Introduction

This section provides an accounting primer to explain the basic concepts of accounting, its structure, standards and definitions. The need to review these concepts is greater now than ever. Please read this whole section before you begin editing your manual.
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Subject Matter Expertise

JOHN MCPEEK, CPA

John McPeek is a co-author of the *Complete Guide to a Business Policy & Procedure Manual*. Mr. McPeek was also a co-author in the development the *ISO 9000 Production & Documentation Manual*. Mr. McPeek has over 18 years of operational management experience with both start-up and larger businesses.

He started as a CPA with McGladrey & Pullen, LLP, a leading CPA firm serving middle-market businesses. He then moved on to a few start-up medical and dental manufacturing companies serving in various capacities as Corporate Controller, Vice President of Finance and Operations, and President. While in these positions, he was instrumental in establishing company wide organizational policies and procedures as well as implementing protocols for meeting Food & Drug Administration regulatory requirements for medical devices and Department of Defense contract requirements.

He is currently the President of ASI Medical, Inc. located in Englewood, Colorado and is personally responsible for the innovative design and manufacturing of their line of products. He is a graduate of Colorado State University holding a Bachelor of Science Degree in Business Administration.

BUD CARLSON, CPA

Bud Carlson brings together over 29 years of public accounting, retail and business management experience. Mr. Carlson has successfully worked both in finance, management and accounting.

As a business owner he managed his own company for six years before selling the business. As an accountant, he has spent nine years as a CPA and computer audit specialist at KMPG Peat Marwick auditing various retail and wholesale distributors including prominent SEC clients.

He has implemented numerous management reporting systems for a various small to mid-sized businesses. Mr. Carlson holds a Bachelor of Science in Business from the University of Denver and a Bachelor of Science in Accounting from Thomas College. He is an active member of AICPA.
JAMES SKELTON
James Skelton has been writing policy and procedures for over twenty years. He has personally authored manuals on topics from administration, operations, training, to employee handbooks, personnel, policy and procedures, and accounting.

He has attended professional courses in Resource Management and National Security Planning. He has an extensive background in management, administration and technical writing. He is also certified as a Professional in Human Resources through the Society for Human Resource Management.

He holds a Bachelor of Science Degree in Management and Organizational Development from the University of West Florida and a graduate level education in Systems Engineering, Systems Safety Management and Management Information Systems from the Naval Postgraduate School in Monterey, CA.

CHRISTOPHER ANDERSON, MBA
Chris Anderson has over 17 years of sales, marketing and business management experience working with small to large corporations. He served as President of a catalog, Internet and mail order company specializing in finance and investment analysis products. He served as Vice President at Arc Tangent, a direct mail marketing software publisher where he managed all operations, sales, and administration. Prior to Arc Tangent, Mr. Anderson managed North American distribution sales for Interactive Systems, a UNIX operating system developer and publisher.

He has worked as a marketing analyst as Nixdorf Computer Corporation, an electrical engineer for McDonnell Douglas Corporation developing missile simulation software for the US Navy as well as developing MIL-STD documentation. He served as a Lieutenant and Aeronautical Engineering Duty Officer for the US Navy working for the Naval Air System Command.

He is currently the Managing Director of 4expertise.com, Inc. He holds Master in Business Administration from Pepperdine University and a Bachelor of Science degree in Electrical Engineering from Southern Illinois University.
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Who Needs Accounting Policies and Procedures?
This introduction is an accounting primer to explain the basic concepts of accounting, its structure, standards and definitions. The need to review these concepts is greater now than ever. On one hand, popular accounting programs for small and mid-sized businesses have become more widely used than ever before, and on the other hand, industry consolidation has significantly reduced the accounting program choices to just a handful.

These choices are typically inexpensive, easy to implement, and come with little support to develop appropriate policies and procedures to ensure that the data generated by these programs is accurate and complete. Entry-level software like Quickbooks® and midlevel software like MAS-90 or Great Plains share this common deficiency. The "support" documentation is long on the explanation of user features and short on policy and procedural advice for appropriate use.

The Recent Past
Only twenty years ago, small to medium sized businesses faced daunting choices for selecting an accounting system. There were only three choices: Continue to use a full manual system (a comprehensive pegboard "one-write" system, employing many journals anchored to an imposing cloth bound general ledger book that rivaled the size of the largest Webster's Dictionary), purchase or lease a computerized accounting system, or build your own. The manual systems were not trivial. They were produced by major firms, which provided on-site implementation and training. These systems were well documented with many policies and procedures built into the regimented use of the "one-write" journals and corresponding ledgers.

An alternative decision was to purchase or lease an automated information system. But this required another decision of whether to buy a "ready made" product or build your own. To make this decision, the company would typically hire a consultant or CPA firm to perform a comprehensive "needs" analysis. The consultant would eventually select, either a commercially built multi-module accounting program (like Solomon, our Real World), or a programmer to develop the structure from custom code (RPG was a popular language used to create custom accounting programs).

Either one of these alternatives would have to run on a leased or purchased dedicated mini-computer system, (the IBM 36 was the popular mid-size business choice for many years). Both solutions required tremendous resources in time and money. Even the "ready made" solutions required plenty of additional programming to fit it into the specific company's needs. For a half a year or more, various consultants, programmers and specialists would write code, test and rewrite code.

In either case, documentation was paramount. Hence policies and procedures, as they applied to the mechanics of the accounting system were well documented as a by-product of the installation and implementation process. The total costs in the purchase or lease of the hardware and software (ready made or custom built), and in the company's own human resources, was staggering.
The Present
Imagine the months of decision making preparation, the months of development, the reams of documentation and the total costs that easily went from tens of thousands, to hundreds of thousands of dollars. Compare this to the present practice occurring throughout the country on a daily basis. The owner, or the owner's controller or other designee walks into a local retailer, picks up a copy of the most successfully marketed accounting software package, (ie: the one occupying the most prime and visible shelf space), drives back to the office, and loads the program on any available PC computer. There you have it: the decision making process, "needs" analysis, implementation and installation; all for the price of $299!

The future
The future begins today, with your purchase of this 4expertise™ Accounting Policies and Procedures Manual. This manual is needed more now than ever. Accounting systems are more accessible than ever before. Unfortunately, they come with no instructions. The user guide that comes with the accounting software only explains what the menu options do, it doesn't explain which options result in sound accounting practices.
Accounting software is looking more and more like your own internet browser home page, (no surprise since each manufacturer is competing to be your primary web portal). In the process, the actual functions of accounting are less obvious, and as a result, less understood.
This introduction is a look behind the scenes of the "splash screen". Hopefully, by understanding the concepts and consistent accounting rules utilized by all accounting software programs, you will develop more confidence to rely on the information generated by the program and you will be able to use it more effectively to run your company.

Accounting Basics

Three important terms that are easily confused:

- **Bookkeeping**
- **Accounting**
- **Reporting**

What are they and how do they interrelate?
Bookkeeping

Bookkeeping and accounting share two basic goals:

- To keep track of income and expenses, thereby improving The Company's ability to achieve profitability
- To collect the necessary financial information about The Company's business to file required reports and tax returns

Bookkeeping refers to the actual transactional entering and recording of data. Examples are writing checks, processing payroll, making deposits, recording disbursements and recording receipts.

Accounting

Accounting encompasses the broader responsibilities over developing and maintaining the accounting system under which bookkeeping functions are performed. Accounting is concerned with the timely and accurate recording of transactions, providing useful management information, and properly reporting such information for various user needs. Developing and maintaining an accounting system involves setting up and maintaining an appropriate chart of accounts for the particular business. Policies and procedures are then established to provide guidance for all possible financial transactions, from source documents (checks, sales orders, etc.), to journals (payroll journal, cash disbursement journal, invoice register, etc.), to the general ledger, (based on the chart of accounts), and ultimately to a variety of reports for all internal and external needs.

Bookkeeping and reporting can be thought of as the input and output of a complete accounting system. Accounting policies and procedures ensure

The integrity of the input data and
The accuracy and validity of the report output.
Reporting

Reporting, (the output of the data generated through various bookkeeping functions), is used for both internal and external purposes. Internal Reports are reports used within the company, by both management and other designated personnel. Internal reporting can be further divided into financial and non-financial data. Non-financial data includes a variety of measurement and productivity data, applicable to the specific business. These can be daily customer count, web page "hits", production activity per employee hour, units and total weight of product shipped, or even daily weather conditions.

Financial data

Examples of financial data reports include:

- **Financial statements** - Profit and loss reports (income statement), balance sheets and cash flow statements
- **Daily reports** with critical balances, such as, sales, cash level, inventory, accounts receivable and accounts payable
- **Segmented profit and loss reports** (or P/L) on specific jobs, profit centers or departments
- **Register reports**, listing all transactions for specific areas such as, payroll, checks, receipts, invoices, etc.
- **Listings** of source data files such as customer, employee, vendor and inventory lists.
- **Aging reports** for both Customers (accounts receivable or A/R) and Vendors (accounts payables or A/P)
- **Inventory reports** for costing and valuation
- **Exception reports** - open purchase orders, back orders, inventory stock outs.

External reports generated for the use of people or organizations outside of the business. Report data and format will vary depending on user:

- **Banks, lending institutions.** To observe the financial viability of a business and to determine its ability to support additional amounts and types of debt financing
- **Employees.** To determine the stability of the business of their employer - this may be useful in wage negotiations
- **Suppliers.** To assess the suitability of granting credit terms to a business
- **Existing and Potential Investors.** To assess the potential risk of investing in a business and to monitor the status of existing investment in a business
• **Public.** To gain more insight into any business, which is legally required to make certain financial information available

• **Government.** To fulfill the requirements of all applicable local, state and federal reporting statutes, including income, sales, insurance, property, and payroll tax returns

• **Media / Press.** To use available business reports in specific trade and business publications

**Components of an Accounting System**

The financial transactions of any accounting system can be grouped into four major transaction cycle groups: Revenue Cycle, Purchase Cycle, Payroll Cycle, and General Journal Cycle.

Transactions in the form of sales invoices, receipts, purchase invoices, checks and payroll entries are posted to the appropriate journals. Simultaneously, these postings are also recorded in the General Ledger. The General Ledger accumulates all transaction activity,
organized by account classification. Various reports, including financial statements can then be prepared from the data collected in the General Ledger. Corrections or necessary adjustments can be made to the General Ledger by creating adjusting journal entries, posted to the general journal.

The following outline on the next two pages provides more explanatory detail on these four cycles:

1. Revenue Cycle

   Order Entry
   Invoices entered through direct entry, through sales orders or through a point-of-sales system, (such as a cash register) are posted to the sales journal. These entries also accumulate on the accounts receivable ledger, organized by customer.
   If the business maintains an inventory, the posting of sales also affects the inventory ledger.
   Finally, all sales journal activity is also posted to the general ledger.

   Receipts / Deposits
   Receipts on sales and other bank deposits are posted to the cash receipts journal.
   Sales receipts information also accumulates on the accounts receivable ledger, organized by customer.
   These postings are also entered on the bank account ledger.
   Finally, all cash receipts journal activity is also posted to the general ledger.

   Accounts Receivable
   Accounts Receivable is a separate journal that records both sales and cash receipt data by customer.
   The data comes from the postings to the cash receipts journal and the sales invoice journal.

2. Purchase Cycle

   Purchase Orders / Purchasing
   Invoices entered through direct entry or through purchase orders are posted to the purchase journal.
   These entries also accumulate on the accounts payable ledger, organized by vendor.
   If the business maintains an inventory, the posting of purchases also affects the inventory ledger.
Finally, all purchase journal activity is also posted to the general ledger Cash Disbursements / Checks
Payments on account or for expenses are posted to the cash disbursement journal.
Payment on account information also accumulates on the accounts payable ledger, organized by vendor.
These postings are also entered on the bank account ledger.
Finally, all cash disbursement journal activity is also posted to the general ledger.

Accounts Payable
Accounts Payable is a separate journal that records both sales and cash receipt data by vendor.
The data comes from the postings to the cash disbursement journal and the purchase journal.

3. Payroll Cycle
Payroll data, by employee, for each payroll data is entered into the payroll journal.
These postings are also entered in the cash disbursements journal and the payroll ledger.
Finally, all payroll journal activity is also posted to the general ledger.

General Journal Cycle
Corrections or adjustments to the above major transaction cycles can be made through adjusting journal entries, posted directly to the General Ledger.
These are compiled in a separate journal, known as the General Journal.

How does posting work?
The specific postings, as outlined in the cycles above, do not necessarily take place as separate steps, especially in computerized environments. There are only two basic methods of posting in computerized accounting systems: real-time posting and batch posting.
In real-time posting, the source transaction, (check, bill, payment, receipt, etc.), is posted to the specific journal and any related subsidiary ledgers (accounts receivable, accounts payable, inventory, bank account, etc.), and is simultaneously posted to the general ledger.
In batch posting, the journals and subsidiary ledgers are posted, but entries are not yet posted to the general ledger. Posting these journals to the general ledger is done separately. Typically, a group of transactions is entered, a full day's worth, for example. Later, after the journals are reviewed for accuracy, this entire day's group, or "batch" is posted to the general ledger.
To understand this posting process better, it would be helpful to follow specific transactions through a sample company. First, however, we need to define various accounting terms and concepts.

**Accounting Terms and Concepts**

**Double-Entry Accounting**

We can justifiably thank the 14th century Italian merchants for developing the double-entry system of accounting that we still use today. It is widely believed that Benedetto Cotrugli was the first to document this concept of double-entry accounting. In 1458, he wrote *Delia Mercatura et del Mercante Perfetto (Of Trading and the Perfect Trader)*, which included a brief chapter describing many of the features of double entry accounting. Years later in 1494, Luca Pacioli, from San Sepulcro in medieval Tuscany, published The *Summa*’s 36 short chapters on bookkeeping, entitled "De Computis et Scripturis" ("Of Reckonings and Writings"), so that the subjects of the Duke of Urbino could learn how to conduct business and to provide the trader with a fast method to determine his assets and liabilities.

For centuries before, commercial transactions had been recorded and journalized, whether on paper, papyrus or clay tablets. However, these journals provided only totals of transaction groupings. It was the Italians that first recognized that it is impossible for a business transaction to occur without affecting at least TWO accounts. There can never be only one effect from a transaction.

An Italian farmer sells wood to a shipbuilder for 400 ducats. To account for this transaction he would record: wood sale - 400 ducats. His "sales" account has been increased by 400 ducats. But, what else has happened? What other account was affected? His "cash" account also increased by 400 ducats. What if he sells his wood to the shipbuilder on credit, and he receives no cash? In this case it's his "accounts receivable" account, which increased by 400 ducats.

There are always, at least two sides to each transaction.

Later, when the shipbuilder pays his debt to the farmer, the farmer records an increase in his cash and a decrease in his accounts receivable by 400 ducats, respectively. You can see that an integral feature of this double entry system is that the transactions must equal. At the time, this new method was heralded as an astounding discovery, and was described as: "a magic mirror in which the adept sees both himself and others."

Today, double entry bookkeeping is used as a method of recording a transaction in two or more different places or ledger accounts. This practice simplifies finding errors since the totals of both ledger accounts should agree.

**Debits = Credits**

Bookkeeping entries are divided into DEBITS and CREDITS. The DEBIT side is typically on the left of the ledger page and the CREDITS are placed on the right. The origin of the words "Debits" and "Credits" come from the simple concept: who owes you and whom do you owe.
DEBITS record transactions relating to purchases, expenses or increases in the assets of the organization. CREDITS record transactions relating to revenues or an increase in the equity and liabilities of the organization. Recording a transaction requires both a DEBIT and a CREDIT entry. If the entries have been correctly recorded, then the totals from both sides of the ledger should agree.

This method of double-entry bookkeeping, where we list debits on one side and credits on the other is marked by the absolute requirement that those two columns sum to zero. It's the basis for tracking all our vast financial affairs today.

The following list illustrates the effect of posting either a DEBIT or CREDIT entry on each major account type:

<table>
<thead>
<tr>
<th>Account Type</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Increases</td>
<td>Decreases</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Decreases</td>
<td>Increases</td>
</tr>
<tr>
<td>Owners Equity</td>
<td>Decreases</td>
<td>Increases</td>
</tr>
<tr>
<td>Income</td>
<td>Decreases</td>
<td>Increases</td>
</tr>
<tr>
<td>Expenses</td>
<td>Increases</td>
<td>Decreases</td>
</tr>
</tbody>
</table>

These account types are the general account classifications used in all accounting systems. They are also used to organize the general ledger, from which financial statements are developed.

An expansion of these account types is outlined below.

**Basic Accounting Structure**

**Balance sheet**

Contains accounts whose value is determined at a specific point in time

**Assets** - accounts with value that you own

- **Cash** - the amount on hand or in the bank at a specific point in time
- **Accounts Receivable** - how much people owe you
- **Inventory** - the value of business merchandise for sale
- **Fixed Assets** - the value of property and equipment

**Liabilities** - accounts with value that you owe to others

- **Accounts Payable** - how much you owe others for unpaid purchases
- **Debt** - how much you owe others for money borrowed
- **Other Liabilities** - services or money owed to others

**Equity**

- **Contributed Capital** - money invested in business by ownership
- **Distributions** - dividends and other types of money paid out to ownership
- **Capital Stock** - money invested in exchange for company ownership
- **Retained Earnings** - earnings retained in business from net profits

**Income Statement**

Contains accounts whose value is determined over a period of time (day, week, month, year, etc).

- **Income**: total sales and income recorded over a period time
- **Expenses**: total purchases and other expenses recorded over a period of time

**Basic Accounting Formula:**

All transactions are posted to one or more of these accounts. As discussed earlier, every posted transaction must balance. That is, debits must equal credits. Furthermore, the result of every posting, if done correctly, will never put the Basic Accounting Formula out of balance. All asset accounts will always equal the total of all liability and owner equity accounts. If this formula is ever out of balance, the cause will always be an incorrect transaction posting where debits did not equal credits.

Assets include those accounts, which give value to the company: cash, accounts receivable, inventory, property, etc. Liabilities are those accounts which reduce the company's value: accounts payable, debt, and other liabilities. If total assets are greater than liabilities, then this **net value** (that is, the total of all assets minus liabilities) represents the true value of the business, otherwise known as its **Equity**. Hence, the Basic Accounting Formula can be expressed and equally understood in these two ways:

\[
\text{Assets} = \text{Liabilities} + \text{Equity}
\]

or

\[
\text{Assets} - \text{Liabilities} = \text{Equity}
\]

If the company's assets are less than its liabilities, then it will necessarily show a negative equity. This makes intuitive sense to anyone following the business in bankruptcy. When a business owes more than it has in value, the resulting negative equity is an obvious warning sign.

The equity accounts include owner's contributions, distributions, and retained earnings. Retained earnings operate in a manner unique to all other accounts. It contains the net effect of postings to all income and expense accounts. It is truly the one account, which links the balance sheet accounts (assets, liabilities and owner's equity) with the income and expense accounts.
Understanding the importance of retained earnings, the Basic Accounting Equation could be expanded thus:

\[
\text{Investor and owner contributions,} \\
\text{and distributions} \\
\text{Retained Earnings}
\]

\[
\text{ASSETS} = \text{LIABILITIES} + (\text{OWNER'S EQUITY ACCOUNTS} + \text{INCOME} - \text{EXPENSE})
\]

\[
\text{EQUITY}
\]

The following illustrates the interrelationship of these accounts:

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Assets</td>
</tr>
<tr>
<td>Expenses</td>
<td>Liabilities</td>
</tr>
<tr>
<td>Net Income</td>
<td>Owner's Equity</td>
</tr>
<tr>
<td></td>
<td>Retained Earnings</td>
</tr>
</tbody>
</table>

When a transaction, like writing a check or paying a bill, is executed in an accounting program, the software is designed to take this transaction event and create the proper and necessary debit and credit entries to record the effects of the transaction in the appropriate journals and general ledger accounts.
SUMMARY OF ACCOUNTING CYCLES & ACCOUNTING CONCEPTS CASE STUDY

Slick Switch Co. - Example Company

Now that the accounting terms and concepts have been defined and explained and the accounting cycles have been presented, it's time to put it all together.

Regardless of the cycle, specific transactions are posted through journals and into the general ledger in a similar fashion.

When a transaction is posted in the computer, a journal entry is automatically created along with any necessary entry to subsidiary ledgers. Subsidiary ledgers are specific lists of detail transactions. For example, the Accounts Receivable ledger organizes all invoice and cash receipt transactions by customer. Likewise, the Inventory ledger organizes all purchase and sale transactions by inventory item.

In real-time posting system, the journal entries are also, simultaneously posted to the applicable general ledger account. The general ledger contains all transaction postings, classified by account. The accounts are organized in the same manner as balance sheet and income statement financial statements. The order of accounts starts with the asset accounts, then the liability accounts, then the equity accounts, and finally, the income and expense accounts. All forms of financial statements can be generated from the general ledger. Financial statements are simply a reporting component of any accounting program.

To better understand the complete process of double entry accounting through the accounting cycle process, the following pages diagram purchase and revenue cycle transactions, from purchase of merchandise to sales invoice and final collection on the sale, for the company, Slick Switch Co. We shall also assume that this business utilizes an inventory module to track inventory.
SLICK SWITCH, CO - PURCHASE CYCLE EXAMPLE

PURCHASE TRANSACTION

A purchase invoice is entered into the computer, when product is purchased and the bill is received from vendor.

The computer makes the following postings simultaneously:

Several posting events happen automatically as a result of a single purchase entry in the computer. The purchase journal is updated to add this transaction, the inventory subsidiary ledger has an additional 10 switches added, at a cost of $60 each, and the accounts payable subsidiary ledger has an additional invoice of $600 included with Vendor: SS Supply, Inc. If this is a real-time posting system, the general ledger is also updated to reflect both the inventory and the accounts payable increase. Notice, that there is no expense recorded at this time. The value of the inventory has increased by $600, but the company has not recorded any expense. Only
when product is sold, will the cost of the product be expensed. This reflects a very important **matching** concept in accounting. The cost of the product is matched to the related sale, at the time of sale, not at the time it is purchased and added to inventory.

**SLICK SWITCH, CO - REVENUE CYCLE EXAMPLE**

A sales order is entered into the computer, and a sales invoice is printed. The computer makes the following postings **simultaneously**:

Notice how many postings are occurring from just one sales invoice. The bookkeeper enters a single invoice and the computer automatically posts journals, subsidiary ledgers and the general ledger, simultaneously. To the bookkeeper it might seem like a single entry is being made (1 switch @ $100.00). However, behind the scenes, the computer program is judiciously posting double entries for each transaction, ensuring that all debits and credits equal.
On the debit side, a receivable of $107.00 is recorded. On the credit side, a sale of $100.00 is recorded and a payable to the state for sales tax of $7.00 is recorded.

Notice that the program is now recording an expense of $60, representing the cost of the product sold. Simultaneously, it is reducing the inventory asset account by $60. In the end, all debits and credits are equal.

**SLICK SWITCH, CO - FINANCIAL STATEMENT REPORT #1**

Before posting any more transactions, let's produce financial statements based on the activity recorded so far. Remember that financial statements are one of many types of reports that can be prepared from the data compiled in the general ledger.

The Balance Sheet and Income Statement would look like this:

<table>
<thead>
<tr>
<th>Slick Switch Company</th>
<th>Slick Switch Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td>Assets</td>
<td>Income</td>
</tr>
<tr>
<td>Cash</td>
<td>Sales</td>
</tr>
<tr>
<td></td>
<td>100</td>
</tr>
<tr>
<td>Accts Rec</td>
<td>Total Income</td>
</tr>
<tr>
<td></td>
<td>100</td>
</tr>
<tr>
<td>Inventory</td>
<td>Expenses</td>
</tr>
<tr>
<td></td>
<td>Cost of Sales</td>
</tr>
<tr>
<td></td>
<td>60</td>
</tr>
<tr>
<td>Total Assets</td>
<td>Total Expenses</td>
</tr>
<tr>
<td></td>
<td>60</td>
</tr>
<tr>
<td>Liabilities &amp; Equity</td>
<td></td>
</tr>
<tr>
<td>Accts Pay</td>
<td>Net Income</td>
</tr>
<tr>
<td></td>
<td>$ 40</td>
</tr>
<tr>
<td>Sales Tax Pay</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained Earn.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Liab /Equity</td>
<td></td>
</tr>
<tr>
<td></td>
<td>647 $</td>
</tr>
</tbody>
</table>

Slick Switch Co. shows total assets of $647 and total liabilities of $607. Using the Basic Accounting Formula, this means that Slick Switch Co. has a positive equity (or net worth) of $40. Note that the retained earnings (equity) of $40 is indeed equal to the earnings recorded on the income statement. This illustrates the relationship between these two statements.

Notice that the financial statements show a profit of $40, even though no actual cash was either spent or deposited. So far, no money has changed hands. Slick Switch bought its inventory and credit and also extended credit to its customer.

We will now add two more transactions to Slick Switch and see what the effect will be on the financial statements. The following examples will illustrate the payment of Slick Switch's bill to SS Supply, Inc. and the deposit of money received from AAA, Inc. on the open invoice.
SLICK SWITCH, CO - PURCHASE CYCLE EXAMPLE
CASH DISBURSEMENT TRANSACTION

A payment is entered into the computer and a check is printed, made out to SS Supply, Inc. for $600.

The computer makes the following postings simultaneously:

<table>
<thead>
<tr>
<th>General Ledger</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$600.00</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
<td>$600.00</td>
</tr>
<tr>
<td>Sales Tax Payable</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The bookkeeper simply records the payment and prints out the check. The accounting program automatically reduces cash for the check written and reduces accounts payable for the payment of the $600 bill owed to SS Supply, Inc.
A cash receipt is entered into the computer and a deposit is made to the bank for $107 received from AAA, Inc.

The computer makes the following postings simultaneously:

The bookkeeper simply records the payment received and deposits the money in the company's bank account. The accounting program automatically increases cash for the amount deposited and reduces accounts receivable for the payment of the $107 invoice owed from AAA, Inc.
the financial statements.
The Balance Sheet and Income Statement would now look like this:

<table>
<thead>
<tr>
<th>Slick Switch Company</th>
<th>Slick Switch Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
<td><strong>Income Statement</strong></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(493)</td>
</tr>
<tr>
<td>Accts Rec</td>
<td>-</td>
</tr>
<tr>
<td>Inventory</td>
<td>540</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$ 47</td>
</tr>
<tr>
<td><strong>Liabilities &amp; Equity</strong></td>
<td></td>
</tr>
<tr>
<td>Accts Pay</td>
<td>-</td>
</tr>
<tr>
<td>Sales Tax Pay</td>
<td>7</td>
</tr>
<tr>
<td>Retained Earn.</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total Liab /Equity</strong></td>
<td>47 $</td>
</tr>
</tbody>
</table>

**Income**

<table>
<thead>
<tr>
<th>Sales</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Income</td>
<td>100</td>
</tr>
</tbody>
</table>

**Expenses**

<table>
<thead>
<tr>
<th>Cost of Sales</th>
<th>60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Expenses</td>
<td>60</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$ 40</td>
</tr>
</tbody>
</table>

The most noticeable feature of these statements is the negative cash balance of $493. Naturally, it would be difficult to overdraw this amount. As a practical matter, this company would have started its business with a certain amount in its bank account, as a beginning equity contribution by the owner. Still, this example accurately illustrates the fact that a company's cash position can change significantly, even when its earnings don't change at all. Notice that the earnings are the same as in the first example. This is a good example of the most common complaint voiced by business owners as they try to understand their own financial statements. "How can my income statement show that I'm making a profit, when I have no cash?!" Most business owners have encountered this situation, which proves the maxim:

"Cash, not profits, drives a business."

In Slick Switch's example, although a nice profit was earned on the $100 sale, the investment in inventory is consuming more cash than the company has. To remain solvent it must either borrow or inject additional working capital funds from the owner or other investors. A growing company is rarely be able to fund its growth on profits, alone. It will generally need some working capital, from either equity or debt to provide enough cash to transact business.

This dramatically demonstrates the need for a third type of financial statement: Statement of Changes in Financial Position. This is a third statement, generally included with the Balance Sheet and the Income Statement, as a necessary part of a complete financial report.

There are several ways to produce this, which are beyond the scope of this Accounting Introduction. Suffice it to say that this statement is designed to
inform the reader of all the transactions that affected cash. It helps to answer the
question;

"If I'm making a profit, where's my cash?"

Below is an example of an abbreviated Statement of Changes in Financial
Position based on the Slick Switch, Co. example.

<table>
<thead>
<tr>
<th>Slick Switch Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Changes in Financial Position</td>
</tr>
<tr>
<td>Sources of Cash</td>
</tr>
<tr>
<td>Net Earnings</td>
</tr>
<tr>
<td>Increase in Sales Tax Payable</td>
</tr>
<tr>
<td>Uses of Cash</td>
</tr>
<tr>
<td>Increase in Inventory</td>
</tr>
<tr>
<td>Net Change in Financial Position</td>
</tr>
</tbody>
</table>

This ending number agrees with the change in cash. For many businesses, the changes
that occur to cash are the most critical factors in its strategic planning. The Statement of
Changes in Financial Position is helpful in this effort. However, all three financial
statements should be used and referred to equally.

**Accounting Structure - Accounting Software Programs**

A final word concerning accounting structure is needed, here. While it is helpful to understand
the accounting structure in terms of its four basic cycles (revenue, purchasing, payroll and
general), and its implementation in terms of the double-entry, debit and credit system, most
accounting programs are not organized in the same manner.

To navigate more easily in any accounting software it is important to understand the basic
organizational structure that is common to all accounting software. In spite of all the ancillary
menu options and all the different terms used by competing software products, there are really
only three major components of any accounting software package: Input, Output, and
Maintenance.

Input refers to all of the "bookkeeping" tasks of all four accounting cycles. This includes
entering invoices, checks, bills, payments, payroll and adjusting entries. Each accounting
software may "disguise" this input function under different names: "tasks" or "activities", or it
may include specific input functions separately under each cycle area, or it may simply provide
icon pictures of activities to be clicked on. Regardless of the specialized "look" of the program,
the most important and most heavily used routine in any accounting software is data input.

Output refers to all of the reporting functions of the program. Once transactional data has been
entered, the only usefulness in having it entered is the ability to retrieve it in a variety of report
formats. Generally, these reporting options are found grouped together
under one menu, not surprisingly labeled, "reports"! However, with some programs, they are scattered throughout the menus as appendages to each major cycle activity. Maintenance can be broken down into two sub-categories: utility maintenance and data file maintenance. Utility maintenance refers to overall utility features like backup, restore, import and export data, fiscal year close, purge or condense data and repair data. These are all usually found on one menu and are generally placed under administrative password control to prevent unwanted casual use. Data file maintenance does require data input, but the input is not transactional. This refers to the creation and maintenance of the chart of accounts (in support of the general ledger), the customer list, vendor list, inventory list and employee list. These are generally found in one area usually labeled "maintain" or "lists". In other programs they may be separated and found within each module (i.e.: customer list in the accounts receivable module or revenue cycle). Understanding how your own accounting software works, (where its input, output and maintenance functions are and how the four accounting cycles are organized), is as important as understanding the actual double entry accounting that is occurring "behind the scenes". As you will discover throughout the Accounting Policies and Procedures Manual, you need to know how the numbers have developed and where they came from, in order to establish effective policies and procedures to insure their integrity, accuracy and completeness.

**Accounting Methods**

**Accrual Method**

The accounting method used in the Slick Switch Company example is called the accrual method, defined as the method of keeping accounts which shows expenses incurred and income earned for a given period, although such expenses and income may not have been actually paid or received in cash. Hence, the financial statements of Slick Switch Co. show revenues and expenses, even before any such revenues or expenses are paid.

The accrual method is the more acceptable and the more widely used because it correctly matches the earning process to the activity. In other words, revenue is recorded when services or goods are rendered or shipped, regardless of when paid.

**Cash Method**

The cash method of accounting is familiar to most individuals since personal income tax returns are filed on the cash basis. As the name implies, revenues and expenses are only recorded when the consideration paid actually changes hands. This could be months after the actual event occurred.

Many small business owners prefer the cash basis due to its simplicity and ease of understanding. At the end of any given period, the recorded net income will agree more closely to the change in the business's cash balance. However, when requesting financing from any bank or agency, business owners are generally asked to furnish financial statements, prepared on the accrual basis. Clearly any "stakeholders" want to see the true effect on the financial statements of activities, as they occur, as opposed to when they are paid.
Many small businesses (under $1,000,000 in sales) are allowed to use the cash basis method for filing business tax returns, even if the business keeps its books on the accrual basis. In a growing business, income taxes can be deferred for a year for revenues recorded from increases in accounts receivables.

**Percentage of Completion Method**

The percentage of completion method is a variant of the accrual method, used for businesses with long term contracts, primarily construction contractors. Instead of valuing revenues based on services invoiced, contractors will adjust the revenue billed to agree with the estimated percentage of the total contract that has been completed to date.

**Reporting Standards**

Many transactions are entered routinely through the accounting system without much concern about reporting standards. However, other transactions can be handled in different ways depending on a person's judgment over the facts and circumstances. For example, if a business decides to lease an expensive piece of machinery, how should the lease payments be recorded? Perhaps they should be simply charged to lease expense. However, maybe the terms of the lease imply an obligation and the payments represent a payoff of that obligation. In that case, a portion of the payment should be applied to the debt and the other portion charged to interest expense.

The resulting financial statements would look different in those two cases. The usefulness of financial statements would be severely limited if their presentation was based solely upon the preparer's judgment. Consequently, certain standards must be agreed upon and followed.

**GAAP - Generally Accepted Accounting Principles**

There was no commonly agreed upon standardization over accounting practices until after the great depression of 1933. In response to the vast sums lost by investors in the stock market crash, the Securities and Exchange Commission (SEC) was established and given authority to set accounting standards for publicly held corporations. In an effort to stave off further government regulation, the accounting profession, organized under the American Institute of Certified Public Accountants (AICPA), issued its first auditing standards in 1939. This began its attempt at self-regulation, though the AICPA continues to work with the SEC and defers to the SEC on regulatory reporting requirements for publicly held companies.

Between then and 1959 the AICPA issued 51 authoritative pronouncements known as Accounting Research Bulletins (ARB) that formed the basis of what became known as generally accepted accounting principles (GAAP). From 1959 to 1973 the Accounting Principles Board (APB) issued 31 additional standards.

In 1973 a new full-time independent body, separate from the AICPA was created, called the Financial Accounting Standards Board (FASB). This board has issued over 147 Statements of Standards by the end of 2002. These standards, along with official interpretations, Accounting Research Bulletins (ARB), previously issued pronouncements, SEC rulings, industry guides, and other exposure drafts make up the current basket of generally accepted accounting principles.
The Matching Principle
Woven through all of the GAAP pronouncements are several universal principles. One is the concept of matching. Accrual and percentage of completion methods represent attempts to more properly match the financial statement presentation to the actual transactions that have occurred. Revenues are matched to services performed and product sold, and expenses are matched to activities that have incurred expenses. This is why accrual based reporting conforms to GAAP and cash based reporting does not. The matching principle is a keystone of generally accepted accounting practice.

Conformity
Conformity is another widely used concept in accounting. The method of implementing percentage of completion, for example, should be the same for all companies. Only by practicing conformity will there be comparability. Investors, lenders and business owners, could not properly evaluate the success of a particular business as compared to the rest of its industry, if all businesses used different methods for recording transactions. Conformity is another fundamental principle in GAAP.

Valuation
A common consensus in GAAP reporting is the agreement that financial statements are valued on an historical basis. This is an important concept that provides for consistent conformity. As an example, real estate is valued at its original cost, not what it might be worth on an appraised value.
Accounting board pronouncements have continued to modify this principle to make financial reports even more conservative than historical basis, by requiring a downward adjustment, if the potential selling value has fallen below the original cost.
An example is inventory, when obsolescence reduces its value below its original cost. Another example is the yearly devaluing of fixed assets through depreciation. Each year the original cost of a building or equipment is lowered by writing off a portion of its expected life and expensing it to depreciation. Other assets like accounts receivable are reviewed and written down to their expected realizable value by charging off any amount deemed uncollectible to bad debt expense.
The overall attempt is to present financial statements on the most conservative basis possible. The objective is to ensure that the net worth recorded on a company's financial statements is never more than the true value of a company, based upon the lower of historical cost or the expected realized selling price of its assets minus its liabilities.
Events in the early years of the 2000's have shown how important this objective is. In spite of all the GAAP pronouncements in place, "creative accounting" techniques that push the gray areas of accounting valuation issues have resulted in significant, previously undisclosed impairments to the financial statements of companies like Tyco, Enron, and WorldCom.

Inventory Valuation
Inventory valuation is a specially treated area that deserves specific mention. Inventory is always valued at the lower or cost or market (realizable value, net of selling costs). However, cost can be determined in three different ways.
First In - First Out (FIFO) values the cost of inventory based on the principle that the first item purchased is the first item to be sold. Visually, this method mimics a store owner's method of stocking shelves by putting its most recent purchases at the back of the shelf, so that the older product is sold first. Hence, the value of the amount of inventory on hand, always represents the cost of the very latest purchases. In a true FIFO valuation, each purchase is tracked as a separate layer with its own cost. Sales are also tracked and taken from one or more specific layers.

A variant on the FIFO method is the Average Cost FIFO method, which eliminates the need to keep track of separate purchasing layers. The cost of each new purchase is added to the "pool" which changes the overall cost of the "pool". Sales are then taken from this single "pool", leaving a value of the inventory on hand that closely resembles, but not necessarily equals, the value of inventory on a true FIFO method.

A final method of valuation is based on Last In - First Out (LIFO). This is the opposite of FIFO: the last items purchased are deemed to be the first items sold. This means that the ending inventory value is comprised of the very first items purchased. This value could be lower than the FIFO value, particularly in inflationary times.

One might ask how two opposing methods of valuation could both be allowed under GAAP, particularly, when this would seem to violate the important principle of conformity. This is one of many good examples of the challenge to create a consensus of opinion when there are several options, which have equal justification and support. Accounting principles are not static laws handed down from the mountaintop, hence the term, "generally accepted".

In this case, there is current justification and support for either method. In deference to conformity, GAAP provides that financial statements valuing inventory on LIFO are to include a footnote reference, which discloses the valuation difference between LIFO and FIFO. This is one of many compromises that provide conformity over different methods of valuation.

Materiality

A final important concept in all of GAAP is materiality. Surprisingly, coming from a group of professionals known for their penchant for chasing down pennies, every pronouncement contains a materiality clause that allows for non-compliance in any area, if the effect on the financial statement presentation is clearly immaterial. In other words, if the effect is minimal or does not represent a significant change in the financial position of the account then it might be considered immaterial.

Types of Reports

The reporting standards discussed above may not really affect many small and mid-size owners, if their reporting needs are primarily internal. However, it does help to understand the rationale for those standards. These standards trigger the most basic questions that must be answered in setting up an accounting system: cash or accrual? Or, FIFO or LIFO?
External Reports
External reports were discussed briefly in the early part of this introduction, in terms of the "audience" or specific users for company information. Generally, one of the more important users is the Internal Revenue Service (IRS) and various state and local taxing authorities. Required income tax returns can be prepared more easily from financial reports that are classified in a comparable manner. A tax practitioner is usually retained to prepare and file these returns. The report most commonly requested of the company is the general ledger and related financial statements.

The second most likely external user for a company's financial statements is a bank or other debt or equity institution. The financial institution may well dictate the report needed. Copies of tax returns and company prepared financial statements may be all that is required. On the other hand, the financial institution may require a higher level of assurance by requesting that an independent accounting firm either compiles, reviews, or audits the financial statements of the company.

In this case, the company might want to know what is required and the difference between these types of reports. First of all, only Certified Public Accountants (CPA) that meet a higher level peer review and other reporting standards, can issue these statements. A public accountant (PA), tax practitioner, or an accountant who is not a licensed CPA cannot issue such statements. Even a fully licensed CPA must keep their license current with continuing education and documented peer review to be able to issue opinions on these reports.

Compilation
A business owner will need to find a CPA with the necessary credentials to request a compilation, review or audit. The least expensive report, and one that should satisfy most banks for small and mid-sized business, is a compilation. Essentially, the CPA reviews the financial statements prepared by the company and attaches an accountant's report to it. No further investigation is performed.
Interestingly, the standard compilation report issued by a CPA is nothing more than a glorified disclaimer, stating that the CPA is providing no financial statement assurance. The AICPA defines a compilation as "a service where the accountant presents, in the form of financial statements, information that is the representation of the company's management and owners without undertaking to express assurance on the financial statements."

Review
A review involves essentially the same process as a compilation except that the auditor does perform certain analytical reviews: reviewing account balances for reasonableness, and questioning management about material modifications that might be made in order for the statements to be in conformity with GAAP. In a review report the CPA expresses a "limited assurance", (but not an opinion), about the reasonableness of the financial statements and their conformity to a comprehensive basis of accounting like GAAP, cash basis or income tax basis reporting.
Audit
An audit provides the highest level of financial statement assurance. An audit may take considerably more time than either a compilation or review. The audit work, itself, can fill several large binders of documentation for a small to medium size business.

Every balance sheet account is proven, within the limits of materiality. Direct confirmations of account balances are mailed from the CPA to banks, customers, vendors, and other debt holders to validate the balances of cash, accounts receivable, accounts payable, and other assets and liabilities. If inventory is material, the CPA must observe the inventory counting as of the report date. The CPA also tests the accounting procedures and internal controls, including computer controls. All transactions are subject to audit under a statistical sampling formula.

A surprisingly large amount of time is spent in non-financial areas to determine any claims, lawsuits, contingencies or other events that could harm the company. Incorporation and other organizational papers are reviewed, all leases, loan documents and other contracts are reviewed, and all minutes and other relevant correspondence is read. The CPA also sends letters to all attorneys asking for full disclosure on any relevant matter.

The AICPA defines an audit as an engagement where a CPA provides an opinion about the fairness of a financial statement presentation in accordance with a comprehensive basis of accounting such as: GAAP, cash basis or income tax basis. This is a fairly simple statement for what can easily involve weeks of work for even a relatively wellstructured small business.

It's important to recognize the relative costs of these three types of reports. If the cost of an audit is $12,000, a review for the same business might average $4,000, and a compilation, $3,000. Relative to an audit, a review and compilation are considerably less expensive.

However, the difference in cost between a review and compilation is not nearly as great. This is important to remember if faced with a requirement from a lender or investor. If they request an audit, you might try to convince them that a review is adequate and certainly provides more assurance than a compilation. This could save you considerable expense.

SEC - Audit
For publicly held companies, an audit is the minimum level of assurance required. In addition to the audit, there are other SEC reporting requirements, depending on the size of the business. A full explanation of these SEC reports is beyond the scope of this introduction.

Internal Reports
Internal reports were discussed earlier in this introduction. Much emphasis has been given to financial statement reports; the balance sheet, income statement, and statement of cash flows. These three are the most important reports on the overall financial condition of the company over a given period of time. A primary objective in developing policies and procedures over the accounting function is to improve the timeliness, accuracy and completeness of these statements.
A company's accounting or information system can provide much more than those three statements, however. Management should be encouraged to use the data available in the accounting system for other uses. Financial statements are extremely useful, however, they only provide current valuation, and transactional information from the past.

A statement of cash flow, reconciling the sources and uses of cash, can be a useful starting point for extrapolating data that projects the anticipated sources and uses of cash needed into the future. By analyzing the changes in the agings of accounts receivable and accounts payable, estimates can be developed to anticipate future cash receipts and future cash payments. The relationship between sales, inventory levels and related cost of sales can be used to determine the anticipated needs for additional inventory related to projected sales. Using the data captured by the accounting system every day, a projected cash flow report, updated daily, can be a powerful tool to alert management in enough time to properly react to anticipated additional working capital requirements.

With a powerful forward-looking cash management tool, like the described projected cash flow report, the projected activity levels in future months can be used to create budgets in the current and succeeding months.

With income statement projections, projected cash flow reports and budgets we have a truly interactive management information system. Data collected from the past is used to project the future, fed back into the budgets, which control the present and determine the future. This creates a continually updated management information loop. This provides a business with the tools to act, not just react.

**SUMMARY**

We hope this introduction to your 4expertise™ Accounting Policies and Procedures manual will increase your appreciation of the importance of establishing effective accounting procedures. Your business is a continuous flowing stream of transactions. Like a net cast across the stream, effective accounting policies and procedures will help trap all of the data; completely and accurately. Once collected, the real benefit is utilizing the data to provide the information needed to review the past, position the present and chart the future.
Call 800-221-3104 toll free (US & Canada)
or
email: info@4expertise.com to ask questions or order.

Can also be ordered at http://www.4expertise.com/ the shopping cart Store of Hard-to-Find Business Tools with over 2000 downloadable forms, templates, software, manuals, job descriptions, game bird books, dental SOPs, e-books, free gifts, free-form software, medical tools, consulting tools, marketing tools, wills, living wills, advanced directives, and much more. We accept all major credit cards and ship internationally. All products have a 30-day money back guarantee.