College Guild
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Introduction to Business

Unit 4 of 6

Accounting & Finance

In this unit, we will define the key accounting statements used for businesses, discuss how to use those statements to make business decisions, and explore the different options for financing a new business.

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Important! Most questions in this course are essay questions and have no single correct answer.

Glossary of Terms:

1. **Asset** – anything that has value to a business and helps it make money, whether physical or not.
2. **Debt financing** – borrowing money from banks or another group to pay the costs to start or operate a business.
3. **Equity financing** – when a business sells shares of ownership (or equity) in the company to investors in exchange for cash.
4. **Liability** – debts or obligations owed by the business to other parties that must be repaid in the future.
5. **Liquidity** – having enough cash on hand to operate the business.
6. **Owner's Equity** – a business's total net worth according to its Balance Sheet (also equal to total assets minus total liabilities).
7. **Self-Financing** – when a business owner relies on their personal resources to pay for starting and operating the business.

Part 4: Accounting & Finance

If the primary goal in business is to make money, it is fair to say that tracking and planning how money is used is incredibly important. That is where **Accounting** and **Finance** come into play.

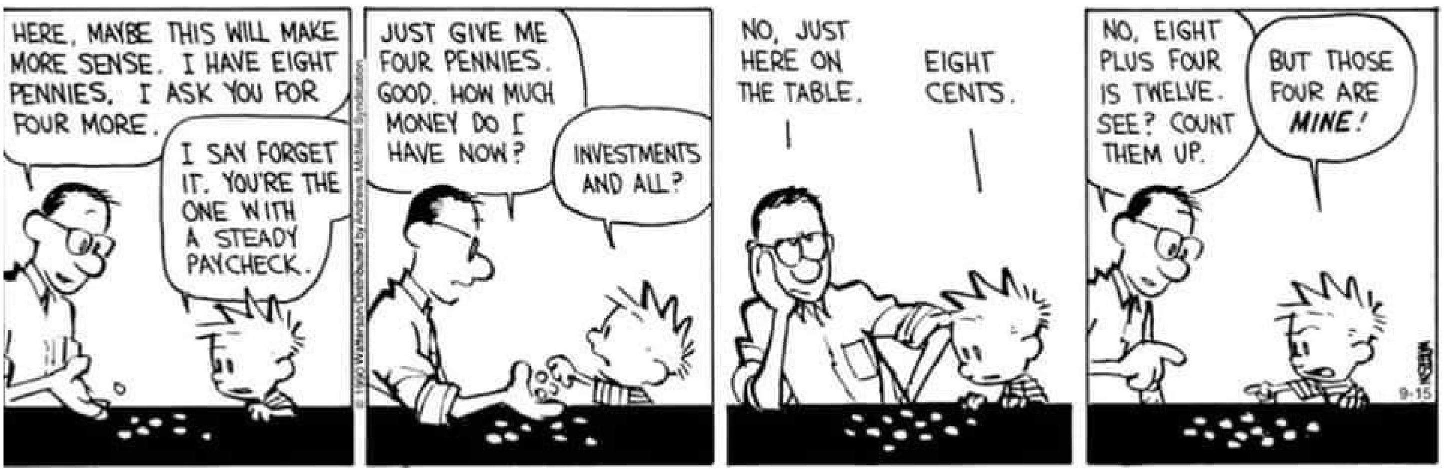
<u>Accounting</u> involves keeping a detailed record of everything that has value in a company: not just money itself, but also anything that has monetary value. If your business is a barber shop, the accounting function would count and track every pair of scissors, barber chair, and towel you buy. Accounting also tracks every penny you spend on renting a space, labor and marketing, and all the money you make from cutting hair. Accounting organizes all the information about your business so you can understand where your money is going and where it's coming from – it's like a diary that tracks every detail to understand the health of your business.

<u>Finance</u> relates to the big picture money issues in business: for example, figuring out how to get money you need to start your barber shop, and how to use that money wisely. Finance is also about making decisions on what to do with your

profits from cutting hair – should you spend them on hiring more barbers? More advertising? Maybe open another barber shop in a different neighborhood? Or just pocket that money to save for later? Finance is all about managing and planning how to use money to make your business successful.

1. **Accounting and finance are separate functions, but they are closely related. A finance function cannot succeed without a good accounting function. Why is that?**
2. **Is it possible to run a successful company without strong accounting and finance? Why or why not?**

In small businesses, you can add accounting and finance to the list of functions that the business owner typically handles him-/herself (along with Marketing and Operations). But accurately tracking and planning how businesses spend money is so critical, it can be common to hire someone to focus specifically on these areas: accountants (also called bookkeepers).



Bill Watterson, Calvin and Hobbes

Accounting: General Ledger

In accounting, there is one document that tracks every detail and transaction for the business: the General Ledger (or “GL”). These days, almost all companies use accounting programs to act as their general ledgers, but before computers were widely used, GLs were typically thick, heavy books filled with hand-written notes and numbers. For your imaginary barber shop, you would record all transactions involving anything of value for your business. Every time someone spends money or gets money for something related to the business, you write it down in the general ledger.

Each record you write in the general ledger is a called a Journal Entry, and there are several types to record different transactions – the most common types are:

1) **Revenue Entries**: these entries record money earned by the business. For example, when you get paid for trimming someone’s hair, the money received is recorded as revenue.
2) **Expense Entries**: these record costs of running the business in its operations. Common business costs include things like rent, payroll, supplies or utilities.
3) **Asset Entries**: these entries record the purchase of assets – assets are things that are useful to your business and help it make money. Assets can be physical things, such as equipment, tools, vehicles, or even money itself.

Assets can also be non-physical: company secrets (special ways of doing things or making products), customer lists, or software are some examples.

4) **Liability Entries**: these record business liabilities, which are obligations or debts owed by the business to outside parties. You can think of liabilities as things that have *negative* value for a company, such as a loan taken out from a bank that must be repaid, money owed to suppliers, or taxes that must be paid in the future.

In the general ledger, you would capture every transaction of these different types so you can have an accurate and comprehensive view of your business history and health.

3. **In the barbershop example, let's suppose your general ledger did not capture any revenue entries. If someone were to examine the GL, what would be their view of the business?**
4. **Give three examples of business assets that a barbershop business would likely need, and three examples of liabilities that the business might have.**

A common way to understand the financial health of a business is by looking at financial statements or reports, which summarize all the company's journal entries during a specific period of time. These statements will only be useful if a company has accurate and comprehensive records within its general ledger.

Accounting: Financial Statements

The three commonly used financial statements that businesses use to measure their company's health are:

- **Profit and Loss Statement** (also known as the "P&L" or the "Income Statement"): shows if your company made or lost money
- **Balance Sheet**: shows what your company owns and what it owes.
- **Cash Flow Statement**: tracks where your company's money comes from and where it is going

Let's dive into each statement in a bit more detail.

Proft & Loss Statement (or P&L)

The P&L is like a report card for your business. It shows how much money your company made (revenue) and how much it spent (expenses) to make that money. If your business made more than you spent, that's a profit! But if it spent more than it made, that's a loss. P&L's are specific to a period of time, and describe all the money made and spent within that period (usually a month, a quarter or three months, or a year).

Let's take a look at an imaginary P&L for a barbershop business to explore the common elements:

		2020
REVENUES		
Sales - Hair Cuts	$	200
Sales - Shaves	$	100
Total Revenues	**$**	**300**
COST OF GOODS SOLD (COGS)		
Cost of Goods Sold - Hair Cuts	$	100
Cost of Goods Sold - Shaves	$	25
Total COGS	**$**	**125**
GROSS PROFIT		
Gross Profit - Hair Cuts	$	100
Gross Profit - Shaves	$	75
Total Gross Profit	**$**	**175**
Gross Margin %		*58%*
OPERATING EXPENSES		
Rent	$	100
Other Expenses	$	25
Total Expenses	**$**	**125**
NET PROFIT	**$**	**50**
Profit Margin %		*17%*

- Revenue (or sales) refers to the money a business collects from selling its products or services within a specific timeframe. In this example, the business made $200 from hair cuts and $100 from shaves in 2020.
- Cost of Goods Sold (or "COGS") is the direct cost of selling the company's product. For a business that sells physical goods, COGS would include the cost of raw materials and manufacturing the goods. For sales of services, COGS typically refers to the labor needed to provide those services (for instance the wages of barbers).
- Gross Profit is the money a business makes from its products after taking away the direct costs of making the products, calculated as Revenues minus COGS.
- Gross Margin measures how profitable the company's products are, as a % of total sales. In 2020, the company's gross margin was 58% ($175 divided by $300)
- Operating Expenses refers to the costs of running the business. Rent is a significant expense for many businesses.
- Net Profit is calculated by taking total gross profit and subtracting operating expenses. This business made a net profit of $50 in 2020.
- Profit Margin measures how profitable a business is, as a % of total sales. This business's profit margin in 2020 was 17% ($50 divided by $300).

5. **It is possible to calculate gross margin % for individual services. Hair Cuts had a 50% gross margin in 2020 ($100 Gross Profit divided by $200 Sales). What was the gross margin of Shaves?**
6. **Compare the gross margin % 's between Hair Cuts and Shaves – what does this tell you? How might this information influence your business decisions in the future?**
7. **What costs might be contained in "Other Expenses" for a barbershop business?**

Balance Sheet

The Balance Sheet is a snapshot of your company's finances at a specific moment in time. It is like taking a photo of everything that your business owns (assets) and what it owes (liabilities). If you subtract what is owed from what is owned, you get your business's total net worth, which tells you how much your company is worth – also called **Owner's Equity**. The total value of a company's assets must equal (or *balance with)* the value of all liabilities plus owner's equity – this is why the report is called the "Balance Sheet."

Let's take a look at an imaginary Balance Sheet for a barbershop business to explore the common elements:

- Cash refers to all the money a business has available to spend at that time, whether physical money in hand or in a company's bank account.
- Accounts Receivable (or "AR") is the money that is owed by customers to a business for goods or services that have been provided but not yet paid for.
- Loans are one of the most common liabilities for a business.
- Accounts Payable (or "AP") is like the opposite of Accounts Receivable – it is money that a business owes to other parties for goods or services that have been received but not yet paid for.

		Dec 31 2020
ASSETS		
Cash	$	1,000
Accounts Receivable	$	500
Total Revenues	**$**	**1,500**
LIABILITIES		
Bank Loan	$	250
Accounts Payable	$	750
Total COGS	**$**	**1,000**
OWNER'S EQUITY		
Total Owner's Equity	**$**	**500**

8. **If your barbershop provided a $10 haircut and the customer promised to pay you tomorrow, would that transaction create $10 in Accounts Receivable or Accounts Payable?**
9. **What number from the above Balance Sheet represents the net value of the business?**

Cash Flow Statement

Liquidity, or having enough cash on hand to operate, is one of the biggest challenges of a business. The Cash Flow Statement tracks all the money that comes in and out of your business, to help you understand the company's liquidity. It shows where your money is coming from (selling haircuts and other services) and where it's going (like paying for labor or buying supplies). It shows if the company is making enough money to cover its expenses and if any cash is left over to save or spend.

The Cash Flow Statement may sound similar to the P&L, but the main difference is time. Generally, the P&L cares about when sales are made, regardless of if payment is received immediately or in the future. The Cash Flow Statement cares about when money is received, and not when the sale was made.

In the P&L example above, your barbershop sold $300 in services with $250 in total costs, profiting $50 – not bad! But imagine that all your customers paid on credit terms, so your actual cash intake from sales that year was $0. If your costs are paid when they are due, then your business must find $250 to cover those costs while you are waiting to receive payment for the $300 in sales. Looking at the P&L, you may not see this problem but a Cash Flow Statement would point out the issue.

10. **If your barbershop has liquidity problems, what are some things you could do to improve its cash situation?**
11. **Having a lot of cash on hand is generally a great thing for a business. But companies try to avoid having *too much* cash – what might be a problem of having too much cash?**

Financing a Business

While Accounting keeps track of the money coming in and going out of a company, Finance figures out how to use that money wisely to help the business succeed. One of the biggest finance decisions for a company is how and where to invest to best help the company operate and grow. This is particularly important for startup businesses, which typically choose from three main ways of financing the business: Debt, Equity, and Self-Financing.

Debt financing is borrowing money from banks or other financial institutions to pay the costs to start and operate a business. This debt is then paid back over time with interest. The main advantage of debt financing is that a business owner doesn't have to use their own money to start the business; they borrow the money instead. Debt also does not require giving up any ownership in the company, so the founder/owner can maintain complete control of the business.

On the other hand, debt has some big downsides. One is the interest – the borrower will have to pay back the borrowed amount plus interest (otherwise why would the lender agree to loan the money?). The size of the interest rate is affected by several factors: the health of the overall economy at the time, the riskiness of the business venture, and the credit worthiness of the borrower (as determined by the individual's financial situation, credit history, previous employment, and future prospects). A borrower with poor credit worthiness will have to pay much higher interest than others might. Another drawback of debt is that loans are very hard to obtain for a business that is brand new, versus one that has been operating for years. Banks hate risk, and lending money to a new business venture with no track record, no customers and no sales is quite risky! In these situations, banks and other lenders will require assets to secure the loan, meaning the borrower must pledge personal property that the bank can seize if the loan is not repaid in full.

12. **Let us suppose your barbershop takes out a bank loan of $10,000, to be repaid after one year with 10% interest. What amount would you need to pay to the bank after a year?**

Equity financing involves a business selling shares of ownership (or equity) to investors in exchange for cash. This allows investors to become partial owners of the business and have a share of its future profits and losses. Like debt financing, the advantage of equity financing is that the owner doesn't have to use his/her own funds to finance the business. And unlike debt financing, equity financing does not require borrowing money that must be repaid with interest.

Equity financing has its drawbacks as well. By taking on equity investors, business owners give up a slice of future profits and ownership. For instance, if you sold 20% of your barbershop to an investor, that investor would receive 20% of all future business profits, *and* 20% of the sale price if you decided to sell your business in the future. Equity investors may also demand some say in key company decisions – who to hire, where to invest money, or other decisions over which business owners may not want to give up control. Also, equity investment for a new business is very hard to obtain. An investor must be convinced of the potential of the business idea and the promise of the business founder/owner; only then would the investor give enough money to sustain the company through its startup phase.

How to properly assign a dollar value to a business has derailed many equity financing discussions. The owner and investor must agree on a business valuation in order to determine what $ is invested and what % of the company is transferred to the investor. For new businesses, this can be even harder as the discussion is based on theoretical revenues and profits to come – no one knows what the future holds!

13. **You need $10,000 to start your new barbershop. You believe it will generate $5,000 in profit each year. What % ownership of the barbershop would you be willing to offer to an equity investor, in exchange for the $10,000 you need?**

Self-Financing (also called "bootstrapping") is when the business owner relies on his/her personal resources to pay for starting and operating the business. The owner uses personal savings, credit cards, or money from friends and family to finance the business, until the company can make enough money to cover its own expenses. The advantage of this approach is the owner retains full control of the company and its future profits, which would not happen with equity financing. There is also no need to pay back a loan with interest, as with debt financing.

The obvious drawback to self-financing is that the owner must have enough personal resources to consider this. The costs to start a business can be significant – business licenses, rent, equipment, marketing, payroll for employees, and starting inventory are just some of the potential costs for starting a business, and all of these may need to be paid before the company makes its first cent from sales!

14. You decide to self-finance your barbershop business, and fund on your own the $10,000 needed to start up. What are some ideas for getting that amount of money together?

Securing enough financing for a business is critical, and there are several ways get there (including others we have not discussed like Crowdfunding). All paths have their own challenges, especially for a new business getting off the ground.

15. Suppose you were starting a new business, and needed $5,000 to get it off the ground. What type of financing would you think is best to raise this money, and why?

Case Study: Mi Rancho

In 1939, Mexican-American couple Jose and Maria Tamayo opened Mi Rancho, a store producing organic tortillas and Mexican foods, in Oakland California in 1939. When it opened, it was the only Mexican grocery store in the area, and attracted people from all over especially for their fresh hand-made tortillas. The store regularly drew lunchtime crowds that lined up around the block for their delicious and authentic Mexican food.

Eventually, driven by Mi Rancho's commitment to quality and sustainability, the store started supplying its tortillas and chips to many restaurants in the local area. Over the decades, the company grew massively by distributing to other businesses, and now sells its products throughout the United States and even many other countries.

Original Mi Rancho store, www.mirancho.com

In recent years, as Mi Rancho grew to meet demand for organic and authentic Mexican food, the company had to rely on investment from outside companies. While successful for its long history, building the teams, systems, and facilities needed to enable its expansion required significant funds. In exchange, the company granted partial ownership to outside investment firms, and those investments gave the company the ability to grow production, expand its sales network, and launch new product lines.

Today, while the company is partially owned by investment firms, Mi Rancho remains a family-run business making over a billion tortillas each year.

16. Do you think Mi Rancho would be as big and successful today if the owners chose not to bring in outside investment?

Self-Reflection Exercise

17. What was the most interesting thing you learned about Accounting and Finance?

18. How do the lessons of Accounting and Finance apply to your own life?

19. Liquidity is a major challenge for not only businesses, but also people! How can a person make sure he/she has healthy liquidity in their life?

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Remember: First names only & please let us know if your address changes

Appendix
Introduction to Business: Unit 4 of 6

Sources:

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https://www.investopedia.com/terms/c/crowdfunding.asp
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