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Basics of Accounting Are Vital to Survival for Entrepreneurs

By DARREN DAHL

Few people start a business because they are good with numbers. In fact, the terms “accounting” and “financial analysis” tend to put business owners to sleep or send them screaming from the room. But to run a business effectively, most owners need to have some understanding of their finances.

It is, for example, entirely possible for a company to be profitable but fail anyway because it does not have enough cash coming in to pay its bills.

“It’s like a racecar that goes too fast and runs out of gas,” said Doug Tatum, a serial entrepreneur who is a visiting professor of entrepreneurship at Middle Tennessee State University in Murfreesboro. Business owners do not necessarily need to know how to prepare a balance sheet, but they do have to know which gauges to watch.

One obvious step is to work with a bookkeeper or accountant, someone who can help navigate arcane accounting and tax rules and organize your affairs. But owners should understand that accounting is not just about paying taxes or reporting results.

“Small-business owners tend to hate accounting because it’s boring,” said Brian Hamilton, chief executive of Sageworks, a company in Raleigh, N.C., that tracks financial data for privately held businesses. “The mistake they make is not thinking about how they can use certain numbers as tools to better manage where their business is headed tomorrow.”

What follows is a guide to better understanding the numbers that drive a business. As the examples make clear, even smart people with advanced degrees can become confused by accounting issues. **DON’T MISTAKE DEBT FOR PROFIT** After earning a master’s degree in industrial engineering, Bart Justice figured he would get a job doing computer simulations or technical sales. Then in 2004, he learned about the paper-shredding industry, which was booming because of a rash of new security laws. Mr. Justice obtained a loan from

a local bank to buy a mobile shredding truck, hired a truck driver and opened shop in Huntsville, Ala., as Secure Destruction Service.

The company hit \$70,000 in sales its first year. Within four years, Secure Destruction had annual revenue of \$500,000 and employed six people across two offices, one in Huntsville, the other in Birmingham, Ala.

To finance his growth — adding a shredding truck, for example — Mr. Justice kept borrowing money from the bank, not realizing that the more he grew, the more he needed to borrow because his revenue was not covering his expenses. The loans meant he had money in his accounts — but it was borrowed money.

“I knew how to print a financial statement from QuickBooks, but I couldn’t tell you what it meant,” he said.

It was not until early 2008 when he joined a peer group for Christian business owners called C12, that Mr. Justice was forced to confront the truth. “They would ask me questions about my numbers, and I didn’t know how to answer them,” he said. “They told me my business was going to fail unless I got a handle on paying down my debt.”

He hired an accountant and began analyzing how aspects of his business were performing, which led him to sell several pieces of equipment and to stop serving clients if he was losing money on them.

The advice proved timely. As the recession set in, the market for shredding collapsed. But with a leaner and smarter operation, Secure Destruction survived.

MANAGE RECEIVABLES Two years ago, Paul Burns brought on Eric Edelson as a partner to help run Fireclay Tile, which is based in San Jose, Calif., and manufactures ceramic tile using recycled materials. Mr. Edelson, who had left a career as an investment banker in New York to get an M.B.A. at Stanford, knew the business had been struggling, but he was hopeful that he could help.

One number that looked impressive to him was the company’s accounts receivable balance, which was more than \$100,000. That was money owed to Fireclay by its wholesale clients. “At first, I thought it was kind of neat since we could count on all that cash coming in,” Mr. Edelson said. “But after I started digging into it, I noticed a lot of stale accounts that were more than six months overdue.”

Mr. Edelson hired a third-party company to help Fireclay collect its receivables, but many of the companies had gone out of business. Sensing a lost cause, he changed tactics. After

writing off most of the balance, he stopped sending new shipments to customers who had a balance due and started getting more upfront payments and staying on top of customers.

By making sure customers could not buy more tile until they paid for what they had already bought, Mr. Edelson gave his customers an incentive to pay up. That has helped cut Fireclay's receivables balance to less than \$30,000.

UNDERSTAND YOUR EXPENSES After he graduated from law school five years ago, Daniel Gershburg, then 24, decided to open a bankruptcy and real estate law practice in Brooklyn. "I literally didn't know anything about accounting," Mr. Gershburg said. The only number he paid attention to was the gross sales he was pulling in through retainers.

He said he believed that to build his fledgling legal business, he needed to spend money on advertising. In fact, even though his revenue was only \$5,000 a month, he started spending as much as \$4,000 a month on television commercials, Internet ads and search engine optimization.

The result was a vicious cycle: the more revenue he took in, the more compelled he felt to buy more ads to land additional clients. His expenses were increasing faster than his revenue.

Eventually, Mr. Gershburg decided to cut his advertising budget. With fewer clients coming in the door, he raised his prices on current clients because he could now spend more time on their cases. As the quality of his work improved, he began landing more referrals, which did not cost him a dime in advertising.

"By shrinking my practice," Mr. Gershburg said, "I was able to double my profit in a single year."

TRACK YOUR BREAK-EVEN In 2003, when Todd Campbell decided to start E.B. Capital Markets, which provides research on the stock market to portfolio managers, he focused on building and marketing his product. "The last thing I wanted to figure out was the nuts and bolts of keeping track of receivables and payables," he said. "I hated accounting."

He hired a bookkeeper, but he paid attention only at tax time. Then the recession hit, and Mr. Campbell, whose company is based in Durham, N.H., recognized that he needed to get a better handle on how his company was performing, including whether he would be able to make payroll.

That is when he seized upon the notion of tracking his break-even number, the point at which revenue for a given period equals expenses. To do the calculation requires knowing total expenses and gross profit percentage, which is determined by dividing gross profit by sales.

Here's how to do the math: If Mr. Campbell's monthly expenses were \$20,000 and if his gross profit percentage was 50 percent, he would divide \$20,000 by 50 percent to get a break-even number of \$40,000 — the amount he had to sell to break even.

“It is the single best indicator because it helps you see if the canary in the coal mine is getting woozy,” Mr. Campbell said. “Now I know what decisions I have to make today so that I don't have to panic a few months from now.”