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The Language of Accounting

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The Language of Accounting

ACCOUNTING: A NECESSARY EVIL?
Many of the small-business managers I know view accounting this way. It's overhead and really doesn't contribute to the bottom line. Or does it? The people who run the accounting system speak in an unintelligible blur of debits and credits. They have little grasp of the operation that generates the money to pay their salaries.

Sound familiar? Maybe you're one of the entrepreneurs who share these thoughts. Welcome. I'm not out to convert you to the good of accounting. However, my guess is that once you see how to set up an efficient accounting system for your small business-one that really does contribute to overall profitability-you'll convert yourself.

Information Means Profits
The purpose of the accounting system is to communicate. It produces useful information (not raw data) that tells specific things about the company. To those who understand what this intricate system is saying (and you'll be one of them by the end of this book), it's like money in the bank.

Suddenly, information that you need to run the company is at your fingertips. Of course, this information is couched in financial terms. That's the language your accounting system uses. But it's not complicated and-with help from this book-it's not foreign.

Here are two examples that prove this.

Overdrawing TDO's bank account
TDO Enterprises fabricates the chassis boxes for computers. It always seemed that there wasn't enough money in the bank to pay the bills. A quick look at the aging of accounts receivable revealed that customers paid on average two weeks after the time stated in the terms of sale.

Rather than dip into its line of credit again, TDO's solution was to mount an aggressive collection campaign. The company used its accounts receivable system to monitor progress toward getting and keeping customers current.

Within the space of two months, TDO's bank account balance had risen to a point where it could pay its bills regularly without having to draw on its credit line.

MAG's eroding profit margins
MAG Partners, Ltd. sells grass seed on a wholesale basis. Profits recently turned down for no apparent reason. However, the partners were savvy enough to investigate the sales department's ability to pass on recent price increases to customers.

Comparison of the sales prices for MAG's grass seed with what MAG had to pay for it showed a 20 percent decline in gross profit margin (sales - cost of goods sold = gross margin). The solution was to dock sales commissions for the amount under the company's list price. Profits miraculously rebounded.

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Knowing What to Look For

Was the language the accounting system used to describe these two problems foreign? No. Was the solution a great mystery? Again, no. For TDO, the answer was simply to collect receivables faster. The accounting system identified the delinquent customers. For MAG, the answer was to raise prices. Once again, the accounting system showed which products and salespeople weren't following company policy.

All management needed was an understanding of the information available in the accounting system to help run the company. That's how we'll use your accounting system.

WHAT YOU WANT FROM YOUR ACCOUNTING SYSTEM

The kind of information we found in the prior examples is what you want from your accounting system. This feedback must

- Be accurate
- Fulfill management's requirements
- Be easy to use

We can employ information like this in solving problems and running the business. As well as having the attributes of accuracy, relevancy, and simplicity, our accounting system ought to be set up in such a way that it does not require an inordinate amount of time to maintain. Remember, you aren't an accountant, and we don't want you to spend your time trying to do accounting.

Further, your accounting system should not require a CPA to operate it or to interpret the output. Some of the popular automated accounting systems require specific knowledge not only about computers but about the field of accounting as well. Make sure that those running the system have the background needed to install and operate it. If they don't, get a package that is more in tune with your firm's capabilities.

Further, if you are using an automated accounting package, it must run on the computer equipment that is either currently in place or to be acquired in the near future.

If you choose to use an automated accounting system, this book will be of immense help in teaching you the basics of how it works. Whether manual or automated, all accounting systems use debits, credits, a general ledger, and subledgers. All entries are posted the same way. The only difference is which buttons to push. The last chapter demonstrates methods of selecting the proper automated accounting system for your company.

ACCOUNTING FOR THE BUSINESS CYCLE

The business cycle is nothing more than the flow of transactions needed in your business to complete a sale and collect the proceeds. It's important to setting up your accounting system. We want to know what types of transactions are involved and the accounting entries to make along the way. Most companies business cycles progress something like this:

1. Purchase raw materials.
2. Enter goods into raw materials inventory.
3. Begin the manufacturing or assembly process.
4. Enter goods into work in process inventory.
5. Pay suppliers or pay employees (at service companies).
6. Complete the manufacturing or assembly process.
7. Enter goods into finished goods inventory.
8. Sell the inventory.
9. Collect payment for credit sales.

Briefly, here is the way your accounting system interacts at each stage of the business cycle.

Purchase Raw Materials
What happens when you buy the raw materials used to create your company's product? You receive the goods, and you either pay cash for the goods or obligate the company for future payment. Both transactions require these accounting entries:

- Increase raw materials inventory
- Decrease cash (if you paid on the spot)
- Increase accounts payable (if you didn't)

At this point, we've covered the first two steps of the business cycle listed above.

Begin the Manufacturing Process
When we use raw materials to make our product, the accounting system transfers the inventory from raw materials to an intermediate stage called work in process (WIP for short). This transaction explains the third and fourth steps of the business cycle.

Pay Suppliers
Sometime during the production process we must pay our suppliers if we bought the raw materials on credit. The accounting entry for this transaction does two things:

- Reduces accounts payable
- Reduces cash

Complete the Manufacturing Process
At last, we have completed our manufacturing process. Now we can move the product from the work in process inventory to the finished goods inventory. This transaction particularly interests the sales staff, since it means that the product is now available for sale, and that's what generates their commissions. The entries into the accounting system that record this event go like this:

- Reduce work in process inventory
- Increase finished goods inventory

We've now completed the sixth and seventh steps of the business cycle.

Sell the Product
At last we're ready to make a sale. If it's a credit sale, our accounting system must record these transactions:

- Reduction in finished goods inventory
- Increase in accounts receivable
- Increase in sales revenue

If this was a cash sale, replace the increase in receivables with an increase in cash. We just finished the eighth step of the business cycle.

Collect the Receivable
The final stage of the business cycle is conversion of the receivable (which is an asset) into spendable cash. When the customer pays, the accounting system records a decrease in receivables and an increase in cash.

This ends the business cycle and the various accounting transactions involved. The accounting system we're setting up will cover every one of these transactions.

*** Source [Adams - Accounting for the New Business](#)**
The Strategies and Practices You Need to Account
for Your Success by Christopher R. Malburg, CPA, MBA

Basic Accounting | Projections | Credit & Collections | Purchasing/Cost Control