



zenbusiness academy

# Accounting & Taxes

ZENBUSINESS.COM

# How do I set up my business accounting?

This course covers the basics of accounting and taxes for small business owners, freelancers, and consultants. Accounting and taxes may seem intimidating, but after this series of lessons, you'll feel comfortable performing basic accounting tasks.

## Why accounting is important

Before we explore HOW to manage [accounting](#) tasks for your business, let's discover WHY accounting is important. Accounting provides valuable information about your business's finances, and allows you to accurately prepare and file your taxes.

Accounting has several other functions for your business. Here are just a few of the benefits:

- **Financing:** When pursuing outside financing from a bank or an investor, having detailed accounting records that demonstrate your financial health can help you secure a loan or partnership.
- **Protection:** Diligent accounting can help protect your assets by showing you where all of your money is coming and going, which can help you avoid mismanagement, fraud, and losses as a result of human error.
- **Growth:** Accounting helps your business grow by empowering you to find ways to cut spending and project future earnings or costs.
- **Savings:** Accounting can even save you money at tax time by giving your accountant thorough records, which they will use to find potential tax deductions.

# Two primary accounting methods for businesses

There are two primary accounting methods that businesses use to analyze information and create helpful financial reports. The difference between the two methods is in the timing of when sales and expenses are recorded in your accounts.

The first method is called **cash basis accounting**. Cash basis accounting records revenue and payments when the actual cash comes into or leaves your possession. This method does NOT involve the use of accounts payable and accounts receivable.

New business owners usually prefer this method of accounting because it's simple to implement and understand. Cash basis accounting works best for smaller businesses that do not have a lot of inventory to keep track of.



## Cash Basis Accounting

- Records revenue and expenses when money is exchanged
- Use your business bank account to assess cash in and cash out
- Best for small, non-retail businesses

The second method is called **accrual accounting**. Accrual accounting records income and expenses when they're earned. For example, using accrual accounting, a business that has billed a customer \$1000 would record that \$1000 as income the day the invoice is generated, even though the cash has not yet been paid by the customer. Similarly, the same business would record an expenditure of \$500 if they ordered \$500 worth of materials but have not yet sent a payment to the vendor.

Accrual accounting is the most commonly used accounting method because it gives a more realistic idea of income and expenses over a period of time, which is helpful for long-term decision making. However, accrual accounting can cause issues with cash flow if the business owner commits to expenditures that they aren't able to cover.

Consider showing graphic with the following information:

#### Accrual Accounting

- Records revenue expenses when they are earned (bill received, invoice sent, etc.)
- Uses Accounts Payable and Accounts Receivable

# Stay organized with income and expense tracking software

If you think this seems a little intimidating, you're not alone. Fortunately, [income and expense tracking software](#) can help you keep everything organized. As the business grows, and if it makes sense to do so, you may want to hire someone to take care of your accounting for you. But in the meantime, accounting software can be simple to use, effective, and more affordable.

To learn whether you'll need the services of a professional accountant, visit the [ZenBusiness](#) website and try our free accounting assessment with any business formation plan.

With an understanding of your accounting options, plus the resources available from our site, small business owners can feel empowered to make informed decisions. Next, check out the second lesson in our Accounting and Taxes series, which covers financial reports and how they can give you meaningful insights into your business.



## Accrual Accounting

- Records revenue expenses when they are earned (bill received, invoice sent, etc.)
- Uses Accounts Payable and Accounts Receivable

# Using Financial Reports to Understand Your Business

In the previous lesson, we recommended that you use income and expense tracking software to run your business because of all the benefits those applications offer. One of these benefits is that income and expense tracking software generates **financial reports**, which allow you to examine different areas of your business and make informed decisions.

In this lesson, we'll explore which financial reports are useful to new business owners, as well as how to create and use them.

Financial reports are tools that you will use throughout your journey as a business owner. These reports tell you about your cash flow, including where your money came from, where money was spent, what you owe to others, what is owed to you, and where your assets currently are.

By creating and analyzing financial reports, you'll be able to gauge the financial wellness of your business and develop plans and strategies to make improvements. These reports also come in handy for simplifying tax filings and maximizing your tax exemptions.

## Balance Sheet

The first financial report we'll cover is called a [balance sheet](#). A balance sheet contains three sections:

- Assets
- Liabilities



- Shareholders' equity

Shareholders' equity represents the cash that any shareholders (including yourself) would receive if you were to close your business, sell your materials, inventory, and equipment, and pay off your debts.

Here's an example of a balance sheet:

ASSETS	
Bank Account	\$2,000
Accounts Receivable	\$6,000
Equipment	\$1,000
<b>Total Assets</b>	<b>\$9,000</b>
LIABILITIES	
Accounts Payable	\$200
Long-Term Debt	\$2,000
<b>Total Liabilities</b>	<b>\$2,200</b>
OWNER'S EQUITY	
Capital	\$6,000
Retained Earnings	\$12,000
Drawing	-\$8,000
<b>Total Equity</b>	<b>\$10,000</b>

## Sample Balance Sheet

Use this format but change the company name and numbers. Place notes next to the balance sheet so that they can be viewed side-by-side with the example.

Notes for filling out a balance sheet:

- Assets are listed in order of how quickly they can be converted into cash, with cash being at the top.
- Liabilities are listed by their due dates, with the short-term debts, called current debts, at the top, and long-term debts below.
- A completed balance sheet tells you how much you've put into your business, the amount of debt you've accumulated, and whether you're likely to be able to pay all debts.

The balance sheet includes the components that you need to complete the **balance sheet equation**, which is sometimes referred to as the **fundamental accounting equation**.



**Liabilities** — **Shareholder's Equity** = **Assets**

## Income Statements

Next, let's learn about **income statements**. An income statement provides a breakdown of your revenue and expenses.

At the top of the above example, you'll see the earnings from your business activities, also called **top-line revenue** or **gross revenue**. Next are expenses including cost of goods sold, rent, wages, supplies, utilities, and more. **Net income** is calculated by subtracting your total expenses from your revenue.

## Cash Flow Statement

Try not to confuse income statements with our next accounting report: the **cash flow statement**. This report is important to you as an owner because it tells you if you have enough cash to pay your expenses and debts and purchase new assets.



Here's an example of what a cash flow statement looks like:

# Cash Flow Statement

1. List incoming cash from sales.
2. Subtract outgoing cash that you've paid to employees, vendors, suppliers, etc.
3. List cash flow from investing. This cash flow can be negative or positive.
4. Record cash flow from financing activities. Cash increases if you take out a loan, and decreases when you pay a loan.
5. Total everything up to see your total cash flow.
6. Add that total to your beginning cash balance

My Awesome Company  
CASH FLOW STATEMENT  
For the Period Ended Dec 31, 2019

## Cash Flows from Operations

Customer Payments	2,000,000
Material Purchases	640,000
Payroll Costs	840,000
Other Payments	352,000
Total	\$168,000

## Cash Flows from Investing

Equipment Purchase	40,000
Total	\$40,000

## Cash Flows from Financing

Loan Payments	60,000
Total	\$60,000

Net Change in Cash	\$68,000
Beginning Cash Balance	\$92,000
Ending Cash Balance	\$160,000

Notes for filling out a cash flow statement:

- List incoming cash from sales.
- Subtract outgoing cash that you've paid to employees, vendors, suppliers, etc.
- List cash flow from investing. This cash flow can be negative or positive.
- Record cash flow from financing activities. Cash increases if you take out a loan, and decreases when you pay a loan.
- Total everything up to see your total [cash flow](#).
- Add that total to your beginning cash balance.

The resulting number after you complete your report is your **ending cash balance**, which is the exact amount of money you have available for use. This number can be positive or negative, and it will help you make key decisions about your business.

Financial reports don't seem as complicated if you know what you're looking at. [ZenBusiness](#) is here to make things simple, from business formation to compliance and beyond — so don't hesitate to reach out with any questions. Up next, our accounting lesson series concludes with a deep dive into small business taxes.

# What Every Small Business Owner Should Know About Taxes

Running a small business can be unpredictable. One of the few aspects of business ownership that stays consistent from year to year is paying [taxes](#). Being tax compliant is one of the most important duties as a business owner, and it's also one of the most stressful if you don't have the right resources.

In some ways, business taxes are similar to your personal income taxes. You'll owe taxes at multiple governmental levels, including federal taxes, state taxes, and sometimes local taxes.

The type of business you operate can have a powerful impact on how your business is taxed. If you haven't already formed your business, what you learn from this lesson may help you decide what kind of business you would like to form.

## Limited Liability Companies (LLCs)

To begin, let's explore limited liability companies, or LLCs. LLCs are businesses formed through the state. All states, along with Washington, D.C., allow both single-member and multi-member LLCs. This structure helps protect the owner's personal assets and is less of a risk to own and operate.

## Limited Liability Company (LLC)

- Can consist of just the owner or multiple owners
- Help protect your assets from liabilities such as lawsuits
- Offer pass-through taxation, meaning the income of the business passes through directly to the owners (shareholders) of the business without first being taxed at the business level

## Sole Proprietorships

Next are sole proprietorships. Sole proprietorships consist of single owners who are not required to file a separate tax return for their business. Instead, all of the net income from their business will be subject to self-employment taxation.

## Sole Proprietorship

- Only file personal tax returns (like LLC members and partnerships)
- Are subject to self-employment tax (unless they elect S corporation status, in which case only part of their business income is subject to self-employment taxes)

# Partnerships

Partnerships are businesses that are owned by two or more people. Each year, partnerships file an entity-level informational return that shows income, deductions, gains, losses, and other financial information. Each individual partner must then report their share of the net income because the partnership itself does not pay federal income tax.

## Partnership

- File an informational return via Form 1065 that shows how much money was made
- The partnership itself does not pay federal income tax, but business income instead passes through to the partners who report their specific portion of business income and pay taxes on their individual returns
- Schedule K must be submitted to summarize the partners' entire share of profits
- Instead of Form W-2 being delivered to each partner, Schedule K-1 must be submitted to show each partner's separate share

# S Corporations and C Corporations

S corporations represent a tax classification for businesses that have one class of stock and no more than 100 shareholders. S corporation owners pay self-employment taxes on their salaries — but only pay regular, personal income tax on distributions. To avoid any improprieties by classifying everything as distributions, please note that owners must pay themselves “reasonable compensation,” which is subject to the Federal Insurance

Contributions Act tax and Social Security. An LLC or C Corporation can apply to the IRS to be taxed as an S corporation.

## **S Corporation**

- No Self-Employed Contributions Act taxes levied on dividends
- Salary is taxed for Social Security and more

Like most other business entities, corporations are usually liable for income, estimated tax, Social Security and Medicare taxes, federal unemployment tax, and more. They can also claim some tax benefits, specifically special tax deductions. The default form of corporations are C corporations, and they are a separate tax-paying entity from the business owner.

## **C Corporation**

- Are subject to double taxation on income taxes, meaning that income is taxed both at the corporate level and the personal level
- Can take advantage of corporate tax deductions
- Are separate entities from owners

# Six general types of business taxes

One thing to keep in mind here is that LLCs and S corporations represent the best of both worlds, so to speak. They both offer pass-through taxation just like sole proprietorships and general partnerships do, but they also offer liability protection just like a corporation does. Now that we've clarified the different classification options, let's explore the six general types of business taxes.

- **Income tax:** Paid as you earn income throughout the year, usually quarterly in estimated amounts.
- **Self-employment tax:** Your contribution to Social Security and Medicare as a business owner.
- **Employment and payroll taxes:** For businesses with employees. Includes Social Security and Medicare taxes, etc.
- **Excise taxes:** For businesses that manufacture or sell certain products, operate certain kinds of businesses, or use various kinds of equipment, facilities, or products.
- **Sales taxes:** Assessed by state or local governments.
- **Property taxes:** A tax fee based on the assessed value of any property you own.

## Preparation is key

These taxes and fees may seem intimidating, but the key to stress-free tax filing is preparation. First, Visit [IRS.gov](https://www.irs.gov) and check your tax requirements based on your business classification. Next, pay your estimated taxes quarterly to stay compliant and avoid falling behind. And finally, be aware of the deductions you might be able to claim, and track expenses meticulously in order to take advantage of them.

Some common small business deductions include costs of advertising and promotion, business travel expenses, business insurance, legal and professional fees, bank fees, and even education expenses to improve your expertise.



Hiring a CPA or using income and expense tracking software can help ensure accuracy and maximize your deductions. If you aren't sure what you need, check out our free assessment. This wraps up our accounting and taxes lesson series. In our next course, learn about market research and business strategies.

# Glossary of Terms

## **Cash basis accounting**

An accounting method that records revenue and payments when actual cash comes into or leaves your possession. This method does NOT involve the use of accounts payable and accounts receivable.

## **Accrual accounting**

An accounting method that records income and expenses when they're earned.

## **Income and expense tracking software**

Software that helps you track and organize all incoming and outgoing funds.

## **Balance sheet**

A report showing your business assets, liabilities, and owner's equity. Tallying up your assets, liabilities, and owner's/shareholders' equity tells you the total equity of your business.

## **Fundamental accounting equation**

A formula for determining your assets. The equation is  $ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY$ .

## **Income statements**

An income statement provides a breakdown of your revenue and expenses.

## **Top-line revenue/gross revenue**

The earnings from your business activities.

## **Expenses**

In an income statement, this section includes expenses such as cost of goods sold, rent, wages, supplies, utilities, and more.

## **Net income**

The result of your income statement. Net income is calculated by subtracting your total expenses from your revenue.

## **Cash flow statement**

A financial report that helps you determine if you have enough cash to pay your expenses and debts and purchase new assets.

## **Ending cash balance**

The exact amount of money you have available for use.

## **Limited liability companies (LLCs)**

LLCs are businesses formed through the state. All states, along with Washington, D.C., allow both single-member and multi-member LLCs.

## **Sole proprietorships**

Sole proprietorships consist of single owners who are not required to file a separate tax return for their business. Instead, all of the net income from their business will be subject to self-employment taxation.

## **Partnerships**

Businesses that are owned by two or more people.

## **S corporations**

A tax classification for businesses that have one class of stock and no more than 100 shareholders. S corporation owners pay self-employment taxes on their salaries – but

only pay regular, personal income tax on distributions.

## **C corporations**

The default form of corporations are C corporations, and they are a separate tax-paying entity from the business owner.

## **Income tax**

A tax that is paid as you earn income throughout the year, usually quarterly in estimated amounts.

## **Self-Employment tax**

Your contribution to Social Security and Medicare as a business owner.

## **Employment and payroll taxes**

Taxes paid by businesses with employees. These taxes include Social Security and Medicare taxes, etc.

## **Excise taxes**

Taxes for businesses that manufacture or sell certain products, operate certain kinds of businesses, or use various kinds of equipment, facilities, or products.

## **Sales taxes**

Taxes on sold products or services. These taxes are assessed by state or local governments.

## **Property taxes**

A tax fee based on the assessed value of any property you own.