Accounting 101

Everything you need to know
about accounting for your small business.

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Chapter 1

What is accounting and why does it matter?

What is accounting?

Accounting is the process of recording the financial transactions of your business. The accounting process is an important function of business as it reveals financial inconsistencies and redundancies which could lead to better business operations. Having complete and current accounting, properly executed, can make the difference between business success and failure. Keep reading to see why accounting is important and how it can help you start “rollin’ in the dough.”

Why does accounting Matter?

Understand the financial health of your business.

You’ve invested heavily in your business – your time, your money (maybe other people’s money), and a lot is riding on your success. Without proper accounting you can never have a true, real-time gauge of the health and value of your company. As the owner, it’s your job to responsibly steward your company’s assets and liabilities. You can’t know that this is happening without access to the proper accounting reports.

Be a better candidate for future financing.

Unless you’re independently wealthy and willing to self-fund any capital needs your business may have, the time may come when you’ll need an infusion of green backs. This can happen for a number of reasons. Your business may grow like a weed, and you’ll need a line of credit to fund growth. Or you may experience an unexpected setback and need capital to keep things running smoothly until your next sale.

Whatever the case, if you have current and accurate accounting records, getting the money you need from a bank or potential investors will be much easier. Even if you only ever seek financial help from friends and family, having good accounting records to show them will demonstrate that you respect their investment and will safeguard their trust.

Get to your end goal faster.

Whatever your business goals – selling to a bigger fish for a lump sum, providing a stream of income for your retirement, or doing something philanthropic for your community – proper accounting can help you get there faster. Accounting will provide you the insight you need to make better decisions about your business finances. And better decisions will directly affect the short and long term success of your business.

If you're guessing at your businesses strength by checking your bank balance and making financial decisions based on who is calling you for money, you aren't managing your business; your business is managing you. You don't know how or when to adjust spending or cut expenses, you're just making guesses based on gut feelings (Yikes!). Accounting will help you understand the past and see into your future. Running a business is hard enough – don't do it blindfolded.

Be more efficient in the long term.

The longer you wait to implement a proper accounting system in your business, the more it will cost to implement one in the future. Starting from day one will prevent costly mistakes that will have to be corrected eventually (by avoiding them all together). Manually culling through hundreds or even thousands of invoices and receipts months or years after the fact will cost exponentially more than implementing a simple accounting system at the outset of your business.

Chapter 2

Accounting words every business owner should know

Like any technical discipline, accounting can be demystified by learning the “secret” language. Learn these essential accounting terms and master business finance.

Accounting

In every business, money comes in and money goes out. Accounting is nothing more than tracking the when, who and how much of money flowing through your business, and then reporting it. It’s that simple. See? Nothing to be afraid of!

Assets & Liabilities

Both accounting and financial words, assets and liabilities appear on your Balance Sheet. An asset is anything your business owns. Examples are cash (money in the bank), accounts receivable, inventory, a loan to an employee, equipment - any tangible thing that your company holds. The cost of an asset is not deducted on your Profit & Loss Statement.

A Liability is something you owe to someone else. Examples are accounts payable, equipment loans, tax liabilities – basically anything you owe. Unless liabilities exist for a specific or strategic reason, you want to keep them to a minimum. The payment of a liability is not deducted on your Profit & Loss Statement.

To win in the game of business, you want to grow your assets and shrink your liabilities.

Debit & Credits

Debits & Credits are accounting-specific words, and represent entries in your General Ledger (the chronological list of every financial transaction in your “books”). Credits appear on the right side, and Debits appear on the left side of your General Ledger. For every value posted as a Credit, there must be a balancing entry posted as a Debit. Unless you are in the accounting business, this is all you need to know about this.

Double-Entry Accounting

Double-Entry Accounting is also known as “Real” Accounting. Double-entry simply shows both sides of any transaction. Here’s an example:

You take money from your checking account to buy something for your business, let’s say an inkjet printer for $200, then you're going to debit the checking account for $200 and credit your related expense account for $200. In summary, you took $200 from one account and tracked the other side of the transaction, giving it to another account. Pretty simple, right? Double-entry accounting helps keep track of your money movements by displaying paired debits and credits relative to what you've spent or saved.

Why it matters…

Every financial move you make affects your Balance Sheet. Double-entry accounting assures that every transaction is completely recorded to maintain balance.

Income Statement (aka Profit & Loss, P&L)

Your income statement reports your income and expense results from business operations for a set period of time. It tallies the income you bring in and the expenses that go out. This report is commonly produced on a monthly basis, and again on a quarterly basis. An annual income statement, along with other financial reports, will be used to produce your annual income tax return. It can be generated to display this year's period next to last year's for comparison purposes. It's the bottom-line indicator of how your business did for the period chosen.

Expense

This one's easy. An expense is anything your business pays for that is deducted in the current period. When expenses exceed income, you are losing money. Losses are paid for by **equity** (defined later). Too many expenses in excess of income, and you're out of business.

General Ledger

Your General Ledger is the recording of all your debits and credits.

Balance Sheet

We all want to know how we're doing, right? Your Balance Sheet is a snapshot of your business' financial position at a given point in time. It represents the balances of Asset, Liability and Equity accounts on the day it is generated, and results in the business Net Worth. It provides a picture of how liquid and solvent (flush with cash) your business is or isn't; how burdened with debt your business is; and what equity the business holds. Many banks will analyze a business' balance sheet to determine whether or not they will extend financing.

Fixed Costs

Fixed costs are expenses your business incurs on a regular basis that don't fluctuate month to month with sales. Rent, internet and phone bills are examples of fixed costs. Sometimes you might hear these costs being referred to as "overhead" or "general & administrative" expenses. Bottom-line, it's a cost that is fixed, and it won't change based on products or services you sell or don't sell.

Variable Costs

Variable costs are the opposite of fixed costs. They are costs that change based on the production of income inside your business. For example, if you manufacture and sell wooden sheds, then the amount you spend on wood goes up and down based on how many sheds you sell. This cost for wood is a variable cost because it changes based on your business needs. Tied to sales are commissions, shipping, royalties, etc. Marketing and advertising can be a variable expense if they are not contractually constant and season or situational in nature. Get it? Expenses that can vary are variable!

Owner's Equity

As the owner of a business, you basically own the assets inside that business. The equity of the assets in the business is comprised of the total value of the assets, minus the total value of liabilities. What's left over is called equity. As the owner of the business, you have rights to the equity. This is called Owner's Equity. From year to year it adjusts for annual profit or loss and any distributions or dividends paid out to owners.

Cash or Accrual Accounting

These words identify "accounting methods". Cash and/or accrual accounting are methods of reporting financial transactions. They represent the two different ways for generating accounting reports. The cash method is distinguished by its "real time" treatment of transactions – you record income when you actually receive money, and expenses when you actually spend it. Transactions suspended in time (receivables and payables, most notably) are not shown on cash reports. In contrast, the accrual method records transactions when they are created – an invoice to a customer shows in sales, and an expense for office supplies shows when the Staples order is received. At some point in the future you will receive payment from the customer and will pay the Staples bill, but the income and expense have already been recorded in your accrual books.

Accounting assumes every invoice will be collected and every bill paid. For this reason, accrual accounting is the pure reflection of your business' activity. Unfortunately, some invoices become bad debts, so the cash accounting method is a more real-time reflection of where your business is today. For tax purposes, businesses with inventory are generally required to report on the accrual basis, and businesses without inventory are reported on the cash basis.

Chapter 3

Accounting reports every business owner should use

Reports, reports, reports! They are the secret sauce to business management. The small things that happen in your business every day combine to create a big impact on your financial success. There's no way to know that these things happen if you can't see them. Financial reports are where they appear. Below is a list of things you should strive to keep track of through your accounting software.

Account Statements

This one's obvious, but so obvious it sometimes gets missed. You need to review the periodic statements provided to you by third parties, like monthly bank statements. Comparison of these statements with your internal accounting reports will quickly reveal errors or fraud. By making sure the deposits you are recording in your accounting system are matching the ones your bank is receiving, and that the payments being made match as well, you can make sure that your accounting processes are accurately reflecting your financial activity.

Sales Tax Report

If you're in a business that collects Sales Tax, this can be tricky. Keeping track of how much tax your company collected and remitted is extremely important. A review with your tax professional of your Sales Tax Reports and the Sales Tax Returns you are filing will keep this in check.

Income by Customer

Not all customers are created equal. Some might be good at paying you in full and on time, others may be a large portion of your overall billing. Getting paid too slow, or not at all by your largest customers or only having a few small paying customers is a good way to ensure early (unpaid) retirement. Viewing your income by each customer will help you analyze your customer base and determine where you need to make adjustments.

Expense by Vendor

In most small businesses, your vendors are an extended part of your team. If it weren't for them, it would be harder to be in business. But knowing with whom you spend most of your money (and why) will help you make smart decisions when it comes to negotiating pricing, delivery, payment terms, etc. It will help you recognize vendor vulnerabilities you may have, or maybe even alert you to when it's time to start looking for a new or additional provider.

Receivables

Your receivables report shows you money that you're owed by your customers, and will reveal who is overdue. Regular attention to this key accounting report will help you identify on-time and late payers, potential problems in your invoicing system, the need for collection activity, and help you execute your cash flow or budget plans. Regularly ignoring this key accounting report will result in never getting paid and early (unpaid) retirement.

Payables

Now the shoe is on the other foot! A payables report will help you keep track of money you owe your vendors, and when that payment is/was due. Remember, timely payment of your bills can affect your business credit and influence the relationship you have with your vendors. Let's say you have an urgent need one day and you call a vendor for help. Who do you think they're going to go above and beyond for - the guy who never pays his bills, or the "partner" who watches his payables and makes sure payments go out on time?

Sales

Seems obvious; you need to know the details of your current sales. This report should be configured to tell you what is selling, who are selling, what they are selling it for, and to whom. This information will help you to make management decisions about ordering (if you maintain inventories), staffing, receivable financing, manufacturing/production needs, etc. It can help you anticipate bottlenecks in your system and solve problems before they arise.

Income Statement (aka Profit & Loss, P&L)

All of your business operations are summarized on your Income Statement. An Income Statement provides a quick look at your sales and expenses. You can configure this report to represent today, this week, this month, or this year-to-date (YTD). You can configure this report to present on a Cash or Accrual basis – and both of these views can be helpful. Many business owners avoid looking at this report because they are afraid that they won't like the results. Be honest enough with yourself to look anyway. It's the only way you can make the management decisions required to get the result you want.

Balance Sheet

The current profitability, creditworthiness, and salability of your business are all reflected by your Balance Sheet. It presents a snapshot in time of your business' assets, liabilities and equity. This report can be generated for today, last week, last month, or any day your business existed, and reflects the numbers true to that day. Unlike a P&L, which reflects an accumulation of transactions within the period represented by the report, a Balance Sheet only reflects the value for that day.

Chapter 4

How to measure your success

You're working hard, you've implemented systems in your business and now you want to take your pulse. Taking a step back and understanding how you're doing overall can help you stay motivated to keep pushing forward in the growth of your business. Here are four indicators you can monitor through accounting that will show that you're on the right track.

1. Accurate & Organized Records

Operating your business with accurate and organized books and records will allow you to track money coming in, money going out, and what's left over (or short). The data at your disposal gives you the power to see and analyze every phase of your company from a financial standpoint.

2. Cash Flow

If you've collected all your sales, paid all your bills, and have anything left, then you have positive cash flow. If not, then you have negative cash flow. Either way, cash flow is the simplest measure of your success. It doesn't directly correlate to "profit," but it is a good indication of your company's profitability. The more complete your data, the more accurately you can diagnose your cash flow and make the adjustments to create more success.

3. Are You Reaching Your Own Personal Goals?

The other measure of your success is the accomplishment of your personal goals. You went into business for more than money, and you won't enjoy your business success until you are firmly on the path to reaching the goals you set for your life outside of your business.

Chapter 5

Can I do it myself, or do I need an accountant?

This question can only be answered by analyzing your personal situation. How comfortable are you with managing finances in general? How much time do you have on a daily or weekly basis, to handle the financial part of your business? Is it possible (and more efficient) to bring in an expert or do you just need help to get set up? YOU have to make the final decision for what's best for your business, but here are six areas where having an accounting expert in your corner can be helpful.

1. Getting Your Business Started

Starting any business requires the need to make several important decisions that can affect the short-term and long-term success of your venture. If you haven't done this before, you'll want someone to help you through questions like: Should I incorporate or form an LLC? How much should my product or service cost to ensure profitability? What should I use to contract employees and when should I hire staff?

Working with a tax and accounting professional from the very beginning can help you make the right decisions and get you started on track.

2. Fiscal Year or Calendar Year?

Accounting cycles run on an annual basis. Depending on how your business operates, that "year-end" may come at the end of the calendar year (December 31st) or it may come at the end of a predetermined quarter; this is called a fiscal year. A calendar or fiscal year-end may be more advantageous for you because of predictable business sales or expense cycles. For example, a ski lodge in Vermont would be at a disadvantage to close its year on December 31st (right in the middle of the "busy season" for that business), and a surf shop in California wouldn't be best served with a year-end of July 30th. Thinking through these issues will allow you to determine which setup is most advantageous for your business. If your business has a concentrated period of revenue or expense, your year-end is best placed to take the best advantage of it.

3. Ongoing Management of Your Business Accounts

Every business owner has more than one thing on their plate on any given day, and these things can vary widely. They can range from a decision about a technical aspect of your business operation, to an employee issue, to a vendor negotiation, or a customer service task. It's tough to do it all yourself, every day, all the time. Having professionals on call that you trust can makes it dramatically easier to face the unexpected nature of being in business.

4. Help With Financial Reports

Any good accounting software will allow you to generate robust reports that will feed you the data you need to make smart decisions in your business. Knowing which reports are important, how to generate them, and then how to read and interpret them is key to your business' development. Will you know how to generate the correct reports and then decipher what they mean on your own? Probably not right away. An accounting professional will help you learn which reports are important to your specific business, and provide context to the data so you know exactly what to do with it.

5. Company Taxes

Filing your business tax return doesn't have to be a time of fear and loathing. By keeping up to date on your accounting and keeping in sync with your tax and accounting professional, tax time can be a breeze. When you're not trying to backfill months of entries, or track down paperwork that's lost somewhere in the "Bermuda Triangle" of your automobile, office, or home, tax time is merely reporting the result of your work throughout the year.

6. Sales and Payroll Taxes

If you sell goods or have employees, you will need to prepare, file and pay these taxes. The returns will likely be due much more frequently than once a year. The penalties for improper filing or payment can be steep. The agencies responsible for collecting these taxes hold trainings and workshops to help business owners learn the rules.

The best advice anyone ever offered a business owner was to do "what they do best," and delegate everything else. Because tax and accounting professionals work with many business owners, and many times in varying industries, they have probably already done something similar to what you are doing and can help you get it done faster, less expensively and with less struggle. Many of the tasks in your business you will need to know how to do, so it is done just the way you want. The financial management of your business is not one of those tasks unless you want it to be, at which point you should consider setting aside time for some formal training.

Chapter 6

Congratulations!

You're now ready to take charge of the financial management of your business! We hope this guide has been educational, but more importantly, helpful. We believe that understanding *what* accounting really is and *why* it's important to your specific business, will give you an edge in making your business a success.

If you think you need help with any part of the financial systems in your business (setup, organization, management, accounting, or specific advice for your situation), we'd love to help!

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