A Small Builder's Guide to Accounting

Do debits and credits scare the daylights out of you? Master these basic accounting principles and overcome your fear of figures.

by Jack Philbin

Many small contractors think of accounting as a necessary evil. If financial records weren't required for tax purposes, they would bid the whole process good riddance. Call me a bean-counter, but I take the opposite view. I'm a remodeler in the Chicago area, and I spend most of my time selling and administrating the jobs my field crews are working on. For me, the financial end of the business is its heart and soul. I work hard and have a lot invested in my company's success. I've learned from experience that if I don't keep an eye on my money, no one else will.

I don't mean to say that other builders don't want to make money — they do. But as soon as an accountant-type starts talking about equity, debits, credits, assets, and liabilities, they're lost. Faced with this bewildering terminology, contractors who have spent years in the field perfecting their craftsmanship tend to give up on trying to understand the principles that make an accounting system work.

Don't make that mistake. Accounting isn't that difficult to understand. In fact, it's a lot easier than laying out rafters or designing a room addition. But there is a lot to learn, and I can't cover it all in one article. I can, however, introduce basic principles of accounting, and show you how standard financial reports are put together.

Checkbook Accounting

Most builders start out using their checkbook to keep track of their company's financial health. Unfortunately, while scrupulously making entries in your checkbook will prevent you from overdrawing your checking account, it can't tell you whether you're making

Glossary of Accounting Terms

account: a numbered category that holds records for similar types of transactions

accrual basis: an accounting method that recognizes income at the time it is earned (but before money is collected), and expenses at the time they are incurred (but before debts are paid) (see *cash basis*)

assets: cash, or property and equipment that can be sold for cash

balance sheet: a financial statement showing a company's assets, liabilities, and owner's equity as of a certain date

cash basis: an accounting method that does not recognize revenue until the money owed is actually collected, and does not recognize expenses until debts are actually paid (see *accrual basis*)

chart of accounts: a complete list of accounts, arranged in five sections: assets, liabilities, owner's equity, income, and expenses

cost of sales: see *direct costs*

creditor's equity: (see *liabilities*)

debits and credits: terms used to indicate increasing or decreasing an account. By convention, debits are always recorded on the left side of a ledger, credits on the right. Debits and credits must always be in balance (see *double-entry*)

direct costs: costs such as materials, labor, and subcontractors that can be assigned to a particular job

double-entry: an accounting method that requires recording each transaction in two or more accounts, with balanced (equal) debits and credits

income statement: a financial statement covering a given period of time, and showing all income and expenses, and the resulting net profit or loss

indirect costs: general operating costs (such as rent, phone service, and office supplies) that cannot be assigned to a particular job

liabilities: the claims of creditors (such as banks) against a company's assets (also called *creditor's equity*)

net profit: income in excess of all business costs and expenses

overhead: indirect costs included in the selling price (usually allocated as a percentage of direct costs)

owner's equity: the amount of a company's total assets that belong to the owner

profit-and-loss statement: see *income statement*

retained earnings: accumulated business profit that is not distributed to owner, but remains in the business

sales: an account that records income from business operations

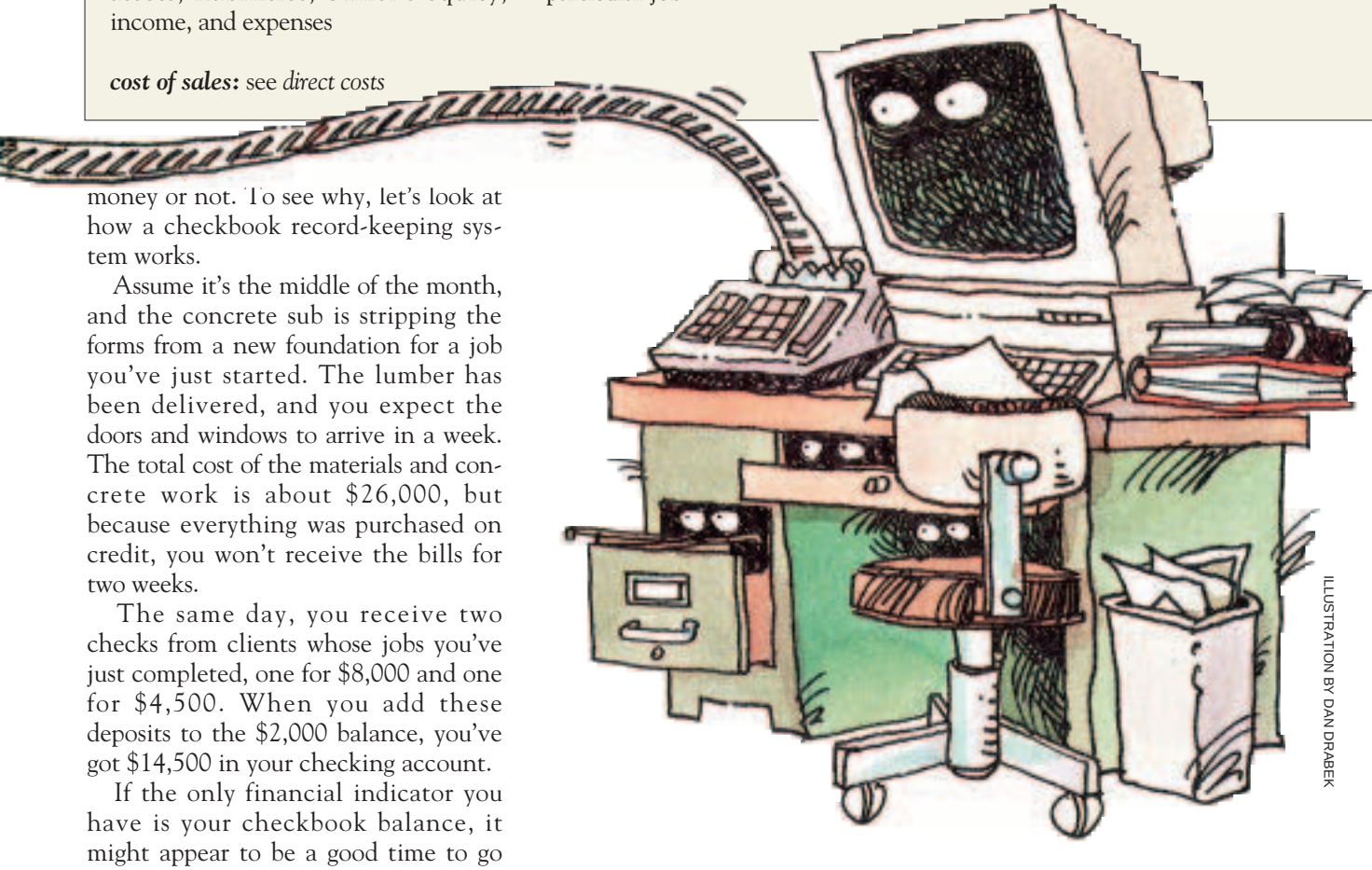

ILLUSTRATION BY DAN DRABEK

money or not. To see why, let's look at how a checkbook record-keeping system works.

Assume it's the middle of the month, and the concrete sub is stripping the forms from a new foundation for a job you've just started. The lumber has been delivered, and you expect the doors and windows to arrive in a week. The total cost of the materials and concrete work is about $26,000, but because everything was purchased on credit, you won't receive the bills for two weeks.

The same day, you receive two checks from clients whose jobs you've just completed, one for $8,000 and one for $4,500. When you add these deposits to the $2,000 balance, you've got $14,500 in your checking account.

If the only financial indicator you have is your checkbook balance, it might appear to be a good time to go

Chart of Accounts

100-199 Assets (debit to increase)

101 Petty Cash
102 Cash Account
111 Cert. of Deposit
115 Payroll Advances
*120 Accounts Receivable
129 Plan Deposits
*131 Prepaid Taxes
*134 Prepaid Insurance
155 Furniture/Fixtures
156 Construction Equip.
157 Vehicles
181 Accum. Depreciation: Furnitures/Fixtures
182 Accum. Depreciation: Construction Equip.
183 Accum. Depreciation: Vehicles

200-299 Liabilities (credit to increase)

*220 Accounts Payable
*231 FICA Payable
232 Fed. Income Tax Withheld
233 State Income Tax Withheld
*234 State Unemployment Tax
*235 Workers Comp. Payable
*236 Gen. Liability Insurance Payable
*238 Fed. Unemployment Tax Payable
*241 Accrued Medical Insurance
*242 Accrued Employee Payroll Savings
*245 State Income Tax Payable
251 Note Payable

300-499 Equity (credit to increase)

*304 Capital Stock
*309 Dividends Paid
310 Cumulative Profits
320 Retained Earnings

400-499 Income (credit to increase)

400 Contract Income – Residential
401 Contract Income – Commercial
402 Finance Charges
405 Design/Plan Fees
470 Other Income
480 Interest Income
490 Discounts Earned

500-799 Expenses (debit to increase)

(500-599 Direct Costs)

500 Materials
501 Subcontractors
510 Trash Removal
520 Permits & Fees
540 Direct Labor
541 Direct Labor – Payroll Taxes
542 Direct Labor – Medical Benefits
543 Direct Labor – Workers Comp.
544 General Liability Insurance
550 Vehicle Fuel/Maintenance
552 Architectural/Design/Engineering Fees

(600-799 Indirect Costs)

605 General Insurance (tools)
607 Taxes/Licenses
608 Dues/Subscriptions
609 Interest
610 Education/Training – Employees
611 Legal/Accounting Fees
612 Utilities
613 Telephone
614 Rent
615 Office Equipment
616 Marketing
617 Contributions
618 Bank Service Charges
619 Advertising
621 Postage
627 Furniture/Fixtures Depreciation
638 Equipment Depreciation
639 Vehicle Depreciation
640 Overhead Labor
641 Overhead Payroll Taxes
642 Overhead Medical Benefits
643 Overhead Workers Comp.
650 Tool Repair/Replacement
664 Office Repair/Maintenance

(700-799 Administrative Expenses)

710 Education/Training – Owner
730 Vehicle – Owner
740 Owner Salary
741 Owner Payroll Taxes
742 Owner Payroll Benefits
743 Owner Workers Comp.
790 State Income Tax Expense

** These accounts are used with accrual basis accounting.*

Figure 1. *All financial transactions are recorded in numbered categories called accounts. The five main groups used by financial reports — assets, liabilities, equities, income, and expenses — can be further subdivided. For example, accounts 500-799 represent expenses, which are organized into three subgroups: direct costs, indirect costs, and administrative expenses. These subgroupings have no effect on the basic accounting formula, but are useful when you want to isolate specific financial information, such as the amount spent on administrative expenses.*

The numbering system has been developed through convention, and varies slightly from company to company. When you set up your chart, leave room between account numbers so you can add accounts as you need them.

out and buy a new truck. The problem, however, is that none of the money in your checking account is yours — you owe it all to someone else. If your business is very small, you might be able to adjust for future bills, because you personally order all of the material for every job. But when you have several jobs going at once, each of which has a foreman who orders materials for his project, it's easy to lose track.

The shortcomings of checkbook accounting are also complicated by payroll withholding taxes, quarterly insurance payments, and other liabilities that accumulate steadily, but are payable at some future date.

Assets, Liabilities, and Equity

The goal of accounting (besides providing tax information) is to determine whether your financial stake in your company, called *equity*, is increasing or decreasing. The basic formula is:

Assets = Liability + Equity

Assets include cash, plus materials and equipment you own that can be readily sold for cash. *Liabilities* are all the debts the company owes. *Equity* is the amount of money left over from company operations after all of the bills have been paid.

Every dollar your company takes in or pays out affects this formula. And like any other mathematical equation, whenever one element of this formula increases or decreases, it affects the other two (see "Debits, Credits, and Double-Entry,"). The ability to keep track of this constant relationship between assets, liabilities, and equity is the main advantage of using an accounting system instead of a checkbook (see "Accrual vs. Cash Accounting," next page). A checkbook balance does not track liabilities (such as money owed subs and suppliers), so it sometimes shows more equity than there really is. On the other hand, because a checkbook tracks only cash, it may show less than actual equity; receivables (such as money owed by clients) are not included.

Records and Reports

An accounting system is a method of keeping track of financial transactions, which can then be summarized into reports, or financial statements.

Chart of accounts. Whether you must always be in balance. For example, let's say you purchase $200 worth of materials. Two accounts are affected: Cash is credited (decreased) and Materials is debited (increased):

#102 Cash Account

	debits	credits
ABC Lumber Co.		$200

#500 Materials Account

	debits	credits
Lumber	$200	

The basic accounting formula (Assets = Liabilities + Equity) is set up so that the total of all debit accounts and all credit accounts is the same. In the sample chart of accounts, Liabilities, Equity, and Income are credit balance accounts that are offset by the debit balance Expense accounts (Direct Costs, Indirect Costs, and Administrative Expenses). If the company is making money, the sum of these accounts appears on one side of the accounting equation as a net credit. This offsets Assets — a debit account — on the other side of the equation.

— *J.P.*

Income Statement
ABC Construction Company
December 31, 1993

Revenues:		
Sales	$510,000	
Cost of Sales	383,000	
Gross Profit		**$127,000**
Operating Expenses:		
Interest	$2,300	
Marketing	5,000	
General and Admin.	93,100	
Total Operating Expenses:		**$100,400**
Net Profit (or Loss) before taxes:		**$26,600**

Figure 2. *An income statement (also called a profit/loss statement or "P-and-L") summarizes all revenue and expenses associated with the operation of a construction company. If the "bottom line" is a positive number, the company earned a net profit (more money came in than went out). A negative number indicates a net loss (more debt was incurred than could be covered by revenue).*

Debits, Credits, and Double-Entry

In checkbook accounting, only one "account" changes with each transaction: the checkbook balance, or cash account. The amount is either increased or decreased, depending on whether you make a deposit or write a check.

Debits and credits. Double-entry accounting, however, records every transaction in at least two accounts. An entry in one account is offset by a corresponding entry in another account. Accountants refer to these offsetting entries as *debits* and *credits*, two terms that are probably responsible for most of the confusion surrounding double-entry accounting. Unfortunately, the way these terms are used is often the exact opposite of their common-sense meaning. Debits and credits can increase or decrease the amount in an account, depending on what type of account it is. For instance, when you deposit money in your checking account, you increase the balance, which common sense tells you is a credit. But cash is an asset account, so it is increased with a debit. Go figure.

The special meaning of these terms has developed by convention, but the important thing to remember is that credits and debits

keep track manually or on a computer, the first step in establishing an accounting system is to set up numbered categories, or *accounts*, in which to record all financial transactions. Accounts are organized into five main groups, according to the kind of information they represent — assets, liabilities, equities, income, and expenses — and the whole list is called a *chart of accounts* (see Figure 1, page 58).

The more complicated your business is, the more accounts you will have. To keep things simple, the chart shown in Figure 1 includes only the accounts that are necessary to keep accurate records for a small construction company. As your company grows, you can add accounts as you need them.

Income statement. Totals from the income and expense accounts all appear on a report called an *income statement* (Figure 2, previous page). This statement summarizes all construction revenue (usually called sales), and all expenses (cost of sales). For most small construction companies, sales revenue is usually lumped together into one amount. But if you want to keep track of both new construction and remodeling sales, for example, you could list these separately (you would also need to create separate accounts for each type of work).

For a construction company, there are two types of expenses: the costs of construction and the general operating expenses of running a business. Construction costs, or *direct costs*, include items such as lumber and subcontractors (which can be traced directly to a particular job) as well as other construction-related costs, such as supervisory time and company vehicle expenses.

General operating expenses, called *indirect costs* or *overhead*, include administrative costs (such as office supplies and office rent), marketing expenses (such as the cost of an advertising brochure), and financing costs (such as interest on a line of credit).

On an income statement, the sum of cost of sales and expenses is subtracted from revenue, resulting in the "bottom line" — net profit or loss for the time period covered by the report. You can prepare an income statement as often as you like, but its accuracy depends on how frequently you bring the numbers in the accounts up to date. My accounting information is stored on computer, and my bookkeeper updates all financial transactions daily (including payroll).

I make an appointment to visit with my money every Saturday morning. Why so often? I work hard, and I want to make sure that all my effort is paying off. My income statement helps me gauge my company's performance, and helps me to predict financial disasters before they happen. For example, I once had a couple of less-than-honest employees who decided to enrich themselves at my expense. They were charging clients for extras and pocketing the money. Had I not been watching material and labor costs on my income statement, I might never have found out about their deception.

There's more to an accounting system than I've been able to cover in this article. If you want to find out more about income statements, balance sheets, and financial ratios, I suggest you read the following books:

- *Accounting and Financial Management for Builders* (NAHB Home Builder Press, 1988; 800/223-2665. 83 pages. $25.)
- *Managing a Contracting Business* by Harold Squire (Squire and Associates, 1991; 614/451-4860. 185 pages. $31.50.). ■

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Accrual vs. Cash Accounting

The accuracy of accounting information depends in part on when amounts are entered, or posted, to accounts. In the early years of my business, I kept my records on a *cash basis*. In other words, I didn't record income until I actually received a check from a customer. Similarly, I didn't record an expense until I paid a supplier or subcontractor.

But cash accounting, like checkbook accounting, doesn't provide for any way to track money you owe but haven't yet paid, or money you have billed for but haven't yet received. If you receive a couple of payments from customers before you receive bills from vendors, cash accounting makes it appear as if you have more money than you really do.

Accrual basis accounting is the most accurate way of knowing where your business stands. This system recognizes income when a job is completed and billed (but before payment is received), and recognizes expenses when a bill or invoice is received (but before it is paid).

Accrual accounting requires several special accounts (marked with an asterisk in the sample chart of accounts). For example, *#120 Accounts Receivable*, holds amounts due from customers until payment is actually made. Similarly, *#220 Accounts Payable* holds amounts due to suppliers and subs until the bills are actually paid.

A typical accrual system would treat the purchase of materials — and subsequent payment for them — with balanced debit and credit entries in four accounts:

- When the bill for the materials arrives, #220 Accounts Payable is *credited* (increased), and #500 Materials is *debited* (increased).
- When the bill is paid, #220 Accounts Payable is *debited* (decreased) and #102 Cash is *credited* (decreased).

Accrual accounting used to be a record-keeping chore, but today's "fill-in-the-blanks" accounting software makes it much easier to get accurate, up-to-date financial information. (Accrual accounting may have tax consequences, so check with a CPA before making the switch.)

— *J.P.*