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— Thomas J. Watson

APPENDIX D: GUIDE TO KEEPING FINANCIAL RECORDS IN THE VIRTUAL ENTERPRISE

Introduction

Keeping accurate records is imperative if a business is going to succeed. There are many different ways to keep track of a business's daily transactions. Choices can vary from a simple, single-entry bookkeeping system to a more complicated double entry accounting system. There are also numerous computerized accounting programs such QuickBooks and Peach Tree.

Regardless of which recordkeeping or accounting system you choose, all businesses must maintain records to keep track of its daily transactions. These records enable you to tell what is happening with the business and are used to generate profit and loss statements and balance sheets.

What information must you keep track of? Where can you keep track of this information?

One way to keep track of the above information is to use the following forms that have been designed for the typical VE. Suggestions for use are provided in the following table:

Information You Need to Record	Forms to Use
Increases and decreases in cash	Revenue and expense journal
Sales made to customers	Sales journal
Amounts due from customers (Accounts Receivable)	Schedule of Accounts Receivable
Purchases made from vendors	Purchases journal
Amounts due from vendors (Accounts Payable)	Schedule of Accounts Payable
A list of all assets owned by the firm	Assets Log
Inventory (all products that are purchased for resale)	Inventory Record
Payroll, payroll taxes and payroll deductions	Payroll Register

A more detailed description of these forms and instructions for using them follows.

Revenue and Expense Journal

This is the main general record used by a business to record individual transactions where cash is received or checks are written. Transactions are recorded as increases to cash or decreases from cash. Each transaction should be entered on a separate line, and should include the date and the VEC Bank reference number.

- **Cash increases**

  When cash is received by the business, indicate the amount received in the column titled *Increases*. Some businesses receive payment at the time they make the sale of their goods and/or services. These firms would include two additional columns, titled *Sales* and *Sales Tax*, and make entries in those columns whenever they record a sale for which they received payment at the time of the sale.

  For almost all VE firms however, sales are made *on account*, which means that the sale is made and payment is received at a later date. In this case, the sale will be recorded in the *Sales Journal* (see below). When the customer eventually pays the bill, the receipt of cash

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will be recorded in the *Revenue and Expense Journal*. The amount of cash received will be recorded in the column titled *Increases*. On the same line, the amount of the increase should be entered in the column titled *Accounts Receivable*.

- **Cash decreases**

  When cash is paid by the business, indicate the amount paid in the column titled *Decreases*. On the same line, indicate the amount of the decrease in an additional column, under the column heading that describes the purpose of the cash decrease. The more columns you include in the journal, the more organized the information will be. Typical column headings might include:

  — Salaries
  — Payroll taxes
  — Rent
  — Utilities
  — Advertising
  — Inventory purchases
  — Freight
  — Miscellaneous

To acquaint you with a Revenue and Expense Journal, a completed record is included in the appendix along with a blank Revenue and Expense Journal.

Sales Journal

This journal is used to record all sales that your company makes to customers. It should include the following information:

- Date of sale
- Customer's name
- Invoice number
- Amount of sale
- Amount of sales tax due

Date	Customer	Invoice No.	Sale Amt.	Sales Tax	Total

To acquaint you with a Sales Journal, a completed record is included in the appendix along with a blank Sales Journal.

Schedule of Accounts Receivable

This record is used to help you keep track of debts owed to the company as a result of the sale of a product or the rendering of a service to a customer. Each customer should be assigned an account number and have a separate page with account information as indicated on the form that follows.

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Invoice Date	Invoice No.	Invoice Amount	Date Paid	Amount Paid	Invoice Balance

Each form should include the customer's name, address and account number. The balances from each customer's individual records should be summarized in a form so that the total amount of accounts receivable can be determined. A sample of this form is provided:

Date	Customer	Balance

Purchases Journal

This is a record of debts owed by your company for goods purchased or services rendered. Most purchases in VE are made *on account*, which describes a situation where goods and/or services are ordered but not paid for until a later date. You, as the customer, will not able to pay an invoice until you have received the invoice. The vendor, on the other hand, will not generate an invoice for you until you have placed an order. Furthermore, you probably will not pay the invoice immediately after you receive it, especially if the vendor provides payment terms that allow you a 15 or 30 day grace period before payment is due.

This procedure—where items are purchased and paid for subsequently—is actually typical for most firms. In order to keep track of purchases on account, firms use a form similar to the one that follows.

Date	Vendor	Invoice No.	Description	Amount

Schedule of Accounts Payable

This record is used to help you keep track of debts the company owes to vendors as a result of the purchase of a product or service. Each vendor should be assigned an account number and have a separate page with account information as indicated on the form that follows:

Invoice Date	Invoice No.	Invoice Amount	Date Paid	Amount Paid	Invoice Balance

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Each form should include the vendor's name, address and account number. The balances from each vendor's individual records should be summarized in a form so that the total amount of accounts payable can be determined. A sample of this form is provided:

Date	Vendor	Balance

Assets Log

This is a list of all **assets** that the company owns that the company will **capitalize**. An asset, by definition, is something a business owns that has value and can be converted to cash. When a company capitalizes an asset, it means that they will **not** record the purchase of the asset as an **expense**. (Note that the accounting definition of an expense is the consumption of an asset used during the course of business.) Instead, they will record the expense over time as **depreciation**. Assets that are capitalized generally cost more than one hundred dollars and have a useful life longer than one year.

For example, when a firm buys a box of paper clips, the purchase is expensed. When the company buys office furniture, which costs more than one hundred dollars, and is expected to last more than one year, the purchase is capitalized.

All capitalized assets are reported on the balance sheet, and will be reported at historical cost (that is, the actual price paid for the asset). All depreciation that has been taken on each asset is also indicated on the balance sheet under the title of **accumulated depreciation**.

The VE rules for depreciation are simpler than the rules used by the Internal Revenue Service (IRS), which can be quite complex. In VE, all assets are depreciated in the same way, using what is known as the *straight-line method*, with a five-year life. This means that all assets are assumed to have a useful life of five years, and will decrease in value equally over each of the five years. To calculate depreciation expense, use the following formula:

Cost of asset / 5 = annual depreciation expense.

Each asset will have an accumulated depreciation account that is used to record the total depreciation for the asset. After five years, the asset will have been fully depreciated. The asset will continue to be reported on the balance sheet, at historical cost, until it is disposed of. Note that when the accumulated depreciation amount is equal to the historical cost of the asset, the asset has been fully depreciated and is probably not worth anything close to its historical cost.

Depreciation expense is unique in that no cash is expended and yet, it is included when a firm determines its net profit or loss. Since firms must pay tax on their earnings, depreciation expense enables a company to lower the amount of their corporate income tax without having to give up cash.

A sample of an Assets Log follows:

Asset Name	Date Placed in Service	Asset Cost	Recovery Period	Depre-ciation Method	Prior Depre-ciation	Date Sold	Sale Price

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Inventory Record

These are the records that keep track of all the products purchased for resale. Products bought for resale are known as **merchandise**. The VEC requires a report that contains the beginning and ending inventory for each taxable year. The complexity of your inventory records will vary depending upon the number of different items you sell.

Remember: you can't sell an item that you didn't buy. Whenever you order merchandise from the wholesaling company, you need to keep track of the quantity ordered, and the price you will pay for each unit. Similarly, when you sell merchandise, you need to keep track of the number of units sold.

The design and nature of the inventory control form will vary from firm to firm depending on the quantity and diversity of products sold. At minimum, the form should include:

- Purchase date
- Name and description of the item
- Number of units bought
- Price you paid for the units bought
- Number of units you sold
- Price you paid for the units that you sold (not the price you sold the unit for, rather, the price you paid for the unit you sold. If your costs remain constant throughout the year, it will be easy to keep track of this information. If the cost of the merchandise that you buy from the wholesaler varies throughout the year however, then keeping track of your cost for all merchandise sold is more complex. Accountants have developed numerous ways to determine the cost of the merchandise sold. Examples of different inventory costing methods include first-in, first-out (FIFO) last-in, last-out (LIFO), gross profit method, average cost method and specific identification. The method recommended for you is specific identification where it is assumed that each item of inventory is marked, tagged, or coded with its "specific" unit cost.)
- Ending balance (quantity and dollar value).

A sample form follows:

Item Name:									
Item No:									
Description:									
	Purchased			**Sold**			**Balance**		
Date	**Units**	**Unit Cost**	**Total**	**Units**	**Unit Cost**	**Cost of Goods Sold**	**Units**	**Unit Cost**	**Total**

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If the firm sells more than one product, then a separate form should be used for each individual inventory item and these forms should be summarized into a controlling form. The controlling form would include the ending balance of each of the individual inventory items.

A sample of the controlling form follows:

Date	Item Name	Item No.	Quantity on Hand	Cost	Total

If you have paid different unit prices for the merchandise, you can use an average cost in the controlling form.

Payroll Register

A payroll register is a business form that summarizes the entire payroll for each payroll period. In VE, a payroll register template has been created using spreadsheet software. The spreadsheet has a separate row for information for each employee that is further organized under different column headings.

A sample payroll register is provided. Column numbers are provided for the explanations provided below and should not be included in the payroll register you prepare.

COMPANY NAME

Payroll Register

For the period beginning _____________ *and ending* ________________ .

1	2	3	4	5	6	7	8	9	10	11	12
Name	**Hours**	**Hourly Rate**	**Gross Pay**	**FICA**	**Medi-care**	**FWT**	**SWT**	**SDI**	**401 (VE)**	**Total Deduc-tions**	**Net Pay**

Directions to complete the payroll register are as follows:

Column 1. Enter employee's name.

Column 2. Enter the number of hours that the employee worked during the pay period. This information could be obtained from the Human Resources Department.

Column 3. Enter the hourly rate. The Human Resources Department would have determined the hourly rates.

Column 4. Determine the gross pay by multiplying the hourly rate by the hours worked.

Column 5. FICA is an acronym for the Federal Insurance Contributions Act, commonly referred to as Social Security. The rate is 6.2% and is paid by all employees on their wages up to $84,900.

FICA is **not** collected on wages in excess of $84,900. To calculate the FICA amount, multiply the rate, 0.062 times the gross pay. If there are employees who might potentially earn more than the ceiling amount of $84,900, be certain to stop withholding FICA from their earnings beyond this amount.

Column 6. The rate to be withheld for Medicare is 1.45%. There is no ceiling on Medicare; no wages are exempt from this tax. To calculate the Medicare payment, multiply the gross wages by the rate, 0.0145.

Column 7. Federal Withholding Tax (FWT) is withheld from all VE employees. It is a pre-payment of the Federal Income Tax that each employee will be required to pay, when they file their personal income taxes (due by April 15 of the following year). In most cases, VE employees won't know what their earnings for the year will be until the year is over. But in the meantime, employers must withhold a portion of the FWT from each paycheck. The recommended amount to withhold from all employees' gross wages is 15% (multiply the gross wages by 0.15).

When employees file their personal income tax returns, they will compare their total income tax bill for the year (referred to as their tax liability) to the amount of tax that has been withheld from their paychecks during the course of the year. They can then determine whether they have paid to much or too little. If they have paid too much, when they file their personal tax return, they will request a tax refund. If they have paid too little, they will have to make an additional payment to the tax collecting authority when they file their tax return.

Column 8. *State Withholding Tax (SWT)* is similar to FWT except that this tax is paid to the state, not the federal government. This tax is also due on or before April 15 of the following year. The state income tax rate is lower than the federal income tax rate. The total amount of state income tax due cannot be determined until the employee's gross earnings for the year are known. Employers must also withhold an estimate of the SWT from each paycheck. The recommended amount to withhold from all employees' gross wages is 5% (multiply the gross wages by 0.05).

Column 9. *SDI* is an acronym for *State Disability Insurance.* This insurance would supplement Social Security benefits and *Workman's Compensation* that is available in the event that an employee is injured and unable to work. The rate is one-half of 1% and is charged only to the first $5,000 of an employees wages. Since it is quite possible that VE employees might earn more than $5,000 in a given year, care must be given to insure that SDI is not deducted from earnings above $5,000.

Column 10. *401(VE)* is a deferred savings plan that is unique to the VE tax code. It is similar to 401(k) plans and deferred savings plans provided by many companies. Employees must decide what percentage of their wages they would like to contribute to the plan. The amount of their contribution, up to a maximum of $7,000 per year, is exempt from FWT. Firms offer the 401(VE) as a benefit to their employees. Firms that decide to offer a 401(VE) plan to its employees are required to match their employees' contributions, dollar for dollar. When employees and firms make contributions to a 401(VE), the contributions belong to the plan and are considered plan assets. It is the responsibility of the firm's benefits manager to ensure that the plan assets are properly invested. Plan assets may be invested through a virtual brokerage firm (such as Senior Investors) or through the VEC. VEC will offer a guaranteed rate of return, which will vary from year-to-year, depending on market conditions. Regardless of where the 401(VE) assets are invested, all plans must be liquidated after March 31, and preferably before the NYC International Trade Fair.

Column 11. This column is the sum of columns five through ten.

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Column 12. This column is the difference between gross pay (column 4) and total deductions (column 11). This is the net pay (take-home pay) of each employee that will be transferred from the firm checking account to each individual employee's account.

Financial Statement Preparation

After transactions have been identified and recorded in the appropriate form, information can be summarized and then reported in the financial statements. In Virtual Enterprises, two financial statements are required: an *income statement* and a *balance sheet*. Each of these financial statements will be described for you.

Income Statement

An income statement presents the revenues and expenses and resulting net income or loss of a company for a specific time period. The time period covered may be a month, a quarter (three months), six months or a year. The sections of income statements vary, depending on the nature of the business. However, these differences are not substantial. Most income statements have the following components:

1. **Heading.** Centered at the top of the statement, the heading lists the name of the business, the name of the statement, and the time period covered by the statement.
2. **Sales Revenue Section.** List of sales revenue for the company.
3. **Cost of Goods Sold Section.** The company's cost of the merchandise it has sold.
4. **Gross Profit Section.** Indicates the difference between total sales revenue and the cost of goods sold.
5. **Expenses Section.** Indicates O*perating expenses*. *Operating expenses* are defined as the costs that a business incurs that are necessary for the company to operate. Typical operating expenses for VE firms are salaries, rent, utilities, insurance, advertising, freight-out, depreciation and payroll taxes.
6. **Income from Operations Section.** Indicates the difference between gross profit and operating expenses.
7. **Other Revenue and Gains/Other Expenses and Losses Section.** Revenues, gains, expenses and losses that are the result of activities that are not the result of activities characteristic of the company's primary operations.
8. **Income before Income Taxes.** Income from operations is combined with other revenue and gains and/or other expenses and losses. The resulting number is used to calculate the corporation's income tax.
9. **Income Tax Expense.** The corporate income tax, which can be determined by completing Form 1120 VE, is reported here.
10. **Net Income.** This is the amount that is left after the total of all expenses for the period has been subtracted from the total of all revenue for the same period.

A sample **income statement** is provided:

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VE COMPANY, INC.
Income Statement
For the year ended April 30, 2002

Sales revenue		**$460,000**
Cost of goods sold		**316,000**
Gross profit		**144,000**
OPERATING EXPENSES		
Salaries	**45,000**	
Rent	**19,000**	
Utilities	**17,000**	
Advertising	**16,000**	
Depreciation—computers	**8,000**	
Freight-out	**7,000**	
Payroll tax	**3,443**	
Insurance	**2,000**	
TOTAL OPERATING EXPENSES	**117,443**	
Income from operations		**26,557**
Other revenues and gains		**10,000**
Other expenses and losses		**4,000**
Income before income taxes		**32,557**
Income tax expense		**5,535**
NET INCOME		**27,022**

Balance Sheet

The *balance sheet*, which is prepared after the income statement is completed, is a record of the financial condition of a business on a certain date. It shows the *assets*, the *liabilities* and the *owner's equity* of a business. Since *stockholders* are the owners of a corporation, the owner's equity section of a corporation's balance sheet is called *stockholders' equity*.

A balance sheet will include a heading that is centered at the top and contains the name of the business, the name of the statement, and the date of the statement. Note that the date on the balance sheet consists of a month, a day and a year. Unlike the income statement, the balance sheet is not for a period of time; instead, it shows the condition of the business on a given day.

The *assets* section of the balance sheet is listed first and contains a list of all the assets the business owns. *Assets* are property or items of value that the business owns and can be converted to cash. Each asset is reported at the cost the company paid when they were acquired. Assets are listed according to their *liquidity,* which is a measure of the ease with which they can be converted to cash. Total assets are the sum of the value of all of the business' assets.

Liabilities, the company's debts and obligations owed to *creditors* (a creditor is a person or business, which is owed money) are listed next in the liability section. Current liabilities (due within one year) and long-term liabilities (not due until at least one year from the date of the balance sheet) should be shown separately.

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The *stockholders' equity* section is the next and last section. Stockholders' equity is reported in two parts:

- **Equity contributed by stockholders**. Stockholders contribute to the equity in the corporation by acquiring shares of stock issued by the corporation. Stockholders' investments are recorded in the *Capital Stock* account of the corporation.
- **Equity earned through business profits.** The second part of the stockholders' equity is the amount of net income earned during the fiscal period and retained by the corporation. The amount of net income, not distributed to the stockholders as a return on their investment, represents an increase in the stockholders' equity and is referred to as *retained earnings*.

Thus, the stockholders' equity is the net worth of a company representing the cumulative profits and losses of the company plus or minus any contributions or withdrawals by the owners. The stockholders' claim on the assets of a business (owner's equity) is always equal to total assets minus total liabilities. The assets of a business are supplied or claimed by either creditors or owners. Therefore, if total liabilities (creditors' claims) are subtracted from total assets, the result must be equal to the owner's claims.

If a business possesses more assets than it owes to its creditors (liabilities), then its net worth will be positive. If the business owes more than it possesses, its net worth will be negative.

The **balance sheet** is prepared after the income statement because the amount of net income or loss shown on the income statement must be used to update the *retained earnings* balance.

A sample balance sheet for a VE firm is provided below:

VE COMPANY, INC.
Balance Sheet
April 30, 2002

ASSETS	
Cash in bank	**21,284**
Accounts receivable	**6,364**
Merchandise inventory	**81,385**
Office supplies	**1,839**
Computers	**60,000**
Accumulated depreciation	**(12,000)**
Furniture	**20,000**
TOTAL ASSETS	**178,872**
LIABILITIES	
Accounts payable	**12,316**
Payroll tax payable	**2,330**
Sales tax payable	**1,440**
TOTAL LIABILITIES	**16,086**
STOCKHOLDERS' EQUITY	
Capital stock	**75,000**
Retained earnings	**87,786**
TOTAL STOCKHOLDERS' EQUITY	**162,786**
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**178,872**