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# FINANCIAL MANAGEMENT FOR SMALL BUSINESSES

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Prepared by:



## **Section I INTRODUCTION**

Critical to the success of a profit-motivated small business is a financial management system. Usually the responsibility for monitoring this system should be born by the owner and/or manager. While the company may have a bookkeeper or accountant on staff, or contract for these services, the ultimate financial management responsibility is that of the owner and/or manager.

The purpose of this document is to provide a financial management overview. It is not our intent to be all encompassing; rather, to deal with several key issues. The material is presented in a direct and pointed format. We want the business owner and/or manager to be able to immediately use the information; thus, following a brief discussion of a topic, we occasionally include some questions and sample forms to use for analyzing your own business.

Our goals for the material contained in this document are four (4):

- ◆ To demonstrate the importance of record keeping and provide some instruction on how to simplify this important task.
- ◆ To show the business owner and/or manager how to extract valuable information from financial reports.
- ◆ To discuss several common financial problems that may be revealed through analysis of financial reports.
- ◆ To illustrate the benefits of budgeting and forecasting for your business and provide some instruction on how to integrate these tools into everyday business operations.

The topics covered in this document include these:

**II. RECORD KEEPING**

**III. FINANCIAL REPORTS**

**IV. KEY RATIOS AND FINANCIAL LEVERAGE**

**V. IMPROVING YOUR FINANCIAL CONDITION**

**VI. BUDGETING AND FORECASTING**

## **Section II RECORD KEEPING**

The foundational elements of a financial management system are records. These provide the data from which financial statements are prepared. A comprehensive record keeping system is of critical importance to a successful business. The system can be comprehensive without being complex. Our goal in this section is to highlight some key considerations for a record keeping system. You can obtain additional information by going to the IRS website – [www.irs.gov](http://www.irs.gov) - and downloading a copy of a document entitled Starting a Business and Keeping Records.

It is important that a business owner not mix business and personal records. Do the following and you will have made the necessary first steps to developing a comprehensive record keeping system:

- ◆ Keep a personal calendar.
- ◆ Separate checking accounts for business and personal accounts.
- ◆ Separate credit cards for business and personal transactions.
- ◆ Run all money received through company account.

### **Basic Records to Track**

There are five (5) basic records to track:

- ◆ Sales
- ◆ Money Received
- ◆ Money Disbursed
- ◆ Accounts Receivable
- ◆ Accounts Payable

### **Sales**

With sales records, remember to:

- ◆ Keep invoice copies (keep all of them, including voided ones).
- ◆ Track sales by type or category.
- ◆ If you keep an inventory, keep records at cost.
- ◆ Remember sales tax.
- ◆ Fill out Form 1099: Miscellaneous Income for vendors you have paid more than \$600 in the reporting year, if they are not a corporation.
- ◆ Keep track of trades (I pay; you pay; best way to go).

### **Money Received**

Remember to record this information for money received:

- ◆ Record date received, and how it was paid to your company.
- ◆ Note date of bank deposit, if different from date received.
- ◆ Keep copy of bank deposit ticket (noting cash, checks and credit cards)
- ◆ Adjust Accounts Receivable as appropriate.

### **Money Disbursed**

Above all else, keep the business checkbook register current, and do bank reconciliation's each month. In addition, money disbursement records should include:

- ◆ Sales slips, credit card receipts and the like.
- ◆ Entertainment and meals receipts.
- ◆ Promotion expenditures (like food served during seminar or workshop).
- ◆ Auto expenditures or mileage.

Set up a petty cash account for small items paid by cash. Keep receipts.

**A word of caution is important here: Do not give the IRS or anyone else copies of your records, without you also having a copy. Your copy should be the original. Further, it is better to provide hard copies of records to the IRS and others, when requested, rather than providing this information over the phone. It is a good practice to always keep a paper trail!**

## Section 1

### FINANCIAL REPORTS

The natural center of gravity for a small business is cash flow. Cash needs to flow so that a business can:

- ◆ Earn a profit.
- ◆ Experience control of its financial condition.
- ◆ Prevent cash shortages.

Financial reports are the tools whereby these cash flow management tasks can be accomplished. There are three (3) critical reports:

- ◆ **Income Statement (sometimes referred to as a profit and loss statement)**
- ◆ **Balance Sheet**
- ◆ **Cash Flow Statement**

The **Income Statement** and **Balance Sheet** are standard elements of most financial reports. **Cash Flow Statements** are not but should be. Through these three (3) reports, the business owner and/or manager can track:

- ◆ Where the money came from.
- ◆ Where it is currently being used.
- ◆ How often it is turning over.

#### Income Statement

An **Income Statement** is a record of a company's revenue and expenses for a given period; usually, monthly, with quarterly and annual summaries prepared. The key components are:

**Revenue**

**-Cost of Goods Sold**

**=Gross Profit**

**-Operating Expenses**

**-Depreciation**

**=Operating Profit**

**-Interest**

**=Profit Before Income Tax**

**-Income Tax**

**=Net Income**

In this illustration, a "-" means minus, and a "=" means equal.

Sometimes different terms are used in an income statement; for example, "sales" instead of "revenue". Also, some businesses do not have "cost of goods sold", like service enterprises. Most of the other terms are common to all business categories.

### **Balance Sheet**

The components of a **Balance Sheet** are more ordered to standardized and uniform rules of classification than in an **Income Statement**. Most of businesses (excepting financial institutions, public utilities, railroads and a few other specialized businesses) use the format shown below.

**Balance Sheets** reflect the business condition at the close of business on the last day of the **Income Statement** period (usually monthly, quarterly and/or annually). **Balance Sheets** are comprised of accounts organized under six (6) major categories:

<b><u>Left Side (or top)</u></b>	<b><u>Right Side (or bottom)</u></b>
<b>Current Assets</b>	<b>Current Liabilities</b>
<b>Fixed Assets</b>	<b>Long-Term Liabilities</b>
<b>Other</b>	<b>Owners' Equity</b>

*Current Assets* are cash or other assets that will be converted into cash during one operating cycle. *Fixed Assets* are long-term operating assets used by a business over several years. *Other Assets* is for those assets that do not fit into either of the other two (2) categories.

*Current Liabilities* include all a company's liabilities that will be paid in one year or less from the balance sheet date. *Long-Term Liabilities* are debts whose maturity dates are more than one year after the balance sheet date. Liabilities are both claims on the assets of a business, and the source of assets. The remaining source of assets besides current and long-term liabilities is *Owners' Equity*, which is comprised of paid-in capital and retained earnings.

The term "balance" reflects that the sum of both sides (or top and bottom) of a **Balance Sheet** must be the same.

### **Cash Flow Statement**

Whereas an **Income Statement** is used to review and evaluate the profit performance of a business, **Cash Flow Statements** enable cash flow for the year to be examined. The data contained in both statements is the base from which budgets are prepared.

**Cash Flow Statement** formats can vary. Typically included, however, are the following categories:

**Receipts**

- Cash Sales
- Credit Sales (collections from only)
- New Equity
- Loans
- Other

**Total Receipts**

**Payments**

- Owners' Draw
- Cost of Goods Sold
- Operating Expenses
- Interest
- Principal Payments
- Leasehold Improvements
- Inventory
- Capital Purchases
- Debt Refinance
- Other

**Total Payments**

**Cash Flow (or deficit)**

**Opening Cash Balance**

**Closing Cash Balance**

The totals are shown for a given cycle; for example, monthly; then a cumulative amount is shown for all the periods in the cycle

**Several Key Relationships**

There are several important relationships reflected between these three (3) financial reports. Briefly discussed next are several of the key factors.

**Sales Revenue (Income Statement) and Accounts Receivable (Balance Sheet)**

The critical measurement here is expressed as a ratio (*Accounts Receivable Turnover Factor*). It reflects the average number of days between sale of merchandise or a service, and receipt of payment for these items. It is typically reflected as the average number of weeks between sale and payment divided into 52 weeks (e.g.  $52/6 = 8.67$ ). In the example, accounts receivable turnover 8.67 times per year. The primary reason this measurement is important is because the

less days between sale and receipt of cash, the more days you have cash to work with. This can mean less money that you have to borrow and on which interest must be paid.

### **Cost of Goods Sold (Income Statement) and Inventory (Balance Sheet)**

This applies to those businesses that maintain an inventory for resale. The measurement is referred to as *Inventory Turnover Ratio*. The higher the turnover, the less inventory that is available for sale. This can reduce the need for capital. Conversely, too little inventory can mean lost sales, which has a profit impact. Balance is the key here. For retail outlets, an *Inventory Turnover Ratio* of 4-6 is quite good.

### **Accounts Payable (Balance Sheet)**

Rather than a specific ratio, important to remember here is how to treat operating expenses and inventory purchases. These should be recorded as an Account Payable upon receipt of the invoice. This is done so that the business owner and/or manager can better manage cash, making sure that adequate funds are available when needed to pay expenses and purchase assets.

A business can be profitable but run out of cash. The gap between recording a profit and receiving the cash can erode the operating profit by making it necessary to borrow money (on which interest is paid) to meet cash flow needs.

### **Depreciation (Income Statement and Balance Sheet) and Fixed Assets (Balance Sheet)**

*Depreciation* is a paper transaction and does not directly affect cash flow. The concept is to spread the cost of a fixed asset over its useful life. On the **Balance Sheet**, accumulated depreciation is deducted from the fixed asset cost to determine *Book Value*. *Book Value* is not the same as replacement cost. It is a good policy to keep up on the estimated replacement cost for a business fixed asset. This can guide asset disposition and acquisition decisions.

## Section 2

### KEY RATIOS AND FINANCIAL LEVERAGE

There are two (2) classes of financial ratios that are very valuable in determining how your business fairs against others in the same industry. These ratios are one of the factors used by financial institutions to make loan decisions. The categories are *Debt Paying Ratios and Return on Investment Ratios*.

#### **Debt Paying Ratios**

The *Debt Paying Ratios* are:

- ◆ **Current Ratio.**
- ◆ **Quick Ratio.**
- ◆ **Debt to Equity Ratio.**

The data to compute these ratios is found in the **Balance Sheet**.

#### **Current Ratio**

This ratio is for purposes of determining short term solvency of a business. It is calculated by dividing *Total Current Assets* by *Total Current Liabilities*. Generally, a ratio of 2:1 is preferred by lenders. They do rely on the industry ratios contained in a publication like Annual Statement Studies, by RMA, to determine the range of comparables appropriate for a specific group of businesses.

What is the *Current Ratio* for your business? Use the latest **Balance Sheet** that you have available, and then work to get this updated as soon as possible, if it is over 90 days old.

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Are there any notes that you think need to be made about your businesses ratio?

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What are the ratio ranges for comparable businesses? This information can be obtained from Warren Cooley.

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### **Quick Ratio**

This is sometimes referred to as the *Acid Test Ratio*. It includes cash, marketable securities and Accounts Receivable divided by Total Current Liabilities. It is called a *Quick Ratio* because only cash and assets quickly convertible to cash are included.

For this ratio, the general rule of thumb is 1:1. There are several exceptions, and again, you should check the RMA Annual Statement Studies for business group comparable. Warren Cooley can provide requested information.

What is the *Quick Ratio* for your business?

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Are there any explanatory notes you need to make about your businesses ratio?

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What is the comparable ratio for other similar businesses? Again, you could obtain this information from a VEDC consultant.

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### **Debt to Equity Ratio**

Some debt is good, but too much is dangerous. The purpose of this ratio is to determine whether a business is using debt to its advantage or detriment. It is computed by dividing *Total Liabilities* by *Total Stockholders' Equity*.

The rule of thumb for this ratio is a rate lower than 1:1. There are several industries, however, where the rate is higher. Use the RMA Annual Statement Studies to determine the comparables relevant to your business.

What is your current *Debt to Equity Ratio*?

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Are there any explanatory notes you need to make about your businesses ratio?

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What is the comparable ratio?

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### **Return on Investment Ratios**

There are two (2) of these:

- ◆ *Return on Equity Ratio*
- ◆ *Return on Assets Ratio*

The information for them is found in the **Income Statement** and **Balance Sheet**.

### **Return on Equity Ratio**

This is computed by dividing *Net Income* by *Total Stockholders Equity*. It is a bottom line measurement of the return on investment and can be compared with the returns expected and received on other investments.

What is your current *Return on Equity Ratio*?

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How does this ratio compare with the return you are expecting, or have experienced on other investments?

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Are you satisfied with this ratio? If not, what ratio are you expecting?

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### **Return on Asset Ratio**

This ratio is calculated by dividing operating profit (remember to exclude interest and income taxes) by total assets. The result will be expressed as a percent. Then, determine what interest rates you are paying for both short term and long-term debt. The difference between the two (2) rates is the focal point of *Financial Leverage* which will be discussed next in this section. The goal is to use debt capital to earn a higher *Return on Asset Ratio* than the annual interest rate percent paid for debt.

What is your current *Return on Asset Ratio*?

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What is the weighted interest rate currently being paid on short term and long-term debt?

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Now compare the two (2). What is the difference?

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Do you have a positive *Financial Leverage* position? If so, what is the amount?

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Are there any notes you would like to make concerning these questions?

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### **Financial Leverage**

Whether *Financial Leverage* is a benefit to a business can be determined quite easily. The process requires three (3) steps:

- ◆ Determine the operating profit that is earned on the capital supplied by liabilities. This is computed by multiplying *Total Liabilities* by *Pre-Tax Return on Assets*.
- ◆ Deduct the interest expense from the amount computed in the first step.
- ◆ The resulting amount will be the *Financial Leverage* gain or loss for the year.

For illustration purposes, it is assumed there was a *Financial Leverage* gain for the year of \$100,000, and that the pre-tax operating profit was \$400,000. *Financial Leverage*, then, provided \$100,000 of the \$400,000 pre-tax operating profit, or 25%.

Conversely, in a poor business year, the *Pre-Tax Return on Assets* rate may be lower than the annual interest rate paid for capital. In this case, *Financial Leverage* works against the company. This is more likely to occur when interest rates are rising.

What was the financial leverage condition of your business at the end of the last calendar or fiscal year?

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What is the current financial leverage condition?

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Currently is financial leverage working for your company or against it?

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## Section 3

### IMPROVING YOUR FINANCIAL CONDITION

There are three (3) factors which a business owner and/or manager need to pay close and consistent attention to:

- ◆ **Ratio of Sales Revenue to Assets** (*Sales Revenue* divided by *Total Assets*).
- ◆ **Ratio of Debt to Equity** (*Financial Leverage*).
- ◆ **Ratio of Operating Expenses to Sales Revenue** (*Operating Profit*).

#### Ratio of Sales Revenue to Assets

This ratio is typical for many business groups, other than some services. The rationale is that assets are required to generate sales. Assets will not generate sales, but they are required to see sales generated. The goal is to generate a ratio that is as high as possible and is within the reasonable expectation range of a businesses industry group.

There are several factors which could contribute to a low ratio:

- ◆ The wrong assets are employed.
- ◆ Operational issues are impeding sales (high staff turnover, etc.)
- ◆ The business is location is not good.
- ◆ Marketing and advertising are not effective.
- ◆ Competition is impacting business.
- ◆ There is poor management.

There are more possibilities. The purpose of this ratio is to provide a benchmark which one can use to indicate if there are issues that need to be addressed. The cause of these issues will require more comprehensive evaluation by the business owner and/or manager.

#### Ratio of Debt to Equity

This is the measurement of *Financial Leverage*. The previous discussion on this topic will not be repeated here. The goal is to continually monitor *Financial Leverage*, with an eye toward maintaining the most optimum condition possible. There will be times when it is prudent to use a higher level of debt financing, and other times when a lower amount is warranted.

Generally stated, the intent is to use that mix of debt and equity that will generate the greatest operating profit.

### **Ratio of Operating Expenses to Sales Revenue**

It is imperative that a business maintain a good record of revenue and expenses, with detail provided by a chart of accounts. The financial report in which they are recorded is an income, or profit and loss statement. It is desirable to have this information summarized in report form on a monthly, quarterly and annual basis.

The goal is to keep the ratio of operating expenses to sales revenue as low as possible. This too requires constant attention by the business owner and/or manager.

There are three key categories of expenses - fixed, variable and semi-variable. The business owner and/or manager needs to know which expenses fall into which category. Rent, for example, is typically a fixed cost. A business has a lease (unless they own the building they occupy), which states what the monthly rent/lease payment will be. Payroll, on the other hand, is both fixed and variable (semi-variable). Variable costs are easier to alter than fixed costs.

## Section 4

### BUDGETING AND FORECASTING

Record keeping, and financial reports deal primarily with a historical analysis of a business. Contrarily, budgeting and forecasting are concerned with the future.

A budget is a forecast of all income and expenditures over a given period. The format is typically the same as that of an income statement; in fact, budget summaries are sometimes referred to as pro forma income statements, or pro forma operating statements. The period covered by a budget is usually annual, with monthly and quarterly detail also shown. It is difficult to accurately project for more than five (5) years in the future.

The primary benefit of a budget is that it enables you to perceive problems before they occur, and to take remedial steps if necessary. Budgets indicate:

- ◆ Cash requirements.
- ◆ Start-up costs.
- ◆ Day-to-day costs.
- ◆ Revenue required to support business operations.
- ◆ Expected profit.

One can, then, alter expenditures, sales or profit expectations.

#### **Basic Budget Concepts**

A budget is comprised of three (3) primary elements:

- ◆ Sales revenue.
- ◆ Operating costs.
- ◆ Profit.

There are sub-elements of *operating costs and profit*. *Operating costs* consist of some expenses that are *variable*; that is, they vary directly with sales. There are also costs, like rent, that are basically *fixed*; and, other expenses, like payroll that are *semi-variable*; that is, they contain parts that are *fixed* and parts that are *variable*.

*Profit* consists of money earned by the business; after all operating expenses are paid. A goal should be a return on investment comparable to what that same money could earn elsewhere. Depending on the business structure, *profit* may be the same as *owners' earnings*. Whether the owners' earnings include payroll and profit, or just profit, another goal should be owners' earnings that are comparable to what the person could earn elsewhere.

## **Budget Process**

The answer to three (3) questions will help to guide the budget process:

- ◆ What is the target *profit*?
- ◆ What will it *cost* to produce the target *profit*?
- ◆ How much *sales revenue* will be required to support both *operating costs* and *profit*?

The budget process can either be top-down or bottom-up; that is, start with sales revenue and work down, or start with profit and work up. The bottom-up approach would look like this:

- ◆ Profit (owners earning) goal.
- ◆ Operating costs estimate.
- ◆ Gross profit goal.
- ◆ Cost of goods sold ratio.
- ◆ Sales revenue requirement.

Now a market test needs to be conducted to determine how this sales revenue goal can be achieved. If not possible, then, adjustments to a justifiable level are required. Impacted elements of the budget will require re-working.

Within the overall budget, or master budget, can be a series of more specific budgets; for example:

- ◆ Sales (units and dollars).
- ◆ Cost of goods sold.
- ◆ Selling expenses (per account and cash requirements).
- ◆ Administrative expenses (per account and cash requirements).
- ◆ Income statement.
- ◆ Cash flow statement.
- ◆ Balance sheet.

For a budget(s) to be a working tool, actual *sales revenue*, *operating costs* and *profit* need to be compared for the projection period, with the budgeted amounts.

## **Preparing a Budget**

A budget requires forecasting. It is an estimate of potential sales revenue, operating expenses and profit. If one is preparing a budget for an existing business, then, historical operations are one base from which to forecast. This data, however, needs to be evaluated from its' relevancy for the future: Are there changes that you plan for your business that will potentially change the future financial performance?

It was previously described how one could work from the bottom up (starting with profit), or the top down (starting with sales revenue) in budgeting. There are industry ratios available for many

expense accounts. These are typically expressed as a percentage of sales revenue. Some of the more common ratios available are for these expense accounts:

- ◆ Cost of goods sold.
- ◆ Payroll
- ◆ Occupancy charges (rent, utilities, etc.)
- ◆ Advertising

The first step in preparing a budget is to prepare a chart of expense accounts. Next determine whether you are going to start with sales revenue and work down, or profit and work up. No matter, each number needs to be justified. Use notes to record assumptions. Get help from someone experienced in a similar business. This type of assistance is available by Warren Cooley @ 805-390-3985, or warren@econdevconsult.com.

The following attachments are provided to assist you with your business planning tasks:

- ◆ *Exhibit 1 – Operating Expense Worksheet*
- ◆ *Exhibit 2 – Pro Forma Income Statement*
- ◆ *Exhibit 3 – Pro Forma Cash Flow Statement*
- ◆ *Exhibit 4 – Pro Forma Balance Sheet*
- ◆ *Exhibit 5 – Estimated Start-up Costs.*







Exhibit 4

PRO FORMA BALANCE SHEET  
FOR

	As Of Date: _____		As Of Date: _____
<b>ASSETS</b>			
<b>Current Assets</b>			
Cash			
Marketable Securities			
Accounts Receivable (net)			
Inventory			
Prepaid Expenses			
Other -			
Other -			
Other -			
<b>Total</b>	\$ -		\$ -
<b>Long-Term Assets</b>			
Property, Plant & Equipment			
Less: Accumulated Depreciation			
Net Property, Plant & Equipment			
Other -			
Other -			
Other -			
<b>Total</b>	\$ -		\$ -
<b>Total Assets</b>			
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>	\$ -		\$ -
<b>Current Liabilities</b>			
Short-Term Debt			
Current Maturities on Long-Term Debt			
Accounts Payable			
Taxes Payable			
Accrued Liabilities			
Other -			
Other -			
Other -			
<b>Total</b>	\$ -		\$ -
<b>Long-Term Liabilities</b>			
Long-Term Debt Minus Current Maturities			
Deferred Income Taxes			
Other -			
Other -			
Other -			
<b>Total</b>	\$ -		\$ -
<b>Equity</b>	\$ -		\$ -
<b>Total Liabilities and Equity</b>	\$ -		\$ -

**Exhibit 5**

**ESTIMATED START-UP COSTS  
FOR**

<b>ITEM</b>	<b>Start-Up</b>	<b>Expansion- Phase I</b>	<b>Expansion - Phase II</b>
Working Capital	\$ -	\$ -	\$ -
Inventory	\$ -	\$ -	\$ -
Furniture, Fixtures and Equipment	\$ -	\$ -	\$ -
Leasehold Improvements	\$ -	\$ -	\$ -
Other - Utility Deposits	\$ -	\$ -	\$ -
Other - Rent Deposit	\$ -	\$ -	\$ -
Other - Permits and Fees	\$ -	\$ -	\$ -
Other - Misc	\$ -	\$ -	\$ -
<b>Total</b>	\$ -	\$ -	\$ -