Business and Accounting
The Editor’s Questions
Section 0100A

Presentation Objectives

The goal of this section is to present the following concepts to the reader.

1. An introduction into the concept of federal, state, county, and city governmental relations with businesses operating within their realm of regulation and control.
2. Address why businesses exist.
3. Provide a basic introduction to sole proprietorships, partnerships, and corporations.
4. Provide a basic introduction to for profit and not-for-profit or nonprofit businesses.
5. Provide a basic introduction into wholesalers, retailers, manufacturers, service providers, and conglomerates.
6. Provide a basic appreciation for why accounting exists and how it serves the business.
7. Provide a non-technical distinction between accounting and bookkeeping.
8. Provide a brief introduction into the difference between managerial, financial, and tax accounting.
9. Address common myths associated with accounting.
10. Provide guidance on how to succeed in an accounting course.

Contents

Helter Skelter Management

Because when someone is asked "What kind of business is it?" The answer is very by a number of options which include:

1. Sole proprietorship, partnership, or corporation,
2. For-profit or not-for-profit/nonprofit, and
3. Wholesaler, Retailer, manufacturer, service provider, or conglomerate.

There's probably a few more options and the person answering the question can take any one item from line 1, any one item from line 2, and one or more items from line 3. Or he can take any one item and only one item from all of the options in the three lines. With that range of flexibility, when trying to define business, where you start? You throw everything on the floor and try to sort chaos into order. This chapter will probably be the most irrationally structured chapter of the text because of the Editor's Questions and the numerous ways to answer them.

The Editors Questions

There are several questions that are classified as the Editor's Questions. The reason for this is, theoretically, if these questions are answered the complete story is told. They include the common ones that we all know such as Who, What, Why, Where, When, With Whom, and How. Depending on the situation there may be a couple more, seldom are there any fewer. There's an old adage that nobody does anything alone, you just may not see whom he or she is doing it with or for so the With Whom question is often relevant and ignored.

Federal and State Governmental Relations to Businesses

While the federal government may tax a business, it does not charter businesses. Businesses are chartered and licensed primarily through the individual states or U.S. territories that they are operating within. However, there are businesses which require licensing or approval by the U.S. government. These types of businesses are engaged in activities like securities and exchange trades, manufacturing of food for human consumption, and the manufacture of drugs for use by humans. States may additionally impose licensing requirements on these types of businesses.

The states charter corporations and license businesses in accordance with their own rules and regulations. The rules and regulations vary from state to state so trying to compile them into one document would result in a huge document and way too many hours of work and study to benefit from them. While not using factual numbers, we will deal with the State of Utopia as the 51st state of the union. This is obviously a fictional state so we can make up our fictional rules and regulations as examples. The State of Utopia may have a law that says you can do home repairs as an unlicensed repairman as long as the repairs are not considered structural and the total fees charged do not exceed $500. The logic of such a rule or regulation such as this is, untrained and unqualified individuals making structural repairs to buildings may put the residents and general public at risk. However, to require a homeowner to hire a licensed electrician to repair a broken porch light may result in an unacceptable financial burden. So there is a compromise, some degree of capability is exempt from licensing and direct oversight and degree of function is capped by a fee limitation or a capabilities limitation.

Dealing with our State of Utopia, it may also say that any work other than minor maintenance resulting in total fees of less than $500 associated with electrical, plumbing, air conditioning, heating, or ventilation must be accomplished by a licensed tradesperson. And, structural repairs or installations must be inspected by a city, county or state designated inspector. These types of statements are made to protect the individuals and society.

Why Are There Businesses?

Why are there businesses? Businesses are set up by individuals to accomplish a goal. Sometimes that goal is to earn a profit, sometimes that goal is to accomplish a task such as a humanitarian effort, or to produce a particular product or event. So who would start these businesses? The vast majority of the entire population of the earth has probably started the business at one time or another. In a land far far far away and a time long long long ago I shoveled snow, cut grass, washed cars, and took care of pets during vacations to earn money. While not a formal business in the light of a college financial accounting class, these were businesses. Chances are you did something very similar. Some businesses such as lemonade stands start and end on the same day. Some businesses have been started by great-great-grandparents and continue to this day. Businesses thrive through their life by the effort of those who own, lead, and manage them as well as those who work for them. In this course and in this program we are going to discuss primarily a for profit business formed as a corporation which is publicly traded under U.S. rules, regulations, and codes. Many of these rules, regulations, and codes come from organizations such as the U.S. Securities and Exchange Commission as well as state, county, and city governments. As a generic text, we will not go into depth or detail on those as that is an issue of professional guidance left to certified public accountants and lawyers.

Sole Proprietorship, Partnership, or Corporation

Sole Proprietorship

Depending on state regulations, a sole proprietorship may be owned by one individual, one individual and his or her significant other, or by one family that resides in the same household. State regulations change on this. In this text we will generally consider a sole proprietorship owned and operated by one individual that individual may have other employees so it is not necessarily one person business. One of the issues with a sole proprietorship is personal liability. In a sole proprietorship all assets of the owner are at risk whether they are associated with or involved with the business are not. Even with this level of personal risk the largest number of businesses in the United States by government survey are sole proprietorships. And they function very well and very effectively resulting in substantial tax benefit to the governments which oversee them and appropriate financial benefit to the individuals that fund them and operate them. Many texts will state that sole proprietorships are not licensed by the states and this is a possible misstatement. In most states when a sole proprietorship is engaged in specific activities, such as electrical, plumbing, auto repair, heating, air conditioning, the sole proprietorships require a degree of licensing by the state, the county, and / or the cities for the safety of the clients and society. As discussed earlier there may be operating privileges with certain limitations inside some of these types of professions. Sole proprietorships are also going to have to be recorded or licensed by the state, county, or city as appropriate when it sells goods on the retail market which have a sales tax obligation within those jurisdictions.

For tax purposes sole proprietorships report business activities, revenues and expenses, on a schedule C format with their U.S. federal income tax return. With this filing their earnings are considered to be taxed once, at the individual rate. And business losses may actually reduce tax obligations from other income activities. Contrary to rumor and folklore a sole proprietorship is not required by tax code to be profitable within 3 years of commencing operation or any other specific time frame. However what is phrased as hobby businesses, these are where you would start a business so you can buy materials for your hobby at wholesale rather than retail, may result in a tax evaluation adverse to the owners financial standings since this type of business is a tax evasion action for sales tax. In our mythical state of utopia we have an interesting rule that the minimum income tax placed on all businesses regardless of other structures is $1000 a year. This type of rule or regulation basically says if you want to hobby business it's going to be non-advantageous unless you can save more than $1000 a year.

Partnerships

Partnerships follow the same general rules and regulations as sole proprietorships with the added element of more than one owner. In some states a husband-and-wife may make a declaration to operate a business as a sole proprietorship since it's within one household, or they can make a declaration to operate the business as a partnership since they are both active, responsible, and making decisions within the business. The same issue of licensing due to the particular activities applies to partnerships as it does to sole proprietorships.

Partnerships as a business, file a tax report with the U.S. Internal Revenue Service, the IRS, reporting each partners portion of reportable income for the partnership. Then the individuals report this value on their individual federal income tax return and pay income taxes on that financial gain at the individual rate. This is very similar to how a sole proprietorship resolves its income tax obligation to the federal government.

Corporations

Under the U.S. tax code there are two types of corporations, subchapter C and subchapter S. Subchapter C corporations are business entities which, with appropriate licensing and without violating any laws can pretty much do anything they want. Our three greatest military men are all subchapter C corporations. We know them as General Mills (General Mills, Inc.), General Motors (General Motors Company), and General Electric (General Electric Company). Subchapter S corporations, the "S" does not stand for small – that's folklore, are restricted by a number of factors under the tax code. They are often referred to as closely held corporations as who can hold their stock is restricted by law. From time to time some of these factors change so these are some of the general restrictions on an S corporation. It must be a domestic, U.S. corporation, it can only have one class of stock, it cannot have more than 100 shareholders, profits and losses are allocated to the shareholders in proportion to their investment interest in the corporation, and while the corporation does a tax filing, gains and losses are taxed on the individual shareholders tax returns.

For-Profit or Not-for-Profit / Nonprofit Businesses

For-profit businesses

When dealing with corporation a for profit business is a business which has the ability or legal entitlement to pay or distribute to its investors dividends. You will learn later on that dividends are not an expense of a business, they are not part of the revenues minus expenses equals net income equation, they are a reward provided to investors, to owners for risking value through investment to the company. When dealing with a sole proprietorship or partnership the rewards to owners are considered to be withdrawals or drawings depending on the language someone wants to use. They have the same effect of the financial position of the company as a corporation's dividends. You will see this later in the text.

Not-for-Profit or Nonprofit Businesses

The titles mean the same so the terms are used interchangeably and in some legal documents for rules and regulations you will find the 2 terms intermixed heavily primarily based on who wrote that portion of the document your reading. So there is no difference between a not-for-profit and a nonprofit business. The difference between a not-for-profit, and I will try to standardize to that term for this text, and a for profit business is a not-for-profit business cannot pay dividends to its investors. While the term not-for-profit may imply some high degree of moral obligation to its clients or customers in fact of law and existence no such promise or obligation is made. Some not-for-profit businesses pay executives which created them millions of dollars annually for salaries and bonuses. Several years ago several credit reform companies which were using religious orientated titles and being operated under not-for-profit registrations were paying the individuals which founded them millions of dollars per year for salaries when those individuals were hardly even active in the operations of the business. Numerous government agencies have cracked down on some of these types of operations however many still exist today. This is not to say that all not-for-profit or bad, it is to say that just because a company claims that they are not-for-profit does not mean they're good, bad, or ugly. You need to know the details underneath them.

In summary the difference between a for-profit and a not-for-profit business is whether the business can through the character of its registration pay dividends are not. Just because it is a for-profit business does not mean it's going to make a profit. In addition, just because its not-for-profit does not mean it is going to accomplish its goal. The accounting for not-for-profit differs from a for-profit business, is the subject of advanced accounting courses, and these businesses still need to file tax information forms so the government can see what is happening.

Wholesaler, Retailer, Manufacturer, Service Provider, or Conglomerate

Wholesaler

All wholesaler falls into one of several categories depending on what the manufacturer, or the client, or both require. Some manufacturers will not sell and smaller lots than those that are commonly two large for many businesses to purchase. So wholesaler would purchase large quantities from this company, resell it to a retailer in smaller quantities which the retailer can handle. Or the retailer may not want to deal with 5, 7, or 8 vendors so wholesaler steps in and purchases from numerous manufacturers so the retailer or client can make one phone call and purchase a diverse product line. This is quite common in small retailers and food service facilities.

Retailer

A retailer, or retail as in business, is a business entity which purchases the goods in the same basic configuration as they are going to be sold in. Most of your big-box stores are retailers, as a consumer most of your business is done with retailers. Retailers can, in the new economy, be what are referred to as brick-and-mortar, can be Internet or digital, or can be both. You may see a retailer who modifies or changes the product to some minor degree. For example your local grocery store made by tomatoes by the ton and put them out for you to pick and purchased by the pound. This is not a major change to the product and does not require extensive labor or machinery by the retailer.

Manufacturer

A manufacturer is someone who takes raw materials and invests time and overhead into it you create something new. A steel mill would take or from a mine, provide labor, and consume utilities to run its machinery to create steel. Its input would be a real product called ore and its output would be a finished product called steel. This finished product from a manufacturer may be the raw material for another manufacturer such as a stamping mill which would take a steel and get an Stamper forge it into another customers desired shape. There is a common element to manufacturers that you will learn and accounting and that is they will have three values involved in manufacturing, raw materials, direct labor, and factory or manufacturing overhead. A manufacturer can make the decision whether they're going to sell through a wholesaler, through a retailer, or directly to the final consumer.

Service Provider

As the U.S. economy shifts we have moved from an agrarian or agriculturally based economy into a manufacturing economy and we are now moving into a service economy. As such it seems more and more service providers enter the business environment daily. Service providers do all of those things that you consider appropriate and necessary. And there's some degree of argument as to whether some companies are product providers or service providers. Is a true coffee shop or product provider or service provider? Well it has a product, coffee, as a personal preference I go with service provider. Others will disagree and draw hardline between service and product providers. These are preferences. Not absolutes. A service provider may or may not sell a product in the process of providing a service and when they do sell a product they may sell it for cost or at a markup. Common service providers include medical facilities, janitorial companies, window washing companies, auto repair businesses, and many more you see along the way.

Conglomerate

Depending on how we want to define conglomerate we can either be vertically integrated, horizontally integrated, or mixed. A breakfast cereal company would be vertically integrated if it owns the farms on which the grain is produced, owns the vehicles which deliver the grains to the Mills, owns the Mills and food processing facilities, and optionally the trucks delivering the finished product to the stores. One of the reasons to be vertically integrated is that you maintain total control over your product until it is presented to the purchaser, the ultimate consumer. There's actually a fair amount of these companies around and most of the time you don't even realize it.

To be horizontally integrated the company would be positioned in wide to provide the same sort of options to a multitude of vendors and clients. For example a trucking company may have flatbed trucks for unusual loads and shapes, refrigerated trucks for grocery type shipments, tanker trucks for fluid shipments and dump trucks for grains, sand, and stone. This company, as horizontally integrated is providing a similar service with special considerations to a multitude of different customers and clients.

When a conglomerate is mixed it may own a television broadcasting system, a food services business, a lightbulb manufacturing business, a financial institution providing customer and client services, and an aircraft engine manufacturing operation. These companies are diverse often resulting in steady income as the economy shifts since valleys in one sector may be compensated by peaks in another. When you look at a company and you see a title, you cannot determine the type of company it is from the title or its actions.

Why Do We Have Accounting?

First and foremost, because someone has a question and we can provide most of the answers.

Accounting is the scorekeeper for business. Is our team doing good, is our team doing bad, does our team need help? Accounting is the team within the company that provides information about internal activities, and activities between the vendors and the company, and activities between the company and its clients. It's tough to imagine the total number of activities an effective accountant and accounting department would be in and a large active company such as the major corporations in the world. However, the accountant and the information provided by the accountant are just as important if not more so for the small business that cannot afford a $5,000 mistake. I take that number for reason, if any one of the U.S.'s three greatest military men, Generals, Mills, Motors, and Electric, made a $5,000 mistake its management should be concerned but would not put the company in jeopardy. A small five-man operation which is providing general manual labor could be severely jeopardized by a $500 mistake. It stresses that accounting assist companies in being successful and effective.

Accounting can tell you when you need to pay your vendors to be most beneficial to your cash flow, let you know that you need to call some of your customers and clients for payment on an appropriate schedule, advise you what price would be appropriate for your product or service, and evaluate whether expenses are reasonable, extravagant, or unnecessary. So accounting should be involved in almost every decision the company makes, particularly if that decision involves the flow of value through the company or its interactions with vendors, employees, or clients and customers.

The Difference Between Accounting and Bookkeeping

There is no law stating accounting does ABC and bookkeeping does XYZ. There are numerous organizations who feel that they have the privilege to define one or the other but they cannot take you to court if you hire a person and decide to call them a bookkeeper instead of an accountant, or if you hire a person and call them an accountant instead of a bookkeeper. But there must be a separation, a difference. Here is mine, a bookkeeper works in today and primarily with cash entering the company from customers or leaving the company to vendors. An accountant usually works in yesterday or tomorrow and most often with values rather than cash. An additional distinction is you can generally define a bookkeeper's responsibilities in a yes/no logic chart that read something like this, "Did the envelope you just opened concert contain a check?" If the answer is yes, process it as accounts receivable and see if the payer is a client or customer of the company and has an outstanding balance. If the answer is no check the envelope for sales order or request.

An accountant's responsibility is going to be to determine the indirect costs of items such as utilities, insurance, taxes, supervisory costs associated with manufacturing and establishing the correct amount of overhead that each product produced will be burdened with.

Both positions require training, education, and professionalism as well as honesty and integrity. However the bookkeeping position I would define as an action position based on information provided while the accounting position generates information based on data provided.

There are some states with laws which prohibit you from putting “Accounting” or “Accountant” type words in your business name or title unless the principals in the business are CPAs.

Managerial, Financial, or Tax Accounting

This is another “not a governmental limitation” issues so … There are as many types of accounting as someone wants to imagine. Probably the top lists are managerial accounting by the number of accountants involved. Financial / public accountants doing audits of financial reports and doing consulting most likely follows financial or public accountants. The next is most likely tax accountants.

Managerial Accountants

Managerial accountants are those accountants working inside the company and answering the questions of management. There are few rules applicable to the reports provided by a management accountant to the management of the business. The two major rules would be honesty and clarity. If the boss wants an inventory report without “MSP” (miscellaneous small parts) included in it, that is fine. This report would not, and cannot be released to the public. The management accountant is going be the answer person for the company and those answers will all be internal documents.

Financial Accountants

Financial accounting is the basis for the vast majority of all accounting actions so it is the core of almost all formal accounting education. This genre of accounting focuses on the processes and rules & regulations related to public reporting. This reporting is done through four basic reports or their appropriate substitutes – the income statement which is sometimes called the statement of operations, the statement of retained earnings with acceptable substitutes of other reports such as the statement of owners’ equity, statement of partners’ equity, or the statement of stockholders’ (shareholders’) equity, the balance sheet which is sometimes called the statement of financial position, and the statement of cash flows in either the direct or indirect format.

Contrary to popular belief and what you are taught in most financial accounting courses, the four financial statements produced for the annual reports are actually only a small part of the total report made to shareholders and possible investors. Look around and find a favorite, large, publicly traded business. Then open up their homepage on the Internet. Look around the homepage for a title such as "Investors," "Investor Relations," or "Company." This is often at the bottom of the homepage, occasionally near the upper right in the main title bar. Dig through the various menu options to find the publicly released annual financial reports. They are often available for downloading as a PDF (Portable Data Format) file. You can also often locate SEC filings such as the 10-K report, the annual filing, or the 10-Q report, the quarterly filing. There are examples of the annual report to shareholders, 10-K, and 10-Q in the Class Support File. These reports are quite different from what you will find in most textbooks.

In most large companies the filing of SEC and annual shareholder reports is done with a cooperation between accounting and legal to minimize the likelihood and cost of mistakes. The annual report to shareholders is often glossy, printed in color, with lots of photos of activities and successes. The SEC filings are very generic and text based for data mining by analysts.

Tax Accountants

Tax accounting is rather complex, interesting, and rewarding of you are good at it. The issues are taxes are based on neither accrual or cash accounting but an accounting concept best referred to as "tax accounting" or "modified cash accounting." When you make a sale under financial accounting in 2015 and receive payment in 2016, it is income in 2015 and positive cash flow in 2016. For taxes it is reportable in 2015 but not taxable until cash is received in 2016 where it is also positive cash flow. Associated with this the financial statements may be using different inventory valuation concepts and depreciation methods than taxes. This creates income tax assets or liabilities for future periods. Tax accounting is fun and usually the subject of graduate level courses.

Accrual Accounting or Cash Accounting

Accrual Accounting

There are different methods or processes of accounting other than those already discussed. Accrual accounting is moving a lot of values and adjusting the presentation for the movement of value into, within, and out of the business. Most accounting is actually accrual accounting and income tax rules and regulations often drive it that way even for small businesses. This is because a business cannot, and should not, charge a current period with the massive cost of a piece of equipment which will render a value or a service to the business over the next five, ten, or forty years. This would damage one period's net income and add false enrichment to follow-on periods. And the IRS, regardless of sole proprietorship, partnership, or corporation is going to frown on major expenditures being classified as expenses. There are some special rules and these take part in tax accounting and cause financial and tax accounting differences – those assets and liabilities discussed in a previous section.

Cash Accounting

Cash accounting is encouraged for only a few businesses by the IRS or the SEC and then under special circumstances. Its rules are relatively simple and are based on your checkbook. If you receive it, it is revenue and taxable. If you spend it, it is an expense and a deduction from revenues to provide net income. Depending on other rules, you have not long-term fixed assets to depreciate since they are written off as expenses upon acquisition. You have no long-term debt as it recorded as an expense when payments are made. With these rules in place, you have no assets other than cash, no liabilities, and only owners' equity to balance out the cash. Lemonade stands are good cash accounting businesses for 10-year olds. Lawn mowing and snow shoveling are good cash accounting businesses for 15-year olds. Other than that, I am out of comments on cash accounting as it falsely states major issues with even the small lawn care businesses that own one lawnmower, several rakes, a trailer, a leaf blower, etc.

Myths of Accounting

The number one method of accounting is that you need to be a good mathematician to be a good accountant. You do need to know how to add, subtract, divide, and multiply as well as work with percentages to do basic accounting. You will have tools such as the calculator on your cell phone, an adding machine, or a spreadsheet or worksheet type program to help you out as well as the mathematical functions placed into the computerized accounting programs by the programmers. As an accountant you are most likely not going to have to find the volume of a cone with a slanted base or the surface area of a sphere. As a cost accountant you may have to find the square inches of a sheet of material and calculate the amount of material utilized to manufacture and assembly or part but this basically rests on simple math and basic geometry.

Another major method associated with accounting is that it is hard. In accounting 2+2 is always going to equal four and the answer is never going to vary by the color of the sunrise this morning in the East or by the ups and downs of Wall Street. If you purchase 50 items at two dollars each your cost is going to be $100. If you are entitled to a two dollar discount by rendering payment before January 15, 2015, on January 14, 2015, you only have to pay $98. No smoke, no magic, no hidden logic.

The last minute to be addressed at this time is going to be that there are a lot of unknowns and accounting. False. In the process of accounting there can be a no unknowns. You may have to compute and on identified, such as you owed the vendor $100 and you're only going to pay $98 where does the differential of two dollars go? But this is actually an easy answer if you understand the logic. And accounting is extremely logical. If Mr. Spock had not been the first officer of the USS Enterprise (NCC-1701) he would most likely been an accountant based on his logical evaluation of chaos and data. [As retired naval officer I've always wondered what these letters meant on the spaceship Enterprise so I finally looked them up, United Space Ship and Naval Construction Contract.]

How to Succeed in an Accounting Course

Being successful in an accounting course has the same requirements as most other courses. You need to read the material, and if you do not understand it, you need to read it again, and then ask questions. You need to understand the first element before moving onto the second element because accounting is very sequential in personal and professional development. The subject matter is cumulative in nature. What you learn on the first day will be used on every day that follows. What you learn on the second day requires a fundamental and operational knowledge of the material from the first day and will be used on the third day. And it continues for the rest of your accounting career. Life is the same way.

You need to appreciate that the most important student in the course is you. And if you have a question or an issue, you need to bring it up and get it resolved. You cannot success in the course or in life if you have an issue in the front of your mind blocking new information from entering and preventing already attained learning from being utilized to your benefit.

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