

13

Small Business Accounting: Projecting and Evaluating Performance

Source: Entrepreneurial Small Business, Katz & Green, 2e
McGraw-Hill/Irwin

Chapter 13

Why Accounting Matters

- Proves what your business did financially
- Shows how much your business is worth
- Banks, creditors, development agencies, and investors require it
- Provides easy-to-understand plans for business operations
- You can't know how your business is doing without it

13-2

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Question

All of the following are types of accounting except:

- a) Financial accounting
- b) Tax accounting
- c) Expense accounting
- d) Managerial accounting

13-3

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- Three types of accounting:
 - Managerial accounting: used by managers for planning and control
 - Tax accounting: used for calculating and reporting taxes
 - Financial accounting: used by banks and outside investors

13-4

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Basic Concepts

- **Business entity concept:** a business has an existence separate from that of its owners
- **Going concern:** business is expected to continue in existence for the foreseeable future
- **Accounting equation:** assets = liabilities + owner's equity

13-5

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- **What is a cost? What is an expense?**
 - **Costs:** real changes in what you own
 - **Expenses:** entries made in your accounting system to record your use of goods and services
 - Managerial accounting is focused on predicting the future, so it uses expenses only for budgeting and planning purpose

13-6

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- **Information usefulness:** must be accurate and relevant
 - Only **two reasons** to do accounting:
 - To produce information that is useful to you for managing your business
 - To meet legal or contractual requirements

13-7

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- **Computerized accounting:** most commonly used (QuickBooks, Peachtree)
 - Systems should easily accomplish:
 - Easy-to-understand user interface
 - Context-sensitive help function
 - Income statements
 - Classified balance sheet
 - Development of a cash budget
 - Produce financial statements

13-8

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Example

Which Accounting Software is Best for You?

- Two main types of accounting software:
 - industry specific and generic
- Consider the following for choosing a package:
 - The size of your business
 - The industry you're in
 - The components you need
 - Available support
 - Financial resources
 - Professional recommendations
 - Ease of use

<http://www.entrepreneur.com/money/moneymanagement/financialmanagementtool/midspgarnetman/article166216.html>

13-9

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Setting Up an Accounting System

- Accounting functions:
 - Accounts payable
- Payroll

– Fixed asset	– Accounts receivable
– Inventory	– Insurance register
– Credit card sales	– Investments
	– Leasehold records

13-10

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Financial Reports

- **Five common financial statements:**
 - Income statement
 - Statement of retained earnings
 - Statement of owner's equity
 - Balance sheet
 - Cash flow statement
 - Important thing is that the information flows all the way from the income statement to the balance sheet

13-11

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- **Income statement:** primary source of information about a business' profitability
 - **Revenues – Expenses = Net income**
 - Difficulties in understanding the income statement
 - Disagreements about **what** exactly should be reported as revenue
 - Disputes over **when** to recognize revenues
 - Most small business do not have problems with these; sales are cash, or the same as cash

13-12

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- **Balance sheet: "Statement of Financial Position"**
 - Snapshot of financial holdings and liabilities at the close of business on a specified date
 - Minimum detail is to report assets and liabilities in two categories: **Current** and **Long-term**
 - Used to determine the liquidity, financial flexibility, and financial strength of the business

13-13

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- **Balance sheet: cont.**
 - **Limitations:**
 - All values listed are **historical** values
 - Value recorded in the accounting records can be widely different from the asset's current value
 - Balance sheet might not completely reflect the business
 - Certain assets and liabilities are omitted from the balance sheet

13-14

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- **Cash flow statement: sources and uses of cash by the business**
 - Cash flows from **operating activities**
 - Cash flows from **investing activities**
 - Cash flows from **financing activities**
 - **Net effect** of foreign exchange rates
 - **Net change** in cash balance during the period
 - **Non-cash** investing and financing activities

13-15

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Example

Building a Financial Budget

- Business budgeting is one of the most powerful financial tools available
- Most effective financial budget includes both a short-range month-to-month plan for at least a calendar year and a quarter-to-quarter long-range plan you use for financial statement reporting
- It is important to budget both the income statement and balance sheet

<http://www.entrepreneur.com/money/moneymanagement/financialanalysis/article21642.html>

13-16

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- **Financing activities: actions taken by management to finance the operations of the business**
 - **Net effect of foreign exchange rates:** rates often vary rapidly
 - **Net change in cash balance:** reconciles the net increase and decrease with the beginning balance
 - **Non-cash investing and financing:** exchange of value other than cash takes place

13-17

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Financial accounting can be a highly valuable aid in decision making

- Reporting to outsiders
- Record keeping
- Taxation
- Control of receivables
- Analysis of business operations

13-18

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- **Managerial accounting** techniques will make you a better small business manager
- More **accurate** at forecasting profits, planning operations, and conserving scarce resources
- **Managerial functions:**
 - Planning, organizing, staffing, directing, and controlling

13-19

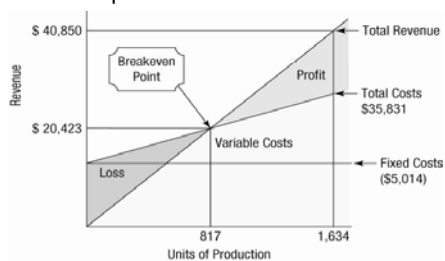
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- **Cost-Volume-Profit analysis:** technique which looks at the fixed and variable costs of a business to arrive at a number of unit sales (volume) to maximize profits
- **Variable Costs:** costs that change with each unit produced
 - Raw materials
- **Fixed Costs:** costs that remain constant regardless of quantity of output
 - rent

13-20

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- **Breakeven Point :** point at which total costs equal total sales



13-21

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Business Plan and the Budget

- **Business plan:** specifies the amounts and types of inputs required to achieve a set of desired outcomes
- Based on **assumptions:**
 - How risks can be controlled
 - What opportunities can be taken
- **Budgets** have the advantage of being comprised of a series of small schedules

13-22

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- **Planning / budgeting:** process through which strategy is mapped into a series of tactical and operational actions
 - Budget becomes a **standard** against which performance can be measured
 - **Basis** for controlling activities and the use of resources
 - **Few** small business owners consistently budget

13-23

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- **Sales budget:** projected future level of sales in units multiplied by the sales price per unit

Note that April sales forecast is needed to determine the ending inventory for March.

SCHEDULE 13.1 SYLLIBROS, CO. INC. Sales Budget For the Quarter Ending March 31, 2008					
Month/Quarter	Jan	Feb	Mar	Apr	Quarter 1 Total
Sales in units					
Books	608	621	634	648	1,863
Unit Sales Price	29.00	29.00	29.00	29.00	29.00
Revenue from books	14,208.00	14,507.00	14,586.00	14,592.00	43,793.00
Magazines	81	83	85		249
Unit Sales Price	\$17.00	\$17.00	\$17.00		\$17.00
Revenue from magazines	1,377.00	1,411.00	1,445.00		4,233.00
Shipping fee @ 1.00 per book	612.00	621.00	645.00		2,754.00
Misc. Media	0.00	0.00	0.00		0.00
Gross Sales	16,579.00	16,937.00	17,296.00		50,812.00
Less credit card processing fee	468.00	474.00	484.31		1,426.31
Less discounts on book sales	1,428.00	1,458.35	1,488.80		4,375.15
Net Sales	14,683.00	15,004.65	15,323.89		45,011.54

13-24

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- **Purchases budget:** number of units that are expected to be acquired during the budget period

SCHEDULE 13.2
MYLIBROS.COM
Manufacturing Budget
For the Quarter Ending March 31, 2009

Month/Quarter	Jan	Feb	Mar	Quarter
Books:				
Units in units	608	621	634	1,863
Desired ending inventory (20% of next quarter's sales rounded up to next integer whole number)	—	361	368	368
Inventory required	373	361	368	1,102
Less beginning inventory	368	373	361	368
Books to be purchased	614	629	634	1,877
Cost per book	\$14.10	\$14.10	\$14.10	\$14.10
Total cost of books purchased	\$8,651.40	\$8,875.90	\$8,839.40	\$26,366.70
Magazines:				
Units in units	81	83	80	244
Desired ending inventory	—	—	—	—
Inventory required	81	83	80	244
Less beginning inventory	—	—	—	—
Magazines to be purchased	81	83	80	244
Cost per magazine (grossed)	\$13.04	\$13.04	\$13.04	\$13.04
Total cost of magazines purchased	\$1,056.24	\$1,082.00	\$1,043.20	\$3,181.44
Total cost of inventory purchases	\$9,707.64	\$9,957.90	\$9,882.60	\$29,548.14

13-25

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- **Cost of Goods Sold Budget:** predicted cost of product actually sold during accounting period
- **Labor budget:** amount and cost of labor needed to meet required production
 - Assume that labor can easily be increased or decreased
 - Can easily be modeled as a fixed cost

13-26

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SCHEDULE 13.4
MYLIBROS.COM
Labor Budget
For the Quarter Ending March 31, 2009

Month/Quarter	Jan	Feb	Mar	Quarter
Number of units shipped	608	621	634	1,863
Time per shipment (1/10 hours)	0.215	0.215	0.215	—
Hours to be worked	130.72	133.55	136.31	400.545
Wage rate, including employment taxes	10.00	10.00	10.00	—
Cost of employee benefits	—	—	—	—
Total labor cost	1,307.20	1,335.15	1,363.10	4,005.45

13-27

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- **Manufacturing overhead budget:** usually treated as fixed costs
 - Becoming more common for managers to use activity-based cost estimates for overhead

SCHEDULE 13.5
MYLIBROS.COM
Overhead Budget
For the Quarter Ending March 31, 2009

Month/Quarter	Jan	Feb	Mar	Quarter
Rent	1,500.00	1,500.00	1,500.00	4,500.00
Maintenance	500.00	500.00	500.00	1,500.00
Depreciation	429.32	429.32	429.32	1,287.96
Total overhead	2,429.32	2,429.32	2,429.32	7,287.96

13-28

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- **Selling, general, and administrative budget:** SG&A, contains both costs that change with production and costs that do not
 - Advertising and freight are variable costs in respect to sales

SCHEDULE 13.5
MYLIBROS.COM
Selling General and Administrative Budget
For the Quarter Ending March 31, 2009

Month/Quarter	Jan	Feb	Mar	Quarter
Selling	1,216.79	1,242.34	1,268.43	3,727.56
General	835.00	835.00	835.00	2,505.00
Administrative & wages	442.80	414.80	398.90	1,244.50
Total SG&A	2,494.59	2,492.14	2,462.33	7,449.06

Administrative & wages is the \$1,750 monthly budget from the MyLibros business plan, less the amount allocated to labor in Schedule 13.4.

13-29

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- **Budgeted income statement:** budgets that have been completed to this point are combined into pro forma financial statements
 - Common to create the statement in only a fiscal year format

13-30

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- **Completing a comprehensive budget:**
 - Final processes to be accomplished to produce a complete master budget
 - Budgeted cash receipts
 - Budgeted cash payments
 - Cash budget
 - From these statements, prepare:
 - Pro Forma projected balance sheet
 - Pro Forma projected cash flow statement

13-31

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- **Controlling:**
 - Managerial accounting provides information that allows managers to determine how well the business is doing in attaining its goals
 - **Variiances** should be evaluated to determine the significance; they occur due to one of these events
 - Prices are different from what was estimated
 - Quantities are different from what was estimated

13-32

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Decision Making

- To make good decisions, you need:
 - Good information
 - Efficient ways to condense information
 - Methods to help compare alternatives

13-33

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- **Managerial accounting** is both a source of information and a methodology to reduce the complexity of the information
- **Accounting** is useful for:
 - Managers of small businesses
 - Record keeping
 - Reporting to absentee owners
 - Substantiating assertions made to regulators and taxing agencies

13-34

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Summary

3-35