Chapter 1

# Managing Your Small Business Finances

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- Tuning into the styles of financial statements
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- Previewing what's ahead

The small business manager has to be a jack-of-all-trades. You have to be good at sales and marketing. You have to be knowledgeable about hiring, training, and motivating employees. You have to understand production systems if you are in the manufacturing business. You have to be smart at purchasing. You should be aware of business law and government regulations. You have to figure out where you have an edge on your competitors. Equally important, you need good skills for managing the *financial affairs* of your business.

## Identifying Financial Management Functions

Managing the finances of a small business is not just doing one or two things. Financial management is broader than you might think — it involves a palette of functions:

- Raising sufficient capital for the assets needed by your business
- Earning adequate profit consistently and predictably
- Managing cash flow from profit

- Minimizing threats of fraud and other losses
- Minimizing the income tax burden on your business and its owners
- Forecasting the cash needs of your business
- Keeping your financial condition in good shape and out of trouble
- Putting a value on your business when the time comes

When you grow your business to 50 or 100 million dollars annual sales — and we know you will someday — you can hire a chief financial officer (CFO) to manage the financial functions of your business. In the meantime these responsibilities fall in your lap, so you better know how to manage the financial affairs of your business.

The failure rate of new businesses is high. Many entrepreneurs would like to think that if they have a good business model, boundless enthusiasm, and work tirelessly they are sure to succeed. The evidence speaks otherwise. Many embryonic businesses hit financial roadblocks because the owner/manager does not understand how to manage the financial affairs of his or her business.

To press home our point we ask an embarrassing question: do you really have the basic skills and knowledge for managing the financial affairs of your business? Are you really on top of the financial functions that keep your business on course and out of trouble for achieving your financial objectives? Our book helps you to answer yes to these questions.

# Tuning In to the Communication Styles of Financial Statements

We should be upfront about one thing: as a small business manager you must have a solid understanding of your *financial statements.* You can't really manage the financial affairs of your business without having a good grip on your financial statements. There's no getting around this requirement.


We could beat around the bush and suggest that you might be able to get along with only a minimal grasp on your financial statements. This would be a risky strategy, however. Most likely you'd end up wasting time and money. You'd have to spend too much time asking your Controller or your CPA to explain things. A CPA doesn't come cheap. (Check with Tage, the coauthor of this book, regarding his hourly rate for advising small business clients.)

TIP

Financial statements are prepared according to established, or one could say entrenched *conventions.* Uniform *styles and formats* for reporting financial statements have evolved over the years and become generally accepted. The conventions for financial statement reporting can be compared to the design rules for highway signs and traffic signals. Without standardization there would be a lot of accidents.

It would be confusing if each business made up its own practices for presenting its financial statements. If your financial statements did not abide by these rules they would look suspect to your lenders, owners, and anyone else who sees the financials. They might question whether your accountant is competent. They may wonder what you are up to if your financial statements don't conform to the established rules of the game.

We present many financial statements and accounting reports throughout the book. Therefore, at this early point in the book we explain the communication styles and conventions of financial statements. To illustrate these customary formats of presentation we use the *P&L (profit and loss) statement* shown in Table 1-1 for a business. *Note:* This business example is organized as a pass-through entity for income tax purposes and, therefore, does not itself pay income tax. (We discuss pass-through entities in Chapter 9.)

**Table 1-1 P&L Statement for Year**

| | | |
|---|---|---|
| Sales revenue | | $5,218,000 |
| Cost of goods sold expense | | $3,267,000 |
| Gross margin | | $1,951,000 |
| Sales and marketing expenses | $397,000 | |
| Administrative and general expenses | $1,087,000 | $1,484,000 |
| Operating profit | | $467,000 |
| Interest expense | | $186,000 |
| Net Income | | $281,000 |

The following financial statement conventions may seem evident, but then again you might not be aware of all of them:

- You read a financial statement from the top down. *Sales revenue* is listed first, which is the gross (total) income from the sale of products and services before any expenses are deducted. If the main revenue stream of the business is from selling products the first expense deducted from sales revenue is *cost of goods sold,* as in this example.

Deducting cost of goods sold expense from sales revenue gives *gross margin* (also called *gross profit*). The number of other expense lines in a P&L statement varies from business to business. Before interest expense is deducted the standard practice is to show *operating profit* (also called *operating earnings*), which is profit before interest expense.

- The sample P&L statement includes two columns of numbers. Note that the $1,484,000 total of the two operating expenses (that is, sales and marketing expenses plus administrative and general expenses) in the left column is entered in the right column. Some financial statements display all figures in a single column.
- An amount that is deducted from another amount — such as the cost of goods sold expense — may be placed in parentheses to indicate that it is being subtracted from the amount above it. Or, the accountant who prepared the financial statement may assume that you know that expenses are deducted from sales revenue, so no parentheses are put around the number. You see expenses presented both ways in financial reports, but you hardly ever see a minus (negative) sign in front of expenses — it's just not done.
- Notice the use of dollar signs in the P&L statement example. In the illustration all amounts are have a dollar sign prefix. However, financial reporting practices vary quite a bit on this matter. The first number in a column always has a dollar sign but from here down it's a matter of personal preference.
- To indicate that a calculation is being done, a single underline is drawn under a number, as you see under the $3,267,000 cost of goods sold expense number in the P&L statement example. This means that the expense amount is being subtracted from sales revenue. The number below the underline, therefore, is a *calculated* amount.
- Dollar amounts in a column are always aligned to the right, as your see in the P&L statement example. Trying to read down a column of numbers that are not right aligned would be asking too much; the reader might develop vertigo reading down a jagged column of numbers.
- In the sample P&L statement dollar amounts are rounded to the nearest thousand for ease of reading, which is why you see all zeros in the last three places of each number. Really big businesses round off to the nearest million, and drop the last six digits. The accountant could have dropped off the last three digits in the P&L statement, but probably wouldn't in most cases.

TIP

Many accountants don't like rounding off amounts reported in a financial statement — so you see every dollar amount carried out to the last dollar, and sometimes even to the last penny. However, this gives a false sense of precision. Accounting for business transactions cannot be accurate down to the last dollar; this is nonsense. A well-known economist once quipped that accountants would rather be precisely wrong than approximately correct. Ouch! That stings because there's a strong element of truth behind the comment.

- The final number in a column usually is double underlined, as you see for the $281,000 bottom-line profit number in the P&L statement. This is about as carried away as accountants get in their work — a double underline. Instead of a double underline for a bottom-line number, it may appear in **bold.**

The accounting terminology in financial statements is mixed bag. Many terms are straightforward. If you have business experience you should understand most terms. But, like lawyers and doctors, accountants use esoteric terms that you don't see outside of financial statements. Accounting is often called the language of business, but it's a foreign language to many business managers.

TIP

Look once more at the terminology in the P&L statement example. You probably know what the terms mean, don't you? Nevertheless, we must admit that accountants use jargon more than they should. In some situations accountants resort to arcane terminology to be technically correct, like language used by lawyers in filing lawsuits and drawing up contracts. Your accountant should prepare financial statements that are as jargon-free as possible. Where we have to use jargon in the book we pause and clarify what the terms mean in plain English.

# Previewing What's Ahead

To give you an idea of what's coming down the pike in the book, we pose questions about small business financial management and tell you the chapters in which you can find the answers:

- What are the key reasons why cash flow deviates from bottom-line profit for the year? See Chapter 3
- How do you tell whether your business is dangerously close to insolvency? See Chapter 4
- How do you protect your business against accounting errors and fraud? See Chapter 5
- Which is better for profit an increase in sales volume or an equal percent increase in sales price? See Chapter 8
- What information do you need for controlling costs? See Chapter 6

- How large should your assets be relative to your sales revenue and expenses? See Chapter 11
- What is the best legal organization form for your business from the income tax point of view? See Chapter 9
- What are the sources of capital for your business? See Chapter 10
- How do you put a value on your business if you're thinking of selling? See Chapter 14
- How do you terminate a business, financially and legally? See Chapter 15