

The answers to all your financial questions
in one step-by-step guide to running your business

Small Business Financial Management Kit

FOR
DUMMIES[®]

Handy templates
with how-to
guidance

**A Reference
for the
Rest of Us!**[®]

FREE eTips at dummies.com[®]

Tage C. Tracy, CPA

Financial and business consultant

John A. Tracy, CPA

Professor Emeritus of Accounting,
University of Colorado at Boulder



The answers to all your financial questions
in one step-by-step guide to running your business

Small Business Financial Management Kit

FOR
DUMMIES[®]

Handy templates
with how-to
guidance

**A Reference
for the
Rest of Us!**[®]

FREE eTips at dummies.com[®]

Tage C. Tracy, CPA
Financial and business consultant

John A. Tracy, CPA
Professor Emeritus of Accounting,
University of Colorado at Boulder



***Small Business Financial
Management Kit For
Dummies®***

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



Wiley Publishing, Inc.

Small Business Financial Management Kit For Dummies®

Published by

Wiley Publishing, Inc.

111 River St.

Hoboken, NJ 07030-5774

www.wiley.com

Copyright © 2007 by Wiley Publishing, Inc.,
Indianapolis, Indiana

Published by Wiley Publishing, Inc., Indianapolis, Indiana

Published simultaneously in Canada

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Sections 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, 978-750-8400, fax 978-646-8600. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street,

Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Trademarks: Wiley, the Wiley Publishing logo, For Dummies, the Dummies Man logo, A Reference for the Rest of Us!, The Dummies Way, Dummies Daily, The Fun and Easy Way, Dummies.com and related trade dress are trademarks or registered trademarks of John Wiley & Sons, Inc. and/or its affiliates in the United States and other countries, and may not be used without written permission. All other trademarks are the property of their respective owners. Wiley Publishing, Inc., is not associated with any product or vendor mentioned in this book.

LIMIT OF LIABILITY/DISCLAIMER OF WARRANTY: The publisher and the author make no representations or warranties with respect to the accuracy or completeness of the contents of this work and specifically disclaim all warranties, including without limitation warranties of fitness for a particular purpose. No warranty may be created or extended by sales or promotional materials. The advice and strategies contained herein may not be suitable for every situation. This work is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If professional assistance is required, the services of a competent professional person should be sought. Neither the publisher nor the author shall be liable for damages arising herefrom. The fact that an organization or Website is referred to in this

work as a citation and/or a potential source of further information does not mean that the author or the publisher endorses the information the organization or Website may provide or recommendations it may make. Further, readers should be aware that Internet Websites listed in this work may have changed or disappeared between when this work was written and when it is read.

For general information on our other products and services, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

For technical support, please visit www.wiley.com/techsupport.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books.

Library of Congress Control Number: 2007926399

ISBN: 978-0-470-12508-3

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2



About the Authors

Tage C. Tracy (Poway, California) is the principal owner of TMK & Associates, an accounting, financial, and strategic business planning consulting firm focused on supporting small- to medium-sized businesses since 1993. Tage received his baccalaureate in accounting in 1985 from the University of Colorado at Boulder with honors. Tage began his career with Coopers & Lybrand (now merged into PricewaterhouseCoopers). More recently, Tage coauthored with his father, John Tracy, *How to Manage Profit and Cash Flow*.

John A. Tracy (Boulder, Colorado) is Professor of Accounting, Emeritus, at the University of Colorado in Boulder. Before his 35-year tenure at Boulder, he was on the business faculty 4 years at the University of California at Berkeley. He served as staff accountant at Ernst & Young and is the author of several books on accounting and finance, including *Accounting For Dummies*, *Accounting Workbook For Dummies*, *The Fast Forward MBA in Finance*, *How to Read a Financial Report*, and coauthor with his son, Tage, of *How to Manage Profit and Cash Flow*. Dr. Tracy received his B.S.C. degree from Creighton University and earned his MBA and PhD degrees from the University of Wisconsin. He is a CPA (inactive) in Colorado.

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.

Authors' Acknowledgments

We are deeply grateful to everyone at Wiley Publishing, Inc. who helped produce this book. Their professionalism and courtesy were much appreciated. First, we thank Mike Lewis, the acquisition editor. He stayed with us on developing the concept for the book. We appreciate his encouragement. Our editor, Kelly Ewing, was exceptional. It was a pleasure working with her. We owe Kelly a debt that we cannot repay. So, a simple but heartfelt “thank you” will have to do. We sincerely thank Wade Harb who reviewed our manuscript. He offered many helpful suggestions that made the book much better.

Publisher's Acknowledgments

We're proud of this book; please send us your comments through our Dummies online registration form located at www.dummies.com/register/.

Some of the people who helped bring this book to market include the following:

Acquisitions, Editorial, and Media Development

Project Editor: Kelly Ewing

Acquisitions Editor: Michael Lewis

General Reviewer: Wade Harb

Editorial Manager: Michelle Hacker

Editorial Assistants: Erin Calligan Mooney, Joe Niesen, Leeann Harney

Cartoons: Rich Tennant (www.the5thwave.com)

Composition Services

Project Coordinator: Patrick Redmond

Layout and Graphics: Carrie A. Foster, Brooke Graczyk, Stephanie D. Jumper, Heather Ryan, Alicia B.

South

Anniversary Logo Design: Richard Pacifico

Proofreaders: Aptara, Cynthia Fields

Indexer: Aptara

Publishing and Editorial for Consumer Dummies

Diane Graves Steele, Vice President and Publisher,
Consumer Dummies

Joyce Pepple, Acquisitions Director, Consumer
Dummies

Kristin A. Cocks, Product Development Director,
Consumer Dummies

Michael Spring, Vice President and Publisher, Travel

Kelly Regan, Editorial Director, Travel

Publishing for Technology Dummies

Andy Cummings, Vice President and Publisher,
Dummies Technology/General User

Composition Services

Gerry Fahey, Vice President of Production Services

Debbie Stailey, Director of Composition Services

Contents

Title

Introduction

About This Book

Conventions Used in This Book

What You're Not to Read

Foolish Assumptions

How This Book Is Organized

About the CD

Icons Used in This Book

Where to Go from Here

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

Chapter 1: Managing Your Small Business Finances

Identifying Financial Management Functions

Tuning In to the Communication Styles of Financial Statements

Previewing What's Ahead

Chapter 2: Understanding Your P&L and Profit Performance

Getting Intimate with Your P&L (Profit and Loss) Report

Measuring and Reporting Profit and Loss

Presenting the P&L Report for Your Business

Breaking Through the Breakeven Barrier

Improving Profit

[Chapter 3: Getting Up to Speed on Cash Flow from Profit](#)

[Sorting Out Your Sources of Cash](#)

[Avoiding Confusion Between Profit and Its Cash Flow](#)

[Deciding How to Have Cash Flow Information Reported to You](#)

[Introducing the Statement of Cash Flows](#)

[Summing Up the Critical Importance of Cash Flow from Profit](#)

[Chapter 4: Keeping Your Business Solvent](#)

[Liquidity and Business Solvency](#)

[Business Solvency Measurements Tools](#)

[Liquidity Measurement Tools](#)

[Liquidity Traps](#)

[Untapped Sources of Liquidity](#)

[Financial Leverage — the Good, the Bad, and the Ugly](#)

[Part II : Using Tools of the Trade](#)

[Chapter 5: Protecting the Family Jewels](#)

[Recognizing the Need for Controls](#)

[Clarifying Terminology](#)

[Reporting on Internal Controls](#)

[Distinguishing Security and Safety Procedures from Internal Controls](#)

[Policing Internal Controls](#)

[Surveying Internal Controls for Small Businesses](#)

[Presenting Internal Control Guideposts for Small Business Managers](#)

[Chapter 6: Scrutinizing Your Costs](#)

[Getting in the Right Frame of Mind](#)

[Getting Down to Business](#)

[Looking into Cost of Goods Sold Expense](#)

[Focusing on Profit Centers](#)

[Reducing Your Costs](#)

[Chapter 7: Practical Budgeting Techniques for Your Business](#)

[Deciding Where the Budgeting Process Starts](#)

[Honing in on Budgeting Tools](#)

[Budgeting Resources](#)

[Preparing an Actual Budget or Forecast](#)

[Understanding Internal Versus External Budgets](#)

[Creating a Living Budget](#)

[Using the Budget as a Business Management Tool](#)

[Using Budgets in Other Ways](#)

[Chapter 8: Making Decisions with a Profit Model](#)

[Introducing the Profit Model](#)

[Stopping at Profit Before Income Tax](#)

[Improving Margin](#)

[Using the Profit Model for Trade-off Analysis](#)

[Pushing Cost Increases Through to Prices](#)

[Getting Behind the Reasons for Cost Changes](#)

[Distinguishing Cost Decreases: Productivity Gains Versus Cutting Quality](#)

[Part III : Dealing with Small Business Financial Issues](#)

[Chapter 9: Jumping Through Tax Hoops](#)

[Thinking about Business Taxes](#)

[Coming to Terms with Income Taxation and the Business Legal Structure](#)

[Filing Annual Income Tax Returns](#)

[Understanding How Taxable Income Is Calculated](#)

[Managing Payroll Taxes](#)

[Remembering Other Types of Business Taxes \(The Fun Is Just Starting\)](#)

[Discovering Hidden Taxes](#)

[Chapter 10: Raising Capital for Your Business](#)

[Getting the Scoop on Capital](#)

[Developing a Business Plan](#)

[Finding Sources of Capital](#)

[Understanding Business Legal Structures and Raising Capital](#)

[Putting Your Capital to Good Use](#)

[Chapter 11: Diagnosing Your Financial Condition](#)

[Connecting the P&L and Balance Sheet](#)

[Spotting Financial Condition Problems](#)

[Part IV : Looking at Service and Manufacturing Businesses](#)

[Chapter 12: When You Sell Services](#)

[Comparing the Financial Statements of Service and Product Businesses](#)

[Looking at the Expense Structures of Product and Service Businesses](#)

[Contrasting Sales Volume and Sales Price Changes Impact on Profit](#)

[Selling Some Products with Services](#)

[Chapter 13: When You Make the Products You Sell](#)

[Setting the Stage](#)

[Introducing a Manufacturing Example](#)

[Computing Product Cost \(Per Unit\)](#)

[Tweaking the Basic Product Cost](#)

[Looking at Cost Accounting Beyond Manufacturing](#)

Part V : Reaching the End of the Line

Chapter 14: Putting a Market Value on Your Business and Selling

Why You Need Business Valuations

How Businesses are Valued

The Keys to a Successful Business Valuation

Types of Business Acquisitions

Structuring the Sale of Your Business

The Business Acquisition Process

Chapter 15: Hanging Up the Spikes and Terminating Your Business

Looking into Business Terminations

Delving into Bankruptcy Protection

Planning the Burial

Managing Assets to Maximize Value

Satisfying Liabilities

Thinking about Employees, Insurance, and Taxes

Managing Logistics

Part VI : The Part of Tens

Chapter 16: Ten Management Rules for Small Business Survival

Remember That Planning Counts

Secure Capital

Don't Overlook Management Resources

Understand the Selling Cycle

Don't Fail to Communicate

Practice CART

Remember to KISS

[Comply, Comply, Comply](#)

[Execute Your Exit Strategy](#)

[Know When to Say When](#)

[Chapter 17: Ten Hard-Core Financial Tools and Tactics](#)

[Understand Profit Mechanics](#)

[Understand Cash Flow](#)

[Know Your Sources of Profit](#)

[Analyze Year-to-Year Profit Change](#)

[Keep Sizes of Assets Under Control](#)

[Budget Profit and Cash](#)

[Audit Your Controls](#)

[Choose the Right Legal Entity](#)

[Stabilize Your Sources of Capital](#)

[Don't Massage Your Financial Numbers](#)

[Appendix: About the CD](#)

[System Requirements](#)

[Using the CD](#)

[What You'll Find on the CD](#)

[Troubleshooting](#)

[Customer Care](#)

[: Further Reading](#)

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.