THEME: STARTING OR BUYING A NEW BUSINESS

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ACCOUNTING TERM: Amortization

Amortization is the process of spreading the cost of intangible assets over a uniform period of time. For example, if the cost of an intangible asset was $1,000 and the period of time was five years or sixty months, then by dividing $1,000 by 60, the result is a monthly amortization cost of $16.67.

FEATURE ARTICLE: Setting Up The Beginning Balance Sheet

Setting up your books properly at the very beginning will go a long way in keeping you out of trouble later on. When you start, or buy, a new business there is a lot more to it than just selling your goods or services, and writing checks for your expenses.

First, you must decide what type of business entity best fits your needs. Will it be a sole proprietorship, partnership, C or S corporation, or perhaps even a non-profit organization? Knowing this will help you decide what type of bookkeeping system is required. Although similar, each type of business entity has certain accounts that are unique to it. Therefore, from an accounting standpoint, your first order of business will be to set up a Chart of Accounts that includes all the general ledger accounts you are going to use.

Next, you will need to make a list of all the transactions that have occurred *before* you opened your doors for business. Once you have done this, then you will translate those events into accounting transactions that are recorded in your General Journal.

Let's think about a typical situation for someone who is starting his/her business either from the ground up or through a purchase. The size and scope of the new business will determine whether certain costs will occur. For example, if it is decided that the business should be incorporated, then there will probably be costs for lawyers and accountants, incorporation fees to the state, and board of directors' meeting expenses. These are called "Organizational Expenses" and have to be treated as capital expenditures as opposed to current operational expenses.

If the business requires employees, there may be training costs. There could be investigative costs, including: analysis of potential markets; facilities; labor force; financial projections; etc. There also could be costs for advertising the business opening, or travel to the opening. In addition, there might be consulting fees or other professional fees for advice regarding the structure of the new business.

These types of expenses are called, “Business Start-Up Costs” and also have to be treated as capital expenditures.

If you are buying a business, the purchase might include a “covenant not to compete”, copyrights or patents, a franchise, trademark, or trade names. It could also include a customer list, or contracts with customers, or perhaps specialized computer software not available to the general public. These items are called “Identifiable Intangible Assets” and are considered capital expenditures.

Another common intangible asset that can come with the purchase of another business is called “Goodwill”. Goodwill is the ability of a business enterprise to earn a rate of return on net assets (owner’s investment) in excess of a normal rate for the industry in which the business enterprise operates. In other words, Goodwill is the difference between the value of a business enterprise as a whole and the sum of the current fair values of its identifiable tangible and intangible net assets. Think of it like this: You buy a business for $50,000. You know that the fair value of all the equipment, inventory and patents is $40,000. The remaining difference of $10,000 is considered to be Goodwill. Since there may be a variety of reasons why this Goodwill exists, Goodwill is considered to be an “Unidentifiable Intangible Asset”. Goodwill is a capital expenditure as opposed to a current operating expense.

Then, there are the tangible assets that one might purchase brand new or that are part of an existing business. Tangible assets are said to be items “you can stub your toe on”, such as equipment, furniture and fixtures, buildings, land, inventory, etc. Tangible assets are capital expenditures that are expensed, depending on their nature, via depreciation or cost of goods sold.

So you can see you have a job to do to set up your books properly. You have acquired all these assets, but another question to be answered is: Where did the money come from to purchase them? Did it come from your personal savings account? Did you borrow the money? Or, did you do some of both? Here is an example of what your starting journal entry might look like:

DESCRIPTION	DEBIT	CREDIT
Cash	50,000	
Common Stock		25,000
Notes Payable		25,000

This journal entry records where the money came from. It is wise to deposit the initial money into the business bank account first, and *then* buy the assets so there is a good audit trail of what transpired. The next journal entry example shows how to record the acquisition costs of the purchase:

DESCRIPTION	DEBIT	CREDIT
Inventory	5,000	
Equipment	12,000	
Furniture & Fixtures	3,000	
Start-Up Costs	5,000	
Organizational Costs	3,000	
Patent	5,000	
Franchise Fee	7,000	
Goodwill	10,000	
Cash		50,000
To record acquisition costs		

These are the steps required to establish your beginning Balance Sheet. Now you are ready to begin recording the current operating revenue and expenses of your new business.

QUESTION: Can Start-Up Costs, Organizational Expenses, and Intangible Assets Be Written Off?

The answer to this question is, yes, but how they are written off depends on whether you are working under Generally Accepted Accounting Principles (GAAP) or United States tax law. If you live outside the U.S. it would be wise to check on the rules pertaining to your own country. Most small businesses follow U.S. tax law when determining the length of time to amortize Start-Up (Preoperating) Costs, Organizational Expenses, and Intangible Assets. They do this because, to do otherwise, would require preparation of another set of financial statements. GAAP rules generally allow for amortization of no more than forty years unless you can establish a basis for a shorter term. Therefore, let's focus on the U.S. tax law.

Start-Up Costs and Organizational Expenses can be amortized over a minimum period of five years. The amortization period begins the month you started doing business. However, you must elect to do so on the tax return you are filing, otherwise you will not be able to recover their cost until you sell or dispose of the business. The election must be made by the due date of the return, including extensions, and is accomplished by attaching a statement to the return showing information such as the type of expense, date incurred, and amortization period.

Amortization for intangible assets is a minimum period of fifteen years beginning in the month the assets were purchased. There is no election required for intangible assets.

Here's how the monthly amortization journal entries would look based on the above example:

DESCRIPTION	DEBIT	CREDIT
Amortization	83.33	
Accumulated Amort.		83.33
To record amortization of Start-up Costs $5000 over 60 mo.		

DESCRIPTION	DEBIT	CREDIT
Amortization	50.00	
Accumulated Amort.		50.00
To record amortization of Organizational Exp. of $3,000 over 60 mo.		

DESCRIPTION	DEBIT	CREDIT
Amortization	122.22	
Accumulated Amort.		122.22
To record amortization of Intangible Assets of $22,000 over 180 mo.		

There are certain “Acquisition Costs” such as, the cost of issuing or selling stocks or securities, including commissions, professional fees and printing costs, plus the cost of transferring assets to a corporation, and the cost of marketing interest in a partnership, that cannot be amortized. These costs are capitalized and add to the basis of the business and are only recovered when the business is sold or disposed of. It is not likely that you will ever encounter these types of costs when buying or starting a small business.

TIP: Internal Controls

You read about this in every newspaper in every town in the entire country: Some bookkeeper, trusted by the owner of a small business, embezzles thousands of dollars. If the theft doesn’t put owner out of business, it certainly causes a major headache.

The reason we hear of these cases so often is that, in a small business, there may only be the owner and a bookkeeper. The owner doesn’t like doing the books, doesn’t understand them, and relies on this one person to take care of things. The bookkeeper, who is usually having personal financial difficulties, takes a small amount of money intending to pay it back. No one seems to notice, so more is taken. Over a period of time, it starts to mount up to a lot of money.

This is where the concept of "internal control" comes in. Essentially, any business, regardless of size, should have an internal control system in place to protect against losses, both intentional and unintentional. This is because "internal control" systems will: 1) protect cash and other assets; 2) promote efficiency in processing transactions; and,3) ensure reliability of financial records.

Most internal control systems are based on the principle of separation of duties. Separating duties makes it more difficult for theft and errors to go undetected. It is highly unusual for two employees to "collude" in an effort to steal from the company.

I worked as an internal auditor for a newspaper chain for three years. My job was to walk in to the newspaper offices unannounced and go directly to the cash boxes, count them, and verify receipts. One of my most important audit steps was to make sure the internal control procedures were in place and working properly. Here are a few suggestions for internal controls:

- Allow only specific designated individuals to handle cash.
- Give responsibility for bookkeeping to an individual who does not handle cash.
- Use numbered receipts to document all payments.
- Make all bank deposits promptly.
- The person who prepares the bank reconciliation should be different than the one handling cash.
- If possible, the person who makes the bank deposit should be different than the one who handles the cash and the one who prepares the bank reconciliation.
- Make deposits intact with no amounts withdrawn to pay expenses.
- Keep cash and checkbook in a locked drawer or cash register.
- Since tills will never be 100% correct all the time, establish a tolerance level for overages and shortages to determine the point at which corrective measures will be triggered.
- Make all disbursements by check, except minimal amounts paid from petty cash.
- Make certain every payment is related to a paper document, such as a voucher, to ensure that a paper trail exists for all disbursements.
- Conduct random surprise counts of petty cash and cash drawers.
- Count inventory and other assets frequently and compare with company books.

An internal control system set up early as a preventative measure is more efficient than establishing a corrective system in reaction to a loss. If there is just you and the bookkeeper, you need to learn how to do some of the bookkeeping tasks so you can spot check the bookkeeper's work. That, in itself, is an excellent preventative measure.

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