

How to Assess Your Bookkeeping and Accounting

Guide to Self Audit the Bookkeeping and Accounting in a Small Business

By BizMove Management Training Institute

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Table of Contents

[1. Introduction](#)

[2. Preliminary Questions](#)

[3. Bookkeeping and Accounting Assessment Analysis](#)

Bonus Guide

[4. How to Plan for Future Financing Needs](#)

1. Introduction

Small businesses often fail because owners are unaware of the many elements that can prevent the business from growing and being successful. Often, small businesses are organized around the manager's specific area of expertise, such as marketing, accounting or production. This specialized expertise often prevents the business owner from recognizing problems that may arise in other parts of the business.

This guide will provide you, the small business entrepreneur, with the essentials for conducting a comprehensive search for existing or potential problems in your Bookkeeping and Accounting. This guide was designed with small businesses in mind and addresses their unique problems and opportunities.

The author has combined case evidence, logical procedures, expert advice and systematic thinking to create this planning assessment guide. This instrument is not exhaustive, i.e., the business owner/manager still must rely on personal judgment and past experience. However, it does provide a systematic framework to ensure that critical areas have been addressed before action is taken. This guide is a tool, not a replacement for good management skill. Audits and handbooks cannot do the manager's job; however, effectively designed instruments, such as this audit, can save valuable time for the seasoned as well as the novice small business manager.

How to Use This Guide

In order to gain maximum effectiveness from this guide, you should answer all questions in the audit, with an affirmative answer indicating no problem and a negative answer indicating the presence of a problem in a specific area.

After completing answering the preliminary questions, you can proceed to review the analysis of each section of the audit that follows to determine what action is most appropriate. The audit analysis provides an overview of how the various elements of the audit are related. This audit covers the critical function of the Bookkeeping and Accounting in a small business..

[Go to Top](#)

2. Preliminary Questions

Please answer each of the following questions with a 'Yes' or a 'No', then proceed to the analysis section:

A. The company has a bookkeeping system.

single entry ----- double entry -----

The owner

1. Prepares the books.
 - a. Understands the how and why.
 - b. Prepares own financial statements.
2. Pays for bookkeeping service.
 - a. Understands financial statements.

- b. Has taxes done by bookkeeper.
- c. Has compared cost for bookkeeper with that of a CPA.

B. The company reconciles bank statements monthly.

C. The company keeps income and expense statements accurate and prepares statements monthly.

The owner

- 1. Understands purpose of financial statements.
- 2. Compares several monthly statements for trends.
- 3. Compares statements against industry averages.
- 4. Knows current financial status of business.

D. The company makes monthly deposits for taxes.

The owner

- 1. Makes deposits on time to avoid penalties.

E. The company has a credit policy.

The company

- 1. Ages billing system monthly.
- 2. Accesses late payment fee from customers.
- 3. Writes off bad debts.
- 4. Has good collection policies.
- 5. Has a series of increasingly pointed letters to collect from late customers.
- 6. Has VISA, MasterCard, or other credit card system.
- 7. Emphasizes cash discounts.

F. The owner considers tax implications.

- 1. Considers buy versus lease possibilities.
- 2. Considers possible advantages/disadvantages of incorporation.
- 4. Does not pay tax penalties.

[Go to Top](#)

3. Bookkeeping and Accounting Assessment Analysis

A. The company has a single- or double-entry bookkeeping system.

Record keeping is vital to the survival and success of any business. According to analysis of the cases studied, problems with record keeping constituted the second-largest problem area. Whether the business used a single- or double-entry system did not appear to be as important as how the system was executed. Timely and accurate record keeping is essential.

1. The owner prepares the books.

The small business owner who understands bookkeeping, records the transactions and prepares the financial statements has an intimate knowledge of the business. Knowledge of these accounting and financial aspects makes the owner credible with lending institutions. It also keeps the owner out of financial trouble and helps him or her stay focused on ways to make a profit.

2. The owner pays for bookkeeping service.

The owner who does not understand the essentials of bookkeeping needs to hire a trusted professional. Even then, the owner needs to understand financial statements. Failure to understand essential financial statements is an indication that the owner has surrendered managerial responsibility. It is generally wise to have the professional bookkeeping service prepare taxes when the service is already keeping the books. The owner who does not do the record keeping is rarely in close enough touch with the records to adequately prepare tax forms. The business owner who delegates so much financial responsibility to others should think seriously about using a CPA.

B. The owner reconciles bank statements monthly.

A quick way to get into financial trouble is not to reconcile bank statements monthly. With a single-entry bookkeeping system, this is the only way to maintain accuracy. Even when a doubleentry system is used, reconciling statements monthly is the only sure way to catch mistakes. Too many small business owners put this off because of other, more pressing, concerns. This destroys the validity of their own financial statements, causing them to make important decisions based on erroneous data.

C. The owner keeps income and expense statements accurate and prepares statements monthly.

The ability to track the flow of funds into and out of the business is necessary for continued viability. Cash flow problems have closed many small businesses. The monthly preparation of accurate income and expense statements is the best single way to avert critical cash shortages.

1. The owner understands purpose of financial statements.

An owner who understands that financial statements are essential for directing and controlling a business will more likely take them seriously. Well-prepared business

statements put the owner in control of the business, facilitate relationships with lending institutions and simplify tax preparation, often saving the owner tax dollars.

2. The owner compares several monthly statements for trends.

Comparing monthly and annual statements for trends provides financial data for planning purposes. Trend analysis is essential for efficient inventory control, capital budgeting, vacation scheduling, timely advertising, promotional campaigns and profit maximization.

3. The owner compares statements against industrial averages.

Knowing how a business compares financially to others helps the owner who is seeking loans or expansion opportunities. Such knowledge also provides the owner with both a psychological and planning advantage, adds to the owner's awareness of how well the industry is doing as a whole and provides an early warning system for market fluctuations and trends.

4. The owner knows current financial status of business.

Not knowing how the business is doing financially is a major reason for small business failures. Managing the business with relatively simple financial tools and staying constantly in touch with the business's financial status is critical if an adequate profit is to be made. Although good record keeping is time consuming and takes away from doing the actual work of the business, it is essential nevertheless if the business is to be a success.

D. The owner makes deposits on time to avoid penalties.

Penalties are costly and take away from profits. In several of the cases studied, late deposits had become so chronic, and the penalties so high, that the businesses were financially threatened. Chronic penalties for late deposits are a sure sign of poor business practices and can be a warning sign to lending institutions that the business is heading for financial trouble, making it highly unlikely the owner will be able to get a loan when needed.

E. The company has a credit policy.

Providing credit to customers can often increase sales volume. But if the business does not have a written credit policy or does not follow it exactly, the business may lose more money on bad debts than the additional sales brought in. Written credit policies often speed debt collections, especially when discounts can be made for early payments. Several of the cases studied showed a marked improvement in cash flow after credit policies were implemented.

1. The company ages the billing system monthly.

Monthly aging of the bills due keeps the owner in touch with who the best customers are. Last year's excellent customer can be today's problem customer.

2. The company assesses a late payment fee from customers.

Late payments can jeopardize the business-customer relationship, because the customer is not aware of how poor payment habits affect the business. Providing discounts for early payments is an effective way to encourage customers to pay on time. This will improve cash flow and even build customer loyalty.

3. The company writes off bad debts.

Not writing off bad debts gives a false sense of net worth and can threaten the financial performance of the business. This also lets the owner know which customers are poor credit risks.

4. The company has good collection policies.

Many small business owners detest debt collections. A good collection policy simplifies collections and is an effective deterrent to late payments and bad debts. Timely and effective debt collection is essential for positive cash flow and increases profits because it diminishes the need for short-term operating loans.

5. The company has a series of increasingly pointed letters to collect from late customers.

The customer who is truly a collection problem will not be influenced by discounts or good collection policies alone. These customers probably have cash flow problems or other financial problems of their own. Late notices and overdue statements with increasingly demanding language will be required. Often letters from a lawyer can be helpful. As a last resort, it may be wise to turn them over to a collection agency.

6. The company has VISA, MasterCard or other credit card systems.

Credit card systems provide timely cash turnaround and put the financing burden directly on the customer. The worry and headaches alleviated by using a credit card system more than justify the small fee credit card companies charge. Such a system also simplifies bookkeeping and billing and lowers operating costs in these areas.

7. The company emphasizes cash discounts.

Cash discounts encourage customers to pay now rather than use credit. Informing customers that paying by cash saves them money improves cash flow and decreases collection costs.

F. The owner considers tax implications.

Waiting until the last minute to consider the tax implications for the purchase of equipment and other capital outlays can be costly. Thinking ahead and discussing tax implications of various alternatives with an accountant early in the year can save in taxes. Tax considerations are essential for all businesses, but for the small business, such considerations can make the difference between a profit and a loss.

1. The owner considers buy versus lease possibilities.

Deciding whether to buy or lease equipment is an important business consideration. Leasing rather than borrowing money to buy can help cash flow, save taxes and increase total operating capital. One reason to consider leasing equipment is that it may save downtime when equipment needs repairs.

2. The owner considers possible advantages and disadvantages of incorporation.

Each kind of business structure has its own advantages. Most of the businesses in the cases studied were either sole proprietorships or corporations..

3. The owner does not pay tax penalties.

It should be obvious that any business paying tax penalties is losing profits. Worse than this, not paying taxes on time creates many time-consuming headaches. It also sends a message to lenders that the business is a poor risk.

[Go to Top](#)

4. How to Plan for Future Financing Needs

Studies overwhelmingly identify bad management as the leading cause of business failure. Bad management translates to poor planning by management.

All too often, the owner is so caught up in the day-to-day tasks of getting the product out the door and struggling to collect receivables to meet the payroll that he or she does not plan. There never seems to be time to prepare Pro Formas or Budgets. Often new managers understand their products but not the financial statements or the bookkeeping records, which they feel are for the benefit of the IRS or the bank. Such overburdened owner/managers can scarcely identify what will affect their businesses next week, let alone over the coming months and years. But, you may ask, "What should I do? How can I, as a small business owner/manager, avoid getting bogged down? How can I ensure success?"

Success may be ensured only by focusing on all factors affecting a business's performance. Focusing on planning is essential to survival.

Short-term planning is generally concerned with profit planning or budgeting. Long-term planning is generally strategic, setting goals for sales growth and profitability over a minimum of three to five years.

The tools for short- and long-term plans have been explained previously in this section: Pro Forma Income Statements, Cash Flow Statements or Budgets, Ratio Analysis, and pricing considerations. The business's short-term plan should be prepared on a monthly basis for a year into the future, employing the Pro Forma Income Statement and the Cash Flow Budget.

Long-Term Planning

The long-term or strategic plan focuses on Pro Forma Statements of Income prepared for annual periods three to five years into the future. You may be asking yourself, "How can I possibly predict what will affect my business that far into the future?" Granted, it's hard to imagine all the variables that will affect your business in the next year, let alone the next three to five years. The key, however, is control - control of your business's future course of expansion through the use of the financial tools explained in this section.

First determine a rate of growth that is desirable and reasonably attainable. Then employ Pro Formas and Cash Flow Budgets to calculate the capital required to finance the inventory, plant, equipment, and personnel needs necessary to attain that growth in sales volume. The business owner/manager must anticipate capital needs in time to make satisfactory arrangements for outside funds if internally generated funds from retained earnings are insufficient.

Growth can be funded in only two ways: with profits or by borrowing. If expansion outstrips the capital available to support higher levels of accounts receivable, inventory, fixed assets, and operating expenses, a business's development will be slowed or stopped entirely by its failure to meet debts as they become payable. Such insolvency will result in the business's assets being liquidated to meet the demands of the creditors. The only way to avoid this "outstripping of capital" is by planning to control growth. Growth must be understood to be controlled. This understanding requires knowledge of past financial performance and of the future requirements of the business.

These needs must be forecast in writing - using the Pro Forma Income Statement in particular - for three to five years in the future. After projecting reasonable sales volumes and profitability, use the Cash Flow Budget to determine (on a quarterly basis for the next three to five years) how these projected sales volumes translate into the flow of cash in and out of the business during normal operations. Where additional inventory, equipment, or other physical assets are necessary to support the sales forecast, you must determine whether or not the business will generate enough profit to sustain the growth forecast.

Often, businesses simply grow too rapidly for internally generated cash to sufficiently support the growth. If profits are inadequate to carry the growth forecast, the owner/manager must either make arrangements for working growth capital to be borrowed, or slow growth to allow internal cash to "catch up" and keep pace with the expansion. Because arranging financing and obtaining additional equity capital takes time, this need must be anticipated well in advance to avoid business interruption.

To develop effective long-term plans, you should do the following steps:

- 1. Determine your personal objectives and how they affect your willingness and ability to pursue financial goals for your business.** This consideration, often overlooked, will help you determine whether or not your business goals fit your personal plans. For example, suppose you hope to become a millionaire by age 45 through your

business but your long-term strategic plan reveals that only modest sales growth and very slim profit margins on that volume are attainable in your industry. You must either adjust your personal goals or get into a different business. Long range planning enables you to be realistic about the future of your personal and business expectations.

2. Set goals and objectives for the company (growth rates, return on investment, and direction as the business expands and matures). Express these goals in specific numbers, for example, sales growth of 10 percent a year, increases in gross and net profit margins of 2 to 3 percent a year, a return on investment of not less than 9 to 10 percent a year. Use these long-range plans to develop forecasts of sales and profitability and compare actual results from operations to these forecasts. If after these goals are established actual performance continuously falls short of target, the wise business owner will reassess both the realism of expectations and the desirability of continuing to pursue the enterprise.

3. Develop long-range plans that enable you to attain your goals and objectives. Focus on the strengths and weaknesses of your business and on internal and external factors that will affect the accomplishment of your goals. Develop strategies based upon careful analysis of all relevant factors (pricing strategies, market potential, competition, cost of borrowed and equity capital as compared to using only profits for expansions, etc.) to provide direction for the future of your business.

4. Focus on the financial, human, and physical requirements necessary to fulfill your plan by developing forecasts of sales, expenses, and retain earnings over the next three to five years.

5. Study methods of operation, product mix, new market opportunities, and other such factors to help identify ways to improve your company's productivity and profitability.

6. Revise, revise. Always use your most recent financial statements to adjust your short- and long-term plans. Compare your company's financial performance regularly with current industry data to determine how your results compare with others in your industry. Learn where your business may have performance weaknesses. Don't be afraid to modify your plans if your expectations have been either too aggressive or too conservative.

Planning is a perpetual process. It is the key to prosperity for your business.

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[Go to Top](#)