



Accounting Brief

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What do I need to know about accounting when I start my business?

In addition to cash vs. accrual accounting, there is the format of the balance sheet and income statement. There are several other statements and management reports that should be created and used, however these two are the basic statements required for taxes and normal business operations. In setting up the accounting system, it is recommended that you have professional help. The owners of the business need to have a good understanding of what the statements mean.

Balance Sheet:

The balance sheet is a snapshot of what you have in the business at a point in time. There are five sections to a balance sheet.

Current Assets:

This section has your cash, receivables and inventory. It also includes expenses paid in advance. This is everything of value that is cash, or will be cash in the ordinary course of business.

Long Term Assets:

This section has the property plant and equipment of the business. All of the assets of the business that are used in the business, rather than held for sale are considered long term assets. Deposits are also included in this section of the balance sheet.

Current Liabilities:

This section has the current bills of the company. Anything that must be paid in the next year is counted in Current Liabilities.

Long Term Liabilities:

This section includes notes payable and other debts that are owed, but do not need to be paid in the next year.

Equity:

This section has how much of the business is the owners investment, including earnings not taken out of the business. If you take the total of all assets and subtract the total of all liabilities, the difference is the equity in the business.

Income Statement:

The income statement (profit and loss statement, P&L) should be a primary tool for managing the business. It is a review of what has happened in the business over a period of time (months or years). There are two general methods for setting up the income statement. The most common used in small business is a tax based system. This is



generally not a good management tool for the owners. What is explained here is a management based system. If your local CPA or other accountant is setting up the income statement for you, make sure that they understand how you want the statement formatted.

Sales:

All sales are included in this line. If there are returns, discounts or credits, these should be separated in lines under sales and totaled, so there is a total net sales line. If there are different types of products, it is often beneficial to have a sales line for each type of product. This makes it easier for the owner to see where the revenue is coming from.

Cost of Sales:

All costs that go into making and delivering the product are included as separate lines in cost of sales. This includes labor, materials, packaging, repairs, supplies and delivery. These are variable costs. They are the expenses that are required for each sale. For each dollar in sales there should be some percentage of cost that is related to the sales. The difference between Sales and Cost of Sales is called the Gross Profit. The Gross Profit Percentage is valuable to the owner in evaluating the business. This is calculated by dividing the Gross Profit by Total Sales. This percentage should remain fairly constant over time in an accrual based system. In a cash based system, there is little value.

Selling Expense:

In the area selling expense should be all expenses associated with sales and marketing. This includes salaries, advertising, travel, catalogs, brochures, business cards, and any other expense related to marketing and selling the product. The total sales and marketing expense can be seen as a percentage of sales by dividing the total by sales. This percentage should be monitored to make sure the percentage of Sales and Marketing expense does not increase. You can spend more money but the expense should not increase faster than sales.

Operating Expense:

Operating Expense is the rest of the expenses of the business. These are the fixed expenses. If you did not sell anything, but kept the business running, what would you have to pay? These are a series of accounts for expenses like administrative salaries, rent, telephone, insurance, subscriptions, legal and accounting fees.

Net Income:

Net Income is the bottom line. If you take Sales minus Cost of Sales, minus Sales and marketing, minus Operating Expense you have Net Income.