Entrepreneur & Innovation Exchange
Published online at EIX.org on August 11 2022
DOI: 10.32617/798-630a0dc235da2

These 10 Common Accounting Mistakes Can Doom Early-Stage Enterprises

Phil Greenwood (University of Wisconsin - Madison)

KEYWORDS: Entrepreneurship, Finance, Accounting.

In tough operating environments, firms will need to closely monitor their financial and operating results to ensure financial survival. An ineffective or non-existent financial/accounting system in an early-stage enterprise can result in a variety of challenges that threaten its very existence. CB Insights notes one of the most often cited reasons for startup failures is the startup 'ran out of cash/failed to raise new capital'.[1]

This article will identify a variety of common finance and accounting pitfalls experienced by early-stage enterprises, why they matter, and how they might be corrected. My advice here is mostly targeted to companies that are already selling products and have hired employees. But even solo entrepreneurs in the pre-revenue phase will benefit from "thinking forward" through the issues discussed below so they can prepare for choices they may later face.

Pitfall # 1 - Blurring Business and Personal Finances

Entrepreneurs make the mistake of mixing business and personal finances. This might seem minor when your business is small but can pose significant issues once you begin to scale. The best way to set up a business is by opening a business bank account at your local financial institution. Keep all personal and business transactions separate from one another. If an expense is paid for personally and used in the business, set up a reimbursement account to the founder where the expense is recorded on the business' books and a payable or short-term debt account is set up for the liability. Once the business reimburses the founder, then take funds out of the business' cash account and reduce the liability.

Keeping transactions separate may seem like a major inconvenience, but it is a necessary step for legal and tax purposes. If the firm's legal organization form is an LLC, S-Corp, or C-Corp, the owner/member's personal liability is limited. If personal and company funds are co-mingled, the lack of separation may make it more difficult to legally show that the firm is a separate entity from the person. From a tax perspective, one of the items that most attracts an audit from Federal or State Tax authorities is running personal expenses through the business as a tax deduction.

Pitfall #2 – Not hiring a Finance Director

This is a big mistake you find in many young companies. Founding teams find it hard to rationalize hiring a financial executive in the early stages when money is tight and there are so many critical needs to address. Also, in many ventures, the founding team with little business experience may not realize the value of a good financial mind and a strong financial system for the firm.

A good financial manager provides credibility to the enterprise. Having a good finance person signals to investors and other stakeholders that your firm's team has a certain level of business acumen. They recognize the importance. A second thing a finance person can provide is information. An experienced finance manager will monitor key financial metrics, develop solid financial reports, and help the management team communicate with investors. Good finance people are expensive – a hard expense to justify when the firm may have limited resources. To stay within budget, a startup may not need a full-time CFO or controller. Instead, consider a fractional CFO or an external accounting firm that provides CFO services.

Pitfall #3 – Not thinking about financial projections

It's true that trying to develop "accurate" future projections can be a futile exercise. However, the process of financial planning forces a startup team to evaluate their business model assumptions under various financial scenarios. Seasoned external viewers of a young firm's financial projections realize they usually won't be accurate. Still, well-prepared projections convey that the founding team took the time to develop the critical assumptions that summarize the hoped-for results of the business model.

Many startup founders outsource the development of financial projections to outside consultants, who may develop an income statement, balance sheet and cash flow projection that might have little connection to the business strategy. Moreover, during a pitch or strategy meeting, it's not unusual for a disinterested founder/CEO to be unable to answer questions about the company's financials. This sends "red flags" to bankers and equity investors, who will see a team that wants their investment but has little regard for the financial management of the organization. It's critical that the entire founding team know the key numbers, critical assumptions, and risks associated with the financial projections.

Pitfall #4 –Limited (or Non-Existing) Financial Reporting

An effective financial system is not just a high-priced software program. An effective system includes setting up a meaningful general ledger that shows a clear trail of accounting transactions, provides relevant financial reports, is timely in its transaction recording, and maintains competent internal controls. Many startups, due to limited finance and accounting experience, ignore the importance of these issues.

An effective financial system should address some of the following questions:

1. Are the general ledger accounts established so that they summarize into meaningful categories that build a trail to the financial statements?
2. Is the system able to create financial reports on a timely basis, real time if possible?
3. Does the system have flexible database capabilities allowing customized reports?
4. Does management understand and use the system and the information that it creates, or does the CFO maintain it primarily for external users?
5. Does the system generate managerial accounting information, such as information on product costs and customer acquisition costs?

An accounting software system for a startup should be installed when you are forming your business! Trying to add and utilize a software system at a later stage presents a lot of problems. Most notably, firms that try to fit their accounting system to the company's operations find it a difficult exercise requiring customization of the software, and customization is expensive. Get the accounting software system at the start and put it to good use. Your management, employees, investors, and external auditors will love you for it.

Pitfall #5 – Not understanding Operating Leverage

Essentially, operating leverage is an examination of cost behavior that compares the ratio of fixed operating costs to variable operating costs. Operating leverage is lowest (highest) in companies that have a low (high) proportion of fixed operating costs in relation to variable operating costs.

Why is this significant? In the startup stage, there is great uncertainty about the timing and amount of revenue generation. If a firm's cost structure suggests high operating leverage, the firm will have significant expenses where no revenue is occurring. If revenues are delayed 12 months or more, the firm will risk running out of cash sooner than perhaps planned, requiring more financing at less than favorable terms or even liquidation. Also, it provides a framework for breakeven analysis under varying scenarios, including the impact of price changes, changing the cost structure or other critical analysis.

Pitfall #6 – Confusing Cash Flow with Profit

It's not uncommon to hear a small business owner state, "my accountant always tells me the business is profitable yet I don't seem to ever see any cash." Many entrepreneurs don't understand the difference between profit and cash flow. Early in the life of a firm, financial decisions should be made based on their impact on the cash flow of the business rather than on bottom line profitability. While profitability will be critical to monitor later, the cash flow is the life blood of the organization at the pre-revenue stage. Every employee should understand how much cash is in the bank, what the cash burn rate is, and how many decisions must be evaluated in how the choices will affect the cash flow of the business.

EIX.org (2022)
DOI:
10.32617/798-630a0dc235da2

It's essential that management assure that employees at all levels have training or access to training about the impact of cash flow on the business. It's also critical that they be exposed to examples illustrating the difference between cash flow and profit, especially if the firm is on the accrual method of accounting. For instance, it is helpful if employees understand the importance of depreciation expense taken based on newly purchased fixed assets and how it affects profitability and cash flow.

Pitfall # 7 - Lax Accounting Practices

Most entrepreneurs will admit that they are not expert accountants. Yet, these same entrepreneurs try to handle their finances in house. This costly mistake forces startup founders to focus their attention on things like payroll and bank reconciliation (https://www.accountingdepartment.com/blog/bid/333259/Understanding-Financial-Statements-General-Ledger-Reconciliation) s rather than solely focusing on how to grow their business. A trained professional will ensure your records are up to date, record transactions properly, and keep track of your accounts receivable and payable. This will allow you to spend your time and resources into expanding your business.

One of the more common mistakes is that firms declare revenue as soon as they make a sale. This makes your books look better — at least at first — but it does little to show true profits. The problem with counting your revenue too early is that you overlook the expenses that go into the final delivery of products. Whether you are selling products or providing services, you should consider your expenses before you can determine your real profit. You put your startup in jeopardy when you start making business decisions without seeing the full picture.

Another example is lack of consistency in separating employees from contractors. The Internal Revenue Service (IRS) maintains strict guidelines on what distinguishes an independent contractor from an employee. (Note: https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee) Failure to follow such guidelines can lead to substantial fines and also payment of payroll taxes when a consultant is in fact an employee. Most importantly, it opens the firm up to an IRS audit, which may allow them to look at "everything."

Pitfall #8. Not reconciling books with bank accounts

It's important for your business to reconcile its accounts frequently. Reconciling is the process of checking that an account balance as listed on your books is accurate and correct, ensuring that it matches the real balance of your bank account. From time to time, small costs and expenses can go unrecorded. Reconciling your accounts—from your business's bank cash to its payable accounts—lets you accurately track your financial situation.

Small businesses should reconcile their books every month to ensure all transactions are accurately recorded, preventing their books from becoming out of sync with the real status of their accounts.

Pitfall #9 – Not Keeping an Updated Capitalization Table

"Cap Tables" track the shareholders of the company by tracking the number of shares they own at the current market price of the stock. Too many times, a firm will either forget to update the valuation of each shareholder's holdings or not provide an accurate count of the shares on a fully-diluted basis (i.e., as if all shares, preferred or options, were outstanding). The cap table is incredibly important when making finance decisions, as it provides current investors the value and percentage ownership of their shares, and it describes the capital structure to potential new investors.

Pitfall #10 – Unrealistic Company Valuation

Ask an entrepreneur the value of their company and you typically will receive an answer that may be five or 10 times higher than what realistic market and intrinsic valuation methods suggest. It's critical for founders to understand the value of their company, especially when seeking rounds of financing and when discussing the potential sale of their firm. An entrepreneur's unrealistic valuation can disrupt a potentially beneficial discussion with an interested acquirer. Entrepreneurs must understand applicable valuation methods. I recommend a range of valuations: asset value, earnings-based valuations, and market-based valuations to provide a realistic estimate.

EIX.org (2022)
DOI:
10.32617/798-630a0dc235da2

Conclusion

Avoiding these pitfalls will help set your business on a firm financial footing. In some cases my advice requires early [DPF3] investments of money and attention, but your business will reap the benefits later on. When your company is growing, you'll find yourself even more strapped for time, so you'll be glad you made the right choices early on.

[1] https://www.cbinsights.com/research/startup-failure-reasons-top/

EIX.org (2022)
DOI: 10.32617/798-630a0dc235da2