BUSINESS FINANCE IS HARD

...But it doesn't have to be

A BUSINESS FINANCE PRIMER

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FINDING YOUR WAY ON

THE PAPER TRAIL

For most small business owners, the financial side of running a business is the most complicated. With all the jargon, theories, formulas, and spreadsheets it can seem like business finance is an impenetrable fortress of knowledge you'll never be able to enter.

While there is always a benefit to hiring a professional to dive into the nitty gritty of managing your books and filing taxes, it's always good for a business owner to understand the basics of finance. And, fortunately, it's not as hard as it seems. This book will help explain the most common concepts, and how to find your way through the paper trail.

THE BIG THREE

PROFIT & LOSS

For a small business owner there is nothing more important than having a solid grasp of your financial position. That is why accountants have devised three really nifty documents that pull together the entire financial picture of a company: the balance sheet, the statement of cash flows, and the profit and loss statement. These three documents give a business owner three different views of the business, and together provide a solid overview of how the company is doing financially.

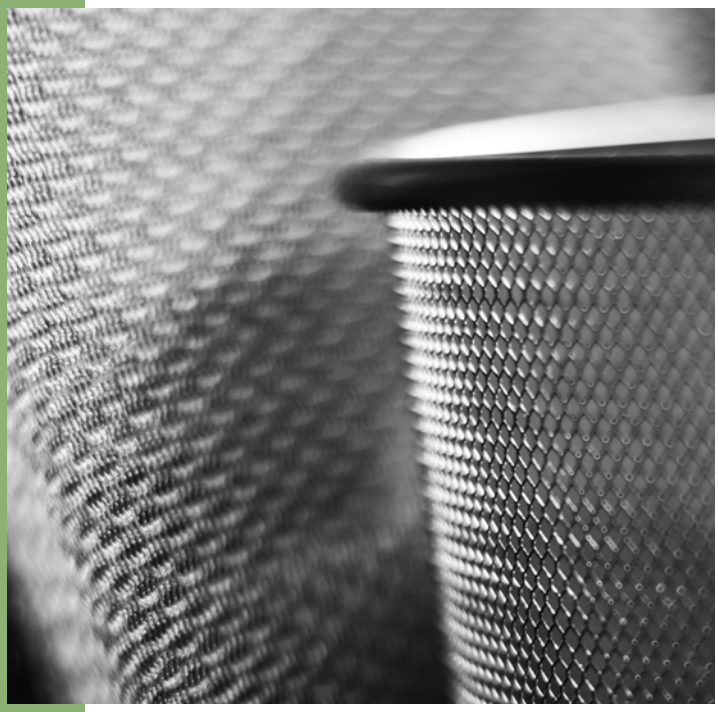
Let's start with the most common and easily understood of the three documents: The Profit & Loss statement (or P&L). The P&L is probably the closest thing to what most Americans would think of as a "budget."

It isn't a budget--since it looks at past financial events--but it is laid out in a very similar way. Essentially, a P&L takes your business income, subtracts your costs and expenses, and shows what you have left.

The below image is of a sample P&L for ABC Business, Inc. While it's extremely simplified, it does a great job of highlighting the key pieces that make up a Profit and Loss statement.

ABC Business, Inc.
Income Statement
For Year Ended December 31, 2017

Sales revenue	$26,000
Cost of goods sold expense	$14,300
Gross margin	$11,700
Selling, general, and administrative expenses	$8,700
Operating earnings	$3,000
Interest expenses	$400
Earnings before income tax	$2,600
Income tax expense	$910
Net income	$1,690



THE PARTS OF THE P&L

Sales Revenue

This is your top line revenue, meaning the full amount that you took in from sales of your product or service. This is usually the number most business owners are familiar with, but it is literally just the starting point for determining a company's profitability.

Cost of Goods Sold (COGS)

The next number is the total "cost of doing business." This doesn't include costs of salespeople, or marketing, but the actually input costs for the product or service you produce. For instance, if you sell wooden toys, then the COGS will be the cost of the wood, screws, and direct labor required to produce the finished product. If you sell a service, then the COGS will usually be lower, but could still include the cost of labor that is directly responsible for delivering the service.

The key for considering labor in COGS is whether the labor can be reasonably attributed to individual products. For instance, if you own a mechanic shop then you can't deliver your service without mechanics, so the cost of that labor would go into your COGS.

Gross Profit

Your Gross Profit is the amount you have left after COGS is subtracted from your revenue. So, if you sell a $200 watch, and it costs $60 to make, your Gross Profit is $140, or 70% Gross Margin(140/200). This number is very important because it tells you essentially how much money you have left to operate the business.

Expenses

The next part of the P&L are the expenses, listed above as "Selling, general, and administrative expenses." This is where you put all the other "costs of doing business," all the staplers, paper products, salaries, benefits and lawyer costs. Everything you need to operate your business goes here, and usually this makes up the bulk of the costs of operating your business.

Operating Earnings (EBITDA)

Once you've subtracted all the costs from your revenue, you're left with what is called EBITDA (earnings before interest, taxes, depreciation, and amortization). Essentially, it's the money you have left over before all the financial variables come into play. This is a very important number because it gives you a solid idea of how financially healthy your company is. While fiscal concerns like taxes and interest might reduce this amount more, usually your Operating Earnings will be close to your Net Profit, and also give you an idea of how profitable the base business operations are. That's why most investors evaluate businesses based on their EBITDA.

"Essentially, a P&L takes your business income, subtracts your costs and expenses, and shows what you have left."

Interest and Taxes

These two numbers are going to fluctuate based on the amount of profit and whether you've borrowed money or not, but after you've figured out the operational profit, you subtract first any interest you've paid on loans, and then the amount in taxes owed on business profits.

Net Profit

After everything is said and done, the "bottom line" is your Net Profit. This is how much money you made after everything else was paid. Ideally this number should be a positive one, but there are certain situations (which your financial consultant could explain) where running at a loss might be advantageous for tax purposes.

THE BALANCE SHEET

The next report in the pantheon of small business financial documentation I want to discuss is the Balance Sheet. Like the P&L, the Balance Sheet is used to report key financial information to management and shareholders, providing a snapshot of the business as a of a specific date.

One of the best things about financial documents is that the name usually tells you what you need to know. In this case, the right and left side of the Balance Sheet need to be equal.

Understanding a Balance Sheet isn't too terribly complex (though the insights gleaned can be very powerful). Essentially, a Balance Sheet is represented by this simple equation:

Assets = Liabilities + Equity

Assets: All the stuff the business owns, or is owed.

Liabilities: All the stuff the business owes.

Equity: How much money investors have put into the business plus profit the business decides to keep after dividends have been paid out.

You may be asking, "How can the assets and liabilities always match?" That's a great question. The answer is that they rarely do, which is why the concept of Equity is in the Balance Sheet. If there are more liabilities than assets, then the shareholder equity could be negative, and the opposite is true, too.

BUSINESS CONSULTING COMPANY
BALANCE SHEET
As at December 31, 2015

Assets		$	Liabilities & Stockholders' equity		$
Current assets:			Liabilities:		
Cash		85,550	Notes payable		5,000
Accounts receivable		4,700	Accounts payable		1,600
Prepaid building rent		1,500	Salaries payable		2,000
Unexpired insurance		3,600	Income tax payable		3,000
Supplies		250	Unearned service revenue		4,400
Total current assets		95,600	Total liabilities		16,000
Non-current assets:			Stockholders' equity:		
Equipment	9,000		Capital stock	50,000	
Acc. dep. - Equipment	3,600	5,400	Retained earnings	35,000	85,000
Total assets		101,000	Total liabilities & stockholders' equity		101,000

PARTS OF A BALANCE SHEET

3 KEY PARTS

Assets

There are two types of assets: current and fixed (in this example called "Non-current"). Current Assets are anything that will be used within 1 year of the date of the Balance Sheet. In this example, Cash, Accounts Receivables, Supplies, and a few cash equivalent products (prepaid rent and insurance) are being considered current assets. This business plans on using all these assets within 1 year. Fixed assets are, by definition, all the other things the business owns but will not be readily converting to cash: equipment, real estate, vehicles, etc. (less depreciation). On the left side of the Balance Sheet these assets are totaled up and represent the sum total of the assets of the business.

Liabilities

Similar to assets, liabilities are broken up into two categories: current and long-term (FYI, this example doesn't have any long-term liabilities listed). Current Liabilities represent money the company will have to pay out within 1 year of the date of the Balance Sheet. Loans, accounts payable, employee pay that hasn't been paid out yet, are all common current liabilities that most businesses have. Long-term liabilities are payments that will come due more than 1 year out from the Balance Sheet date. Common long-term liabilities are bond payments, and balloon payment loans.

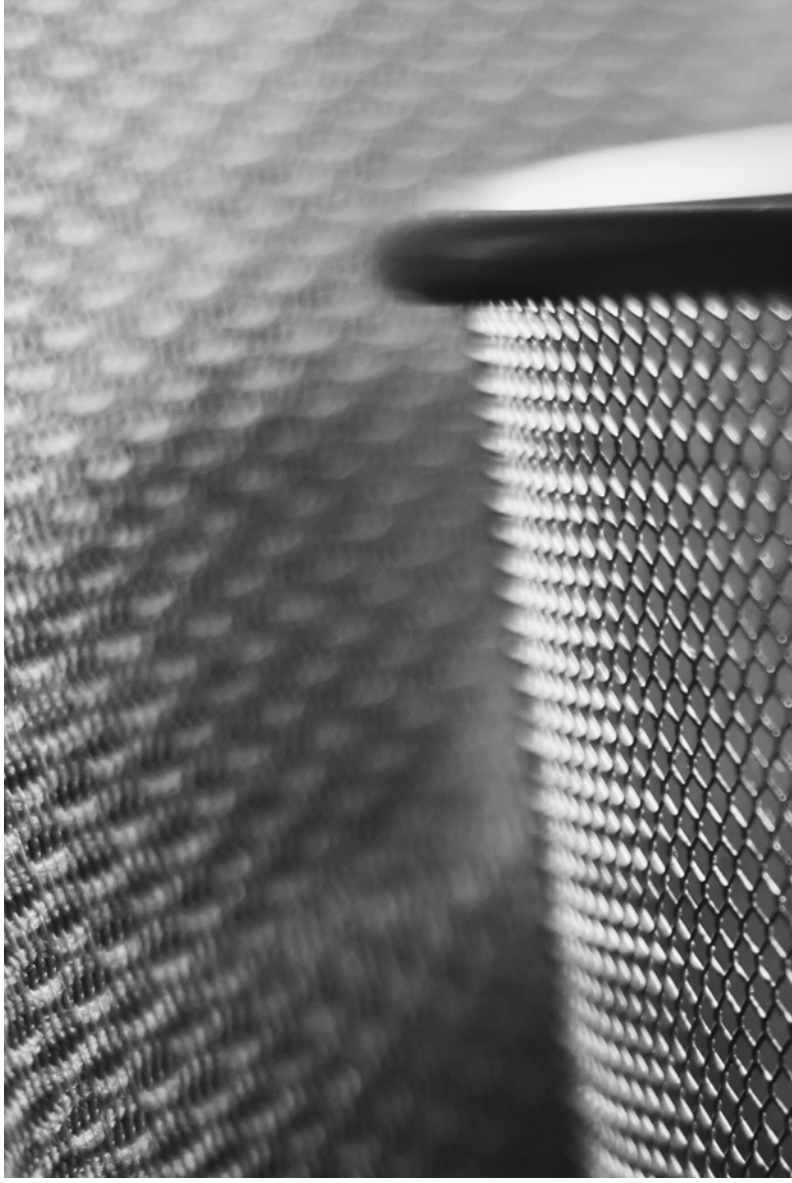
"A Balance Sheet gives you a good snapshot of your business at a specific point in time."

PARTS OF A BALANCE SHEET

(CONTINUED)

Equity

Equity is the amount initially invested by shareholders plus Retained Earnings (the amount of money the company earned after paying out dividends to shareholders). If, for instance, no dividends were paid out, then all the retained earnings would go to the right side of the Balance Sheet. At a basic level, in a healthy company, the total equity represents the "value" of the business. If one were to liquidate all the assets, pay off all the liabilities, and give all the shareholders their money back, the retained earnings would be the money left over to divvy up to shareholders.



SO, WHAT DOES THIS MEAN?

For starters, the Balance Sheet directly relates to the Profit and Loss Statement, because the retained earnings that pop up on the Balance Sheet is a function of the Net Profit from the bottom of the P&L. So, taking these two documents together, you can see not only how profitable your company is, but also how valuable it is, and whether you're asset or liability heavy. There are also two key metrics you can glean from the Balance Sheet: working capital and debt-to-equity. Working Capital is calculated by simply subtracting current liabilities form current assets. This gives you a good idea of how "liquid" your company is and whether or not you can expect short term financial issues. The Debt-to-Equity ratio is calculated by dividing your company's total debt by the shareholder equity. Like a Debt-to-Income ratio used in home lending, this ratio shows you how much your business is being financed through debt versus cash or other wholly-owned funds. It may appear simple, but as you can see the Balance Sheet is a powerful tool for understanding the short and long term health of your business.

CASH FLOW STATE-MENT

Now it's time to break down arguably the most important of all the financial documents, the Cash Flow Statement. Everyone knows that cash is king in a small business. Without it, there is simply no way to keep your business afloat. But, one of the most common conundrums for small businesses is that you can be making money and growing, and yet still have trouble paying the light bill each month. How can that be? When a profitable business is having trouble making payments, that can often indicate an issue with the timing of cash coming in and out of the business, otherwise known as cash flow. While the P&L is great at showing where your money is being spent and whether your business is profitable, and the Balance Sheet is great for showing how much value you're bringing to shareholders, neither of them tell you whether you'll make payroll this month. That's where the Cash Flow Statement comes in.

Cash Flow Statement
For the Year Ended December 31, 2016

Cash Flow from Operations	
Cash receipts from customers	86,772
Cash paid for inventory	(7,400)
Cash paid for wages	(53,000)
Net Cash Flow from Operations	**26,372**
Cash Flow from Investing	
Cash receipts from sale of property and equipment	13,500
Cash paid for purchase of equipment	(17,500)
Net Cash Flow from Investing	**(4,000)**
Cash Flow from Financing	
Cash paid for loan repayment	(5,000)
Net Cash Flow from Financing	**(5,000)**
Net Increase in Cash	**17,372**

So, let's take a look at what makes a Cash Flow Statement tick: You start by picking the period of time you'd like to analyze. In the example above, it's for the entire year ending December 31, 2016. At the very top (not shown here) you would

put your starting cash position (how much you had in the bank at the start of the period). Then you figure out how much you made from operations by doing this:

Cash from selling your stuff
- Cash paid for inventory
- Cash paid for labor and other operating expenses

Total Cash from Operations

This is essentially your net profit from your Profit and Loss.

Next, you figure out how much cash you took in (or sent out) for investing. In this example, the only investment activity was selling and purchasing equipment.

Last, you figure out the cash flow from financing activities. In this example they subtracted the amount paid for a loan.

Then, you total it all up:

Starting Cash Position
+Cash From Operations
+ Cash from Investing+ Cash from Financing

Ending Cash Position

PUTTING IT ALL TOGETHER

FINDING THE MEANING IN

YOUR FINANCIALS

We've now broken down the three main financial documents every small business owner should be familiar with: The Profit and Loss Statement, the Balance Sheet, and the Cash Flow Statement. But for many business owners, these documents can still be hard to parse, even if you know what you're looking at. So, let's breakdown some of the key financial metrics these documents can help you better understand about your business.

Profitability

The most obvious metric that can be better understood through your financials is profitability. In particular, the Profit and Loss Statement (P&L) is designed to show exactly that. If you understand nothing else from a P&L, you should know that the number at the very bottom should be positive. If it's negative, then you probably have a problem. But, what other types of profitability metrics can be gleaned from studying your financials? For starters, Net Profit (AKA, "bottom line") is not the only type of profit you should be looking at. Comparing Gross Profit over time can tell you whether your raw costs are going up, or if labor costs are too high, or even whether you should increase your prices. While it's good to have a strong bottom line, sometimes the truth of your finances can be buried deeper in the P&L.

Ratios

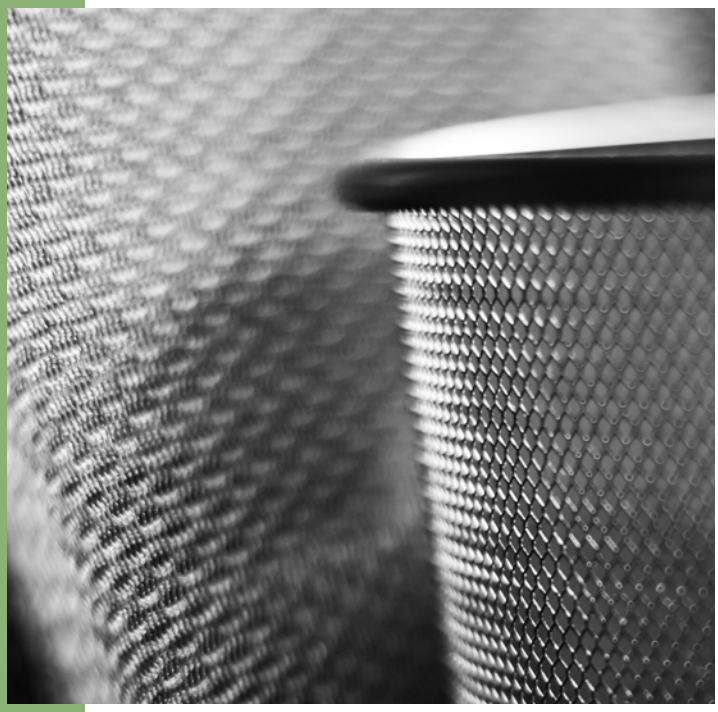
Financial gurus over time have developed several important ratios that can be determined based on the numbers on the Balance Sheet. Each ratio gives you a different glimpse into your business, and taken together they can be a valuable tool.

Working Capital = Current Assets – Current Liabilities

Essentially, Working Capital helps you understand how much you have left to play around with if all your liabilities were called at the same time. If you have more current liabilities than current assets, you're in danger of hitting a cash crunch in the near future. This is something that wouldn't be obvious from a P&L, since a company could be profitable and still not have enough cash to cover a crunch.

Quick Ratio = (Current Assets – Inventory) / Current Liabilities

Sure the Quick Ratio may look the same as Working Capital on the surface, but there is a fundamental difference. Working Capital includes inventory in the asset category, which is essentially assuming your inventory could be easily sold and converted into cash in a crunch. But what if you sell something that can't easily be sold quickly? Say, like airplanes, for instance. That's where the Quick Ratio helps give you a clearer picture of your true short term cash position.



Debt to Total Assets = Total Debt / Total Assets

Debt to Total Assets Ratio gives you a snapshot of what is considered the company's financial leverage. This means what percentage of the company's assets were purchased with debt. For example, a company may have a lot of cash on hand, and if the Debt to Total Assets ratio is high, you could assume this cash came from loans as opposed to running a profitable operation.

The Flow of Cash

Another key way these financial documents can give you insight into your business is by highlighting the three primary ways cash can move in and out of your business: operations, investments, and financing. The operating section of the Cash Flow Statement tells you how much cash you've received and used in the routine operations of your business. Essentially, it's the P&L condensed down to a few lines. The investing section deals with cash flows for big projects (such as equipment and property purchases), as well as purchases and sales related to stocks or other investments. The financing section gives you an idea of how your business is financed. By breaking down cash flow into these three basic categories, the Cash Flow Statement makes it easy for small business owners to get a handle on why the cash balances went up or down. For instance a profitable company could hit a cash snag if they spend all their money on buying an expensive piece of equipment. Understanding your cash flows can help you budget for the future and identify potential financial problems before they even start.

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