

***Small Business Financial
Management Kit***

FOR
DUMMIES®

by Tage C. Tracy, CPA and John A. Tracy, CPA



Wiley Publishing, Inc.

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Dedication

We dedicate this book to Edgar F. Jeffries, presently 96 years of age. Edgar is John's father-in-law and Tage's grandfather. In the midst of the Great Depression, Edgar and his father opened a small grocery store in Fort Dodge, Iowa. From scratch, they built Jeffries Grocery into a successful and respected institution. We quote Edgar more than once in this book.

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Introduction

A lot of small business owners/managers muddle through rather than knowingly manage the financial affairs of their business. They have a good overall business model and they manage other aspects of their business fairly well. But when you start talking about financial topics, they get sweaty palms. They do little more than keep tabs on their cash balance. That's no way to run a railroad!

This book, quite simply, explains the fundamentals of small business financial management. We explain the accounting reports — which are called *financial statements* or just *financials* — you need to understand in running your business. We discuss many other critical financial management topics, including raising capital, making smart profit decisions, and choosing the best form of legal entity for income tax.

About This Book

Business managers are busy people, and they have to carefully budget their time. Small business owners/managers are especially busy people; they have no time to waste. We promise not to waste your time in reading this book. In every chapter, we cut to the chase. We contain our discussions to fundamentals — topics you must know to handle the financial affairs of your business.

This book is not like a mystery novel; you can read the chapters in any order. Each chapter stands on its own feet. You may have more interest in one chapter than others, so you can begin with the chapters that have highest priority to you. Where a topic overlaps with a topic in another chapter, we provide a cross-reference.

By all means, use the book as a reference manual. Put the book on your desk and refer to it as the need arises. It's your book, so you can mark topics with comments in the margins or place sticky notes on pages you refer to often. This book isn't a college textbook. You don't have to memorize things for exams. The only test is whether you improve your skills for managing the financial affairs of your business.

Conventions Used in This Book

Throughout the book, we use financial statement examples. Many chapters use figures to demonstrate the financial statements that you work with in managing the financial affairs of your business. We explain what these financial statements mean and how to interpret the information.

The examples are as realistic as we can make them without getting bogged down in too many details. When, for example, we present an example of a P&L (profit and loss) statement, we make sure that its numbers make sense for actual businesses. The examples are not theoretical; the examples are from the real world.

In preparing financial statements, your accountant conforms to the *standardized formats and terminology* adopted by the accounting profession. In other words, your accountant adheres to the established protocols for presenting financial statements. These rules are the grammar for communicating information in financial statements. However, accounting comes across as a foreign language to many business managers, and we keep this point in mind on every page of the book. In Chapter 1, we begin by explaining the communication conventions of financial statements.

Speaking of accountants, we should distinguish between the *internal accountant*, who is an employee of your business, and the *outside, independent accounting professional* who advises you from time to time. A small business employs an accountant who is in charge of its accounting system. The employee's job title may be Controller, In-Charge Accountant, or Office Manager. In this book, the term *accountant* refers to the person on your payroll. We refer to your independent professional accountant as a CPA (certified public accountant).

What You're Not to Read

Not every topic may have you sitting on the edge of your seat. For example, if you're not a manufacturer, you may not be terribly interested in Chapter 13, and if you're not a service business, you may glance over Chapter 12 in a hurry. You can skip over topics that aren't immediately relevant or urgent. You won't hurt our feelings if you tread lightly on some topics.

We suspect that a few topics in the book are more detailed than you're interested in. You should refer the more technical aspects to your accountant and make sure that the accountant follows through on the assignment. A good example is Chapter 5 on *internal controls*, which refer to the procedures put in place to minimize errors and fraud. You should definitely understand the critical need for establishing and enforcing effective controls. But the implementation of internal controls is a job for your accountant.

Foolish Assumptions

In writing this book, we've done our best to put ourselves in your shoes as a small business manager. Of course, we don't know you personally. But we have a good composite profile of you based on our experience in consulting with small business managers and explaining financial issues to business managers who have a limited background in financial matters.

Perhaps you've attended a short course in finance for the nonfinance manager, which would give you a leg up for reading this book. We should mention that many of these short courses focus mainly on financial statement analysis and do not explore the broader range of financial management issues that small business owners/managers have to deal with.

We take nothing for granted and start our discussions at ground zero. We present the material from the ground level up. The more you already know about the topics, the quicker you can move through the discussion. Whether you're a neophyte or veteran, you can discover useful insights and knowledge in this book. If nothing else, the book is a checklist of the things you ought to know for managing the finances of a small business.

How This Book Is Organized

This book is divided into parts, and each part is divided into chapters. The following sections describe what you find in each part.

Part I: Improving Your Profit, Cash Flow, and Solvency

In keeping your small business thriving and growing you encounter three financial imperatives: (1) making adequate profit consistently; (2) generating cash flow from profit for the needs of the business and its owners; and (3) controlling the financial condition of your business by keeping it healthy and avoiding insolvency. You receive a financial statement for each imperative. Part I explains these three financial statements and how to use this information for making a profit and controlling the cash flow and financial condition of your business.

Part II: Using Tools of the Trade

Part II explains basic small business financial management tools. It explores internal controls that minimize accounting errors and threats of fraud from within and without your business, as well as cost control, which goes beyond the simplistic notion of just minimizing costs. This part also covers practical budgeting and planning techniques for the small business and how to develop and use a *profit model* for decision-making analysis.

Part III: Dealing with Small Business Financial Issues

In starting a business, the founders have to decide which type of legal entity to use. This part explains the alternative legal entities for carrying on business activities and what you should consider from the income tax point of view when you structure your business. This part also offers practical advice on how to raise the capital you need for your business.

Part IV: Looking at Service and Manufacturing Businesses

Part IV describes services businesses and how they differ from businesses that sell products, as well as how manufacturing businesses determine their product cost. Although you may not be a service business or a manufacturer, you can gain insights from this part.

Part V: Reaching the End of the Line

This part of the book has a special place in our hearts — not because we want you to go out of business, of course. But there may come a time when a successful business wants to cash in its chips and leave the game. You probably know of several entrepreneurs who decided to sell out and move on to new challenges. This part presents a concise explanation of small business valuation methods. It also walks you through the steps of liquidating assets, paying liabilities, and making final distributions to owners (assuming that some money is left after paying liabilities and the lawyers).

Part VI: The Part of Tens

The Part of Tens is a staple in every *For Dummies* book. These chapters offer pithy lists of advice that sum up the main points explained in the chapters. One chapter offers general management rules for the small business. First and foremost, you must be a good manager to make your small business venture a success. The second chapter focuses on ten important financial management rules and techniques.

About the CD

Every financial statement example in the book is on the CD that accompanies the book. We prepared all examples using the Excel spreadsheet program from Microsoft. Of course, you need to have Excel on your computer to open and use each example's worksheet.

You can use each example on the CD as a template, or pattern for your business situation or to explore alternative scenarios. For example, you can quickly analyze what would happen to profit if sales volume had been 10 percent higher or lower than in the example. To use the template for your business you need to replace the data in the example with the data for your business situation. You would probably assign this data entry process to your accountant, who should find the templates very useful. Your accountant can easily expand or modify the template to fit the particular circumstances of your business.



John, a coauthor of this book, has written *How To Read A Financial Report*, *The Fast Forward MBA in Finance*, and *How To Manage Profit and Cash Flow* with Tague, a coauthor of this book. (John Wiley & Sons is the publisher of all three books.) The books use financial statement examples that were prepared using Excel. John offers to e-mail the Excel worksheets to the reader. Literally hundreds and hundreds of readers have asked for the Excel worksheets. We thought it would be more convenient to provide the worksheets on the CD for this book. This book and its CD constitute an integrated kit.

Icons Used in This Book

Throughout this book, you see some little pictures in the margin. These icons highlight the following types of information:



This icon serves to remind you that the financial statement example is on the CD for the book. Each worksheet example is prepared as a template. You can open the figure with the Excel spreadsheet program and follow along on your computer screen each step in the explanation. This makes the explanation more live and real time. You can also change the data in the example to simulate outcomes for alternative scenarios, which is an effective learning method.



This icon asks you to keep in mind an important point that is central in the explanation of the topic at hand.



This icon highlights, well, *tips* for applying financial management techniques. These pointers and advisories are worth highlighting with a yellow marker so that you don't forget them. On second thought, this icon saves you the cost of buying a highlighter pen.



This sign warns you about speed bumps and potholes on the financial highway. Taking special note of this material can steer you around a financial road hazard and keep you from blowing a fiscal tire. You can save yourself a lot of trouble by paying attention to these warning signs.

Where to Go from Here

You may want to start with Chapter 1 and proceed through the chapters in order. If you're fairly familiar with the design of financial statements, start with Chapter 2, which explains how to read your P&L statement. If you already have a good handle on the P&L statement, you could start with Chapter 3 if you have questions about *cash flow* – and in our experience, small business managers have many questions on cash flow!

If your highest priority concerns are about income tax issues, you can jump into Chapter 9 right away. If you're having problems in raising capital for your business, you may want to start with Chapter 10. If you worry about fraud threats against your business, Chapter 5 is a good place to start.

Starting and managing a small business is a tremendously challenging undertaking, and we applaud you. You have a lot of guts. And you also need a lot of financial management savvy. We hope our book helps you succeed.

Part I

Improving Your Profit, Cash Flow, and Solvency

The 5th Wave

By Rich Tennant



"Business here is good, but the weak dollar is killing my overseas markets!"

In this part . . .

We begin with a general overview of what's involved in managing the financial affairs of the small business. Financial statements are the main source of information for carrying out your financial management functions. So, we carefully explain the conventions and customs accountants use in preparing financial statements.

The three primary financial imperatives of every business are to make profit, generate cash flow from making profit (which is not the same as making profit), and control financial condition and solvency. Accordingly, a separate financial statement is prepared for each purpose. We explain these three primary financial statements. Quite simply, you don't know what you're doing without a solid understanding of these financial statements.