# Chapter 1

# Accounting Basics

Accounting and record keeping are the systems used to organize and track the flow of money taken in and paid out of your construction business.

## The Numbers

To the customer, the value of your construction business is in the quality of the functional product that you produce for them.

Everyone else in contact with your construction business, (Internal Revenue Service, State Department of Revenue, banks, and your family) measures your business competence by its financial health (the numbers).

*A contractor makes promises that have financial impacts on the customer, the business, and the owner's family. Society does not fear for the contractor's integrity, but for the fact that they often do not know what they are doing.*

## Purpose

Any business accounting system has two basic purposes:

- Tax Accounting
- Financial Accounting

## Record Keeping Tools

The financial and tax accounting tools necessary to produce the numbers reflecting the real cash position of your construction business are the following:

- Record keeping system
- Balance sheet
- Income statement
- Cash flow statement
- Filing or sorting system

## Tax Accounting

Tax accounting helps produce the records and information necessary to complete your business tax forms. This system depends on the structure of your business, whether it is a sole proprietorship, partnership, limited liability company, or corporation (see the Quick Reference Tool at the end of this manual).

"Some people regard discipline as a chore. For me, it's a kind of order that sets me free to fly."
Julie Andrews

Your goal is to provide correct tax payments as determined and supported by your accounting and record keeping system.

The IRS does not require any particular kind of records or filing system. However, your record keeping and accounting system has to help you complete the tax forms and calculate the tax payments correctly or it is useless.

The IRS *does* require that any records you use be adequate and show the current financial situation (regarding income, expenses, and deductions) of your construction business.

***Note***

A computerized record keeping system that calculates your tax forms is a valuable advantage of a good accounting and record keeping system. However, I recommend you learn to do this, or any system, on paper before going to a computer program.

## Financial Accounting

Financial accounting helps produce information critical to maintaining the financial well-being of your business.

# Financial Statements

"The most expensive professional is the one you don't hire when you should."
David Scully, CPA

Financial statements are the numerical "pictures" of your business. They tell you the:

- Value, or net worth (balance sheet)
- Profit (income statement)
- Ability to pay your bills on time (cash statement)

The most critical part of financial accounting to your contracting business is cash management.

# "Schedule C"

"Schedule C" is the IRS tax form you use to compute your net income as a sole proprietor. It is also true that partnerships, limited liability companies, and corporations can use "Schedule C" to determine net income for tax purposes.

The "Schedule C" form includes all the pieces necessary to construct a useful system of accounts. Tax accounting and financial accounting can be done with the "Schedule C" format.

The "Schedule C" is also the foundation for an efficient record keeping system. In this course you will learn to use a simple accounting and record keeping system based upon the IRS "Schedule C."

Take a moment to familiarize yourself with Exhibit 1, the "Schedule C" form, at the end of this chapter.

"I don't like money, actually, but it quiets my nerves."
Joe Lewis

# Income and Expenses

Basic accounting helps provide a mechanism for the construction contractor to produce complete, accurate, and current records of the business's construction activity.

A basic accounting system deals with:

- When and how to record and report income
- When and how to record and report expenses

## Cash Position

One of the most damaging, if not fatal, situations for the construction business is a cash shortage. If cash is not available to pay bills, a profitable business may have to shut down.

## "Schedule C" and Business Accounting

The "Schedule C" is made up of five parts. Part I is business income. Part II is expenses of operating the business. Part III is expenses of producing a product, the cost of what is sold. Part IV lists information on any vehicle you are claiming expenses on. Part V lists business expenses not detailed in Part II.

***Note***

We will discuss "Schedule C" in the order of part I, followed by Part III, then Parts II and V. This allows us to show "gross profit" in a construction business before "net profit." Part IV is information only on the vehicle you are claiming expenses for and, therefore, is not included in calculations.

## Income: Part I of the "Schedule C"

Income includes all money taken in by your business and generated from construction activity. Even though this seems like a simple idea, it is vitally important to have a system for carefully tracking income. This means knowing where income is being generated and if all money due on a project has been paid.

## Cost of Goods Sold: Part III of the "Schedule C"

The *Cost of Goods Sold* section contains the *direct expense* costs to produce your construction products. These costs include:

- Labor costs incurred to complete a project:
  - Subcontractors
  - Company employees working on the project
  - Contract labor
  - The owner of the company, if working on the project and the business is a corporation
- All materials and supplies necessary to construct the project

There are many nerves in the human body, but the most sensitive is the one that goes from the brain to the pocket book.

## Gross Profit

The income of a business less the cost of goods sold is the*gross profit* for the business.

Total Income
— Cost of Goods Sold
= Gross Profit

This calculation can be for the:

- Particular project
- Month of business activity
- Category of business such as remodeling, new homes, specialty projects, etc.
- Tax year of the business

## Expenses: Parts II and V of the "Schedule C"

Expenses listed in these parts refer to the indirect costs incurred in doing business.

**Note**

*Indirect expenses* are often referred to as overhead expenses.

These indirect expenses are the costs of operating a business. They include *current* and *fixed expenses*.

Financial records are the answers to the questions: What money have we taken in? What have we spent on buying materials and paying for labor? What is it costing to run the business? What part of the predicted profit did we keep?

- Current expenses include:
  - Rent
  - Phone
  - Office supplies
  - Payroll expenses (for office personnel only, not construction project labor)
  - Tool repair and purchase
  - Insurance
  - Vehicles
  - Legal and professional services
  - Other current indirect expenses incurred for business operation

- Fixed expenses include:
  - Mortgages
  - Loans over one year
  - Other preset payments over one year

**Note**

These indirect expenses are distinguished from the direct cost of goods sold that is specific to completing the construction project.

## Net Profit

The total of the indirect expenses subtracted from the gross profit results in the net profit of the business.

Gross Profit
— Indirect Expenses
= Net Profit

Net profit is used to calculate:

- Your self employment tax, (IRS "Schedule SE")
- Your income amount on "Form 1040"
- Other income calculations

Even if your business is a partnership, limited liability company, or a corporation, you can benefit by using "Schedule C" to design your accounting system.

# Accounting Methods

There are two general methods of accounting used by businesses:

- Cash method
- Accrual method

## Cash Method

Under the cash method you report income when received, and expenses when paid.

## Accrual Method

Under the accrual method you report income when earned (not received) and expenses when owed (not paid). See *IRS Publication #334, Tax Guide for Small Business.*

***Warning***

The accrual method must be used by businesses with an annual income of over $5,000,000 or by businesses with inventories.

Once you begin using a particular accounting method, you will need permission from the IRS to change to another method.

*Money is power in business. The owner carefully manages money in the business to maintain power in the marketplace.*

# Bookkeeping Systems

"It is more vital than ever that you assume greater responsibility for your financial future. You ought not to rely exclusively on paid advisors. You should be knowledgable enough to raise good questions and evaluate answers when you deal with a professional. The informed client gets the best advice." Julian Block, Tax Attorney

There are two types of bookkeeping systems:

- Single entry
- Double entry

## Single Entry

The single entry system is based on a *singular ledger entry* (a written record of the numbers of your business). See the Quick Reference Tool at the end of this manual. It uses the following to keep records of income and expense flow:

- Daily summary of cash receipts
- Monthly summary of cash receipts
- Monthly summary of cash disbursements

The single entry system is used in the cash accounting method only. Since most construction companies carry no inventory, and normally have few other assets, cash is the only major asset for the contractor. Therefore, single entry accounting is typically used in most contracting businesses.

Because most contracting companies use a cash method of accounting, they can immediately understand their cash position and act to avoid problems.

### Advantages to Single Entry System

- The cash method, single entry system of accounting, quickly shows your company's ability to pay bills on time.
- Only one entry is needed in a journal for Income, Cost of Goods Sold, or Expenses.
- It is easy to move totals around to calculate gross profit and net profit.
- Single entry accounting is relatively simple and less time consuming than double entry. The business owner can usually keep the books and avoid the cost of hiring an accountant.

***Note***

If you do your own books, you will tend to know the financial condition of your business better and be able to quickly make adjustments when necessary.

**Disadvantages to Single Entry System**

- There is no automatic double check on the entry.
- Because of possible inaccuracies, the records may be unsuitable for some financing purposes.

***Warning***

There is a danger in keeping the books so simple that they are not useful. Be sure you know what information you need to record for your business.

## Double Entry

Double entry bookkeeping can only be used with the accrual method. Most small contracting companies do not need to use this complex accounting system.

Many people believe in life, liberty, and the purchase of happiness.

The double entry method provides a permanent record of business transactions. Every entry contains both a debit and a credit.

All credits (income and assets) must match debits (expenses, cost of goods sold, and liabilities). "Balance the books" means the credit and debit sides of the books have to match, or balance.

The double entry system records income, expenses, and cost of goods sold, and shows how they affect your business assets and liabilities. Therefore, the system keeps the total business picture in focus at all times.

***Warning***

While the business financial picture is in focus, the cash position of the business (its ability to pay its current bills on time) is not apparent with this system.

The double entry system records the flow of income and expenses using the following steps:

- Record transactions in journals.
- Post entries to ledgers to show:
  - Income
  - Expenses
  - Assets
  - Liabilities
  - Net worth
- Close income and expense accounts at the end of the accounting period; day, week, month, quarter.
- Keep asset, liability, and net worth accounts open continuously.

*Some say money is a curse. If so, you can always find someone to take the curse away from you.*

## Advantages to Double Entry System

- Mistakes are minimized through the automatic checking mechanism of the double entry; credits have to match debits.
- Financial statements generated with this system are more accurate and are usually accepted by most bankers and other financial people.
- The profitability and value of a business can be determined quickly.
- If you have a product to sell and an inventory of that product on hand, this system accounts for it.

***Note***

Even computer accounting system records may not be acceptable to some lenders. The entries can be changed to reflect the desired result. If you have to borrow money, check with your lender on the types of records that will be required.

## Disadvantages to Double Entry System

- The double entry system, used with the accrual method, is a more complex form of accounting. Most contractors would not have the time to do this form of accounting.
- Double entry accounting is usually more expensive to maintain. Most contractors hire someone to maintain a double entry system.

- The cash statement is a separate series of calculations, outside the double entry system.

***Tip***

Discuss your accounting system with a professional. Here, as in many cases of seeking advice, you may wish to get a "second opinion."

The Construction Contracting Academy recommends the use of the single entry/cash method system of accounting because it is the one most easily adapted to the construction business.

A shady business never produces a sunny life.

Single entry/cash method accounting is relatively simple and less time consuming. A contractor is more able to keep records up-to-date. However, the best accounting system is the one that is actually "used."

***Note***

Computer accounting systems automatically do accrual and double entry.

# Exhibit 1: Schedule C

**SCHEDULE C (Form 1040)**

Department of the Treasury
Internal Revenue Service (U)

## Profit or Loss From Business

(Sole Proprietorship)

➤ **Partnerships, joint ventures, etc., must file Form 1065.**

➤ **Attach to Form 1040 or Form 1041.** ➤ **See Instructions for Schedule C (Form 1040).**

OMB No. 1545-0074

Attachment Sequence No. **09**

Name of proprietor | **Social security number (SSN)**

**A** Principal business or profession, including product or service (see page C-1)

**B** Enter principal business code (see page C-6) ➤

**C** Business name. If no separate business name, leave blank.

**D** Employer ID number (EIN), if any

**E** Business address (including suite or room no.) ➤
City, town or post office, state, and ZIP code

**F** Accounting method: (1) ❑ Cash (2) ❑ Accrual (3) ❑ Other (specify) ➤

**G** Method(s) used to value closing inventory: (1) ❑ Cost (2) ❑ Lower of cost or market (3) ❑ Other (attach explanation) (4) ❑ Does not apply (if checked, skip line H)

| | | Yes | No |
|---|---|---|---|
| **H** | Was there any change in determining quantities, costs, or valuations between opening and closing inventory? (if "Yes," attach explanation.) | | |
| **I** | Did you "materially participate" in the operation of this business during 1993? (if "No," see page C-2 for limit on losses.) | | |

**J** If you started or acquired this business during 1993, check here ➤ ❑

## Part I Income

| | | | |
|---|---|---|---|
| **1** | Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here* ➤ ❑ | 1 | |
| **2** | Returns and allowances | 2 | |
| **3** | Subtract line 2 from line 1 | 3 | |
| **4** | Cost of goods sold (from line 40 on page 2) | 4 | |
| **5** | **Gross profit.** Subtract line 4 from line 3 | 5 | |
| **6** | Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-2) | 6 | |
| **7** | **Gross income.** Add lines 5 and 6 ➤ | 7 | |

## Part II Expenses. Caution: Do not enter expenses for business use of your home on lines 8 - 27. Instead, see line 30.

| | | | |
|---|---|---|---|
| **8** | Advertising | 8 | |
| **9** | Bad debts from sales or services (see page C-3) | 9 | |
| **10** | Car and truck expenses (see page C-3) | 10 | |
| **11** | Commissions and fees | 11 | |
| **12** | Depletion | 12 | |
| **13** | Depreciation and section 179 expense deduction (not included in Part III) (see page C-3) | 13 | |
| **14** | Employee benefit programs (other than on line 19) | 14 | |
| **15** | Insurance (other than health) | 15 | |
| **16** | Interest: | | |
| a | Mortgage (paid to banks, etc.) | 16a | |
| b | Other | 16b | |
| **17** | Legal and professional services | 17 | |
| **18** | Office expense | 18 | |

| | | | |
|---|---|---|---|
| **19** | Pension and profit-sharing plans | 19 | |
| **20** | Rent or lease (see page C-4): | | |
| a | Vehicles, machinery, and equipment | 20a | |
| b | Other business property | 20b | |
| **21** | Repairs and maintenance | 21 | |
| **22** | Supplies (not included in Part III) | 22 | |
| **23** | Taxes and licenses | 23 | |
| **24** | Travel, meals, and entertainment: | | |
| a | Travel | 24a | |
| b | Meals and entertainment | | |
| c | Enter 20% of line 24b subject to limitations (see page C-4) | | |
| d | Subtract line 24c from line 24b | 24d | |
| **25** | Utilities | 25 | |
| **26** | Wages (less jobs credit) | 26 | |
| **27** | Other expenses (from line 46 on page 2) | 27 | |

| | | | |
|---|---|---|---|
| **28** | **Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns. ➤ | 28 | |
| **29** | Tentative profit (loss). Subtract line 28 from line 7 | 29 | |
| **30** | Expenses for business use of your home attach **Form 8829** | 30 | |
| **31** | **Net profit or (loss)**. Subtract line 30 from line 29. • If a profit, enter here and on **Form 1040, line 12**. And ALSO on **Schedule SE, line 2** enter the net profit on **Schedule SE, line 2** (statutory employees, see page C-5). Fiduciaries, enter on **Form 1041, line 3**. • If a loss, you MUST GO ON TO LINE 32. | 31 | |

**32** If you have a loss, check the box that describes your investment in this activity (see page C-5)
• If you checked 32a, enter the loss on **Form 1040, line 12,** and **ALSO on Schedule SE, line 2** (statutory employees, page C-5). Fiduciaries, enter on Form 1041, line 3.).
• If you checked 32b, you MUST attach **Form 6198**.

**32a** ❑ All investment is at risk.
**32b** ❑ Some investment is not at risk.

Schedule C (Form 1040) (Page 2)

**Part III** **Cost of Goods Sold** (See page C-5)

33 Method(s) used to value closing inventory: a ❑ Cost b ❑ Lower of cost or market c ❑ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ❑ Yes ❑ No

| | | | |
|---|---|---|---|
| 35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation | 35 | | |
| 36 Purchases less cost of items withdrawn for personal use | 36 | | |
| 37 Cost of labor. Do not include salary paid to yourself | 37 | | |
| 38 Materials and supplies | 38 | | |
| 39 Other costs | 39 | | |
| 40 **Add lines 35 through 39** | 40 | | |
| 41 Inventory at end of year | 41 | | |
| 42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4 | 42 | | |

**Part IV** **Information on Your Vehicle.** Complete this part **ONLY** if you are claiming car or truck expenses on line 10 and are not required to file Form 4562 for this business. See instructions for line 13 on page C-3 to find out if you must file.

43 When did you place your vehicle in service for business purposes? (month, day, year) ➤ / / .

44 Of the total number of miles you drove your vehicle during 1997, enter the number of miles you used your vehicle for:

a Business ........ b Commuting ........ c Other ........

45 Do you (or your spouse) have another vehicle available for personal use? ❑ Yes ❑ No

46 Was your vehicle available for use during off-duty hours? ❑ Yes ❑ No

47a Do you have evidence to support your deduction? ❑ Yes ❑ No

b If "Yes," is the evidence written? ❑ Yes ❑ No

**Part V** **Other Expenses.** List below business expenses not included on lines 8 - 26 or line 30.

| | | |
|---|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| 46 **Total other expenses.** Enter here and on page 1, line 27 ........ 48 | | |