

Accounting - An Introduction – by Dan Sautner

"Revenge of the math club" is how many independent business owners view the need for accounting. Unfortunately, this may result in the owner totally ignoring the entire process and using other tools to run his business. We say unfortunately, because accounting, and the products of accounting, can assist you in the operation of your business. Just as you have had to learn other skills to be successful - personnel, law and purchasing, to name a few - learning a little about the process and products of accounting will make you more powerful as a business owner. Your company probably represents your major personal investment and your retirement plan, so it is worth the time and effort to better understand what accounting can do for you. This article, and the ones that will follow shortly, will help you in turning accounting from a dreaded past-time into something that can give you more control over your day-to-day activity. While it's realistic to say that you may not actually enjoy it, it should become another part of your monthly routine. Your business may be involved in your business product; likewise, your business life is concerned with profitability.

Accounting is a language of numbers. The process of accounting seeks to reduce the activities of every business to a common measurement, that being the dollar. By doing this, it allows comparisons of such diverse activities as advertising, banking and the buying of inventory to be expressed in such a way as to make them comparable. In doing this it will give you, the reader, clues as to what happened in a business, and, given that things remain the same, what will happen in the future. The language of accounting also allows other parties to better understand what you do within your business. These other readers of your information (bankers, suppliers and investors) need a summary picture of what took place and how well you are doing.

The process of accounting is designed in such a way that for every monetary transaction that takes place an entry for recording that transaction occurs. An example is the purchase of a new fixture in the store. The accounting system will transfer dollars from your bank account to your furniture account. This process of recording transactions tries to achieve three main goals: assuring that transactions are accurate, that they are complete and that they are authorized. The ideal scenario would be: a customer walking in, the owner recording that particular sale and then depositing the receipt. This is what accounting is designed to do. This aspect of accounting is called "internal control". It is designed to assist, not replace, the owner in the control of his business.

Financial statements are the products of accounting. These statements are primarily developed to assist you in running your business. Expressed in a common format - dollars - it shows the results of every decision you have made in the past, so that you can make decisions about the future. These are the major benefits of financial statements. Other purposes are to allow you to file an income tax return, to seek additional funding with your lender and to eventually attract a buyer or investor in your business. These other considerations are secondary, however, to the major role of financial statements, which is to assist you in doing better in your business.

The financial statements are usually composed of three different statements, each with its own purpose. The major statement is the income statement, sometimes called the profit and loss statement or P&L. This product of accounting summarizes the results of operation for a given period of time. First it will show the sales, which represent your customers coming into your place

of business and accepting what you have to sell. Along with the sales are the associated costs to provide these customers with a reason to give you money. These costs will include the obvious direct costs, such as wages, supplies and advertising. It will also include a class of expense called indirect or overhead expenses. These are usually expenses that will occur in the business regardless of whether you have sales or not. While direct costs will vary with the volume of sales, indirect costs reflect the mere fact that you opened for business. Examples of indirect costs are: rent, interest expense, and utilities. Some of you may want to reclassify these expenses, and I suppose that we could argue that labor, for example, is not a variable cost, but rather fixed. More on this in a later article. Once we have totaled our different types of expenses we then subtract them from our sales. This will give us a net income or loss. The net income or loss represents how well you have used the resources available to you. On one level it also represents how likely it is that you will remain in business. Personally, I always look at the trend in net income. This is the final benefit of this statement. In business it is not where you have been, but rather where you are going. The income statement will help you in this determination.

The second major product from the process of accounting is the balance sheet. This is usually referred to as a snapshot of the financial position of the company at a point in time. At the end of a period (year or month), the accounting system should allow you to examine your exact position in terms of what you have in the company, what you owe to outsiders and what you own yourself. It will show you the original value of the assets you have purchased and still have on hand. Some examples of this are furniture and fixtures, inventory, money in the bank, and monies owed to you by outsiders. This is offset by the liabilities section. These are the company's obligations to outsiders. Examples of liabilities are: trade payables for goods and services received but not paid for, debt to outsiders such as your bank, and amounts due to the various taxing agencies, such as payroll and sales taxes. The final section of the balance sheet is the equity section. This area of the statement shows your original investment and the sum of undistributed income earned in previous periods. We use this statement periodically to examine the advancement of the company in terms of increasing its assets and to better understand what resources are available to the company in order to conduct business. Typically, bankers, creditors and investors are interested in this statement to help them understand the tangible worth of a business.

The last statement is called the cash flow statement or source and application of funds. This statement shows how the company took in cash and how it was spent. Adjusted net income, for instance, is your net cash position from the operation of your business. You may have paid down some debt, and this would be shown as a use of funds. You may have reduced your inventory from the prior period and this is shown as a source of funds. If you, the owner, contributed funds, this would be shown as a source, and conversely if you withdrew funds it would be shown as a use of funds. The cash flow statement effectively ties together the Income Statement and the Balance Sheet, and expresses it in terms of the change in your cash position. A bank statement will tell you this, but it will not tell you the "how" and "why" of the change.

What we have discussed is the basics of accounting and its products. We realize that you need more information, and that you are going to have to rely at least partially on outside experts. Some of you are relying upon other means to understand your financial position. This is too dangerous for your major investment. The purpose of this article, and ones that will follow in the future, are to make you more aware of accounting, and how to use it to make your business more successful.