Learn *Small Business* ACCOUNTING in 7 DAYS

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ROD CALDWELL

LEARN SMALL BUSINESS ACCOUNTING IN 7 DAYS

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Rod Caldwell

Wrightbooks

For my darling wife Robyn, without whose support and encouragement this book would never have been written.

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About the author

Rod Caldwell is a tax accountant by profession and a TAFE business lecturer by choice. He worked for the Australian Taxation Office (ATO) for 20 years before leaving in 2005 to start a new career as a lecturer in business studies at a Perth technical college. Rod has a bachelor of commerce degree from the University of Western Australia and a postgraduate diploma in advanced taxation from the University of New South Wales. Rod is also a Fellow of CPA Australia.

This book was written as a direct result of his involvement with small business owners through the Adult and Community Education courses he delivers in Western Australia. Rod is also the author of *Learn Bookkeeping in 7 Days*.

Additional resources are available from the author's website www.tpabusiness.com.au. The author can be contacted by email at <rod@tpabusiness.com.au>. All comments from the readers of this book, students or lecturers are welcome.

Preface

Who should read this book?

Learn Small Business Accounting in 7 Days is aimed at the small business operator, often a home-based business, with an annual turnover of less than $2 million, as well as larger businesses with a turnover of up to $20 million. It is the second book in the Learn in 7 Days series, the first being *Learn Bookkeeping in 7 Days*.

This book assumes that the reader is aware of bookkeeping procedures to a standard at least equal to that covered in *Learn Bookkeeping in 7 Days*. It takes the reader from the trial balance stage, where we were at the end of *Learn Bookkeeping in 7 Days*, to the production of the final accounting reports. The book also covers payroll.

This book as a lecturer's resource

If you are considering using this text for a non-accredited course in accounting, your course is probably a series of two- or three-hour sessions over six to eight weeks. This text has been deliberately constructed over seven evenly deliverable 'days' in order to facilitate this.

Resources for lecturers' use, such as additional exercises and the exercise solutions, are available from my website at www.tpabusiness.com.au.

Rod Caldwell

Perth

May 2011

Day 1

Setting the scene

Key terms and concepts

- *International Financial Reporting Standards (IFRS):* a legally enforceable set of accounting standards that apply to larger businesses.
- *Generally Accepted Accounting Practices (GAAP):* a set of standards that apply on a voluntary basis to all entities.
- *Small to medium enterprises (SME):* business entities that usually fall within the $20 million to $100 million turnover that are subject to IFRS.
- *Small business entity:* a tax term for a business with a turnover of less than $2 million.
- *Small business:* the generally accepted term for businesses with a turnover between $2 million and $20 million and fewer than five employees.
- *Micro business:* the term that usually refers to businesses with a turnover less than $2 million that do not employ any staff.
- *Sole proprietor:* a person in business by themselves with no formal structure.
- *Partnership:* two people, usually a husband and wife, working together in the business.
- *Company:* a formally registered proprietary limited entity that is legally separate from the owners.
- *Trust:* a tax effective method of running a business that combines elements of a partnership and a company.

We are at war!

As a **small business** proprietor, have you ever tried to find the answer to a very simple question, only to be bombarded by an avalanche of extraneous material? You wade through this material hoping that your answer may be there somewhere, only to be cut down time and again. Finally you just give up.

The information revolution, which started with so much promise, has degenerated into an electronic information war. We are bombarded by volumes of material, only a fraction of which is relevant to us. The prime cause of this is twofold: the cost restraints of a paper-based information society are being replaced by the 'no cost' electronic equivalent, and also because of the underlying perception that ‘more is better’.

The **Australian Taxation Office (ATO)** is one of the prime culprits. Why say something meaningful in 20 words when you can now use 200 or 2000 for the same cost and appear to be all the more knowledgeable for it? The Tax Office appears to have little understanding of the needs of its readers and is ‘silo’ driven. By this, I mean that the Tax Office consists of public servants all serving a different master. The **GST** ‘silo’ will only comment on GST matters, even when what they are commenting about has an impact on other areas. For this reason you have to hunt the database for the complete answer, rather than your question being anticipated and the answer readily available to you.

This book is a shield

This book deals only with the main issues, the issues that you deal with most of the time. It reduces the information bombardment into manageable units that you can easily understand and presents you with workable solutions in an easy-to-read, easy-to-digest format.

What is covered in this book?

This book assumes that you already have a background in **bookkeeping**. You understand the difference between a **debit** and a **credit**, what a **transaction** is and you are familiar with **journals**, ledgers and the **trial balance**. We start at the trial balance stage and move forward, through end-of-period adjustments to the **final reports**. On the way we look at **assets** and **inventory**, then some speciality subjects such as the employment and remuneration of staff members.

But this is first and foremost an **accounting** text. We look at the financial aspects of business management and what drives it, but we will not be looking at how to run a business.

What influences financial decisions?

Why are we in business? The simplistic answer is often ‘to make money!’ But this is not usually the prime driving force behind small business owners. People start small businesses for many reasons:

- *Accidental businesses*. This type of small business is best explained by example. An accountant retires and starts to make wooden toys for his grandchildren. In order to finance his hobby he also sells his toys at a market stall. So far his activity could be called a hobby. However, a toy store sees his product and asks if he could supply the store with a few samples to ‘see how it goes’. The hobby is now a business.

- *Contractors*. Many tradespeople are in business as contractors rather than **wage** employees. Many professionals in the accounting and IT industries are also becoming contractors. This is usually a lifestyle choice.
- *Home based*. Home-based businesses — in particular, internet-based sales businesses — are a growing trend. These businesses are often started by stay-at-home mums to supplement the family income. Often home-based businesses grow into a fully fledged business enterprise in their own right. The downside can be the feeling of isolation that being at home 24/7 brings.
- *Lifestyle*. 'Wouldn't it be nice if ... ?' is the question that all salaried and wage employees have asked themselves more than once. But the reality is often less than they expected: long hours for small returns are the norm.

Business planning is the traditional approach to formally starting a small business and many small businesses are started with the intention of achieving goals. If, however, you are already in business it is not too late to think about where you are going and what you really wish to achieve.

Business planning is the key to success and should not be underestimated. It is not a single exercise to be done and put into the bottom drawer. Business planning is a continual cycle of planning, budgeting, analysing performance, then modifying and remodifying your goals.

Who wants to know?

Your money-making efforts will attract the notice of a number of interested parties. The Tax Office will be deeply interested in your efforts, not only from the viewpoint of the money you make, but also from the perspective of the GST you collect and pay, and income that you pay to your staff. Other interested parties include your bank, which wants to know if you are making sufficient funds to cover your loans, and your investors. You may not have any investors yet, but what about when it comes time to either grow or sell your business? You will need to present a full set of books for the last three years in order to maximise your return.

Your financial affairs are regulated by Generally Accepted Accounting Principles (GAAP), a voluntary code developed by accounting societies to encourage consistency in reporting. However, as a result of a number of spectacular failures of companies whose financial reports were less than perfect, governments worldwide are now adopting and legislating **International Financial Reporting Standards (IFRS)**.

The IFRS standards are law in Australia and regulated through the Australian Accounting Standards Board (AASB). They apply to any reporting entity (the GAAP still applies, voluntarily, to all others). A reporting entity is any entity that has external stakeholders and therefore can apply to companies with **turnovers** as low as $20 million (**small to medium enterprises** or SMEs). We limit our discussion to entities that have no external stakeholders, or shareholders, and have a turnover less than $20 million. However, GAAP is slowly being replaced by IFRS standards and therefore it makes sense to apply IFRS wherever possible, even if we are not legally obliged to do so.

Another reason to adopt IFRS is that government entities are now slowly adopting IFRS principles in their reporting requirements and this includes tax law. The tax provisions on FOREX (foreign exchange) specifically mention IFRS and apply different reporting requirements to IFRS-compliant entities than they do to others.

The good news is that on a practical level for small businesses, tax law requirements and the requirements of GAAP and IFRS are rarely at odds. The main thrust of IFRS is to address the very complex transactions of large business corporations where the various GAAPs varied in their treatment.

What is a small business?

This book is aimed at small businesses with turnover of less than $20 million, which covers two business sectors, the micro sector with a turnover up to $2 million and small business up to $20 million. For the purposes of the discussion on payroll we assume you have fewer than 10 employees.

This may appear a strange distinction to some readers because the Tax Office defines a small business as a business entity with a turnover of less than $2 million, while the Australian Bureau of Statistics (ABS) uses employee numbers and IFRS defines a small to medium enterprise (SME) in terms that could include a $100 million entity.

There are many definitions of small and medium business. In this book we use the following definitions.

- A *micro business* is a business entity with a turnover of up to $2 million that satisfies the tax office definition of a small business and is able to use small business tax concessions. These are often home-based businesses.
- A *small business* is a business with a turnover of more than $2 million that is not able to use the small business tax concession but does not have any external investors; that is, it does not fall within the IFRS definition of an SME.
- A *small to medium enterprise* is a reporting entity for IFRS purposes; that is, it has external investors who are not part of the internal management team of the entity.

This book covers the accounting requirements of both micro and small businesses and relies heavily on the tax office requirements for this purpose. The reasoning behind this is that a **micro business** will often grow very quickly into a **small business entity**.

A plumber will often start off as a micro business, then employ an apprentice who becomes the first employee and so the entity grows.

There are millions of small and micro businesses in Australia. Of the 2 051 085 actively **trading businesses** in Australia in June 2009, more than 95 per cent were small (employing fewer than 20 people, the majority less than five). Two-thirds of these small businesses do not employ any staff and are considered to be micro businesses. Only 1 per cent of businesses employ more than 20 staff. More than 65 per cent of businesses had a turnover of less than $2 million.

Small business tax concessions

If you are in business, irrespective of the legal type of business you have, and the total turnover of all your business activities is less than $2 million, either actual or estimated, then you are able to use the small business tax concessions. These concessions are:

- simplified **depreciation** rules that we discuss on day 2 when we look at assets
- simplified trading **stock** rules that we look at on day 3 when we discuss inventory
- immediate deduction for prepaid expenses that we discuss on day 4 when we look at end-of-year adjustments and the final reports.

However, the main concession is that we can report our income tax obligation under **cash accounting** rules and if we do this we can also report our GST obligations on our BAS under cash accounting rules.

Cash versus accrual

If you are dealing strictly in **cash** then this section does not really apply to you, but if you either purchase inventory or sell your services or inventory on a credit (pay later) basis, then this is certainly of concern. Under accounting rules you record the purchase or sale at the time that all of the legally enforceable conditions of the contract have been complied with; that is, at the time you become the owner of the goods, or supply the goods and services. The question of the exact time that ‘property’ in inventory transfers to someone else is discussed in day 3, which is devoted to inventory issues.

The problem we face is that, if you record your **purchases** and sales at the time of the transaction and not at the time of receipt of payment, then you have to pay both your income tax obligations and your GST obligations in real cash, possibly before your clients settle their accounts. This can lead to cash flow issues.

The good news for micro businesses (small business entities according to the Tax Office definition) is that irrespective of how you conduct the transaction, you only account to the Tax Office for income tax and GST when payment is received. However, this applies only to **revenue** items. You can still claim your full GST credit on assets bought on time payment terms.

A side benefit of accounting for your transaction when you receive the cash is that if one of your clients goes ‘bad’, then you do not have to make income tax and GST adjustments for **bad debts**, as the income amount was not reported in the first instance.

A problem with accounting on a cash basis occurs when you move from a micro to a small business. Small businesses with a turnover of more than $2 million must account for their transactions on an accrual basis. But some of your accrual transactions will not have been reported under your previous cash regime and therefore you will be required to make an adjustment for GST and income tax, which is almost akin to a penalty for growing beyond the micro stage.

Small business structures

According to the ABS, at June 2009 there were 605 015 sole proprietors, 360 228 partnerships, 414 020 trusts and 670 951 companies in Australia. Let’s take a look at the difference between each type of entity.

Sole proprietorship

When you first start out in business it is usually just you alone. Legally you are the business — you are responsible for all of the debts of the business and entitled to all of the profits. The business cheque account holds the funds that you have allocated to the business and over which you have full control. However, under the entity convention the business funds belong to the business and you, as the business owner, are treated as a completely separate entity. The entity convention is the cornerstone of accounting principles and that applies equally to all **legal entity** types.

You must account for your business funds separately from your private funds. Your business funds and private funds must be kept and treated as two distinctly separate amounts. When you pay for private expenditure out of business funds you must record this in your business accounts.

Partnership

The most tax effective way to minimise your tax bill is to split your income with your spouse. The easiest way to do this is to go into **partnership**. This means that your spouse will have an equal say over how the business operates, but is also equally liable for any debts and entitled to any profits that the business may make. The presumption of a 50–50 split can be modified by agreement, called a **partnership agreement**, but usually in the husband-and-wife situation the most cost effective method is to have the business funds held in joint names as proof of the existence of the partnership. No other legal formalities are required.

However, if you are going into partnership with anyone other than your spouse, you should seek legal advice and have a formal partnership agreement drawn up. The reason for this is the legal term ‘joint and several’, which means that you are not just responsible for your portion of the debts, but in fact all of the partners are all 100 per cent responsible for all of the debts of the business.

Family trust

If the idea of a partnership with your spouse does not appeal to you but you still wish to take advantage of the tax relief obtained by splitting your income for tax purposes, then a trust is the best method to use. Under a trust you can also include other members of your family who will share the tax burden, but not have any say in, or control over, the running of the business.

A family trust is the most common form of trust, where all of the beneficiaries are members of your immediate family. This legal structure would normally be set up by your accountant and requires the creation of a trust deed.

For accounting purposes, the cheque account is the business and your legal arrangements only come into play in the distribution of the profits (taxable income) of the business. As the sole owner of the business, you are still responsible for all of the business debts but none of the profits as these now belong to the beneficiaries.

Companies

Very few small businesses run through a traditional **company** structure. This is because you are limited to a small number of shareholders and therefore your source of finance is also limited and the distribution of profits is a rather difficult exercise. The positive side is that under the company rules you are limited in your liability to the amount of funds you have invested in the business. This is why small business owners are often confronted with personal guarantees that banks and other creditors will insist upon to override this protection.

Now we get complicated!

A lot of businesses are owned by companies, but the companies are being used as a shield and a conduit for the distribution of profits to non-participating family members. A trust, even a family trust, must have a trustee in charge, who owns and runs the business. However, a business is a legal entity, able to transact on its own account through its agents (owners). Therefore the trustee of a family trust can be a single director, single shareholder company.

In effect you can have it both ways. As the single director of a company that owns the business, all debts of the business are limited to your shareholding, usually $1. The company, acting through its agent (which in this case is you), can decide who in the family will get which part of the business income so that you minimise your tax bill. This type of structure is known as a corporate trustee of a discretionary family trust.

Although this structure is by far the most common for tax purposes, it is also the most expensive to run. A small business accountant’s bill of between $5000 and $10 000 per year would not be unusual. The easiest way to keep this bill under control is to make sure that your accounts are kept correctly in the first instance and that your accountant has as little bookkeeping to do as possible, which is the objective of this book.

Chart of accounts revisited

From your knowledge of bookkeeping you will know that a **chart of accounts** acts as an index to the **general ledger**. There is no formal structure to a chart of accounts; it can be laid out in any manner that you see fit. However, for this text we will use what has become known as the standard chart of accounts as is commonly used in most small business accounting programs such as MYOB and Quicken.

A general ledger is divided into categories (or sections), usually assets, liabilities, equity, revenue, **cost of sales** and expenses. Under the standard chart of accounts we allocate the numbers 1 to 6 to each of these sections:

1 Assets

2 Liabilities

3 Equity

4 Revenue

5 Cost of sales

6 Expenses.

However, the revenue, cost of sales and expenses categories contain only income and expense items that relate to the operations of the business. For income and expenses outside normal trading operations we need two further categories:

8 Other income

9 Other expenses.

Item 7 is not used to comply with the MYOB standard chart of accounts.

Assets

An asset is an outlay that will provide a future benefit, such as the purchase of a motor vehicle. Many assets, for example property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset. Patents and copyrights, for example, are assets if they have a future economic benefit that is expected to benefit the business.

Assets are further subdivided into three categories:

- current assets
- noncurrent assets
- intangible assets.

A **current asset** provides a future benefit within the next accounting cycle. Current assets are typically liquid assets such as cash and **accounts receivable**.

A noncurrent asset will provide a future benefit over a longer term and was previously known as a fixed asset. Most physical assets such as PPE (property, plant and equipment) are **noncurrent assets**. The cost of a noncurrent asset, with the exception of land, is usually allocated to an expense over its effective life by a process known as depreciation.

Intangible assets are assets with no physical form, such as patents and copyrights. The **accounting standards** include intangible assets with noncurrent assets, but it is Australian practice to separate the two due to the difference in tax treatment. The cost of an intangible asset is usually allocated to an expense over its life by a process known as amortisation. Goodwill is an intangible asset that, under Australian Standards and tax law, is not amortised.

Assets are recorded in the accounts at their cost. This is known as the historical cost convention. They are recorded at the time that the 'property' in the assets passes. Property is a legal term that represents a bundle of rights, the most significant of which is the right to dispose of the asset as you see fit. If you can't sell it you don't own it!

Each year you review the holding cost of your assets in a process known as an impairment review to see if they are still worth at least their carrying value. Assets and asset valuations are discussed further in day 3.

Liabilities

An essential characteristic of a liability is that the entity has a present obligation that will result in a future outlay. You have a present obligation to pay for the goods and that obligation has been delayed to a future time under the conditions of the purchase. This can arise in the normal course of business where you purchase goods on credit terms.

Liabilities are divided into two categories:

- current liabilities