Street Smarts: Our Irrational Fear of Numbers

> No, you didn't start a company because you wanted to learn accounting. But you had better learn some -- pronto -- if you want to understand your business

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January is a good month for fresh starts, and so we've chosen this issue to begin the next phase in the evolution of Street Smarts. In the coming months, we're going to follow a handful of businesses as they grapple with the challenges of starting up, growing, or simply surviving in the worst economy we've seen in a very long time. The companies involved are those I have been, or will be, mentoring. Regular readers of this column are familiar with a few of them -- Brian Kelly's City Beans and Mike Baicher's West End Express, to name two. Others you haven't met yet, as I've begun working with them only recently. And three of the businesses will be owned and operated by readers of this column. Yours could be one of them.

Let me explain. We began thinking about changing the focus of Street Smarts more than a year ago, as I was getting ready to sell a majority stake in my three principal businesses. I knew I'd be doing more pro bono mentoring of entrepreneurs, and I figured we'd want to write more about the challenges they were facing. I also thought it would be fun to offer readers the opportunity to participate. You may recall the note we ran in several issues inviting people to contact me if they were interested in receiving my advice. We expected to hear from a couple dozen readers. In fact, we got hundreds of responses, which was gratifying but also put us in a quandary. How were we going to decide which companies I should take on, and how would we manage the logistics of building long-distance relationships?

As it happened, my co-author, Bo Burlingham, and I were just then finishing our book, *The Knack: How Street-Smart Entrepreneurs Learn to Handle Whatever Comes Up*. We wanted a website to go with the book, and as I was talking to our website designer, I had an idea: Why don't we hold a contest? The winners would get an all-expenses-paid trip to New York City, where they would spend a day with me. I'd help them with whatever business challenges they were facing, and we'd lay the groundwork for an ongoing relationship, with the possibility of regular updates on their progress in the pages of *Inc.*

The contest is now up and running at our website, at ***theknack.info***. There you will find a 10-question quiz on general business topics. To qualify for the next round, you have to get all of the answers right, but you can take the quiz as many times as you like. Once you pass Level One, you become eligible for Level Two, a quiz based on the concepts we've written about both in these columns and in the book. Those who pass the Level Two quiz will be asked to fill out a brief questionnaire, and we'll choose the winners from that group.

Let me say a few words here about how I choose the people I mentor. I usually start by interviewing them in my Brooklyn office for an hour or so. By the end of the discussion, I know whether or not I have any knowledge or experience that could be helpful to them and whether they are willing to listen to me. Notice I said "listen to me." I didn't say "take my advice." I never tell people what to do. Indeed, if they have a strong gut feeling that is different from mine, I encourage them to go with it. But I want them to be open to looking at their situation in a way different from how they've been looking at it before. Otherwise, I will be wasting my time.

One of the first steps always is to look at the numbers. Consider, for example, a business whose founders I met through my participation in *Inc.'s* annual Inc. 500 conference. The founders had all been involved in staging the conferences, either as employees of *Inc.* or as independent contractors. It's almost impossible to spend time around successful entrepreneurs without thinking about becoming one of them, and that prospect had proved irresistible for three of the conference producers: Elizabeth Busch, Anne Frey-Mott, and Beckie Jankiewicz.

Two of the women, Anne and Elizabeth, already had their own businesses. Anne's company, Conference Solutions, had been around for 11 years and specialized in selecting sites, negotiating contracts, and managing relationships with hotels and conference centers. Elizabeth, who had launched her business in 2005, focused more on the design and marketing of events. Beckie was director of events for *Inc.* and its sister publication, *Fast Company,* and had experience in handling the logistical challenges of developing several projects simultaneously. Although the three of them had no formal link, they often partnered on conferences. Inevitably, they began thinking about starting a business together. The closer they looked at the possibility, the more convinced they became that they could work more efficiently, market more effectively, create more value, and produce better results overall if they were part of the same company -- a full-service events business. Last February, Beckie left her job at Mansueto Ventures (*Inc.'s* parent company), and in April she, Anne, and Elizabeth formed The Event Studio, with each as an equal partner. The plan was for Elizabeth to phase out her company as its current projects were completed, but Anne would keep Conference Solutions alive for the sake of customers that did not need the other services offered by The Event Studio.

They were still in the formative stage of their new business when they first came to me for advice in December 2007. Unlike most companies I work with, theirs was essentially a start-up. Then again, I was already familiar with, and had a high opinion of, their work, and I thought their logic for joining forces made sense. But I could also see that, while they had a clear vision of where they wanted to wind up, they didn't understand the steps they had to take to get there. Having taken those steps many times myself, I offered to be their guide. They readily accepted.

As the offspring of two existing businesses, The Event Studio began with a significant advantage not enjoyed by most brand-new ventures: revenue. Anne's business and Elizabeth's business both had ongoing, unfinished projects of the sort their new company would be signing up in the future. Anne and Elizabeth could hire The Event Studio to do the remaining work on those projects. When the old companies got paid by their customers, they could pay The Event Studio, thereby generating the cash flow the new company needed to get off the ground.

That's exactly what Anne and Elizabeth did, but when I spoke with them again several months later, I realized they had neglected a critical step. They hadn't made sure that The Event Studio submitted bills to their respective companies for the work done. They hadn't thought of it, of course, because they were the ones doing the work, just as if they had simply continued to partner. Billing their old companies felt like sending invoices to themselves. Problem was, the customers' contracts were with the old companies, and those were the entities that received the payments. Unless the old companies, in turn, received -- and paid -- bills from The Event Studio, it would appear that Anne and Elizabeth had taken the money and invested it in the new business.

So, you ask, what's wrong with that? Nothing, in principle. It wouldn't become a concern for them until they had their accountants figure out their respective tax liabilities for the year. At that point, they would discover they owed a lot more than they expected. Why? Because each of their old companies would have revenue with no expenses to put against it. The expenses would have been incurred by The Event Studio. The money that the old companies received from their customers for the work done by The Event Studio would look like pure profit, on which they would be taxed accordingly. Fortunately, we caught the oversight in time.

To be sure, they didn't necessarily need my help to avoid this particular pitfall. A good accountant might well have discovered what had happened before Anne and Elizabeth were forced to pay taxes they didn't really owe. Then again, many outside accountants don't ask all the questions they should about the numbers they're given. They're too busy. They have dozens of clients and only so much time to spend on each one. That's why it's dangerous for entrepreneurs to rely on an outside accountant to oversee their finances. Like it or not, you need to understand the numbers of your business, and that requires knowing something about accounting.

And if there's one aspect you need to know, it's the difference between cash- based and accrual-based accounting.

Otherwise, you won't really know whether you're making or losing money. Here's the (somewhat oversimplified) difference in a nutshell: With cash-based accounting, you record sales and expenses only when money changes hands. That is, you don't recognize a sale until you get paid for it or an expense until you hand over the cash. With accrual-based accounting, you record sales and expenses when you do the work involved in creating and delivering the product or service a customer has agreed to purchase.

All individuals and most small businesses use cash-based accounting to figure out what taxes they owe, and it's fine for that purpose. But cash-based accounting doesn't tell you how you're really doing as a business, and as a result it can lead you astray. I'll give you a hypothetical example. Suppose The Event Studio books two new events in December. One is a large conference that will take place the following spring, for which the company receives a deposit of $10,000 but on which it does no work in December. The other is a sales meeting scheduled for February. Let's say the total fee for that one is $6,000, and the company operates at a 50 percent gross margin, meaning its direct costs will be $3,000. It will be paid half of its total fee for the sales meeting in the middle of January. Nevertheless, it completes a third of the work in December and pays a third of the costs, or $1,000.

On a cash basis, the women made $9,000 ($10,000 of cash received minus $1,000 of expenses paid) during the month. If they had no other sales or expenses during the year, that's the amount on which they would pay taxes. But to understand how the business really did in December, they need to look at sales and expenses on an accrual basis. They can't include the $10,000 deposit in their sales figure, because they did no work on the conference during the month. On the other hand, since they've done a third of the work on the sales meeting, they can record a third of the total fee, or $2,000, as well as the $1,000 they incurred to cover the cost of that work. So their profit for the month was really $1,000, not $9,000. (For the purposes of this example, we're ignoring overhead expenses.)

Now, all that may seem obvious to you, but it doesn't seem so obvious if you aren't used to working with the numbers of a business. When I asked The Event Studio women for their 2008 income statement, they had no idea whether to include the deposits in their sales totals. Similarly, they didn't know whether to include expenses they'd been billed for but hadn't yet paid. Predictably, what they produced was a mishmash, and not because they're stupid. On the contrary, all three are extremely bright. But if you've never taken the time to learn the basics of accounting, even experienced entrepreneurs can get tripped up.

On the other hand, when you do learn the basics of accounting, you realize that the numbers aren't as complicated as you feared and that you're finally developing the knowledge you need to be in control of your company. As we went through their income statement, I had the sense that Elizabeth, Beckie, and Anne felt a fog lifting. It was a small step on the road to building their business, but it was a crucial one. We'll be looking at the next steps in the months ahead.

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