Chapter 7

Accounting Basics

LEARNING OUTCOMES

By the end of this class, you will be able to:

- Speak to your accountant in their own language.
- Develop an accounting task schedule.

WHY THIS MATTERS

Accounting is important for making business decisions and legal/tax obligations and is a key part of business plans, growth projections, and loan applications. This information helps to communicate and establish credibility with lenders and helps ensure accurate reporting to the IRS. In short, accounting is important for three major reasons:

1. It allows you to evaluate your store's performance, allocate your budget, and compare data across time.
2. It ensures legal compliance and proper reporting to the IRS and that liabilities such as sales tax, income tax, and payroll tax and withholdings, to name a few, are appropriately addressed.
3. It helps you create future projections and analyze trends to keep your operations profitable.

CHAPTER OUTLINE

7.1 THE BASICS

Accounting is a language that provides information about the financial health of your business. You learn the language by learning to track daily business operations (payroll, gift card sales, invoices) in your accounting software. If those daily operating records are done properly, you'll then have the financial information you need for reports you need to prepare for outsiders (the IRS, shareholders, banks, the public, creditors, etc.) and information for the business's managers to plan for the future (through financial plans, budgets, analyses, etc.) and/or make adjustments to reflect changing conditions.

Accounting is basically just tracking where your money is going. It's important to record your financial transactions so you can generate an overall picture of your store's financial health and so you can analyze those transactions to better understand your financial situation. Up-to-date records of your business transactions also help you compare historical data to current data so you can assess your performance over time.

7.2 WHY IS ACCOUNTING INTIMIDATING?

Accounting is intimidating and confusing. Accounting also has unfamiliar jargon/terminology that is sometimes difficult to understand. And the fear of math and getting your numbers wrong is very real, because if you get the numbers wrong, there could be legal and/or tax consequences for those mistakes. What if the IRS comes knocking and something is incorrect? That is really scary!

Accounting also requires specific software, and it can be intimidating to learn something new. It's also a big time commitment, especially if you do all your own bookkeeping.

With accounting, you're also serving two masters – your own business and the IRS – and sometimes those two things conflict. And let's face it, if you're not a numbers person, accounting can be boring.

It's important to remember that you don't realize it, but you use accounting every day in your personal life. When you buy a cup of coffee, for example, you exchange money, via cash, debit, or credit, in exchange for your beverage. The coffee shop receives the cash and provides you with a yummy drink. That is accounting.

7.3 WHO CAN HELP?

There are several types of finance professionals you can hire based on your needs.

Bookkeeper

Bookkeepers are professionally trained on using accounting software and can help with financial recordkeeping. Bookkeepers are responsible for providing accurate, up-to-date financial reports and information. Most often, their reports go to owners and managers to help them make decisions. Essentially, a bookkeeper keeps your official financial records. You can be your own bookkeeper, train an employee, or hire a **1099** contractor.

Tax Professional

A **tax professional** prepares, calculates, and files income tax returns on behalf of individuals and businesses. There are several different types of tax preparers, with some having credentials issued by third-party organizations while others are non-credentialed. This person can be an **accountant**, a **Certified Public Accountant (CPA)**, or an **Enrolled Agent**. CPAs and Enrolled Agents can also represent you during an IRS audit.

Essentially, tax professionals help clients file their taxes and ensure the accuracy of tax forms. They prepare their clients to be able to pay any needed fees and review financial records. They also calculate tax returns, and manage communication between clients and tax authorities. It's possible to just use something like TurboTax for this; however, we highly suggest staying away from that, as small businesses are often complicated, and tax professionals can ensure your filings are accurate and that you're getting all you can back from the IRS.

Business Advisor

A **business advisor** helps you make business financial decisions, interpret your financial data, etc. This could be a mentor, coach, accountant, or a Chief Financial Officer. They are typically responsible for planning and executing business strategies to improve efficiency in operations and financial management of businesses. They prepare budgets, advise on projects and marketing, and perform risk analysis.

Payroll Company

Payroll companies are tools businesses can utilize to assist in paying employees and remitting payroll taxes. This arrangement is often beneficial for employers to save time. Payroll companies may also help with human resources and employee benefits. Although employers are ultimately responsible for paying employees on time and remitting payroll taxes and forms on time and correctly, hiring a payroll company can help with this process.

7.3.1 ACCOUNTANT VS CPA

One thing to note when working with financial professionals is that accountants and **certified public accountants (CPAs)** aren't necessarily the same. While it may seem that people use these terms interchangeably, all CPAs are accountants, but not all accountants are CPAs.

Accountants

- Have at least a Bachelor's degree in accounting. They are educated on the subject, but not necessarily professionally certified.
- Cannot represent you in an IRS audit.
- Do not necessarily have requirements for continuing education.
- Qualified to manage day-to-day financial activity, such as reconciling accounts, analyzing financial statements, and preparing budgets.
- No governing body that requires them to stick to certain ethics (no oversight).

Certified Public Accountants (CPAs)

- Licensed by a professional governing body.
- Required to undergo continuing education to maintain their license.
- Held to more stringent standards than unlicensed accountants, and expected to abide by the code of conduct of the Association of International Certified Professional Accountants.
- Held to a fiduciary standard, which means they must put their clients' interests above all else.
- Can prepare audited financial statements, as required by the SEC for public companies.
- If selling your business, the buyer may require an external audit by a CPA.
- Can represent you in an IRS audit (Enrolled Agents can also represent you in an audit).

Professional oversight and an extra certification are the key differences between an accountant and a CPA. Because of the extra standards, a CPA will cost you more than an unlicensed accountant. Small businesses don't necessarily need a CPA. Fun fact: Only about 50% of accountants in the US are actively licensed CPAs.

7.4 ACCOUNTING WORKFLOW

Let's walk through the workflow of what actually happens in accounting when you make a financial transaction, which can include depositing cash, writing a check/paying a bill, taking out a loan, etc.

A financial transaction is made.
Once made, you enter that transaction into your accounting register for the affected financial account. This means you record the money flowing into or out of your bank account.

The transaction is linked to a category.
Next, you need to link the transaction to a category from your **Chart of Accounts**, such as inventory for a vendor payment or utilities for an electric bill payment. Then you're done! Congratulations, you have done Double Entry accounting!

Chapter 8: Bookkeeping for Booksellers will go into great detail about how to categorize your transactions in your Chart of Accounts. You can succeed at double entry accounting even if you never learn the difference between debits and credits. In fact, modern accounting software generally hides the behind-the-scenes details of debits and credits, so they are not something you have to use every day. The good thing is that if you enter something incorrectly (like as a debit when it's supposed to be a credit or vice versa), checking the balance on that account/category will immediately tell you that the numbers are wrong, and you can just switch them.

If you'd like to dive deeper into debits and credits, see the Dig Deeper section at the end of this chapter.

7.5 CASH VS ACCRUAL VS MODIFIED CASH ACCOUNTING

An accounting decision the IRS asks you to make with your first business tax return is whether you will use cash basis accounting or accrual. The difference between the two is timing. In **cash accounting**, you record **revenue** and **expenses** when you pay or receive money. With **accrual accounting**, you make a record when you receive a bill or send an invoice regardless of when it actually gets paid.

The term "cash" in cash accounting means payment, not literal cash. Thus, in cash accounting you usually record expenses paid by credit card when your card is charged, not when you actually pay your monthly credit card bill.

Cash accounting usually makes sense to people, as it's just like keeping a check register or looking at your online bank statement. In cash accounting, you aren't required to keep track of accounts receivable and payable in your accounting records because you don't owe tax on any sales until you receive payment for it and you aren't allowed to deduct any expenses until you actually pay them.

Accrual accounting requires more work and may seem a little more mystifying, but it actually gives you a better financial picture of your business's cash flow as it helps remind you about those customers who owe you money and about big bills you may have coming due soon. The purpose of accrual is to try to record income in the period in which it was earned and expenses in the period in which they were spent, regardless of when the money exchanges hands.

For example, do you ever extend terms to schools and deliver books to them with just a purchase order number as a promise of future payment? In accrual accounting, you would record that sale as income in the month you delivered the books, regardless of when the school actually paid you.

Accrual accounting also tends to smooth out the ups and down of your monthly profit and loss reports by taking expenses you may pay annually, like your liability insurance, and allocating a portion of that bill to each month's expenses, rather than have the whole amount show up in the month you were invoiced for it.

The IRS requires all inventory based businesses, such as bookstores, to use the accrual method when calculating inventory expense which is then referred to as **Cost of Goods Sold**.

However, if your business is under $25 million in sales, you can use cash accounting for everything else. This hybrid model is called **Modified Cash Accounting** and is what a lot of smaller bookstores use. Under this model, you record transactions related to long-term **assets** and inventory under the accrual method but use cash accounting for short-term assets and expenses. Over time as your business grows you may find that you adopt more and more elements of accrual accounting and may eventually want to switch entirely, which requires you to file **Form 3115** with the IRS and could affect your tax owed for the year.

Keep in mind that if you're using Modified Cash Accounting, you may have to change back and forth between Cash and Accrual modes when you run various reports in your accounting software. Make sure you discuss this with your accountant.

7.6 HOW TO CALCULATE COST OF GOODS SOLD (COGS)

Cost of Goods Sold (COGS) refers to the cost of the inventory you sold during a specific period of time regardless of when you actually paid for the inventory. Another term for COGS is Cost of Sales. The two mean exactly the same thing. So how does one calculate the cost of only the inventory you sold during a period?

The official formula for retail businesses is that **COGS = Starting Inventory + Net Purchases - Ending Inventory**.

The formula above is from the **Schedule C** tax form used for a **sole proprietorship**. It has a few extra lines that would apply if you were a publisher or manufacturer who is actually producing the product but usually don't apply to straight retailers. However, it might if you actually make some of your own goods (like how some stores make candles).

It's really important that you and your tax advisor are on the same page about how you are calculating COGS, what data/reports you need to provide them, etc.

For tax purposes, COGS is a specific number, but a lot of times when you hear the term being used it's shorthand for a related figure: Cost of Goods Sold as a percentage of sales. Once you've calculated your COGS for a period, you simply divide it by your sales for the same period to get a percentage. For example, your accountant tells you that your COGS for the year was $50,000. If your sales for the year were $100,000, then your COGS percentage is 50%. But what if sales at full retail were $100,000 but you gave everyone a 10% discount and only took in $90,000 of income? In that case your COGS percentage would increase to 55.55%.

7.6.1 AVERAGE VS SPECIFIC COST

Traditionally, all the pieces of the COGS formula: starting inventory, ending inventory, and purchases, are calculated at cost. When calculating your starting and ending inventory costs, you can either use **specific cost** or **average cost**, but just like everything else tax-related, once you pick a method, you can't just change it on a whim.

Modern point of sale systems make the specific cost method possible. Under this method, you receive against your invoices and your POS tracks the cost of each individual item so when you run your starting and ending inventory reports, you get the cost of just the particular books remaining in inventory.

Before modern POS systems, the specific cost system required too much time, so average cost is also a legal method. With the average cost method, you estimate.

You would track the amounts spend on inventory and the quantity of books bought and sold, then calculate an average cost per book. You would then use the average cost to calculate your cost of goods sold.

Even though you are legally only required to calculate COGS at the end of your tax year, you should have discussions related to COGS at the beginning of the tax year so you make sure you are keeping all the required records.

If you have a good receiving system and remember to run your reports on time, then getting your starting and ending inventory at cost is pretty straightforward. **Net purchases**, though, is where smaller businesses tend to run into issues. This is because you are supposed to track all the invoices and return credits received during the period, not just the ones you paid. The book industry generates a LOT of invoices, and if you're a small one-person shop, you may not have the bandwidth to enter each individual one into your accounting software.

If you only order from one vendor or you prepay for all your inventory on a credit card, then tracking your purchases will be much easier than if you have a myriad of vendor accounts all with different terms. Hopefully, you got some good tips on how to manage the flood of invoices in Chapter 3: Vendor, Debt, & Tax Management.

Depending on your POS and how well you receive, you may be able to generate purchases and returns reports from within it. This is probably a good conversation for everyone to have with their tax advisor as soon as possible to make sure you are on the same page about how to calculate net purchases.

Given how complicated using the official formula for COGS is, many bookstores are tempted to simply use the calculated COGS presented by their POS system. However, you really need to discuss the pros and cons of this with your accountant, as the government may require you to have all three pieces of information (starting inventory, net purchases, and ending inventory), not just the already calculated figure.

7.7 ACCOUNTING SOFTWARE

Technically, accounting software is not absolutely required. You could get by with Excel if need be. However, we do not recommend presenting your tax professional with a box of receipts and paper statements. The amount they would charge you to sort through and categorize it all would be ruinous.

Free online software like Wave and Xero was designed for service businesses like coaches and consultants that do a lot of invoicing. You may be able to hack it to support a bookstore, but in general it is not recommended for retail, inventory based businesses.

If you have no previous bookkeeping experience, you usually need some help getting your books set up. If you've already found an accountant or a bookkeeper, then ask what software programs they are comfortable with and recommend. They may even be able to get you a deal on pricing. Most bookstores use Quickbooks Desktop, Quickbooks Online, or Sage. If you've ever used Quicken to track your own personal expenses, then Quickbooks will feel very similar.

It is currently possible to stay on QuickBooks Desktop if you've been using it, but it looks like all entry-level bookkeeping software for new clients is moving into the cloud, and thus will incur a monthly fee in perpetuity.

7.8 WHO DOES YOUR BOOKKEEPING?

Startup owners usually either do all the bookkeeping or none of it, depending on your previous experience and the size of your business. Or if your business is a partnership, perhaps only one partner is responsible for the financial side.

However, we recommend that even if you don't enjoy bookkeeping or have the time to do it regularly, you at least take time to learn how to do it. There's a common acronym GIGO, which stands for Garbage In, Garbage Out. If your bookkeeping is not done correctly, your resulting financial reports are not going to be very reliable.

Even if you love bookkeeping, as your business starts to grow, owners should typically begin outsourcing some or all of the bookkeeping. You could train a **W2** employee to become a bookkeeper or you can hire an experienced bookkeeper as a **1099** contractor. Depending on your needs, a 1099 contractor may come into your business to work or work online. However you outsource, remember that you also need to design an oversight system to catch both simple mistakes as well as intentional embezzlement or fraud. Accountants usually refer to this oversight as financial controls, and they can be a great resource for you. Chapter 2: Daily Store Finance discussed some simple financial controls to implement.

7.9 BACKUPS & DOCUMENT RETENTION SYSTEMS

The next thing you need to consider in your accounting system is a backup system and document retention policy.

If you use online software, it is backed up automatically. But if you use Quickbooks Desktop or Excel, it's best to create a system to back it up to the cloud.

You should discuss federal and state document retention requirements with your accountant. The IRS requirements usually range from three to seven years, but records related to property may be much longer, and your state may have additional requirements.

If you accept credit cards, check with your merchant provider to see if and how long you need to retain copies of signed receipts and other documentation. Customers may have up to six months to dispute a transaction, so you need to keep the documentation until that window closes.

Some records you'll need in perpetuity, such as those documenting your business structure. In the case of an LLC, you need articles of organization and an operating agreement, which you have to present anytime you switch banks. If you ever want to apply for certification as a minority or woman-owned business, they usually ask for other startup related documents, like proof of where your startup funds came from. You'll also want easy access to important business documents like your previous tax filings, your lease, loan documents, insurance policies, etc.

In this day and age, we recommend digitizing and organizing documents by year if possible. If you're not storing your digitized documents online, they also need to be backed up.

Even if you have current online access to documents like bank statements and payroll reports, you should get into the habit of downloading these each year then backing them up to your own cloud storage in case you switch vendors and lose access. Plus, banks only give you easy access to a few years worth of statements; after that, they charge you a record search fee. And after seven years, the records may be gone for good.

7.10 GETTING INTO A FINANCIAL RHYTHM

It will make accounting easier for you if you start to develop a rhythm for your store and create some checklists so nothing falls through the cracks. Each week, you or your staff will be doing the day-to-day financial tasks discussed in Chapter 2: Daily Store Finance of making bank deposits, reconciling credit card and website remittances, and placing change orders. In Chapter 8: Bookkeeping for Booksellers, you'll learn about keeping up with bookkeeping data entry. A senior staffer such as the owner, general manager, or Chief Financial Officer should monitor sales and cash flow, which will be discussed in Chapter 9: Cash Flow Deep Dive.

On a monthly basis, whoever is responsible for bookkeeping will finish up data entry, reconcile statements, close your books, and prepare monthly financial reports. Your bookkeeper may also pay bills, or you may reserve that right as the owner or manager. Your store may also need to remit monthly sales tax and payroll tax payments. You as the owner or manager should set time on your calendar to review your monthly financial reports, which should include a **profit & loss statement**, which we will deep dive into in Chapter 11.

On a quarterly basis, some owners may need to make estimated tax payments. Those stores with employees will need to file quarterly payroll forms and may need to make quarterly unemployment tax payments. Depending on your business, quarterly financial reports are often more meaningful than monthly ones, so put extra time to review these on your calendar at the end of each quarter.

We highly recommend meeting with your tax advisor at least twice a year. If you have a separate business coach or advisor, biannual meetings may also be useful there. If your tax filings are on a calendar year basis, then you'll usually meet with your tax advisor in the spring to discuss your upcoming tax filing and expectations for the next calendar year.

Prior to meeting your tax advisor, you may have already met with your business coach to create a plan and set those expectations for the next fiscal year. You may also want to have a meeting with your tax advisor in late summer or early fall to check in about how sales are comparing to expectation and to discuss recent or prospective changes to the tax code and any odd bookkeeping question you may have. It may seem counterintuitive, but having a banner quarter is a strong sign that you should talk to your tax adviser sooner rather than later. The tax code is full of income-related brackets and cliffs that can jump your tax bill up an enormous amount, but with enough advance warning, a good tax advisor can help you navigate them. Whereas, having a weak quarter could be the trigger to call your business coach ASAP.

On an annual basis, you must produce year-end reports that include Cost of Goods Sold and file income tax in all applicable jurisdictions: federal, state if required, and possibly city. Your city or county may also require you to file a **business property tax** return and/or renew a business license. If you have employees you'll need to submit W2s and other annual payroll forms. 1099s may be required for contractors, landlords, accountants, and other services you pay by check or bank draft. If you are required to provide worker's comp insurance, you'll have an annual audit at some point in the year.

Many stores create annual budgets and sales projections, which you'll learn about in Chapter 12: Creating & Analyzing Your Budget. You should download yearly payroll provider reports and clean out any old company records you are no longer required to retain. Depending on how you calculate Cost of Goods Sold, you may be required to do an annual physical inventory, but it's a recommended practice even if not legally required. If you have company vehicles or drive your personal vehicle for business tasks other than commuting, you need to document the mileage of each vehicle at the start and end of your accounting year.

7.11 MEETING WITH YOUR TAX PROFESSIONAL

Your tax advisor usually makes more per hour than you do, so it pays to prepare well for your meetings so you get the best value out of them.

Before you e-mail your advisor a question, make sure you know whether they bill you for those or not.

You may find it useful to keep an open document of running questions and schedule a meeting when one of those questions turns urgent, or if you get an IRS notice, see a lot of variance up or down from the previous year, either in business income or in total family income, or if it's been at least six months since you last met.

Prior to the meeting, run your financial reports and send those to your advisor along with your questions as your "agenda." Or if you use online accounting software, you may be able to give your advisor access to your account.

We have included a sample agenda checklist in the **Templates & Resources** section.

7.12 INTRODUCTION TO CLASSIC FINANCIAL STATEMENTS

Publicly traded companies and those in regulated industries have to comply with GAAP (generally accepted accounting principles), but many large private businesses voluntarily comply as well. GAAP requires that companies produce three classic financial statements on a quarterly basis: a **Profit & Loss Statement**, a **Balance Sheet**, and a **Cash Flow Statement**.

We will deep dive into each of these in later chapters, but here's a brief introduction to each.

Profit & Loss Statement

The **Profit & Loss Statement**, called a P&L for short, may also be called an Income Statement or Statement of Operations. It summarizes all the transactions in your Income, Expense, and Other Income/Expense categories from your Chart of Accounts over the reporting period. Theoretically, it shows whether your business is making a profit or losing money, but as you'll see in Chapter 11: Profit & Loss Deep Dive, there are nuances related to owner's pay and your business structure.

Balance Sheet

The **Balance Sheet**, also called the Statement of Financial Position, summarizes the value of your Asset, Liability, and Equity categories in your Chart of Accounts as of a specific date. It shows what a business owns and owes. It's called a "balance sheet" because your total **assets** should exactly match, or be in balance with, the combined total of your **liabilities** and **equity**.

You may be familiar with the term equity from owning a house. Equity is the amount you'd realize after selling all your business assets and paying off all your business liabilities. With your house, your initial equity is your down payment, but if the market value of your house increases, your equity could grow. It can also shrink if you let your house fall into disrepair or your neighborhood goes to pot. The equity listed on your company balance sheet is an estimated amount. Whether you'd receive that amount or more from selling your business depends on too many factors to go into during this course, but usually the higher the equity, the better.

Cash Flow Statement

Lastly is the **Cash Flow Statement**. Under GAAP, the first two reports are run on an accrual basis, and the Cash Flow Statement fills in the gaps to show how cash is entering and leaving a company. Cash is the lifeblood of a business. Many retail stores don't make their profits for the year until the fourth quarter. However, if you run out of cash to pay your rent and staff in July, potential fourth quarter profits don't really matter.

Even though most bookstores are not required to follow GAAP, these statements are important financial tools, and understanding them will increase your financial self-confidence as a business owner.

7.13 INITIAL ACCOUNTING DECISIONS

There are some initial accounting decisions you should have made when your store was founded; however, sometimes things slip through the cracks, or you may have needed to make some early decisions without full knowledge and now want to rethink them. The following are decisions every store needs to make regarding accounting and finances.

Business Bank Accounts

Every business should have a separate business bank account. This is legally required if you have a DBA or have created your business as a separate entity (an LLC, partnership, or corporation) but is strongly recommended even for sole proprietorships.

The benefit of a separate account is to more easily separate your business and personal transactions for tax prep, to look more professional or legitimate (which can be important for pop-ups, bookmobiles, etc.), and to help establish business credit.

Depending on your model, you may use Square for your credit card processing, but most banks also offer what are called merchant accounts and are happy to set that up for you as a bundle with your business checking account. Having an official business checking account may in fact be a requirement for traditional merchant processors.

When shopping for banks, business owners are typically most concerned about convenience, fees, and minimum balance requirements. But during the pandemic, it became clear that relationships are just as important. The banks that got the best reviews during that period tended to be regional banks, who were more helpful to their small business customers than the big national banks. For more advice on building relationships with your bank, see the Dig Deeper section of Chapter 3: Vendor, Debt, & Tax Management.

Credit unions often have lower fees and minimums than banks, but they are geared toward personal banking and may not offer business accounts or only offer limited business services. Online banks may be a good place to keep a business savings account but are not recommended for your main business checking account if you're going to accept cash from customers.

Out of convenience, many owners open their business bank account at the same bank where they have their personal accounts. But just like with insurance, internet services, and your merchant account, it may be worth your while to shop around every so often for a better fit.

Hiring a Tax Advisor/Accountant

Ideally, you want to start working with an accountant or tax advisor before you open your doors as they can help you decide on your business structure, explain tax implications of different choices you have (like whether to classify your startup capital as an investment or a loan to the business), and help you find other advisors. Theoretically, you could do all your business tax filings yourself, but business accounting is usually intimidating enough that most owners want professional help with it.

Many business owners only meet with their accountant once a year for tax prep, but if you can find someone who can help you learn what you don't already know and is good at answering questions clearly, it's probably worth your time and money to meet with them more often, especially in the early days of your business or any time you're contemplating significant changes. And even if nothing changes in your business, the tax code can change wildly from year to year and can be hard for lay people to interpret.

The best way to find a good accountant is through other references. If you're in a big city with other bookstores, ask who they use. If you're the only bookstore in town, talk to other retail stores and to restaurants, since they also have to calculate cost of goods. Accountants may specialize just like anyone else and finding one with a roster of small business retail clients similar in size and scope to your store means they will already be familiar with common issues.

Also think about your current level of need and whether that is changing. As your business grows, you may need more services, such as bookkeeping help or financial planning. Or perhaps you want the safety net of a larger firm, rather than a single person who might get sick or retire. Or perhaps you started out with a CPA because of their extra credentials but now you can get by with a less expensive person.

Even once you find a reputable tax advisor, keep in mind that they depend on the accuracy of *your* records, and they can still make mistakes. It's your responsibility to oversee what they prepare, ask questions about anything you don't understand, and make sure nothing obvious seems off.

Your Fiscal Year

Your business **fiscal year** is set by the first business tax return you file, so many people use the calendar year without realizing they may have had other options.

A sole proprietor reports their business income or loss on their owner's tax return, which is almost always the calendar year. A partnership or LLC must generally use the same tax year as the majority of its owners. An S corporation or a personal service corporation must generally use a calendar year. A C corporation that starts after January 1 can choose any 12-month period they want for their fiscal year or use the calendar year.

After you've filed your initial business tax return, you can only change your fiscal year with the IRS's permission by filing **Form 1128**, and you can typically only do this once every ten years. To change your fiscal year, you typically have to provide a business rationale other than avoiding tax.

For seasonal businesses, it makes sense that their accounting period should include the entire season. For a business like a ski resort, the calendar year would break the winter skiing season into two fiscal years and require them to do inventory and other fiscal year end tasks right in the middle of their busiest time of year.

For other businesses, it may make business sense to change your fiscal year if associated expenses would fall in a different fiscal year than the income they produce. This is the main reason retail stores use a different year. If merchandise is non-returnable and must be put on sale to be cleared out, you may need time after the holiday season to run those sales. In this case, you'd want your fiscal year to end after those sales so your advertising and markdown expenses offset your non-markdown sales in the same fiscal year.

Some counties require businesses to pay business property tax based on their fiscal year-end inventory levels. Given this, you may want your fiscal year to end during a time of low inventory levels. However, that is not a valid "business reason" in the eyes of the IRS to change your fiscal year.

SUMMARY

Why It Matters

Accounting is important for three major reasons:

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2. It ensures legal compliance and proper reporting to the IRS and that liabilities such as sales tax, income tax, and payroll tax and withholdings, to name a few, are appropriately addressed.
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7.4 Accounting Workflow

A financial transaction is made. Once made, you record the money flowing into or out of your bank account. Then, the transaction is linked to a category from your Chart of Accounts. Then you're done!

7.5 Cash vs Accrual vs Modified Cash Accounting

In **cash accounting**, you record revenue and expenses when you pay or receive money. With **accrual accounting**, you make a record when you receive a bill or send an invoice regardless of when it actually gets paid. In **modified cash accounting**, you record transactions related to long-term assets and inventory under the accrual method but use cash accounting for short-term assets and expenses.

7.6 How to Calculate Cost of Goods Sold (COGS)

The official formula for retail businesses is:

COGS = Starting Inventory + Net Purchases - Ending Inventory

7.6.1 Average vs Specific Cost

Under the specific method, you receive against your invoices and your point of sale system tracks the cost of each individual item so when you run your starting and ending inventory reports, you get the cost of just the particular books remaining in inventory. Before modern POS systems, the specific cost system required too much time, so average cost is also a legal method. With the average cost method, you estimate.

7.7 Accounting Software

Free online software like Wave and Xero was designed for service businesses like coaches and consultants that do a lot of invoicing. You may be able to hack it to support a bookstore, but in general it is not recommended for retail, inventory based businesses. Most bookstores use Quickbooks Desktop, Quickbooks Online, or Sage.

7.8 Who Does Your Bookkeeping?

Startup owners usually either do all the bookkeeping or none of it, depending on your previous experience and the size of your business. Or if your business is a partnership, perhaps only one partner is responsible for the financial side. We recommend that even if you don't enjoy bookkeeping or have the time to do it regularly, you at least take time to learn how to do it. If your bookkeeping is not done correctly, your resulting financial reports are not going to be very reliable.

7.9 Backups & Document Retention Systems

If you use online software, it is backed up automatically. But if you use Quickbooks Desktop or Excel, it's best to create a system to back it up to the cloud. You should discuss federal and state document retention requirements with your accountant. The IRS requirements usually range from three to seven years, but records related to property may be much longer, and your state may have additional requirements.

7.10 Getting Into a Financial Rhythm

It will make accounting easier for you if you start to develop a rhythm for your store and create some checklists so nothing falls through the cracks. We've provided an accounting calendar in the **Templates & Resources** section to help you develop a good rhythm.

7.11 Meeting With Your Tax Professional

You may find it useful to keep an open document of running questions and schedule a meeting when one of those questions turns urgent, or if you get an IRS notice, see a lot of variance up or down from the previous year, either in business income or in total family income, or if it's been at least six months since you last met.

Prior to the meeting, run your financial reports and send those to your advisor along with your questions as your "agenda." Or if you use online accounting software, you may be able to give your advisor access to your account.

We have included a sample agenda checklist in the **Templates & Resources** section.

7.12 Introduction to Classic Financial Statements

The **Profit & Loss Statement**, called a P&L for short, may also be called an Income Statement or Statement of Operations. It summarizes all the transactions in your Income, Expense, and Other Income/Expense categories from your Chart of Accounts over the reporting period.

The **Balance Sheet**, also called the Statement of Financial Position, summarizes the value of your Asset, Liability, and Equity categories in your Chart of Accounts as of a specific date.

The **Cash Flow Statement** fills in the gaps to show how cash is entering and leaving a company.

7.13 Initial Accounting Decisions

Every business should open a separate business bank account, hire a tax advisor/accountant, and determine your **fiscal year**.

KEY TAKEAWAYS

- Accounting is basically just tracking where your money is going.
- The accounting workflow is simply recording a financial transaction then linking that transaction to a category within your Chart of Accounts.
- In cash accounting, you record financial transactions when money changes hands; whereas in accrual accounting, your record transactions when they happen regardless of when money changes hands. Modified cash accounting is a mix of the two.
- COGS = Starting Inventory + Net Purchases – Ending Inventory
- The Profit & Loss Statement, Balance Sheet, and Cash Flow Statement are the three classic financial statements every business should use.

TEMPLATES & RESOURCES

- **Resource**: Accounting Calendar
- **Resource**: Sample Tax Advisor Meeting Agenda

KEY TERMS

- 1099
- Accountant
- Accounting
- Accrual Accounting
- Assets
- Average Cost
- Balance Sheet
- Bookkeeper
- Business Advisor
- Business Property Tax
- Cash Accounting
- Cash Flow Statement
- Certified Public Accountant (CPA)
- Chart of Accounts
- Cost of Goods Sold (COGS)
- Enrolled Agent
- Expenses
- Fiscal Year
- Form 1128
- Form 3115
- Liabilities
- Modified Cash Accounting
- Net Purchases
- Profit & Loss Statement
- Revenue
- Schedule C
- Sole Proprietorship
- Specific Cost
- Tax Professional
- W2

REVIEW QUESTIONS

True or False:

- The only person who can speak to the IRS on your behalf is a CPA (certified public accountant).
- The COGS formula is: COGS = Starting Inventory + Net Purchases + Ending Inventory.
- The accounting workflow is recording a financial transaction then linking that transaction to a category within your Chart of Accounts.

ANSWER KEY

- F
- F
- T

DEBITS & CREDITS AND DOUBLE ENTRY ACCOUNTING

WHAT IS DOUBLE ENTRY ACCOUNTING?

Your bookkeeping accounts are a database just like your point of sale system. You're tracking items (in this case, financial transactions) over time and storing information about those items. Accounts can be real live bank accounts or "virtual accounts" like Accounts Payable and Accounts Receivable. Single Entry accounting is a simple and straightforward method: you only record income and expenses, and each transaction is a single entry in your records. Double Entry accounting, then, means there are two entries for each transaction.

Let's begin with a brief history lesson: Double Entry accounting was officially developed in the mercantile period of Europe to help rationalize commercial transactions and make trade more efficient. The concept of double-entry bookkeeping, however, dates back to the Romans and early Medieval Middle Eastern civilizations, where simplified versions of the method can be found. Some thinkers have argued that double entry accounting was a key technology responsible for the birth of capitalism.

The modern double entry system started to become widely used in the 13th and 14th centuries by Italian merchants. The first known documentation of the double entry system was recorded in 1494 by Luca Pacioli, who is widely known today as the "Father of Accounting" because of the book he published that year detailing the concepts of the double entry accounting method.

Today, Double Entry Accounting is the main accounting system used by most modern accounting software, as it tells the full story of what is happening with your money.

It's called "double entry" because every transaction you make involves both a debit and a credit - as one account increases, another must decrease, and the sum of every debit and its corresponding credit must equal zero.

Just like in your POS where you track author and title and can search on either one, in your accounting system, you want to track both the transaction and its category. For example, when you purchase office supplies, you would record the money coming out of your bank account AND record the purchase in your "Office Supplies" category.

DIG DEEPER

Categories come from your Chart of Accounts, which we'll go into in detail in Chapter 8: Bookkeeping for Booksellers. While single entry only tracks revenue and expenses, double entry also tracks equity, assets like inventory, and liabilities like accounts payable. You'll learn all about these categories as we move through this course, but for now, it's important to understand that while the double entry system may seem like more work, it paints a more complete picture of how money is moving through your business.

ACCRUAL DOUBLE ENTRY SYSTEM

Accrual accounting requires the double entry system that is supported by Quickbooks and other accounting software. In this system, every transaction balances out to zero, with one account being debited and another being credited the same amount. You debit the account that value is flowing into and credit the account that value is flowing out of (usually your bank account).

Let's walk through how that works with inventory. Under the accrual system, if you are on terms with a publisher, you would enter inventory invoices as you receive them, debiting your Inventory asset account and crediting Accounts Payable. When you buy inventory, value flows into the inventory asset account, which means it gets entered in the debit column on the left. That means the other account has to get credited to balance it out.

DOUBLE ENTRY ACCOUNTING

Example: $100 invoice for inventory received, then paid. $50 of the inventory sold by the end of the month.

ACCOUNT	DEBIT	CREDIT
Inventory	$100	
Accounts Payable		$100
Accounts Payable	$100	
Bank Account		$100
Cost of Goods Sold	$50	
Inventory		$50

DIG DEEPER

When you pay the invoice, you would debit Accounts Payable and credit your bank account, since money is leaving the bank. But asset accounts like inventory aren't an expense, so how do you get to deduct inventory as an expense from your income? That's where Cost of Goods Sold comes in. You have to calculate the cost of only the inventory you sold during the period, and then you debit Cost of Goods Sold, which is an expense account, and credit Inventory, which is an asset account.

The double entry accounting system is based on the accounting equation:
Assets = Liabilities + Equity

If you look at this equation, it's a bit easier to understand debits and credits. Debits increase your asset accounts, which means they have to decrease your liabilities and equity accounts, because they're on opposite sides of the equation. Credits increase your liabilities and equity, therefore they must decrease your assets, again because they're on opposite sides. Similarly, debits increase your expense accounts, which means they decrease your revenue accounts, and credits decrease expenses and increase revenue, again because revenue and expenses are opposites.

Here's a nifty chart to help you remember when to debit or credit an account.

ACCOUNT	INCREASE	DECREASE
Assets	Debit	Credit
Liabilities	Credit	Debit
Equity	Credit	Debit
Expenses	Debit	Credit
Revenue	Credit	Debit