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Small Business Accounting

So you've recently started your own business or perhaps been running one for some time. Whatever the case accounting for your business is vital. Why? There are a number of critical issues that must be maintained if your business is to prosper:

1. Government tax compliance: Income tax, commodity tax, Workers Safety Insurance, Health tax, etc.
2. Payroll compliance.
3. Cash management
 - 3.1. Accounts Receivable
 - 3.2. Accounts Payable
 - 3.3. Banking
4. Profitability management. You do measure product / service margins don't you?
5. Inventory control, management.
6. Shareholders Account. Are you aware of the potential tax consequences?
7. Operations reporting & management.

Failure to comply with government reporting & remittance requirements can add significantly to your costs as penalties & interest will be incurred. If your accounting is done right then compliance becomes a simple uncomplicated issue.

Accounting Software:

Don't even consider using Excel to track all your accounting needs. Even very experienced Excel users (myself included) would never consider it an effective alternative. The need to extract GST & track receivables may impose an administrative burden. Good accounting software is inexpensive. Far less costly than to have an accountant try to decipher a cryptic mix of spreadsheets & other documents.

Sadly many users assume the software is correct & their accountant or bookkeeper is the cause of the recent software oriented headache. While too often the accountant or bookkeeper doesn't use the software most effectively, software is also often to blame for the less than stellar performance.

You also need to be aware of what is commonly referred to as "application erosion". This is effectively the software is not being used in the most efficient or effective manner. The notes that follow may prompt you to look a bit deeper. Correct software set-up is important.

It's also very important to understand that basic accounting is not difficult for accountants or bookkeepers. The way your software functions (or doesn't) & the procedures used can adversely effect your business. There are only a handful of modules the average business owner needs to either use or understand. We'll try to explain best practices for most modules & what to look for to know whether your accountant or software is up to the mark!

The modules that most business owners will use will be:

1. Banking





2. Billing (Sales) & receivables
3. Purchasing / procurement & payables
4. Payroll
5. Inventory

Note, that modules will often have some degree of overlap, even significant. Your billing module will drive your sales reporting & accounts receivable.

General Ledger / Chart of Accounts:

The general ledger is normally the domain of the accountant.

1. Having a well structured chart of accounts is critical for managing your business. Too frequently we find businesses skip a "cost of sales" segment, referring to these costs simply as expenses. This means the costs of providing either the service or product are mixed with other operating costs. This method would mask the margins the products or services provide. Business owners need to know what profit margins their products or services deliver. Profit is the prime reason for their existence, yet vital information is not reported. We have an entire article on the chart of accounts, to raise awareness of the many issues. For more information refer to our previous article.
2. Visibility of your financial statements requires a chart of accounts that is well structured & logically grouped. Too often the financial reports have too much detail & not enough information. Costs should be logically grouped. i.e. facility costs includes: rent, property taxes, utilities, etc. Segregating these costs will mask them. Grouping costs helps highlight areas requiring attention.
3. Most accounting systems require that accounts be assigned to an account group such as bank, fixed assets, etc. If these are not set-up correctly it is likely that your reporting & procedures may be adversely effected. Sadly even good accounting systems don't always get this right.
4. Journal entries are by definition "adjusting". If your accountant uses them extensively, you may need to determine why. Journal entries should only be infrequently required. Having numerous journal entries is an indication the accounting system either dated or is not being used effectively. Many systems allow transactions to be prepared through various modules & the need for journal entries should be minimal. If there are a lot of journals, consider that there is a strong possibility that either your staff training is not up to par, or your system has some limitations.
5. Consider too one of the first things Canada Revenue Agency looks for during an audit: Journal Entries. Why? Because they're used to correct other transactions, indications of potential errors.
6. Process, procedures & functionality need to be carefully matched to your accounting systems. If your requirements are basic, then most systems will match your needs. If you have unique requirements, you'll need to ensure your software supports the specific requirement: progress billing, backorders, deposits, etc.
7. Many accounting systems allow users to back date transactions. While this can prove to be a great time saver, it can also cause untold headaches. Understand the implications of back dating transactions & whether they will help or hinder. Changing transactions that effect already reconciled bank accounts, inventory, accounts receivable or accounts payable may cause errors in the respective reporting for these modules. This can lead to significant & unnecessary rework. When transactions are simply expense coding changes then the risk is minimal.
8. Get in the habit of closing accounting periods shortly after both month end & the bank reconciliation are completed. If adjustments are required, then open the accounting periods, but be sure to understand the outcome & then close the period again. Many accountants experience changed year end balances when compiling year end statements (generally for CRA tax filing).





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Banking:

1. To manage cash & related forecasts consider the following: Your cash accounts should be absolutely spot on. You should have complete confidence that the balances in your cash accounts are both current & accurate. Consider these accounts to be your "Bible".
2. Given the real risk of becoming a victim of fraud, or perhaps simple error, reconciling & reviewing bank statements & accounts is important. Many presume that banks need only be reconciled monthly. This should be considered the minimum period. In many instances it is recommended that reconciliations be completed on a weekly basis, especially when the volume or value is high.
3. Utilize the bank reconciliation module supported by your accounting system. To reconcile outside of the accounting system is inefficient & rarely as timely. It can also be prone to either error or fraud.
4. If your bank is reconciled on a frequent basis, perhaps weekly, you can rely on it to drive cash forecasting. Forecasting your cash flow is vital in an economic downturn, seasonality of volume or if you have capacity constraints.
5. Preauthorized payments & other future dated commitments such as leases should be booked one or two weeks in advance of transaction date. Manage & control your commitments. This will ensure that forecasts will not miss these & trigger panic if a cash shortage is uncovered. Failure to proactively book all bank transactions impedes efficiency.
6. There should be few uncleared transactions & none older than 6 months (stale dated). These outstanding amounts, if significant, can adversely impact your reported cash balances.
7. Be aware that banks often limit the time allowed to have errors or omissions corrected. This is generally 30 days. Our experience has been banks may refute any claims beyond this time frame. Have doubts? Ask a lawyer.
8. In the event of either an error or fraud that you do catch, it's better to catch it earlier than later. The damage that can be done to your reputation from bouncing cheques & the work to correct this can be significant. The fact it may have been someone else's error does little mitigate the embarrassment or costs.

Leases:

1. Leases are divided into two principal types: capital or operating.
 - 1.1. Operating leases are fully deductible from income reducing taxes.
 - 1.2. A capital lease is effectively a financing arrangement & the assets purchased must be capitalized. This type of lease is not fully tax deductible, as you can only claim capital cost allowance (depreciation) based on the CRA's prescribed rates for that asset type.
2. It is important to understand the difference & assess the true cost of purchases. Commercial leases are not bound by the same rules as retail & the rates or terms need to be confirmed.

Purchasing / Payables:

A very common misconception by business owners is that expenses are only need to be recorded when they are paid. This is contrary to best accounting practices & also causes several other things to go wrong that can cost a business time & money. The brief explanation of the best methods follows:

1. Firstly most businesses are GST registered & the related GST ITC's (Input Tax Credits) can be claimed based on when the transaction occurs not when it is paid. Suppose your business were on a monthly GST cycle (most are) and bought \$100,000 of materials with \$5,000 of GST. If you waited to claim the GST until the bill was paid you might not take credit for the ITC for 2 to 3 months (depending on specific timing of the invoice and terms). This means you'd be out the \$5,000 cash longer that is needed. Now extend this logic & the potential cash consumption might cause some pain.





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2. Enter bills first then print cheques. Most accounting systems look for duplicate vendor invoice numbers & will warn the user if a duplicate exists. This can help reduce the chances of duplicate payments. Most systems also use the entry of bills to print cheques & provide a list of invoices that are paid. This is the preferred method & best practice. If invoices are only entered when they are paid the ability to control the invoices & payments is more difficult. Few accounting systems allow a detailed listing of invoices on a cheque that is directly paid (does not flow through accounts payable). This can often result in "batches" of invoices being paid, without keeping track of all the required detail. Duplicate or missed payments can then easily result.
 3. When trying to manage cash & forecast future cash requirements knowing what invoices are pending is vital. Entering invoice only when they are "to be paid", would result in cash forecasts being inaccurate. If they have not been entered the commitments to vendors would not be known. The consequence can be an even greater cash crunch.
 4. Period results require that all transactions be entered in the correct period. While many entrepreneurs don't focus enough on their income statement & balance sheet detail, their accountants should. This especially important at year end. If vendor invoices are not in the accounting system & there are no clear methods for ensuring what is outstanding, there is a very real possibility that these expenses could go unreported. The result could be income taxes paid on the overstated profits.
 5. When using purchase orders (PO's) for either supply or service, most systems can record the liability (through a second accounts payable account) upon receipt of the product or service. Failure to process transactions in the same manner as the process can also result in errors. If goods are received via PO receipt & are processed separately (or paid directly) the expenses, inventory & perhaps GST may all be incorrect.
- In summary, follow best practices & allow your accountant to process vendor invoice through payables.

Credit Cards / Cash Payments:

Credit cards are clearly a significant part of the cash cycle. What often gets overlooked is that there are several ways that the transactions can be recorded. Too often business owners use methods that are not either effective or efficient. Depending on the manner that credit cards are used within a company will determine the most appropriate use.

1. Resist the temptation to give employee's, however senior, company credit cards. The company not the employee will be liable. If the employee may need an advance of funds, provide an advance with a waiver to allow for future payroll deduction.
2. If the credit card is that of the owner or employee, not a company card and the transactions include only some company expenses, then the best method is to simply accumulate all the charges for a given statement & enter them as an accounts payable voucher. Consider using one of our templates to make this process painless. See sample output attached.
3. If there are a significant number of charges or the card is used largely for the company a better alternative is to ensure that all transactions are recorded & the credit card is reconciled. This would then include the opening balance & all transactions including payments. Many systems allow credit card transactions to be reconciled in the same manner as banks.

Other things to consider are:

4. You should retain receipts to prove the expense was business related, not shareholders draw. (Was that \$1,800 electronics purchase a new laptop or a big screen TV?) The CRA is often OK with statement charges when the charges are more likely business, but they are not obliged to accept statements without supporting documents.
5. Be sure you capture taxes & shareholder amounts correctly. The consequences of errors can be significant.





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Sales / Billing / Receivables:

Often people find a need to file paper copies of invoices. Most systems support invoice re-print & you can generally rely on them to support a paperless (ok, less paper) filing system. Resist the urge: save time, money & trees, don't print & file redundant copies.

1. Ensuring that your billings are detailed enough to mitigate any challenges, especially for services. A bill for "Services Rendered" without sufficient detail may leave the invoice in limbo.
2. Ensure all you invoicing includes all pertinent information, including terms. Most systems allow commodity taxes to be prompted by either product or customer. If you fail to bill a client for PST, & they go broke, understand your business will still be responsible for the unbilled / uncollected PST.
3. Many clients find a need to use an alternate, often Word or Excel to create an invoice outside their accounting system. This can be due to a need for off-line remote invoicing, or occasionally to allow for better formatting. Consider getting your billings produced from within your accounting system. Invoicing is about billing for service, not a marketing tool. Pretty graphics won't make much difference on your invoice. Complete & accurate will. Provided the basic information is included on the bill, there is no advantage to using outside tools. Most systems allow for invoices to be customized & will still be presentable.
4. Resist the temptation to create custom numbering schemes. The invoice number should simply be that a sequential number. If there is some logical compelling reason, perhaps, generally, no.
5. All customer payments need to be applied to outstanding receivables exactly as the customer instructs. Failure to apply payments as provided on the remittance advice may lead to a difficult to reconcile balance & either customer frustration, delayed payments or both.
6. Establishing credit limits & closely monitoring credit should be considered.

Inventory:

For those that require inventory there are several key issues to ensure are correctly configured.

1. Units of measure (UOM) are important to get correct. Take the time to ensure your purchasing, inventory & selling units are correctly set & conversions are readily available. Conversion from metric to imperial are not an issue, but conversion from weight to piece or other dissimilar (feet to kilo) can be more challenging. Incorrect conversion can often cause gross margin & other reporting failures. These often adversely affect profitability.
2. Costs & selling prices need to be accurately set. Failure to set pricing or costs can result in incorrect invoicing (or pricing cost are incorrect when using cost plus).
3. The value you assign inventory will directly impact your profits. Priced too low, profits & related taxes go down. Too high, profits & related tax go up. Understand what the "right" numbers should be. The tax man & your bank account manager have opposing views.
4. Know how to measure the basics of your inventory. These should include:
 - 4.1. Inventory turns: How many times it sells in a year. Higher is better.
 - 4.2. Inventory aging: How old is it?
 - 4.3. Inventory values: What's the average (or standard) cost?

Payroll:

Often payroll is set up without regard for either the nature of the expenses, or a breakdown of manpower costs.

1. When setting up your payroll reporting, ensure that all staff are charged to appropriate accounts. This should be cost of sales for operations or service staff, sales staff to sales expenses, etc.
2. Manpower costs should also be structured to allow for a meaningful reporting. All costs associated with salary / wage costs including training, safety equipment, wages premiums (overtime). Most systems will





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also allow statutory benefit costs to be allocated to their respective payroll costs compiled in an appropriate structure. The results on the income statement will prove to be far more meaningful.

3. Other manpower related costs should be grouped with wages & salaries, such as training, auto benefits. This will help heighten awareness of the total manpower costs.

Foreign Exchange (FX):

1. If you deal in foreign exchange by virtue of buying or selling products or services outside of Canada, you should consider using the FX module within your accounting software. Understand that there are a few alternatives to reporting foreign currency. The most common practices are:
 - 1.1. A single account in foreign currency, but always presented in domestic currency. This then requires that the system tracks each FX transaction in both currencies. For most users this method is easier to manage.
 - 1.2. Multiple accounts for foreign exchange. While a bit more complex for novice staff to handle, it does allow far greater clarity in reporting. This can be an important consideration as visibility may be required when large transactions occur.
2. You will likely need to have multiple accounts for banking, accounts receivable & accounts payable. Some systems can keep all foreign accounts in a single ledger/account, so you may only need multiple bank accounts.
3. Understand that some systems make FX more difficult than it should be. There are several common headaches:
 - 3.1. inability to easily track transactions in the most appropriate currency
 - 3.2. complex correction methods at month end
4. If you struggle to keep you foreign currency straight, be sure to select a system that supports foreign currency.

Conclusions:

This is a brief overview of what you should expect from your accountant/bookkeeper & accounting system.

Adopting these practices will ensure your statements tell you where your business is going. Once the setup of your accounting system is in place, there should only be occasion need to make corrections.

If we can help call us!

Glenn Middleton, CMA
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Other Related Articles:

- Chart of Accounts
- Capacity Planning
- Foreign Currency explained for the small business owner
- Cash Forecasts

