Implementing Effective Accounting Systems for Small Business Entities

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Abstract

Sales, profits, and market expansion consume the minds of small business entrepreneurs. Bookkeeping and the proper reporting of economic activities is often viewed as a hindrance to the already scarce time of zealous entrepreneurial minds, and as Benjamin Franklin once noted, “time is money.” Implementing an accounting system for small entities can seem daunting, perplexing, and even frivolous. As a result, many small business owners pursue a minimalist strategy in choosing a system that reports only necessary information and takes the smallest amount of time. Accounting by nature is meant to provide information to decision makers. The divide between adequate and thorough information is often the divide that separates efficient, successful businesses from bankrupt business. As a finance and accounting student at Ball State University, I have had the opportunity to work with a small business, MDTekk, in their startup state and help them implement a time efficient and useful accounting information system. I have been able to work directly with a small business entity in addressing many of the challenges facing small businesses and their mission to materialize a useful system.
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# Table of Contents

**Part I: Effectively Implementing an Accounting Structure for Small Business Entities**

- Introduction ........................................ 5
- Selecting a Legal Entity Type ....................... 6
- Understanding the Users of Financial Information 9
- Assessing the Necessary Qualities of Information 12
- Gathering Necessary Information .................. 15
- Selecting the Appropriate Software ............... 16
- Understanding the General Accounting Principles 17
- Developing a Chart of Accounts .................. 20
- Understanding the Income Statement .............. 22
- Understanding the Statement of Retained Earnings 25
- Understanding the Balance Sheet .................. 26
- Understanding the Statement of Cash Flows ....... 28
- Putting Accounting Information to Work ......... 29

**Part II: Reflection on working with MDTekk** .......... 31
Part I: Effectively Implementing an Accounting Structure for Small Business Entities

Introduction

Profits are the prime concern of any business. Small businesses are no exception. Owners and managers of small business often find themselves vulnerable to threats in changing market conditions. Small businesses do not possess the resources and capabilities to survive recessions or adapt to changing markets like a Fortune 500 company does. As a result, the bottom line is often scrutinized in greater detail. In addition, time is even more precious. Unfortunately, accounting or bookkeeping is often not properly used. Accounting innately is "an information and measurement system that identifies, records, and communicates relevant, reliable, and comparable information about an organization’s business activities" (Wild 4).

Companies use accounting information systems to record the economic activities that occur within the company. An accounting information system is "a system of interrelated manual and computer parts that uses processes such as collecting, recording, summarizing, analyzing (using decision models), and managing data to provide output information to users" (Hansen 967). When used correctly, accounting information systems should accomplish the objectives of accounting by providing timely and useful information to users. This quality information should enable owners and managers to improve the financial condition of their business by making wise decisions that impact the health of the company. In order to successfully implement accounting information systems, a company should: evaluate and chose an appropriate entity type, establish an accounting framework, accumulate the necessary information, establish a basic accounting structure, develop a balance sheet, develop an income statement, understand
tax implications, and evaluate the big picture. By addressing these issues, a company will be able to generate useful information that will help the company grow.

Selecting a Legal Entity Type

The first decision point in selecting an entity type is determining the legal entity type. Sole proprietorships, partnerships, and corporations are the three main types of business entities. Each of the three types has various advantages and disadvantages. While numerous differences between entity types exist, the focus here is on those differences that affect the accounting process.

The primary benefit of a corporation, specifically a C Corporation, classification is the separation of the legal entity from its owners. This means that the personal assets of the owner are not subject to creditor claims in the case of bankruptcy. The owners of a corporation are only liable up to the amount of money invested into the corporation. Thus, the entity will create equity accounts to keep track of the amount of capital invested in the company. The implementation of equity accounts is discussed in further detail in the Developing a Chart of Accounts section. This structure provides owners with the security of knowing they will not be personally liable. C Corporations are often used when a mature company sees growth opportunities that would require capital investments that exceed amounts available through individual investors and loans. This structure does come at a cost. The main drawback of corporations is the tax structure to which they are subjected. United States tax law taxes corporations twice. First, corporations are taxed on their yearly profits. Second, shareholders are taxed on the dividends they receive. In addition to the drawback of double taxation, corporations will incur incorporation fees and higher tax rates than the other entities (Katz,
C Corporations are subject to complex paperwork, tax structures, and other legal requirements. These entities are formed under state law and must adhere to the laws instituted by the state (U.S. Small Business Association).

The second type of legal entity is a partnership. A partnership is a type of business structure where ownership is concentrated among a few investors. Many types of partnerships exist. The differences between the types of partnerships reside primarily in ownership liability. In a general partnership (GP), multiple partners contribute to the company and possess unlimited liability. The limited liability partnership (LLP) is much like a general partnership with the primary difference being a partner is not personally liable for the malpractice of the other partners. Unlimited liability still exists if the business ends in bankruptcy and no malpractice is present. A limited liability company (LLC) allows the company to be taxed like a partnership while having the limited liability of a corporation. In a limited partnership, at least one general partner with unlimited liability is present. In addition, one or more limited partners with limited liability are present. Partnerships are governed by partnership percentages. Each partner is responsible for his or her relative percentage of each economic event of the company.

Partners are given a basis in the entity for the value of assets contributed. A partner is not taxed on money received unless the amount received is in excess of the basis contributed to the partnership. Distributions in excess of a partner’s basis are taxed at appropriate rates. Often the excess is taxed at capital gain rates (Hoffman 21.1–21.42). Under partnerships, companies can set up guaranteed payments. Guaranteed payments are distributions to partners with no regard to partnership income (Internal Revenue Service). In essence, these
payments allow partnerships to distribute funds to partners in the form of a salary. Guaranteed payments must be a fixed amount. These payments are treated as an expense and reduce net income. As a result, the tax on net income will decrease. However, partners are taxed on these amounts as ordinary income (Hoffman 21.34-21.35).

Companies choose the partnership structure for a variety of reasons. First, partnerships are much easier to start than corporations as they are cheaper and require less paperwork. In addition, partnerships allow individuals to synergize the human and capital resources and remain a private entity. As a private entity they will be subject to fewer regulations and be required to disclose less financial information about their business. This structure enables companies to have access to a larger amount of capital than they would have had access to as a sole proprietor. However, capital availability is still limited in comparison to corporations.

The final type of legal structure is the sole proprietorship. Under a sole proprietorship, one individual is in control of the company. A sole proprietor is not legally separated from the business and thus has unlimited liability. Under a sole proprietorship, the company does not file a tax return. Instead, the sole proprietor pays self-employment tax on the income (Kamoroff 25-27). The primary benefit of this structure is the ease of formation. The structure is not as complex as a corporation or partnership. The downside of a sole proprietorship is the limited funding available to sole proprietors. This type of entity structure is often the choice of individuals looking to start a business. It is the easiest to create and does not involve any special arrangements. As its ability to raise capital is limited, this is often the first stage of growth businesses.
Picking a type of entity is the first step in establishing a business. The type of entity should fit the owner’s financing risk aversion preferences. Once the structure is chosen, a company can move forward in establishing a framework for the accounting structure.

**Understanding the Users of Financial Information**

The next step in achieving the successful implementation of an efficient accounting structure is establishing a framework. It is here that the owner or manager must step back and remember the purpose of an accounting structure. From above, we established that accounting is a system for organizing, summarizing, and relaying information about a business (Wild 4). The business is the core of this definition. The business enters into economic actions that are the lifeblood of the company. These economic actions are first identified as relevant to the company. Next, these actions are recorded in the form of transactions. Finally, this information is presented in a way that is useful to the users of financial information. Therefore, the product of any accounting system is organized and useful information. Now that we have established a definition, we need to understand the end users of the information.

Accounting users include anyone who uses financial information about a company to make decisions. This includes entities both within and outside the company. External users include stockholders, banks, customers, consumer groups, governments and external auditors. Internal users include officers, managers, sales executives, internal auditors, controllers, and employees. Accounting information should be tailored to the needs of specific groups. Different legal entities established above have different needs for accounting information.

For large corporations, the primary external users are stockholders. Different stock investors will have different informational preferences but the large majority of stock investors
or prospective stock investors are interested in profit margins, debt levels, and net income amounts. Corporations also need to provide information to institutional debt investors such as banks and bond investors. These investors are not as concerned with profit margins and net income amounts. Instead, they want to make sure the company has enough money to pay back its debt holders, which have a primary interest in the company. This means that the company must pay debt holders their contractual amounts before distributing any excess profits to the stockholders. These two primary external users drive the design of externally reported information for corporations. Internally, managers, officers, and sales representatives have different needs. A high-ranking manager may have bonuses linked to company profitability. Because most small business entities are not corporations, time spent analyzing corporations will be limited and the focus will shift to partnerships and sole proprietorships.

Partnerships and proprietorships often have very similar end users; therefore the analysis of these types of entities is consolidated. Externally, partnerships do not have stockholders and thus information does not need to be tailored to that group. Instead, equity funding comes from either partners or venture capitalists. Venture capitalists offer funding to partnerships with the expectation of high returns in the future. These returns are expected around five to ten years after the investment. Roughly 3,000 companies are funded from venture capitalists (National Venture Capital Association). In most cases, venture capitalists have a close relationship with the companies they invest in. They are often given management positions. As a result, they would also be considered internal users. Occasionally, venture capitalists take a passive approach to investing as they trust in management’s abilities. Just like stock investors, venture capitalists will have varying preferences when looking for financial
information. Unlike stock investors, venture capitalists usually are few and each own large portions of the company. As a result, companies should provide information specifically tailored to its venture capitalists' needs. The venture capitalists will have a prominent voice in implementing an accounting information system, so the needs for any particular business should be clear.

Partnerships and proprietorships often receive large amounts of funding in the form of debt obligations. These investors include banks, savings and loan companies, co-ops, mortgage and finance companies, and individual investors (Wild 5). They often have similar concerns as debt investors to larger corporations. Small business debt investors often have strict requirements. Debt lenders look at the amount of assets on a company's balance sheet. They want to see the amount of assets available for collateral in case of default. They also look at the ratio of assets to total debt and debt to equity ratios (Lorenz-Fife 52-53). Debt lenders view high asset to debt ratios as positive, as the liabilities are covered by the assets in case of bankruptcy. The debt to equity ratio shows what percentage of the company is funded by the respective categories. If the company is financed almost entirely by debt that would illustrate a risky position for potential lenders, as other debt holders would have a primary claim on assets if the company collapsed. Debt lenders are also concerned with a company's ability to make routine payments. This will largely be established by the credit rating of the company. In addition to this, lenders will look to the current ratio (current assets/current liabilities) and net working capital (current assets minus current liabilities). Current assets are assets which will be converted to cash easily (within the year). Current liabilities are liabilities that must be paid in the current year. This shows the lender the degree to which a company can fund its short term
liabilities with its short term assets. If the short term liabilities exceed the short term assets, a lender may have reservations about the ability of the firm to make payments (Bukics and Engle25). Debt lenders will often refrain from investing if the owners’ equity in the company is low, revenue is largely received from a single source, or business projections are unsound (Lorenz-Fife 56). All of these considerations help to provide a framework for developing an accounting information system that is detailed later on in the Selecting the Appropriate Software section.

In addition to the aforementioned users, partnerships and proprietorships need to generate information to internal users. Internal information users for small business owners are generally concentrated in management. Management makes a variety of information-based decisions. Some decisions include but are not limited to adding financing, assessing the inventory turnover, isolating products to determine profitability, assessing employee productivity, finding bottlenecks in production, forecasting sales and inventory needs, projecting tax expense, assessing growth, allocating costs, and benchmarking the company to its competitors. Management’s uses of information are crucial for operating success. As a result, the accounting system implemented should accommodate management needs.

Assessing the Necessary Qualities of Information

Before designing an accounting information system, a company should establish and/or review the desired characteristics of information. This is a crucial step as it will eliminate wasted time resulting from gathering and generating unnecessary information. According to FASB’s *Statement of Financial Accounting Concepts No. 2*, quality information should be relevant, reliable, comparable and consistent, material, and have benefits that exceed its costs.
The first area of interest is the relevance of the information. Relevant information enables decision makers to evaluate past events, understand current circumstances, and make decisions based on the future. It details the results of past business initiatives. Part of relevance, according to FASB, is timeliness. Accounting information should be available before it loses its ability to be useful. It should enable users to make timely decisions about the future. For instance, information is usually made available in the quarter following the end of the fiscal year to external users. Management must be able to first access the information, often within the current year, to create financial statements in order to make decisions (Katz 409). Information released five years after the occurrence of economic events would not be useful to any of the users mentioned above.

The next quality of information is reliability. Reliability is the assurance to the user that the presented information is free of error. Reliability is expressed in degrees. Information is not merely reliable or unreliable; rather the degree with which a user can rely on the information is key (FASB). Third party verification is the best means of securing information reliability. External auditor or CPA verification assures users that the information audited or examined is correct within all material respect as vouched by the third party. Information generated and released by the same entity is only as reliable as the entity and its established internal controls. As such, this information is not seen as very reliable. Lenders and other users may request an external audit or assurance prior to lending. Because of these requirements, information reliability is of prime importance to small businesses with capital needs.

In addition to relevance and reliability, comparability and consistency are crucial qualities of information. Users of information would not find much use in information that
could not be compared to similar information of other entities. In addition, users would find little use in inconsistent information. For instance, a manager cannot compare current year results to prior years if the information is not recorded in the same manner. If information from a company were inconsistent, a user would not be able to compare one period of a company’s operations with another. As a result, companies should conform to the Generally Accepted Accounting Principles. This set of rules establishes a standard that when followed will help companies produce comparable and consistent information.

Yet another aspect of information to be considered is materiality. Companies should assess the relative value of each category of information. Those aspects of information of little relative value, whether because it is irrelevant or small in amount, should be deemed immaterial. Information is irrelevant when it provides little value to users. For instance, it would likely be irrelevant to disclose which specific inventory purchases were included in accounts payable at year-end. In addition, information would be immaterial if the amount was too miniscule to influence the decisions made by users. An example would be building permit fees. A company would usually not need to disclose this expense as a separate line item on the income statement if it represents less than 1% of operating expenses. Therefore, only material economic actions should be reported in detail on financial statements. To clarify, all economic events should be recorded regardless of amount or relevance; however, the detail at which they are reported depends on their materiality. (FASB)

The final characteristic of information pertains to whether information has benefits that exceed costs. It would be unwise and economically unsound to provided information that had a cost that exceeded its value. Therefore, all aspects of information should be evaluated as to
its value that it can add to financial information as a whole. Those aspects of little value should not be reviewed in great detail. This is often difficult to assess as information has different value for different users. This is where a thorough assessment of users is critical in deciding what information is necessary and can add value to the company. (FASB)

Taken together, the characteristics of reliability, comparability and consistency, materiality, and benefits that exceed costs create valuable information. If information possesses all of these characteristics it will enable managers and owners and other users to make quality decisions. Quality information is presented in a way that is easy to understand, helpful in producing financial statements, helpful in the development of budgets, and easily transferred to external users. It should allow management to easily access data to generate reports and provide an audit trail that enables companies to continue success in the future (Katz 409). The lack of even one of the aspects mentioned above could result in poor decisions that could impair the ability of the company to continue operations.

Gathering Necessary Information

The final step prior to creating and implementing an information system is gathering the necessary information. This step involves gathering all material information that will aid internal management in establishing the financial condition of the company. This should include information about past events, current transactions, and future obligations. These documents are source documents and will be referenced throughout the lifetime of the entity. One can gather information by chronologically progressing through the company's history and gathering evidence of transactions. Another possible way is to go through the basic balance sheet and income statement structures and find information pertaining to each category. The
main balance sheet categories are: current assets, long-term assets, current liabilities, long-term liabilities, and equity transactions. Many current assets can be obtained by looking at bank statements. Such items include cash and cash equivalents. Other items such as marketable securities can be evidenced through contractual agreements. Long-term assets can be evidenced through receipts to prove their book value. Liabilities are of prime importance when gathering documentation. Contractual debt agreements from the second party vendor, whether short-term or long term, should be filed to provide reliability. Equity amounts can often be evidenced by verified contribution receipts or check stubs verifying distributions of resources. Income statement accounts include operating income, operating expenses, other income, and other expenses. These items can be verified through receipts of purchase and sale. Other good sources of information include cash register tapes, bills, salary records, travel receipts, and bank statements (Ingram). To reiterate, the benefit of gathering information should exceed the cost. This information can be physical or electronic as long as it can be easily accessed.

Selecting the Appropriate Software

After selecting an entity type, understanding the major users of information, understanding the necessary qualities of information, and gathering the needed information, it is time to establish a basic accounting structure for recording economic events. This phase involves selecting and purchasing the necessary software, understanding the basic principles of accounting, and establishing a chart of accounts.

The first step requires the company to purchase an accounting information system to record transactions. Three main accounting information systems are QuickBooks, Peachtree,
and Xero (Baker, P.). These systems are targeted at aiding smaller businesses in recording the economic events surrounding their company. Each system has different features that should be evaluated as to its suitability to the company. Spreadsheet software will also help companies to organize data into useful information. The major spreadsheet application is Microsoft Excel. This software will help the company to generate internal reports for various departments. In addition to accounting information software and spreadsheet software, a pdf software that enables a company to generate and annotate pdfs will enable small businesses to record economic activities. This is exceptionally useful in noting specific transactions or referencing other work papers. Once the appropriate software is purchased, a company should create a file storage system that enables those inside the company to easily access financial data.

**Understanding the General Accounting Principles**

Before entering the economic events into the accounting information system a company should review the general principles and assumptions of financial accounting. Those principles and assumptions include the measurement principle, the revenue recognition principle, the expense recognition principle, the full disclosure principle, the going concern assumption, the monetary unit assumption, the time period assumption, and the business entity assumption. The combination of accounting principles and assumptions provides a reference for entering transactions. These principles and assumptions act as a skeleton for financial reporting. Together they help to assure information is relevant, reliable, and consistent. Further rules, known as the Generally Accepted Accounting Principles, act as the lifeblood of transactions. They provide specific guidance for specific transactions.
The first principle, the measurement or cost principle, states that accounting information should be based on an item’s cost. Cost is the amount paid in cash or the cash equivalent of items given as consideration. Under some circumstances an item could be adjusted to fair value. The scope of these situations is beyond this text.

The next principle is the revenue recognition principle. This principle dictates when revenues can be realized. Three concepts govern recognition. First, revenue is recognized when earned. For services, revenue is recognized when performed. For goods, revenue is recognized when ownership is transferred from the seller to buyer. Second, payment for the goods or services can be cash, noncash consideration, or credit. The method of payment does not affect the date of sale. Third, the value of revenue is equivalent to the amount received in cash plus the fair value of any items transferred. Failing to correctly record revenues could cause financial statements to fail to relay an accurate picture about the business by overstating or understating sales.

The third principle is the expense recognition principle. This principle, also known as the matching principle, states that a company records all costs that correspond to the revenue reported. This is crucial when accounting for inventory. Only the inventory that corresponds to the goods sold are considered expenses. The remainder must remain in inventory until sold. This prevents companies from making large inventory purchases at year-end with intent to reduce taxes for the current year.

The final principle is the full disclosure principle. This states that a company should report all events applicable to a company that would impact a user’s decision. Thus, all
economic events should be reported. In addition, many disclosures should be reported in order to give users an accurate picture of the condition of the company (Wild 10-11).

Next, the going concern assumption states that a business will continue operating instead of being closed or sold. This implies that the company will not liquidate its assets in the foreseeable future. Any indication that the company is heading into liquidation or bankruptcy should be disclosed in the financial statements (Averkamp).

The monetary unit assumption implies that all transactions can be stated in monetary units. The monetary units used in reports depend on the country of residence. This assumption ignores inflation in reporting amounts in the financial statements (Averkamp).

The time period assumption assumes that a business’s economic life can be divided into equivalent periods for reporting periods. The basic unit of reporting is the fiscal year. The time period used for reporting purposes should always be stated at the title of the financial statements. The income statement and statement of cash flows generally cover one year periods. The titles of these financial statements should read “For the Year Ended...” Balance Sheets represent the corresponding asset, liability and equity amounts at a specific moment in time. The titles on these reports should include the date on which these amounts were valued (Wild 19-20). Companies can choose to input accounting information in a variety of ways. Some accounting systems can be linked to sales registers to provide for routine smooth recording. If this avenue is not chosen, companies often manually enter transactions. The detail with which accounting information is entered depends on the level of detail needed to provide information to users. Transactions can be entered individually or in groups. Entering transactions in via groups is known as batch entry. Batch entry is useful as it takes less time,
but it also fails to provide detailed information. Information can also be entered immediately after occurrence or it can be entered at regular intervals such as week end or month end. A long lag time between occurrence and recording could prevent managers from making timely decisions.

The final assumption is the business entity assumption. This assumption states that the business for which economic events are being reported is separate from other business entities. The types of business entities were mentioned above.

**Developing a Chart of Accounts**

The next step in implementing an accounting structure is developing a chart of accounts (COA). The chart of accounts is “the foundation of the finance function” (Deloitte). In essence, the chart of accounts is an index that allows users to quickly locate a specific account. The chart of accounts includes all the accounts used by an entity. Accounts are divided into five main categories: assets, liabilities, owners’ equity, income, and expenses. Sometimes, cost of sales is included as a sixth category. Each individual account is given an identification number. The quantity of characters in a chart’s identification numbers is dependent on the number of accounts a company uses. For this discussion we will use three characters. In order to quickly identify each category, each category is given a uniform starting number. Assets are given numbers that begin with a one (i.e. 101 or 190). Liabilities are assigned numbers starting with a two. Equity accounts begin with the number three. Revenues are assigned the number four. Expenses start with a five. Finally, cost of sales is assigned the number six. Further codification can link subcategories such as current assets or operating expenses. The codification of
accounts enables accountants and other internal staff to quickly reference accounts when making transactions.

Knowing the distinction between each type of account is critical in moving forward. Income statement accounts include revenue, cost of goods sold, and expense accounts. Revenue is income generated through sales of goods or services produced by the business. Refer back to the revenue recognition principle for timing of reporting revenue. Revenue accounts include income from operations, interest income, and income from extraordinary items. Cost of goods sold are direct cost to provide the good or service. This includes the cost of any products or materials used to create the finished product. This also includes the cost of direct labor on the product. Material purchases and worker salaries are examples of this type of account. Expenses are the indirect costs incurred in doing business that are not directly attributable to a specific product or service. Examples of expense include maintenance expense, executive salary expense, and payroll taxes.

The primary balance sheet categories are assets, liabilities, and equity accounts. Assets are items that an entity owns that are expected to have a life beyond the current year. Assets include cash, land, and accounts receivable. Liabilities are encumbrances on businesses operations that represent an outside party’s claim on the assets of a company. Examples of liabilities include accounts payable and notes payable. Finally, equity accounts represent the ownership stake of the company. Equity accounts include partnership contributions and distributions as well as retained earnings (Baker, C.R. 11-14).

Once a company has a grasp on the indexing of accounts, it is time to select the accounts that will be used in the company’s operations. Often the best way to add accounts is
to add them as you use them during the course of operations. The level to which you detail accounts depends on the materiality of the information. If office supplies expense makes up a very small portion of total expenses, it is immaterial and it may be wise to include this account under the title other expenses. If, however, this account is material in nature, it should be separated from other expenses as its own line item. Companies should shy away from having too many accounts as this makes work more daunting and can often provide too much information. However, too few accounts can provide too little information to users. In addition, it is often more difficult and more time consuming to split one account into two separate accounts than it is to merge two smaller accounts. Careful consideration of the users, criteria of good information, and accounting principles and assumptions should be reviewed before selecting the accounts to include in the chart of accounts.

Understanding the Income Statement

After establishing a foundational knowledge of accounting and creating a chart of accounts, it is time to shift the focus to the finished product: the financial statements. The purpose of financial statements is to succinctly but thoroughly present accounting information with the qualities aforementioned to external users. The four main financial statements will be covered in this section. They will be covered in order of completion: Income Statement, Statement of Changes in Owners’ Equity, Balance Sheet, then the Cash Flow Statement. “Financial statements form the basis for understanding the financial position of a business...” and “[assess] its historical and prospective financial performance” (Fraser 1). They enable users to make educated decisions. Arguably, financial statements for small businesses are more crucial than financial statements for large corporations. External users of small business
financial statements often have little to no access to information regarding the condition of the businesses they deal with. This stands in contrast to the publicity and transparency that exists with larger corporations. Therefore, it is crucial that small businesses provide useful financial statements that enable them to establish partnerships with external financing sources.

The first completed financial statement is the Income Statement. The Income Statement presents the profit or loss of a business over a specific period of time usually a year (DeThomas 6). Two types of Income Statements, the single step and the multiple step income statement, can be used. The single step Income Statement is the easiest to produce but also produces less useful information. To create a single step income statement, all revenues are grouped together and then all expenses are grouped together. The net of the two numbers results in the net profit. Often, this method is more appropriate for businesses that have only one main source of income in the form of sales.

As transactions become more complex, it is often better to create the multiple step Income Statement. The multiple step Income Statement follows a uniform convention in arriving at net profit. The first number presented is total sales. Cost of goods sold is deducted from sales to arrive at gross profit. Gross profit, while not net profit, is a crucial number in assessing operations. A manager can use gross profit to determine the gross profit margin (gross profit/total sales); this number illustrates the ability of a firm to create value on its core line of business. After arriving at gross profit, operating expenses should be detailed and summed up to arrive at total operating expenses. The level of detail of each line item depends on its decision usefulness to users. It may be useful for a small business to detail wages and salaries expense and accounting and legal fees as these would be useful to external users when
evaluating the profitability per dollar of employee salaries as an efficiency measure. Also, the percentage of legal fees to total sales gives users information about the issues arising per dollar of sales. One additional expense that is not evident by the flow of cash or resources is depreciation. “Depreciation is used to allocate the cost of tangible fixed assets such as buildings, machinery, equipment, furniture and fixtures, and motor vehicles” (Fraser 96). Small businesses often have many fixed assets to depreciate.

The total from operating expenses is then deducted from gross profit to arrive at net operating income. This amount details the income that the company is able to generate from operations. Unlike the single step Income Statement, users of the multiple step income statement can evaluate the business on its core products or services. This enables users to better understand if the strategy of the particular company is likely to be successful in the future. After arriving at net operating income, other income and expenses are detailed (Bukics 194-196). Total other expenses are deducted from operating expenses to arrive at income before income taxes. This category includes any income or expense amount that does not arise from operations. Some examples include interest income, interest expense, gains or losses from investments, and gains or losses from the sale of fixed assets (Fraser 98). By separating this from income from operations, it is more difficult to inflate net income. Businesses are unable to sell assets at a gain or realize gains or losses on investments to inflate their bottom line without being detected by users. For small business, interest expense on debt is very likely to be present. Also, sales of fixed assets, assets with a useful life that extends multiple years, is very common.
The final aspect of the Income Statement is income taxes. This amount is deducted from pretax income to arrive at net profit or net income. Net income represents the residual amount of income from revenues after all expenses have been deducted. It is important to note that the net profit usually does not equal the amount of cash added to a business. This is due to noncash transactions, which will be covered in the statement of cash flows. Note that the matching principle stated that businesses should match expenses with revenues. Thus a purchase of inventory would appear as an asset when purchased but would not be realized as an expense until the inventory was sold.

Understanding the Statement of Retained Earnings

The Income Statement only represents one period of time. As a result the amount of net income or loss in year one is not reflected in the succeeding financial statements. Instead, all of the income and expense accounts are closed to retained earnings for corporations or partners’ share accounts for partnerships and sole proprietorships (Sunny Suffolk Community College). As small businesses usually are partnerships or sole proprietorships we will focus on the latter. The Statement of Retained Earnings details the changes in the equity accounts located on the Balance Sheet. Due to its nature, it is often called the Statement of Changes in Owners’ Equity for the period it is representing. For purposes of providing useful information, the Statement of Retained Earnings generally covers the same time frame that the Income Statement covers. Usually this time frame is a year.

The statement begins with the equity amounts from the end of the prior year. Net income amounts along with additional capital contributions are added to the prior year’s total partners’ capital amount. Net losses and partners’ drawings out of the business are subtracted.
to arrive at the total capital amounts for the end of the year (Bukics 208-209). This statement is often segmented by dividing the capital amounts amongst the partners according to their respective ownership amounts. They are then assigned their share of net income or net loss.

**Understanding the Balance Sheet**

The Balance Sheet, or The Statement of Financial Position, illustrates the financial structure of a company at a specific moment in time. The moment in time is usually the end of the year that the Income Statement and Statement of Changes in Owners’ Equity cover. The Balance Sheet is an embodiment of the accounting equation: Assets = Liabilities + Owners Equity. Thus, the Balance Sheet is broken down into three sections: assets, liabilities, and owners’ equity.

Assets represent “the financial resources available to the firm for use in the operations and growth of the business” (Bukics 204). Assets are both tangible and intangible, short term and long term. They can pertain to operations or they can be related to subsidiary business interests. On the Balance Sheet, assets are listed in terms of liquidity. Liquidity is measured by the time in which the asset will be converted to cash. Thus two categories arise: current assets and long-term. Current assets can be converted to cash within a year. Cash, accounts receivable, and inventory are prime examples of current assets (DeThomas 16). As mentioned, inventory purchased but not sold by year end should not be included as an expense. Instead, these amounts should be shown as a current asset on the Balance Sheet. Inventory is much unlike other assets as it has multiple valuation possibilities. Some options include the last in first out (LIFO) method, first in first out (FIFO) method, the specific identification method, and the weighted average method. Under the last in first out method, inventory sold is the
inventory most recently purchased. In the first in first out method, inventory sold is considered to have a cost equal to the inventory that has been held the longest. The specific identification method assigns each inventory item a specific cost. Finally the weighted average cost method gives each inventory item a cost equal to the average of all the similar goods currently held in inventory (Wild 207-212). Long-term assets will remain for more than one year. Buildings and equipment are examples of long-term assets.

The next aspect of the Balance Sheet is the liabilities section. Liabilities represent the creditors’ claims on the assets. Like assets, liabilities can be both current and long-term in nature. Current liabilities represent claims that must be satisfied in one year or less. Accounts and notes payable are the most common types of short-term liabilities for small businesses. In addition, the current portion of long-term debt is also considered a current liability. The current portion represents the amount of principal that will be paid in the current period. Long-term liabilities represent obligations that will be satisfied in a period beyond the current period (Bukics 205).

The final section of the Balance Sheet is the equity section. This section represents the owners’ claim on the assets. Owners have a residual interest in the assets of the company. This means that the debt holders, as represented by the liability portion of the Balance Sheet, have the first claim on the assets of the company in the case of financial collapse. The equity amount also represents the owners’ basis, or their ownership amount, in the company. The basis is manipulated by the adjustments listed in the Statement of Changes of Owners Equity. It should be noted that in the case of default, the amount of equity may not be able to be recovered. This is due to the difference between the market values of the assets and the value recorded in
accounting records. Accounting records assets at their respective book values. Generally this means that the assets are recorded at the purchase price. Sometimes assets can be adjusted to their fair values. However, at the time of bankruptcy, assets could have appreciated or depreciated resulting in an amount available to owners that differs from the amount listed on the Balance Sheet.

**Understanding the Statement of Cash Flows**

Arguably the most useful financial statement is the Statement of Cash Flows. This statement indicates the cash inflows and outflows of a business. It strictly deals with cash exchanged. The cash flow statement is divided into three main sections: cash flows from investing activities, cash flows from financing activities, and the cash flows from operating activities.

The cash flows from investing activities pertain to transactions that affect the investment base of the business. These include buying, selling, or disposing of securities or long-term assets as well as lending and collecting cash in the form of loans. For a small business, the most common type of investing activity cash flows would be the purchase and sale of long-term assets such as property, buildings, and equipment. Occasionally, small businesses may lend money if they have excess cash.

The next section is cash flows from financing activities. This section focuses on the cash transactions surrounding the financing of the company. For small businesses this includes proceeds from borrowing loans, investments from owners, distributions to owners, and repayment of debt.
The cash flow from operations section includes but is not limited to the economic activities recorded in the operations sections of the Income Statement. This section includes every cash flow not included in the investing and financing sections. Two options exist for reporting this section: the direct and indirect methods. The direct method will include cash received from customers and cash paid to suppliers. In contrast, the indirect method will start with net income. Interest and tax expenses are also included in this section (Fraser 121). In addition to gaining and spending cash, any noncash expenses or sources listed on the Income Statement should be reversed. One such example is depreciation expense. This amount is deducted from sales when arriving at net income. However, this amount was not actually paid in cash; thus it must be added back on the Statement of Cash Flows.

The summation of the three areas results in cash provided or used for the year. This amount, when combined with the amount listed on the Balance Sheet at the end of last year, should equal to the amount listed on the Balance Sheet for the end of this year. When viewing the cash flow statement, individuals can see where exactly where cash is being generated. This prevents users from being deceived by an asset sale and thinking that the company is thriving when the primary operations are not supporting the financing activities.

**Putting Accounting Information to Work**

After establishing an entity type, understanding the users of information, understanding the necessary qualities of accounting information, gathering the necessary source documents, selecting an accounting software, becoming familiar with the basic principles and assumptions of accounting, developing a chart of accounts, and understanding the basic aspects of the four main financial statements, it is time to put the accounting information to work. Accounting
information can be crafted to satisfy a plethora of purposes. Accounting information can be used to generate need-specific reports and analyze financial condition.

Need-specific reports enable managers to learn about specific aspects of the business. Information can be used to draft amortization schedules, employee productivity reports, sales trends, expense trends etc. Companies can also use accounting information to specifically track inventory flow through the production process. This will aid in the costing of inventory when products are sold. In addition, companies can track the quality of suppliers by tracking defective parts received. This will enable managers to make wise decisions when making future purchase decisions.

In addition to generating need specific reports, accounting information will help managers to use financial ratios to evaluate and project importance. Financial ratios can evaluate liquidity, efficiency, profitability, solvency, and leverage. This will help managers and owners identify the strengths and weaknesses of the company. This information will pave the way for management policy in the future. Accounting, albeit complex in nature, is the key to business success. In the words of Charles Munger, Vice President of Berkshire Hathaway Corporation, “You have to know accounting. It’s the language of practical business life.”

(Charles Munger...)
Part II: Reflection on working with MDTekk

I am currently a senior Accounting and Finance major at Ball State University. I have had an auditing internship in which I audited low-income housing apartment communities subject to governmental regulation. I have also had a corporate taxation internship in which I completed tax returns for individuals as well as small businesses. Recently I have accepted a position to work with Somerset CPA's starting in October 2014. There I will be able to work closely with small businesses dealing with a plethora of financial structures and situations. Over the past year I have developed a passion for working with small businesses. This has been fueled both by my professional experiences as well as conversations I have had with friends who own or manage the accounting and finance functions of small closely-held businesses. My passion was set into action after coming into contact with Zach Marvel, a recent graduate of Ball State University, and Justin Dunmyer, a student in his last semester at Ball State University. My interaction with them as well as the rest of MDTekk has been a truly phenomenal educational experience.

I began working with MDTekk in October of 2013, two months after Marvel and Dunmyer merged their individual businesses and officially became MDTekk LLP. At the time I began working with them, MDTekk had four employees, two of which were part time. MDTekk is a retail business specializing in repairing, refurbishing, and customizing electronic devices. Their primary line of business deals with smart phones, tablets, and MP3 players. At the time I began working with MDTekk, they had already elected to file as a limited liability partnership. The two owners, Dunmyer and Marvel, each contributed assets and contingencies to the business.
My first few weeks working with MDTekk were spent largely observing their transactions and understanding their contingencies and commitments. Their most prominent functions were purchasing and sales. The majority of all purchases were via eBay. Sales were concentrated in three main areas; eBay via PayPal, Amazon, and local hand to hand sales. My first challenge was understanding the way Amazon and PayPal recorded sales, sales return, taxes, fees, and other miscellaneous charges. After formatting and organizing the result into a useful format, I was able to query the two databases to generate sales reports that could be used for source document purposes. After some help from Dunmyer and Marvel, we implemented a uniform receipt system that allowed all local purchases to be easily converted into uniform information.

Next I began to look for a way to document the expenses of MDTekk. MDTekk had one bank account that provided monthly statements. This provided some detail on expenses. Both Amazon and eBay allowed MDTekk to purchase out of their balances in the respective accounts. Thus monthly expense reports could be generated through those venues. Both accounts were fortified by MDTekk’s bank account in the case that the respective accounts dropped to zero. In combination with these documents, we were able to set up a receipting system to account for all expenses paid for in cash. With a combination of all these documents, all cash and credit payments could be accounted for.

Next I researched all the contingencies that MDTekk was subject to. MDTekk received financing from debt as well as contributed capital. Loan agreements were reviewed. In addition, we created amortization schedules to have information on the timing of payments.
After reviewing the revenues, expenses, and liabilities, the assets were determined. Most of the assets held within the company were acquired via the merger. As such, assets held the values listed in the merger agreements. At this time, we completed an inventory count. We created a system for easily identifying various products. As MDTekk deals with over 100 various makes and models of items, this process posed some difficulty. With the aid of Intuit by QuickBooks, we were able to categorize each item by maker, model, size, and color. This enabled MDTekk to quickly respond to customer inquiries about the availability of a specific item. This system also allows MDTekk to easily scan items into inventory when purchased and move them to cost of goods sold when sold. MDTekk chose to use the weighted average cost method for recording inventory amounts.

Finally, equity amounts were established at the amount of the contribution of each respective owner. Both Dunmyer and Marvel elected to receive guaranteed payments. Thus this amount will be recorded as a weekly expense. Contribution schedules were created to document the breakdown of the contributed assets and liabilities.

After generating online sales reports, local sales invoices, online expense reports, bank statements, local purchase receipts, asset values, and contribution schedules, I began to form the chart of accounts. As the business was recently formed, it was difficult to ascertain which expenses should receive their own line item and which should be combined. As a result, the preliminary chart of accounts consisted of roughly 30 accounts. After creating the chart of accounts, I was able to enter the information into QuickBooks to establish a basic structure.

After generating a basic structure through QuickBooks, I looked to create more useful information. Some of the income items of MDTekk pertained to smaller ventures not
consistent with their primary business strategy. As a result I separated these income amounts from total sales. In addition, expenses were segmented. The first division was separating expenses directly related to the servicing of the products such as tools, supplies, glue, and other miscellaneous items. These items were separated from the fixed costs such as rent and utilities. This enabled MDTekk to view their profitability from operations. In addition, expense reports were queried to evaluate the profitability of each supplier. Even though, MDTekk had some suppliers cheaper than others, profitability was limited as a higher percentage of these products were defective. Cash reconciliations were created to inform MDTekk as to where their cash was flowing. Employee productivity reports informed MDTekk of the ability of employees to complete certain tasks. This enabled MDTekk to allocate human resources to their most profitable areas.

Financial ratios were also used to improve the operations of MDTekk. Inventory turnover ratios showed a very slow turnover while profitability on individual units were high. When I first began working with MDTekk, they expressed restraint when executing expansion as they feared the additional burden could result in disaster. After reviewing the ratios in combination with the employee productivity reports, Dunmyer and Marvel realized that they were relying heavily on one technician to pay the expenses of the company. Originally, Dunmyer and Marvel were able to spend the majority, around 90%, of their time working on products. As they began to grow, they looked to expand to a larger facility. In addition, they began generating increased interest from the local community. These necessary business interactions drew them away from their primary focus. As a result they were only able to spend around 30% of their time focusing on their products. While this was an exciting time
because of expansion possibilities, this period severely weakened the bottom line. It also restricted their cash flow as more cash was being sent out in the form of wages and fixed expenses than was coming in. Using the information generated from accounting information in combination with an assessment of growth opportunities, MDTekk hired an additional five technicians. Now they have six technicians working for them. A month into the expansion, MDTekk is experiencing sales that amount to roughly five times the amount generated prior to the hiring decisions. Expansion is set to continue as more opportunities are presenting themselves.

Accounting provided to MDTekk also benefited MDTekk via its external users. MDTekk was able to send its financial statements to loan companies to seek additional financing. Prior to establishing an accounting structure, they were only able to estimate cash flows and sales levels. This enabled MDTekk to generate funds to help fuel their expansion.

Despite being a laborious and often confusing process, accounting information provides data that can act as a catalyst for small business growth. MDTekk is just one example of this. Through the utilization of accounting information, MDTekk was able to receive an accurate picture about their current state. They were able to understand what was causing poor cash flows. Accounting information pointed them towards success. As internal users they were able to manipulate their resources and business strategy to generate large and sustainable profit increases. Accounting by nature is very dynamic, its information will continue to prove useful as long as owners, managers, and debtors need to make decisions. Thus this tool should be continually sharpened to ensure its usefulness.
This was a truly enriching experience. The experience I have gained from working directly with an upstart company was priceless. I am very thankful to MDTekk for allowing me the opportunity. Looking back I have learned a great deal about relevant information and assessing the cost/benefit analysis that corresponds with generating information. I also have learned about the trajectory changing power of accounting information. If I were to start over again I would change one element. As the accounting information was not entered into QuickBooks until roughly three months after its occurrence, we elected to batch enter the information at the date of entry. As time progressed this proved to handicap the usefulness of some of the information. Instead of being able to compare uniform monthly periods, we were forced to evaluate uneven blocks of information. This prohibited us from implementing trend analysis to revenues and expenses. Despite this revision, I am very happy with the project and the experience I have gained through it.
Works Consulted


Charles munger: A lesson on Elementary, Worldly Wisdom As It Relates To Investment Management & Business. www.ritholtz.com


FASB. (Financial Accounting Standards Board). May 1980. Original Pronouncement As Amended:


www.nvca.org.


