

Small Business Accounting, Big Deal

By Michelle Wright

Recently, much of the news coverage of large corporations is concerned with their accounting practices, or “cooking of the books.” These corporations are now facing public scrutiny for their practice of overstating profits, understating expenses, capitalizing expenditures, and improperly reporting debt. Some of these large corporations are also filing for bankruptcy. These practices have led to the general public investing in companies that on paper look like sound investments, but in reality they are not.

Large corporations are not the only ones that “cook the books.” However, small businesses are not usually overstating profit, but instead have a tendency to understate earnings in the hopes of minimizing taxes. This can be detrimental to the small business owner, and often the consequences of these actions are not revealed for many years and the punishment or actions may be quite severe.

First, while paying less tax may seem like a short-term solution to cash flow problems, the ability to obtain financing for expansion in the future will depend on the income from the past. Many small business owners have turned to the bank to finance capital expenditures only to be turned down due to past sales performance. The bank uses previous tax returns to gauge growth and cash flow. If the

business continually showed losses on the tax returns, the bank will require a greater amount of collateral or a larger capital injection from the owner before approving a loan.

Second, small business owners that are sole proprietors pay their Social Security taxes based on the income of the business. If they continually show losses in the business, they may fail to qualify for Social Security benefits or only qualify for a very small amount. These same owners will also have difficulty obtaining personal loans because banks use personal tax returns to qualify the owners for loans. With little or no income reported on the tax return, the bank cannot justify the lending of large amounts without the owner showing the ability to make the payments. Owners may also find refinancing of existing debt difficult to obtain without a secondary source of repayment.

Another reason that improper accounting is detrimental to a small business is the potential for growth through investors or the opportunity to sell the business. If the small business owner is looking for growth and seeks investors, the investors will want to see past performance of the business. They too will rely on the numbers that have been reported on the tax returns. Potential buyers of the business will use past sales and profits in calculating what they determine to be the fair

market value of the business. While investors and the banks may realize from an on-site visit to the business or by looking at the owner’s personal financial statement that the business is successful, not reporting income properly brings the integrity and honesty of the owner into question. This causes the bankers and investors to question the character of the owner and makes lending to the owner or investing in the business a greater potential risk.

For all of these reasons, and more, it is important for small businesses to use proper accounting practices. These practices involve properly recording all business receipts (yes, even cash); making sure that only business expenses are included in the business’s financial statements and on the tax return; and accounting properly for any debt incurred by the business and for any loans that the business makes to related parties.

One of the simplest ways to accomplish this is to keep all business and personal transactions separate. Make sure that all sales are deposited and that all expenses are recorded in the business checking account or on a business credit card. If personal funds are used, make a reimbursement from the business and include receipts for the purchases made on behalf of the business.

Small business owners can also find ways to use profits from their

business and invest them in tax-free retirement funds. This allows the owner to properly show the business’s profit potential and still minimize personal income taxes. In the end, proper accounting practices and financial planning will prove to be more

Business Sense



beneficial than the short-term results of “cooking the books.”

For further assistance with your small business accounting, contact your local Small Business Development Center.

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