

CAESAR ACCOUNTING SYSTEM

Components of the Accounting System

Think of the accounting system as a wheel whose hub is the general ledger (G/L). Feeding the hub information are the spokes of the wheel. These include

- Accounts receivable
- Accounts payable
- Order entry
- Inventory control
- Cost accounting
- Payroll
- Fixed assets accounting

These modules are ledgers themselves. We call them sub ledgers. Each contains the detailed entries of its specific field, such as accounts receivable. For example, each day the receivables sub ledger records all credit sales and payments received. The transactions net together then go up to the G/L to increase or decrease A/R, increase cash and decrease inventory.

ORGANIZATION OF THE ACCOUNTING DEPARTMENT

Assignment of Duties

Here's your first assignment: Figure out who is going to do what in your new accounting system. The duties and areas of responsibility we need to assign include

- Overall responsibility for the accounting system
- Management of the computer system (if you're using one)
- Accounts receivable
- Accounts payable
- Order entry
- Cost accounting
- Monthly reporting
- Inventory control
- Payroll (even if you use an outside payroll service, someone must be in control and responsible)
- Internal accounting control
- Fixed assets

In many cases the same person will do many of these things. However, these are the areas we'll be dealing with in setting up the accounting system. The person you assign to be in overall charge of the system should be the one who is most familiar with accounting. If you are just starting your company, you might want to think about the background of some of your new employees. At least one should have the capacity to run the accounting system.

If you find it difficult to determine someone's expertise in a field with which you are unfamiliar, here are some solutions:

1. Have them interviewed by an expert.
2. Carefully check references from past jobs. Ask detailed questions on exactly what they did in the accounting function. Compare the answers with what they say they did.
3. Ask them some accounting questions. It may sound odd that you (of all people) should be asking such questions. However, even if you can't judge the technical merit of the answers, you can get a feel for how comfortable they are with the subject and the authority with which they answer.

The Language of Accounting

Information Means Profits

the purpose of the accounting system is to communicate. It produces useful information (not raw data) that tells specific things about the company. To those who understand what this intricate system is saying, it's like money in the bank.

Suddenly, information that you need to run the company is at your fingertips. Of course, this information is couched in financial terms. That's the language your accounting system uses. Here are two examples:

WHAT YOU WANT FROM YOUR ACCOUNTING SYSTEM

The kind of information we found in the prior examples is what you want from your accounting system. This feedback must

- Be accurate
- Fulfill management's requirements
- Be easy to use

We can employ information like this in solving problems and running the business. As well as having the attributes of accuracy, relevancy, and simplicity, our accounting system ought to be set up in such a way that it does not require an inordinate amount of time to maintain.

Further, your accounting system should not require a CPA to operate it or to interpret the output. Some of the popular automated accounting systems require specific knowledge not only about computers but about the field of accounting as well.

If you choose to use CAESAR Accounting System, this will be of immense help in teaching you the basics of how it works. Whether manual or automated, all accounting systems use debits, credits, a general ledger, and sub ledgers. All entries are posted the same way. The only difference is which buttons to push.

ACCOUNTING FOR THE BUSINESS CYCLE

the business cycle is nothing more than the flow of transactions needed in your business to complete a sale and collect the proceeds. It's important to setting up your accounting system. We want to know what types of transactions are involved and the accounting entries to make along the way. Most companies business cycles progress something like this:

1. Purchase raw materials.
2. Enter goods into raw materials inventory.
3. Begin the manufacturing or assembly process.
4. Enter goods into work in process inventory.
5. Pay suppliers or pay employees.
6. Complete the manufacturing or assembly process.
7. Enter goods into finished goods inventory.
8. Sell the inventory.
9. Collect payment for credit sales.

Briefly, here is the way your accounting system interacts at each stage of the **Business Cycle**.

Purchase Raw Materials

what happens when you buy the raw materials used to create your company's product? You receive the goods, and you either pay cash for the goods or obligate the company for future payment. Both transactions require these accounting entries:

- Increase raw materials inventory
- Decrease cash (if you paid on the spot)
- Increase accounts payable (if you didn't)

At this point, we've covered the first two steps of the business cycle listed above.

Begin the Manufacturing Process

when we use raw materials to make our product, the accounting system transfers the inventory from raw materials to an intermediate stage called work in process (WIP for short). This transaction explains the third and fourth steps of the business cycle.

Pay Suppliers

sometime during the production process we must pay our suppliers if we bought the raw materials on credit. The accounting entry for this transaction does two things:

- Reduces accounts payable
- Reduces cash

Complete the Manufacturing Process

At last; we have completed our manufacturing process. Now we can move the product from the work in process inventory to the finished goods inventory. This transaction particularly interests the sales staff, since it means that the product is now available for sale, and that's what generates their commissions. The entries into the accounting system that record this event go like this:

- **Reduce work in process inventory**
- **Increase finished goods inventory**

We've now completed the sixth and seventh steps of the business cycle.

Sell the Product

At last we're ready to make a sale. If it's a credit sale, our accounting system must record these transactions:

- **Reduction in finished goods inventory**
- **Increase in accounts receivable**
- **Increase in sales revenue**

If this was a cash sale, replace the increase in receivables with an increase in cash. We just finished the eighth step of the business cycle.

Collect the Receivable

the final stage of the business cycle is conversion of the receivable (**which is an asset**) into spend able cash. When the customer pays, the accounting system records a decrease in receivables and an increase in cash.

This ends the business cycle and the various accounting transactions involved. The accounting system we're setting up will cover every one of these transactions

Balance Sheets

A balance sheet is a snapshot of a business' financial condition at a specific moment in time, usually at the close of an accounting period. **A balance sheet comprises assets, liabilities, and owners' or stockholders' equity. Assets and liabilities** are divided into short- and long-term obligations including cash accounts such as checking, money market, or government securities. **At any given time, assets must equal liabilities plus owners' equity.**

- An asset is anything the business owns that has monetary value.
- Liabilities are the claims of creditors against the assets of the business.

What is a balance sheet used for?

A balance sheet helps a small business owner quickly get a handle on the financial strength and capabilities of the business. Is the business in a position to expand? Can the business easily handle the normal financial ebbs and flows of revenues and expenses? Or should the business take immediate steps to bolster cash reserves?

Balance sheets can identify and analyze trends, particularly in the area of receivables and payables. Is the receivables cycle lengthening? Can receivables be collected more aggressively? Is some debt uncollectible? Has the business been slowing down payables to forestall an inevitable cash shortage?

Balance sheets, along with income statements, are the most basic elements in providing financial reporting to potential lenders such as banks, investors, and vendors who are considering how much credit to grant the firm.

1. Assets

Assets are subdivided into current and long-term assets to reflect the ease of liquidating each asset. Cash, for obvious reasons, is considered the most liquid of all assets. Long-term assets, such as real estate or machinery, are less likely to sell overnight or have the capability of being quickly converted into a current asset such as cash.

2. Current assets

Current assets are any assets that can be easily converted into cash within one calendar year. Examples of current assets would be checking or money market accounts, accounts receivable, and notes receivable that are due within one year's time.

• Cash

Money available immediately, such as in checking accounts, is the most liquid of all short-term assets.

• Accounts receivables

this is money owed to the business for purchases made by customers, suppliers, and other vendors.

• Notes receivables

Notes receivables that are due within one year are current assets. Notes that cannot be collected on within one year should be considered long-term assets.

3. Fixed assets

fixed assets include land, buildings, machinery, and vehicles that are used in connection with the business.

- **Land**

Land is considered a fixed asset but, unlike other fixed assets, **is not depreciated**, because land is considered an asset that never wears out.

- **Buildings**

Buildings are categorized as fixed assets and **are depreciated** over time.

- **Office equipment**

this includes office equipment such as copiers, fax machines, printers, and computers used in your business.

- **Machinery**

This figure represents machines and equipment used in your plant to produce your product. Examples of machinery might include lathes, conveyor belts, or a printing press.

- **Vehicles**

this would include any vehicles used in your business.

- **Total fixed assets**

this is the total dollar value of all fixed assets in your business, less any accumulated depreciation.

4. **Total assets**

this figure represents the total dollar value of both the short-term and long-term assets of your business.

5. **Liabilities and owners' equity**

This includes all debts and obligations owed by the business to outside creditors, vendors, or banks that are payable within one year, plus the owners' equity. Often, this side of the balance sheet is simply referred to as "Liabilities."

- **Accounts payable**

this is comprised of all short-term obligations owed by your business to creditors, suppliers, and other vendors. Accounts payable can include supplies and materials acquired on credit.

- **Notes payable**

this represents money owed on a short-term collection cycle of one year or less. It may include bank notes, mortgage obligations, or vehicle payments.

- **Accrued payroll and withholding**

this includes any earned wages or withholdings that are owed to or for employees but have not yet been paid.

- **Total current liabilities**

this is the sum total of all current liabilities owed to creditors that must be paid within a one-year time frame.

- **Long-term liabilities**

these are any debts or obligations owed by the business that are due more than one year out from the current date.

- **Mortgage note payable**

this is the balance of a mortgage that extends out beyond the current year. For example, you may have paid off three years of a fifteen-year mortgage note, of which the remaining eleven years, not counting the current year, are considered long-term.

- **Owners' equity**

sometimes this is referred to as stockholders' equity. Owners' equity is made up of the initial investment in the business as well as any retained earnings that are reinvested in the business.

- **Common stock**

this is stock issued as part of the initial or later-stage investment in the business.

- **Retained earnings**

these are earnings reinvested in the business after the deduction of any distributions to shareholders, such as dividend payments.

6. Total liabilities and owners' equity

this comprises all debts and monies that are owed to outside creditors, vendors, or banks and the remaining monies that are owed to shareholders, including retained earnings reinvested in the business.

Income Statements

An income statement, otherwise known as a profit and loss statement, is a summary of a company's profit or loss during any one given period of time, such as a month, three months, or one year. The income statement records all revenues for a business during this given period, as well as the operating expenses for the business.

What is income statements used for?

You use an income statement to track revenues and expenses so that you can determine the operating performance of your business over a period of time. Small business owners use these statements to find out what areas of their business are over budget or under budget. Specific items that are causing unexpected expenditures can be pinpointed, such as phone, fax, mail, or supply expenses. Income statements can also track dramatic increases in product returns or cost of goods sold as a percentage of sales. They also can be used to determine income tax liability.

It is very important to format an income statement so that it is appropriate to the business being conducted.

Income statements, along with balance sheets, are the most basic elements required by potential lenders, such as banks, investors, and vendors. They will use the financial reporting contained therein to determine credit limits.

1. Sales

the sales figure represents the amount of revenue generated by the business. The amount recorded here is the total sales, less any product returns or sales discounts.

2. Cost of goods sold

this number represents the costs directly associated with making or acquiring your products. Costs include materials purchased from outside suppliers used in the manufacture of your product, as well as any internal expenses directly expended in the manufacturing process.

- **Gross profit**

Gross profit is derived by subtracting the cost of goods sold from net sales. It does not include any operating expenses or income taxes.

3. Operating expenses

these are the daily expenses incurred in the operation of your business. In this sample, they are divided into two categories: selling, and general and administrative expenses.

- **Sales salaries**

these are the salaries plus bonuses and commissions paid to your sales staff.

- **Collateral and promotions**

Collateral fees are expenses incurred in the creation or purchase of printed sales materials used by your sales staff in marketing and selling your product. Promotion fees include any product samples and giveaways used to promote or sell your product.

- **Advertising**

these represent all costs involved in creating and placing print or multi-media advertising.

- **Other sales costs**

these include any other costs associated with selling your product. They may include travel, client meals, sales meetings, equipment rental for presentations, copying, or miscellaneous printing costs.

- **Office salaries**

these are the salaries of full- and part-time office personnel.

- **Rent**

these are the fees incurred to rent or lease office or industrial space.

- **Utilities**

these include costs for heating, air conditioning, electricity, phone equipment rental, and phone usage used in connection with your business.

- **Depreciation**

Depreciation is an annual expense that takes into account the loss in value of equipment used in your business. Examples of equipment that may be subject to depreciation includes copiers, computers, printers, and fax machines.

- **Other overhead costs**

Expense items that do not fall into other categories or cannot be clearly associated with a particular product or function are considered to be other overhead costs. These types of expenses may include insurance, office supplies, or cleaning services.

4. Total expenses

this is a tabulation of all expenses incurred in running your business, exclusive of taxes or interest expense on interest income, if any.

5. Net income before taxes

this number represents the amount of income earned by a business prior to paying income taxes. This figure is arrived at by subtracting total operating expenses from gross profit.

6. Taxes

this is the amount of income taxes you owe to the federal government and, if applicable, state and local government taxes.

7. Net income

this is the amount of money the business has earned after paying income taxes

Amortization

In the course of doing business, you will likely acquire what are known as intangible assets. These assets can contribute to the revenue growth of your business and, as such, they can be expensed against these future revenues. An example of an intangible asset is when you buy a patent for an invention.

Calculating amortization

the formula for calculating the amortization on an intangible asset is similar to the one used for calculating straight-line depreciation. You divide the initial cost of the intangible asset by the estimated useful life of the intangible asset. For example, if it costs Dhs 10,000 to acquire a patent and it has an estimated useful life of ten years, the amortized amount per year equals Dhs 1,000. The amount of amortization accumulated since the asset was acquired appears on the balance sheet as a deduction under the amortized asset.

Formula

$$\text{Initial Cost} / \text{Useful Life} = \text{Amortization per Year}$$

$$\text{Dhs } 10,000 / 10 = \text{Dhs } 1,000 \text{ per Year}$$

Depreciation

The concept of depreciation is really pretty simple. For example, let's say you purchase a truck for your business. The truck loses value the minute you drive it out of the dealership. The truck is considered an operational asset in running your business. Each year that you own the truck, it loses some value, until the truck finally stops running and has no value to the business. Measuring the loss in value of an asset is known as depreciation.

Depreciation is considered an expense and is listed in an income statement under expenses. In addition to vehicles that may be used in your business, you can depreciate office furniture, office equipment, any buildings you own, and machinery you use to manufacture products.

Land is not considered an expense, nor can it be depreciated. Land does not wear out like vehicles or equipment.

To find the annual depreciation cost for your assets, you need to know the initial cost of the assets. You also need to determine how many years you think the assets will retain some value for your business. In the case of the truck, it may only have a useful life of ten years before it wears out and loses all value.

Straight-line depreciation

Straight-line depreciation is considered to be the most common method of depreciating assets. To compute the amount of annual depreciation expense using the straight-line method requires two numbers: the initial cost of the asset and its estimated useful life. For example, you purchase a truck for Dhs 20,000 and expect it to have use in your business for ten years. Using the straight-line method for determining depreciation, you would divide the initial cost of the truck by its useful life.

The Dhs 20,000 becomes a depreciation expense that is reported on your income statement under operation expenses at the end of each year.

For tax purposes, some accountants prefer to use other methods of accelerating depreciation in order to record larger amounts of depreciation in the early years of the asset to reduce tax bills as soon as possible.

You need, additionally, to check the regulations published by the federal Internal Revenue Service and various state revenue authorities for any specific rules regarding depreciation and methods of calculating depreciation for various types of assets.

Capital Assets and Depreciation

Almost every business must invest in some major equipment, vehicles, machinery, or furniture in order to operate. Some businesses will require assets such as land, a building, patents, or franchise rights. Major assets that will be used in your business for more than a year are known as "capital assets" and are subject to special treatment under the tax laws. Most importantly, you generally can't deduct the entire cost of acquiring such an asset in the year you acquire it.

Why not? Because one of the goals of accounting is to accurately measure a business's gross income, expenses, and net income (earnings) during a given period of time, usually a year. If a business were allowed to reduce one year's gross income by an expense deduction for the total cost of an item that will be used for several years, the result would be an understatement of earnings in the year the asset was purchased, and an overstatement of earnings during the following years.

It follows that, for "capital assets" (assets that have a useful life of more than one year), the cost must be written off (that is, depreciated or amortized) over more than one year.

Theoretically, the cost of an asset should be deducted over the number of years that the asset will be used, according to the actual drop in value that the asset will suffer each year. At the end of each year, you could subtract all depreciation claimed to date from the cost of the asset, to arrive at the asset's "book value," which would be equal to its market value. At the end of the asset's useful life for the business, any non depreciable portion would represent the salvage value for which the asset could be sold or scrapped.

Since the actual drop in value of each business asset would be difficult and time-consuming to compute (if indeed it could be computed at all), accountants use a variety of conventions to approximate and standardize the depreciation process.

For example, the straight-line method assumes that the asset depreciates by an equal percentage of its original value for each year that it's used. In contrast, the declining balance method assumes that the asset depreciates more in the earlier years. The following table compares the depreciation amounts that would be available

under these two methods, for a Dhs 1,000 asset that's expected to be used for five years and then sold for Dhs 100 in scrap.

Year	Straight-Line Method		Declining-Balance Method	
	Annual Depreciation	Year-End Book Value	Annual Depreciation	Year-End Book Value
1	Dhs 900 x 20%= Dhs 180	Dhs 1,000-Dhs 180= Dhs 820	Dhs 1,000 x 40%= Dhs 400	Dhs 1,000-Dhs 400= Dhs 600
2	Dhs 900 x 20%= Dhs 180	Dhs 820-Dhs 180= Dhs 640	Dhs 600 x 40%= Dhs 240	Dhs 600-Dhs 240= Dhs 360
3	Dhs 900 x 20%= Dhs 180	Dhs 640-Dhs 180= Dhs 460	Dhs 360 x 40%= Dhs 144	Dhs 360-144= Dhs 216
4	Dhs 900 x 20%= Dhs 180	Dhs 460-Dhs 180= Dhs 280	Dhs 216 x 40%= Dhs 86.40	Dhs 216-Dhs 86.40= Dhs 129.60
5	Dhs 900 x 20%= Dhs 180	Dhs 280-Dhs 180= Dhs 100	Dhs 129.60 x 40%= Dhs 51.84	Dhs 129.60-Dhs 51.84= Dhs 77.76

As you can see, the straight-line method results in the same deduction amount every year, while the declining-balance method results in larger deductions in the first years and much smaller deductions in the last two years. One implication of this system is that if the equipment is expected to be sold for a higher value at some point in the middle of its life, the declining balance method can result in a greater taxable gain that year because the book value of the asset will be relatively lower.

Notes:

Dhs = UAE Dirham