can find the details of unemployment taxes for your own state at [PayrollTaxes.com](http://PayrollTaxes.com) ([www.payrolltaxes.com/PayrollTaxes/00000104.htm](http://www.payrolltaxes.com/PayrollTaxes/00000104.htm)).

State	Percentage Range	Maximum Salary Taxed	New Employer Percentage Range
California	1.5 to 6.2	\$ 7,000	3.4
Georgia	0.03 to 6.48	\$ 8,500	2.62
Nebraska	0.05 to 5.4	\$ 7,000	3.5
New York	0.9 to 8.9	\$ 8,500	3.4
Rhode Island	1.69 to 9.79	\$16,000	2.04

As you can see the percentage range can vary widely. This percentage is based on your company's experience rating. States use four different kinds of formulas to determine your rating:

- ◆ **Benefit ratio formula.** This formula looks at the ratio of benefits to payrolls over the last three years. Your company's rate also can be adjusted based on the overall balance in the state unemployment insurance fund.
- ◆ **Benefit wage formula.** This formula is based on the proportion of a company's payroll paid to those workers who become unemployed and receive benefits divided by the company's total taxable wages.
- ◆ **Payroll decline ratio formula.** This formula is based on the decline in a company's payrolls from year to year or from quarter to quarter.
- ◆ **Reserve ratio formula.** This formula is based on the company's balance in the reserve account, which is cumulative from the date the employer is first subject to state unemployment tax. The reserve account is calculated by totaling contributions minus total benefits paid. This amount is then divided by the company's total payroll. The higher the reserve ratio is, the lower the required contribution rate.

To get a better understanding of how unemployment taxes are calculated in your state, your best bet is to set up a meeting with the state unemployment office. Not only will this meeting help you to understand how the taxes work, but it will also help you understand how you can minimize your unemployment tax bite.

After you know what your tax rate is, the calculation is not difficult. For example, assume the new company is located in Georgia and has 10 employees with a total annual payroll of \$400,000. The unemployment tax would be calculated this way.



State unemployment taxes:

$$\$8,500 \times 10 \times 2.62\% = \$2,227$$

$$(\$8,500 \text{ max income} \times 10 \text{ employees} \times \text{new employer rate of } 2.62\%)$$

Federal unemployment taxes:

$$\$7,000 \times 10 \times 6.2\% = \$4,340$$

The total tax due is \$2,227 to the state unemployment fund and \$2,113 to the federal unemployment fund. Remember that you subtract any state unemployment taxes you pay from the amount you owe in federal unemployment taxes.

Unemployment insurance tax is reported and paid quarterly, but you should expense it monthly so you match your monthly expenses with your monthly income. With \$4,340 in total taxes due, quarterly payments would be \$1,085, and the monthly tax amount would be \$361.67. When the company closes its payroll accounts for the month, it records this entry.

	Debit	Credit
5900 Payroll Taxes	\$361.67	
2300 Accrued Payroll Taxes		\$361.67

In this entry, the payroll taxes are recorded as an expense and the accrued future liability of the payroll tax payment increases the amount in the Accrued Payroll Taxes account that is due at the end of the quarter.

When the company records the quarterly tax payment of \$1,085, the entry is as follows.

	Debit	Credit
2300 Accrued Payroll Taxes	\$1,085	
1100 Cash in Checking		\$1,085

In this entry the company is reducing the amount of its liability (the Accrued Payroll Taxes account) and reducing the amount of an asset, the Cash in Checking account.

## In-House or Outsource?

Your head may be spinning now that you've seen how much is involved on the employer's side when it comes to payroll and paying taxes. We haven't even touched on the complications added with benefits.

Payroll can be such a time-consuming task for small businesses that the trend has been to outsource payroll to a company that specializes in payroll management. However, now that more software programs are available to handle the complexities of payroll, many small companies are saving the fees they had to pay to payroll specialty companies and bringing the function back inside the company.

Small companies, in particular, were dissatisfied with the attention their payrolls received. A payroll company obviously gives priority to their largest customers and makes the smaller company a lower priority. This lack of customer service has helped to fuel the push to bring payrolls back in-house.

### Accounting Answers

Many alternatives to manage payroll are on the market. Business.com has an excellent collection of links you can use to review the possibilities at [www.business.com/directory/accounting/software/](http://www.business.com/directory/accounting/software/). Whatever you decide, be sure to talk with others in your business network to see how they manage payroll and compare notes. You may find your best solution is a small local payroll company that is offering service at a reasonable rate, or you may decide buying payroll software is your best option.

Calculate the number of hours you spend preparing payroll and determine what that is costing your company. Then put together an alternative that includes keeping payroll in-house with the proper payroll software versus outsourcing payroll to a company that specializes in handling it. If outsourcing payroll allows you to hire one less person, you might find that outsourcing is your best alternative. It's a numbers game, and only you can determine what is best for your company.

The next chapter takes a look at benefit alternatives and how they impact the job of payroll management as well as payroll costs.

### **The Least You Need to Know**

- ◆ After you begin to hire employees, you take on the role of tax collector for the federal and state governments as part of your payroll operation.
- ◆ Federal withholding taxes can be calculated using a percentage method or using tables. Both methods require you to know how employees file their taxes and how many withholding allowances they claim.
- ◆ In addition to the employer's share of Social Security and Medicare, you also must pay taxes to help fund the state and federal unemployment insurance funds.



# Chapter 14

## Benefiting Employees

### In This Chapter

- ◆ Benefit breaks
- ◆ Income busters
- ◆ Valuing fringes
- ◆ Cafeteria route

Figuring out payroll taxes can make managing the payroll a complicated and time-consuming job, but when you add benefits to the mix, you have a very convoluted pie. This pie can be even more confusing when you add cafeteria benefits plans.

Some benefits are tax-exempt for the employee; others require the employee to pay tax on all or part of the benefit. Some benefit costs are shared by the employer and employee. Sometimes these shared costs reduce the salary before you calculate all taxes; others are exempt only from federal income taxes or state taxes.

This chapter reviews the tax-exempt benefits and the partially exempt benefits. Then it reviews benefits that are taxable or partially taxable. Next it delves into how you value benefits. Finally, the chapter describes cafeteria benefit plans and how you handle them as part of your payroll calculations.

## Exploring Tax-Exempt Benefits

Many of the benefits you offer your employees are exempt from taxation for the employee and offer your business a tax deduction to reduce the business's tax bill. Health insurance, life insurance, and qualified retirement plans are the most common examples of these benefits. Yet many business owners do not know about the many other benefits that are exempt or taxable.

With tax-exempt benefits, you don't need to add the amount you pay as the employer toward these benefits. Also, any insurance premium or retirement contribution paid by the employee is subtracted from his or her pay before you calculate income taxes. As needed, we indicate in this section which benefits are only excluded from federal taxes and which benefits can also be excluded from Social Security and Medicare taxes. Most of these benefits are probably also exempt from state or local taxes, but you need to check with your state to be certain. To make it easier for you to find the benefits, we put them in alphabetical order.

### Accident and Health Benefits

Costs of accident and health insurance are tax-exempt whether they are paid by the employer or employee. This is one of the benefits that are not only excluded from calculations for federal income taxes, but also for Social Security, Medicare, and the employer and employee's FUTA taxes.

### Achievement Awards

If your company awards employees for length of service or safety achievement, up to \$1,600 of personal property given can be exempted from an employee's taxable income. This figure represents the amount your company can deduct as a business expense for a qualified achievement award. This exclusion does not apply to cash, cash equivalents, gift certificates, vacations, meals, lodging, theater or sporting events tickets, stocks, bonds, or other securities. To qualify for this exemption, an achievement award must meet the following requirements.

- ◆ It must be awarded as part of a meaningful presentation.
- ◆ It must be awarded under conditions and circumstances that do not create a significant likelihood of disguised pay.
- ◆ Length-of-service awards cannot be given during the first five years of employment nor can they have been given in any of the prior four years. Awards of very small value do not disqualify as length-of-service awards.

- ◆ Safety achievement awards are not qualified if given to a manager, administrator, clerical employee, or other professional employee. Also, you cannot give a safety achievement award to more than 10 percent of your employees, unless those awards are of very small value.

If your achievement awards do not meet these qualifications, the maximum you can give to an employee as a tax-exempt award is \$400. Any awards that exceed these allowable levels must be included as taxable income on the employee's paycheck.

## Adoption Assistance

If you offer adoption assistance to your employees, you can provide these benefits without having to include this assistance in the employee's taxable compensation when calculating federal income taxes. You do, however, have to include these payments when calculating Social Security, Medicare, and FUTA.

## Athletic Facilities

You can offer employees use of an on-premises gym or other athletic facility without having to include the value of this benefit as part of their taxable salary. The athletic facility must be on premises you own or lease, but it does not have to be on your business premises. To qualify, the facility must be substantially for the use of your employees, their spouses, and their dependent children.

## De Minimis (Minimal) Benefits

You are not required to track benefits that have very little value as long as they are not cash. Examples of *De Minimis benefits* include the following advantages.

- ◆ Occasional copier use
- ◆ Holiday gifts, other than cash, with a low fair market value
- ◆ Group term life insurance payable on the death of an employee's spouse or dependent with less than a \$2,000 face value
- ◆ Meals
- ◆ Occasional parties or picnics

### def•i•ni•tion

**De Minimis benefits** are benefits that have so little value it would be unreasonable or administratively impractical to track them. Cash, no matter how little, is never excludable from tax calculations under the De Minimis benefits rule.



**Biz Tips**

For more information on the complicated rules of dependent care assistance, see IRS Publication 503, "Child and Dependent Care Expenses," which is available at [www.irs.gov/pub/irs-pdf/p503.pdf](http://www.irs.gov/pub/irs-pdf/p503.pdf).

- ◆ Occasional tickets for entertainment or sporting events
- ◆ Transportation benefits (more information about these rules follows)
- ◆ Occasional typing of personal letters by a company secretary

Phew. Can you imagine if you had to keep track of copier use and parties by each employee? What an administrative nightmare!

## Dependent Care Assistance

You can provide dependent care assistance for your employees and exclude that assistance from their taxable income. The services must meet two tests.

- ◆ They must be for a qualifying person's care.
- ◆ They must be offered because they allow the person to work.

## Educational Assistance

When you help your employees go back to school, you can provide up to \$5,250 in educational assistance and exclude that assistance as part of the calculations for all federal taxes, including income taxes, Social Security taxes, Medicare taxes, and your business's FUTA calculations. The courses must have a reasonable relationship to your business or be required as part of a degree program. Excludable expenses include tuition, cost of books, equipment, fees, and supplies.

To qualify, your employee assistance program must be in writing and set up under rules that do not favor highly compensated employees. Also, your program cannot provide more than 5 percent of its benefits to shareholders or owners. You also must give reasonable notice of the program to eligible employees.

## Employee Discounts

If you offer your employees a discount on your products or services, you can exclude the value of these discounts from all tax calculations as long as they do not exceed 20 percent of the price you charge to customers who are not employees. If discounts



are available only to highly compensated employees, the discounts cannot be excluded from wage compensation. You cannot exclude employee discounts for real property or other personal property commonly held for investment such as stocks or bonds.

## **Group Term Life Insurance**

You can offer group term life insurance and exempt its value from federal income taxes, Social Security taxes, and Medicare taxes, but there are limitations. The exclusion is allowed only up to the cost of \$50,000 in life insurance. Premiums for life insurance benefits you provide above that limit must be added to the employee's salary when calculating Social Security and Medicare taxes. To qualify, the life insurance benefits must be offered to at least 10 full-time employees. Also, the insurance cannot cover an employee's spouse or dependents unless the cost of the insurance fits under the De Minimis benefits rules discussed previously. If your group life insurance favors key employees, you must include the cost of the insurance in your key employees' wages.

## **Lodging on Your Business Premises**

You can exclude the value of lodging that you furnish your employees from their wages provided the lodging is furnished on your business premises, it is furnished for your convenience, and it is a condition of employment. This is most likely to be a question if you are running a small hotel/motel and want certain employees to live on the premises or if you own apartment buildings and want certain employees to live in the buildings they maintain or manage.

## **Meals**

You can furnish two types of meals to your employees without having to report the value of the benefit as part of the employee's salary. One type is De Minimis meals (bet that's a word you hadn't heard of before this chapter), which include coffee, doughnuts, or soft drinks as well as occasional meals or meal money to enable an employee to work overtime. Occasional parties or picnics for employees and their guests also fit in this category. The second type allowed without reporting the value as part of compensation is meals that you furnish employees on your business premises for your convenience. This practice is common in restaurants. You do not have to report the meals as part of the employee's wages.

## Moving Expense Reimbursements

You can exclude all moving expense reimbursements from an employee's compensation for all types of federal taxes provided the expenses would meet the test of qualifying write-offs if the employee deducted the expenses himself or herself. Allowable expenses include the moving of household goods and personal items and traveling from the former home to the new home. The cost of meals is not deductible. Keep in mind that the move must meet the distance test of at least 50 miles between the new job location and old job location. You also have to report the qualifying moving expenses that were paid. You do this at the end of the year on the employee's W-2 in box 12. You do not have to report payments to third parties, such as direct payments to a moving company, or the value of moving services that you provide in kind, such as the cost of labor of a company crew or expenses incurred with use of a company truck to move an employee.

## Retirement Planning

You can exclude from income the value of any retirement planning advice or information you provide to your employee or his or her spouse provided you offer a qualified retirement plan. Contributions the employee or the company makes to a qualified retirement plan are exempt from federal income taxes, but they are not exempt from calculations for Social Security and Medicare taxes. The amount of contributions that qualify differ depending on the type of retirement plan you offer.



### Biz Tips

The types of retirement plans available vary greatly depending on the size of your business. An excellent chart from *Business Week* ([www.businessweek.com/smallbiz/0006/sb000630.htm](http://www.businessweek.com/smallbiz/0006/sb000630.htm)) summarizes the various plans available and the employer's responsibility if he or she decides to offer a plan. IRS Publication 560, "Retirement Plans for Small Business" ([www.irs.gov/pub/irs-pdf/p560.pdf](http://www.irs.gov/pub/irs-pdf/p560.pdf)), is an excellent resource for researching the details of retirement plans and their rules.

## Transportation Benefits

Transportation benefits come in two types. One type is De Minimis (there's that word again) benefits, and the second is qualified transportation benefits. To fit in the De Minimis category the transportation must have little value and must be provided only occasionally, such as when the employee works overtime. Qualified transportation

benefits can include a ride in a commuter highway vehicle between the employee's home and work, a transit pass, or a qualified parking space near the location from which the employee commutes to work, such as a train station or on or near your business premises.

De Minimis benefits can be fully excluded from an employee's compensation when calculating all federal taxes, but qualified transportation benefits face some limitations. The maximum that can be excluded from an employee's income is \$105 for rides in a highway vehicle or transit pass and \$200 for qualified parking.

## **Working Condition Benefits**

You can exclude from compensation for all federal taxes the value of property or services that you provide your employee so that the employee can do his or her job. Examples of working condition benefits include a company car for business purposes or job-related education. When you provide a vehicle, the value of the exclusion is limited to the deductions an employee would be allowed to deduct as a business expense if the employee had used his or her own vehicle. Outplacement services also fall under the provisions of working condition benefits. Outplacement services do not qualify if you give the employee the option of receiving cash or taxable benefits in place of services.

### **Accounting Answers**

One benefit not mentioned is employee stock options and employee stock purchase plans because these rules are very complicated depending on the type of stock option, at what price the option or stock is offered, and when the option is exercised (bought) and sold. Because this book is for small businesses not likely to be public companies or offer stock options, we decided not to delve deeply into this complicated benefit option. If you are thinking of offering stock options, a good source for information is the National Center for Employee Ownership ([www.nceo.org](http://www.nceo.org)).

## **Reviewing Taxable Benefits**

Basically any benefit that the government does not specify in Publication 15-B, "Employer's Tax Guide to Fringe Benefits" ([www.irs.gov/pub/irs-pdf/p15b.pdf](http://www.irs.gov/pub/irs-pdf/p15b.pdf)) as nontaxable should be considered taxable and included in the employee's compensation. Some key benefits that must be included are personal use of a company auto, group life insurance over \$50,000, third-party sick pay, and benefits that exceed the

limits including transportation benefits, education benefits, dependent care benefits, and employee discounts. If you decide to pay your employee's share of Social Security and Medicare taxes, you must include the amount you pay in the employee's income.

## Valuing Benefits

Basically, when you try to value benefits the general rule is that the benefit should be valued at the fair market value (FMV). The FMV would be the amount the employee would have to pay a third party in an *arm's length transaction* to buy or lease the benefit.

### def•i•n•i•t•i•o•n

An *arm's length transaction* is a transaction between two unrelated or unaffiliated parties or a transaction conducted between related or affiliated parties as if they were unrelated to avoid the appearance of a conflict of interest.

You must value any benefits by January 31 of the next year, so you will be able to report these benefits on the employee's W-2. You can withhold the necessary taxes on taxable benefits either during each pay period or take them out quarterly, semiannually, or yearly.

You also have the option of taking out withholding taxes at the time the employee receives the benefit in one pay period or treating it as though it were made in several payments. For example, if your employee received \$1,000 toward education benefits over the

amount you can exempt, you can report that as four payments and take out necessary taxes in four different pay periods to minimize the tax bite even if the payment were received during one pay period. You must withhold all federal taxes on the date you choose to treat the benefits as paid.

Benefits related to vehicles are probably the most complicated to value. The details of vehicle valuation could fill an entire chapter, so we'll just highlight the key rules you need to consider. For the details and full valuation rules, please read IRS Publication 15-B.

You can use two methods to calculate the value of a vehicle: the cents-per-mile rule or the lease value rule. If the vehicle is leased, you can use only the cents-per-mile rule if the lease is based on cents-per-mile. Otherwise you value the lease based on what the employee would have to pay to a third party to lease the same or similar vehicle.

## Cents-Per-Mile Rule

When using the cents-per-mile rule, you multiply the standard mileage rate (40.5 cents for 2005 from January through August 31, and 48.5 from September 1

through December 31.) times the number of miles the employee used the vehicle for personal use, which includes any use not specifically for your trade or business. The cents-per-mile rule includes the value of insurance and maintenance.

## Commuting Rule

If you provide a vehicle to the employee and it is used to commute back and forth to work, you must multiply the commuting use of the vehicle by \$1.50 for each one-way trip the vehicle is used for the purposes of commuting between work and home. This rule can greatly decrease the cents-per-mile rule by designating the miles used for commuting differently than personal mileage. For example, if an employee lives 20 miles from work, the trip from home to the office would be valued at \$1.50 under the commuting rule, but would have a value of \$9.70 (48.5 cents multiplied by 20 miles) under the personal use rule. In order to qualify for the commuting rule, the vehicle must meet these provisions:

- ◆ You provide the employee with the vehicle for use in your trade or business, and you require the employee to commute in the vehicle to and from your business location. If you require the employee to carry at least three employees to and from work in an employer-sponsored commuting pool, it meets this requirement even if the employee does not use the car otherwise through the day. You should include the \$1.50 per one-way trip in each employee's compensation, not just the driver's.
- ◆ You have a written policy that does not allow the employee to use the vehicle for personal purposes other than commuting to and from work. The only exception can be for De Minimis personal use (such as a stop on the way to work or from work to run a personal errand).
- ◆ The employee does not use the vehicle for any personal purposes other than commuting to and from work or for De Minimis personal use.
- ◆ If the vehicle is a car, it cannot be used by a *control employee* to qualify under this rule.

### def·i·ni·tion

A **control employee** is someone who is a board member or elected officer whose pay is \$85,000 or more, a director, an employee whose pay is more than \$170,000, or an employee who owns more than 1 percent of the business. These compensation amounts are for 2005; they are adjusted periodically for inflation.

## **Lease Value Rule**

If the vehicle is leased, you determine the FMV based on the annual lease value. The IRS makes it very easy to determine the annual lease value. Page 20 of Publication 15-B has a chart that includes the automobile FMV and the corresponding annual lease value. These tables do not include the cost of insurance or maintenance.

You can reduce the lease value if the employee uses the vehicle for business purposes. Any reduction in the lease value would be excluded from the employee's wages based on the working condition benefit mentioned previously. You can choose to include the full lease value in the employee's wages. If you do, then the employee would write off the business use as a nonreimbursed business expense.

## **Using Cafeteria Plans**

Nope, we're not talking about offering a lunch spot. Some benefits plans are called cafeteria plans. These types of plans allow your employees to choose among various benefits, depending on which ones fill their specific needs. The plan must include at least one taxable benefit, such as cash, and at least one nontaxable benefit, such as health insurance.

A cafeteria plan can include accident and health benefits, adoption assistance, group term life insurance, accidental death insurance, disability insurance, and a qualified retirement plan. Cafeteria plans cannot include medical savings accounts, athletic facilities, De Minimis benefits, educational assistance, employee discounts, lodging on your business premises, meals, moving expenses, transportation benefits, or working condition benefits.

Basically, employees are given the chance to choose between receiving cash or taxable benefits instead of certain qualified benefits that can be excluded from wages. If the employee does decide to take a qualified benefit under the cafeteria plan, that benefit does not need to be reported as taxable even though the employee chose not to take cash or receive a taxable benefit.

## **Your Tax Benefits for Offering Benefits**

You may be wondering why you should offer benefits, which are just a drain on your business profits. Most companies that offer benefits do so to be competitive when recruiting employees and as an incentive to retain employees.

Finding the right mix of benefits to attract new employees and keep old employees differs by industry and what your local competitors are doing. Benefits make employees happier and less stressed. Happy and healthy employees are more productive, and productive employees help your business be more successful.

Even though benefits reduce your profit margin, the government pays part of this cost through the tax reduction you receive for offering benefits. You can write off the costs of most employee benefits as an expense and reduce your tax bill, which is based on net profits.

The next chapter pinpoints what tax and benefits records you need to keep to satisfy both financial and government reporting requirements.

### **The Least You Need to Know**

- ◆ Many employee benefits are exempt from taxes and do not have to be reported as part of the employee's compensation when calculating federal taxes.
- ◆ Some benefits are exempt only from federal income taxes, but they must be included as part of the calculations for Social Security and Medicare taxes, as well as unemployment taxes.
- ◆ Taxable benefits should be reported at Fair Market Value (FMV) and included as part of an employee's compensation.
- ◆ Some employers offer their employees more flexibility in their choice of benefits by using a cafeteria plan.





# Chapter 15

## Keeping Tax and Benefit Records

### In This Chapter

- ◆ Recording pay
- ◆ Depositing taxes
- ◆ Avoiding penalties
- ◆ Following rules

Now that you know the details behind the payroll system, you need to know what records are necessary to keep about these transactions for both internal and external purposes. We warn you: be prepared to do a lot of paper pushing. Internally you need to track your company's liabilities related to payroll; externally you need to report your payroll and related taxes to federal, state, and local governments.

### Posting Payroll

First, let's talk about posting payroll. You can post all your payroll taxes into the balance sheet liability account called Accrued Payroll Taxes (2300),

but if you manage a sizeable payroll, you may prefer to set up individual accounts for each type of tax and benefit. These individual accounts include the following.

- ◆ Accrued Federal Withholding Payable (2310)
- ◆ Accrued State Withholding Payable (2315)
- ◆ Accrued Federal Unemployment Payable (2320)
- ◆ Accrued State Unemployment Payable (2325)
- ◆ Accrued Employee FICA Payable (2330)
- ◆ Accrued Employee Medical Insurance Payable (2335)
- ◆ Accrued Employee Elective Insurance Deductions Payable (2340)
- ◆ Accrued *Garnishments* and Other Withholding Payable (2345)

## def·i·ni·tion

**Garnishments** are a means for creditors to collect money due them by getting a court order to take money out of a person's wages. As an employer, you could be sent instructions from a court to withhold a certain amount of money from an employee's paycheck until a judgment is satisfied. The employer must take the money out of an employee's paycheck and send it directly to the creditor if ordered by a court.

You may also want to set up additional expense accounts rather than post all payroll taxes to just the Payroll Taxes (5900) account. Some states also have state-sponsored disability insurance. If your state does, you would need to add accounts for that as well.

- ◆ Employer FICA (5905)
- ◆ Employer Unemployment—State (5910)
- ◆ Employer Unemployment—Federal (5915)

We made provisions for an employee's insurance expense account when we set up the chart of accounts, but if you decide to offer other benefits such as retirement, you need to set up expense accounts to track those benefit costs as well.

For example, take a look at this format for the entry to post payroll.

	Debit	Credit
6200 Salaries and Wages	\$	
2300 Accrued Payroll Taxes		\$
2335 Accrued Employee Medical Insurance		\$
2340 Accrued Employee Elective Insurance		\$
1000 Cash in Checking		\$

If you were to decide to track accrued payroll taxes within individual accounts for each payroll type, then you would post the amount to each accrual account individually, and the list of accounts would be much longer. Small businesses with few employees usually have only one balance sheet account for accruing payroll taxes, but as the business grows, more accounts may be added to track each type of payroll tax separately.

Note that we posted a debit to the expense account Salaries and Wages, which increases the balance in that account. Expense accounts carry debit balances, which are subtracted from income accounts (which usually have credit balances) when you prepare the profit and loss statement. We posted credits to the accrued accounts in the liability section of the balance sheet, which increase the balances of those accounts. The credit posted to the Cash in Checking account decreases the balance in this asset account.

You should also post any employer expenses related to payroll as well; such an entry uses the following format.

	Debit	Credit
5900 Payroll Taxes	\$	
5400 Insurance-Employees Group	\$	
2300 Accrued Payroll Taxes		\$
2000 Accounts Payable		\$

Note that we post to the expense accounts using a debit, which increases those balances. The amounts related to the liability accounts are posted as credits, which increases those accounts as well. Basically you are recording the tax and insurance expenses related to that payroll period even though you won't pay these expenses

until they are due. Accrued insurance payments are posted to the Accounts Payable account or to individual payable accounts for each insurance company.

In addition to posting the payroll totals to the affected general ledger accounts, you also need to set up individual records for each employee and post specific employee information on those records. You should set up an employee payroll record card for each employee that includes the following information.

- ◆ Name, address, phone number, Social Security number
- ◆ Department
- ◆ Date started
- ◆ Pay rate
- ◆ Pay period (weekly, biweekly, semimonthly, monthly)
- ◆ Hourly or salaried
- ◆ Exempt or nonexempt
- ◆ W-4 withholding allowances
- ◆ Employee benefits
- ◆ Payroll deductions

Most of this information is entered when the employee is hired and does not have to be updated with each payroll. Adjustments are made either by employee request (such as a decision to change W-4 withholding or benefits) or manager request (such as pay rate change or job classification change). Other changes are made yearly, such as a cost-of-living increase or benefits change.

You should also keep a payroll ledger for each employee that lists the details of each employee's paycheck at the end of each pay period. This detail not only includes pay information, but also includes hours worked and tracks hours used for vacation days, holidays, sick days, and personal leave. In most companies, the payroll is used to manage benefits related to days off and to track how many days each employee has left to take with pay. If all paid benefit days are used and the employee still needs time off, the employee has to take unpaid leave. You need to track the unpaid leave as well and indicate salary reductions.

## Making Payroll Tax Deposits

Although most state and federal tax reports are filed quarterly, you pay your employer taxes more regularly than that unless your total tax liability for the quarter is under \$2,500. The only exception is federal unemployment tax reports, which are filed annually. Federal unemployment taxes are paid quarterly, but if your quarterly liability is below \$100 you don't need to pay unemployment taxes until the liability is above \$100. If your annual liability is below \$100, you can pay that amount when you file the annual report.

How often you need to pay taxes depends on the size of your payroll. The following sections explain how you go about paying employer taxes. The next chapter covers the details of filing tax reports.

## Federal Withholding, Social Security, and Medicare

Whenever your business's federal tax liability (including both employer and employee's taxes) is more than \$2,500 per quarter, you must pay these taxes more frequently than once per quarter. Companies with a tax liability of less than \$50,000 per year can make these payments monthly; otherwise, these payments are made semiweekly.

Tax deposits, whether made monthly or semiweekly, are paid to an authorized financial institution or the Federal Reserve Bank in your area. You can make these deposits electronically using the Federal Electronic Tax Payment System (EFTPS) or by using Form 8109, "Federal Tax Deposit (FTD) Coupon," which is shown in the following figure.

Darken only one TYPE OF TAX		FEDERAL RESERVE BANK	Darken only one TAX PERIOD	
TYPE OF TAX	TYPE OF TAX		TAX PERIOD	TAX PERIOD
<input type="checkbox"/> 941	<input type="checkbox"/> 945		<input type="checkbox"/> 1st Quarter	
<input type="checkbox"/> 990-C	<input type="checkbox"/> 1120		<input type="checkbox"/> 2nd Quarter	
<input type="checkbox"/> 943	<input type="checkbox"/> 990-T		<input type="checkbox"/> 3rd Quarter	
<input type="checkbox"/> 720	<input type="checkbox"/> 990-PF		<input type="checkbox"/> 4th Quarter	
<input type="checkbox"/> CT-1	<input type="checkbox"/> 1042			
<input type="checkbox"/> 940				

35

FOR BANK USE IN MICR ENCODING

Federal Tax Deposit Coupon  
Form 8109-B (Rev. 12-2000)

*Employers use this coupon to pay their taxes.*

You can see in the picture of the coupon that you must indicate the purpose of the payment and the quarter for which you are making the payment. There are many tax types from which to select, but most will not be relevant to your business. Here are the possibilities.

- ◆ Form 941, “Employer’s Quarterly Federal Tax Return.” This form includes federal withholding taxes, Social Security taxes, and Medicare taxes.
- ◆ Form 990-C, “Farmer’s Cooperative Association Income Tax Return.”
- ◆ Form 943, “Employer’s Annual Tax Return for Agricultural Employers.”
- ◆ Form 720, “Quarterly Federal Excise Tax Return.” This form is specific to the aviation industry.
- ◆ Form CT-1, “Employer’s Annual Railroad Retirement Tax Return.”



**Biz Tips**

If you are just starting out, you’ll be sent a Federal Tax Deposit (FTD) coupon book when you receive your employer identification number. The IRS tracks the number of coupons you use and automatically sends you additional FTD coupons when you need them.

- ◆ Form 940, “Employer’s Annual Federal Unemployment Tax.”
- ◆ Form 945, “Annual Return of Withheld Federal Income Tax.”
- ◆ Form 1120, “Corporation Income Tax Return.”
- ◆ Form 990-T, “Exempt Organization Business Income Tax Return.”
- ◆ Form 990-PF, “Return of Private Foundation.”
- ◆ Form 1042, “Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.”

You also must be certain that you include the correct employer identification number and name on the tax deposit coupon. The IRS uses this coupon to credit your account, so be sure to recheck the information carefully before making your deposit. Also, remember to make the check or money order payable to the financial institution or Federal Reserve Bank where you make your deposit, not to the IRS.

New employers usually start out as monthly depositors for the first year. All other employers follow a payment schedule based on the amount of taxes paid previously.

Employers who must pay taxes monthly do so by the fifteenth day of the following month. For example, your January taxes would be paid on February 15. If the date your taxes are due falls on a Saturday, Sunday, or legal holiday, the deposit is due on the next banking day.

Employers who pay semiweekly must deposit taxes on or before Wednesday or Friday, based on the following schedule.

1. The employment taxes on payments made to your employees on Wednesday, Thursday, and/or Friday must be deposited by the following Wednesday.
2. The taxes on payments made to your employees on Saturday, Sunday, Monday, and/or Tuesday must be deposited by the following Friday.

Larger employers that accumulate taxes of \$100,000 or more on any day during a deposit period must deposit them on the next banking day. If this \$100,000 deposit rule applies and you are a monthly schedule depositor, you become a semiweekly depositor at least for the remainder of the current tax year and the next tax year.

Employers who make tax payments of more than \$200,000 in any tax year are required to deposit these taxes electronically using EFTPS. Otherwise, participation in the electronic filing system is voluntary.

## Federal Unemployment Taxes

You use the same coupon to pay your unemployment taxes. You only need to pay these taxes quarterly and possibly even less frequently if the amount due is less than \$100 in any one quarter. For example, if you owe only \$50 per quarter on federal unemployment taxes, you can pay the taxes once every two quarters. If a payment is due, it should be paid by the fifteenth day after the end of each quarter.

## State Unemployment Taxes

States collect their taxes quarterly. Some even let businesses file their reports online. For example, Georgia companies can file and pay their quarterly unemployment taxes at this site ([www.dol.state.ga.us/em/tax\\_and\\_wage\\_reports.htm](http://www.dol.state.ga.us/em/tax_and_wage_reports.htm)).

As mentioned in the last chapter, each state has its own set of rules for how much you have to pay in unemployment taxes and how you must pay those taxes. The one consistency is that the tax reports are filed quarterly. Here is the schedule.

Reporting Period	Due Date of Reports
January 1 to March 31	On or before April 30
April 1 to June 30	On or before July 31
July 1 to September 30	On or before October 31
October 1 to December 31	On or before January 31

Most states will issue a tax lien against the business if the taxes are not filed and paid on time. Penalties and interest also are charged for late payments. If the taxing authority must go to court to collect taxes, any court or processing costs are in addition to any taxes, interest, and penalties charged.

## Avoiding Tax Penalties

You certainly want to avoid having to pay penalties and interest. Your tax bite is high enough. The only way to avoid penalty and interest charges is to be sure your payments are made in a timely manner.



### Audit Alarms

If you have been assessed penalties, don't ignore them. Pay them or talk with the taxing authority to see if you can get them reversed. Ignoring penalties and interest will only incur additional penalties and interest on the unpaid balance.

A company may have a hard time estimating the full quarterly tax bill because so many variables exist. If you are unsure of your liability, you are better off making slightly higher payments each month rather than getting socked with penalty or interest payments at the end of a quarter because you underpaid your taxes. If you've overpaid, it's much easier to pay less on the last payment that quarter than to risk being hit with penalties or interest for underpayment of taxes. Penalties can be as high as 20 percent of the unpaid tax liability.

If the payment due date falls on a Saturday, Sunday, or other bank holiday, the tax is due the next banking day. You must deposit 100 percent of the tax due before the end of the quarter to avoid penalties or interest. There is some leeway for errors if the shortfall is not substantial. You may even be able to get tax penalties reversed if you give the taxing authority a valid reason for the delay in paying taxes.

## Workers' Compensation

We haven't yet touched on one other liability your business will incur after you start hiring employees: workers' compensation. Workers' compensation is insurance coverage for claims related to injuries on the job. The only state in which you are not required to carry this insurance is Texas.

Benefits to the employee can include payments for loss of income, medical expenses, vocational rehabilitation, and death benefits if an employee is injured on the job. Some states have a state-based workers' compensation fund in which employers must participate; other states allow you to participate in the state insurance program or buy



insurance from a private company. About half the states allow you to work with HMOs, PPOs, or other managed-care providers to handle workers' claims.

Each state has its own set of rules regarding how much medical coverage you must provide and the percentage of lost wages you must pay. Some states even require the company to pay for funeral expenses and financial support for dependents as part of workers' compensation benefits. Some state rules even specify who gets to pick the physician who cares for the injured employee, which can be the employer, employee, the state, or a combination of these. Many states have an approved list of physicians who provide care under workers' compensation rules.

You won't find a lot of variation in the cost of workers' compensation insurance in your state. The premiums are usually based on a rate classification from either a national rating bureau called the National Council on Compensation Insurance (NCCI) or from a state rating bureau. Rates are calculated based on risks within your company's business classifications. If your type of business has a high rate of employee injury, your base rate for insurance will be higher.



#### Audit Alarms

Your business can be closed down if an employee is injured on the job and you don't have workers' compensation insurance. Depending on the type of business organization you have (as discussed in Chapter 1), you can be held personally liable.

If your state does allow you to buy Workers' Compensation Insurance through private companies, there is some competition. Insurers can give discounts for companies that have good safety standards in place and a low history of claims. The best way to keep costs down is to offer safe working conditions and maintain good records of your claims history.

Small businesses with fewer than four or five employees may not be required to carry workers' compensation insurance in certain states. Other states require the insurance only for certain types of job classifications. You'll have to research the requirements for your state by contacting the state labor department or working with your insurance agent.

## Conforming to Federal and State Regulations

After reading these chapters on federal and state regulations regarding your employees and their wages, you may think you'll never be able to master all these rules. The good news is that after you learn the federal rules, you'll probably find that most of your state rules mirror the federal requirements.



**Biz Tips**

You can seek assistance through your state labor department as you learn the ropes. You also can find a lot of resources online at the U.S. Department of Labor ([www.dol.gov/dol/topic/index.htm](http://www.dol.gov/dol/topic/index.htm)).

When you get your employer identification numbers from the federal and state governments, you will receive full information about relevant federal and state tax and labor laws. You also should be sent automatically any forms you need in order to file employer-related reports. But if you don't receive the form you cannot use that fact as a defense for not filing. So if you're not sure about what you need to file, be sure to talk with your tax and legal advisors.

The next chapter reviews the forms you need to file with the federal and state agencies related to your payroll and your employees.

## The Least You Need to Know

- ◆ Employers pay federal income, Medicare, and Social Security taxes either monthly or semiweekly depending on the size of their payroll.
- ◆ Federal unemployment taxes are paid quarterly unless the amount due is less than \$100. State unemployment taxes are also paid quarterly.
- ◆ Your business can incur a 20 percent penalty and interest on unpaid or underpaid taxes. One hundred percent of taxes must be deposited by the due date.
- ◆ You must carry Workers' Compensation Insurance in every state but Texas. Some states require you to carry insurance only on employees in certain job classifications, and some states require this insurance only if you have five or more employees.

# Chapter 16

## Reporting Employee Costs

### In This Chapter

- ◆ Employee tax records
- ◆ Tax reports
- ◆ Reporting unemployment taxes
- ◆ Owner's tax options

Phew. We're sure you are glad to be through with the details about payroll taxes and benefits rules. We're certainly glad it's over.

No question, maintaining accurate payroll records is the most difficult task accounting has with regard to employees. Aren't you glad you don't have to learn all the federal and state rules related to human resource issues and only have to worry about the numbers?

Now we'll move on to how you use all the information you've collected about your employees (their pay, their deductions, and their benefits) to complete the quarterly reports to federal and state governments.

### Preparing Employee Ledgers

Before you can even start preparing the quarterly reports, you first must make sure your employee ledgers are up-to-date. We'll assume you have

posted to all employee ledgers and now just need to pull the quarterly information together.



**Biz Tips**

You do need to track employee benefit contributions as well in the ledger even if they are not taxable, but you don't need this information to prepare the quarterly reports. The benefit numbers are an important part of the year-end payroll reports that we'll be discussing in Chapter 23.

Let's revisit the records of the three employees we introduced in Chapter 13. Just to make it easier to work with these numbers for reporting purposes, we're going to assume that \$1,300 represented taxable wages and tax exempt benefits have already been taken out of the numbers.

We're going to assume you post to these ledgers monthly, after you close the books. We'll be taking a closer look at how you close the books in the next section. In 2005, January had five pay weeks—employees are paid on Monday and there were five

Mondays in January that year. Books were closed and posted on February 3. February had four pay weeks with books closed and posted on March 3. March had four pay weeks also with books closed and posted on April 1. Here is what the ledgers should look like for the three employees we introduced in Chapter 13.

Jack  
 Address  
 Pay Information SS#  
 M-7  
 Benefit Information

Date	Taxable Wages	SS	Med	Fed WH	State WH	Net Check
2/3	\$6,500	\$403.00	\$94.25	\$515	\$77.25	\$5,410.50
3/3	\$5,200	\$322.40	\$75.40	\$412	\$61.80	\$4,328.40
<u>4/1</u>	<u>\$5,200</u>	<u>\$322.40</u>	<u>\$75.40</u>	<u>\$412</u>	<u>\$61.80</u>	<u>\$4,328.40</u>
1st Q	\$16,900	\$1,047.80	\$245.05	\$1,339	\$200.85	\$14,067.30

Judy  
 Address  
 Pay Information SS# S-1  
 Benefit Information

Date	Taxable Wages	SS	Med	Fed WH	State WH	Net Check
2/3	\$6,500	\$403.00	\$94.25	\$1,250	\$187.50	\$4,565.25
3/3	\$5,200	\$322.40	\$75.40	\$1,000	\$150.00	\$3,652.20
<u>4/1</u>	<u>\$5,200</u>	<u>\$322.40</u>	<u>\$75.40</u>	<u>\$1,000</u>	<u>\$150.00</u>	<u>\$3,652.20</u>
1st Q	\$16,900	\$1,047.80	\$245.05	\$3,250	\$487.50	\$11,869.65

Jane  
 Address  
 Pay Information SS# M-3  
 Benefit Information

Date	Taxable Wages	SS	Med	Fed WH	State WH	Net Check
2/3	\$6,500	\$403.00	\$94.25	\$700	\$105.00	\$5,197.75
3/3	\$5,200	\$322.40	\$75.40	\$560	\$84.00	\$4,158.20
<u>4/1</u>	<u>\$5,200</u>	<u>\$322.40</u>	<u>\$75.40</u>	<u>\$560</u>	<u>\$84.00</u>	<u>\$4,158.20</u>
1st Q	\$16,900	\$1,047.80	\$245.05	\$1,820	\$273.00	\$13,514.15

After you've calculated all your employee ledger sheets for the quarter, you would then compile the quarterly totals on a new worksheet for the quarter. Here is how that worksheet would look.

Emp SS#	Taxable Wages	SS	Med	Fed WH	State WH
Jack SS#	\$16,900	\$1,047.80	\$245.05	\$1,339	\$200.85
Judy SS#	\$16,900	\$1,047.80	\$245.05	\$3,250	\$487.50
Jane SS#	\$16,900	\$1,047.80	\$245.05	\$1,820	\$273.00
1st Q	\$50,700	\$3,143.40	\$735.15	\$6,409	\$961.35

You don't need to include a column for the net check. That information is not needed for the quarterly reports.



**Business Bites**

"The hardest thing in the world to understand is the income tax." —Albert Einstein

Total taxes due to the federal government based on employee withholding are \$10,287.55, which include \$3,143.40 for Social Security, \$735.15 for Medicare, and \$6,409 for income tax withholding. Withholding at the state level was \$961.35. We will assume these federal payments were made monthly using the FTD coupons as discussed in the last chapter and state payments were made using the form or coupon required by your state.

Remember that matching payments for the employer's portion of Social Security and Medicare also would need to be made, which would increase the total based on employee payroll to \$14,673.10 (\$3,143.40 for Social Security and \$735.15 for Medicare).

Tax totals are:

Federal Withholding	= \$6,409.00
Social Security	= \$6,286.80
Medicare	= \$1,470.30
State Withholding	= \$961.35

You should double-check your figures by multiplying the total taxable income times the required contributions.

For Social Security:  $\$50,700 \times 12.4\% = \$6,286.80$

For Medicare:  $\$50,700 \times 2.9\% = \$1,470.30$

Now you have all the information you need to complete the quarterly reports. Quarterly reports for the first quarter will be due on or before April 30. Here is a chart that shows when quarterly reports are due each year.

---

<b>Reporting Period</b>	<b>Due Date of the Reports</b>
January 1 to March 31	On or before April 30
April 1 to June 30	On or before July 31
July 1 to September 30	On or before October 31
October 1 to December 31	On or before January 31 of the next year

---

Now let's take a look at the key reports you will need to file.

## **Federal Payroll Tax Reports**

Luckily on the federal side there is only one form you need to file to report all your payroll related taxes—Form 941, “Employer’s Quarterly Federal Tax Return.” After you’ve completed your quarterly spreadsheets, it is a rather easy form to fill out.

As you can see in the sample form that we completed, the calculations are very simple. Here is a line-by-line explanation:

Line 1 is the number of employees on the payroll (only required for March).

Line 2 is the total wages.

Line 3 is the total federal income tax withheld.

Line 4 is blank because we have no adjustments for preceding quarters.

Line 5 is the same as Line 3 because there were no adjustments.

Line 6 is the Social Security taxes.

Line 7 is the Medicare taxes.

Line 8 totals Lines 6 and 7.

Line 9 allows you to make adjustments to Social Security and Medicare taxes, if any.

Line 10 totals Lines 8 and 9.

Line 11 totals Lines 5 and 10.

Line 12 allows you to report any advances to Earned Income Credit.

Line 13 is used to figure net taxes by subtracting Line 12 from Line 11.

Line 14 is where you state the total of your FTD coupon or electronic EFTPS payments for the quarter.

Line 15 is where you indicate any balance due.

Line 16 is where you indicate any overpayment and designate whether you want it to be applied to the next return or refunded to you.

Line 17 is where you indicate your monthly liability for the quarter. If you are a larger employer and have to file semiweekly payments, then you would need to attach Schedule B to list your semiweekly liability. The detail provided on Line 17 is used by the IRS to decide whether to penalize you. The IRS compares the weekly or monthly liability to the actual payments.

**VERSION B**

**Form 941 for 2005: Employer's Quarterly Federal Tax Return** 9901

(Rev. January 2005) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

Employer identification number  -

Name (not your trade name)

Trade name (if any)

Address

Number Street Suite or room number

City State ZIP code

**Report for this Quarter ...**  
(Check one.)

1: January, February, March

2: April, May, June

3: July, August, September

4: October, November, December

Read the separate instructions before you fill out this form. Please type or print within the boxes.

**Part 1: Answer these questions for this quarter.**

**1** Number of employees who received wages, tips, or other compensation for the pay period including: Mar. 12 (Quarter 1), June 12 (Quarter 2), Sept. 12 (Quarter 3), Dec. 12 (Quarter 4) . . . . . **1**

**2** Wages, tips, and other compensation . . . . . **2**

**3** Total income tax withheld from wages, tips, and other compensation . . . . . **3**

**4** If no wages, tips, and other compensation are subject to social security or Medicare tax . . .  Check and go to line 6.

**5** Taxable social security and Medicare wages and tips:

	Column 1	Column 2
<b>5a</b> Taxable social security wages <input type="text"/> × .124 = <input type="text"/>		
<b>5b</b> Taxable social security tips <input type="text"/> × .124 = <input type="text"/>		
<b>5c</b> Taxable Medicare wages & tips <input type="text"/> × .029 = <input type="text"/>		
<b>5d</b> Total social security and Medicare taxes (Column 2, lines 5a + 5b + 5c = line 5d) . . . . . <b>5d</b> <input type="text"/>		

**6** Total taxes before adjustments (lines 3 + 5d = line 6) . . . . . **6**

**7** Tax adjustments (If your answer is a negative number, write it in brackets.):

<b>7a</b> Current quarter's fractions of cents . . . . . <input type="text"/>
<b>7b</b> Current quarter's sick pay . . . . . <input type="text"/>
<b>7c</b> Current quarter's adjustments for tips and group-term life insurance . . . . . <input type="text"/>
<b>7d</b> Current year's income tax withholding (Attach Form 941c) . . . . . <input type="text"/>
<b>7e</b> Prior quarters' social security and Medicare taxes (Attach Form 941c) . . . . . <input type="text"/>
<b>7f</b> Special additions to federal income tax (reserved use) . . . . . <input type="text"/>
<b>7g</b> Special additions to social security and Medicare (reserved use) . . . . . <input type="text"/>
<b>7h</b> Total adjustments (Combine all amounts: lines 7a through 7g.) . . . . . <b>7h</b> <input type="text"/>

**8** Total taxes after adjustments (Combine lines 6 and 7h.) . . . . . **8**

**9** Advance earned income credit (EIC) payments made to employees . . . . . **9**

**10** Total taxes after adjustment for advance EIC (lines 8 - 9 = line 10) . . . . . **10**

**11** Total deposits for this quarter, including overpayment applied from a prior quarter . . . . . **11**

**12** Balance due (lines 10 - 11 = line 12) Make checks payable to the *United States Treasury* . . . **12**

**13** Overpayment (If line 11 is more than line 10, write the difference here.)   Check one  Apply to next return.  Send a refund.

**Next**

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 1-2005)

Sample Federal Form 941, "Employer's Quarterly Federal Tax Return."



VERSION B

9902

Name (not your trade name) Employer identification number

**Part 2: Tell us about your deposit schedule for this quarter.**

If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see Pub. 15 (Circular E), section 11.

14   Write the state abbreviation for the state where you made your deposits OR write "MU" if you made your deposits in multiple states.

15 Check one:  Line 10 is less than \$2,500. Go to Part 3.  
 You were a monthly schedule depositor for the entire quarter. Fill out your tax liability for each month. Then go to Part 3.

Tax liability: Month 1  .  
 Month 2  .  
 Month 3  .  
 Total  . Total must equal line 10.

You were a semiweekly schedule depositor for any part of this quarter. Fill out Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors, and attach it to this form.

**Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.**

16 If your business has closed and you do not have to file returns in the future . . . . .  Check here, and enter the final date you paid wages  /  / .

17 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . .  Check here.

**Part 4: May we contact your third-party designee?**

Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.

Yes. Designee's name   
 Phone (  ) -  Personal Identification Number (PIN)

No.

**Part 5: Sign here**

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

**X** Sign your name here   
 Print name and title   
 Date  /  /  Phone (  ) -

**Part 6: For paid preparers only (optional)**

Preparer's signature   
 Firm's name   
 Address  EIN   
 ZIP code   
 Date  /  /  Phone (  ) -  SSN/PTIN   
 Check if you are self-employed.



**Biz Tips**

If your tax due for the quarter is less than \$2,500, you don't have to make monthly payments. Instead you can pay the quarterly tax when you file Form 941. There is a voucher as part of Form 941 that small employers can use to pay their taxes.

Surprised it's that easy? Yes, getting to this point was time-consuming and sometimes confusing, but after you have the numbers calculated the actual reporting is relatively simple. The key is to keep your employee ledgers up-to-date on a monthly basis, so that developing the quarter worksheet is relatively painless.

You may wonder why we developed the worksheet with details about each employee. You don't need it for the federal quarterly reports, but you will need it for your state reports.

## State Payroll Tax Reports

Unfortunately, the state side of the equation is much more difficult to complete. States do need to have the detail by employee name and Social Security number because they need this information to manage the unemployment records.

Some states have you file the detail as part of a quarterly wage and tax report; others have a simple report for the state income tax and a more detailed report for unemployment. In Chapter 15, we showed you how employers from Georgia could file their unemployment report online.

Georgia requires employee details to be filed with its "Employer's Quarterly Tax and Wage Report." Part I can be as many pages as an employer needs to list its employees. Part II is a simple one-page document that is used to report income taxes. The Georgia report is shown on the following pages.

Each state has its own forms, so we've just included Georgia to give you one example.

There are nine states in which you will not have to worry about filing state income tax forms—Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. The states do not have an income tax on wages. New Hampshire and Tennessee do tax dividends and interest.

If you are operating a business in one of these states and all your employees work in that state, then you won't have to worry about filing state income tax forms. There is no getting around the unemployment forms. Those are needed in every state.

Some states allow you to file all these forms electronically and even require electronic transmission for large companies.

<b>EMPLOYER'S QUARTERLY TAX AND WAGE REPORT - PART I</b> <small>GEORGIA DEPARTMENT OF LABOR-- P.O. BOX 740234 - ATLANTA, GA 30374-0234 Tel: (404) 656-3145</small>				
REPORT FOR THE QUARTER ENDING _____				
Attach any wage sheets to this page. Use BLACK ink only.		DOL Account Number	Qtr/Yr	Total Tax Rate   Form must be Filed By
<p>Parts I &amp; II of this report must always be submitted. Enter zeroes in TOTAL GROSS WAGES PAID THIS QUARTER if no wages were paid for this quarter.</p>				
1. Social Security Number	2. Employee's Name		3. Total Individual Wages Paid This Quarter	
	<small>Last</small>	<small>First</small> <small>MI</small>		
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
_____	_____	_____	\$ _____	
PAGE ____ OF ____ WAGE SHEETS			TOTAL WAGES FOR THIS PAGE \$ _____	
(Enter this amount on PART II, Line 2) _____			TOTAL GROSS WAGES PAID THIS QUARTER \$ _____	
MESSAGE AREA				
<small>EL3103 DOL-4N (R-9/97)</small>				

*Part I of the Georgia Employer's Quarterly Tax and Wage Report.*

**EMPLOYER'S QUARTERLY TAX AND WAGE REPORT - PART II**  
 GEORGIA DEPARTMENT OF LABOR - P.O. BOX 740234 - ATLANTA, GA 30374-0234 Tel. (404) 656-3145  
 REPORT FOR THE QUARTER ENDING

**ELECTRONIC FORM PROCESSING**  
 DO NOT staple any items to this page.  
 Use BLACK ink only.

DOL Account Number | Qtr/Yr | Total Tax Rate | Form must be Filed By

**FORM ENTRY EXAMPLE:**  
 (PLEASE PRINT CLEARLY)

1 | 2 | 6 | 9 | 0 | 0

1. For each month, report the number of covered workers who worked during or received pay for the payroll period which includes the 12th of the month -----

	(1ST MONTH)	(2ND MONTH)	(3RD MONTH)
2. Total GROSS WAGES Paid This Quarter----- \$			
3. MINUS Non-Taxable Wages Paid This Quarter---			
4. TAXABLE WAGES Paid This Quarter-----			
5. Contribution Tax Due: X taxable wages (line 4) -----			
6. Administrative Assessment Due: X taxable wages (line 4) -----			
7. Interest On Lines 5 and 6: See Instructions Due after -----			
8. Penalty is for filing late, not based on total amount due:(See Instructions) Due after -----			
9. Balance as of -----			
10. TOTAL AMOUNT DUE : (SUM of lines 5 thru 9)----- \$			

PARTS I & II OF THIS REPORT MUST ALWAYS BE SUBMITTED. ENTER ZEROS ON LINE 2 IF NO WAGES WERE PAID THIS QUARTER.

UNLESS PARTS I & II OF THIS REPORT ARE FILED AND THE TOTAL AMOUNT DUE IS PAID, A F.I. FA. (TAX LIEN) WILL BE ISSUED AS REQUIRED BY LAW. **Return these original forms (Parts I & II) with check payable to GA DEPT of LABOR.**

FOR DEPT USE ONLY

Phone (404) 656-5590 **EMPLOYER CHANGE REQUEST** - If ANY of the following items have changed, please complete the appropriate information below.

**A.** If you are a new employer, or the name of your business or MAILING ADDRESS has changed, or is incorrect, enter the correct information below:

(Business Name) \_\_\_\_\_

(Street Address) \_\_\_\_\_

(Street Address) \_\_\_\_\_

(City) \_\_\_\_\_ (State) \_\_\_\_\_ (Zip) \_\_\_\_\_

(Phone) \_\_\_\_\_

**B.** If the PRINCIPAL LOCATION of your business operations in GEORGIA has changed, enter the correct address below (DO NOT use a P.O. Box number for Principal Location):

(Street Address) \_\_\_\_\_

(Street Address) \_\_\_\_\_

(City) \_\_\_\_\_ (State) \_\_\_\_\_ (Zip) \_\_\_\_\_

(Phone) \_\_\_\_\_

**C.** As a new employer, enter your Federal Identification number below.

\_\_\_\_\_ - \_\_\_\_\_

If the Federal ID number changed due to a change in ownership, complete section D.

**D.** If your business was discontinued or if a change in ownership has occurred, please complete the following:

(Check One)

Business Discontinued     Entire Business Sold     Corporation Formed

Partners Added or Withdrawn     Merger     Partial Sale

Corporate Name Change Only (Attach copy of Amendment to Charter)

Other (Attach Explanation)

Effective Date (MM/DD/YY) \_\_\_\_/\_\_\_\_/\_\_\_\_

(New Owner's Name) \_\_\_\_\_

(Street Address) \_\_\_\_\_

(Street Address) \_\_\_\_\_

(City) \_\_\_\_\_ (State) \_\_\_\_\_ (Zip) \_\_\_\_\_

(Phone) \_\_\_\_\_

I certify that the information contained in this report and any subsequent pages attached is true and correct and that no part of the tax will or is to be deducted from the worker's wages.

(Employer Name and Address) \_\_\_\_\_

Signature and title of individual responsible for information provided \_\_\_\_\_

Phone No. \_\_\_\_\_ Date \_\_\_\_\_  
 EL3104 DOL-4N (R-9/97)

Part II of the Georgia Employer's Quarterly Tax and Wage Report.

## Unemployment Reports

If your state has a simple income tax reporting form or no income tax reporting form, then you will have an unemployment form similar to Part I of the Georgia Employer's Quarterly Tax and Wage Report.

As mentioned previously, states must maintain quarterly records of every employee's earnings. These records are used to determine unemployment benefits if the employee is laid off or fired. Calculating state unemployment tax isn't that difficult using the quarterly worksheet we developed.

The basic information that states need for each individual is the name, Social Security number, and total quarterly wages. Other information may be required in some states. For example, the number of weeks worked is required to determine eligibility in some states. After you add the total wages together, which in our example was \$50,700, that is the only number you need to calculate unemployment taxes. Since we are using Georgia as an example for the forms, we'll use its unemployment tax rate. Remember, each state sets its own rate.

Georgia's wage base for unemployment is \$8,500 and the tax rate for new employers is 2.62 percent, so we'll use that rate in this example. All three employees exceed that base, so we'll multiply  $\$8,500 \times 3$  to find the base, which is \$25,500. After you know the base, you multiply that by the tax rate. Here is the unemployment tax due for our practice company.

$$\$25,500 \times .0262 = \$668.10.$$

In addition to state unemployment taxes, a company would also need to pay federal unemployment taxes. The base salary for federal unemployment taxes is \$7,000 and the tax rate is .8 percent. The federal rate can be up to 6.2 percent but a credit for state unemployment tax of up to 5.4 percent is allowed, so the actual rate employers use to calculate federal unemployment tax is the difference between the two maximums or  $6.2 - 5.4 = .8$  percent. Calculating federal unemployment taxes, the total due would be

$$\$21,000 (\$7,000 \times 3) \times .008 = \$168.$$

Because this amount exceeds \$100, the employer does need to make a payment for this quarter using the FTD coupon and indicating that this is a payment toward Form 940, "Employer's Annual Federal Unemployment Tax." Form 940 is filed once a year, so only a payment is needed at the end of the first quarter. At least that's one less form to worry about.

## Your Tax Reports

So far, we've discussed how you as an owner pay your employees' taxes. When it comes to your own taxes, this involves different types of forms, depending on how you have organized your business.

If you are a sole proprietor, you would report all your earnings on a Schedule C, "Profit or Loss from a Business or Profession" at the end of the year. Any funds you withdraw from the business during the year should be tracked in the Equity account, Drawing (3400).

### Accounting Answers

Remember, the Drawing account does not affect the profit or loss of your company. When you calculate your P&L and determine your net income, the amount you withdrew for personal use is not included there. Instead, draws impact the equity side of the balance sheet.

As a sole proprietor, you don't include any of your personal estimated tax payments on the employer's federal forms. Instead you make quarterly estimated tax payments using Form 1040-ES. This should include your Social Security and Medicare taxes due, as well as your income taxes. As an employer you will have to pay both the employee and employer share of the Medicare and Social Security taxes.

If your company is organized as a partnership, then you would file an information report, Form 1065, which will include a Schedule K-1, "Shareholder's

Share of Income, Credits, Deductions, etc.," for each partner. The partners use this form to report their income and expenses from the business on their individual tax returns. Partners also make estimated payments using Form 1040-ES.

If you have decided to incorporate your company or have decided to pay your company taxes as though you were a corporation, then you can include yourself as an employee, pay yourself a wage, and be listed along with your other employees on the payroll tax reports.

Now that we've got all the nitty-gritty out of the way, we're going to move on to closing the books for the month.

## The Least You Need To Know

- ◆ Keeping your employee ledgers up-to-date is critical so you can prepare the required state and federal quarterly tax reports.
- ◆ Each quarter you must file Form 941, "Employer's Quarterly Federal Tax Return."

- ◆ Each quarter you must also file two reports at the state level—one for income taxes and one for unemployment taxes. If you are in one of the nine states that doesn't have an income tax on wages, then you only need to file the unemployment report. Some states may require other payroll-related reports as well.





# Part 4

## Closing Out the Books

Each month you want to get a snapshot of how your business is doing by closing the books. We'll show you how to close out your cash journals and employee accounts. Then we'll teach you how to balance ledgers and finally, how to test all your hard work.





# Chapter 17

## Closing Cash Journals

### In This Chapter

- ◆ Money closing
- ◆ Credit costs
- ◆ Bill delaying
- ◆ Temporary solutions

After a month's worth of business activity, you definitely want to see how you are doing. At the end of each month you need to do a series of accounting tasks to be certain everything proves out correctly. This also gives you a good handle on your business's income and expenses.

Basically you start this process from the bottom up. In other words, you check your balances in subledgers or journals to be sure they are correct. Then you match these numbers to the control accounts in the general ledger, such as Accounts Receivable and Accounts Payable, and finally you prove out the general ledger. After all that is done, you are ready to develop your financial statements for the month.

Let's start with the lowest rung—proving out your cash receipts and cash disbursements journals.

## Closing Cash Receipts Journal

We're going to revisit our make-believe company, Lisa's Candle Shop, and take the company's books through a month-end closing. Our first stop is the cash receipts journal. This is the subledger where a business tracks the details of its daily cash receipts, including cash, credit cards, and store credit. Only summaries of the day's receipts are posted to the general ledger.

You may remember in Chapter 7 we had this summary of the day's receipts for Lisa's Candle shop on February 15, 2005.

Date: 2/15/2005		
Cashier: Sally Smith		
Beginning Cash		\$50.00
Cash Sales	\$200.00	
Credit Card Sales	\$400.00	
Store Charge Sales	\$350.00	
Total Sales		\$950.00
Sales on Credit		\$750.00
Cash Received		\$200.00
Total Cash in Register		\$250.00

Although we know a business would not have the exact same number of sales at the exact same level each day, we're going to take a shortcut and make believe Lisa's Candle shop does. To find her total sales for the month, we're going to multiply these numbers by 28 for the days of February and assume the monthly totals represent actual month-end numbers. Also, to simplify this example, we'll put Lisa, as the owner, in charge of closing the books. Most owners have an accountant or staff person who takes this responsibility.

## Summarizing Cash and Credit Transactions

First, let's summarize the cash and credit transactions.

Cash Sales	\$5,600
Credit Card Sales	\$11,200

Store Charge Sales	\$9,800
Total Sales	\$26,600

You may remember that we indicated Lisa's Candle Shop took out 5 percent for taxes, so our total Sales Tax Collected would be \$1,330 ( $\$26,600 \times 5\%$ ).

## Understanding Monthly Credit Card Fees

If you decide to accept credit cards, there are a number of monthly fees you'll need to understand. When checking out pricing be sure you know which fees will be charged to your business on a monthly basis.

- ◆ **The Address Verification Service Fee (AVS)** is a key prevention measure for fraud when credit card sales are accepted. This is primarily used by businesses that take orders by phone or e-mail and do not have the credit card in hand to verify a signature. There is a per-transaction fee to use this service.
- ◆ **The Discount Rate** is a charge based on a percentage of the dollar sale or return transaction. This rate varies greatly depending on the type of business. If you use a terminal to swipe cards, the fees are usually lower because the possibility of key-entry errors is eliminated.
- ◆ **The Secure Payment Gateway Fee** is a service provided to e-commerce merchants so they can process transactions securely over the Internet. This is usually a set monthly fee.
- ◆ **The Customer Support Fee** is charged monthly by some banks if the store wants support 24 hours a day for 365 days a year. In some cases support is offered in more than one language.
- ◆ **The Monthly Minimum Fee** is the least a store must pay to accept credit cards even if the credit sales do not generate enough in transaction fees. This fee usually ranges between \$10 and \$30. If you are going to accept credit cards, be sure you'll meet the minimum or you could find the convenience offered to a few customers may end up costing you more than it's worth.
- ◆ **The Transaction Fee** is a fee assessed for each transaction submitted for authorization. Even if the card is denied, your business will have to pay this fee for trying to make the transaction.
- ◆ **Equipment and Software Fees** are fees based on the equipment and computer software you decide to use. In most cases credit card equipment is purchased or leased.
- ◆ **Chargeback and Retrieval Fees** are fees charged if a transaction is disputed.

## Accepting Credit Cards

Before getting into the specifics of closing Lisa's cash receipts journal, let's take a brief side trip to discuss the topic of choosing a bank to handle your credit card services. This can be an important choice that can affect the service you offer your customers, as well as the service your sales people get when they process credit card purchases.

You should make your choice carefully after getting proposals from numerous banks. Not only must you understand the monthly fees your business will be charged, but you also need to compare start-up fees. Your best bet is to develop a spreadsheet so you can easily compare these costs.

Also, don't make your decision solely on the basis of fees. You may find the lowest cost provider does not offer the service you need or has hidden fees that are not readily apparent in the proposal. Ask for and check references from other stores actually using the banks you are considering before making a final selection.

## Recording Credit Card Costs

Now back to closing the books. Lisa chose to work with the bank that handles all her business accounts and has a fairly simple arrangement with fees totaling 2 percent of all credit card sales. So the credit card charges that would have been taken out of the month's sales should total \$224 ( $\$11,200 \times 2\%$ ).

At the end of the month, Lisa will receive a statement that shows her transactions and fees for the month. Banks do not bill credit card charges and expect a company to pay the bill. Instead, credit card fees are calculated by the bank and then deducted from the account to which the credit card purchases have been deposited. This is similar to the way banks handle charges for checking accounts. The details of all charges are sent with a month-end summary of credit card transactions. In addition to fees, any chargebacks related to disputed charges are deducted from the account and reported in this summary.

When Lisa gets her month-end summary, she needs to be certain that all costs or deductions related to credit card sales are properly recorded in her books. Credit card costs would be shown in the Cost of Sales section of the P&L because they are costs directly related to sales. We need to add a new account in the chart of accounts—Credit Card Fees (4360). Here is the entry Lisa would use to record the monthly credit card costs.

	Debit	Credit
4360 Credit Card Fees	\$224	
1000 Cash in Checking		\$224
To record credit card fee charges for the month of February.		

In this entry, the balance in the Credit Card Fees account would increase and the balance in Cash in Checking would decrease. The bank has already reduced the balance in your checking account. With this entry you are just recording the reduction in the company books, not writing a check.

Remember debit balances in the Cost of Sales section are subtracted from Credit balances in the Income section to find your Gross Profit or Income. Your bottom line or net income is calculated by subtracting expenses related to overall operations of the business from the Gross Profit.

Lisa does not track her credit card charges each day, but instead waits until the end of the month when she gets her statement from the bank to record the charges. Since the amount is small and there can be returns or other reasons for a charge to be rejected during the month, it is simpler to just verify these numbers when she gets the bank statement.

Customer returns that were purchased using a credit card should already be recorded in the Purchase Returns and Allowances account. When making that entry, the Cash in Checking account should have been reduced as well, so there should be no need to record returns that have been subtracted on the bank statement.

If Lisa finds a major difference between her monthly totals for credit sales and the bank's report, she would need to review her charges to find the reasons for the difference before closing the books. The most common errors relate to sales or returns that were not properly recorded.



**Audit Alarms**

You should have a method in place to track disputed credit card sales. Keep a ledger that you use to record and track pending disputes. At month-end, assess the disputes still pending and decide whether or not to deduct them from the Sales of Goods or Services.



**Biz Tips**

Only you can decide when it's worth spending the time to find the reason for an error. You may decide that even a \$1 difference is critical and you want to find out why. A larger company may not scour its records unless the difference is over \$100 or possibly even more.

This is just one of the tasks Lisa must perform before she closes her cash journal for the month. Any differences she finds will impact her gross sales and ultimately her net income.

Her next step will be to add up all the store charge accounts and be sure that the totals in Accounts Receivable match the total of store credit sales. Again, if Lisa finds a difference between the total amount due in Accounts Receivable and the total store credit sales, she'll need to find the reasons for the difference before closing her cash journal.

## **Balancing Accounts Receivable**

After Lisa checks out the detail on the individual credit accounts, she will then need to be certain that her closing balances on the store credit and credit card sales plus her cash sales match her totals in the control account, Accounts Receivable.

If there are differences, she would need to find them. With any luck, she already found all the differences when proving the balances for credit card sales and store charge sales and just needs to post entries that correct the errors made.

Remember our balancing act. We carefully made entries into the books that were balanced by credits and debits. Entries that correct differences also need to be balanced. For example, if an error found in the store charge sales turned out to be a return that was not properly recorded, Lisa would need to properly record that return to balance the store charge account ledger as well as the cash receipts journal and ultimately the general ledger.

We'll assume Lisa was lucky and had no corrections to make this month. Her only adjusting entry was to record the credit card fees. Hopefully you'll be that lucky most months.

## **Sending Customer Statements**

After Lisa has reviewed and verified the customer accounts total, the next step will be to send customer statements for the outstanding balances. The first step would be to develop a worksheet showing the customer accounts.

We'll assume Lisa extends credit to a very few people who are her regular customers. Here is an example of a worksheet for store charge accounts.



Name	Balance Due	Current Month	60 Days	90 Days +
Amy	\$1,500	\$1,000	\$500	
Ann	\$500	\$500		
Alex	\$2,000	\$1,500	\$500	
Jane	\$500	\$500		
Jack	\$1,000	\$500	\$500	
Jen	\$1,500		\$500	\$1,000
Jill	\$1,000	\$1,000		
Jim	\$2,000	\$2,000		
Mark	\$500	\$500		
Mary	\$500	\$500		
Terry	\$800	\$300	\$500	
Tom	\$1,500	\$1,000	\$500	
Toni	\$500	\$500		
<b>Total Due</b>	<b>\$13,800</b>	<b>\$9,800</b>	<b>\$3,000</b>	<b>\$1,000</b>

As you can see, Lisa has a number of slow payers. She has a policy of cutting someone off when his or her account is 90 days late. When she sends out the bills to her folks 60 days late she will warn them of the possible cutoff, which hopefully will get them to pay their bills.

Jen has been cut off because her payment is over 90 days late. At some point, Lisa will have to decide whether to write off the account. Because there are a small number of customers involved, she may work with Jen individually to work up a payment plan or she could send her to an outside collector. Most retailers will try to collect the money on their own for 6 months before sending the customer to a collection agency. Fees charged for collections can be as high as 30 to 50 percent of the amount collected.



**Biz Tips**

You can see the value of closing the books each month and developing a worksheet of the outstanding customers. This worksheet is called an aging report. This can be a very valuable tool for managing your Accounts Receivable and quickly picking out problem customers.

Now let's move on to closing the cash disbursements journal. Matching your monthly expenses to your monthly income is an important part of the closing process.

## Closing Cash Disbursements Journal

The procedure for closing out the cash disbursements journal is similar to the one for the cash receipts journal. The Accounts Payable account is the control account for disbursements.

### Reviewing Accounts Payable

Most businesses have numerous subaccounts that feed into Accounts Payable so they can track specific expenses. For example, if you've set up individual vendor accounts for your major vendors, your first step will be to prove out those accounts and then check to be certain the total of bills paid and still due match what is in your cash disbursements journal.

When it comes time to close the books at the end of a month, you probably will have bills you paid that represent quarterly or annual payments. You also may have bills that need to be paid for expenses incurred during the month that won't actually be paid until the next month. For example, when Lisa's Candle Shop buys inventory at the end of the month, the invoice for that inventory probably won't be paid until the next month.

### Balancing Accrual Accounts

After reviewing the remaining bills to be paid, you should be certain to record any bills not yet paid in Accounts Payable that were expenses for the month you are closing. These entries would look like this.

	Debit	Credit
(Expense Account)	\$	
2000 Accounts Payable		\$
To accrue payment for designated expense.		

Sales Tax Collected is another balance sheet account that is likely to carry a balance from one month to the next, depending on when your state or local government requires payment. You should be posting to this accrual account as you complete your daily sales summaries, so you probably don't have any corrections to be made as part of the closing process. When reviewing these numbers at month-end, you could find that the sales tax was not recorded one day. Before closing the books, be sure the balance in Sales Tax Collected matches the balance you calculated based on your sales.

Lisa's Candle Shop had \$1,330 in Sales Tax Collected based on our preceding calculation. Before paying those taxes to the government entities, Lisa would definitely want to review the actual entries to Sales Tax Collected and make sure they match the numbers being submitted on the sales tax reports. Any difference is certainly worth researching, because it could impact the amount of tax due.



#### Business Bites

Q. What's the definition of a good tax accountant?

A. Someone who has a loophole named after him.

Another account that probably has a balance that carries over from month to month is Accrued Payroll Taxes. As you remember from our discussion in the last section, some payments from this account are only made once every quarter while others are made once or twice a month. We'll take a closer look at that account in the next chapter when we discuss closing the payroll journal.

During the close-out process of Accounts Payable, you may also find bills that were charged to the wrong account. Before closing the books, you should make the adjusting entries to correct those errors. These changes are critical to be certain your P&L Statement reflects your actual income and expenses and that the expenses are reflected in this statement accurately.

## Temporary Posting Journal

Some businesses also work with a temporary posting journal. This journal is used when a check has been written to pay a bill on time, but full details for how that check should be allocated and to which accounts are not yet known.

For example, this happens commonly when a business uses an outside payroll service. Frequently a check must be written to the payroll service before full details about the payroll are available. The accounting department definitely wants to record the cash disbursement, but may not yet be able to prepare entries to the accounts that will be affected.

The transaction would be posted to an account called Temporary Distribution (9999). After the full details are known, adjusting entries will be made to accurately record the expenses by reducing the amount in Temporary Distribution and recording the expense to the proper accounts.

When closing the books, it is important to review transactions in the Temporary Distribution account and post adjusting entries for as much of the account as possible. Any uncategorized expenses would be reported as a Miscellaneous Expense when

preparing the financial reports, but internally you would need to track these Temporary Distributions closely and adjust them as quickly as possible.

## Posting to the General Ledger

As you make the adjusting entries to correct errors or complete transaction information, keep a worksheet of all the entries. Ultimately you will need to post them to the general ledger to maintain the balance of your books.

You don't need to post to the general ledger as you find each correction. After you've finished closing your subledgers you can post corrections in an entry that summarizes the changes.

For example, if you found several corrections when closing the cash receipts journal, you would post the details involving specific customers or receipts to that journal, but you only need to summarize the amounts for the general ledger.

Closing books and making corrections is a lot easier if you are using a computerized accounting system. A correction made to a specific entry automatically updates the control accounts in the general ledger.

Now we'll take a closer look at how you close the payroll journal and employee expense accounts.

### The Least You Need to Know

- ◆ Month-end closing is a bottom-up approach. You start with the details of subledgers and work up to the master controller, the general ledger.
- ◆ Closing your cash receipts journal also provides an excellent opportunity to review the accuracy of your sales numbers, as well as manage your credit sales.
- ◆ When closing the cash disbursements journal, you not only check for errors, but you also make sure you have accurately matched the expenses for the month and accrued any costs or expenses not yet paid.

# Chapter 18

## Closing Employee Accounts

### In This Chapter

- ◆ Employee expensing
- ◆ Expensing control
- ◆ Checking checks
- ◆ Payroll posting

Even though you don't need to report employees' earnings to government entities on a monthly basis, it's still important to close the employee accounts at the end of each month.

If you are doing the payroll in-house, the proper entries are probably already in place. For companies that use a payroll service, the payroll total for the month is probably sitting in a temporary account waiting for the details to distribute the information to the proper expense accounts. This distribution is handled as part of the closing process at the end of the month.

Another key part of employee records is the individual employee expense accounts. You should maintain records of expenses for each employee. At month-end you need to close the accounts and check to be sure all your numbers do balance between the employee expense accounts and the P&L expense accounts to which they were charged.

The closing process is a means of being certain the details are correct. After you confirm the details, the final step of putting together the month-end reports should be relatively smooth with everything recorded and in balance. At least we can hope that will be the case.

## Closing Employee Expense Accounts

Most businesses will reimburse an employee's business-related expenses. Some require employees to submit an expense report immediately after a business trip or taking a client out for a meal. Others schedule a day of the week in which expense reports are reviewed and paid. This encourages employees to submit reports in time for that weekly review in order to get a check as quickly as possible.

One advantage to the accounting department of setting aside one day a week to handle expense reports is that it allows them to manage the work flow and plan for what can be a time-consuming process to review and pay those expenses. Usually an employee must submit an expense report that lists business expenses and show receipts for each expense. A supervisor or manager must approve the expense report before submitting it to Accounting for reimbursement.

Trips, meals, and entertainment are not the only items that could appear on the report. Sometimes an office runs short of critical supplies and one of the employees must volunteer to run out to get them in an emergency. Frequently this employee will charge the purchase to a personal credit card and then submit an expense report for reimbursement.



### **Biz Tips**

You set the rules for what you will reimburse. You also need to carefully monitor how much each employee is expensing.

Your accounting department may want to alert a manager if a particular employee's expenses seem high compared to others in the department, so the manager will know to more carefully scrutinize the expense reports for possible abuses.

Reimbursement for the use of a personal car for business purposes is another common item on an employee expense account. Sales people regularly will submit expense reports for promotion materials they had copied while on the road.

After the accounting clerk who is processing expense accounts finishes reviewing the reports, he or she would then need to post the entries in the cash disbursements journal and the affected expense accounts. In addition to those postings, the clerk would also add the details to the individual employee's records.

The posting to the cash disbursements journal could be a summary of all the employee expense reports processed, but the clerk should attach his or her work papers so the details are available if a question arises later. The expense report and copies of the receipts submitted by each employee should be kept in the employee's file.

Here is a sample of how to post employee expenses.

	Debit	Credit
5700 Meals and Entertainment	\$	
5800 Office Expense	\$	
6250 Supplies	\$	
6300 Travel	\$	
6460 Vehicle Expense—Employee Reimbursement	\$	
1000 Cash in Checking		\$

The closing process is an excellent time to confirm that the numbers in your expense accounts match the totals recorded in your employees' individual ledgers. This is also a good time to review expenses and be certain there doesn't appear to be abuse. Your best bet is to prepare a spreadsheet with one line per employee and columns of the common expenses for the business. Here's what that spreadsheet could look like.

Name	Car Expenses	Meal Expenses	Travel Expenses	Office Expenses
Jack	\$150	\$125	\$950	\$75
Jane	\$75	\$50	\$650	\$15
Jill	\$60	\$75	\$500	\$25

Quickly glancing at this spreadsheet, you can see that Jack's expenses are considerably higher than Jane's or Jill's, even though they are all in the same department with the same job. Their manager may not have noticed this difference when signing the weekly expense reports, because they didn't seem that out of line at the end of each week.

Accounting should give the manager a summary of the expenses submitted by each employee at the end of the month, so he or she can review them and possibly question an employee whose numbers are much higher.

**Business Bites**

Q: When does the accountant laugh the loudest?

A: When someone asks for a raise.

There may be nothing wrong. Let's assume these are expense reports for outside sales people and Jack just happened to have a great month with a lot more appointments than Jane or Jill. If that were not the case and Jack's sales activity was no better than



### Audit Alarms

Don't wait until the quarterly reports are due to verify all your payroll tax accounts. This task will be much harder if you put it off because you'll have to go back three months if you detect any errors.

Jane's or Jill's, the manager may need to look more closely at Jack's expenses and discuss getting them in line with others in the same job.

You can see that closing accounts and verifying the numbers is not the only purpose of the month-end close process. Looking at the month in summary really helps you to pick out problems, whether they involve an employee who is submitting higher-than-normal expense reports or a customer who is not paying their bill on time.

## Posting Payroll

Whether or not you use an outside service to handle your payroll, when the payroll is complete you will receive a report that details the amount paid, the benefits costs deducted from the employee's paycheck, the taxes deducted from the paycheck, and the net check given to each employee.

If you are handling payroll in-house, these numbers will either be generated by your payroll software (when the payroll is complete) or will be part of a spreadsheet you develop in order to make out your paychecks by hand. An outside payroll service will probably not give you a report with each pay period, but instead will submit a report at the end of each month to report payroll activity.

The only difference in your books will be whether you have the actual details when you write the checks to your employees or you get the details at the end of month and just record the check given to the payroll company so they could process and send the checks. Many companies don't even send checks today. Instead, pay is sent electronically to deposit the money directly into the employees' accounts.

Companies with an in-house payroll operation should record the payroll details when the payroll is complete in a summary entry to the payroll-related accounts and credit the actual cash used in the Cash in Checking account. Companies that use outside payroll services will have to wait until the month-end report to record the payroll details. The check given to the payroll service is usually entered into a Temporary Distribution Account until they get the details at the end of the month.



The primary purpose of the month-end close for the payroll accounts is to verify that your postings to all related accounts are accurate. These accounts include Cash in Checking, Accrued Payroll Taxes (federal and state income, Social Security, Medicare), and Accrued Benefits (health insurance, retirement contributions, and so on). Some companies also collect dues for unions and need to track those deductions, while others collect charitable donations, such as for United Way, and must track those deductions.

Reviewing all these details at month-end close not only makes sure you are accurately matching employee expenses for the month with company income, it also gives you an opportunity to review your accrued tax accounts to be sure these balances are accurate.

## Posting to the General Ledger

After you verify that all the payroll-related accounts are accurate and reflect the expenses for the month, you would close these accounts and post a summary entry to the general ledger. Most companies do not post payroll details to the general ledger, but instead use a subledger, the payroll ledger, to track that detail.

In addition to the payroll ledger, the company also has an individual ledger card and file on each employee as we discussed in Chapter 15. When you close the books at the end of the month, you will be verifying that the information in the payroll ledger matches the total in the individual ledgers. The process would be similar to totaling vendor accounts to verify the balance in Accounts Payable, or customer accounts to verify the balance in Accounts Receivable.

## Tracking Benefits

Money is not the only thing you'll need to track. Most companies use the payroll system to manage employee time off for vacation time, sick time, personal time, and family leaves.

During month-end close, you should be certain that employee time records are accurately updated. In addition to noting hours taken off, you'll need to update any accrual of additional hours. Some companies set up a time pool at the beginning of the year and allow employees to use that pool from day one. Most companies set up a time-accrual system and add hours to an employee's records at the end of each month worked.

For example, let's assume a company allows 12 days a year for vacation. This is easy to calculate because it means an employee earns one vacation day at the end of each month worked.

Now that we've checked all the details of posting to the subledgers and the individual accounts, we'll move on to reconciling this information with your bank accounts and posting adjusting entries to your general ledger accounts.

### **The Least You Need to Know**

- ◆ You must determine what employee expenses you will reimburse and then monitor these expense reports to be certain there isn't abuse.
- ◆ Payroll details should be posted and checked at month-end close to be sure the proper entries have been made to expense and accrual accounts.
- ◆ Don't wait until the quarterly reports are due to verify your payroll numbers.
- ◆ Payroll closing is not only concerned with money. Most companies track employee time off as part of their payroll system as well.

# Chapter 19

## Balancing the Ledger

### In This Chapter

- ◆ Proving accounts
- ◆ Adjusting for errors
- ◆ Making the posts

Now that you've closed all your subledgers, it's time to work on the general ledger and your bank accounts.

Still using that bottom-up approach, we'll start with proving out the Cash in Checking account and make sure that matches what you have in the bank account.

Next we'll look at how you adjust for any errors and then finally how you post all you've just done to the general ledger.

### Reconciling Bank Accounts

As part of our closing process, we've already reviewed all the subledgers that you use to record the details of all your cash transactions—cash receipts journal, cash disbursements journal, and payroll journal. If you missed any transaction, these should now all be posted in adjusting entries to the Cash in Checking account.



### Business Bites

My CPA is shy and retiring. He's \$250,000 shy. That's why he's retiring.

If you've done everything right and found all the errors, the balance in your bank checking account should match the balance in the Cash in Checking account. Your statement from the bank might not be in yet and you can't officially close the books until you get that, but you can make sure that at least your internal ledgers all prove out.

You may find you have a difference and need to do some detective work to find the problem. Finding discrepancies can be like looking for a needle in a haystack, but luckily there are a few good places to start depending on the differences you find.

- ◆ When your balance in the checkbook is higher than the balance in the Cash in Checking account, your first step should be to recheck your deposits and make sure they have all been properly posted to the Cash in Checking account.
- ◆ When your balance in the checkbook is lower than the Cash in Checking account, the most likely culprits are checks that might not have been properly posted and recorded.
- ◆ If all your deposits and checks are correct, then you'll need to check your math in your checkbook account. You may have added or subtracted incorrectly. If you are using a manual accounting system rather than a computerized system, you'll also need to check the math in your ledgers.



### Biz Tips

One trick you quickly learn as an accountant is that if the difference can be divided by nine, the error is most likely a transposition of numbers. For example, the number should be 129, but was written as 192. The difference is 63, which when divided by 9 is 7.

By proving out your subledgers before the bank statement arrives, your task of verifying that statement should be relatively simple. Reconciling a business bank account is similar to verifying the balance in your personal checking account. You do that, don't you? Well, at least every few months?

In a business account it is critical to reconcile the checking account every month to be sure your month-end statements are correct. The format for reconciling your bank statement is relatively simple. Here's what it should look like.

Transactions	Beginning Balance	Deposits	Disbursements	Ending Balance
Balance per Bank Statement	\$	\$	\$	\$
Deposits in Transit (list all missing deposits)		\$		\$
Outstanding Checks (list all checks that have not been processed by the bank)			(\$)	(\$)
Total	\$	\$	\$	\$
Balance per checkbook and Cash in Checking (which should already be the same)				\$

If the ending balance and the balance per checkbook match, your work is done. If not, use the steps previously mentioned when verifying your Cash in Checking account to find out why there is a difference.

Deposits usually show up on your check statement very quickly. Unless you happen to make a deposit on the day the statement was closed by the bank, all your deposits should be there. If you do find a deposit missing, be sure you keep that proof of deposit and verify with the bank that it is in your account.

Today, many people use online banking and can quickly verify deposits that did not show on the statement. If you don't use online banking, you may have automated phone access to check your most recent deposits. Otherwise, if neither online banking or an automated phone system is available, you may want to make a quick call to your bank to be sure there isn't a problem. You certainly don't want any checks to bounce.

When everything is proved out, keep the worksheet and the bank statement together. You'll have an easy reference for the next month to review checks and deposits that were missing and make sure they have all cleared with the next statement.

If checks are outstanding on two statements in a row, it's time to find out why they have not been cashed. A check could have gotten lost in the mail and never been received by the vendor who is still waiting for payment. Calling that vendor and finding out if there is a problem could save you interest expenses or late fees.

## Developing Ledger Adjustments

Any error found during this reconciliation process will need to be properly recorded using balanced entries. For example, suppose Lisa found that a check written to pay for utilities was not recorded in the cash disbursements journal or Cash in Checking. She would correct that during the reconciliation process with this entry.

	Debit	Credit
6400 Utilities	\$	
1000 Cash in Checking		\$
To record payment for utilities.		

After you post all your entries, you will need to review your closing balances for the subledgers and accounts that were impacted by the corrections.

Even though you'll be making these adjustments when the bank statement arrives during the next month, the corrections should be posted to the month in which the transaction occurred. For example, if Lisa found this error involving a February payment for utilities in March when reviewing February's bank statement, she would post the correction to adjust February's numbers, not as a March expense.

### def•i•ni•tion

**General journal entries** are any entries made to correct or adjust balances in the general ledger accounts.

Your books are not closed for the month until you have completed all your adjusting entries. You may prepare your month-end statements before getting your bank statement to get a quick idea of how your business fared during the month, but you may need to revise those if you do find errors.

## Posting to the General Ledger

After you get all the details taken care of, you may still find you need to adjust ledger accounts. These entries are called *general journal entries*.

Some of the most common adjustments you make at month-end include recording depreciation and any prepaid expenses that relate to the month being closed. In Chapter 5, we calculated Lisa's Candle Shop depreciation expenses and found that they totaled \$254 for fixtures and furniture and \$150 for equipment for the year. Since these numbers are low, we decided she would record depreciation annually rather than monthly, but if she did decide to record these figures monthly, this is how the entry would look.

	Debit	Credit
Depreciation Expense	\$33.67	
Accumulated Depreciation— Furniture and Fixtures		\$21.17
Accumulated Depreciation— Equipment		\$12.50
To record monthly depreciation.		

Lisa also would need to record her rent expense as a general journal entry. In Chapter 5, we said she paid her rent quarterly and recorded that Prepaid Expense as \$2,400. Her adjusting entry for February would be the following.

	Debit	Credit
6050 Rent Expense	\$800	
1250 Prepaid Expense		\$800
To record rent expense.		

You may remember that Prepaid Expense is an Asset account. This general journal entry would reduce the Asset account on the balance sheet and increase the Rent Expense account on the P&L Statement.

Lisa also recorded her annual business insurance premium of \$1,200 in the Prepaid Expense account. Her adjusting entry for February would be the following.

	Debit	Credit
5450 Insurance—General	\$100	
1250 Prepaid Expenses		\$100
To record insurance expense.		

Your business will probably have a number of prepaid expenses and depreciation adjustments to make at month-end. Keeping a ledger that lists all your month-end adjustments will make the closing process much easier.

The month-end general journal entries are always the last entries you make before getting ready to test your work. You test your work by doing a trial balance. This is the last thing you need to do before preparing your financial statements. We'll learn how to do this critical test in the next chapter.

## **The Least You Need to Know**

- ◆ Reconcile your Cash in Checking account with your bank account before you even get your bank statement. This is a good way to check your work and to minimize the errors you may find when you get your bank statement.
- ◆ You don't close your books for the month until you reconcile your bank statement. You may find adjustments are needed if you find errors while reconciling the bank statement.
- ◆ After you've checked your books, you'll also need to prepare general journal entries that reflect expenses that are prepaid or to show depreciation of your assets.



# Chapter 20

## Testing Your Work

### In This Chapter

- ◆ Balance tests
- ◆ Correcting failures
- ◆ Passing the tests
- ◆ Preparing to report

The moment of reckoning has arrived. You've carefully entered all your data using balanced entries. You've reviewed all your detail accounts to be sure everything has been entered correctly.

Now it's test time. Using what is called a trial balance, you can test to find out whether your accounts truly are in balance. If your test fails, then unfortunately you have more detective work to do.

### Doing a Trial Balance

First, let's explain what a trial balance is. Basically it's a worksheet or report that lists all of the accounts in the general ledger, the monthly summary of account totals, and their year-to-date balances.

If you are using a computerized system, the trial balance can be generated automatically and printed. Even if the accounts are in balance, it still might not mean the numbers are accurate. We're sure you've heard the standard phrase for computer data—"garbage in, garbage out." The computer may prevent you from making a computer entry that is not balanced, but you can still enter inaccurate numbers.

You'll get a much better idea of how a trial balance works and the components that make up this balance by doing one manually. So we'll close out Lisa's Candle Shop books for the month of February using the manual method.

We've already reviewed the month-end totals for sales and many of the balance sheet account totals stay the same from month to month. Just to make things easier, we're going to assume that Lisa found she had the same amount of inventory left at the end of February as she had at the end of January. We develop purchase and sales costs using \$26,600, which was our total for Sales of Goods Sold developed in Chapter 17. We'll assume Lisa has a monthly Salaries and Wage Expense of \$3,800. Many of the other numbers you see we have developed just for this example.

Here's a trial balance for Lisa's Candle Shop dated February 28, 2005.

	Balance 1/31/2005	Debits	Credits	Balance 2/28/2005
<i>Balance Sheet Accounts</i>				
Cash in Checking	\$5,189.16	\$22,884.86	\$(24,166.31)	\$3,907.71
Cash on Hand	\$400.00			\$400.00
Accounts Receivable	\$11,000.00	\$9,800.00	\$(7,000.00)	\$13,800.00
Inventory	\$1,550.00			\$1,550.00
Prepaid Expenses	\$2,700.00		\$(900.00)	\$1,800.00
Furniture and Fixtures	\$1,700.00			\$1,700.00
Equipment	\$600.00			\$600.00
Deposits	\$600.00			\$600.00
Accounts Payable	\$(1,200.00)	\$1,200.00	\$(1,200.00)	\$(1,200.00)
Sales Tax Collected	\$(1,200.00)	\$1,200.00	\$(1,330.00)	\$(1,330.00)
Accrued Payroll Taxes	\$(671.40)		\$(671.40)	\$(1,342.80)
Loans Payable	\$(4,930.16)	\$70.25		\$(4,859.91)
Capital	\$(15,000.00)			\$(15,000.00)
Drawing	\$0.00	\$2,000.00		\$2,000.00
Retained Earnings	\$(737.60)		\$(1,887.40)	\$(2,625.00)
	\$0.00	\$37,155.11	\$(37,155.11)	\$0.00

	Balance 1/31/2005	Debits	Credits	Balance 2/28/2005
<i>P&amp;L Statement Accounts</i>				
Sales of Goods or Services	\$(22,400.00)		\$(26,600.00)	\$(49,000.00)
Sales Discounts	\$300.00	\$600.00		\$900.00
Sales Returns & Allowances	\$200.00	\$400.00		\$600.00
Purchases	\$13,073.00	\$15,443.00		\$28,516.00
Purchase Discounts	\$(261.47)		\$(308.86)	\$(570.33)
Credit Card Fees	\$196.00	\$224.00		\$420.00
Advertising	\$1,000.00	\$1,000.00		\$2,000.00
Bank Service Charges	\$45.00	\$45.00		\$90.00
Insurance General	\$100.00	\$100.00		\$200.00
Interest Expense	\$29.17	\$28.76		\$57.93
Legal & Accounting	\$300.00	\$300.00		\$600.00
Office Expense	\$250.00	\$250.00		\$500.00
Payroll Taxes	\$335.70	\$335.70		\$671.40
Postage	\$125.00	\$125.00		\$250.00
Rent Expense	\$800.00	\$800.00		\$1,600.00
Salaries & Wages	\$3,800.00	\$3,800.00		\$7,600.00
Supplies	\$920.00	\$1,120.00		\$2,040.00
Telephone Expense	\$150.00	\$150.00		\$300.00
Utilities	\$300.00	\$300.00		\$600.00
Net Profit	\$(737.60)	\$25,021.46	(\$26,908.86)	\$(2,625.00)

You can see that debit accounts are positive numbers, while credit accounts are negative numbers. The totals in the Debit and Credit columns are the closing totals of each account in the chart of accounts. At the top of the worksheet are the balance sheet accounts and at the bottom are the P&L Statement accounts.

We mentioned before that the final balancing act is to calculate Retained Earnings, which is the same as your net profit. That number is calculated using the trial balance by subtracting February's year-to-date net profit from January's net profit.

$$\$2,625.00 - \$737.60 = \$1,887.40$$

If all accounts are in balance, when you plug that number into the February column on the balance sheet your balance sheet should be balanced. If it isn't, it means you've got to look for an error.

The simplest solution is a mistake in transferring the account closing balances to the worksheet or a computation error. If reviewing these possibilities doesn't uncover the difference, you then have to go back and recheck your detail accounts.

## def•i•ni•tion

**Retained earnings** are the net profits that you leave in the business from month to month. These earnings are reinvested in the business and are used to grow the business. If a company pays dividends, these payments are taken from Retained Earnings.

You can see why it's so important to be sure your detail accounts are accurate before closing those accounts and the subledgers and transferring the numbers to the trial balance worksheet. The more careful you are when finalizing your subaccounts and subledgers, the more likely your trial balance will pass the test on the first try.

Note that when we plugged in the *retained earnings* figure in the balance sheet section, the debits and credits are in balance. The year-to-date account totals as of January 31 and February 28 are shown as zero. That also is a sign of success. Remember the formula for the Balance Sheet:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

You can also see that the debits side will equal the credits side in the P&L section of the worksheet if you add the Retained Earnings to the debits. Bet you had your doubts this would work as you were learning how to make entries.

Here's what a trial balance for February month-end would look like for Lisa's Candle Shop if she uses a computerized accounting system.

### Biz Tips

When using a computerized system, you can print out a trial balance at any time during the month to review accounts, giving you quick access to a snapshot of your business's activity throughout the month. You'll find it's a great management tool if you suspect a problem.

Lisa's Candle Shop  
 trial balance  
 As of February 28, 2005

Number	Account	Debit	Credit
1000	Cash in Checking	\$3,907.71	
1020	Cash on Hand	\$400.00	
1100	Accounts Receivable	\$13,800.00	
1200	Inventory	\$1,550.00	
1250	Prepaid Expenses	\$1,800.00	
1500	Furniture and Fixtures	\$1,700.00	
1550	Equipment	\$600.00	
1580	Deposits	\$600.00	
2000	Accounts Payable		\$1,200.00
2100	Sales Tax Collected		\$1,330.00
2300	Accrued Payroll Taxes		\$1,342.80
2400	Loans Payable		\$4,859.91
3200	Retained Earnings		\$737.60
3300	Capital		\$15,000.00
3400	Drawing	\$2,000.00	
4000	Sales of Goods or Services		\$26,600.00
4010	Sales Discounts	\$600.00	
4020	Sales Returns & Allowances	\$400.00	
4300	Purchases	\$15,443.00	
4310	Purchase Discounts		\$308.86
4330	Credit Card Fees	\$224.00	
5100	Advertising	\$1,000.00	
5200	Bank Service Charges	\$45.00	
5450	Insurance General	\$100.00	
5550	Interest Expense	\$28.76	
5650	Legal & Accounting	\$300.00	
5800	Office Expense	\$250.00	
5900	Payroll Taxes	\$335.70	
6000	Postage	\$125.00	
6050	Rent Expense	\$800.00	

*continues*

*continued*

Number	Account	Debit	Credit
6200	Salaries & Wages	\$3,800.00	
6250	Supplies	\$1,120.00	
6350	Telephone Expense	\$150.00	
6400	Utilities	\$300.00	
		\$51,579.17	\$51,579.17

## Reviewing the General Ledger

Now that we have passed the test, you should take one more look at the ending numbers and see if any glaring errors pop out at you. Seeing your accounts summarized on one page can help you quickly find an error. For example, if your Sales of Goods or Services Sold seem outrageously high or your Purchases are out of whack compared to your sales figures, that might be a sign of a problem.

Intuitively you should know if your business actually had the activity that is reflected in that trial balance. Double-check any numbers by going back to the transaction details for any accounts that seem to have an unusual balance based on your prior business experience for that type of income or expense.

## Developing the Financial Statements

Now you have all the information you need to develop the month-end financial statements. When you get to December, this accumulated information will also give you what you need for your year-end statements as well.

As we mentioned earlier, the balance sheet section of the chart of accounts was developed based on the order in which accounts will appear on the balance sheet. The Profit and Loss Statement is more flexible and you can format it in a way that best matches your business needs.

Some companies like to compare current-year financial data with prior-year data and show year-to-date information for both years. This allows them to compare year to year and see how the current year income and expenses compare to the prior year. This can give you a good overview of increases or decreases in expenses and sales.

The statements also give you the information you need to do cost analysis and determine your profitability. Some companies even prepare profit and loss statements with percentages so they can more easily track key cost factors. For example, Lisa may want to track how changes in the cost of the products she sells impact her gross profits. By adding a percentage column to the P&L Statement, she can quickly see any change in the percentage of Cost of Goods Sold vs. Sales as well as Expenses vs. Gross Profits. Any major increase in these cost and expense percentages would be a sign of a problem that needs to be addressed.

An increase in the costs percentage might mean that the purchases of goods to be sold have increased dramatically and it's time to consider an increase in sales price or find a new vendor. An increase in the percentage of expenses may mean that certain spending on operating expenses is too high and controls need to be put in place.

After we develop the balance sheet in the next chapter, we'll review some basic cost-accounting techniques you can use to analyze your statement. Then we'll move on to the P&L Statement and its role in cost accounting.

### **The Least You Need to Know**

- ◆ After you've checked all your details, it's time to check your work. You do this by preparing a trial balance.
- ◆ Trial balances can be prepared manually using a worksheet or by printing out the trial balance from your computer.
- ◆ After proving your accounts using the trial balance you have all the information you need to develop your financial statements.

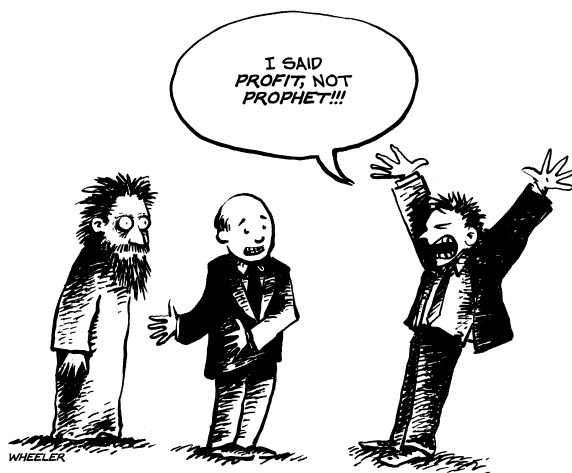




# Part 5

## Putting On a Show

After you've closed the books, you'll want to prepare statements that show how well your business is doing. You'll need these for internal management as well as to provide necessary information to financial institutions and investors who provide financing for your business. You'll also need to report your business activities and payroll matters to governmental agencies.





# Chapter 21

## Balancing Act

### In This Chapter

- ◆ Developing the sheet
- ◆ Checking liquidity
- ◆ Managing assets
- ◆ Understanding debt

You've probably been wondering how paying attention to all this detail will help you manage your business.

You've put a lot of work into building your accounting system; now you'll learn how to take advantage of the fruits of all that labor.

After all the data is in place and you've checked its accuracy, we can use the numbers to help you understand how well your business is doing, as well as present your business to investors and bankers.

### Producing the Balance Sheet

The first step is to develop the balance sheet. The balance sheet is a quick glance at your business at some point in the year. This financial statement is always done on a year-to-date basis until you get to the year-end close.

We develop the balance sheet for Lisa's Candle Shop, and then show you various financial analysis tools that help gauge how the business is doing. These tools are useful to management for internal assessment as well as to external entities, such as a bank or potential investor.

Here's the balance sheet for Lisa's Candle Shop at the end of February.

Lisa's Candle Shop  
BALANCE SHEET  
As of February 28, 2005

**Assets**

**Current Assets**

Cash in Checking	\$3,907.71	
Cash on Hand	\$400.00	
Accounts Receivable	\$13,800.00	
Inventory	\$1,550.00	
Prepaid Expenses	\$1,800.00	
<b>Total Current Assets</b>		<b>\$21,457.71</b>

**Property and Equipment**

Furniture and Fixtures	\$1,700.00	
Equipment	\$600.00	
<b>Total Property and Equipment</b>		<b>\$2,300.00</b>

**Other Assets**

Deposits	\$600.00	
<b>Total Other Assets</b>		<b>\$600.00</b>

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<b>Total Assets</b>		<b>\$24,357.71</b>
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**Liabilities and Equity****Current Liabilities**

Accounts Payable	\$1,200.00	
Sales Tax Collected	\$1,330.00	
Accrued Payroll Taxes	\$1,342.80	
<b>Total Current Liabilities</b>		<b>\$3,872.80</b>

**Long-Term Liabilities**

Loans Payable	\$4,859.91	
<b>Total Long-Term Liabilities</b>		<b>\$4,859.91</b>

**Equity**

Retained Earnings	\$2,625.00	
Capital	\$15,000.00	
Drawing	(\$2,000.00)	
<b>Total Equity</b>		<b>\$15,625.00</b>

<b>Total Assets</b>		<b>\$24,357.71</b>
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Before we start analyzing the numbers, let's take a quick look at the format. You'll notice that we've grouped the accounts in several categories. For Assets, we have *Current Assets*, Property and Equipment, and Other Assets. For Liabilities and Equity, we have *Current Liabilities*, Long-Term Liabilities, and Equity.

These groupings make it easier for you and any financial institution or investor to quickly see the status of your company. The Current Assets section includes assets that will be used in a 12-month period. The same time frame is true for Current Liabilities, which includes liabilities you'll need to pay within 12 months.

**def·i·ni·tion**

**Current Assets** includes the total of accounts a business has in cash and cash equivalents, Accounts Receivable, Inventory, marketable securities, prepaid expenses, and any other assets that can be converted to cash in less than one year. **Current Liabilities** is the total of all money owed by a company that is due in less than one year.

Anything that has an impact on your assets or liabilities for more than 12 months fits into a long-term category. On the asset side you may have additional categories such as Land and Buildings and Intangible Assets, which could include line items such as Patents, Trademarks, and Copyrights.

The equity section for most businesses that are not sole proprietorships will also have an account in the equity section of the balance sheet for common stock. That would normally be the first account in the equity section if Common Stock has been issued.

### Accounting Answers

If you want to learn more about financial statements and how they are interpreted, IBM did an excellent job of explaining them at this website: [www.ibm.com/investor/financialguide/irgifsb.phtml](http://www.ibm.com/investor/financialguide/irgifsb.phtml).

When we start analyzing the following balance sheet you will see why these categories become very useful for various analytical tools. Before we can show those tools, we also need to prepare a balance sheet for the month of January, so we have something we can use for comparison to evaluate the health of the business. Here's the balance sheet as of January 31, 2005.

Lisa's Candle Shop  
BALANCE SHEET  
As of January 31, 2005

#### Assets

##### Current Assets

Cash in Checking	\$5,189.16	
Cash on Hand	\$400.00	
Accounts Receivable	\$11,000.00	
Inventory	\$1,550.00	
Prepaid Expenses	\$2,700.00	
<b>Total Current Assets</b>		<b>\$20,839.16</b>

##### Property and Equipment

Furniture and Fixtures	\$1,700.00	
Equipment	\$600.00	
<b>Total Property and Equipment</b>		<b>\$2,300.00</b>

<b>Other Assets</b>		
Deposits	\$600.00	
<b>Total Other Assets</b>		<b>\$600.00</b>
<hr/>		
<b>Total Assets</b>		<b>\$23,739.16</b>
<b>Liabilities and Equity</b>		
<b>Current Liabilities</b>		
Accounts Payable	\$1,200.00	
Sales Tax Collected	\$1,200.00	
Accrued Payroll Taxes	\$671.40	
<b>Total Current Liabilities</b>		<b>\$3,071.40</b>
<b>Long-Term Liabilities</b>		
Loans Payable	\$4,930.16	
<b>Total Long-Term Liabilities</b>		<b>\$4,930.16</b>
<b>Equity</b>		
Retained Earnings	\$737.60	
Capital	\$15,000.00	
<b>Total Equity</b>		<b>\$15,737.60</b>
<hr/>		
<b>Total Assets</b>		<b>\$23,739.16</b>

Now let's see how these two balance sheets can help you assess your cash status, manage your assets, and review your debt. All this is done by using ratio analysis, which shows you the relationships between financial statement accounts.



**Biz Tips**

You can find the ratios for your type of business at BizStats ([www.bizstats.com](http://www.bizstats.com)).

To help you understand how well your business is doing, you need to compare it to others in the same industry. You can do that by finding out the industry averages for your business. We checked Bizstats.com to find out the industry averages for Lisa's

Candle Shop. There are a number of categories for retail. We'll use the ones for miscellaneous retail stores to learn how to use these ratios.

## Checking Your Cash Status

Let's start with the liquidity ratios. These ratios allow you to test whether your company can meet its financial obligations. If you can't pay your bills, your business won't

### def·i·nition

**Current Ratio** compares current assets to current liabilities to give a quick glimpse at your business's ability to pay bills. **Quick (Acid Test) Ratio** is similar to the Current Ratio, but does not include Inventory. Inventories are the least liquid of the current assets and some believe they should not be included when assessing liquidity.

be alive for long. There are two commonly used liquidity ratios: *Current Ratio* and *Quick (Acid Test) Ratio*.

By comparing current assets to current liabilities, financial institutions or investors can judge whether a company is getting into financial difficulty and may not be able to pay its bills. Even if you aren't seeking additional financing, it's a good idea to check this ratio regularly. If current liabilities are rising faster than current assets, then the ratio will fall, which could be a sign of trouble.

The formula to calculate Current Ratio is:

$$\text{Current Assets} \div \text{Current Liabilities} = \text{Current Ratio}$$

Let's calculate the ratio for Lisa's Candle Shop.

$$\begin{aligned} &\text{January Current Ratio} \\ &\$20,839.16 \div \$3,071.40 = 6.8 \end{aligned}$$

$$\begin{aligned} &\text{February Current Ratio} \\ &\$21,457.71 \div \$3,872.80 = 5.5 \end{aligned}$$

The number has fallen, largely because of the increase in payroll taxes payable, but is still a strong ratio. If Lisa were not paying bills on time, this would make the ratio fall more drastically. Let's look at what would happen if the closing balance for Lisa's Accounts Payable account had risen by \$5,000 to \$6,200 in February. Her new February Current Ratio would be:

$$\begin{aligned} &\text{New February Current Ratio} \\ &\$21,457.71 \div \$8,872.80 = 2.4 \end{aligned}$$

You can see how much the ratio would drop. This could be a clear sign of trouble to a financial institution considering new loans, but it does not necessarily mean the



company would not be able to borrow, only that borrowing costs may be higher because the company may not get as favorable an interest rate.

Financial institutions will compare Lisa's Candle Shop to industry averages for that type of business when determining whether to loan funds. The Current Asset Ratio for miscellaneous retail is 1.8 according to the BizStats website mentioned earlier. Even at this level Lisa's Candle Shop would still be doing better than others in its industry.

Some financial institutions will use the Quick Ratio rather than the current ratio. The formula for calculating the Quick Ratio is:

$$(\text{Current Assets} - \text{Inventories}) \div \text{Current Liabilities} = \text{Quick Ratio}$$

Lisa's Candle Shop's Quick Ratios are:

$$\begin{aligned} &\text{January Current Ratio} \\ &(\$20,839.16 - \$1,550) \div \$3,071.40 = 6.3 \end{aligned}$$

and

$$\begin{aligned} &\text{February Current Ratio} \\ &(\$21,457.71 - \$1,550) \div \$3,872.80 = 5.1 \end{aligned}$$

For Lisa's Candle Shop, this ratio still looks very good, but what would happen to the ratio if sales slowed for Lisa's Candle Shop and Inventory levels rose? Let's look at what would happen to the ratio if Inventory increased by \$5,000.

$$\begin{aligned} &\text{January Current Ratio} \\ &(\$20,839.16 - \$1,550) \div \$3,071.40 = 6.3 \end{aligned}$$

and

$$\begin{aligned} &\text{February Current Ratio} \\ &(\$21,457.71 - \$6,550) \div \$3,872.80 = 3.8 \end{aligned}$$

While the ratios would drop, they are still well above the industry average even for the Current Ratio. You can see a \$5,000 increase in Inventory has a much lower impact on the Quick Ratio than a \$5,000 increase in Accounts Payable would have on the Current Ratio.

Now let's take a look at some other key ratios that you can use for asset management.

## Knowing Your Assets

We have discussed the importance of inventory control and careful monitoring of Accounts Receivable. There are two ratios commonly used to help you monitor these two critical assets: *Inventory Turnover (Inventory Utilization) Ratio* and *Average Collection Period Ratio*.

**def·i·ni·tion**

**Inventory Turnover (Inventory Utilization) Ratio** looks at how quickly Inventory is sold and replaced. **Average Collection Period Ratio** looks at how quickly a company is collecting money from customers who use store credit.

You can quickly test your inventory turnover using a ratio that is called Inventory Turnover Ratio or Inventory Utilization Ratio. This ratio looks at how quickly your inventory is being sold and restocked. The formula for this ratio is:

$$\text{Sales} \div \text{Inventory} = \text{Inventory Turnover}$$

For Lisa's Candle Shop, the Inventory Turnover Ratio is:

$$\$26,600 \div \$1,550 = 17.16.$$

This means that Lisa will turn over her inventory 17.16 times per year. The industry average for miscellaneous retail stores is 3.7. Lisa's Candle Shop is definitely turning over its inventory more rapidly than is common for these types of stores. Don't you wish your business were doing this well? That's an advantage of a make-believe world.

The ratio to test how well your company is doing at collecting its Accounts Receivable is called the Average Collection Period Ratio (ACP). The formula for this ratio is:

$$\text{Receivables} \div \text{Average Credit Sales Per Day} = \text{ACP}$$

In calculating the month-end sales figures for Lisa's Candle Shop, we assumed the same level for sales daily. Total store credit sales per day were \$350 according to those assumptions.

For Lisa's Candle Shop, the ACP ratio is:

$$\$13,800 \div \$350 = 39 \text{ days}$$

You may remember that we noticed Lisa's Candle Shop has some slow payers and this ratio shows that as well. It is taking the shop more than one month to collect money due. While it's not terrible, it is slow. A good industry average is considered to be 36 days.

Now let's take a look at a debt ratio that can greatly impact your ability to borrow money for your business.

## Tracking Your Debt

The debt ratio that is most commonly developed using balance sheet numbers is called the Debt to Equity Ratio. This ratio compares what the business owes to what

it owns. A financial institution considering a loan can quickly find out how well a company is managing its financial commitments with this tool. The formula for the Debt to Equity Ratio is:

$$\text{Total Debt} \div \text{Equity} = \text{Debt to Equity Ratio}$$

The Debt to Equity Ratio for Lisa's Candle Shop is:

$$\$8,732.71 \div \$15,625 = .56.$$

This is an excellent ratio and Lisa is in good shape to qualify for additional loans if she feels they will help her grow the business. Miscellaneous retail outlets work with a much higher ratio, which means they carry greater debt. The average Debt to Equity Ratio for miscellaneous retail outlets is 1.2.

Lisa's Candle Shop will still be in good shape in relation to other similar retail outlets even if it borrowed an additional \$5,000 to buy new store fixtures. Here is what the new ratio would be:

$$\$13,732.71 \div \$15,625.00 = .88$$

Even though this takes the store closer to the industry average of 1.2, there is still room for additional borrowing.

These are the key ratios used to review the balance sheets. We'll review the critical ratios for the P&L Statement after we learn how to develop that statement in the next chapter.

## The Least You Need to Know

- ◆ The balance sheet has a number of categories you use to group a business's assets and liabilities based on the liquidity of each.
- ◆ There are numerous ratios you can use as management tools based on the business's balance sheet to assess the relationship of various balance sheet accounts and evaluate how your business is doing.
- ◆ The Current Asset Ratio and the Debt to Equity Ratio are the two key ratios used by financial institutions when considering a loan application.



# Chapter 22

## Getting the Good and Bad News

### In This Chapter

- ◆ Knowing your numbers
- ◆ Judging results
- ◆ Picking out problems
- ◆ Making a statement

We already know how much profit our make-believe company made when we finished the trial balance. We confirmed its accuracy when all the numbers balanced on the balance sheet.

Now it's time to take a closer look at how we got to that profit. The Profit and Loss Statement (P&L) takes you behind the scenes of the balance sheet to give you a more detailed view of your daily business operations. By developing and analyzing your company's P&L Statement (P&L), you will have a snapshot that can help you assess how well your company is doing and quickly find areas that need attention to improve your company's profitability.

We show you how to develop the P&L Statement and how to compare your statement to other similar businesses. We also discuss how to use your P&L Statement for key business decision making and alternatives for formatting the P&L to meet your business needs.

## Developing the Monthly Profit and Loss Statement

In a nutshell, the P&L Statement shows all revenues for a business during the month plus all costs related to sales and expenses related to general operations. We'll develop a monthly statement, but you can use the same format to produce quarterly statements and yearly statements.

As a small business owner, you can use the P&L to assess how well your business is doing, whether you are over or under budget, and what specific expense areas may be contributing to increasing or lowering your net income or profit. Formatting for the P&L is more flexible than the balance sheet and should be designed to meet your business needs.

There are some basic elements that must be in the statement to satisfy outside investors or financial institutions.

- ◆ **Sales** includes your total sales minus any product returns or sales discounts. You don't need to worry about taxes customers paid. When recording sales, sales taxes were taken out of totals and put into the Sales Tax Collected account, so you don't have to show sales taxes on the P&L Statement.
- ◆ **Cost of Goods Sold** includes all costs of purchasing or making your products plus any costs related to selling those products.
- ◆ **Gross Profit** is calculated by subtracting the Cost of Goods Sold from Sales.
- ◆ **Operating Expenses** gives the detail of your business's daily expenses including salaries, advertising, rent, utilities, depreciation, and so on.
- ◆ **Total Expenses** is a total of all expenses before taxes.
- ◆ **Taxes** is the amount your company owes to federal, state, and local governments. If you are a sole proprietorship or partnership, these taxes will be paid on your personal tax return and not charged against your business income.
- ◆ **Net Income (Loss)** shows the amount your company made or lost during the period represented on this statement.

Now that you know the key components of a P&L, let's start developing one for Lisa's Candle Shop. We'll be working with the numbers in the trial balance from Chapter 20.

First, let's calculate Sales.

	January	February
Sales of Goods Sold	\$22,400.00	\$26,600.00
Sales Discounts	(\$300.00)	(\$600.00)
Sales Returns & Allowances	<u>(\$200.00)</u>	<u>(\$400.00)</u>
Total Sales	\$21,900.00	\$25,600.00

Next, we'll calculate Cost of Goods Sold.

Purchases	\$13,073.00	\$15,443.00
Purchase Discounts	(\$261.47)	(\$308.86)
Credit Card Fees	<u>\$196.00</u>	<u>\$224.00</u>
Total Cost of Goods Sold	\$13,007.53	\$15,358.14

You may want to include these calculations on the Income Statement. That's up to you and how much detail you want to show. We're going to keep it simple and just show the totals. Instead of adding the necessary columns that would be needed to show these calculations, we're going to add columns to show the percentage of each line item in relation to sales, which gives us the information we need to compare this business to other similar businesses using a technique called *benchmarking*.

Here's the P&L for Lisa's Candle Shop.

## def·i·ni·tion

**Benchmarking** is a way to measure how your company is doing compared to other similar companies. You can use the benchmarking tool at BizStats ([www.bizstats.com](http://www.bizstats.com)) to find out what the standards are for your type of company based on your total business revenue.

## Lisa's Candle Shop Income Statement as of February 28, 2005

	January 1, 2005 to January 31, 2005		February 1, 2005 to February 28, 2005	
Sales	\$21,900.00	100.0%	\$25,600.00	100.0%
Cost of Goods Sold	(\$13,007.53)	59.4%	(\$15,358.14)	60.0%
Gross Profit	\$8,892.47	40.6%	\$10,241.86	40.0%
Expenses:				
Advertising	\$1,000.00	4.6%	\$1,000.00	3.9%
Bank Charges	\$45.00	0.2%	\$45.00	0.2%
Insurance	\$100.00	0.5%	\$100.00	0.4%
Interest Expense	\$29.17	0.1%	\$28.76	0.1%
Legal & Accounting	\$300.00	1.4%	\$300.00	1.2%
Office Expense	\$250.00	1.1%	\$250.00	1.0%
Payroll Taxes	\$335.70	1.5%	\$335.70	1.3%
Postage	\$125.00	0.6%	\$125.00	0.5%
Rent Expense	\$800.00	3.6%	\$800.00	3.1%
Salaries & Wages	\$3,800.00	17.4%	\$3,800.00	14.8%
Supplies	\$920.00	4.2%	\$1,120.00	4.4%
Telephone Expense	\$150.00	0.7%	150.00	0.6%
Utilities	\$300.00	1.4%	\$300.00	1.2%
Total Expenses	\$8,154.87	37.2%	\$8,354.46	32.6%
Net Income	\$737.60	3.4%	\$1,887.40	7.4%

Just taking a quick glance at these numbers, you can see that the Gross Profit was down slightly as a percentage between January and February because of the increase in Cost of Goods Sold, but overall the increasing sales volume almost doubled Net Income, which is a great sign for a start-up company.

## Using the P&L for Business Decision Making

Now, let's look at how Lisa can use the figures to see how she is doing compared to similar businesses.



First, we need to find out what the averages are for similar retail businesses. To get these numbers, we used the February sales total in the benchmarking tool mentioned at [www.BizStats.com](http://www.BizStats.com). Here are the averages for similar small businesses:

**Average Profitability & Expense Percentages for U.S. Small Businesses**

<b>Retailing—General Merchandise</b>	<b>\$</b>	<b>%</b>
Total Revenue (Sales)	\$25,600	100.0%
Total Expenses as % of Revenue	\$22,991	89.8%
Net Income to Owner as % of Revenue	\$2,609	10.2%
Detail of Expenses (as % of Revenue)		
Cost of Goods Sold	\$16,691	65.2%
Salaries & Wages	\$1,360	5.3%
Advertising	\$183	0.7%
Auto & Truck Expenses	\$268	1.0%
Depreciation	\$313	1.2%
Employee Benefits	\$77	0.3%
Home Office Business Expenses	\$1	0.0%
Insurance	\$195	0.8%
Interest Expenses	\$296	1.2%
Legal & Professional Services	\$75	0.3%
Meals & Entertainment	\$42	0.2%
Office Expenses	\$76	0.3%
Retirement Plans	\$7	0.0%
Rent—Equipment	\$72	0.3%
Rent—Office & Business Property	\$880	3.4%
Repairs	\$159	0.6%
Supplies	\$179	0.7%
Taxes—Business & Payroll	\$399	1.6%
Travel	\$100	0.4%
Utilities	\$648	2.5%
Other Expenses	\$968	3.8%
Total Expenses as % of Revenue	\$22,991	89.8%

Looking at the bottom line, Net Income, Lisa's Candle Shop is below the industry average of 10.2 percent, but considering that this is a new business that's really not bad. She's got a good handle on her Cost of Goods Sold. The industry average is 65.2 percent and Lisa's is 60 percent.

Salaries and wages are considerably higher. The industry average is 5.3 percent and Lisa's Candle Shop is 14.8 percent. That is a drop from January's 17.4 percent though, and given that this is a new store that is just building its sales volume, it's not surprising for that to be out of whack.

After Lisa is open for a few more months, if the downward trend doesn't continue she may want to cut her salary and wage expenses. That's a personal decision based on the service she wants to offer her customers. Lisa needs to determine whether she does need all the sales people she currently has on staff.

**Biz Tips**

Benchmarking your P&L to industry averages is a quick way to see how your business operations compare to other similar companies. When you see a significant difference, take a look at your numbers and see if you can figure out the reason. You don't have to match the industry averages, but if your business is not doing as well as you would like, the differences might give you clues as to what is going wrong and what areas you need to work on to improve your profitability. If you're doing better than industry averages, you can feel great about your success. You still may find areas where you could improve your profitability even more.

The store's rent is slightly above the industry average of 3.4 percent. Lisa's Candle Shop's rent is 3.6 percent of sales. Her supplies number is high at 4.4 percent versus 0.7 percent for the industry average, but that will drop as sales volume increases. She may want to review what supplies are being purchased to see if there is any room to cut back on those expenses.

Tracking these small details can mean a lot to long-term profitability and success. Companies that don't pay attention to these details are the ones most likely destined to fail.

## Reformatting the Data for Specific Uses

As long as your P&L Statement includes the seven pieces of information mentioned earlier in this chapter, you have a lot of flexibility about how to format that statement based on business needs. After Lisa is in business for more than a year, she may want to do a P&L Statement that compares January 2005 to January 2006 and so on

through the year in addition to comparing to the previous month. She can do that by adding an additional column.

She may also find it useful to compare quarter to quarter both for the current year and the previous year. Usually a business that wants to look at the numbers quarterly will do statements, one for the current month and a separate one for the quarter.

You also may want to set up a series of reports based on the P&L that tracks certain trends, such as your Sales and Cost of Goods sold. You could set up a report that gives all the detail for those accounts, rather than just the summary we used. That report could be used only by the departments directly impacted by these specifics. You may not want to make some detail available outside a certain circle of managers and investors.

## **Producing the Year-End P&L Statement**

At year-end, you summarize your activity for the year on the year-end P&L Statement. Many companies show quarter-to-quarter results in addition to the year-end summary. Again, as with the monthly P&L Statement, you have a lot of flexibility about how you set up the year-end statement.

The key points to remember as you design your year-end report are that you include the seven key items mentioned previously plus whatever additional information or detail that makes these statements more useful for you and your managers as you plan your future business activities.

Now that you know how to close your accounts monthly, prove out your numbers, and complete your financial statements, we'll look at how you finish up your payroll before moving on to how to close the books for the year.

### **The Least You Need to Know**

- ◆ Your P&L Statement gives you a summary of your daily business activity as well as your profitability for the period covered by the statement, which can be monthly, quarterly, yearly, or any period that you decide will help you make your business decisions.
- ◆ There are seven key items that must be on your P&L Statement, but otherwise the format is up to you.
- ◆ After you finish preparing your P&L, it's a good idea not only to compare your results to prior months or years, but you also should compare your results to those of similar businesses.



# Chapter 23

## Year-End Payroll Reporting

### In This Chapter

- ◆ Generating W-2s
- ◆ Reporting on W-3
- ◆ Completing 1099s
- ◆ Filing annual reports

Now that we've completed the monthly tasks, let's take a look at how to start the process of closing the books at year-end. You should go ahead and close the December month-end the same way you would close any other month. That way you can find any problems specifically related to that month more easily before trying to balance the books at year-end.

The first step in year-end close is to close your payroll and record any additional payroll tax payments you may need to make. You probably have made most of your payments using quarterly forms and coupons as discussed in Chapter 15. You need to record your final payroll tax payment for the last quarter even though you don't need to pay it until January if you are using the accrual method, so the final quarter's expenses are charged to the proper business year.

You'll be able to use all the quarterly information when filing the year-end reports, which makes this process a lot easier than having to start from scratch at year-end.

The most time-consuming payroll task at year end is compiling and printing the information for employee W-2s and vendor or contractor 1099s. We review how to do this task, and then discuss all the year-end forms you'll need to file after that work is done.

## Producing Employee W-2s

As an employee, you probably always wondered why most companies waited until the last possible minute to give out the W-2s, especially if you're expecting a refund and want to file your tax return as early as possible. After you learn how time-consuming it is to compile these forms, you'll have a better idea of why companies do take so long to get the forms out.

Payroll computer software certainly makes the task easier, but depending on the size of your payroll, it's still time-consuming to check the numbers before sending out the forms. Although you can send a corrected form if you make a mistake, that, too, is a time-consuming process that you hope you can avoid by doing it right the first time. Your company may even have to pay penalties for incorrectly filed W-2s. More on that later.

a Control number <b>22222</b>		OMB No. 1545-0008								
b Employer identification number (EIN)		1 Wages, tips, other compensation		2 Federal income tax withheld						
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld						
		5 Medicare wages and tips		6 Medicare tax withheld						
		7 Social security tips		8 Allocated tips						
d Employee's social security number		9 Advance EIC payment		10 Dependent care benefits						
e Employee's first name and initial Last name		11 Nonqualified plans		12a						
		13 Statutory retirement Third-party options plan 401(k)		12b						
		14 Other		12c						
				12d						
f Employee's address and ZIP code										
15 State Employer's state ID number		16 State wages, tips, etc.		17 State income tax		18 Local wages, tips, etc.		19 Local income tax		20 Locality name
Form <b>W-2</b> Wage and Tax Statement		<b>2005</b>		Department of the Treasury—Internal Revenue Service						
Copy 1—For State, City, or Local Tax Department										

*This is a sample of a 2005 W-2 form.*

First, let's look at what is supposed to be included in all those little boxes. You'll now see why it is so important to keep your employee's paycheck details in a payroll journal or file for each employee individually. Payroll software automatically tracks this information for you.

- ◆ **Box 1:** All wages, tips, and other compensation. This should include any bonuses, prizes, awards, noncash payments (including some fringe benefits as discussed in Chapter 14), or other compensation that does not qualify for an income exclusion or exemption.
- ◆ **Box 2:** Federal Income Tax Withheld.
- ◆ **Box 3:** Social Security Wages. Remember from our discussion in Chapter 14 that some fringe benefits are excluded from Social Security taxes while others are not. If an employee earns more than the maximum to be taxed, then the Social Security maximum would be in this box.
- ◆ **Box 4:** Social Security Tax Withheld.
- ◆ **Box 5:** Medicare Wages and Tips. The same fringe benefits are reported here as with Social Security, but there is no cap on wages, so all the employee's taxable wages would be included.
- ◆ **Box 6:** Medicare Tax Withheld.
- ◆ **Box 7:** Social Security Tips. The tips your employee reported to you should be shown here. The total of this box plus Box 3 should not exceed the Social Security Wage cap.
- ◆ **Box 8:** Allocated tips. Some large food or beverage businesses allocate tips rather than have employees collect and report them separately. These allocated tips are reported in this box.
- ◆ **Box 9:** Advance EIC. If you paid a qualified employee advances on his or her Earned Income Credit, you would report those advances in this box.
- ◆ **Box 10:** Dependent Care Benefits are reported in this box.
- ◆ **Box 11:** Nonqualified Plans. This box is used to report distributions of retirement plan assets that are nonqualified (does not meet federal retirement plan rules). Qualified retirement plan assets distributed are reported on a 1099-R. (This includes 401(k)s, IRAs, pensions, and other qualified plans.)
- ◆ **Box 12:** Codes. Items coded A to Z fit in this category. You report the designated code and its matching dollar amount. For example, Code A is for uncollected Social Security tax on tips, Code J is for nontaxable sick pay, and Code T

is for adoption benefits. You can get a full listing of the codes in the IRS instructions for the W-2, which come with your W-2 forms, or you can download it at [www.irs.gov/pub/irs-pdf/iw2w3.pdf](http://www.irs.gov/pub/irs-pdf/iw2w3.pdf).

- ◆ **Box 13:** Three boxes you can check if they apply. The first box is checked if the employee was a *statutory employee*. The second box is checked if your company offers a qualified retirement plan. The third box is checked if your company serves as a third-party sick pay payer. This is most commonly used if an employee receives compensation from an insurer, such as workers' compensation.

## def•i•ni•tion

**Statutory employees** are employees whose earnings are subject to Social Security and Medicare, but are not subject to federal income tax withholding. For example, this includes agents or traveling salespeople who are allowed to report income and expenses as a business.

- ◆ **Box 14:** Other. This is where miscellaneous items are reported, such as fringe benefits that were included in Box 1 that you need to explain to the employee. Essentially this box is for information to be shared with the employee that gives details about certain figures on the W-2.
- ◆ **Boxes 15 to 20:** State and local tax information.

You must give your employees their W-2s by January 31. These must be mailed on or before January 31. If that date falls on a weekend, you have until the following Monday to supply the forms. You can supply a W-2 earlier if the employee leaves the company. If you can't meet the W-2 deadline, you have to formally request an extension by sending a letter to:

IRS-Martinsburg Computing Center  
Information Reporting Program  
Attn. Extension of Time Coordinator  
240 Murall Drive  
Kearneysville, WV 25430

The letter should include the following information:

- ◆ Your business name and address
- ◆ Your EIN
- ◆ Type of return (W-2)
- ◆ Statement requesting an extension to furnish W-2s to employees



- ◆ Reason for delay
- ◆ Your signature or signature of your authorized agent

Penalties for failing to provide the W-2 on time and correctly can be high. There are three levels if you have requested an extension:

- ◆ \$15 per Form W-2 if you correctly file within 30 days of the due date. The maximum penalty is \$75,000 for the year. Companies with average annual gross revenues under \$5 million face a \$25,000 maximum penalty.
- ◆ \$30 per Form W-2 if you correctly file more than 30 days after the due date but by August 1. Maximum penalty is \$150,000 for large companies and \$50,000 for small businesses.
- ◆ \$50 per Form W-2 if you file after August 1 or do not file required W-2 forms. Maximum penalty is \$250,000 per year and \$100,000 for small businesses.

Your W-2s can be incorrectly filed if you don't include all the necessary information, if the information is incorrect, if you report an incorrect taxpayer identification number (Social Security number), or if you provide unreadable forms. Now you know why you want to check those W-2s carefully even if you use a payroll software program or use an outside company to prepare your payroll.



### Audit Alarms

If you do not file corrections and you do not meet any of the allowable exceptions, your penalty is \$50 per return. Allowable penalty exceptions include reasonable cause (failure to file was because of an event beyond your control and not neglect) and you did your best to avoid the failure to file. If the incorrect information was inconsequential or an omission that did not hinder the Social Security Administration or the IRS from processing the W-2, you also qualify for an allowable exception.

If you don't get an extension, fail to provide the W-2s to your employees by January 31, and cannot show reasonable cause, you could be subject to a \$50 penalty per W-2. This penalty also applies if you fail to include all necessary information or include incorrect information on the W-2.

The stiffest penalty is imposed if the IRS determines your failure to provide the forms on time was an "intentional disregard of payee statement requirements." If that happens, the fine is \$100 per W-2 with no maximum penalty.

You could be hit with a suit for civil damages if you fraudulently file a W-2 claiming you paid someone wages you didn't actually pay. The person may be able to sue you for any damages this caused them.

There are usually four copies of the W-2 given to the employee (one for the employee's file, one to file with the federal income taxes, one for state income taxes, and one for local income taxes). Additionally, one copy is sent to the Federal government and one copy is kept by the employer. That's six copies (or a six-part form). Some states require an eight-part form so that one copy may also be filed with the state tax department and one with any applicable local tax authority.

## Transmitting the Wage Statements

After you complete all your W-2s, you total the numbers and put them on a form that looks very similar, called the W-3. This form summarizes the employer's total payroll numbers for the year.

This is your last chance to reconcile your numbers before actually filing them with the government. Be sure these numbers match the totals you filed on your quarterly 941 reports. If not, it means you have an error somewhere and can avoid possible penalties by finding that error before you file the W-2s.

As a small business you can mail these forms, use the online services of the Social Security Administration ([www.ssa.gov/bsowelcome.htm](http://www.ssa.gov/bsowelcome.htm)), or file using a magnetic media or electronically. Companies with over 250 employees must file these forms by magnetic media or electronically.

You have until February 28 to formally file the W-2s and W-3 with the Social Security Administration. If you are filing electronically, you can wait until March 31. If you report tips, you also need to file Form 8027, "Employer's Annual Information Return of Tip Income and Allocated Tips," with the IRS. You can wait until March 31 for this task as well if you file electronically.

<b>DO NOT STAPLE OR FOLD</b>									
<b>a</b> Control number		<b>33333</b>			<b>For Official Use Only ▶</b> OMB No. 1545-0008				
<b>b</b> Kind of Payer		941 <input type="checkbox"/>	Military <input type="checkbox"/>	943 <input type="checkbox"/>	1 Wages, tips, other compensation		2 Federal income tax withheld		
		CT-1 <input type="checkbox"/>	Hshld. emp. <input type="checkbox"/>	Medicare gov't emp. <input type="checkbox"/>	3 Social security wages		4 Social security tax withheld		
<b>c</b> Total number of Forms W-2		<b>d</b> Establishment number			5 Medicare wages and tips		6 Medicare tax withheld		
<b>e</b> Employer identification number (EIN)					7 Social security tips		8 Allocated tips		
<b>f</b> Employer's name					9 Advance EIC payments		10 Dependent care benefits		
.....					11 Nonqualified plans		12 Deferred compensation		
.....					13 For third-party sick pay use only		14 Income tax withheld by payer of third-party sick pay		
<b>g</b> Employer's address and ZIP code									
<b>h</b> Other EIN used this year									
<b>15</b> State		Employer's state ID number			16 State wages, tips, etc.		17 State income tax		
					18 Local wages, tips, etc.		19 Local income tax		
Contact person					Telephone number (    )		For Official Use Only		
Email address					Fax number (    )				

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ \_\_\_\_\_ Title ▶ \_\_\_\_\_ Date ▶ \_\_\_\_\_

**Form W-3 Transmittal of Wage and Tax Statements**

**Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable.**

**Do not** send any payment (cash, checks, money orders, etc.) with Forms W-2 and W-3.

**Reminder**  
Separate instructions. See the 2005 Instructions for Forms W-2 and W-3 for information on completing this form.

**Purpose of Form**  
Use Form W-3 to transmit Copy A of Form(s) W-2, Wage and Tax Statement. Make a copy of Form W-3 and keep it with Copy D (For Employer) of Form(s) W-2 for your records. Use Form W-3 for the correct year. **File Form W-3 even if only one Form W-2 is being filed.** If you are filing Form(s) W-2 on magnetic media or electronically, **do not** file Form W-3.

**When To File**  
File Form W-3 with Copy A of Form(s) W-2 by February 28, 2006.

**2005**

Department of the Treasury  
Internal Revenue Service

**Where To File**  
Send this entire page with the entire Copy A page of Form(s) W-2 to:

**Social Security Administration  
Data Operations Center  
Wilkes-Barre, PA 18769-0001**

**Note.** If you use "Certified Mail" to file, change the ZIP code to "18769-0002." If you use an IRS-approved private delivery service, add "ATTN: W-2 Process, 1150 E. Mountain Dr." to the address and change the ZIP code to "18702-7997." See **Publication 15 (Circular E), Employer's Tax Guide**, for a list of IRS-approved private delivery services.

**Do not** send magnetic media to the address shown above.

For Privacy Act and Paperwork Reduction Act Notice, see back of Copy D of Form W-2.

Cat. No. 10159Y

*This is the W-3 form used by employers to transmit their W-2s to the Federal government.*

## Producing Vendor and Contractor 1099s

For anyone to whom you pay compensation, but do not consider an employee, you need to provide a 1099 reporting that income if you paid them more than \$600 during the year. These forms are informational forms and are used to report employee allowances, rental income, interest payments, and other miscellaneous payments.

You've probably gotten many of these during your life even if you didn't work as a contractor for interest payments and dividend payments. There are actually 16 different types of 1099s, but luckily you only need to worry about a few of them. They all look basically the same, but require slightly different information. You can order the forms you need online at [www.irs.gov/formspubs/index.html](http://www.irs.gov/formspubs/index.html).

Forms you may need to complete as a small business include:

- ◆ 1099-MISC: Miscellaneous Income
- ◆ 1099-MSA: Distribution from an Archer MSA
- ◆ 1099-R: Distributions from Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.

The 1099-MISC is used for most of your vendors or contractors to whom you provide income. The 1099-MSA is only needed if you offer an Archer Medical Savings Account program. The 1099-R is needed if an employee leaves and withdraws their qualified retirement plan money, whether it is for the purposes of retirement, to roll the money into an IRA, or to withdraw it as a lump sum.

You must give these to the vendors or contractors by January 31, but you don't need to file these with the IRS until February 28. The IRS uses the information gathered on these forms to match income reported by these contractors and vendors on their individual tax returns.

You want three copies of this form. One is sent to the vendor or contractor and the other is sent to the IRS with Form 1096, "Annual Summary and Transmittal of U.S. Information Returns." Of course, you want to keep one copy for your files as well.

That's it for the individual payroll forms. There are a few other annual federal forms you need to file based on your payroll. You most likely will have state forms that mirror the federal forms as well. But, as we mentioned before, that varies state by state, so you'll need to check with your state offices.

<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED				<b>2005</b> Form <b>1099-MISC</b>		<b>Miscellaneous Income</b>		
PAYER'S name, street address, city, state, ZIP code, and telephone no.		1	Rents	OMB No. 1545-0115				
		\$						
		2	Royalties					
		\$		Form <b>1099-MISC</b>	<b>Copy 1 For State Tax Department</b>			
		3	Other income	4				Federal income tax withheld
		\$		\$				
PAYER'S Federal identification number	RECIPIENT'S identification number	5	Fishing boat proceeds	6	Medical and health care payments			
RECIPIENT'S name  Street address (including apt. no.)  City, state, and ZIP code		\$		\$				
		7	Nonemployee compensation	8				Substitute payments in lieu of dividends or interest
		\$		\$				
Account number (see instructions)		9	Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	10	Crop insurance proceeds			
		\$		\$				
		11		12				
		13	Excess golden parachute payments	14	Gross proceeds paid to an attorney			
		\$		\$				
		16	State tax withheld	17				State/Payer's state no.
15a Section 409A deferrals	15b Section 409A income	\$		\$		\$		
		\$		\$		\$		

Form **1099-MISC** Department of the Treasury - Internal Revenue Service

*This is a sample of the 1099-MISC, which is the most commonly used version in a small business.*

Do Not Staple		6969		OMB No. 1545-0108									
Form <b>1096</b> Department of the Treasury Internal Revenue Service		<b>Annual Summary and Transmittal of                  U.S. Information Returns</b>				<b>2005</b> (Rev. March 2005)							
FILER'S name													
Street address (including room or suite number)													
City, state, and ZIP code													
Name of person to contact			Telephone number ( )		<b>For Official Use Only</b> [ ] [ ] [ ] [ ] [ ] [ ] [ ] [ ]								
Email address			Fax number ( )										
1 Employer identification number	2 Social security number	3 Total number of forms	4 Federal income tax withheld \$	5 Total amount reported with this Form 1096 \$									
Enter an "X" in only one box below to indicate the type of form being filed. If this is your <b>final return</b> , enter an "X" here . . . <input type="checkbox"/>													
W-2G 32 <input type="checkbox"/>	1098-E 81 <input type="checkbox"/>	1098-C 78 <input type="checkbox"/>	1098-E 84 <input type="checkbox"/>	1098-T 83 <input type="checkbox"/>	1099-A 80 <input type="checkbox"/>	1099-B 79 <input type="checkbox"/>	1099-C 85 <input type="checkbox"/>	1099-CAP 73 <input type="checkbox"/>	1099-DIV 91 <input type="checkbox"/>	1099-G 86 <input type="checkbox"/>	1099-H 71 <input type="checkbox"/>	1099-INT 92 <input type="checkbox"/>	1099-LTC 93 <input type="checkbox"/>
1099-MISC 95 <input type="checkbox"/>	1099-OID 96 <input type="checkbox"/>	1099-PATR 97 <input type="checkbox"/>	1099-O 31 <input type="checkbox"/>	1099-R 98 <input type="checkbox"/>	1099-S 75 <input type="checkbox"/>	1099-SA 84 <input type="checkbox"/>	5498 28 <input type="checkbox"/>	5498-ESA 72 <input type="checkbox"/>	5498-SA 27 <input type="checkbox"/>				

Return this entire page to the Internal Revenue Service. Photocopies are not acceptable.

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶	Title ▶	Date ▶
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### Instructions

**Purpose of form.** Use this form to transmit paper Forms 1099, 1098, 5498, and W-2G to the Internal Revenue Service. Do not use Form 1096 to transmit electronically or magnetically. For magnetic media, see Form 4804, Transmission of Information Returns Reported Magnetically; for electronic submissions, see Pub. 1220, Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically.

**Who must file.** The name, address, and TIN of the filer on this form must be the same as those you enter in the upper left area of Forms 1099, 1098, 5498, or W-2G. A filer includes a payer; a recipient of mortgage interest payments (including points) or student loan interest; an educational institution; a broker; a barter exchange; a creditor; a person reporting real estate transactions; a trustee or issuer of any individual retirement arrangement, a Coverdell ESA, an HSA, an Archer MSA (including a Medicare Advantage MSA); certain corporations; certain donees of motor vehicles, boats, and airplanes; and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

**Preaddressed Form 1096.** If you received a preaddressed Form 1096 from the IRS with Package 1099, use it to transmit paper Forms 1099, 1098, 5498, and W-2G to the Internal Revenue Service. If any of the preprinted information is incorrect, make corrections on the form.

If you are not using a preaddressed form, enter the filer's name, address (including room, suite, or other unit number), and TIN in the spaces provided on the form.

**When to file.** File Form 1096 with Forms 1099, 1098, or W-2G by February 28, 2006. File Form 1096 with Forms 5498, 5498-ESA, and 5498-SA by May 31, 2006.

**Where To File**  
 Send all information returns filed on paper with Form 1096 to the following:

<p><b>If your principal business, office or agency, or legal residence in the case of an individual, is located in</b></p> <p>Alabama, Arizona, Florida, Georgia, Louisiana, Mississippi, New Mexico, North Carolina, Texas, Virginia</p> <p>Arkansas, Connecticut, Delaware, Kentucky, Maine, Massachusetts, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Vermont, West Virginia</p> <p>Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Carolina, South Dakota, Tennessee, Wisconsin</p>	<p><b>Use the following Internal Revenue Service Center address</b></p> <p>Austin, TX 73301</p> <p>Cincinnati, OH 45999</p> <p>Kansas City, MO 64999</p>
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**For more information and the Privacy Act and Paperwork Reduction Act Notice, see the 2005 General Instructions for Forms 1099, 1098, 5498, and W-2G.**      Cat. No. 144000      Form **1096** (Rev. 3-2005)

*This is a sample of the 1096, which is used to transmit 1099s and other information forms.*

## Filing Federal Government Reports

There are two additional federal forms you'll need to file by January 31. One is used to report unemployment figures and the second is used to report federal income taxes withheld for nonpayroll income.

Form 940 or 940EZ, "Employer's Annual Federal Unemployment (FUTA)," is basically a form in which you summarize your payroll information and calculate your FUTA tax for the year. If you've made all the necessary payments and only pay unemployment contributions to one state, you can use the simpler 940 EZ version. You use the information gathered on the quarterly reports to prepare this form.

Form 945, "Annual Return of Withheld Income Tax," is used to report any nonpayroll income tax withheld. As a small business you probably won't have to worry about this form, but if you do withhold income tax from a pension, annuity, or IRA, you would use this form to report that tax. If your small business includes gambling or gaming, you would report any tax withheld from the winnings on this form.

## Beginning the Cycle Again

You begin the entire cycle again on February 15, which is the date you must request a new W-4 from any employee who claimed an exemption from income taxes the previous year. You probably should send out the forms prior to that date because if the employee does not provide this form by February 16, you must begin withholding taxes from that employee's income. Taxes withheld until a new form is filed are based on a single employee with zero withholding allowances, which is the highest level of tax to be withheld.

So far we've talked about how you report taxes withheld or paid on behalf of your employees. In the next chapter, we'll look at how owners report their business income.

## The Least You Need to Know

- ◆ Completing and filing W-2s and 1099s is one of the most time-consuming tasks for a small business in the month of January. Good record-keeping throughout the year can minimize the pain of this task.
- ◆ If you make a mistake or fail to file the W-2 on time you may be subject to hefty penalties.

- ◆ In addition to the W-2s and 1099s, you must also file information forms that summarize the totals reported on these forms using a W-3 and 1096.
- ◆ Unemployment wage information is reported on the Form 940, “Employer’s Annual Federal Unemployment (FUTA) Tax Return.”



# Part 6

## Closing the Books at Year-End

Your responsibilities for closing the books at the end of the year are similar to month-end close, except now you get to zero some accounts and start fresh the next year. Small business owners report their profit or loss differently on personal and business tax returns depending on how their businesses are structured. After learning all the basics of accounting, you may want to shift to a computerized accounting system if you are using a manual one. We discuss how to convert and give an overview of software choices.





# Chapter 24

## Doing Personal and Business Tax Returns

### In This Chapter

- ◆ Exploring tax types
- ◆ Clearing up the form maze
- ◆ Filing on time
- ◆ Charting forms

Although this is not a tax book, we are going to take a brief look at the tax filing obligations of the business owner. As we discussed in Chapter 1, these obligations vary greatly depending on how a business is structured.

We look at the types of taxes the owner must be concerned with, as well as the forms required, depending on business structure.

### Understanding Tax Types

Basically the small business owner has to worry about four different tax types: income tax, self-employment tax, employment taxes, and excise

taxes. We've covered the employment taxes in the numerous chapters related to payroll taxes.

You've lived with income taxes all your life, so you probably have a good understanding of what those are and how you file forms for them. You need to add some schedules to your 1040, but otherwise things won't be that different.

Self-employment taxes are the ones that hurt the most. That's because as a business owner you must pay both the employee and employer portion of the Social Security and Medicare taxes. You do get to adjust your gross income by deducting the employer portion from your gross income and thereby reducing your tax bill. You need to add Schedule SE to calculate and report these taxes.

Excise taxes are special taxes based on the type of business you run. You may or may not need to worry about these. These are the primary business types that might need to be concerned with excise taxes.

- ◆ Businesses that deal in the sale of ozone-depleting chemicals
- ◆ Communications and air transportation businesses
- ◆ Manufacturing firms
- ◆ Retailers
- ◆ Businesses that engage in the use of heavy trucking, trailers, and tractors

There are also fuel taxes and taxes related to foreign insurance. If you think your business may be impacted by excise taxes, you should download Publication 510, "Excise Taxes for 2005" ([www.irs.gov/pub/irs-pdf/p510.pdf](http://www.irs.gov/pub/irs-pdf/p510.pdf)).

## Sorting Out the Forms

Most sole proprietors and partners file their income taxes using Form 1040. The business doesn't have to file any additional forms if it's owned by a sole proprietor. During the year you'll have to pay estimated taxes using Form 1040-ES. You can download Publication 505, "Tax Withholding and Estimated Taxes" ([www.irs.gov/pub/irs-pdf/p505.pdf](http://www.irs.gov/pub/irs-pdf/p505.pdf)), to learn more about this requirement.

A sole proprietor needs to add Schedule C, "Profit or Loss from Business," which includes most of the information on the P&L Statement. There are some differences because of various tax breaks available to business owners, especially relating to equipment and vehicle purchases. Instructions for this form can be found in your 1040 package.

Businesses structured as a partnership have to file an annual information return on Form 1065. If your business is a partnership, you can learn more about tax rules in Publication 541, “Partnerships,” which can be downloaded at [www.irs.gov/pub/irs-pdf/p541.pdf](http://www.irs.gov/pub/irs-pdf/p541.pdf). As part of this form, the business fills out a Schedule K-1 for each of the partners.

Because the partnership pays no taxes, all income and expenses are passed on to the partners who then include the information on their 1040 returns. Partners need to add Schedule E, “Supplemental Income and Loss.” They use the information provided on Schedule K-1 to complete this form. Partners also need to pay estimated taxes and self-employed taxes.

If either the sole proprietorship or partnership chose to file as a corporation, or the business is structured as a corporation, then a corporate tax return would need to be filed, which is Form 1120. Instructions for Form 1120 can be downloaded at [www.irs.gov/pub/irs-pdf/i1120s.pdf](http://www.irs.gov/pub/irs-pdf/i1120s.pdf). S Corporations file 1120S and pass the income and expenses on to their partners, who are treated as shareholders.

## Meeting Filing Requirements

Filing requirements for most small business owners are the same as for others. Your forms are due the same time with some extension possibilities. Corporate returns for calendar year corporations are due March 15th, instead of the April 15th deadline for personal returns and partnership returns.

The one exception to this rule is corporations that have filed for a fiscal year that is different than the calendar year. These corporations will need to complete the required year-end forms for employees in January and February. The business owner probably pays himself or herself a salary and will receive a W-2, which would then be used to file personal taxes on a Form 1040.



### Business Bites

Q: What did the accountant say when he got a blank check?

A: My deductions have at last caught up with my salary.

The corporation must file its tax returns on the fifteenth day of the third month after the fiscal year ends. For example, if a business’s fiscal year is from September 1 to August 31, then Form 1120 would be due on November 15.

We’ve discussed a lot of federal tax forms that need to be filed by the small business owner. We are not including the excise tax forms here because they vary so greatly by type of business; you should consult Publication 510 to determine the forms needed.

Here is a chart of the key forms grouped by business type.

<b>Federal Taxes You Could Be Liable For:</b>	<b>Forms You Should Use:</b>
<b><i>Sole Proprietor</i></b>	
Income Tax	1040 with Schedule C or Schedule C EZ, Schedule F for a farm business
Self-Employment Tax	Schedule SE attached to 1040
Estimated Tax	1040-ES
Employment Taxes	941, 943 (if a farm business), 940 or 940-EZ, 8109 (not needed if you deposit taxes electronically)
<b><i>Partnership</i></b>	
Annual Return of Income	1065
Employment Tax	Same as a Sole Proprietor
<b><i>Partner in the Partnership</i></b>	
Income Tax	1040 with Schedule E
Self-Employment Tax	Schedule SE attached to 1040
Estimated Tax	1040-ES
<b><i>Corporation (C or S)</i></b>	
Income Tax	1120 or 1120-A (C Corporation), 1120 S (S Corporation)
Estimated Tax	1120-W (C Corporation only) and 8109 payment coupons if taxes are not deposited electronically
Employment Taxes	Same as Sole Proprietor
<b><i>S Corporation Shareholder</i></b>	
Income Tax	1040 with Schedule E
Estimated Tax	1040-ES

Now that we've gotten taxes out of the way, we'll look at how you close the rest of the books for the year.

## **The Least You Need to Know**

- ◆ The tax forms you need and how you file your taxes depend on the business structure you've chosen.
- ◆ Sole proprietors, partners, and shareholders in an S Corporation all report income from the business on their 1040. The difference is that the S Corporation shareholder also has a W-2 for wages.
- ◆ Shareholders of a C Corporation usually pay themselves a salary and get a W-2 for that income to file their personal taxes. They may also report dividend income from the corporation on their personal return.





# Chapter 25

## Closing the Books

### In This Chapter

- ◆ Closing the ledger
- ◆ Assessing customer accounts
- ◆ Reviewing vendor accounts
- ◆ Opening new books

Year-end close is a time of accomplishment as you complete the functions for the previous year and start storing things away. It's also a time of new beginnings as you start accounts for the new year.

Balance sheet accounts are never closed and their balances are carried forward from year to year, but you need to be sure the proper adjustments are made to place transactions in the correct year. P&L Statement accounts are zeroed out. We'll look at the process for completing each of these tasks.

The period of close can take a couple of months as you complete all the necessary tax-reporting requirements, finalize any tax payments, and record other costs or expenses that may need to be charged to the previous business year.

You probably will need to go back and forth between the current and previous years throughout this close process, but there is no need to rush. Accuracy is more important than meeting any time deadline, except the required report-filing.

## Finalizing the General Ledger

There isn't anything you need to do to close balance sheet accounts. They never actually close. Instead, their balances are carried forward. You wouldn't close a checking account and reopen a new one at the start of the next year. The same is true for all Assets, Liabilities, and Equity accounts. Bet you wish you could just zero out those liabilities in the same way we'll be zeroing out the P&L accounts.

You want to note your balances as of December 31 so you can prepare your year-end balance sheets, but that is just so that you have a snapshot of your business. You shouldn't record these year-end balances until you are positive that you have made all the adjusting entries for the year.



### Audit Alarms

If you are working with a computer accounting system, before you even start working with the data to prepare for year-end close, be sure you have a backup of that data. Also be sure to print out a general ledger report so you have a paper copy of the accounts before you start working with them. That way, if you find an error, it will be easier to restore the data and fix the problem.

You need to record any depreciation expense that hasn't been recorded earlier in the year and adjust the balances in the accumulated depreciation accounts on the balance sheet as well as in the individual ledgers for the Assets. You may also need to make adjusting entries related to your Accounts Receivable and Accounts Payable.

## Reviewing Customer Accounts

Your next step is to review your customer accounts. These are part of Accounts Receivable, a balance sheet account, and will not be closed. You certainly want to be sure to carry over any balances not yet collected.

If you have any accounts that are more than 180 days past due, you may need to consider writing off the account. You can judge that by past business experience and decide at what point you give up on trying to collect. If you do have some customers whom you have given up on, you would write off the debt to a *Bad Debts Expense* account.

**def·i·ni·tion**

**Bad Debts Expense** reflects the amount of your company's accounts that are not collectable.

Some companies make this adjustment monthly, others do it yearly. Many decide to just write off a percentage of their Accounts Receivable accounts as bad debts based on historical experience with collecting their store charge accounts. Other companies actually identify the customer accounts they plan to write off and write off totals based on that assessment. We need to establish a new account for this called Bad Debt Expense (5225).

Whatever way you decide to record bad debt, your final adjustment for Accounts Receivable to recognize bad debt would be.

	Debit	Credit
5225 Bad Debt Expense	\$	
1100 Accounts Receivable		\$
To write off unpaid customer charges.		

If you prepared this entry by using a percentage, you would not need to make specific entries in customer accounts. You would want to make specific entries in customer accounts if you developed this number by specifically identifying problem customers. Then you would want to note the write-off on the customer account information.

If you do receive payment on a specific account that was written off the prior year, then you would reverse the entry in this way.

	Debit	Credit
1000 Cash in Checking	\$	
5525 Bad Dept Expense		\$
To record recovery of a bad debt.		

After you've finalized your review of customer accounts, you should note your year-end balances, but the accounts will remain open and active for the next year.

## Finalizing Vendor Accounts

Your vendor accounts also are never closed. These feed into Accounts Payable. Although you might enjoy being able to zero out bills due, you don't get to do it. Instead, as part of the process of finalizing your vendor accounts, you need to be certain you have posted all bills to be paid related to the business year.

You probably will receive bills to be paid at the end of December that you won't actually pay until January. You need to post these bills to Accounts Payable using an accrual entry. For example, if you got a bill for holiday advertising in December on January 2, you would post that to December expenses.

	Debit	Credit
Advertising	\$	
2000 Accounts Payable		\$
To record advertising expenses for December.		

You would also need to record the details in the vendor account ledger. This would increase the balance in the Advertising expense, so your P&L Statement would accurately reflect December expenses. It would also increase the balance in Accounts Payable, so your December and year-end balance sheets would accurately reflect your liabilities.



### Biz Tips

You want to be sure you charge all necessary expenses to the appropriate month and year if you are using the accrual method. Year-end close is the time when you must spend the most time reviewing outstanding invoices, purchase orders, and depreciation accounts to be sure you have recorded all expenses before closing the books.

When you pay the bill in January, you then post this entry.

	Debit	Credit
2000 Accounts Payable	\$	
1000 Cash in Checking		\$
To record payment of advertising invoice.		

You would also need to post the payment details to the vendor's account.

In addition to reviewing invoices you have in hand that are not yet paid, you should also review any outstanding purchase orders and accrue any expenses related to the prior year. Purchase orders that have been completed by the vendor but not yet billed should be noted, and accounting should try to get an invoice as soon as possible as part of the year-end close process. This allows you to accurately match expenses with the year they occurred.

## Closing the P&L Statement Accounts

After you are certain all your income, costs, and expenses have been properly allocated to the appropriate accounts, you should do a trial balance and check your work just like you would at month-end. If everything balances, then you can zero out the accounts in the P&L Statement.



### Audit Alarms

If you are using a computer system, you don't have to do the actual entry. The system will close the books automatically after you indicate you are ready to close them. You should be sure you back up your work before attempting to close the books for the year. You also should print out a general ledger report before attempting the close. That way, if the computer's final calculation is different than you were expecting for Retained Earnings, you can restore the data and find the problem.

If you use a manual system, you can do this with one entry. We'll make-believe that Lisa's Candle Shop's February month-end figures were actually its year-end figures just so that we can show you how to format that entry. Here are the final balances in the P&L Statement account.

	Debit	Credit
Sales of Goods or Services		\$26,600.00
Sales Discounts	\$600.00	
Sales Returns & Allowances	\$400.00	
Purchases	\$15,443.00	
Purchase Discounts		\$308.86
Credit Card Fees	\$224.00	

*continues*

*continued*

	Debit	Credit
Advertising	\$1,000.00	
Bank Service Charges	\$45.00	
Insurance—General	\$100.00	
Interest Expenses	\$28.76	
Legal & Accounting	\$300.00	
Office Expenses	\$250.00	
Payroll Taxes	\$335.70	
Postage	\$125.00	
Rent Expenses	\$800.00	
Salaries & Wages	\$3,800.00	
Supplies	\$1,120.00	
Telephone Expenses	\$150.00	
Utilities	\$300.00	

To zero these out you need to post an entry that will debit the credit accounts to zero and credit the debit accounts to zero. Any remaining money left to balance the entry would go to the Retained Earnings account. If you had a loss for the year, your entry to Retained Earnings would be a debit. If you had a profit for the year, that entry would be a credit. Remember Retained Earnings is an Equity account and credit entries increase balances in that section of the balance sheet.

Here's what the entry would be to close the P&L Statement accounts for the year.

	Debit	Credit
Sales of Goods or Services	\$26,600.00	
Sales Discounts		\$600.00
Sales Returns & Allowances		\$400.00
Purchases		\$15,443.00
Purchase Discounts	\$308.86	
Credit Card Fees		\$224.00
Advertising		\$1,000.00
Bank Service Charges		\$45.00
Insurance—General		\$100.00

	Debit	Credit
Interest Expenses		\$28.76
Legal & Accounting		\$300.00
Office Expenses		\$250.00
Payroll Taxes		\$335.70
Postage		\$125.00
Rent Expenses		\$800.00
Salaries & Wages		\$3,800.00
Supplies		\$1,120.00
Telephone Expenses		\$150.00
Utilities		\$300.00
Retained Earnings		\$2,087.40
To close books for the year 2005.		

### Accounting Answers

Not all computer accounting systems require you to close the books at the end of an accounting period. One such example is QuickBooks, which does not formally close out any accounting period. You can always enter transactions for any time period. The primary reason you do perform a close anyway in QuickBooks is to restrict access to the transactions of prior accounting periods, so you can control who can make changes to prior-year accounts. When you close an accounting period in QuickBooks, what actually happens is you set a closing date. Any transactions entered on or before that closing date are protected by a password you set. To edit or delete a closed transaction, the person making the entry would need to know the password to modify those transactions. We take a closer look at QuickBooks and other accounting software in the next chapter.

## Getting Ready for the New Year

Your business doesn't stop operating just because you are doing the year-end close. As you work through the numbers, you'll find you are working with both the prior year accounts and the current year accounts.

Your software package should allow you to start a new year of P&L accounts with zero balances, before you actually zero out the prior-year accounts in a computer system. If this flexibility is crucial to you, you might want to verify that feature in a software package before you buy it. If you are using a manual system, you can either leave space on a journal page to make room for any additional entries or just start a new page for the more active accounts.

You also need to start new files for all the accounts. Many businesses keep two years of records in the accounting office and box up other years to put them in storage.

That way, if any questions arise relating to the prior year's records, the files are easily accessible. Let's assume Lisa's Candle Shop does that and stores the older records in a storage room at the back of the shop. If the shop is closing the books for 2005, then the first step would be to box up the records from 2004 and put them in storage. Because the shop is a new business, there wouldn't be much to box, maybe just some records relating to the business start-up.



**Biz Tips**

Take your time closing the books. There's no rush as long as you meet whatever filing deadlines are required by governmental agencies.

The empty 2004 file drawers can now be used for the new 2006 files. This will make it easy to work with both the 2005 files as you close out the year and manage the paperwork related to 2006 activity.

If you are using a manual system, you probably will find you want to switch over to a computer system pretty quickly. We'll take a look at how to switch to a computerized system, as well as review some of the most popular accounting software in the next chapter.

## The Least You Need to Know

- ◆ Closing the books at year-end requires many of the same steps as doing a month-end close, including reviewing your Accounts Receivable and Accounts Payable accounts as well as preparing any adjusting entries and doing a trial balance.
- ◆ You need to work in the books from both the previous year and the current year as you finalize the year-end close, because your business operations will not stop.
- ◆ You can either start new pages or leave space for any adjusting entries if you have a manual accounting system. On a computerized accounting system, you start new P&L Statement accounts with zero balances for the new year.



# Chapter 26

## Computerizing the Books

### In This Chapter

- ◆ Program choices
- ◆ Getting started
- ◆ Making it yours
- ◆ Loading it up

Now that you know the basics of accounting and have a sense of how much detail you need to track, you may be thinking you'd prefer to work with a computerized rather than a manual accounting system. Most businesses do reach that point after they start to grow.

We take a quick look at the top software programs, and then review how you go about converting from a manual accounting system to a computerized one.

### Choosing the Software

There are well over 50 accounting software packages from which to choose. For small businesses, the two most popular are QuickBooks and Peachtree Accounting. We've both used QuickBooks, but Peachtree Accounting is certainly a strong alternative you should consider.



### Biz Tips

Business.com ([www.business.com/directory/accounting/software](http://www.business.com/directory/accounting/software)) is a great place to start if you want to research accounting software alternatives. You can find reviews of some key small business packages at CNET ([http://reviews.cnet.com/4520-6405\\_7-6264622.html](http://reviews.cnet.com/4520-6405_7-6264622.html)).

### Accounting Answers

QuickBooks source code is open to third-party developers. This makes it easier for you to add on industry-related software programs, such as legal or warehouse tracking, developed by other software companies, and easily share data among the programs. You can find the list of industry-related software now compatible with QuickBooks at [www.marketplace.intuit.com](http://www.marketplace.intuit.com).

We discuss the key features that differentiate QuickBooks and Peachtree Accounting. You can read the full reviews at CNET.

CNET's January 12, 2005 review of QuickBooks Premier 2004 said,

“Intuit’s QuickBooks Premier Edition 2004 is the best and most comprehensive small-business accounting program out there. With its sophisticated forecasting and business-planning tools, as well as a thoughtful interface packed with helpful tips and wizards for novices, the \$499.95 Premier (\$379.95 upgrade) is best of breed. Despite its power and grace, however, Premier may be too much of a good thing for many small-business owners. Its key new features—including tools for tracking fixed assets and vehicle mileage, estimating cash flow, and managing loans—also come with QuickBooks Pro 2004, which costs \$200 less. That said, professionals who purchase Premier won’t be disappointed.”

There is a QuickBooks 2005 edition, and if you are buying it for the first time, we definitely recommend that edition, but if you already own QuickBooks 2004 there is no reason to upgrade. The changes are

not that dramatic between the 2004 and 2005 editions. CNET, an excellent online source for software reviews, in its Feb. 12, 2005 review, points out that the learning center for beginners in the QuickBooks 2005 edition is the primary advantage of the new software package.

We agree that for most small businesses QuickBooks Pro, which can be bought for half the price of the premier version, \$299.95, would be sufficient to meet your needs as long as sophisticated forecasting is not important to you. You can use QuickBooks over a network with up to five users able to access files simultaneously. The Learning Center is available with QuickBooks Pro as well.

The biggest negative for QuickBooks is the cost of its technical support. You can get free help with installation, but if you have technical questions after setup, phone support is \$75 for a 20 minute support call, plus \$25 for each addition five minute

increments, with a \$150 maximum. You can purchase an annual support plan that costs \$299 at the time of purchase and \$399 after that time.

The 2006 edition of QuickBooks was not yet released at the time this book was written.

Your other key accounting software alternative is Peachtree Complete Accounting. CNET says:

Peachtree Complete Accounting 2006 is a powerhouse bookkeeper for small businesses. This \$300 midrange accounting app in Sage (formerly Best) Software's lineup is a worthwhile upgrade for users of version 2005. Longtime users should enjoy the refinements, such as updated forms and new reports on customer and vendor transaction histories. Peachtree's core strengths remain the same, especially its top-notch inventory management tools, which let you automatically create purchase orders when supplies run low. Bookkeepers who also want to bank online can download statements from your bank's Web site directly into Peachtree 2006, and the new Bill Pay feature saves you from fussing with checks and stamps. We like the \$300 Peachtree Complete, though it's not amazing enough to warrant a switch if you're already happy with another program, such as QuickBooks Pro.

Peachtree interface can be a bit intimidating to first time users, but CNET says:

Longtime Peachtree users will feel comfortable with the interface of version 2006. The My Business screen provides a quick overview of your company's bottom line, and the menu bar provides easy access to dozens of features. Yet Peachtree's menu-driven presentation could intimidate newcomers, who may have to sift through a series of submenus to locate a task. Then again, the Peachtree Demos, accessible via the help menu, familiarize you with common chores, such as how to enter customer credits or e-mail forms.

Peachtree Accounting does offer 30 days of free technical support. After that, if you still want support you'll have to pay some hefty fees. Its basic plan is \$199 for 60 minutes of support. You can pay by the minute, but it costs \$5 per minute with a \$50 minimum.

**Biz Tips**

You can try out Peachtree Accounting for free by downloading it at [www.peachtree.com/download/trial.cfm](http://www.peachtree.com/download/trial.cfm).

As your business grows, you probably need to look at more sophisticated accounting software, which you can find using [www.Business.com](http://www.Business.com) mentioned previously. You may want to talk with people in your network to see which accounting software they prefer. After hearing their pros and cons, you'll have a much better idea of what software would work best for you.

## Setting Up the Application

After you decide on the program you want to use, you'll find each program has a tutorial to help you get started using data from a sample company. Get used to the features by working through this tutorial before you try to set up your own company's books.

If you are converting from a manual to computerized system, you already have a chart of accounts and general ledger in place. If you are starting from scratch, you need to develop these two things before trying to set up your company. Although the software has several different charts of accounts from which you can choose, you should have a good idea of the accounts you want before getting started.

You are asked to enter a company name, address, and tax identification number. After that you have to choose an accounting period. This period cannot be changed. If you enter the wrong accounting period, you have to delete the company and start over.

## Customizing the Software

The software is set up to operate on a monthly accounting period using the calendar year. If your company has a different fiscal year, when you enter that information the software will automatically format the 12 months based on that fiscal year.

Your next task is to set up the chart of accounts. The software has numerous charts of accounts to choose from based on different business types. Select the one closest to your needs and then customize it specifically based on the chart of accounts you have designed.

After you finish the chart of accounts, you'll next be asked for your bank information. Your main bank account will be used for the Cash in Checking (1000) account. If you have other accounts, you can enter them in the system, but you are not required to do so.

If you screw up royally, you can go back to the first screen, delete the company, and start over. Things don't have to be perfect, though. Most of what you enter can be changed later. The key exception is accounting periods.



### **Biz Tips**

You don't have to create the perfect chart of accounts when you first start using the system. You will be able to modify the chart of accounts at any time as needed.

You are now ready to start entering data. If you do want to have a budgeting function, you need to enter your budget information first before entering other data. Next set up your vendor and customer accounts, so your data has a place to go in addition to the chart of accounts, which is used to fill the

general ledger. Your customer and vendor data should be in place before you start adding transactions.

You can add customers and vendors at any time in the future, so don't worry about being sure you haven't missed someone. You also need to set up any subledgers you want to use, such as cash disbursements and cash receipts journals.

If you have employees, you'll need to add their information as well and set up the payroll ledger. The program allows you to set up an employee ledger for each employee.

If everything looks accurate, it's time to add your numbers.



### Audit Alarms

After you have all this information added, you should print out a report to verify the information you have entered before starting to enter transactions. Your initial set-up information is critical if you want to be able to use the system to develop reliable reports later.

## Converting from a Manual to a Computerized System

If you are converting from a manual system to a computerized system, you should enter your data based on your most recent trial balance. The system will let you do a general journal entry with this data.

You should set the date for the general journal entry as the last day of the month prior to the one you'll be starting to use for daily transactions. For example, let's assume Lisa's Candle Shop decides to convert as of March 1. She will enter her trial balance from February 28 to get the accounts set up.

After you've entered all the data, run a series of reports based on that data to be sure things are formatted the way you would like them. Also, check the reports to be sure data matches your reports that were developed manually. This extra step lets you test your setup and be sure that you started the entire computerized process based on accurate numbers that match your prior accounting system's records.

The process may vary slightly depending on the software program chosen. Read through the manual, review the start-up suggestions, and proceed based on the methods that will best meet your business needs.

We have discussed the basics of using a computerized system throughout the book, so you should be familiar with how to use these systems. Now the future of your accounting system is up to you and how carefully you manage its information to help you make key business decisions, manage your money, and make your profits.

### **The Least You Need to Know**

- ◆ There are many accounting software programs out there. The top two for small businesses are QuickBooks and Peachtree Accounting.
- ◆ Be sure to map out your chart of accounts before you start setting up the accounting program.
- ◆ Test your system after you've finished entering the data to be certain the numbers you input match the reports for the most recent month-end.

## Appendix

# A

## Glossary

**accrual accounting** Based on when transactions happen regardless of whether cash actually changes hands. Income is counted when it is earned, and expenses are counted when goods or services are received, even if cash has not been exchanged.

**accounts receivable** Where a business records income that is due on sales or services which will be collected at a later date.

**Address Verification Service Fee (AVS)** A key prevention measure for fraud when credit card sales are accepted. This is primarily used by businesses that take orders by phone or e-mail and do not have the credit card in hand to verify a signature. There is a per-transaction fee to use this service.

**amortization** The method used to write off intangible assets in a way similar to depreciation. Depreciation is used to write off tangible assets.

**amortization schedule** A breakdown of how much of each loan payment is used to pay down a loan and how much is used to pay interest expenses.

**arm's length transaction** A transaction between two unrelated or unaffiliated parties or a transaction conducted between related or affiliated parties as if they were unrelated to avoid the appearance of conflict of interest.

**assets** Things owned by the business.

**average costing** An inventory valuation method that calculates an average cost per unit sold.

**bad debts expense** Reflects the amount of your company's accounts that are not collectable.

**benchmarking** A way to measure how your company is doing compared to other similar companies.

**cash-basis accounting** Based on cash flow. You report expenses when you lay out cash. You report income when cash is received. In addition to hard cash, income is counted as received when you get a check, credit card payment, or any other method common in your business. The same is true for expenses, whether you pay them by cash, check, credit card, or other method. Essentially cash has changed hands when you control the money.

**chargeback and retrieval fees** Fees charged if a credit transaction is disputed.

**compound interest** Calculated not only on the initial principal, but also the accumulated interest of prior periods.

**control account** Shows the total of accounts entered in a subsidiary ledger. For example, Accounts Receivable and Accounts Payable accounts are managed using a separate ledger and their totals are transferred to the general ledger at the end of each month when you close the books for the month.

**control employee** Someone who is a board member or elected officer whose pay is \$80,000 or more, a director, an employee whose pay is more than \$160,000, or an employee who owns more than 1 percent of the business. These are adjusted periodically for inflation.

**cost of sales** Tracks the money spent to sell products.

**credits** Always an increase to a liabilities or income account and a decrease to an asset or expense account. They are always on the right side of an accounting entry.

**current assets** Things you own that you can easily use or liquidate. Cash is an obvious example. Other accounts include cash equivalents, Accounts Receivable, Inventory, marketable securities, prepaid expenses, and any other assets that can be converted to cash in less than one year.

**current liabilities** The total of all money owed by a company that is due in less than one year.



**current ratio** Compares current assets to current liabilities to give a quick glimpse of your business's ability to pay bills.

**customer support fee** Charged monthly by some banks if the store wants support 24 hours a day for 365 days a year. In some cases support is offered in more than one language.

**De Minimis benefits** Benefits that have so little value it would be unreasonable or administratively impractical to track. Cash, no matter how little, is never excludable from tax calculations under the De Minimis benefits rule.

**debits** Always an increase to an asset or expense account and a decrease to a liabilities or income account. They are always on the left side of an accounting entry.

**depreciation** Reduces the value of a tangible asset over a set number of years and records an expense for that asset as it is depreciated.

**discount rate** A charge based on a percentage of the dollar sale or return transaction when charge cards are accepted. This rate varies greatly depending on the type of business. If you use a terminal to swipe cards, the fees are usually lower because the possibility of key-entry errors is eliminated.

**equipment and software fees** Fees based on the equipment and computer software you decide to use if you accept credit cards. In most cases credit card equipment is purchased or leased.

**equity accounts** The value of the business after accounting for liabilities. Essentially, it tracks the value of things owned by the shareholders.

**exempt employee** An employee who is exempt from the Fair Labor Standards Act (FLSA). This means that the employee is not entitled to the minimum wage, equal pay, overtime pay, and child labor provision protections of the FLSA. An employer is not subject to FLSA rules for that employee. Normally this includes executives, administrative personnel, managers, professionals, and outside sales people who are salaried rather than hourly employees. An employer cannot set the specific hours that an exempt employee works.

**expenses** The costs of operating the business.

**fidelity bonds** A type of insurance that covers losses sustained from dishonest acts committed by employees. This can include coverage for losses by a client because of an employee's act, as well as legal damages or court defenses resulting from an employee's dishonest act. Many times fidelity bonding is part of an overall business insurance package.

**First-In, First Out (FIFO)** An inventory valuation method that assumes the first items put onto the shelf are the first items that are sold.

**garnishments** A means for creditors to collect money due to them by getting a court order to take money out of a person's wages. As an employer you could be sent instructions from a court to withhold a certain amount of money from an employee's paycheck until a judgment is satisfied. The employer must take the money out of the employee's paycheck and send it directly to the creditor if ordered by a court.

**general journal entries** Any entries made to correct or adjust balances in the general ledger accounts.

**hourly employees** Paid a certain amount per hour. After an hourly employee works more than 40 hours per week, he is entitled to overtime pay.

**income** Represents the earnings of the business.

**intangible assets** Things of value that cannot be touched, such as licenses, patents, trademarks, and brand names.

**Last In, First Out (LIFO)** An inventory evaluation method that assumes the last items put onto the shelf are the first items that are sold.

**liabilities** Debts that the business owes.

**long-term assets** Things you own, although they are not easily converted to cash for immediate needs. A building is an example of a long-term asset.

**lower of cost or market** An inventory evaluation method that sets inventory costs by whichever is lower—the actual cost of the inventory or the current market value.

**monthly minimum fee** The least a store must pay to accept credit cards, even if the credit sales do not generate enough in transaction fees. This fee usually ranges between \$10 and \$30. If you are going to accept credit cards, be sure you meet the minimum or you could find the convenience offered to a few customers may end up costing you more than it's worth.

**nonexempt employee** An employee who receives protections from the Fair Labor Standards Act (FLSA). Minimum wage, overtime pay, equal pay for equal work, and child labor protection laws are all protections of the FLSA. If you hire children under the age of 18, be certain you understand the special protections in place at both the state and federal levels.

**periodic inventory method** A method that requires a physical count of inventory on a periodic basis. This can be daily, monthly, yearly, or any other time period that meets your business needs.

**perpetual inventory method** A method in which inventory counts are adjusted with each transaction. You need a computerized inventory control system to manage inventory using this method.

**petty cash** The amount of cash kept on hand for incidental expenses.

**point of sale** Usually a location in a store that includes the cash register, a service counter, or any place that your customers can go to pay for and pick up merchandise.

**Quick (Acid Test) Ratio** Similar to the Current Ratio, although it does not include inventory. Inventories are the least liquid of the current assets, and some believe they should not be included when assessing liquidity.

**retained earnings** The net profits that you leave in the business from month to month. These earnings are reinvested in the business and used to grow the business. If a company pays dividends, these payments are taken from Retained Earnings.

**salaried employees** Paid a certain amount per pay period, which is not based on the number of hours worked. Salaried employees, who are also exempt employees, commonly work over 40 hours per week without additional pay.

**secure payment gateway fee** A service provided to e-commerce merchants so they can process transactions securely over the Internet. This is usually a set monthly fee.

**simple interest** Calculated on a principal sum, not compounded on earned interest.

**specific identification** An inventory valuation system that tracks the actual items sold and their individual costs.

**statutory employees** Employees whose earnings are subject to Social Security and Medicare taxes, but are not subject to Federal income tax withholding. For example, this includes agents or traveling salespeople who are allowed to report income and expenses as a business expense.

**transaction fee** A fee assessed for each transaction submitted to a credit card service for authorization. Even if the card is denied, your business will have to pay this fee for trying to make the transaction.

**workers' compensation** A state-mandated protection for employees who are injured on the job.



## Appendix

# B

## Key Business Forms

We discussed a number of forms in this book that you need to get your business started. You can access the forms and full instructions at [www.irs.gov/businesses/small/article/0,,id=99194,00.html](http://www.irs.gov/businesses/small/article/0,,id=99194,00.html). This appendix shows the key forms as examples, but you won't be able to use them to file the forms with the IRS.

Form <b>SS-4</b> (Rev. December 2001) Department of the Treasury Internal Revenue Service	<b>Application for Employer Identification Number</b> (For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.) ▶ See separate instructions for each line. ▶ Keep a copy for your records.	EIN _____  OMB No. 1545-0003														
Type or print clearly.	1 Legal name of entity (or individual) for whom the EIN is being requested															
	2 Trade name of business (if different from name on line 1)	3 Executor, trustee, "care of" name														
	4a Mailing address (room, apt., suite no. and street, or P.O. box)	5a Street address (if different) (Do not enter a P.O. box.)														
	4b City, state, and ZIP code	5b City, state, and ZIP code														
	6 County and state where principal business is located															
	7a Name of principal officer, general partner, grantor, owner, or trustee	7b SSN, ITIN, or EIN														
	8a Type of entity (check only one box) <table style="width: 100%; border: none;"> <tr> <td><input type="checkbox"/> Sole proprietor (SSN) _____</td> <td><input type="checkbox"/> Estate (SSN of decedent) _____</td> </tr> <tr> <td><input type="checkbox"/> Partnership _____</td> <td><input type="checkbox"/> Plan administrator (SSN) _____</td> </tr> <tr> <td><input type="checkbox"/> Corporation (enter form number to be filed) ▶ _____</td> <td><input type="checkbox"/> Trust (SSN of grantor) _____</td> </tr> <tr> <td><input type="checkbox"/> Personal service corp.</td> <td><input type="checkbox"/> National Guard <input type="checkbox"/> State/local government</td> </tr> <tr> <td><input type="checkbox"/> Church or church-controlled organization</td> <td><input type="checkbox"/> Farmers' cooperative <input type="checkbox"/> Federal government/military</td> </tr> <tr> <td><input type="checkbox"/> Other nonprofit organization (specify) ▶ _____</td> <td><input type="checkbox"/> REMIC <input type="checkbox"/> Indian tribal governments/enterprises</td> </tr> <tr> <td><input type="checkbox"/> Other (specify) ▶ _____</td> <td><input type="checkbox"/> Group Exemption Number (GEN) ▶ _____</td> </tr> </table>		<input type="checkbox"/> Sole proprietor (SSN) _____	<input type="checkbox"/> Estate (SSN of decedent) _____	<input type="checkbox"/> Partnership _____	<input type="checkbox"/> Plan administrator (SSN) _____	<input type="checkbox"/> Corporation (enter form number to be filed) ▶ _____	<input type="checkbox"/> Trust (SSN of grantor) _____	<input type="checkbox"/> Personal service corp.	<input type="checkbox"/> National Guard <input type="checkbox"/> State/local government	<input type="checkbox"/> Church or church-controlled organization	<input type="checkbox"/> Farmers' cooperative <input type="checkbox"/> Federal government/military	<input type="checkbox"/> Other nonprofit organization (specify) ▶ _____	<input type="checkbox"/> REMIC <input type="checkbox"/> Indian tribal governments/enterprises	<input type="checkbox"/> Other (specify) ▶ _____	<input type="checkbox"/> Group Exemption Number (GEN) ▶ _____
	<input type="checkbox"/> Sole proprietor (SSN) _____	<input type="checkbox"/> Estate (SSN of decedent) _____														
	<input type="checkbox"/> Partnership _____	<input type="checkbox"/> Plan administrator (SSN) _____														
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<input type="checkbox"/> Personal service corp.	<input type="checkbox"/> National Guard <input type="checkbox"/> State/local government															
<input type="checkbox"/> Church or church-controlled organization	<input type="checkbox"/> Farmers' cooperative <input type="checkbox"/> Federal government/military															
<input type="checkbox"/> Other nonprofit organization (specify) ▶ _____	<input type="checkbox"/> REMIC <input type="checkbox"/> Indian tribal governments/enterprises															
<input type="checkbox"/> Other (specify) ▶ _____	<input type="checkbox"/> Group Exemption Number (GEN) ▶ _____															
8b If a corporation, name the state or foreign country (if applicable) where incorporated	State _____ Foreign country _____															
9 Reason for applying (check only one box) <table style="width: 100%; border: none;"> <tr> <td><input type="checkbox"/> Started new business (specify type) ▶ _____</td> <td><input type="checkbox"/> Banking purpose (specify purpose) ▶ _____</td> </tr> <tr> <td><input type="checkbox"/> Hired employees (Check the box and see line 12.)</td> <td><input type="checkbox"/> Changed type of organization (specify new type) ▶ _____</td> </tr> <tr> <td><input type="checkbox"/> Compliance with IRS withholding regulations</td> <td><input type="checkbox"/> Purchased going business</td> </tr> <tr> <td><input type="checkbox"/> Other (specify) ▶ _____</td> <td><input type="checkbox"/> Created a trust (specify type) ▶ _____</td> </tr> <tr> <td></td> <td><input type="checkbox"/> Created a pension plan (specify type) ▶ _____</td> </tr> </table>		<input type="checkbox"/> Started new business (specify type) ▶ _____	<input type="checkbox"/> Banking purpose (specify purpose) ▶ _____	<input type="checkbox"/> Hired employees (Check the box and see line 12.)	<input type="checkbox"/> Changed type of organization (specify new type) ▶ _____	<input type="checkbox"/> Compliance with IRS withholding regulations	<input type="checkbox"/> Purchased going business	<input type="checkbox"/> Other (specify) ▶ _____	<input type="checkbox"/> Created a trust (specify type) ▶ _____		<input type="checkbox"/> Created a pension plan (specify type) ▶ _____					
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<input type="checkbox"/> Compliance with IRS withholding regulations	<input type="checkbox"/> Purchased going business															
<input type="checkbox"/> Other (specify) ▶ _____	<input type="checkbox"/> Created a trust (specify type) ▶ _____															
	<input type="checkbox"/> Created a pension plan (specify type) ▶ _____															
10 Date business started or acquired (month, day, year)	11 Closing month of accounting year															
12 First date wages or annuities were paid or will be paid (month, day, year) <b>Note:</b> If applicant is a withholding agent, enter date income will first be paid to nonresident alien. (month, day, year) . . . . . ▶																
13 Highest number of employees expected in the next 12 months. <b>Note:</b> If the applicant does not expect to have any employees during the period, enter "-0-." . . . . . ▶																
14 Check one box that best describes the principal activity of your business. <table style="width: 100%; border: none;"> <tr> <td><input type="checkbox"/> Construction</td> <td><input type="checkbox"/> Rental &amp; leasing</td> <td><input type="checkbox"/> Transportation &amp; warehousing</td> <td><input type="checkbox"/> Accommodation &amp; food service</td> <td><input type="checkbox"/> Health care &amp; social assistance</td> <td><input type="checkbox"/> Wholesale-agent/broker</td> </tr> <tr> <td><input type="checkbox"/> Real estate</td> <td><input type="checkbox"/> Manufacturing</td> <td><input type="checkbox"/> Finance &amp; insurance</td> <td><input type="checkbox"/> Other (specify) _____</td> <td><input type="checkbox"/> Wholesale-other</td> <td><input type="checkbox"/> Retail</td> </tr> </table>		<input type="checkbox"/> Construction	<input type="checkbox"/> Rental & leasing	<input type="checkbox"/> Transportation & warehousing	<input type="checkbox"/> Accommodation & food service	<input type="checkbox"/> Health care & social assistance	<input type="checkbox"/> Wholesale-agent/broker	<input type="checkbox"/> Real estate	<input type="checkbox"/> Manufacturing	<input type="checkbox"/> Finance & insurance	<input type="checkbox"/> Other (specify) _____	<input type="checkbox"/> Wholesale-other	<input type="checkbox"/> Retail			
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<input type="checkbox"/> Real estate	<input type="checkbox"/> Manufacturing	<input type="checkbox"/> Finance & insurance	<input type="checkbox"/> Other (specify) _____	<input type="checkbox"/> Wholesale-other	<input type="checkbox"/> Retail											
15 Indicate principal line of merchandise sold; specific construction work done; products produced; or services provided.																
16a Has the applicant ever applied for an employer identification number for this or any other business? . . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No <b>Note:</b> If "Yes," please complete lines 16b and 16c.																
16b If you checked "Yes" on line 16a, give applicant's legal name and trade name shown on prior application if different from line 1 or 2 above. Legal name ▶ _____ Trade name ▶ _____																
16c Approximate date when, and city and state where, the application was filed. Enter previous employer identification number if known. Approximate date when filed (mo., day, year) _____ City and state where filed _____ Previous EIN _____																
Third Party Designee	Complete this section <b>only</b> if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.															
	Designee's name	Designee's telephone number (include area code) ( )														
	Address and ZIP code	Designee's fax number (include area code) ( )														
Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.		Applicant's telephone number (include area code) ( )														
Name and title (type or print clearly) ▶ _____		Applicant's fax number (include area code) ( )														
Signature ▶ _____ Date ▶ _____																

Form SS-4, "Application for Employer Identification Number."

Department of Homeland Security U.S. Citizenship and Immigration Services		OMB No. 1615-0047; Expires 03/31/07		
<b>Employment Eligibility Verification</b>				
<b>Please read instructions carefully before completing this form. The instructions must be available during completion of this form. ANTI-DISCRIMINATION NOTICE: It is illegal to discriminate against work eligible individuals. Employers CANNOT specify which document(s) they will accept from an employee. The refusal to hire an individual because of a future expiration date may also constitute illegal discrimination.</b>				
<b>Section 1. Employee Information and Verification.</b> To be completed and signed by employee at the time employment begins.				
Print Name: Last	First	Middle Initial	Maiden Name	
Address (Street Name and Number)		Apt. #	Date of Birth (month/day/year)	
City	State	Zip Code	Social Security #	
I am aware that federal law provides for imprisonment and/or fines for false statements or use of false documents in connection with the completion of this form.		I attest, under penalty of perjury, that I am (check one of the following): <input type="checkbox"/> A citizen or national of the United States <input type="checkbox"/> A Lawful Permanent Resident (Alien #) A _____ <input type="checkbox"/> An alien authorized to work until _____ (Alien # or Admission #) _____		
Employee's Signature		Date (month/day/year)		
<b>Preparer and/or Translator Certification.</b> (To be completed and signed if Section 1 is prepared by a person other than the employee.) I attest, under penalty of perjury, that I have assisted in the completion of this form and that to the best of my knowledge the information is true and correct.				
Preparer's/Translator's Signature		Print Name		
Address (Street Name and Number, City, State, Zip Code)		Date (month/day/year)		
<b>Section 2. Employer Review and Verification.</b> To be completed and signed by employer. Examine one document from List A OR examine one document from List B and one from List C, as listed on the reverse of this form, and record the title, number and expiration date, if any, of the document(s).				
List A	OR	List B	AND	List C
Document title: _____		_____		_____
Issuing authority: _____		_____		_____
Document #: _____		_____		_____
Expiration Date (if any): _____		_____		_____
Document #: _____		_____		_____
Expiration Date (if any): _____		_____		_____
<b>CERTIFICATION - I attest, under penalty of perjury, that I have examined the document(s) presented by the above-named employee, that the above-listed document(s) appear to be genuine and to relate to the employee named, that the employee began employment on (month/day/year) _____ and that to the best of my knowledge the employee is eligible to work in the United States. (State employment agencies may omit the date the employee began employment.)</b>				
Signature of Employer or Authorized Representative		Print Name	Title	
Business or Organization Name		Address (Street Name and Number, City, State, Zip Code)		Date (month/day/year)
<b>Section 3. Updating and Reverification.</b> To be completed and signed by employer.				
A. New Name (if applicable)			B. Date of rehire (month/day/year) (if applicable)	
C. If employee's previous grant of work authorization has expired, provide the information below for the document that establishes current employment eligibility.				
Document Title: _____		Document #: _____	Expiration Date (if any): _____	
I attest, under penalty of perjury, that to the best of my knowledge, this employee is eligible to work in the United States, and if the employee presented document(s), the document(s) I have examined appear to be genuine and to relate to the individual.				
Signature of Employer or Authorized Representative			Date (month/day/year)	
NOTE: This is the 1991 edition of the Form I-9 that has been rebranded with a current printing date to reflect the recent transition from the INS to DHS and its components.			Form I-9 (Rev. 05/31/05) Page 2	

Form I-9, "Employment Eligibility Verification" (page 1).

<b>LISTS OF ACCEPTABLE DOCUMENTS</b>		
<b>LIST A</b>	<b>OR</b>	<b>AND</b>
<b>Documents that Establish Both Identity and Employment Eligibility</b>	<b>Documents that Establish Identity</b>	<b>Documents that Establish Employment Eligibility</b>
<ol style="list-style-type: none"> <li>1. U.S. Passport (unexpired or expired)</li> <li>2. Certificate of U.S. Citizenship (<i>Form N-560 or N-561</i>)</li> <li>3. Certificate of Naturalization (<i>Form N-550 or N-570</i>)</li> <li>4. Unexpired foreign passport, with <i>I-551</i> stamp or attached <i>Form I-94</i> indicating unexpired employment authorization</li> <li>5. Permanent Resident Card or Alien Registration Receipt Card with photograph (<i>Form I-151 or I-551</i>)</li> <li>6. Unexpired Temporary Resident Card (<i>Form I-688</i>)</li> <li>7. Unexpired Employment Authorization Card (<i>Form I-688A</i>)</li> <li>8. Unexpired Reentry Permit (<i>Form I-327</i>)</li> <li>9. Unexpired Refugee Travel Document (<i>Form I-571</i>)</li> <li>10. Unexpired Employment Authorization Document issued by DHS that contains a photograph (<i>Form I-688B</i>)</li> </ol>	<ol style="list-style-type: none"> <li>1. Driver's license or ID card issued by a state or outlying possession of the United States provided it contains a photograph or information such as name, date of birth, gender, height, eye color and address</li> <li>2. ID card issued by federal, state or local government agencies or entities, provided it contains a photograph or information such as name, date of birth, gender, height, eye color and address</li> <li>3. School ID card with a photograph</li> <li>4. Voter's registration card</li> <li>5. U.S. Military card or draft record</li> <li>6. Military dependent's ID card</li> <li>7. U.S. Coast Guard Merchant Mariner Card</li> <li>8. Native American tribal document</li> <li>9. Driver's license issued by a Canadian government authority</li> </ol> <p style="text-align: center;"><b>For persons under age 18 who are unable to present a document listed above:</b></p> <ol style="list-style-type: none"> <li>10. School record or report card</li> <li>11. Clinic, doctor or hospital record</li> <li>12. Day-care or nursery school record</li> </ol>	<ol style="list-style-type: none"> <li>1. U.S. social security card issued by the Social Security Administration (<i>other than a card stating it is not valid for employment</i>)</li> <li>2. Certification of Birth Abroad issued by the Department of State (<i>Form FS-545 or Form DS-1350</i>)</li> <li>3. Original or certified copy of a birth certificate issued by a state, county, municipal authority or outlying possession of the United States bearing an official seal</li> <li>4. Native American tribal document</li> <li>5. U.S. Citizen ID Card (<i>Form I-197</i>)</li> <li>6. ID Card for use of Resident Citizen in the United States (<i>Form I-179</i>)</li> <li>7. Unexpired employment authorization document issued by DHS (<i>other than those listed under List A</i>)</li> </ol>
<p>Illustrations of many of these documents appear in Part 8 of the Handbook for Employers (M-274)</p>		
<p>Form I-9 (Rev. 05/31/05) Page 3</p>		



### Form W-4 (2005)

**Purpose.** Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay. Because your tax situation may change, you may want to refigure your withholding each year.

**Exemption from withholding.** If you are exempt, complete only lines 1, 2, 3, 4, and 7 and sign the form to validate it. Your exemption for 2005 expires February 16, 2006. See Pub. 505, Tax Withholding and Estimated Tax.

**Note.** You cannot claim exemption from withholding if (a) your income exceeds \$800 and includes more than \$250 of unearned income (for example, interest and dividends) and (b) another person can claim you as a dependent on their tax return.

**Basic instructions.** If you are not exempt, complete the **Personal Allowances Worksheet** below. The worksheets on page 2 adjust your withholding allowances based on itemized deductions, certain credits, adjustments to income, or two-

earner/two-job situations. Complete all worksheets that apply. However, you may claim fewer (or zero) allowances.

**Head of household.** Generally, you may claim head of household filing status on your tax return only if you are unmarried and pay more than 50% of the costs of keeping up a home for yourself and your dependent(s) or other qualifying individuals. See line E below.

**Tax credits.** You can take projected tax credits into account in figuring your allowable number of withholding allowances. Credits for child or dependent care expenses and the child tax credit may be claimed using the **Personal Allowances Worksheet** below. See Pub. 919, How Do I Adjust My Tax Withholding? for information on converting your other credits into withholding allowances.

**Nowage income.** If you have a large amount of nowage income, such as interest or dividends, consider making estimated tax payments using Form 1040-ES, Estimated Tax for Individuals. Otherwise, you may owe additional tax.

**Two earners/two jobs.** If you have a working spouse or more than one job, figure the total number of allowances you are entitled to claim on all jobs using worksheets from only one Form W-4. Your withholding usually will be most accurate when all allowances are claimed on the Form W-4 for the highest paying job and zero allowances are claimed on the others.

**Nonresident alien.** If you are a nonresident alien, see the Instructions for Form 8233 before completing this Form W-4.

**Check your withholding.** After your Form W-4 takes effect, use Pub. 919 to see how the dollar amount you are having withheld compares to your projected total tax for 2005. See Pub. 919, especially if your earnings exceed \$125,000 (Single) or \$175,000 (Married).

**Recent name change?** If your name on line 1 differs from that shown on your social security card, call 1-800-772-1213 to initiate a name change and obtain a social security card showing your correct name.

**Personal Allowances Worksheet (Keep for your records.)**

**A** Enter "1" for yourself if no one else can claim you as a dependent . . . . . **A** \_\_\_\_\_

**B** Enter "1" if:   
 • You are single and have only one job; or   
 • You are married, have only one job, and your spouse does not work; or   
 • Your wages from a second job or your spouse's wages (or the total of both) are \$1,000 or less. . . . . **B** \_\_\_\_\_

**C** Enter "1" for your spouse. But, you may choose to enter "-0-" if you are married and have either a working spouse or more than one job. (Entering "-0-" may help you avoid having too little tax withheld.) . . . . . **C** \_\_\_\_\_

**D** Enter number of dependents (other than your spouse or yourself) you will claim on your tax return . . . . . **D** \_\_\_\_\_

**E** Enter "1" if you will file as head of household on your tax return (see conditions under **Head of household** above) . . . . . **E** \_\_\_\_\_

**F** Enter "1" if you have at least \$1,500 of child or dependent care expenses for which you plan to claim a credit . . . . . **F** \_\_\_\_\_

**(Note. Do not include child support payments. See Pub. 503, Child and Dependent Care Expenses, for details.)**

**G Child Tax Credit** (including additional child tax credit):   
 • If your total income will be less than \$54,000 (\$79,000 if married), enter "2" for each eligible child.   
 • If your total income will be between \$54,000 and \$84,000 (\$79,000 and \$119,000 if married), enter "1" for each eligible child plus "1" additional if you have four or more eligible children. . . . . **G** \_\_\_\_\_

**H** Add lines A through G and enter total here. **(Note. This may be different from the number of exemptions you claim on your tax return.)** ▶ **H** \_\_\_\_\_

For accuracy, complete all worksheets that apply.   
 • If you plan to **itemize or claim adjustments to income** and want to reduce your withholding, see the **Deductions and Adjustments Worksheet** on page 2.   
 • If you have **more than one job or are married and you and your spouse both work** and the combined earnings from all jobs exceed \$35,000 (\$25,000 if married) see the **Two-Earner/Two-Job Worksheet** on page 2 to avoid having too little tax withheld.   
 • If **neither** of the above situations applies, **stop here** and enter the number from line H on line 5 of Form W-4 below.

----- Cut here and give Form W-4 to your employer. Keep the top part for your records. -----

Form <b>W-4</b> Department of the Treasury Internal Revenue Service	<b>Employee's Withholding Allowance Certificate</b> ▶ Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.	OMB No. 1545-0010 <b>2005</b>
1 Type or print your first name and middle initial	Last name	2 Your social security number
Home address (number and street or rural route)		3 <input type="checkbox"/> Single <input type="checkbox"/> Married <input type="checkbox"/> Married, but withhold at higher Single rate. Note: If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.
City or town, state, and ZIP code		4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a new card. <input type="checkbox"/>
5 Total number of allowances you are claiming (from line H above or from the applicable worksheet on page 2)	5	
6 Additional amount, if any, you want withheld from each paycheck	6 \$	
7 I claim exemption from withholding for 2005, and I certify that I meet both of the following conditions for exemption. • Last year I had a right to a refund of all federal income tax withheld because I had no tax liability and • This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here ▶ 7		
Under penalties of perjury, I declare that I have examined this certificate and to the best of my knowledge and belief, it is true, correct, and complete.		
Employee's signature (Form is not valid unless you sign it) ▶		Date ▶
8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.)	9 Office code (optional)	10 Employer identification number (EIN)
For Privacy Act and Paperwork Reduction Act Notice, see page 2. <span style="float: right;">Cat. No. 10220Q Form <b>W-4</b> (2005)</span>		

Form W-4, "Employee's Withholding Allowance Certificate."



**DO NOT CUT, FOLD, OR STAPLE THIS FORM**

<b>a Tax year/Form corrected</b> ..... / <b>W-2</b> .....		44444		<b>For Official Use Only ▶</b> OMB No. 1545-0008	
<b>b Employee's correct SSN</b>			<b>c Corrected name</b> (if checked enter correct name in box e and complete box j)		<b>d Employer's Federal EIN</b>
<b>e Employee's first name and initial</b>		Last name		<b>g Employer's name, address, and ZIP code</b>	
<b>f Employee's address and ZIP code</b>					
<b>Complete boxes h and/or i only if incorrect on last form filed. ▶</b>			<b>h Employee's incorrect SSN</b>		<b>i Employee's name (as incorrectly shown on previous form)</b>
<b>Note: Only complete money fields that are being corrected (except MQGE).</b>					
<b>Previously reported</b>		<b>Correct information</b>		<b>Previously reported</b>	
<b>Correct information</b>		<b>Previously reported</b>		<b>Correct information</b>	
<b>1 Wages, tips, other compensation</b>		<b>1 Wages, tips, other compensation</b>		<b>2 Federal income tax withheld</b>	
<b>2 Federal income tax withheld</b>		<b>2 Federal income tax withheld</b>		<b>3 Social security wages</b>	
<b>3 Social security wages</b>		<b>3 Social security wages</b>		<b>4 Social security tax withheld</b>	
<b>4 Social security tax withheld</b>		<b>4 Social security tax withheld</b>		<b>5 Medicare wages and tips</b>	
<b>5 Medicare wages and tips</b>		<b>5 Medicare wages and tips</b>		<b>6 Medicare tax withheld</b>	
<b>6 Medicare tax withheld</b>		<b>6 Medicare tax withheld</b>		<b>7 Social security tips</b>	
<b>7 Social security tips</b>		<b>7 Social security tips</b>		<b>8 Allocated tips</b>	
<b>8 Allocated tips</b>		<b>8 Allocated tips</b>		<b>9 Advance EIC payment</b>	
<b>9 Advance EIC payment</b>		<b>9 Advance EIC payment</b>		<b>10 Dependent care benefits</b>	
<b>10 Dependent care benefits</b>		<b>10 Dependent care benefits</b>		<b>11 Nonqualified plans</b>	
<b>11 Nonqualified plans</b>		<b>11 Nonqualified plans</b>		<b>12a See instructions for box 12</b>	
<b>12a See instructions for box 12</b>		<b>12a See instructions for box 12</b>		<b>12b See instructions for box 12</b>	
<b>12b See instructions for box 12</b>		<b>12b See instructions for box 12</b>		<b>12c See instructions for box 12</b>	
<b>12c See instructions for box 12</b>		<b>12c See instructions for box 12</b>		<b>12d See instructions for box 12</b>	
<b>12d See instructions for box 12</b>		<b>12d See instructions for box 12</b>		<b>13 Statutory employee Retirement plan Third-party sick pay</b>	
<b>13 Statutory employee Retirement plan Third-party sick pay</b>		<b>13 Statutory employee Retirement plan Third-party sick pay</b>		<b>14 Other (see instructions)</b>	
<b>14 Other (see instructions)</b>		<b>14 Other (see instructions)</b>		<b>15 State</b>	
<b>15 State</b>		<b>15 State</b>		<b>16 State wages, tips, etc.</b>	
<b>16 State wages, tips, etc.</b>		<b>16 State wages, tips, etc.</b>		<b>17 State income tax</b>	
<b>17 State income tax</b>		<b>17 State income tax</b>		<b>18 Local wages, tips, etc.</b>	
<b>18 Local wages, tips, etc.</b>		<b>18 Local wages, tips, etc.</b>		<b>19 Local income tax</b>	
<b>19 Local income tax</b>		<b>19 Local income tax</b>		<b>20 Locality name</b>	
<b>20 Locality name</b>		<b>20 Locality name</b>		<b>20 Locality name</b>	

**State Correction Information**

<b>Previously reported</b>		<b>Correct information</b>		<b>Previously reported</b>		<b>Correct information</b>	
<b>15 State</b>		<b>15 State</b>		<b>15 State</b>		<b>15 State</b>	
Employer's state ID number		Employer's state ID number		Employer's state ID number		Employer's state ID number	
<b>16 State wages, tips, etc.</b>		<b>16 State wages, tips, etc.</b>		<b>16 State wages, tips, etc.</b>		<b>16 State wages, tips, etc.</b>	
<b>17 State income tax</b>		<b>17 State income tax</b>		<b>17 State income tax</b>		<b>17 State income tax</b>	

**Locality Correction Information**

<b>Previously reported</b>		<b>Correct information</b>		<b>Previously reported</b>		<b>Correct information</b>	
<b>18 Local wages, tips, etc.</b>		<b>18 Local wages, tips, etc.</b>		<b>18 Local wages, tips, etc.</b>		<b>18 Local wages, tips, etc.</b>	
<b>19 Local income tax</b>		<b>19 Local income tax</b>		<b>19 Local income tax</b>		<b>19 Local income tax</b>	
<b>20 Locality name</b>		<b>20 Locality name</b>		<b>20 Locality name</b>		<b>20 Locality name</b>	

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Copy A—For Social Security Administration  
 Form **W-2c** (Rev. 12-2002) **Corrected Wage and Tax Statement** Department of the Treasury  
Internal Revenue Service  
 Cat. No. 61437D

Form W-2c, "Corrected Wage and Tax Statement."

<b>DO NOT STAPLE OR FOLD</b>					
<b>a</b> Control number		33333		<b>For Official Use Only ▶</b> OMB No. 1545-0008	
<b>b</b> Kind of Payer ▶	<input type="checkbox"/> 941	<input type="checkbox"/> Military	<input type="checkbox"/> 943	<b>1</b> Wages, tips, other compensation	<b>2</b> Federal income tax withheld
	<input type="checkbox"/> CT-1	<input type="checkbox"/> Hshld. emp.	<input type="checkbox"/> Medicare govt. emp.	<input type="checkbox"/> Third-party sick pay	<b>3</b> Social security wages
<b>c</b> Total number of Forms W-2		<b>d</b> Establishment number		<b>5</b> Medicare wages and tips	<b>6</b> Medicare tax withheld
<b>e</b> Employer identification number (EIN)				<b>7</b> Social security tips	<b>8</b> Allocated tips
<b>f</b> Employer's name				<b>9</b> Advance EIC payments	<b>10</b> Dependent care benefits
.....				<b>11</b> Nonqualified plans	<b>12</b> Deferred compensation
<b>g</b> Employer's address and ZIP code				<b>13</b> For third-party sick pay use only	
<b>h</b> Other EIN used this year				<b>14</b> Income tax withheld by payer of third-party sick pay	
<b>15</b> State Employer's state ID number				<b>16</b> State wages, tips, etc.	<b>17</b> State income tax
				<b>18</b> Local wages, tips, etc.	<b>19</b> Local income tax
Contact person				Telephone number ( )	For Official Use Only
Email address				Fax number ( )	

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ \_\_\_\_\_ Title ▶ \_\_\_\_\_ Date ▶ \_\_\_\_\_

**Form W-3 Transmittal of Wage and Tax Statements**      **2005**

**Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable.**

**Do not** send any payment (cash, checks, money orders, etc.) with Forms W-2 and W-3.

**Reminder**  
**Separate instructions.** See the 2005 Instructions for Forms W-2 and W-3 for information on completing this form.

**Purpose of Form**  
Use Form W-3 to transmit Copy A of Form(s) W-2, Wage and Tax Statement. Make a copy of Form W-3 and keep it with Copy D (For Employer) of Form(s) W-2 for your records. Use Form W-3 for the correct year. **File Form W-3 even if only one Form W-2 is being filed.** If you are filing Form(s) W-2 on magnetic media or electronically, **do not** file Form W-3.

**When To File**  
File Form W-3 with Copy A of Form(s) W-2 by February 28, 2006.

Department of the Treasury  
Internal Revenue Service

**Where To File**  
Send this entire page with the entire Copy A page of Form(s) W-2 to:  
**Social Security Administration  
Data Operations Center  
Wilkes-Barre, PA 18769-0001**

**Note.** If you use "Certified Mail" to file, change the ZIP code to "18769-0002." If you use an IRS-approved private delivery service, add "ATTN: W-2 Process, 1150 E. Mountain Dr." to the address and change the ZIP code to "18702-7997." See **Publication 15 (Circular E), Employer's Tax Guide**, for a list of IRS-approved private delivery services.

**Do not** send magnetic media to the address shown above.

For Privacy Act and Paperwork Reduction Act Notice, see back of Copy D of Form W-2.

Cat. No. 10159Y

Form W-3, "Transmittal of Wage and Tax Statements."

**DO NOT CUT, FOLD OR STAPLE**

<b>a Tax year/Form corrected</b>		<b>5555</b>		<b>For Official Use Only ▶</b> OMB No. 1545-0008	
<b>b Employer's name, address, and ZIP code</b>		<b>c Kind of Payer</b>		941/941-SS <input type="checkbox"/> Military <input type="checkbox"/> 943 <input type="checkbox"/> Sec. 218 <input type="checkbox"/> CT-1 <input type="checkbox"/> Hshld. emp. <input type="checkbox"/> Medicare gov. emp. <input type="checkbox"/> <b>Third-party sick pay</b> <input type="checkbox"/>	
<b>d Number of Forms W-2c</b>	<b>e Employer's Federal EIN</b>	<b>f Establishment number</b>	<b>g Employer's state ID number</b>		
Complete boxes h, i, or j <b>only</b> if incorrect on last form filed.	<b>h Employer's incorrect Federal EIN</b>	<b>i Incorrect establishment number</b>	<b>j Employer's incorrect state ID number</b>		
<b>Total of amounts previously reported as shown on enclosed Forms W-2c.</b>	<b>Total of corrected amounts as shown on enclosed Forms W-2c.</b>	<b>Total of amounts previously reported as shown on enclosed Forms W-2c.</b>	<b>Total of corrected amounts as shown on enclosed Forms W-2c.</b>		
<b>1 Wages, tips, other compensation</b>	<b>1 Wages, tips, other compensation</b>	<b>2 Federal income tax withheld</b>	<b>2 Federal income tax withheld</b>		
<b>3 Social security wages</b>	<b>3 Social security wages</b>	<b>4 Social security tax withheld</b>	<b>4 Social security tax withheld</b>		
<b>5 Medicare wages and tips</b>	<b>5 Medicare wages and tips</b>	<b>6 Medicare tax withheld</b>	<b>6 Medicare tax withheld</b>		
<b>7 Social security tips</b>	<b>7 Social security tips</b>	<b>8 Allocated tips</b>	<b>8 Allocated tips</b>		
<b>9 Advance EIC payments</b>	<b>9 Advance EIC payments</b>	<b>10 Dependent care benefits</b>	<b>10 Dependent care benefits</b>		
<b>11 Nonqualified plans</b>	<b>11 Nonqualified plans</b>	<b>12a-d (Coded items)</b>	<b>12a-d (Coded items)</b>		
<b>14 Inc. tax WH by 3rd party sick pay payer</b>	<b>14 Inc. tax WH by 3rd party sick pay payer</b>				
<b>16 State wages, tips, etc.</b>	<b>16 State wages, tips, etc.</b>	<b>17 State income tax</b>	<b>17 State income tax</b>		
<b>18 Local wages, tips, etc.</b>	<b>18 Local wages, tips, etc.</b>	<b>19 Local income tax</b>	<b>19 Local income tax</b>		
<b>Explain decreases here:</b>					
Has an adjustment been made on an employment tax return filed with the Internal Revenue Service? <input type="checkbox"/> Yes <input type="checkbox"/> No					
If "Yes," give date the return was filed ▶					
Under penalties of perjury, I declare that I have examined this return, including accompanying documents, and, to the best of my knowledge and belief, it is true, correct, and complete.					
<b>Signature ▶</b>		<b>Title ▶</b>		<b>Date ▶</b>	
Contact person		Telephone number ( )		<b>For Official Use Only</b>	
E-mail address		Fax number ( )			

**Purpose of Form**

Use this form to transmit Copy A of Form(s) W-2c, Corrected Wage and Tax Statement (Rev. 12-2002). Make a copy of Form W-3c and keep it with Copy D (for Employer) of Forms W-2c for your records. File Form W-3c even if only one Form W-2c is being filed or if those Forms W-2c are being filed only to correct an employee's name or social security number (SSN). See the separate **Instructions for Forms W-2c and W-3c** (Rev. December 2002) for information on completing this form.

**When To File**

File this form and Copy A of Form(s) W-2c with the Social Security Administration as soon as possible after you discover an error on Forms W-2, W-2AS, W-2AS, W-2GU, W-2CM, or W-2VI. Also provide Copies B, C, and Z of Form W-2c to your employees as soon as possible.

**Where To File**

If you use the U.S. Postal Service, send Forms W-2c and W-3c to the following address:

**Social Security Administration  
Data Operations Center  
P.O. Box 3333  
Wilkes-Barre, PA 18767-3333**

If you use a carrier other than the U.S. Postal Service, send Forms W-2c and W-3c to the following address:


**Social Security Administration  
Data Operations Center  
Attn: W-2c Process  
1150 E. Mountain Drive  
Wilkes-Barre, PA 18702-7997**

Form **W-3C** (Rev. 12-2002) **Transmittal of Corrected Wage and Tax Statements**

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 10164R

Department of the Treasury  
Internal Revenue Service

Form W-3c, "Transmittal of Corrected Wage and Tax Statements."

2005 Estimated Tax Worksheet		Keep for Your Records	
1	Adjusted gross income you expect in 2005 (see instructions below)	1	
2	<ul style="list-style-type: none"> <li>If you plan to itemize deductions, enter the estimated total of your itemized deductions.</li> </ul> <p><b>Caution:</b> If line 1 above is over \$145,950 (\$72,975 if married filing separately), your deduction may be reduced. See Pub. 505 for details.</p> <ul style="list-style-type: none"> <li>If you do not plan to itemize deductions, enter your standard deduction from page 2.</li> </ul>	2	
3	Subtract line 2 from line 1	3	
4	Exemptions. Multiply \$3,200 by the number of personal exemptions. If you can be claimed as a dependent on another person's 2005 return, you cannot claim any dependents and your personal exemption is not allowed. <b>Caution:</b> See Pub. 505 to figure the amount to enter if line 1 above is over: \$218,950 if married filing jointly or qualifying widow(er); \$182,450 if head of household; \$145,950 if single; or \$109,475 if married filing separately	4	
5	Subtract line 4 from line 3	5	
6	<b>Tax.</b> Figure your tax on the amount on line 5 by using the <b>2005 Tax Rate Schedules</b> on page 5. <b>Caution:</b> If you have qualified dividends or a net capital gain, see Pub. 505 to figure the tax	6	
7	Alternative minimum tax from Form 6251	7	
8	Add lines 6 and 7. Also include any tax from Forms 4972 and 8814 and any recapture of education credits (see instructions below)	8	
9	Credits (see instructions below). <b>Do not</b> include any income tax withholding on this line	9	
10	Subtract line 9 from line 8. If zero or less, enter -0-	10	
11	Self-employment tax (see instructions below). Estimate of 2005 net earnings from self-employment \$ . . . . . ; if <b>\$90,000 or less</b> , multiply the amount by 15.3%; if <b>more than \$90,000</b> , multiply the amount by 2.9%, add \$11,160 to the result, and enter the total. <b>Caution:</b> If you also have wages subject to social security tax, see Pub. 505 to figure the amount to enter	11	
12	Other taxes (see instructions below)	12	
13a	Add lines 10 through 12	13a	
b	Earned income credit, additional child tax credit, and credits from <b>Form 4136</b> and <b>Form 8885</b>	13b	
c	<b>Total 2005 estimated tax.</b> Subtract line 13b from line 13a. If zero or less, enter -0- ▶	13c	
14a	Multiply line 13c by 90% (66% for farmers and fishermen)	14a	
b	Enter the tax shown on your 2004 tax return (110% of that amount if you are not a farmer or fisherman and the adjusted gross income shown on that return is more than \$150,000 or, if married filing separately for 2005, more than \$75,000)	14b	
c	<b>Required annual payment to avoid a penalty.</b> Enter the <b>smaller</b> of line 14a or 14b ▶ <b>Caution:</b> Generally, if you do not prepay (through income tax withholding and estimated tax payments) at least the amount on line 14c, you may owe a penalty for not paying enough estimated tax. To avoid a penalty, make sure your estimate on line 13c is as accurate as possible. Even if you pay the required annual payment, you may still owe tax when you file your return. If you prefer, you can pay the amount shown on line 13c. For details, see Pub. 505.	14c	
15	Income tax withheld and estimated to be withheld during 2005 (including income tax withholding on pensions, annuities, certain deferred income, etc.)	15	
16	Subtract line 15 from line 14c. ( <b>Note:</b> If zero or less or line 13c minus line 15 is less than \$1,000, stop here. You are not required to make estimated tax payments.)	16	
17	If the first payment you are required to make is due April 15, 2005, enter 1/4 of line 16 (minus any 2004 overpayment that you are applying to this installment) here, and on your estimated tax payment voucher(s) if you are paying by check or money order. ( <b>Note:</b> Household employers, see instructions below.)	17	

2005 Estimated Tax Worksheet (self-employed or small business owner).

Form	<b>1040-ES</b> Department of the Treasury Internal Revenue Service	<b>2005 Payment Voucher 3</b>	OMB No. 1545-0087		
File only if you are making a payment of estimated tax by check or money order. Mail this voucher with your check or money order payable to the "United States Treasury." Write your social security number and "2005 Form 1040-ES" on your check or money order. Do not send cash. Enclose, but do not staple or attach, your payment with this voucher.		<b>Calendar year—Due Sept. 15, 2005</b> Amount of estimated tax you are paying by check or money order.			
		<table border="1" style="display: inline-table; border-collapse: collapse;"> <tr> <td style="width: 60px; text-align: center;">Dollars</td> <td style="width: 60px; text-align: center;">Cents</td> </tr> </table>		Dollars	Cents
Dollars	Cents				
Type or print	Your first name and initial		Your last name		
	Your social security number				
	If joint payment, complete for spouse				
	Spouse's first name and initial		Spouse's last name		
	Spouse's social security number				
Address (number, street, and apt. no.)					
City, state, and ZIP code. (If a foreign address, enter city, province or state, postal code, and country.)					
For Privacy Act and Paperwork Reduction Act Notice, see instructions on page 5.					
..... Tear off here .....					
Form	<b>1040-ES</b> Department of the Treasury Internal Revenue Service	<b>2005 Payment Voucher 2</b>	OMB No. 1545-0087		
File only if you are making a payment of estimated tax by check or money order. Mail this voucher with your check or money order payable to the "United States Treasury." Write your social security number and "2005 Form 1040-ES" on your check or money order. Do not send cash. Enclose, but do not staple or attach, your payment with this voucher.		<b>Calendar year—Due June 15, 2005</b> Amount of estimated tax you are paying by check or money order.			
		<table border="1" style="display: inline-table; border-collapse: collapse;"> <tr> <td style="width: 60px; text-align: center;">Dollars</td> <td style="width: 60px; text-align: center;">Cents</td> </tr> </table>		Dollars	Cents
Dollars	Cents				
Type or print	Your first name and initial		Your last name		
	Your social security number				
	If joint payment, complete for spouse				
	Spouse's first name and initial		Spouse's last name		
	Spouse's social security number				
Address (number, street, and apt. no.)					
City, state, and ZIP code. (If a foreign address, enter city, province or state, postal code, and country.)					
For Privacy Act and Paperwork Reduction Act Notice, see instructions on page 5.					
..... Tear off here .....					
Form	<b>1040-ES</b> Department of the Treasury Internal Revenue Service	<b>2005 Payment Voucher 1</b>	OMB No. 1545-0087		
File only if you are making a payment of estimated tax by check or money order. Mail this voucher with your check or money order payable to the "United States Treasury." Write your social security number and "2005 Form 1040-ES" on your check or money order. Do not send cash. Enclose, but do not staple or attach, your payment with this voucher.		<b>Calendar year—Due April 15, 2005</b> Amount of estimated tax you are paying by check or money order.			
		<table border="1" style="display: inline-table; border-collapse: collapse;"> <tr> <td style="width: 60px; text-align: center;">Dollars</td> <td style="width: 60px; text-align: center;">Cents</td> </tr> </table>		Dollars	Cents
Dollars	Cents				
Type or print	Your first name and initial		Your last name		
	Your social security number				
	If joint payment, complete for spouse				
	Spouse's first name and initial		Spouse's last name		
	Spouse's social security number				
Address (number, street, and apt. no.)					
City, state, and ZIP code. (If a foreign address, enter city, province or state, postal code, and country.)					

Form 1040-ES, "Estimated Tax Payment Voucher (self-employed or small business owner)."

Form <b>940</b> Department of the Treasury Internal Revenue Service (999)	<b>Employer's Annual Federal Unemployment (FUTA) Tax Return</b>	OMB No. 1545-0028  <div style="border: 1px solid black; padding: 2px; display: inline-block; font-size: 1.2em; font-weight: bold;">2005</div>																																								
▶ See the separate instructions for Form 940 for information on completing this form.		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td>T</td><td>_____</td></tr> <tr><td>FF</td><td>_____</td></tr> <tr><td>FD</td><td>_____</td></tr> <tr><td>FP</td><td>_____</td></tr> <tr><td>I</td><td>_____</td></tr> <tr><td>T</td><td>_____</td></tr> </table>	T	_____	FF	_____	FD	_____	FP	_____	I	_____	T	_____																												
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<b>You must complete this section.</b> ▶	<table style="width: 100%;"> <tr> <td style="width: 50%;">( ) Name (as distinguished from trade name)</td> <td style="width: 50%;">Calendar year</td> </tr> <tr> <td>( ) Trade name, if any</td> <td>Employer identification number (EIN)</td> </tr> <tr> <td>( ) Address (number and street)</td> <td>City, state, and ZIP code</td> </tr> </table>	( ) Name (as distinguished from trade name)	Calendar year	( ) Trade name, if any	Employer identification number (EIN)	( ) Address (number and street)	City, state, and ZIP code																																			
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( ) Trade name, if any	Employer identification number (EIN)																																									
( ) Address (number and street)	City, state, and ZIP code																																									
<p><b>A</b> Are you required to pay unemployment contributions to only one state? (If "No," skip questions B and C.) <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p><b>B</b> Did you pay all state unemployment contributions by January 31, 2006? (1) If you deposited your total FUTA tax when due, check "Yes" if you paid all state unemployment contributions by February 10, 2006. (2) If a 0% experience rate is granted, check "Yes." (3) If "No," skip question C.) <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p><b>C</b> Were all wages that were taxable for FUTA tax also taxable for your state's unemployment tax? <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p><b>D Did you pay any wages in New York?</b> <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span></p> <p><small>If you answered "No" to questions A, B, or C, or "Yes" to question D, you must file Form 940. If you answered "Yes" to questions A-C and "No" to question D you may file Form 940-EZ, which is a simplified version of Form 940. (Successor employers, see <b>Special credit for successor employers</b> in the separate instructions.) You can get Form 940-EZ by calling 1-800-TAX-FORM (1-800-829-3676) or from the IRS website at <a href="http://www.irs.gov">www.irs.gov</a>.</small></p>																																										
<p><small>If you will not have to file returns in the future, check here (see <b>Who Must File</b> in the separate instructions) and complete and sign the return <span style="float: right;"><input type="checkbox"/></span></small></p> <p><small>If this is an Amended Return, check here (see <b>Amended Returns</b> in the separate instructions) <span style="float: right;"><input type="checkbox"/></span></small></p>																																										
<b>Part I Computation of Taxable Wages</b>																																										
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 65%;">1 Total payments (including payments shown on lines 2 and 3) during the calendar year for services of employees</td> <td style="width: 5%; text-align: center;">1</td> <td style="width: 10%;"></td> <td style="width: 10%;"></td> <td style="width: 10%;"></td> </tr> <tr> <td>2 Exempt payments. (Explain all exempt payments, attaching additional sheets if necessary.) ▶</td> <td style="text-align: center;">2</td> <td></td> <td></td> <td></td> </tr> <tr> <td>3 Payments of more than \$7,000 for services. Enter only amounts over the first \$7,000 paid to each employee (see separate instructions). Do not include any exempt payments from line 2. The \$7,000 amount is the federal wage base. Your state wage base may be different. <b>Do not use your state wage limitation</b></td> <td style="text-align: center;">3</td> <td></td> <td></td> <td></td> </tr> <tr> <td>4 Add lines 2 and 3</td> <td style="text-align: center;">4</td> <td></td> <td></td> <td></td> </tr> <tr> <td>5 <b>Total taxable wages</b> (subtract line 4 from line 1)</td> <td style="text-align: center;">5</td> <td></td> <td></td> <td></td> </tr> <tr> <td colspan="5">6 Credit reduction for unrepaid advances to the states listed. Enter the wages <b>included on line 5</b> above for each state and multiply by the rate shown. (See separate Instructions for Form 940.) (a) NY _____ x .006 = _____</td> </tr> <tr> <td colspan="5">(b) XX _____ x .nnn = _____ (c) XX _____ x .nnn = _____</td> </tr> <tr> <td>7 Add credit reduction amounts from lines 6(a) through 6(c) and enter the total here and in Part II, line 5. ▶</td> <td style="text-align: center;">7</td> <td></td> <td></td> <td></td> </tr> </table>			1 Total payments (including payments shown on lines 2 and 3) during the calendar year for services of employees	1				2 Exempt payments. (Explain all exempt payments, attaching additional sheets if necessary.) ▶	2				3 Payments of more than \$7,000 for services. Enter only amounts over the first \$7,000 paid to each employee (see separate instructions). Do not include any exempt payments from line 2. The \$7,000 amount is the federal wage base. Your state wage base may be different. <b>Do not use your state wage limitation</b>	3				4 Add lines 2 and 3	4				5 <b>Total taxable wages</b> (subtract line 4 from line 1)	5				6 Credit reduction for unrepaid advances to the states listed. Enter the wages <b>included on line 5</b> above for each state and multiply by the rate shown. (See separate Instructions for Form 940.) (a) NY _____ x .006 = _____					(b) XX _____ x .nnn = _____ (c) XX _____ x .nnn = _____					7 Add credit reduction amounts from lines 6(a) through 6(c) and enter the total here and in Part II, line 5. ▶	7			
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<p><b>Be sure to complete both sides of this form, and sign in the space provided on the back.</b></p> <p>For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. ▼ <b>DETACH HERE</b> ▼ Cat. No. 112340 Form <b>940</b> (2005)</p>																																										
Form <b>940-V</b> Department of the Treasury Internal Revenue Service	<b>Payment Voucher</b>	OMB No. 1545-0028  <div style="border: 1px solid black; padding: 2px; display: inline-block; font-size: 1.2em; font-weight: bold;">2005</div>																																								
Use this voucher only when making a payment with your return.																																										
<p><small>Complete boxes 1, 2, and 3. Do not send cash, and do not staple your payment to this voucher. Make your check or money order payable to the "United States Treasury." Be sure to enter your employer identification number (EIN), "Form 940," and "2005" on your payment.</small></p>																																										
1 Enter your employer identification number (EIN).	2 <b>Enter the amount of your payment.</b> ▶	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%;">Dollars</td> <td style="width: 30%;">Cents</td> </tr> <tr> <td style="height: 20px;"> </td> <td> </td> </tr> </table>	Dollars	Cents																																						
Dollars	Cents																																									
3 Enter your business name (individual name for sole proprietors).	Enter your address.  Enter your city, state, and ZIP code.																																									

Form 940, "Employer's Annual Federal Unemployment (FUTA) Tax Return" (page 1).



Form 940 (2005)										Page <b>2</b>
Name								Employer identification number (EIN)		
<b>Part II Tax Due or Refund</b>										
<b>1</b> Gross FUTA tax. (Multiply the wages from Part I, line 5, by .062)										<b>1</b>
<b>2</b> Maximum credit. (Multiply the wages from Part I, line 5, by .054)										<b>2</b>
<b>3</b> Computation of tentative credit <b>(Note: All taxpayers must complete the applicable columns.)</b>										
(a) Name of state	(b) State reporting number(s) as shown on employer's state contribution returns	(c) Taxable payroll (as defined in state act)	(d) State experience rate period		(e) State ex- perience rate	(f) Contributions if rate had been 5.4% (col. (c) x .054)	(g) Contributions payable at experience rate (col. (c) x col. (e))	(h) Additional credit (col. (f) minus col.(g)) If 0 or less, enter -0-	(i) Contributions paid to state by 940 due date	
			From	To						
<b>3a</b> Totals										<b>3a</b>
<b>3b</b> Total tentative credit (add line 3a, columns (h) and (i) only—for late payments, also see the instructions for Part II, line 4)										<b>3b</b>
<b>4</b> Credit: Enter the smaller of the amount from Part II, line 2 or line 3b; or the amount from the worksheet on page 7 of the separate instructions										<b>4</b>
<b>5</b> Enter the amount from Part I, line 7										<b>5</b>
<b>6</b> Credit allowable (subtract line 5 from line 4). If zero or less, enter "-0-"										<b>6</b>
<b>7</b> Total FUTA tax (subtract line 6 from line 1). If the result is over \$500, also complete Part III										<b>7</b>
<b>8</b> Total FUTA tax deposited for the year, including any overpayment applied from a prior year										<b>8</b>
<b>9</b> Balance due (subtract line 8 from line 7). Pay to the "United States Treasury." If you owe more than \$500, see <b>Depositing FUTA Tax</b> on page 3 of the separate instructions										<b>9</b>
<b>10</b> Overpayment (subtract line 7 from line 8). Check if it is to be: <input type="checkbox"/> Applied to next return or <input type="checkbox"/> Refunded										<b>10</b>
<b>Part III Record of Quarterly Federal Unemployment Tax Liability (Do not include state liability.) Complete only if line 7 is over \$500. See page 7 of the separate instructions.</b>										
Quarter	First (Jan. 1-Mar. 31)	Second (Apr. 1-June 30)	Third (July 1-Sept. 30)	Fourth (Oct. 1-Dec. 31)	Total for year					
Liability for quarter										
<b>Third-Party Designee</b>	Do you want to allow another person to discuss this return with the IRS (see separate instructions)? <input type="checkbox"/> Yes. Complete the following. <input type="checkbox"/> No									
	Designee's name	Phone no.			Personal identification number (PIN)					
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and, to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees.										
Signature				Title (Owner, etc.)				Date		

Form 940, "Employer's Annual Federal Unemployment (FUTA) Tax Return" (page 2).

**Form 941 for 2005: Employer's Quarterly Federal Tax Return**  
(Rev. January 2005) Department of the Treasury — Internal Revenue Service

9901  
OMB No. 1545-0029

Employer identification number  -

Name (not your trade name)

Trade name (if any)

Address

Number Street Suite or room number

City State ZIP code

**Report for this Quarter ...**  
(Check one.)

1: January, February, March

2: April, May, June

3: July, August, September

4: October, November, December

Read the separate instructions before you fill out this form. Please type or print within the boxes.

**Part 1: Answer these questions for this quarter.**

<b>1</b> Number of employees who received wages, tips, or other compensation for the pay period including: <i>Mar. 12</i> (Quarter 1), <i>June 12</i> (Quarter 2), <i>Sept. 12</i> (Quarter 3), <i>Dec. 12</i> (Quarter 4)	<b>1</b>	<input type="text"/>
<b>2</b> Wages, tips, and other compensation	<b>2</b>	<input type="text"/>
<b>3</b> Total income tax withheld from wages, tips, and other compensation	<b>3</b>	<input type="text"/>
<b>4</b> If no wages, tips, and other compensation are subject to social security or Medicare tax		<input type="checkbox"/> Check and go to line 6.
<b>5</b> Taxable social security and Medicare wages and tips:		
Column 1	Column 2	
<b>5a</b> Taxable social security wages <input type="text"/> × .124 =	<input type="text"/>	<input type="text"/>
<b>5b</b> Taxable social security tips <input type="text"/> × .124 =	<input type="text"/>	<input type="text"/>
<b>5c</b> Taxable Medicare wages & tips <input type="text"/> × .029 =	<input type="text"/>	<input type="text"/>
<b>5d</b> Total social security and Medicare taxes (Column 2, lines 5a + 5b + 5c = line 5d)	<b>5d</b>	<input type="text"/>
<b>6</b> Total taxes before adjustments (lines 3 + 5d = line 6)	<b>6</b>	<input type="text"/>
<b>7</b> Tax adjustments (If your answer is a negative number, write it in brackets.):		
<b>7a</b> Current quarter's fractions of cents		<input type="text"/>
<b>7b</b> Current quarter's sick pay		<input type="text"/>
<b>7c</b> Current quarter's adjustments for tips and group-term life insurance		<input type="text"/>
<b>7d</b> Current year's income tax withholding (Attach Form 941c)		<input type="text"/>
<b>7e</b> Prior quarters' social security and Medicare taxes (Attach Form 941c)		<input type="text"/>
<b>7f</b> Special additions to federal income tax (reserved use)		<input type="text"/>
<b>7g</b> Special additions to social security and Medicare (reserved use)		<input type="text"/>
<b>7h</b> Total adjustments (Combine all amounts: lines 7a through 7g.)	<b>7h</b>	<input type="text"/>
<b>8</b> Total taxes after adjustments (Combine lines 6 and 7h.)	<b>8</b>	<input type="text"/>
<b>9</b> Advance earned income credit (EIC) payments made to employees	<b>9</b>	<input type="text"/>
<b>10</b> Total taxes after adjustment for advance EIC (lines 8 - 9 = line 10)	<b>10</b>	<input type="text"/>
<b>11</b> Total deposits for this quarter, including overpayment applied from a prior quarter	<b>11</b>	<input type="text"/>
<b>12</b> Balance due (lines 10 - 11 = line 12) Make checks payable to the <i>United States Treasury</i>	<b>12</b>	<input type="text"/>
<b>13</b> Overpayment (If line 11 is more than line 10, write the difference here.)		<input type="text"/>

Apply to next return.  
 Send a refund.

**Next**

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher.
Cat. No. 170012
Form **941** (Rev. 1-2005)

Form 941, "Employer's Quarterly Federal Tax Return" (page 1).

9902	
Name (not your trade name)	Employer identification number
<b>Part 2: Tell us about your deposit schedule for this quarter.</b> If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see <i>Pub. 15 (Circular E)</i> , section 11.	
14 <input type="checkbox"/> <input type="checkbox"/> Write the state abbreviation for the state where you made your deposits OR write "MU" if you made your deposits in multiple states.	
15 Check one: <input type="checkbox"/> Line 10 is less than \$2,500. Go to Part 3. <input type="checkbox"/> You were a monthly schedule depositor for the entire quarter. Fill out your tax liability for each month. Then go to Part 3.	
Tax liability: Month 1 <input style="width: 100px;" type="text"/>	
Month 2 <input style="width: 100px;" type="text"/>	
Month 3 <input style="width: 100px;" type="text"/>	
Total <input style="width: 100px;" type="text"/> Total must equal line 10.	
<input type="checkbox"/> You were a semiweekly schedule depositor for any part of this quarter. Fill out <i>Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors</i> , and attach it to this form.	
<b>Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.</b>	
16 If your business has closed and you do not have to file returns in the future . . . . . <input type="checkbox"/> Check here, and enter the final date you paid wages <input style="width: 50px;" type="text"/> / / .	
17 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . . <input type="checkbox"/> Check here.	
<b>Part 4: May we contact your third-party designee?</b>	
Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.	
<input type="checkbox"/> Yes. Designee's name <input style="width: 300px;" type="text"/>	
Phone <input style="width: 100px;" type="text"/> ( ) - <input style="width: 100px;" type="text"/> Personal Identification Number (PIN) <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	
<input type="checkbox"/> No.	
<b>Part 5: Sign here</b>	
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.	
X Sign your name here <input style="width: 300px;" type="text"/>	
Print name and title <input style="width: 300px;" type="text"/>	
Date <input style="width: 50px;" type="text"/> / / Phone <input style="width: 100px;" type="text"/> ( ) - <input style="width: 100px;" type="text"/>	
<b>Part 6: For paid preparers only (optional)</b>	
Preparer's signature <input style="width: 300px;" type="text"/>	
Firm's name <input style="width: 300px;" type="text"/>	
Address <input style="width: 200px;" type="text"/> EIN <input style="width: 100px;" type="text"/>	
Date <input style="width: 50px;" type="text"/> / / Phone <input style="width: 100px;" type="text"/> ( ) - <input style="width: 100px;" type="text"/> ZIP code <input style="width: 100px;" type="text"/>	
<input type="checkbox"/> Check if you are self-employed. SSN/PTIN <input style="width: 100px;" type="text"/>	
Page 2 <span style="float: right;">Form 941 (Rev. 1-2005)</span>	

Form 941, "Employer's Quarterly Federal Tax Return" (page 2).

Form <b>1120</b> Department of the Treasury Internal Revenue Service	<b>U.S. Corporation Income Tax Return</b> For calendar year 2004 or tax year beginning ..... , 2004, ending ..... , 20.... ▶ See separate instructions.	OMB No. 1545-0123  <div style="border: 1px solid black; padding: 2px; display: inline-block; font-weight: bold; font-size: 1.2em;">2004</div>
<b>A Check if:</b>		
1 Consolidated return (attach Form 651) <input type="checkbox"/>	Use <b>IRS label.</b>	Name _____
2 Personal holding co. (attach Sch. PH) <input type="checkbox"/>	Other- <b>wise, print or type.</b>	Number, street, and room or suite no. If a P.O. box, see page 9 of instructions. _____
3 Personal service corp. (see instructions) <input type="checkbox"/>	City or town, state, and ZIP code _____	B Employer identification number _____
4 Schedule M-3 required (attach Sch. M-3) <input type="checkbox"/>		C Date incorporated _____
		D Total assets (see page 8 of instructions) \$ _____
<b>E Check if:</b> (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change		
<b>Income</b>	1a Gross receipts or sales _____ b Less returns and allowances _____ c Bal ▶ _____	1c _____ 2 _____ 3 _____ 4 _____ 5 _____ 6 _____ 7 _____ 8 _____ 9 _____ 10 _____ 11 <b>Total income.</b> Add lines 3 through 10 ▶ _____
<b>Deductions (See instructions for limitations on deductions.)</b>	12 Compensation of officers (Schedule E, line 4) _____ 13 Salaries and wages (less employment credits) _____ 14 Repairs and maintenance _____ 15 Bad debts _____ 16 Rents _____ 17 Taxes and licenses _____ 18 Interest _____ 19 Charitable contributions (see page 14 of instructions for 10% limitation) _____ 20 Depreciation (attach Form 4562) _____ 20 _____ 21 Less depreciation claimed on Schedule A and elsewhere on return _____ 21a _____	12 _____ 13 _____ 14 _____ 15 _____ 16 _____ 17 _____ 18 _____ 19 _____ 20 _____ 21b _____ 22 _____ 23 _____ 24 _____ 25 _____ 26 _____ 27 <b>Total deductions.</b> Add lines 12 through 26. ▶ _____ 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 _____ 29 <b>Less:</b> a Net operating loss deduction (see page 16 of instructions) _____ 29a _____ b Special deductions (Schedule C, line 20) _____ 29b _____
<b>Tax and Payments</b>	30 <b>Taxable income.</b> Subtract line 29c from line 28 (see instructions if Schedule C, line 12, was completed) _____ 31 <b>Total tax (Schedule J, line 11).</b> _____ 32 <b>Payments:</b> a 2003 overpayment credited to 2004. _____ 32a _____ b 2004 estimated tax payments _____ 32b _____ c Less 2004 refund applied for on Form 4466 _____ 32c ( _____ ) d Bal ▶ _____ e Tax deposited with Form 7004 _____ 32d _____ f Credit for tax paid on undistributed capital gains (attach Form 2439) _____ 32e _____ g Credit for Federal tax on fuels (attach Form 4136). See instructions. _____ 32f _____ h _____ 32g _____	30 _____ 31 _____ 32 _____ 33 _____ 34 _____ 35 _____ 36 _____
33 Estimated tax penalty (see page 17 of instructions). Check if Form 2220 is attached <input type="checkbox"/>		
34 <b>Tax due.</b> If line 32h is smaller than the total of lines 31 and 33, enter amount owed _____		
35 <b>Overpayment.</b> If line 32h is larger than the total of lines 31 and 33, enter amount overpaid _____		
36 Enter amount of line 35 you want: <b>Credited to 2005 estimated tax</b> ▶ _____ <b>Refunded</b> ▶ _____		
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
<b>Sign Here</b>	Signature of officer _____ Date _____ Title _____	May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No
<b>Paid Preparer's Use Only</b>	Preparer's signature _____ Date _____ Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN _____
	Firm's name (or yours if self-employed), address, and ZIP code _____	EIN _____ Phone no. ( ) _____
For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.		
Cat. No. 11450Q		Form <b>1120</b> (2004)

Form 1120, "U.S. Corporation Income Tax Return" (page 1).



Form 1120 (2004)	Page <b>3</b>
<b>Schedule J Tax Computation</b> (see page 20 of instructions)	
1 Check if the corporation is a member of a controlled group (see sections 1561 and 1563). . . . . <input type="checkbox"/>	
<b>Important:</b> Members of a controlled group, see page 20 of instructions.	
2a If the box on line 1 is checked, enter the corporation's share of the \$50,000, \$25,000, and \$9,925,000 taxable income brackets (in that order):	
(1) \$ _____ (2) \$ _____ (3) \$ _____	
b Enter the corporation's share of: (1) Additional 5% tax (not more than \$11,750) \$ _____	
(2) Additional 3% tax (not more than \$100,000) \$ _____	
3 Income tax. Check if a qualified personal service corporation under section 448(d)(2) (see page 21) . . . . . <input type="checkbox"/>	3
4 Alternative minimum tax (attach Form 4626) . . . . .	4
5 Add lines 3 and 4 . . . . .	5
6a Foreign tax credit (attach Form 1118) . . . . .	6a
b Possessions tax credit (attach Form 5735) . . . . .	6b
c Check: <input type="checkbox"/> Nonconventional source fuel credit <input type="checkbox"/> OEV credit (attach Form 8834)	6c
d General business credit. Check box(es) and indicate which forms are attached: <input type="checkbox"/> Form 3800 <input type="checkbox"/> Form(s) (specify) ▶	6d
e Credit for prior year minimum tax (attach Form 8827) . . . . .	6e
f Qualified zone academy bond credit (attach Form 8860) . . . . .	6f
7 <b>Total credits.</b> Add lines 6a through 6f . . . . .	7
8 Subtract line 7 from line 5 . . . . .	8
9 Personal holding company tax (attach Schedule PH (Form 1120)) . . . . .	9
10 Other taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611 <input type="checkbox"/> Form 8697 <input type="checkbox"/> Form 8866 <input type="checkbox"/> Other (attach schedule) . . . . .	10
11 <b>Total tax.</b> Add lines 8 through 10. Enter here and on page 1, line 31	11
<b>Schedule K Other Information</b> (see page 23 of instructions)	
1 Check accounting method: a <input type="checkbox"/> Cash	Yes No
b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶	
2 See page 25 of the instructions and enter the:	
a Business activity code no. ▶	
b Business activity ▶	
c Product or service ▶	
3 At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c). . . . .	
If "Yes," attach a schedule showing: (a) name and employer identification number (EIN), (b) percentage owned, and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year.	
4 Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? . . . . .	
If "Yes," enter name and EIN of the parent corporation ▶	
5 At the end of the tax year, did any individual, partnership, corporation, estate, or trust own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c). . . . .	
If "Yes," attach a schedule showing name and identifying number. (Do not include any information already entered in 4 above.) Enter percentage owned ▶	
6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) . . . . .	
If "Yes," file Form 5452, Corporate Report of Nondividend Distributions.	
If this is a consolidated return, answer here for the parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.	
7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of (a) the total voting power of all classes of stock of the corporation entitled to vote or (b) the total value of all classes of stock of the corporation? . . . . .	Yes No
If "Yes," enter: (a) Percentage owned ▶	
and (b) Owner's country ▶	
c The corporation may have to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter number of Forms 5472 attached ▶	
8 Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . . <input type="checkbox"/>	
If checked, the corporation may have to file Form 8281, Information Return for Publicly Offered Original Issue Discount Instruments.	
9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$ _____	
10 Enter the number of shareholders at the end of the tax year (if 75 or fewer) ▶	
11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here <input type="checkbox"/>	
If the corporation is filing a consolidated return, the statement required by Temporary Regulations section 1.1502-21(b)(3)(i) or (ii) must be attached or the election will not be valid.	
12 Enter the available NOL carryover from prior tax years (Do not reduce it by any deduction on line 23a.) ▶ \$ _____	
13 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year and its total assets at the end of the tax year less than \$250,000? . . . . .	
If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 4. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ▶ \$ _____	
<b>Note:</b> If the corporation, at any time during the tax year, had assets or operated a business in a foreign country or U.S. possession, it may be required to attach Schedule N (Form 1120), Foreign Operations of U.S. Corporations, to this return. See Schedule N for details.	
Form 1120 (2004)	

Form 1120, "U.S. Corporation Income Tax Return" (page 3).

Form 1120 (2004)	Page <b>4</b>		
<b>Note:</b> The corporation is not required to complete Schedules L, M-1, and M-2 if Question 13 on Schedule K is answered "Yes."			
<b>Schedule L Balance Sheets per Books</b>			
	Beginning of tax year	End of tax year	
	(a)	(b)	(c) (d)
<b>Assets</b>			
<b>1</b> Cash . . . . .			
<b>2a</b> Trade notes and accounts receivable . . . . .			
<b>b</b> Less allowance for bad debts . . . . .	( )		( )
<b>3</b> Inventories . . . . .			
<b>4</b> U.S. government obligations . . . . .			
<b>5</b> Tax-exempt securities (see instructions) . . . . .			
<b>6</b> Other current assets (attach schedule) . . . . .			
<b>7</b> Loans to shareholders . . . . .			
<b>8</b> Mortgage and real estate loans . . . . .			
<b>9</b> Other investments (attach schedule) . . . . .			
<b>10a</b> Buildings and other depreciable assets . . . . .			
<b>b</b> Less accumulated depreciation . . . . .	( )		( )
<b>11a</b> Depletable assets . . . . .			
<b>b</b> Less accumulated depletion . . . . .	( )		( )
<b>12</b> Land (net of any amortization) . . . . .			
<b>13a</b> Intangible assets (amortizable only) . . . . .			
<b>b</b> Less accumulated amortization . . . . .	( )		( )
<b>14</b> Other assets (attach schedule) . . . . .			
<b>15</b> Total assets . . . . .			
<b>Liabilities and Shareholders' Equity</b>			
<b>16</b> Accounts payable . . . . .			
<b>17</b> Mortgages, notes, bonds payable in less than 1 year . . . . .			
<b>18</b> Other current liabilities (attach schedule) . . . . .			
<b>19</b> Loans from shareholders . . . . .			
<b>20</b> Mortgages, notes, bonds payable in 1 year or more . . . . .			
<b>21</b> Other liabilities (attach schedule) . . . . .			
<b>22</b> Capital stock: <b>a</b> Preferred stock . . . . .			
<b>b</b> Common stock . . . . .			
<b>23</b> Additional paid-in capital . . . . .			
<b>24</b> Retained earnings—Appropriated (attach schedule) . . . . .			
<b>25</b> Retained earnings—Unappropriated . . . . .			
<b>26</b> Adjustments to shareholders' equity (attach schedule) . . . . .			
<b>27</b> Less cost of treasury stock . . . . .	( )		( )
<b>28</b> Total liabilities and shareholders' equity . . . . .			
<b>Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return (see page 24 of instructions)</b>			
<b>1</b> Net income (loss) per books . . . . .		<b>7</b> Income recorded on books this year not included on this return (itemize):	
<b>2</b> Federal income tax per books . . . . .		Tax-exempt interest \$ . . . . .	
<b>3</b> Excess of capital losses over capital gains . . . . .			
<b>4</b> Income subject to tax not recorded on books this year (itemize): . . . . .			
<b>5</b> Expenses recorded on books this year not deducted on this return (itemize): . . . . .		<b>8</b> Deductions on this return not charged against book income this year (itemize):	
<b>a</b> Depreciation . . . . . \$ . . . . .		<b>a</b> Depreciation . . . . . \$ . . . . .	
<b>b</b> Charitable contributions \$ . . . . .		<b>b</b> Charitable contributions \$ . . . . .	
<b>c</b> Travel and entertainment \$ . . . . .			
<b>6</b> Add lines 1 through 5 . . . . .		<b>9</b> Add lines 7 and 8 . . . . .	
		<b>10</b> Income (page 1, line 28)—line 6 less line 9 . . . . .	
<b>Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)</b>			
<b>1</b> Balance at beginning of year . . . . .		<b>5</b> Distributions: <b>a</b> Cash . . . . .	
<b>2</b> Net income (loss) per books . . . . .		<b>b</b> Stock . . . . .	
<b>3</b> Other increases (itemize): . . . . .		<b>c</b> Property . . . . .	
		<b>6</b> Other decreases (itemize): . . . . .	
<b>4</b> Add lines 1, 2, and 3 . . . . .		<b>7</b> Add lines 5 and 6 . . . . .	
		<b>8</b> Balance at end of year (line 4 less line 7) . . . . .	

Form 1120, "U.S. Corporation Income Tax Return" (page 4).

<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED				OMB No. 1545-0115  <div style="font-size: 2em; font-weight: bold;">2005</div>		<b>Miscellaneous Income</b>	
PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Rents		Form <b>1099-MISC</b>		<b>Copy 1 For State Tax Department</b>	
		\$					
		2 Royalties					
		3 Other income		4 Federal income tax withheld			
		\$		\$			
		5 Fishing boat proceeds		6 Medical and health care payments			
PAYER'S Federal identification number		RECIPIENT'S identification number		\$			
RECIPIENT'S name  Street address (including apt. no.)  City, state, and ZIP code		7 Nonemployee compensation		8 Substitute payments in lieu of dividends or interest			
		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>		10 Crop insurance proceeds			
		11		12			
Account number (see instructions)		13 Excess golden parachute payments		14 Gross proceeds paid to an attorney			
		\$		\$			
		15a Section 409A deferrals		16 State tax withheld			
		15b Section 409A income		\$		\$	
Form <b>1099-MISC</b>				Department of the Treasury - Internal Revenue Service			

Form 1099-MISC, "Miscellaneous Income."



<b>Guide to Information Returns</b> <small>(If any date shown falls on a Saturday, Sunday, or legal holiday, the due date is the next business day.)</small>					
Form	Title	What To Report	Amounts To Report	Due Date	
				To IRS	To Recipient <small>(unless indicated otherwise)</small>
1042-S	Foreign Person's U.S. Source Income Subject to Withholding	Payments subject to withholding under Chapter 3 of the Code, including interest, dividends, royalties, pensions and annuities, gambling winnings, compensation for personal services, and distributions by publicly traded partnerships of income effectively connected with the conduct of a U.S. trade or business.	All amounts, except \$10 or more for interest on U.S. deposits paid to Canadian nonresident aliens	March 15	March 15
1098	Mortgage Interest Statement	Mortgage interest (including points) you received in the course of your trade or business from individuals and reimbursements of overpaid interest.	\$600 or more	February 28 *	(To Payer/ Borrower) January 31
1098-C	Contributions of Motor Vehicles, Boats, and Airplanes	Information regarding a donated motor vehicle, boat, or airplane.	Gross proceeds of more than \$500	February 28 *	30 days from date of sale or contribution
1098-E	Student Loan Interest Statement	Student loan interest received in the course of your trade or business.	\$600 or more	February 28 *	January 31
1098-T	Tuition Statement	Qualified tuition and related expenses, reimbursements or refunds, and scholarships or grants (optional).	See instructions	February 28 *	January 31
1099-A	Acquisition or Abandonment of Secured Property	Information about the acquisition or abandonment of property that is security for a debt for which you are the lender.	All amounts	February 28 *	(To Borrower) January 31
1099-B	Proceeds From Broker and Barter Exchange Transactions	Sales or redemptions of securities, futures transactions, commodities, and barter exchange transactions.	All amounts	February 28 *	January 31
1099-C	Cancellation of Debt	Cancellation of a debt owed to a financial institution, the Federal Government, a credit union, RTC, FDIC, NCUA, a military department, the U.S. Postal Service, the Postal Rate Commission, or any organization having a significant trade or business of lending money.	\$600 or more	February 28 *	January 31
1099-CAP	Changes in Corporate Control and Capital Structure	Information about cash, stock, or other property from an acquisition of control or the substantial change in capital structure of a corporation.	Amounts of stock or property valued at \$100 million or more.	February 28 *	(To Shareholders) January 31
1099-DIV	Dividends and Distributions	Distributions, such as dividends, capital gain distributions, or nontaxable distributions, that were paid on stock, and liquidation distributions.	\$10 or more, except \$600 or more for liquidations	February 28 *	January 31
1099-G	Certain Government Payments	Unemployment compensation, state and local income tax refunds, agricultural payments, and taxable grants.	\$10 or more for refunds and unemployment; \$600 or more for all others	February 28 *	January 31
1099-H	Health Coverage Tax Credit (HCTC) Advance Payments	Health insurance premiums paid on behalf of certain individuals.	All amounts	February 28 *	January 31
1099-INT	Interest Income	Interest income.	\$10 or more (\$600 or more in some cases)	February 28 *	January 31
1099-LTC	Long-Term Care and Accelerated Death Benefits	Payments under a long-term care insurance contract and accelerated death benefits paid under a life insurance contract or by a viatical settlement provider.	All amounts	February 28 *	(To Insured and Policyholder) January 31
1099-MISC	Miscellaneous Income  <small>(Also, use this form to report the occurrence of direct sales of \$5,000 or more of consumer goods for resale.)</small>	Rent or royalty payments; prizes and awards that are not for services, such as winnings on TV or radio shows.  Payments to crew members by owners or operators of fishing boats including payments of proceeds from sale of catch.  Payments to a physician, physicians' corporation, or other supplier of health and medical services. Issued mainly by medical assistance programs or health and accident insurance plans.  Payments for services performed for a trade or business by people not treated as its employees. Examples: fees to subcontractors or directors, and golden parachute payments.  Fish purchases paid in cash for resale.  Substitute dividend and tax-exempt interest payments reportable by brokers.  Crop insurance proceeds.  Gross proceeds paid to attorneys.	\$600 or more, except \$10 or more for royalties  All amounts  \$600 or more  \$600 or more  \$600 or more  \$10 or more  \$600 or more  All amounts	February 28 *	January 31
1099-OID	Original Issue Discount	Original issue discount.	\$10 or more	February 28 *	January 31
1099-PATR	Taxable Distributions Received From Cooperatives	Distributions from cooperatives to their patrons.	\$10 or more	February 28 *	January 31

\* The due date is March 31 if filed electronically.


Guide to Information Returns (Continued)					
Form	Title	What To Report	Amounts To Report	Due Date	
				To IRS	To Recipient (unless indicated otherwise)
1099-Q	Payments From Qualified Education Programs (Under Sections 529 and 530)	Earnings from a qualified tuition program and Coverdell ESAs.	All amounts	February 28*	January 31
1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.	Distributions from retirement or profit-sharing plans, any IRA, insurance contracts, and IRA recharacterizations.	\$10 or more	February 28*	January 31
1099-S	Proceeds From Real Estate Transactions	Gross proceeds from the sale or exchange of real estate.	Generally, \$600 or more	February 28*	January 31
1099-SA	Distributions From an HSA, Archer MSA, or Medicare Advantage MSA	Distributions from an HSA, Archer MSA, or Medicare Advantage MSA.	All amounts	February 28*	January 31
5471	Information Return of U.S. Persons With Respect To Certain Foreign Corporations	U.S. persons who are officers, directors, or shareholders in certain foreign corporations report information required by sections 6035, 6036, and 6046, and to compute income from controlled foreign corporations under sections 951-964.	See form instructions	Due date of income tax return	None
5472	Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business	Transactions between a 25% foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by sections 6038A and 6038C.	See form instructions	Due date of income tax return	None
5498	IRA Contribution Information	Contributions (including rollover contributions) to any individual retirement arrangement (IRA) including a SEP, SIMPLE, and Roth IRA; Roth conversions; IRA recharacterizations; and the fair market value (FMV) of the account.	All amounts	May 31	(To Participant) For FMV/RMD Jan.31; For contributions, May 31
5498-ESA	Coverdell ESA Contribution Information	Contributions (including rollover contributions) to a Coverdell ESA.	All amounts	May 31	April 30
5498-SA	HSA, Archer MSA, or Medicare Advantage MSA Information	Contributions to an HSA, Archer MSA and the fair market value of an HSA, Archer MSA, or Medicare Advantage MSA.	All amounts	May 31	(To Participant) May 31
8027	Employer's Annual Information Return of Tip Income and Allocated Tips	Receipts from large food or beverage operations, tips reported by employees, and allocated tips.	See separate instructions	Last day of February*	Allocated tips are shown on Form W-2, due January 31
8300 (IRS/FinCEN form)	Report of Cash Payments Over \$10,000 Received in a Trade or Business	Payments in cash (including certain monetary instruments) or foreign currency received in one transaction, or two or more related transactions, in the course of a trade or business. Does not apply to banks and financial institutions filing Form 4789, and casinos that are required to report such transactions on Form 8362, Currency Transaction Report by Casinos, or, generally, to transactions outside the United States.	Over \$10,000	15 days after date of transaction	(To Payer) January 31
8308	Report of a Sale or Exchange of Certain Partnership Interests	Sale or exchange of a partnership interest involving unrealized receivables or inventory items.	(Transaction only)	Generally, attach to Form 1065 or 1065-B	(To Transferor and Transferee) January 31
W-2G	Certain Gambling Winnings	Gambling winnings from horse racing, dog racing, jai alai, lotteries, keno, bingo, slot machines, sweepstakes, wagering pools, etc.	Generally, \$600 or more; \$1,200 or more from bingo or slot machines; \$1,500 or more from keno	February 28*	January 31
Form 104 (FinCen)	Currency Transaction Report	Each deposit, withdrawal, exchange of currency, or other payment or transfer by, through, or to financial institutions (other than casinos).	Over \$10,000	15 days after date of transaction	Not required
926	Return by a U.S. Transferor of Property to a Foreign Corporation	Transfers of property to a foreign corporation and to report information under section 6038B.	See form instructions	Attach to tax return	None
W-2	Wage and Tax Statement	Wages, tips, other compensation; social security, Medicare, withheld income taxes; and advance earned income credit (EIC) payments. Include bonuses, vacation allowances, severance pay, certain moving expense payments, some kinds of travel allowances, and third-party payments of sick pay.	See separate instructions	To SSA Last day of February*	To Recipient January 31
TD F 90-22.1	Report of Foreign Bank and Financial Accounts	Financial interest in or signature or other authority over a foreign bank account, securities account, or other financial account.	Over \$10,000	To Treasury Dept. June 30	To Recipient None

\*The due date is March 31 if filed electronically.


Form <b>4070</b> (Rev. August 2005) Department of the Treasury Internal Revenue Service	<h3 style="margin: 0;">Employee's Report of Tips to Employer</h3>	OMB No. 1545-0074
Employee's name and address		Social security number : : : :
Employer's name and address (include establishment name, if different)		1 Cash tips received
		2 Credit and debit card tips received
		3 Tips paid out
Month or shorter period in which tips were received from , to ,		4 Net tips (lines 1 + 2 - 3)
Signature		Date
For Paperwork Reduction Act Notice, see the instructions on the back of this form.		Cat. No. 41320P      Form <b>4070</b> (Rev. 8-2005)

Form <b>4070A</b> (Rev. August 2005) Department of the Treasury Internal Revenue Service	<h3 style="margin: 0;">Employee's Daily Record of Tips</h3> <p style="font-size: small; margin: 0;">This is a voluntary form provided for your convenience. See instructions for records you must keep.</p>	OMB No. 1545-0074			
Employee's name and address	Employer's name	Month and year			
	Establishment name (if different)				
Date tips rec'd	Date of entry	a. Tips received directly from customers and other employees	b. Credit and debit card tips received	c. Tips paid out to other employees	d. Names of employees to whom you paid tips
1					
2					
3					
4					
5					
<b>Subtotals</b>					
For Paperwork Reduction Act Notice, see Instructions on the back of Form 4070.					
					Page 1


*Form 4070, "Employee's Report of Tips to Employer" and 4070A, "Employee's Daily Record of Tips."*

<p><b>Form 5500</b>          Department of the Treasury          Internal Revenue Service          Department of Labor          Employees Benefits Security Administration          Pension Benefits          Guaranty Corporation</p>	<p><b>Annual Return/Report of Employee Benefit Plan</b></p> <p>This form is required to be filed under sections 104 and 4065 of the Employee Retirement Income Security Act of 1974 (ERISA) and sections 6047(e), 6057(b), and 6058(a) of the Internal Revenue Code (the Code).</p> <p>▶ <b>Complete all entries in accordance with the instructions to the Form 5500.</b></p>	<p style="text-align: right; font-size: small;">Official Use Only</p> <p style="text-align: right; font-size: x-small;">OMB Nos. 1210-0110 / 1210-0089</p> <p style="text-align: center; font-size: 2em; font-weight: bold;">2005</p> <p style="text-align: center; font-size: small;">This Form is Open to Public Inspection.</p>	
<p><b>Part I Annual Report Identification Information</b></p> <p>For the calendar plan year 2005 or fiscal plan year beginning <input type="text" value="MM"/> <input type="text" value="DD"/> <input type="text" value="YYYY"/> and ending <input type="text" value="MM"/> <input type="text" value="DD"/> <input type="text" value="YYYY"/></p>			
<p><b>A</b> This return/report is for: (1) <input type="checkbox"/> a multiemployer plan; (3) <input type="checkbox"/> a multiple-employer plan; or          (2) <input type="checkbox"/> a single-employer plan (other than a multiple-employer plan); (4) <input type="checkbox"/> a DFE (specify) <input type="text"/></p>			
<p><b>B</b> This return/report is: (1) <input type="checkbox"/> the first return/report filed for the plan; (3) <input type="checkbox"/> the final return/report filed for the plan;          (2) <input type="checkbox"/> an amended return/report; (4) <input type="checkbox"/> a short plan year return/report (less than 12 months).</p>			
<p><b>C</b> If the plan is a collectively-bargained plan, check here <input type="checkbox"/></p> <p><b>D</b> If filing under an extension of time or the DFVC program, check box and attach required information. (see instructions) <input type="checkbox"/></p>			
<p><b>Part II Basic Plan Information -- enter all requested information:</b></p>			
<p><b>1a</b> Name of plan</p> <table border="1" style="width: 100%; height: 40px; border-collapse: collapse;"> <tr><td style="width: 100%;"></td></tr> </table>			
<p><b>1b</b> Three-digit plan number (PN) ▶ <input type="text" value=""/></p>		<p><b>1c</b> Effective date of plan <input type="text" value="MM"/> <input type="text" value="DD"/> <input type="text" value="YYYY"/></p>	
<p><b>Caution:</b> A penalty for the late or incomplete filing of this return/report will be assessed unless reasonable cause is established.</p> <p>Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this return/report, including accompanying schedules, statements and attachments, as well as the electronic version of this return/report if it is being filed electronically, and to the best of my knowledge and belief, it is true, correct and complete.</p>			
<p>Signature of plan administrator</p> <p><b>SIGN HERE</b> ▶ <input type="text" value=""/> Date <input type="text" value="MM"/> <input type="text" value="DD"/> <input type="text" value="YYYY"/></p> <p>Type or print name of individual signing as plan administrator</p> <p>a <input type="text" value=""/></p>			
<p>Signature of employer/plan sponsor/DFE</p> <p><b>SIGN HERE</b> ▶ <input type="text" value=""/> Date <input type="text" value="MM"/> <input type="text" value="DD"/> <input type="text" value="YYYY"/></p> <p>Type or print name of individual signing as employer, plan sponsor or DFE</p> <p>b <input type="text" value=""/></p>			
<p>For Paperwork Reduction Act Notice and OMB Control Numbers, see the instructions for Form 5500. Cat. No. 13500F Form 5500 (2005)</p>			
<p>0 1 0 5 A A 0 1 0 R</p>  <p style="text-align: right; font-size: x-small;">v8.2</p>			

Form 5500, "Annual Return/Report of Employee Benefit Plan" (page 1).

Form 5500 (2005)	Page <b>2</b>	Official Use Only
<b>2a</b> Plan sponsor's name and address (employer, if for single-employer plan) (Address should include room or suite no.)		
1)	Name	
	Name Continued	
2)	C / O	
3)	Street	
4)	City	
5)	State	Zip Code
6)	Foreign Routing Code	2b Employer Identification Number (EIN)
7)	Foreign Country	2c Sponsor's telephone number
8)	D/E/F	2d Business code (see instructions)
9)	Location Address, if different than State	
	Location Address, City/State/Zip, if different than State	
<b>3a</b> Plan administrator's name and address (If same as plan sponsor, enter "Same")		
1)	Name	
	Name Continued	
2)	C / O	
3)	Street	
4)	City	
5)	State	Zip Code
6)	Foreign Routing Code	3b Administrator's EIN
7)	Foreign Country	3c Administrator's telephone number
<b>4</b> If the name and/or EIN of the plan sponsor has changed since the last return/report filed for this plan, enter the name, EIN and the plan number from the last return/report below:		
<b>a</b> Sponsor's name		
<b>b</b> EIN		<b>c</b> PN
0 1 0 5 A A 0 2 0 S 		

Form 5500, "Annual Return/Report of Employee Benefit Plan" (page 2).

<p>Form 5500 (2005)</p>	<p>Page <b>3</b></p> <p style="font-size: small;">Official Use Only</p>
<p><b>5</b> Preparer information (optional)</p> <p><b>a</b> Name (including firm name, if applicable) and address</p>	
<p><b>1)</b> Name</p> <p>Name Continued</p> <p><b>2)</b> State</p> <p><b>3)</b> City</p> <p><b>4)</b> State Zip Code</p> <p><b>5)</b> Foreign Routing Code</p> <p><b>6)</b> Foreign Country</p>	<p><b>b</b> EIN</p> <p><b>c</b> Telephone number</p>
<p><b>6</b> Total number of participants at the beginning of the plan year</p>	
<p><b>7</b> Number of participants as of the end of the plan year (welfare plans complete only lines 7a, 7b, 7c, and 7d)</p>	
<p><b>a</b> Active participants</p>	
<p><b>b</b> Retired or separated participants receiving benefits</p>	
<p><b>c</b> Other retired or separated participants entitled to future benefits</p>	
<p><b>d</b> Subtotal. Add lines 7a, 7b, and 7c</p>	
<p><b>e</b> Deceased participants whose beneficiaries are receiving or are entitled to receive benefits</p>	
<p><b>f</b> Total. Add lines 7d and 7e</p>	
<p><b>g</b> Number of participants with account balances as of the end of the plan year (only defined contribution plans complete this item)</p>	
<p><b>h</b> Number of participants that terminated employment during the plan year with accrued benefits that were less than 100% vested</p>	
<p><b>i</b> If any participant(s) separated from service with a deferred vested benefit, enter the number of separated participants required to be reported on a Schedule SSA (Form 5500)</p>	
<p>0 1 0 5 A A 0 3 0 T</p> 	

Form 5500, "Annual Return/Report of Employee Benefit Plan" (page 3).

**8** Benefits provided under the plan (complete **8a** and **8b**, as applicable)

**a**  Pension benefits (check this box if the plan provides pension benefits and enter below the applicable pension feature codes from the List of Plan Characteristics Codes printed in the instructions):

**b**  Welfare benefits (check this box if the plan provides welfare benefits and enter below the applicable welfare feature codes from the List of Plan Characteristics Codes printed in the instructions):

**9a** Plan funding arrangement (check all that apply)

- (1)  Insurance
- (2)  Code section 412(i) insurance contracts
- (3)  Trust
- (4)  General assets of the sponsor

**9b** Plan benefit arrangement (check all that apply)

- (1)  Insurance
- (2)  Code section 412(i) insurance contracts
- (3)  Trust
- (4)  General assets of the sponsor

**10** Schedules attached (Check all applicable boxes and, where indicated, enter the number attached. See instructions.)

**a** Pension Benefit Schedules

- 1)  **R** (Retirement Plan Information)
- 2)  **B** (Actuarial Information)
- 3)  **E** (ESOP Annual Information)
- 4)  **SSA** (Separated Vested Participant Information)

**b** Financial Schedules

- 1)  **H** (Financial Information)
- 2)  **I** (Financial Information--Small Plan)
- 3)     **A** (Insurance Information)
- 4)  **C** (Service Provider Information)
- 5)  **D** (DFE/Participating Plan Information)
- 6)  **G** (Financial Transaction Schedules)
- 7)     **P** (Trust Fiduciary Information)

FOR INFORMATION PURPOSES ONLY. DO NOT USE FOR FILING



<b>Quick Reference Chart for Form 5500, Schedules and Attachments<sup>1</sup></b>					
	<b>Large Pension Plan</b>	<b>Small Pension Plan</b>	<b>Large Welfare Plan</b>	<b>Small Welfare Plan</b>	<b>DFE</b>
<b>Form 5500</b>	Must complete.	Must complete.	Must complete.	Must complete. <sup>2</sup>	Must complete.
<b>Schedule A</b> (Insurance Information)	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if MTIA, 103-12 IE or GIA has insurance contracts for benefits or investments.
<b>Schedule B</b> (Actuarial Information)	Must complete if defined benefit plan and subject to minimum funding standards. <sup>3</sup>	Must complete if defined benefit plan and subject to minimum funding standards. <sup>3</sup>	Not required.	Not required.	Not required.
<b>Schedule C</b> (Service Provider Information)	Must complete if service provider was paid \$5,000 or more and/or an accountant or actuary was terminated.	Not required.	Must complete if service provider was paid \$5,000 or more and/or an accountant or actuary was terminated.	Not required.	MTIAs, GIAs and 103-12 IEs must complete Part I if service provider paid \$5,000 or more. GIAs and 103-12 IEs must complete Part II if accountant was terminated.
<b>Schedule D</b> (DFE/ Participating Plan Information)	Must complete Part I if plan participated in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participated in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participated in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participated in a CCT, PSA, MTIA, or 103-12 IE.	All DFEs must complete Part II, and DFEs that invest in CCT, PSA, or 103-12 IE must also complete Part I.
<b>Schedule E</b> (ESOP Annual Information)	Must complete if ESOP.	Must complete if ESOP.	Not required.	Not required.	Not required.
<b>Schedule G</b> (Financial Transaction Schedules)	Must complete if Schedule H, line 4b, 4c, or 4d is "Yes." <sup>4</sup>	Not required.	Must complete if Schedule H, line 4b, 4c, or 4d is "Yes." <sup>4</sup>	Not required.	MTIAs, GIAs and 103-12 IEs must complete if Schedule H, line 4b, 4c, or 4d is "Yes." <sup>4</sup>
<b>Schedule H</b> (Financial Information)	Must complete. <sup>4</sup>	Not required.	Must complete. <sup>2,4</sup>	Not required.	All DFEs must complete Parts I, II, and III. MTIAs, 103-12 IEs, and GIAs must also complete Part IV. <sup>4</sup>

"Quick Reference Chart for Form 5500, Schedules and Attachments" (page 1).



	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan	DFE
<b>Schedule I</b> (Financial Information—Small Plan)	Not required.	Must complete.	Not required.	Must complete. <sup>2</sup>	Not required.
<b>Schedule P</b> (Annual Return of Fiduciary of Employee Benefit Trust)	Must file to start running of statute of limitations under Code section 6501(a).	Must file to start running of statute of limitations under Code section 6501(a).	Not required.	Not required.	Not required.
<b>Schedule R</b> (Retirement Plan Information)	Must complete. <sup>5</sup>	Must complete. <sup>5</sup>	Not required.	Not required.	Not required.
<b>Schedule SSA</b> (Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits)	Must complete if plan had separated participants with deferred vested benefits to report.	Must complete if plan had separated participants with deferred vested benefits to report.	Not required.	Not required.	Not required.
<b>Accountant's Report</b>	Must attach.	Not required unless Schedule I, line 4k, is checked "No."	Must attach. <sup>7</sup>	Not required.	Must attach for a GIA or 103-12 IE.

<sup>1</sup> This chart provides only general guidance. Not all rules and requirements are reflected. Refer to specific Form 5500 instructions for complete information on filing requirements (e.g., **Who Must File** on page 3 and **What To File** on page 7). For example, a pension plan is exempt from filing any schedules if the plan uses a Code section 403(b)(1) annuity, 403(b)(7) custodial account, or 408 individual retirement accounts or annuities as the sole funding vehicle for providing benefits. See **Limited Pension Plan Reporting** on page 4.

<sup>2</sup> Unfunded, fully insured and combination unfunded/insured welfare plans covering fewer than 100 participants at the beginning of the plan year that meet the requirements of 29 CFR 2520.104-20 are exempt from filing an annual report. (See **Who Must File** on page 3.) Such a plan with 100 or more participants must file an annual report, but is exempt under 29 CFR 2520.104-44 from the accountant's report requirement and completing Schedule H, but **MUST** complete Schedule G, Part III, to report any nonexempt transactions. See **What To File** on page 7.

<sup>3</sup> Certain money purchase defined contribution plans are required to complete Schedule B, lines 3, 9, and 10 in accordance with the instructions for Schedule R, line 5.

<sup>4</sup> Schedules of assets and reportable (5%) transactions also must be filed with the Form 5500 if Schedule H, line 4i or 4j is "Yes," but use of printed form not required.

<sup>5</sup> A pension plan is exempt from filing Schedule R if each of the following four conditions is met:

- The plan is not a defined benefit plan or otherwise subject to the minimum funding standards of Code section 412 or ERISA section 302.
- No in-kind distributions reportable on line 1 of Schedule R were distributed during the plan year.
- No benefits were distributed during the plan year which are reportable on Form 1099-R using an EIN other than that of the plan sponsor or plan administrator.
- In the case of a plan that is not a profit-sharing, ESOP or stock bonus plan, no plan benefits were distributed during the plan year in the form of a single sum distribution.

**General Instructions to Form 5500** -13-

*"Quick Reference Chart for Form 5500, Schedules and Attachments" (page 2).*



## Appendix



# Small Business Tax and Form Calendar

We pulled together the key tax dates you need and the federal forms that must be submitted on those dates. The dates listed are the actual due dates, but if that due date falls on a federal holiday or weekend, the form or tax payment is due on the next business day.

## January

Employers should give their employees copies of their **Form W-2** as soon as possible in January. The last possible date for mailing is January 31.

**January 1**—Federal holiday (**New Year's Day**)

**January 2**—If you made advance payments for employees eligible for the earned income tax credit and they did not submit a new **Form W-5**, “Earned Income Credit Advance Payment Certificate,” showing continued eligibility, you should stop any future advance payments. You can restart these payments if a new form is submitted.

**January 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

**January 15:**

- ◆ If you need to make estimated tax payments for the previous tax year, they must be paid by this date. This payment is the final tax payment for the previous tax year.
- ◆ If you pay your Social Security, Medicare, and withheld income tax on a monthly deposit, you should make that deposit by this date for the December payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the December payment by this date.

**Martin Luther King Jr. Day** is a federal holiday that falls on the third Monday in January. Banks and federal offices are closed, as well as many state offices and other businesses.

**January 31:**

- ◆ **W-2 forms**, “Wage and Tax Statement,” for your employees must be completed and delivered to your employees by this date.
- ◆ You also must deliver any required **1099 forms** to your vendors or contractors. There are many different types of 1099s. These are the key ones that small businesses use:
  - 1099-MISC**—Miscellaneous Income: for most of your vendors or contractors.
  - 1099-MSA**: Distribution from an Archer MSA.
  - 1099-R**: Distributions from Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, and so on.
- ◆ If you are expecting any **1099 forms** for dividends, interest, rents or any other payments you received during the year, you should get these forms by January 31.
- ◆ If you did not pay your final tax installment on January 15, you can avoid a penalty for late payment of this installment if you file your tax return by this date.
- ◆ You also need to file year-end reports for the federal government if you have employees. **Form 940** or **940EZ**, “Employer’s Annual Federal Unemployment (FUTA),” summarizes your payroll information for the year and is used to calculate your FUTA tax for the year. You won’t need to make a payment as long

as you have made all the necessary contributions to FUTA during the year. The FUTA payment for the last quarter of the previous tax year is due by this date. Don't forget to file any state unemployment forms as well if required by this date.

- ◆ You should use **Form 945**, "Annual Return of Withheld Income Tax," to report any nonpayroll income tax withheld from employees. Your state also probably has forms that must be filed if you have employees.
- ◆ Be sure you add any state requirements to this list. There are probably year-end forms required by the state or local governments for any taxes that might be due such as sales taxes, state FUTA taxes, or other tax payments unique to your state or business.

## February

**February 10**—You should collect **Form 4070**, "Employee's Report of Tips to Employer," from any employee who received \$20 or more in tips.

**President's Day** is a federal holiday that falls on the third Monday in February. Banks and federal offices are closed, as well as many state offices and other businesses.

### **February 15:**

- ◆ Your employees must file a new **W-4**, "Employee's Withholding Allowance Certificate," if they claimed tax-exempt status in the prior tax year to continue tax-exempt status in the current year. If an employee who claimed a tax exemption in the previous tax year has not filed a new W-4, you should begin withholding income tax from his pay.
- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the January payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the January payment by this date.

### **February 28:**

- ◆ If you have employees, you need to file your **Forms W-2** along with **Form W-3**, "Transmittal of Wage and Tax Statements," which summarizes your W-2

statements and transmits those statements. If you file your W-2 statements electronically, you have until March 31 to file them with the Social Security Administration.

- ◆ You need to file **Forms 1099** along with **Forms 1096**, “Annual Summary and Transmittal of U.S. Information Returns.” You must file one Form 1096 for each type of 1099 information return, such as a 1099-MISC. If you file these forms electronically, you have until March 31 to file them with the IRS.
- ◆ You need to file **Form 8027**, “Employer’s Annual Information Return of Tip Income and Allocated Tips,” to summarize the annual tips reported through the year.

## March

**March 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

### **March 15:**

- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the February payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the February payment by this date.

## April

**April 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

### **April 15:**

- ◆ If you pay personal estimated tax payments, your first installment is due for the current tax year.
- ◆ Personal income tax returns are due unless you filed a request for an extension. To request an extension, you should file **Form 4868**, “Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.” To avoid paying a penalty and interest, you must also pay any tax due by this date.

- ◆ If you want to make qualified IRA contributions for the previous tax year, you must make these contributions by this date.
- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the March payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the March payment by this date.
- ◆ If you paid cash wages of \$1,300 or more in the prior tax year to a household employee, you must file **Schedule H**, “Household Employment Taxes,” with your tax return.

#### **April 30:**

- ◆ You must file **Form 941**, “Employer’s Quarterly Federal Tax Return,” if you have employees in order to report the Social Security, Medicare, and income tax withheld for the first quarter of the current tax year. If you deposit your taxes with this form you should also file a **Form 941-V**, which serves as a voucher. If you’ve paid the taxes in full and on time prior to this date, you have 10 additional days to file Form 941.
- ◆ If the amount you must pay in federal unemployment tax for the first quarter is more than \$100, you must deposit that payment by this date.

## **May**

**May 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

#### **May 15:**

- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the April payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the April payment by this date.

**Memorial Day** is a federal holiday observed the last Monday in May. Banks and federal offices will be closed, as well as many state offices and other businesses.

## June

**June 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

**June 15:**

- ◆ If you make quarterly estimated tax payments, your second installment is due by this date.
- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the May payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the May payment by this date.

## July

**July 4—Independence Day** is a federal holiday. Banks and federal offices are closed, as well as many state offices and other businesses.

**July 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

**July 15:**

- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the June payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the June payment by this date.

**July 31:**

- ◆ You must file **Form 941** if you have employees to report the Social Security, Medicare, and income tax withheld for the second quarter of the current tax year.



If you deposit your taxes with this form, you should also file a **Form 941-V**, which serves as a voucher. If you've paid the taxes in full and on time prior to this date, you have 10 additional days to file Form 941.

- ◆ If the amount you must pay in federal unemployment tax is more than \$100, you must deposit that payment by this date.
- ◆ If you maintain an employee benefit plan, such as a pension plan, profit sharing or stock bonus plan, you must file **Form 5500**, "Annual Return of Fiduciary of Employee Benefit Trust," or **5500-EZ** for the previous calendar year. If you file your taxes on a fiscal year basis, then you must file the form by the last day of the seventh month after the plan year ends.

## August

**August 10**—You should collect **Form 4070**, "Employee's Report of Tips to Employer," from any employee who received \$20 or more in tips.

### **August 15:**

- ◆ If you filed requesting a four-month extension on April 15 for your personal taxes, you must file your taxes for the previous tax year by this date. You can file **Form 2688**, "Application for Additional Extension of Time To File U.S. Individual Income Tax Return," if you need an additional two-month extension to file your returns. Note that this additional extension requires a reason and approval by the IRS.
- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the July payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the July payment by this date.

## September

**Labor Day** is a federal holiday that falls on the first Monday in September. Banks and federal offices are closed, as well as many state offices and other businesses.

**September 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

**September 15:**

- ◆ If you make estimated tax payments, the third installment is due.
- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the August payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the August payment by this date.

## October

**October 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

**Columbus Day** is a federal holiday that falls on the second Monday in October. Banks and federal offices are closed, as well as many state offices and other businesses.

**October 15:**

- ◆ If you received an additional two-month extension using **Form 2688** for your prior year taxes, they are due on this date. No more extensions are possible.
- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the September payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the September payment by this date.

**October 31:**

- ◆ You must file **Form 941** if you have employees to report the Social Security, Medicare, and income tax withheld for the third quarter of the current tax year. If you deposit your taxes with this form, you should also file a **Form 941-V**, which serves as a voucher. If you’ve paid the taxes in full and on time prior to this date, you have 10 additional days to file Form 941.
- ◆ If the amount you must pay in federal unemployment tax is more than \$100, you must deposit that payment by this date.

## November

- ◆ During this month you should ask employees if they want to change their withholding allowances or tax status for the next tax year and provide the necessary **W-4** forms for these changes.
- ◆ You should alert any employees who filed for tax exempt status in the current tax year that they need to file a new **W-4** for the next tax year if they want to maintain that status.
- ◆ You should alert any employees who were eligible for earned income credit advances in the current tax year that they must file a new Form **W-5** for the next tax year.

**November 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

**November 11**—**Veteran’s Day** is a federal holiday. Banks and federal offices are closed, as well as many state offices and other businesses.

### **November 15:**

- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the October payment.
- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the October payment by this date.

**Thanksgiving Day** is a federal holiday that always falls on the fourth Thursday of the month. Banks and federal offices are closed, as well as many state offices and other businesses.

## December

**December 10**—You should collect **Form 4070**, “Employee’s Report of Tips to Employer,” from any employee who received \$20 or more in tips.

### **December 15:**

- ◆ If you pay your Social Security, Medicare, and income taxes withheld on a monthly deposit, you should make that deposit by this date for the November payment.

- ◆ If you withhold nonpayroll taxes and you deposit these taxes monthly, you should deposit the November payment by this date.

**December 25—Christmas Day** is a federal holiday. Banks and federal offices are closed, as well as many state offices and other businesses.

**December 31:**

- ◆ If you operate on a cash basis, this is the last day that you can make any payments and charge the amount against expenses for the current tax year or collect income. If you operate on an accrual basis, this is the last day you can book revenue or expenses for the current tax year. Many businesses call throughout the month of December for last minute checks due so they can report income in the current tax year. They also check with vendors for missing invoices so that they can record expenses in the current tax year. If you work on an accrual basis, just billing the client for payments that are due will allow you to book that income in the current tax year. The same is true provided you receive a written invoice for payables that are due.
- ◆ If you want to deduct a Keogh plan contribution for the current tax year and have not yet set up the paperwork, you must establish the Keogh plan by this date in order to deduct that contribution.

## Fiscal Year Businesses

- ◆ If you file your taxes on a fiscal year basis, then your **Form 1040** is due on the 15<sup>th</sup> day of the fourth month after the end of your tax year.
- ◆ Estimated tax payments are due on the 15<sup>th</sup> day of the fourth, sixth, and ninth months of your tax year. The final payment is due on the 15<sup>th</sup> day of the first month after your tax year ends.
- ◆ If you have employees, all of these dates are still the same for employee forms with one exception. Fiscal year filers must file **Form 5500** or **Form 5500-EZ** on the last day of the seventh month after the plan year ends.

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