



by Jay Goltz

Goltz On Business

Accounting Mysteries

You don't see those two words used together very often. As a matter of fact, you don't often see framing and accounting together, either! They're kind of the odd couple: they need to live together, but they hate each other. There are three areas about which I've heard misconceptions bantered around in framing circles. In an effort to help you better understand your business, pay the right amount of taxes, make a profit, and perhaps keep out of jail, I'm going to cover them.

1. Cost of goods sold: It's as it says. It's cost of goods sold. If you sell a piece of art for \$100 and it cost \$50, the cost of goods sold is \$50. It's whatever you paid for the finished product. If I do a custom picture framing project for \$100 and I paid \$28 for the materials, the cost of goods sold is *not* \$28. That is the cost of materials. The cost of goods sold is the cost of the finished framing job, which must include the cost of direct labor. In this case, the "goods" that have been sold are not the framing components; it's the complete frame job. The customer did not purchase a stick of wood, some glass, and other materials. They bought a custom framed picture which someone had to assemble.

If you only do custom framing in your store, the direct labor spent to custom frame items is probably about half of your total payroll. The other half of the labor is sales and management. When your accountant asks what your cost of goods sold is and you give the cost of materials, you might be comparing apples to oranges. This makes for a dangerous situation.

If you are searching for ways to be more profitable, your accountant is going to look at three things: 1) gross profit, 2) expenses, and 3) sales volume. If you tell them that your cost of goods sold is 35%, without telling them that it is actually just

your cost of materials, the accountant will conclude that your gross profit (65%) is very good compared to retailers they know in other sectors.

On the other hand, your labor is going to look too high. Granted, a smart accountant should be able to delve into this and figure it out, but many of the accountants helping framers are not the very best. They are tax preparers that like to think of themselves as accountants. But I digress... The point is, in the future, when referring to the materials that go into a frame job, call them what they are: cost of materials, *not* cost of goods sold.

2. Charitable Deductions: Brace yourself for this one—you're not going to like it. When you custom frame a picture for charity, or donate a framed picture, you've already taken the deduction when you removed it from inventory. Think about it. If you donate a retail job that would sell for \$100, your cost of goods sold (watch how I use this) on that job is about \$50. That would be for materials and direct labor—but you already knew that (if not, start from the top). At the end of the year, your costs are \$50 higher than if you didn't frame the picture. As a result, your profit will be \$50 less.

As a result, you pay less income tax. Ugly reality: the deduction for that donated piece is the same on your income statement as a botched frame job you throw away. Either way, your costs go up \$50. Of course, it's not the same emotionally. One should make you feel good; one should make you feel bad.

Gift certificates—same story. You can't deduct gift certificates because there is no expense incurred until someone actually uses the gift certificate. And you can't deduct the face value of the gift certificate. You can only deduct your costs. You don't have to keep track of it—it's the same story as stated above. The whole idea of tax deductions is to reduce your

income so that you pay less taxes.

Here's a trickier one yet. You personally frame a picture for a charity. You spend eight hours hand-crafting something spectacular. You would like to charge for your time and deduct it—you know it's worth \$1,000. You can't because you never showed it as income in the first place. However, your neighbor buys the framed piece for \$1,000. They donate it. They can deduct the entire \$1,000, because they paid for it with their "after-tax dollars."

I get numerous requests for donations, as I'm sure you do. When I donate something personally, like a coat, that I have paid for with my net income (i.e. my paycheck), I can list this on my tax return as a deduction because I paid income tax on the money that bought the coat. If I take it out of my business, though, it comes out of my pre-tax income, which reduces my income tax—that's why I can't deduct it again.

Tax deductions are really deductions in income, which result in paying less income tax. It's really an income reducer. For instance, a \$1,000 tax deduction is not a tax reduction—you don't pay \$1000 less tax. Your income goes down by \$1000, resulting in you not paying the taxes on that \$1000.

3. Debt Service. When you are paying off a loan for your business, it is not an expense—it's paying down your debt. For instance, you bought a \$7,000 machine. Your accountant says you have to depreciate it over seven years because the IRS doesn't want you to deduct it all at once—they want to spread out the deduction so that it doesn't wipe out your profits (which means they don't get as much of their money from you). This means you are going to take a \$1,000 deduction in each of the seven years.

Say you paid for this machine by taking out a 3-year note for \$220 a month, or \$2,640 per year. Your expense for the year is not just the \$1000 depreciation, nor the \$2,640 payment. Your expense is the \$1000 depreciation and the interest portion of the \$2,640, which is going to start off higher and go down as the loan gets paid off. The rest of the \$2,640 is going toward paying down the debt quicker than you're depreciating the item. (*Note:* In the beginning, the interest will be something like \$500. As the amount of money you owe decreases, the interest you owe goes down. The payment stays the same but more is paid to interest than principle in the beginning.)

If you do a lot of transactions like this, you might

become short of cash, but not because your expenses are too high. It's because you are paying things off faster than they are being depreciated.

Now, if you had taken your own money out of the bank for that machine, at the end of the year you will have more cash than you show on your income statement. Why? While depreciation is a line-item expense, you didn't actually write a check for anything as you would have if you had taken out a loan. The \$7,000 would show up on your balance sheet—not your income statement. Therefore, that extra \$1,000 you could put back in the bank, as you can do for seven years—basically paying the loan back to yourself.

Hopefully, you have found this enlightening. If your brain is a little numb, now you know how I feel everyday!

■

Jay Goltz, Business Editor, started Artists' Frame Service in 1978 fresh out of college. AFS now employs 120 people at its main location in Chicago, IL. Goltz is also the founder of FramerSelect. He has received numerous business honors and is best known for his straight talk on how to succeed in business. He has taught at the National Conference.