Financial News

Small Businesses Need to Understand If They Are Really "Profitable"

By Jack Kern

I met recently with a bank commercial loan officer who specializes in Small Business Administration loans. We talked about the current lending environment and the impact that the method of "financial reporting" can have on her ability to approve a loan. Suddenly she stopped in the middle of what we were discussing and commented, "You know, one of my biggest frustrations with prospective borrowers is the total 'garbage' they send me from QuickBooks. These people really have no idea what they are doing in accounting, and they just don't realize how the kind of information they provide prevents me from understanding their business and approving their loan. And in the current economic environment, forget about a loan, these people don't even know if they are making or losing money, or how they are going to make it to the other side of this recession."

On Quickbooks: As a Certified QuickBooks ProAdvisor, I always tell new clients, "QuickBooks has done a marvelous job of marketing its product based on how 'easy it is to use.' And then I add, "And it is easy to use; however, this is also what makes it very easy to abuse." This is what the SBA lender was talking about. Many people seem to think that QuickBooks somehow miraculously does all your accounting, no matter how you enter the data.

On financial reporting: The May TIR the article entitled "Local Retiree Helps Others 'SCORE' in Business," lists several, very good questions that SCORE counselors may ask people who are considering starting up a business. Another question I ask is, "Who is going to do your monthly accounting, and what method of accounting do you plan to use to monitor the progress of your business?" This speaks to the method of financial reporting. And when I ask this question, I expect to receive a blank stare from my client, and perhaps some questions about what they need for the IRS. But the method of accounting you would use for tax purposes is not (usually) an appropriate method of financial reporting for managing your business.

To put "business finance" into perspective, it is no different in many respects than personal finance. How many of you believe that your mortgage company will wait 30, 60, or even 90 days beyond the due date to get their payment just because someone who owes you money has not paid yet? Paying your bills when you receive money for goods or services is "cash basis" accounting. You report your income when you receive it and your costs when they are paid; many companies use this for tax purposes, because it reduces your taxable income. But in reality, the mortgage company would most likely not tolerate waiting for you. So what you need is adequate savings to pay those bills when you don't have cash coming in.

It is no different in a business. You invoice a customer and give them 30 day terms, but if they pay you in 45 or 60 days; you have to reserve for that in order to operate the business. In business terminology, this is referred to as "timing" and the reserve you need is "working capital." For your profit and loss statement, when you invoice the customer that creates an "account receivable" and that is recorded as a sale immediately, not two months from now. And whatever costs are related to the product you sell are then also immediately recorded as "cost-of-good sold," and recorded in the same month that you invoice the customer. The actual bill for these costs, however, may not need to be paid until 30 to 60 days later. This is "accrual" accounting, and for most businesses, it's the only way to know if your business is making or losing money.

So you have two things to look at: "profit," which reflects the difference between the price of your product and its cost ("accrual basis accounting") and "cash flow," which reflects the "timing of when you received payment from your customer, versus when you paid your vendor. This in part is what the SBA lender was referring to.

The rest of her issue has to do with whether you know anything about accounting. If not, you need the assistance of someone who does, and not just a "tax advisor" at year end. You need to understand both, but manage your books internally so that you know at all times whether or not you are profitable, and can take corrective action quickly if you are not. Unchecked "losses" represent a permanent cash drain on the business and, if hidden, can ultimately destroy your company, while many "timing" issues can often be resolved with improved collections, or possibly even a bank loan. And understanding the difference between the two can mean the difference between your business succeeding or failing.