



Illinois Small Business Development Center  
*Turner Center for Entrepreneurship*

# Business 101: Accounting Concepts

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# IMEC (Illinois Manufacturing Excellence Center)

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- Improvement specialists and technicians
- Providing tools and resources to improve global competitiveness
- Focused on helping you plan for success, grow your business, improve operations, focus on people, and make decisions with data
- Assist over 1600 companies each year
- 19:1 Return on Investment
- The official representative of the MEP national network in Illinois

# Common Problems



- Lack of general accounting background
- Not understanding common terminology
- Incorrect structural set up of general ledger (agnostic of software)
- Incorrect use of process flows leading to a costly clean up efforts
- Inability to use the existing accounting data to make decisions
- Inability to leverage processes to make back office more efficient



# Agenda Topics

- Establish your company as a distinct legal entity
- Don't mix business & personal funds
- Open a business checking account/credit card
- Accrual basis vs cash basis
- Matching principle / revenue recognition
- Save money with deductions for business equipment
- Processes to support best practices and reduce regulatory risk



## Level Setting Definitions

**Asset** – A resource that an entity owns / controls with the expectation that it will provide a future benefit

**Liability** – Something (usually money) an entity owes that is settled over time by  
transfer of economic benefit

**Equity** – An owner's stake in a company (calculated assets – liabilities)

**Sales / Revenue** – Agreement of a buyer / seller regarding price & delivery of a security in exchange for agreed upon compensation

**Expense** – Outflow of money or assets to an entity as payment for an item or service

**Cash Basis** – Method recognizing revenue & expense when cash is received

# Business Structures

## Informal Business Structure

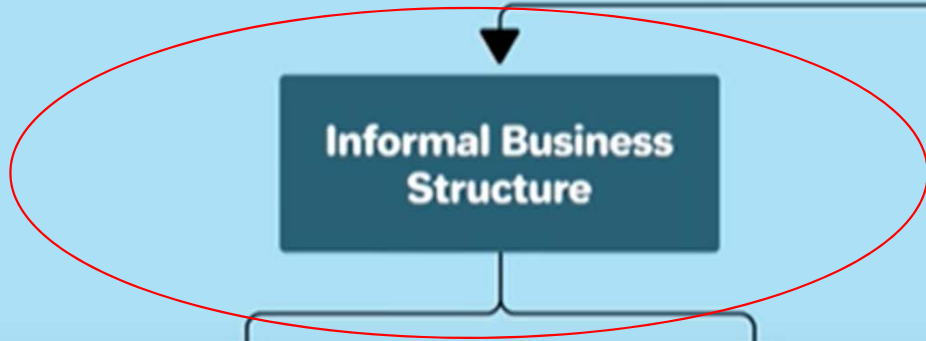
Sole Proprietorship

Partnership

## Formal Business Structure

LLC

Corporation



# Informal business structures



## **Benefits of Sole proprietorship/ general partnership**

- Low risk testing
- Familiar clients

## Disadvantages Informal business structures



### **Formal business structures provide:**

- Credibility
- Personal asset protection
- Builds business credit



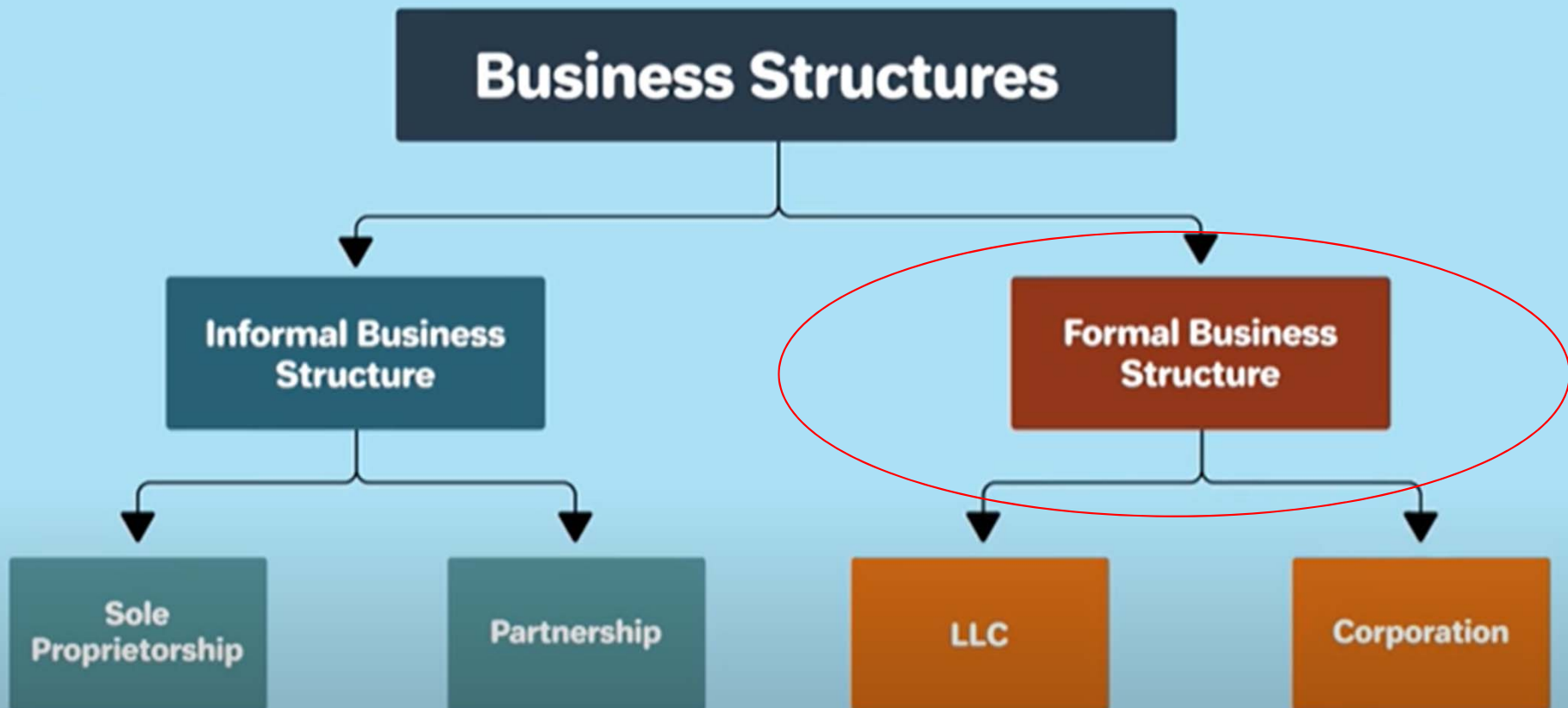
# Informal business structures

## When asset protection is important?

- Growing rapidly
- Acquiring new customers
- Making significant amounts of money



# Business Structures





## Formal business structures

### **Advantages of corporations** (Also known as C-Corp)

- Raise money from venture capital
- List on the Stock Exchange
- Efficiently carry money over between tax years

## Formal business structures



### **Disadvantages of corporations**

- More complex
- More difficult for starter business
- Double taxation

## Formal business structures



### **Advantages of LLC's compared to Corporations:**

- Simpler business structure
- Less paperwork
- Easier to start and maintain
- Only taxed once



## LLC Tax Status

### **Disadvantages of LLC's compared to informal structures**

- More complicated
- Requires additional paperwork
- Requires additional accounting services
- More closely scrutinized by the IRS

# Default vs Special Tax Status



## Tax Classifications

**Default**

**S-Corp**

**C-Corp**



## Default Tax Status: LLC

### **One Member:**

Also known as a “single member LLC” or “disregarded entity”

Pass through to the member for tax purposes

### **Multiple members:**

Treated as a partnership for tax purposes

Pass through means that all LLC distributions to members are subject to employment tax



# C-Corp Tax Status



LLCs classified as a C-Corp

- Has the same pros and cons of a C-Corp
- Should only be used when a company is making a lot of money and plans to reinvest into the business year after year
- Requires effort to follow the legal process of creating a corporate entity

## S-Corp Tax Status



LLC designated as S Corp for tax purposes allows members to become employees of the business, take

1. Reasonable salary - subject to employment and income tax
2. Distribution - only subject to income tax



What is the commingling of funds and why is it a problem?

# Commingling of funds means that you're treating your business's money as your own.



## Some ways to commingle funds are:

- Bank deposits made payable to your business from a client are deposited into your personal bank account.
- Making withdrawals from your business checking account to pay personal expenses without documentation.
- Depositing personal money to pay for business expenses.
- Using the same bank account for your business and personal needs.
- Writing business checks for personal expenses.
- Using a personal credit card for business expenses to get points.
- Moving money back and forth between your business and personal accounts without documentation.

# The problems with commingling funds



If you commingle funds, you could lose your LLC's or corporation's liability protection due to what is known as "piercing the corporate veil".

- All that work to form an LLC or corporation will be for nothing
- Assets will not be protected from creditors if your corporate veil is pierced.
- If you treat your business's money the same as your own, then you risk the exposure of your personal assets.
- It also makes accounting difficult and inaccurate. Accounting is more than just doing your taxes. Accounting tells you how your business is performing, what is doing well, and what needs improvement.



## How do I correct the commingling of funds?

Maybe you have already started your LLC or corporation and made the mistake of commingling funds. Recognizing the mistake early makes it easier to fix. To get started, you'll need to **identify the transactions that were personal**. Some common expenses that are a high priority with the IRS include travel, meals, entertainment, vehicle expenses, and home office expenses.

Those expenses that should be personal can sometimes be reclassified. They could be changed to be a **fringe benefit compensation or a loan to the shareholder**. The loan to a shareholder is a bit trickier and may not be the best to do without help from a CPA.

In summary, commingling funds can cause more of a legal problem than a tax problem. Your primary reason for forming an LLC or corporation in the first place was likely to reduce the your personal liability risks. Commingling funds jeopardizes that protection.



## Cash Basis vs Accrual Basis Accounting



## Introduction Accrual vs Cash

There are a lot of MYTHS about how accounting works. At its core, accounting is based on “Accrual Accounting”. The accrual basis is a set of rules used to record business transactions

I will:

1. Explain what "Accrual Accounting" is
2. Debunk common Accounting Myths



# Accrual Accounting



**Accrual Accounting is best understood through an example:**

Let's say you're the owner of a store that sells pencils:

- You purchase 100 pencils for \$1 each
- You then sell 50 of those pencils for \$3 each
- What's your profit?



## Two ways to calculate profit:

1. Using the “Cash Method” → how most people think accounting works
2. Using the “Accrual Method” → the basis of accounting

# Profit Comparison



## Cash Method

|                | Quantity    | Price      | Total       |
|----------------|-------------|------------|-------------|
| <b>Revenue</b> | 50 Pencils  | \$3 / each | \$150       |
| <b>Cost</b>    | 100 Pencils | \$1 /each  | \$100       |
| <b>Profit</b>  |             |            | <b>\$50</b> |

## Accrual Method

|                | Quantity   | Price      | Total        |
|----------------|------------|------------|--------------|
| <b>Revenue</b> | 50 Pencils | \$3 / each | \$150        |
| <b>Cost</b>    | 50 Pencils | \$1 /each  | <b>\$50</b>  |
| <b>Profit</b>  |            |            | <b>\$100</b> |

 Match Quantity Sold

Notice how profit is completely different under the two methods?

- It's \$50 under the CASH method
- It's \$100 under the ACCRUAL method Why is profit different under Accrual Accounting?

# How “Costs” are determined



## Cash Accounting:

- You bought 100 pencils for \$1, so you expense everything

→ Cost: 100 pencils \* \$1 = \$100

## Accrual Accounting:

- You only expense 50 pencils for \$1

→ Cost: 50 pencils \* \$1 = \$50

This is because under Accrual Accounting you have to match:

**QUANTITY SOLD = QUANTITY EXPENSED**

# Matching Principle

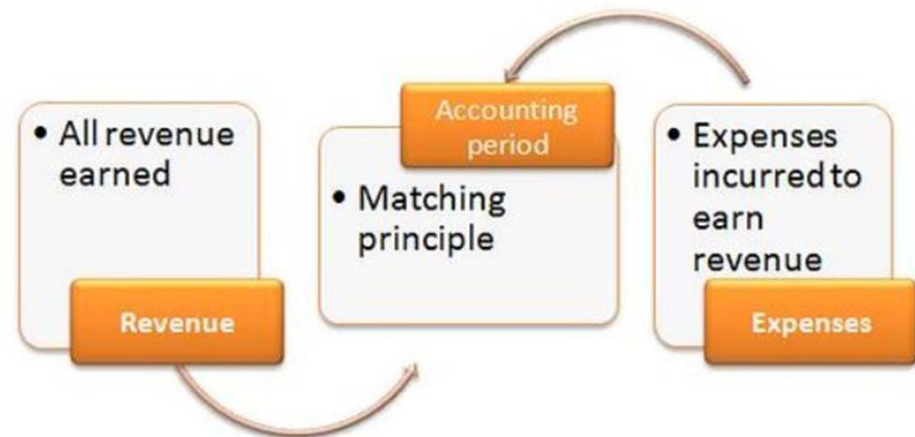


Generally, under accrual accounting

The QUANTITY in your COST must match the QUANTITY in your REVENUE

Why?

Because of the “Matching Principle”





**MYTH:** When you purchase goods, you can expense everything right away

Accounting doesn't work like that

Instead, you only expense the portion of the goods you SOLD

In the above example, that's 50 pencils NOT 100 pencils

The remainder of the unsold pencils are capitalized and expensed ONLY when they are SOLD

# Inventory

Because of the matching principle, there are consequences

One of those consequences is the creation of INVENTORY balances

Inventory is “goods” that you’ve paid for but haven’t sold yet

These goods are capitalized on the balance sheet



In our pencils example, the inventory balance would be calculated as:



### Accrual Method

|                            | Quantity    |
|----------------------------|-------------|
| <b>Pencils Purchased</b>   | 100 Pencils |
| <b>Pencils Sold</b>        | 50 Pencils  |
| <b>Remaining Inventory</b> | 50 Pencils  |



# Capitalizing Assets



Closely related to the inventory example is the concept of Capitalizing Assets

**MYTH:** When a business buys a new computer, you can write-off/expense it right away

That's not how accounting works

Because you will use your computer for 2 to 3 years

Accounting rules prevent you from expensing the computer when you buy it

Instead, just like inventory – the computer is capitalized and slowly expensed over time





## Let's look at an example:

- You buy a computer for \$1,500
- You have to expense the computer over a certain period say, 3 years
- In this case, can only expense \$500 worth in the first year ( $\$1,500 / 3$  years)

### Cash Method

|          | Cost    |
|----------|---------|
| Computer | \$1,500 |
| Expense  | \$1,500 |

### Accrual Method

|          | Cost    |
|----------|---------|
| Computer | \$1,500 |
| Expense  | \$500   |



Write off cost  
over 3 years

# Accounts Receivable



**MYTH:** You can only record a sale when cash is collected

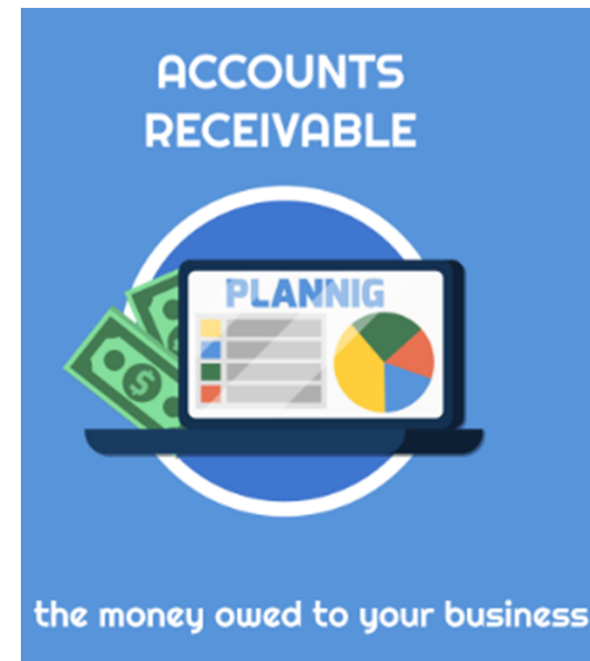
Accounting doesn't work like that

You have to record a sale when you invoice your customer

If your customer takes 1 month to pay your bill, you DON'T wait 1 month to book the sale

Instead, the sale is booked when the customer is invoiced

You then record accounts receivable to show that the customer owes you money for the sale



## Let's look at an example:

- You sell a service to a customer for \$100
- You invoice the customer on December 31, 2021
- The customer pays on January 31, 2022



### Cash Method

|                            | Date              | Sale  |
|----------------------------|-------------------|-------|
| <b>Invoice Date</b>        | December 31, 2021 | -     |
| <b>Accounts Receivable</b> | December 31, 2021 | -     |
| <b>Payment Date</b>        | January 31, 2022  | \$100 |

### Accrual Method

|                            | Date              | Sale  |
|----------------------------|-------------------|-------|
| <b>Invoice Date</b>        | December 31, 2021 | \$100 |
| <b>Accounts Receivable</b> | December 31, 2021 | \$100 |
| <b>Payment Date</b>        | January 31, 2022  | -     |

For accrual Accounting: The sale is booked in December 2021 when the customer was invoiced NOT when payment was received

# Accounts Payable



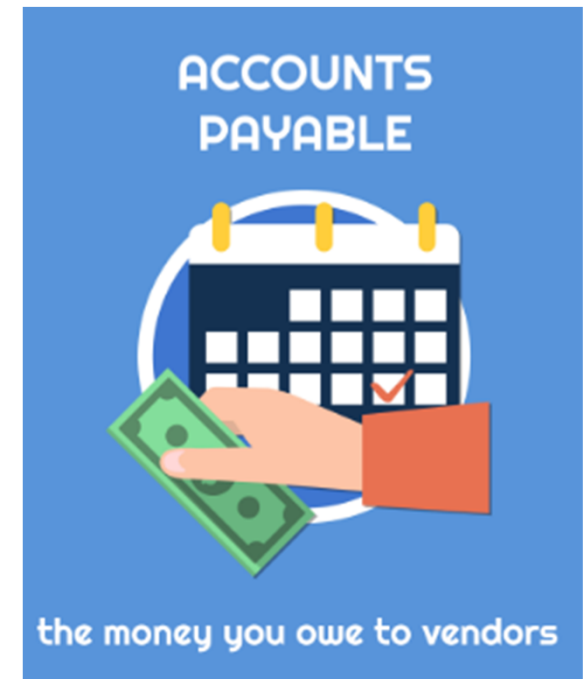
**MYTH:** You can only record an expense when you pay cash to your suppliers

Accounting doesn't work like that

You have to record an expense when you receive a bill from a supplier

If you take 1 month to pay the bill, you DON'T wait 1 month to book the expense

Instead, the expense is booked when you get the bill from your supplier. You then record ACCOUNTS PAYABLE to show that you owe money to your supplier



## Let's look at an example:



- You buy a service from a supplier for \$500
- Your supplier sends you a bill on February 28, 2022
- You pay the bill on March 31, 2022

### Cash Method

|                         | Date              | Sale  |
|-------------------------|-------------------|-------|
| <b>Invoice Date</b>     | February 28, 2022 | -     |
| <b>Accounts Payable</b> | February 28, 2022 | -     |
| <b>Payment Date</b>     | March 31, 2022    | \$500 |

### Accrual Method

|                         | Date              | Sale  |
|-------------------------|-------------------|-------|
| <b>Invoice Date</b>     | February 28, 2022 | \$500 |
| <b>Accounts Payable</b> | February 28, 2022 | \$500 |
| <b>Payment Date</b>     | March 31, 2022    | -     |

In the example above, for Accrual Accounting: The expense is booked on February 28, when you RECEIVED the bill NOT when you PAID the bill

# Tax Treatment for some business equipment



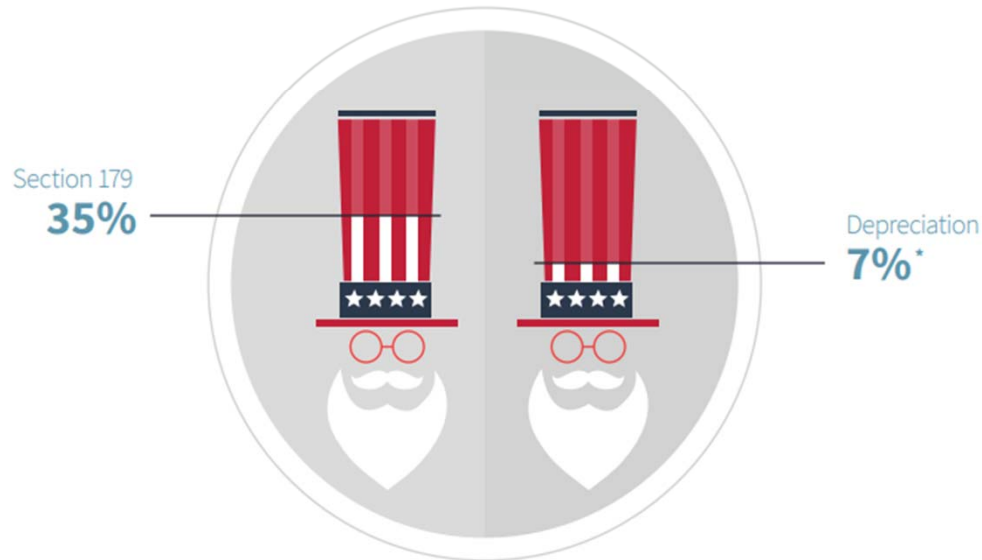
## Benefit From Section 179

Instead of “deducting” qualifying equipment or software over time – according to a set depreciation schedule – Section 179 allows businesses to deduct the full purchase price during the first tax year.

The Section 179 Deduction Limit is \$500,000

## First Tax Year Savings

Section 179 vs. Set Depreciation Schedule

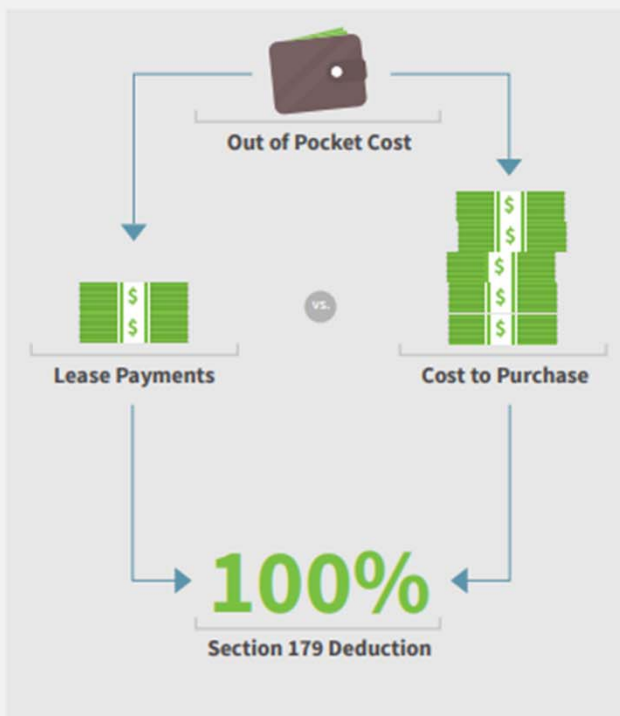


## Should I lease or purchase Section 179 equipment?



### Lease or Purchase?

Section 179 works for most leased or purchased equipment. Since both methods of payment are 100% deductible under Section 179, the biggest difference is in out-of-pocket expense. If you purchase, you pay the entire amount for the equipment out of pocket and then deduct the purchase price on your taxes. If you lease, you pay only the monthly lease payments out of pocket and still get to deduct the full purchase price on your taxes. That is a huge difference that makes good financial sense.



Many vehicles & equipment qualify for Section 179 treatment, but rules are very specific. Talk with a CPA to make sure your purchase qualifies.



# Where do you start?



1. Attend rest of the webinar series
2. Set up standard processes
3. If unable to keep up, outsource



# Attend rest of webinar series



## **Sessions**

1. Accounting Concepts
2. Concepts in Action
3. Quickbooks 101
4. Quickbooks 201

# Set up a Standard Process



## End-to-end accounting checklist



## What is Client Accounting Services?

### What it's Not:

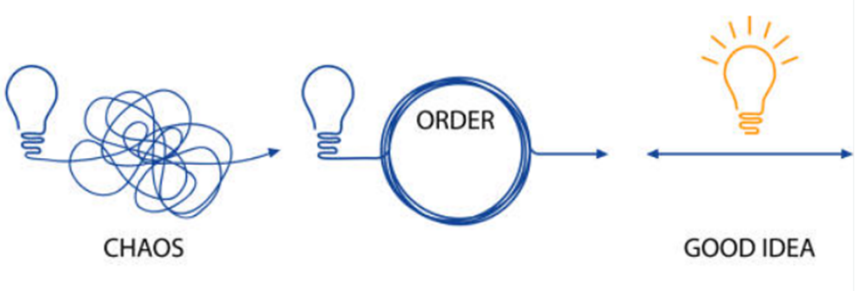
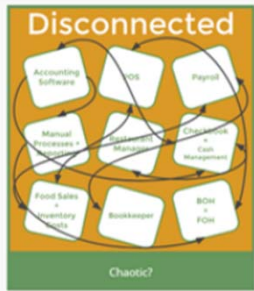
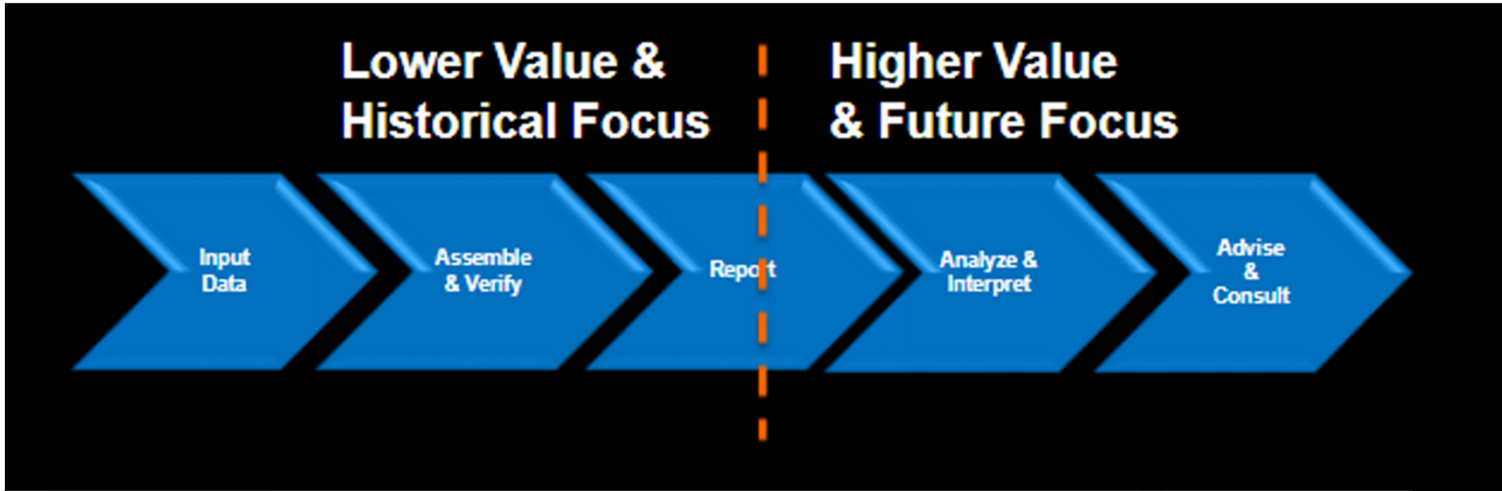
- Bookkeeping
- Write Up
- After the fact reporting

### What it is:

- Financial Statement Preparation
  - General Ledger/Trial Balance
  - Cash Flow Management
  - Payroll Preparation & Reporting
  - Accounts Payable and Receivable
  - Transaction Processing (BPO)
  - **Virtual CFO Services**
  - Controllership
  - Business Advisory
- 



# Value Prop for Clients





## Top Five CAS Offerings

1. Financial statement preparation
2. CFO/Controller Advisory services
3. Accounts Payable
4. Forecasting/budgeting
5. 1099 Creation and Filing





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# Questions?

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