

Understanding Basic Accounting

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Abstract

This course describes in detail the different accounting entities, the different methods of accounting, the Profit and Loss Statement, and the Income Statement. This course further describes ways in which the Income and the Profit and Loss Statements can be used to evaluate your practice.

Learning Objectives

1. To understand what the different accounting entities are
2. To understand the different methods of accounting
3. To understand how to read evaluate an Income Statement and a Profit and Loss Statement
4. To understand how to assess the health of your practice by looking at those statements

Outline

1. **Introduction**
 - a. **Accounting Entities**
 - b. **Method of Accounting**
 - c. **Debits vs. Credits**
 - d. **Dual Entry Accounting**
 - e. **General Ledger**
 - f. **Chart of Accounts**
 - g. **Balance Sheet**
 - h. **Income Statement (P & L)**
2. **Accounting Entities**
 - a. **Sole Proprietorship**
 - b. **Partnerships**
 1. **LLC**
 2. **Corporation**
 - a. **"S" Corporation**
 - b. **"C" Corporation**
 - ii. **Limited Liability Company (LLC)**
 - iii. **"S" Corporation**
 - iv. **"C" Corporation**
3. **Method of Accounting**
 - a. **"Cash-Basis" Accounting**
 - i. **Record ("book") expenses when you actually pay an expense and revenues when the money is actually received**
 - ii. **Used by small businesses, especially by sole proprietorships**
 - iii. **Expenses and revenues are not matched on a month-to-month basis**

- iv. Easy to use
 - b. “Accrual Basis” Accounting
 - i. Expenses and revenues are booked when they are transacted
 - ii. Matches expenses and revenues on a month-to-month basis
 - iii. “Generally Accepted Accounting Principles” (GAAP) demand accrual basis accounting for all incorporated entities. HOWEVER, the IRS does not require this for some smaller corporate entities
 - c. You must use the same method year-after-year.
 - d. If you do decide to change, then you will take a big tax hit during the year in which you change methods
- 4. Dual-Entry Accounting
- 5. General Ledger
 - a. Detailed listing of activity in the various vendor accounts
 - b. Every transaction of your business will be booked into your General Ledger
 - c. Divided according to financial account
- 6. Chart of Accounts
 - a. A division of all of your business accounts into groups that have the same affect on your business
 - b. Five basic accounts
 - i. “Asset Accounts”
 - ii. “Liability Accounts”
 - iii. “Equity Accounts”
 - iv. “Revenue Accounts”
 - v. “Expense Accounts”
 - c. The Chart of Accounts is, by convention, divided into account numbers
 - i. Asset Accounts have a range of 1000—1999
 - ii. Liability Accounts have a range of 2000—2999
 - iii. Equity Accounts have a range of 3000—3999
 - iv. Revenue Accounts have a range of 4000—4999
 - v. Expense Accounts have a range of 5000—6999
- 7. Chart of Accounts: Asset Accounts
 - a. Tangible Asset: “Things of value that you can hold in your hand”
 - b. Intangible Asset: “Things of value that are ephemeral and hard to measure”
 - c. “Short Term” (Less than twelve months)
 - d. “Long Term” (Greater than twelve months)
 - e. Short-Term Tangible Assets
 - i. “Cash on Deposit”
 - ii. Operating Accounts
 - iii. Savings Accounts
 - iv. “Cash on Hand”
 - v. “Accounts Receivable”
 - vi. Only used by companies using the “Accrual Method” of Accounting
 - vii. “Inventory”
 - f. Long-Term Tangible Assets
 - i. Land
 - ii. “Improvements” (Buildings)
 - iii. Accumulated Depreciation
 - iv. Leasehold Improvements
 - v. Vehicles

- vi. Service Value
- vii. Depreciation
- viii. Furniture and Fixtures
- ix. Equipment
- g. Intangible Assets
 - i. "Goodwill" (The value of a business purchased by another business that is over and above the assets minus the liabilities)
 - ii. Customer Loyalty
 - iii. Location
 - iv. Qualified Workforce
 - v. Telephone Number
 - vi. Intellectual Properties
 - vii. Patents
 - viii. Copyrights
 - ix. Exclusive rights
- 8. Finite Value Accounting
 - a. Depreciation
 - b. Accumulated
 - c. Accelerated (Section 179 Deduction)
 - d. Amortization
- 9. Service Life
- 10. Chart of Accounts: Liability Accounts
 - a. Current Liabilities
 - i. Accounts Payable
 - ii. Sales Tax
 - iii. Accrued Payroll Taxes
 - b. Long-term Liabilities
 - i. Loans Payable
 - ii. Mortgage
 - iii. Loans
 - iv. Bonds Payable
- 11. Chart of Accounts: Equity Accounts
 - a. Stock
 - b. Common
 - c. Preferred
- 12. Retained Earnings
- 13. Chart of Accounts: Revenue Accounts
 - a. Revenue
 - b. Sales
 - c. Services
 - d. Materials
 - e. Discounts
 - f. True Discounts
 - g. Credit Card Payments
 - h. Sales Returns and Allowances
 - i. Cost of Goods Sold
 - j. Purchases
 - k. Purchase Discounts
 - l. Purchase Returns and Allowances

- m. Delivery Costs
- 14. Chart of Accounts: Expense Accounts
 - a. Operating Expenses
 - b. Interest Expenses
 - c. Depreciation and Amortization
 - d. Taxes
 - e. Employer's half of Social Security
 - f. Other payroll taxes
 - g. Unemployment taxes
- 15. Balance Sheet
 - a. Period
 - b. Basic Balance Sheet Equation:
 - i. $\text{Assets} = \text{Liabilities} + \text{Equity}$
 - c. A summary of the health of a business that evaluates long-term and short-term obligations against assets
- 16. Accounts Receivable
 - a. This number reflects the total amount of receivables on hand
 - b. You have to look at the "aging" of the receivable
 - c. If you have a highly medical practice, then you will bill a lot of insurance companies, and it is reasonable to expect a time interval between billing and payment
 - d. You need to know your "current" AR (30—45 days or less)
 - e. Subtract the "Current" AR from the "Total AR"—the amount left over is your "Aged" AR
 - f. Your "Aged AR" should never be more than 0.25% and your "Total AR" should not be more than 2.0%
- 17. Salary vs. Distributions
 - a. Salary
 - b. Taxes withheld
 - c. Federal Income Taxes
 - d. FICA (Federal Insurance Contributions Act [26 C USC § 21])
 - e. Funds Social Security and Medicare
 - f. Self Employment Taxes (26 C USC § 1403)
 - i. 15.3% applied to the 92.35% of the net income
 - g. FUTA (Federal Unemployment Tax Act [26 C USC § 23])
 - i. 6.2% on the employer for the first \$7K of employee gross earnings
 - h. On \$150,000 salary, the FICA is \$16,340 with a business deduction of \$8,170 (a tax savings in the 34% tax bracket of \$2,770)
 - i. On \$50,000 salary and \$100,000 Distribution, the FICA is \$7,650 with no business deduction
 - j. One the same "take home pay," you save \$5,920 in taxes (\$16,340 - \$7,650 - \$2,770)
 - k. Disadvantage: You contribute less to SSA, but you get the time value of money over the years to invest the savings
 - l. According to *Flemming v Nestor* (363 US 303 1960) you do not have a property right to SSA payments anyway, and the chances of you getting payments under SSA is remote
- 18. Finally, you need to weigh the state tax laws and implications of salary vs. distributions with your CPA before using this strategy in your state
- 19. Service Revenue

- a. "Traditional" 40%
 - b. "Medical" 50%
20. Surgical Revenue
- a. "Heavy" 10%—20%
 - b. "Average" <5%
21. Material Revenue
- a. "Traditional" 60%
 - b. "Medical" 45%
22. Discounts and Returns
- a. "Service Recovery"—Total Cost of Making Someone Who Is Unhappy, Happy
 - b. Returns
 - c. Staff Time
 - d. Total <0.5%
23. Cost of Sales
- a. "Traditional" 75%—25% Spectacles vs. Contact Lenses
 - b. "Specialty" 50%—50%
 - c. Numbers can be "skewed" by inventory
 - d. If you don't inventory, then "COS" reflects total costs of servicing purchases
 - e. If you inventory, then "COS" reflects costs of servicing purchases plus increases in inventory
 - f. Important to look also at the "Profit Margin" of each revenue category—you might be bringing in a lot in a particular category, but if your margin is low, then you are not bringing much to the "Gross Profit"
24. Basic Ratios
- a. Chair Costs (Fixed Overhead)
 - b. Chair Costs
 - c. Tells you what you have to make above your cost of sales to get to the point where you start making a profit (Your take-home pay)
 - d. Doesn't tell you what is out of whack if the number is skewed
 - e. You need to look at your ratios at that point
 - f. The two areas you can change the quickest are net revenues and cost of sales
 - g. The two hardest to change are leasehold expenses and salaries
 - h. Nothing in your "Fixed Overhead" is fixed. You can always changes stuff around
25. Staff Salaries & Benefits
- a. If the number is high are you overstaffed or are you paying too much?
 - b. Two methods for calculating your "staff density"
 - c. One staff member for every \$100,000 in gross sales
 - d. Gross per staff hour
 - e. Gross Per Staff Hour
26. Things to Check on the P & L
- a. Look for errors
 - b. For example, look at "Royalties"
 - c. Look for items that are booked incorrectly
 - d. Ensure that you book credit card charges and banking charges correctly
 - e. Check items against same period in the previous year
 - f. If things are radically different, then drill down into the issue to find out why
 - g. For example, look at "Salaries-Staff"
 - h. A large number of errors means that your accountant is not doing his/her job correctly or your accounting system is not set up correctly

- i. Leasehold Expenses
 - j. Rent
 - k. Common Area Maintenance (CAM)
 - l. Utility Costs
 - m. Electric
 - n. Water
 - o. Shared Expenses
 - p. Utility
 - q. Taxes
 - r. Using Your Balance Sheet and Your P & L to Find Theft or Loss
 - s. If your “Gross Sales” and “Inventory” are steady and your “Cost of Sales” are increasing, you should suspect that someone is buying product and taking it home with them
 - t. If your “Gross Sales” are going up and your “Inventory” and “Net Profit” are staying steady, then you should suspect that someone is taking cash
 - u. If everything is going up but your “Net Profit,” then you are not controlling “Office Overhead”
- 27. Looking at Office Overhead**
- a. The best ways to lower your “Office Overhead” is to shop your credit card processing fees, your printing costs, and your life insurance”
 - b. Look long and hard at the “Return on Investment” (ROI) on any Yellow Pages advertising
- 28. Conclusions**
- a. Learn the language of the Balance Sheet and the Profit and Loss Statement
 - b. Learn what indicates a healthy practice when looking at the Balance Sheet
 - c. Learn what indicates the proper ratios for “Cost of Sales,” “Staff Costs,” “Leasehold Expenses,” and “Office Overhead”