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When to Upgrade an Accounting System

Deciding when an accounting system should be upgraded is a critical decision for any business. If you wait too long, the results can be disastrous. But if you upgrade too soon, you can incur a substantial expense and have nothing to show for it, or you might choose a system that will quickly become obsolete as the company grows. The key to making the right decision at the right time is a careful examination of your present accounting procedures.

What to look for

The following problems usually indicate that an accounting system needs to be upgraded. Keep in mind, however, that there may be solutions to some of these problems that do not require a system upgrade.

- **Inaccurate data.** Frequent data errors such as inconsistencies between receivables records and the general ledger, or difficulties in reconciling bank statements may be the result of poor employee performance or signs of work overload. Upgrading a computer system won't stop employee carelessness, but if the cause of the errors is simply too much work for employees, a system upgrade may well be the solution.
- **Delays in the flow of information.** A common cause of delays in the flow of financial information is a poor reporting system from departments other than bookkeeping. For example, bookkeeping relies on purchasing to approve invoices for payment, and on shipping departments to supply information about

Illustration by Chris Gash

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taxPOINTS

Divorced or separated parents are often in different tax brackets. At filing time they should determine who will have the greater tax benefit from claiming the children. **Planning tool:** If the parent who usually claims the exemption is in a lower tax bracket, the exemption can be taken by the higher bracket parent simply by filing IRS Form 8332.

Trap: Buying a house for all cash when borrowing will be needed later. On any later borrowing that you may do, you will find that the mortgage interest paid is deductible within limits and only up to the first $100,000 of debt. This is treated as equity borrowing. If you're going to need the money, then borrow at the time you purchase the house since you would be able to deduct the interest on the first $1,000,000 of debt. This is treated as acquisition borrowing.

Paying IRS notices. Always specify on the check what tax you are paying. **Pitfall:** The IRS can apply payments that are not described to any outstanding tax liability that you may have, or that you may not be aware of. The result can be having to pay penalties and interest on a tax that you thought you had paid.

Transferring an IRA. If you are the designated beneficiary of an IRA from your spouse, you can simply transfer the money to your IRA without penalty.

How Long Should You Keep Your Business Records?

One of the most common questions asked by business owners is how long they should keep their business records. The answer depends on several factors: the type of business and what state or regulatory agency requirements apply, for example. But although there's no hard-and-fast answer to the question, the following guidelines apply to most businesses.

Keep for One Year
- Receiving sheets
- Duplicate bank deposit slips
- Requisitions
- Stockroom withdrawal slips
- Bank reconciliations
- Purchase orders

Keep for Two Years
- Proxies of voting stockholders

Keep for Three Years
- Insurance policies
- Petty cash slips
- Correspondence
- Physical inventory tags
- Internal reports
- Employment applications

Keep for Five Years
- Internal audit reports
- Excise tax computations

Keep for Seven Years
- Payroll records and related documents
- Canceled stock and bond certificates
- Accounts payable ledgers
- Accounts receivable ledgers
- Customer invoices
- Vendor invoices
- Subsidiary ledgers
- Time cards
- Vouchers for payments to vendors
- Inventory records
- Expense analysis schedules
- Contracts and leases
- Canceled checks
- Purchasing department copy of purchase orders
- Scrap and salvage records
- Sales records

Keep Permanently
- Deeds and mortgages
- Credit history
- Cash ledgers
- Property appraisals
- Contracts and leases—major
- Accountants' report
- Canceled checks for large and important papers
- Insurance records
- Journals
- Trademark registrations
- Bills of sale for important purchases
- Financial statements
- Minute books, bylaws and certificate of incorporation
- Correspondence—major matters and legal
- Tax returns
- Chart of accounts
- Records dealing with the company's capital structure
- Property records
- General ledgers

Borrowing From Your Company Can Mean Extra Taxes

It's not uncommon for a closely held corporation to pay for some of the personal expenses of its officer-stockholders. On its balance sheet, the business treats such transactions as "loans to officers" which the stockholder owes the company. Although some business owners think that this practice is to their advantage, it can ultimately result in unnecessary higher taxes.

Paul Page is a good example. A natural salesman, Paul began his business career by putting his talents to work for a residential real estate broker. From the beginning, he was a success. When Paul showed a house to a buyer, it was only a matter of time until the "For Sale" sign was covered by a "Sold" sign.

But Paul's ambition went beyond being a successful real estate salesman, for he had always dreamed of being in business for himself. When he saw that his reputation was attracting more and more real estate listings for his employer, Paul knew the time was right to turn his dream into reality and Page Properties, Inc. was born.

The company was an immediate success and generated enough income to pay Paul an annual salary of $90,000 and still show a healthy profit. In addition, the business paid an average of about $20,000 a year for some of Paul's personal expenses. The corporation classified these payments as "loans to officers" and Paul paid a portion of them back to the company each year.

For the taxable year ending December 31, 2014, Page Properties, Inc., reported taxable income of $80,000 and paid $15,450 in federal corporate income tax. Paul also filed his personal 2014 individual income tax return and made his annual contribution to the IRS on his $90,000 salary. By the end of 2014, the amount that Paul owed his company for its payment of his personal expenses was $20,000. However, since the company treated it as a loan to officers, Paul felt comfortable that it wasn't taxable income to him.

A BETTER SOLUTION

If anything can trigger an IRS audit of a corporate income tax return, it's loans to an officer's account. The IRS takes a long hard look at transactions between a closely held corporation and its officer-stockholders. When corporate assets are transferred to a stockholder, the IRS considers the transaction to be a "constructive dividend". Like any other dividend, a constructive dividend is taxable to the stockholder who receives it.

Payment of a stockholder's personal expenses by a corporation is the most common type of constructive dividend. Corporations typically treat such payments as a business expense and claim them on their income tax return. However, the IRS will not allow a business deduction for expenses which are obviously personal. The amount a corporation pays toward these expenses is considered to be a dividend and is fully taxable to the officer-stockholder. As a dividend it is not treated as a deduction on the company's return.

If Paul Page understood the tax law as well as he understood the real estate market, he could have saved a pretty penny on his company's 2014 corporate income tax.

Instead of allowing his company to pay $20,000 for his personal expenses, Paul should have increased his salary by $20,000. This would not change the amount of individual income he would report because his income would be the same - $110,000 in salary instead of $90,000 in salary plus $20,000 in dividends. However, Paul's additional $20,000 in salary would be a deductible expense for Page Properties, Inc. This would reduce the company's taxable income from $80,000 to $60,000 - for a tax savings of $5,450.

The moral of this story is simple. If you need additional income, don't have your company pay for your personal expenses. Take a larger salary instead.

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outgoing orders. If either of these departments does not supply information on time, no accounting system can function properly.

An upgraded computer system is not a substitute for sound reporting procedures. An upgrade should be considered only when it has been determined that reporting procedures are not the cause of delays in the flow of information.

- **Consistently late financial reports.** Outdated financial information is virtually useless. It can cause management to miss significant trends or result in late invoicing which can have a damaging effect on cash flow.

  This problem is often found in companies that use outside service organizations to perform certain accounting functions. Transferring these functions in-house can often eliminate late reports. Internal control of all accounting functions is sometimes a better solution to late financial reports than a system upgrade.

- **Lack of time to prepare financial reports.** Many of the most useful financial reports often take so much time to prepare manually that little or no effort is made to maintain them. Detailed analyses of information such as sales by customer category or by sales territory are simply not available and management is forced to operate without key financial information. There are many good accounting software packages that can provide standard financial reports in a timely manner and make it easier to develop customized reports as well.

- **Unexpected low profitability.** Controlling assets is a powerful tool to improve profits. In itself, this can be sufficient reason to upgrade an accounting system. Tight control over receivables and inventory is essential to profitability. Off-the-shelf software is available to signal reorder action, indicate quantities needed, and identify slow-moving or unprofitable items.

- **Insufficient cash flow.** A variety of financial factors must be monitored to keep cash flow healthy. Accounts receivable, payments to vendors, interest charges, tax planning, and many other financial factors can impact cash flow. It's necessary to keep track of all these elements and to be aware of how each of them effects the others.

  A good receivables software program can speed up collection time by 15% or more by immediately identifying slow-paying customers, creating statements, calculating finance charges, and even generating collection letters.

Where to get advice

Few computer salespeople can be objective about whether an accounting system should be upgraded. If any of the above problems are apparent in your company, it's best to consult with your accountant, who is knowledgeable about accounting software. And above all, be sure you don't make any changes until all accounting problems have been clearly identified.

Executive Strategies

Better decisions: First, try to find the ideal solution to a problem. Since there is never a perfect solution, you'll always have to seek compromises, but if you first determine what's the absolute best for your company, you'll find that your decisions about compromises will be much easier.

Sure road to failure: Try to please everyone.

Mark of leadership: Accept the fact that tough decisions may be unpopular. And that long periods of time may elapse before your efforts are rewarded.