

## **PART I**

# **Using External Reports to Gauge Your Company's Health and Competitive Status**

COPYRIGHTED MATERIAL



## **CHAPTER 1**

### The Key Financial Statements and Their Starring Role



## **In This Chapter**

- How financial statements are developed
- Who reads them and why
- Accounting methods and why they matter
- Key accounts used to produce reports

As a business owner, you want to know if you've made a profit; the income statement gives you the answer, but is that the full picture? Even with an income statement, you still don't know what your company owns, what your company owes, and what equity you have in the business. You also have no idea whether your company is in a good cash position.

While your income statement shows a profit, how much of that profit actually reflects cash you've already taken into the company? The answer depends on when your accountants recognize the revenue that your company earned. Believe it or not, that can be a complex issue, which we'll deal with in greater detail in Chapter 3.

If you want to review what your business owns and what it owes, you need to turn to the balance sheet. If you want a handle on how much cash has flowed into and out of your business, you need to review the statement of cash flows.

Before I get into the details of each of these statements, let's start at the beginning by looking at what numbers are collected to develop these financial statements. Then we can delve into who reads these statements and why they're interested. Following that, I'll talk about the two types of accounting methods that can be used and how they impact the financial statements that you get from your accountant.

## USING EXTERNAL REPORTS

Then we'll take a quick look at the key numbers that are collected and how they're used to produce reports.

Financial reporting gives you a summary of what is happening financially in your company, based purely on the numbers. The key numbers in these reports give you a financial picture that includes the following:

- **Assets:** your company's cash, marketable securities, buildings, land, tools, equipment, vehicles, copyrights, patents, and any other items needed to run a business
- **Liabilities:** your company's debts; reflect the money owed—in such forms as loans, bonds, and unpaid bills—by your company to outsiders
- **Equity:** the money you and other investors have invested in your company
- **Sales:** the value of the products or services that your customers have purchased from your company
- **Costs and expenses**
  - *Costs:* the money you spend to buy or produce your product or service
  - *Expenses:* the money you spend to operate your business, such as expenditures for advertising, compensation for employees, operation of buildings and factories, and supplies to help people run the offices
- **Profit or loss:** the amount of money your company has earned or lost
- **Cash flow:** the amount of money that has flowed into and out of a business during the time period being reported

Without financial reports, you'd have no idea where your company stands financially. You could find out how much money your business has in its bank accounts, but you wouldn't know how much is still due to come in from customers, how much inventory is being held in the warehouse and on the shelf, how much your firm owes, or even how much your firm owns.

## THE KEY FINANCIAL STATEMENTS

### WHO READS THE REPORTS?

As a business owner, you won't be the only person who reads the key external financial statements. Many people count on the information your company presents in its reports. Here are some key groups of readers and why they need accurate information.

- **Executives and other managers:** Managers need this financial information to know how well the company is doing financially so that they can identify any problem areas and make any needed changes to improve the company's financial performance.
- **Other employees:** Your workers need to know whether they're meeting or exceeding their goals and where they need to improve. For example, if a salesperson has to make \$25,000 in sales during the month, he or she needs a financial report at the end of the month to gauge progress in meeting that monthly goal. If the salesperson believes that he or she met the goal but the financial report doesn't show that the goal was met, the salesperson would have to provide details to defend his or her production levels. Most salespeople are paid according to their sales production. Without financial reports, they'd have no idea what their compensation is based on.
- **Creditors:** Creditors need to understand a company's financial results to determine whether they should risk lending more money to the company and to find out whether the firm is meeting the minimum requirements of any loan programs already in place.
- **Investors:** If you are not the only investor in the business, other investors need information to judge whether your company continues to be a good investment and whether they want to invest more money.
- **Government agencies:** These agencies need to be sure that your company complies with regulations set at the state and federal levels. If you operate a company that sells stock on a market, agencies also need to be certain that your company accurately informs the public about its financial position.

## USING EXTERNAL REPORTS

- **Analysts:** If you seek outside investors, they will likely look to analysts to determine whether it is wise to invest money in your company. If investors don't like what they see in the reports, they may decide not to invest. If they have previously invested in your company, they may even decide to sell their stakes.
- **Financial reporters:** If you own a public company, you'll need to respond to the financial press. The role of financial reporters is to provide accurate coverage of a company's operations to the general public. This helps make investors aware of the critical financial issues facing the company and any changes the company makes in its operations. If you own a private company, you have more control over how much information you must give to the press.

## ARE YOUR BUSINESS'S FINANCIAL REPORTS PRIVATE OR PUBLIC?

If you're operating a private company, you don't have to prepare external reports, except for those required by the government, such as the financial statement that you include in your business tax return. If you plan to raise additional cash by enticing investors or by borrowing funds, however, you will need to produce three key financial statements for external readers. Whether these statements must be released to the public depends on your business's structure.

Most small businesses are private companies, so they need to provide these statements only to a small group of stakeholders: managers, investors, suppliers, vendors, and the financial institutions with which they do business. As long as your company doesn't sell shares of stock to the general public, you don't have to make your financial statements public. Some companies, such as Publix Super Markets, are semiprivate. Although Publix stock is available only to employees, the company still has more than 85,000 common shareholders.

But if you do sell stock on a public market, such as the New York Stock Exchange or NASDAQ, you are considered a public company and you are required to file a series of reports with the Securities and Exchange Commission (SEC) or with the state in which you incorporate the business each year. Whether you file with the SEC or your

## THE KEY FINANCIAL STATEMENTS

state depends on the number of investors your company has. If your company has at least 500 investors or at least \$10 million in assets, you'll have to file your financial statements with the SEC. Smaller companies that have incorporated and sold stock must report to the state in which they incorporated, but they aren't required to file with the SEC.

### FILLING THE GAAP

Even if your company doesn't need to make its financial reports public, if you want to raise cash outside a very small circle of friends, you will need to prepare financial statements and have a certified public accountant (CPA) audit them or certify that the financial statements meet the requirements of the generally accepted accounting principles (GAAP). Few banks consider loaning large sums of money to businesses without audited financial statements. Investors who aren't involved in the daily management of a business also usually require audited financial statements.

To meet the demands of GAAP, financial reporting must be relevant, reliable, consistent, and presented in a way that allows the report reader to compare the results with those from prior years, as well as with other companies' financial results. Your accountant (whether he works full time for your company as an employee or is an outside contractor) will be aware of these rules and prepare your financial statements based on these rules, which take up hundreds of thousands of pages. A detailed discussion of GAAP is beyond the scope of this book, but if you want to learn more, visit the website of the Financial Accounting Services Advisory Board ([www.fasab.gov/accounting-standards/authoritative-source-of-gaap](http://www.fasab.gov/accounting-standards/authoritative-source-of-gaap)). Let's take a quick a look at the accountant's role in the production of financial statements and discuss where you fit in.

### The Accountant's Role

Accountants have a language of their own. As a business owner you need to understand their language so that you can have a better grasp of how they develop your company's financial statements and keep your business's books.

## USING EXTERNAL REPORTS

Officially, there are two types of accounting methods that dictate how a company's transactions can be tracked: cash-basis accounting and accrual accounting. The key difference between the two methods impacts how the company records cash coming into and going out of the business. That simple difference can give a company a lot of room for error—or manipulation. In fact, many of the major corporations involved in financial scandals over the past few years have gotten in trouble because they played games with the nuts and bolts of their accounting methods.

### *Cash-Basis Accounting*

The simplest method is called cash-basis accounting. When using this method, companies record expenses in financial accounts when the cash is actually paid out. They record revenue in the books when they actually receive cash in hand or deposit payments in their bank accounts.

For example, suppose your company contracts construction work. You complete a project on December 30, 2011, but don't get paid for it until after your customer inspects the work on January 5, 2012. Using cash-basis accounting, you wouldn't actually enter those earnings into your books until 2012, even though you completed the work in 2011.

Smaller companies that haven't formally incorporated, as well as most sole proprietors, use cash-basis accounting because the system is easier for them to use on their own, meaning they don't have to hire a large accounting staff.

### *Accrual Accounting*

Accrual accounting is much more complex when it comes to recognizing revenue and expenses, but as your company grows, this method becomes a necessity. With accrual accounting your company records revenue when the actual transaction has been completed (such as the completion of work specified in a contract agreement between the company and its customer), not when your company has received the cash. So with accrual accounting, your accountant or

## THE KEY FINANCIAL STATEMENTS

bookkeeper may record revenue even though your company hasn't yet received payment.

Using the same construction contract example from earlier, if your company is using accrual accounting, your accountant would record the revenue upon contract completion on December 30, 2011, even though the customer has not yet paid for the work. Your bottom line at the end of 2011 would look a lot better with that additional revenue.

Expenses are handled in the same way. Your accountant records any expenses when they're incurred, even if your company hasn't paid for the supplies yet. For example, when the company in this example buys materials to complete the construction work, it likely does so on account with its supplier. It may not have to pay that supplier for 30 days or more after it has received the bill. With accrual accounting it would recognize the expense as soon as the supplies have been received and record the bill in an account called accounts payable. If using the cash-basis method, however, the company would not record the expense until cash has actually been paid out.

## WHY ACCOUNTING METHOD MATTERS TO YOUR BOTTOM LINE

Whether your company uses the cash-basis method or the accrual method, accounting can have a major impact on the total revenue your company reports. The method chosen also has an impact on the expenses subtracted from revenue to get the bottom line. With cash-basis accounting, expenses and revenues aren't carefully matched on a month-to-month basis. Expenses aren't recognized until the money has actually been paid out, even if the expenses were incurred in previous months. Also, revenues earned in previous months aren't recognized until the cash has actually been received. Nonetheless, cash-basis accounting has one big benefit: It excels in tracking the actual cash available.

When your company adopts the accrual accounting method, expenses and revenue are better matched. This provides you with a better idea of how much your company is spending to operate each

## USING EXTERNAL REPORTS

month and how much profit your company is making. Your accountant will record expenses (also known as accruing expenses) in the month they were incurred, even if you haven't yet paid the cash. Your accountant will record revenues when a project has been completed, a product has been shipped, or a service has been provided, even if your company has not received a cash payment from the customer. Now let's turn to how this information is actually added to the books.

## DECIPHERING DOUBLE-ENTRY ACCOUNTING

A key concept that you'll need to become familiar with when talking to your accountant is double-entry accounting. Every time your accountant enters information about a financial transaction, it impacts at least two accounts in your company's books.

For example, if you buy office supplies, an entry will be made in the books to increase the value of the office supply account to reflect expenses paid out for new supplies on hand. That entry will be balanced with an entry to decrease the value of the cash account, so the books will reflect the money paid out. If you paid for the supplies on account, then instead of decreasing the cash account, you'll be increasing the accounts payable account, which allows you to track an outstanding debt that you will need to pay in the future.

This may all sound very confusing, but at least 95 percent of businesses in the United States use double-entry accounting, whether they use the cash-basis or accrual accounting method. It's the only way a business can be certain that it has considered both sides of every transaction.

These double entries are done by entering debits and credits into the books. Each time a financial transaction is entered, the debits and credits must equal each other to ensure that the books will balance at the end of the reporting period.

Now things get even trickier. You probably think of the word *debit* as a reduction in your cash. Most nonaccountants see debits only when they take money out of their bank accounts. The word *credit* likely has a more positive connotation in your mind. The most

## THE KEY FINANCIAL STATEMENTS

familiar type of credit may be the one you see when you return an item to a store and your account is credited.

Forget everything you think you know about debits and credits! You're going to have to erase these assumptions from your mind to understand double-entry accounting. A credit may be added to or subtracted from an account, depending on the type of account. The same is true with debits; sometimes they add to an account, and sometimes they subtract from an account.

For example, if a company buys office furniture with cash, the value of the office furniture account increases, while the value of the cash account decreases. If the company purchases \$300 of new furniture, here's how it records the transaction on its books:

<b>Account</b>	<b>Debit</b>	<b>Credit</b>
Office furniture	\$300	
Cash		\$300

In this case, the debit increases the value of the office furniture account and the credit decreases the value of the cash account. Both accounts are asset accounts, which means both accounts represent things the company owns that are shown on the balance sheet.

The assets are balanced or offset by the liabilities (things the company owes) and the equity (claims the owners or shareholders have against the company's assets, such as shares of stock). Double-entry accounting seeks to balance these assets and claims against the assets. In fact, the balance sheet of a company is developed using this formula:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

In addition to establishing accounts to develop the balance sheet and make entries in the double-entry accounting system, accountants must also set up accounts that they use to develop the income statement to show a company's revenue and expenses over a set period of time. The double-entry accounting method impacts not only the way assets and liabilities are entered but also the way revenue and expenses are entered.

## USING EXTERNAL REPORTS

If you want to track your company's sales for the year, you need to be able to decipher debits and credits. If you think an error may exist, your ability to read reports and understand the impact of debits and credits is critical. For example, anytime you think the income statement doesn't accurately reflect your company's success, you have to dig into the debits and credits to be sure your sales are being booked correctly.

A common entry that impacts both the balance sheet and the income statement is one that keeps track of the amount of cash that customers pay to buy a company's products or services. For example, if a customer pays \$500 in cash to buy a product, here's how the entry looks:

<b>Account</b>	<b>Debit</b>	<b>Credit</b>
Cash	\$500	
Sales revenue		\$500

In this case, both the cash account and the sales revenue account increase. One increases using a debit, and the other increases using a credit. Yes, I know this can be confusing! Whether an account increases or decreases from a debit or a credit depends on the type of account it is. See the table that follows to find out when debits and credits increase or decrease an account. This will give you an idea of how these transactions will impact your financial statements.

### **Effects of Debits and Credits**

<b>Account</b>	<b>Debits</b>	<b>Credits</b>
Assets	Increases	Decreases
Liabilities	Decreases	Increases
Income	Decreases	Increases
Expenses	Increases	Decreases

You may want to make a copy of this table and tack it up where you review your company's financial reports until you have become

## THE KEY FINANCIAL STATEMENTS

familiar with the differences. That way you will more easily be able to recognize if a transaction has been entered incorrectly in the books.

### YOUR COMPANY'S FINANCIAL ROAD MAP

Every company has lots of accounts. You and your accountant need a road map to be sure each type of transaction is accurately being entered into the right account. Your accountant does this by developing a chart of accounts, which he or she uses to prepare your financial statements.

The chart of accounts is a listing of all open accounts that the accounting department can use to record transactions. The chart should include a description of the types of transactions that are entered into each account, so the accountant can be sure numbers are added consistently throughout the year. All businesses have a chart of accounts, even if the business is so small that the owners don't even realize they do and have never formally gone about designing it.

The chart of accounts for a business can build itself as the company buys and sells assets for its use and records revenue earned and expenses incurred in its day-to-day operations. If you've never seen a chart of accounts for your business, ask your accountant to show you one. Be sure that the chart of accounts accurately reflects your company's financial transactions in a way that will be meaningful on the financial reports. Although the income statement may reflect only a net sales or net revenue number, you can design internal reports that will give you more detail about what is selling and what isn't. But to get that additional detail on internal reports, you may need to make changes in how transactions are being added to the books and into which accounts they are added.

For example, if you operate a clothing store, the chart of accounts could lump all sales into a sales revenue account, but would that give you the detail you need to know what items are selling and in what sizes? You would probably find it more useful to develop numerous subaccounts to track sales in a way that will enable you to make good purchasing decisions. You could sit down with your accountant, talk

## USING EXTERNAL REPORTS

about the information you need, and develop an account structure that will help you track your sales successes and failures.

To help you become familiar with the types of accounts in the chart of accounts and the types of transactions in those accounts, I developed the following overview of the most common accounts. The chart of accounts can be listed alphabetically, but it is often developed as I did, which is the way you will find them in your financial reports. First will be the balance sheet accounts: assets, then liabilities, and then equity. Then you will see the income statement accounts: revenue and expenses.

### Assets Accounts

Assets accounts come first in the chart of accounts, with the most current accounts (those that the company will use in less than 12 months) listed before the long-term accounts (those that the company will use in more than 12 months).

#### Current Assets Accounts

- **Cash in checking:** This account is always the first one listed. Businesses use this account most often to track their incoming and outgoing cash.
- **Cash in savings:** Any cash your business won't need immediately can be transferred to a savings account that earns interest until it's needed.
- **Cash on hand:** This account tracks any cash your company keeps at its business locations. This includes money in the cash registers as well as petty cash.
- **Accounts receivable:** If your business sells to customers on credit, transactions will be tracked in this account. This does not include major credit card transactions; it includes only those transactions that include credit given directly to customers without a bank intermediary.
- **Inventory:** This account tracks the value of products your company has available for sale, whether it purchases the products from other companies or produces them in-house.

## THE KEY FINANCIAL STATEMENTS

### Long-Term Assets Accounts

- **Land:** This account tracks any land your company holds as an asset. Land is listed separately from buildings on that land, because land does not depreciate in value as a building does as it ages.
- **Buildings:** This account tracks the value of any buildings your company owns. **Accumulated depreciation—Buildings:** This subaccount tracks the depreciation of company-owned buildings. Each year, your firm deducts a portion of the building's value based on the building's costs and the number of years the building will have a productive life.
- **Leasehold improvements:** This account tracks improvements to buildings that your company leases rather than buys. Depreciation of these assets is tracked in **Accumulated depreciation—Leasehold improvements.**
- **Vehicles:** This account tracks the cars, trucks, and other vehicles that your business owns. The initial value added to this account is the value of the vehicles when put into service. Vehicles are also depreciated, and the depreciation subaccount is **Accumulated depreciation—Vehicles.**
- **Furniture and fixtures:** This account tracks all the desks, chairs, and other fixtures your company buys for its offices, warehouses, and retail stores. These assets also are depreciated and tracked in a subaccount named **Accumulated depreciation—Furniture and fixtures.**
- **Equipment:** This account tracks any equipment your company purchases that will be used for more than one year. This equipment includes computers, copiers, cash registers, and any other equipment needs specific to your business. The depreciation subaccount is **Accumulated depreciation—Equipment.**

So far we've looked at tangible assets—assets you can touch or hold in your hand. Companies also hold intangible assets, which have a value that can be difficult to measure.

## USING EXTERNAL REPORTS

### Common Intangible Assets

- **Goodwill:** A company needs this account only when it buys another company. Frequently, when a business purchases another business, it pays more than the actual value of its assets minus its liabilities. The premium paid may account for things such as customer loyalty, exceptional workforce, and great location. This premium paid is shown on the balance sheet as goodwill.
- **Intellectual property:** This account tracks the estimated value of copyrights, patents, other written work, or products for which the company has been granted exclusive rights. These assets are amortized, which is similar to depreciation, since intellectual property has a limited life span. The amortization subaccount is **Accumulated amortization—Intellectual property.**

### Liabilities Accounts

Money your company owes to creditors, vendors, suppliers, contractors, employees, government entities, or anyone else who provides products or services to your company is called a liability. As with assets accounts, liabilities accounts are divided into current liabilities and long-term liabilities.

#### *Current Liabilities Accounts*

Current liabilities accounts include money your company owes that is due to be paid in the next 12 months. The following are accounts commonly used to record current liabilities transactions:

- **Accounts payable:** This account tracks all the payments you owe suppliers, vendors, contractors, and consultants during the next 12 months. Most of the payments made on these accounts are for invoices due in less than two months.
- **Sales tax collected:** This account tracks sales taxes collected for local, state, or federal governments on merchandise sold by your company. Your accountant or bookkeeper will likely record daily transactions in this account as the money

## THE KEY FINANCIAL STATEMENTS

is collected from sales. The money collected then becomes a liability that must be paid to the government entity when due, usually on a monthly basis.

- **Accrued payroll taxes:** This account tracks any taxes you owe local, state, or federal government entities based on withholdings from your employees' paychecks. These payments are usually made monthly.
- **Credit card payable:** This account tracks the payments you owe on company credit cards. Some companies use these accounts as management tools for tracking employee activities and set them up by employee name, department name, or whatever method your company finds useful for monitoring credit card use.

### *Long-Term Liabilities Accounts*

Long-term liabilities accounts track the money you owe that is due beyond the next 12 months. These include the following:

- **Loans payable:** This account commonly tracks debts, such as mortgages or car loans, that your company will pay over a number of years. Your accountant will set up a separate account for each loan, but it may be shown on the balance sheet as one line item.
- **Bonds payable:** This account tracks corporate bonds that your company issued for a term longer than one year. A bond is a type of debt sold on the market that must be repaid in full with interest. As with loans, each bond issue will have a separate account, but the issues will likely be rolled into one line item on your balance sheet.

### Equity Accounts

Not all of your assets involve claims made by your creditors. Your owners or investors also have claims against your company's assets. The equity accounts reflect the portion of your assets owned by you, your investors, or your company's shareholders. If the company isn't

## USING EXTERNAL REPORTS

incorporated, the ownership of the partners or sole proprietors is represented in this part of the balance sheet in an account called owner's equity or shareholders' equity. Here are the most common equity accounts if your business is incorporated:

- **Common stock:** This account reflects the value of the outstanding shares of common stock. Each share of common stock represents a portion of ownership, and this portion is calculated by multiplying the number of outstanding shares times the value of each share.
- **Retained earnings:** This account tracks the profits or losses for a company each year. These numbers reflect earnings retained, rather than those paid out as dividends to owners, and show a company's long-term success or failure.

## INCOME STATEMENT ACCOUNTS

Every income statement starts with revenue earned by the company. Any costs or expenses reduce this revenue. The top section of an income statement includes sales, cost of goods sold, and gross margin. Below this section and before the profit and loss section is a section that shows the expenses. Here are the key accounts in the chart of accounts that make up the income statement.

### Revenue

Your bookkeeper or accountant will record all sales of products or services in revenue accounts. The following are the accounts used to record revenue transactions:

- **Sales of goods or services:** This account tracks the company's revenues for the sale of its products or services.
- **Sales discounts:** This account tracks any discounts the company offers to increase its sales. Most companies do not include this account on the income statement but instead reflect its impact in a net revenue or net sales number on the income

## THE KEY FINANCIAL STATEMENTS

statement. Often the details of this account can be seen only on internal reports.

- **Sales returns and allowances:** This account tracks returns or allowances given to unhappy customers. As with sales discounts, this number will not be seen on the income statement shown to outsiders but instead will be seen only on internal financial reports. A dramatic increase in this number is usually a red flag for company management because it can reflect customer dissatisfaction or possibly be an indication of a quality-control problem.

### Cost of Goods Sold Accounts

Your bookkeeper or accountant will track the costs directly involved in the sale of goods or services in cost of goods sold accounts. The details are usually found only on internally distributed income statements and aren't distributed to company outsiders. Cost of goods sold is usually shown as a single line item on external income statements, but it includes the transactions from these common accounts:

- **Purchases:** This account tracks the cost of merchandise your company buys or produces. For example, a manufacturing company should have an extensive tracking system for its cost of goods that includes accounts for items such as raw materials and labor that are used to produce the final product.
- **Purchase returns and allowances:** This account tracks any transactions involving the return of any damaged or defective products to the manufacturer or vendor.
- **Freight charges:** This account tracks the costs of shipping the goods sold.

### Expense Accounts

Any costs not directly related to generating revenue are entered into your company's books as expenses. Expenses fall into four categories: operating, interest, depreciation or amortization, and taxes.

## USING EXTERNAL REPORTS

A large company can have hundreds of expense accounts, so I don't name each one here but rather give you a broad overview of typical expense account categories:

- **Operating expenses:** Most of your company's expense accounts will fall under the umbrella of operating expenses. These accounts can include advertising, dues and subscriptions, equipment rental, store rental, insurance, legal and accounting fees, meals, entertainment, salaries, office expenses, postage, repairs and maintenance, supplies, travel, telephone, utilities, vehicle expenses, and just about anything else that goes into the cost of operating your business. You and your accountant should sit down and determine the level of detail you want to track. For example, if you think you want to get a better handle on postage expenses and which department is using the most, you could set up expense accounts on a department-by-department basis.
- **Interest expenses:** Interest paid on your company's debt is reflected in the accounts for interest expenses—from credit cards, loans, bonds, or any other type of debt your company carries. Your income statement will show interest expenses as a one-line item, but you can set up accounts that will track interest expenses from credit cards, loans, and bonds separately on internal reports to get better control of these expenses.
- **Depreciation and amortization expenses:** Your company gradually writes down the expense of major assets using depreciation and amortization expenses. For example, if you bought a \$35,000 vehicle, you wouldn't show the full expense of buying that car on the income statement for a single year; instead, you would gradually acknowledge the costs over several years using depreciation. Your profits would be hurt severely if you put the full expense of a major purchase on one year's income statement. These expenses do not reflect an actual cash outlay in any one year.
- **Taxes:** Your company pays numerous types of taxes, but some won't be found on the income statement. Sales taxes aren't

## THE KEY FINANCIAL STATEMENTS

listed in the expense area because they're paid by customers and accrued as a liability until paid. Taxes withheld from employee paychecks are also accrued as a liability and aren't listed as an expense. The types of taxes that *are* expenses for a company include the employer's half of Social Security and Medicare taxes, as well as unemployment taxes and other related payroll taxes that vary depending on the state. If you are incorporated, corporate taxes would be shown on the income statement as well.

Now that you have an idea of what's behind the numbers you find on financial statements, let's take a closer look at the balance sheet and how you can use that statement to gauge the financial health of your company.

### TAKEAWAYS

- Learn the language of accountants and the financial statements they produce so that you can use that information to manage your business more effectively.
- Understand the rules and methods accountants must follow so that you have a better grasp of how the numbers are collected.
- Get to know your company's accounts. They're the financial road map for your business.

