Small Business Budgeting & Financials

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Covered today:

- Impact of personal finances on your small business finances
  - 10 Minutes
- Importance of a Business Plan & key items to address
  - 20 Minutes
- Understanding basic financial statements & business budgeting
  - 75 Minutes
  - Cash-flow analysis
  - Balance sheet
  - Income statement
  - Income projections
- Q&A
Relationship between Personal Finance and Business Finance
Previously on “Financial Empowerment Program 101”…

Designing a personal budget

Types of bank accounts

Paying bills and other expenses

Credit and Credit Scores

Data privacy and cyber security

Payment fraud

Phishing

Vishing

Cyber security

Imitation fraud
How does Personal Finance Impact Business Finance?

Personal finance and business finance are highly interconnected, particularly for small business owners

- For a small business owner, “personal credit” may not be “personal”
- Many lenders use personal credit scores as a part of the decision making process to grant a business loan
  - Your personal credit score reflects “how well you handle money” – a low credit score may indicate that one does not handle finances well, and therefore, one might not be able to handle business finances well either

However, different lenders may view personal credit differently in granting business loan

- Small Business Administration (SBA): Personal credit is highly important, and in most cases, you will need a FICO score of at least 700 to be considered for a loan
- Bank Loan: Personal credit score is often an important factor, although if the business has solid cash flows and / or assets, the lenders may focus less on personal credit
- Independent Investors: When seeking investment through a venture capitalist or angel investor, a personal credit may be less important

The relationship between personal finance and business finance is a “two-way street”

- Not only does personal finance impact business credit, business finance can also impact personal credit
- If you have provided a personal guarantee for your business and then the business fails, you are personally liable for repaying the loan

*Source: Collin College*
Types of Small Business Loans

There are many types of small business loans – below are a few common types of small business loans

Line of Credit
- The most useful type of loan for small-business owners
- Often provides cash available in your business’ checking account which can then be used to purchase inventory, manage working capital, etc.
- Protects the business from emergencies and cash shortfalls
- Not intended for purchases of equipment or real estate
- Often the loan is for one year with a provision to renew annually
- Some loan balance can be carried forward while others must be repaid every month

Term Loans
- Loans that provide up front cash which can then be used to expand the business, buy equipment, etc.
- Similar to a mortgage or a personal loan, term loans have fixed interest rates and often monthly payments over time
- Can be “installment loans,” “balloon loans,” etc.

SBA (Small Business Administration) Loans
- Flexible term, low rate loans guaranteed by the SBA
- However, it is tough to get approved for an SBA loan

The right type of loan depends on your specific situation, and you should consult with your banker / financial advisor so that you can receive the right loan
Types of Small Business Loans (Cont’d)

Many small business loans may require a “personal guarantee”
• A personal guarantee means that the loan is your own personal obligation in addition to the obligation of your business entity
• A loan with a personal guarantee may have a better rate than a loan without a guarantee
• Also, some lenders may only provide loans as long as you guarantee the loan personally
• If your business fails, you are liable for repaying the loan; failure to do so would impact your personal credit
  • A business bankruptcy would not protect the guarantor from having to repay the loan
• If you are going to provide a personal guarantee, have your legal counsel review the guarantee agreement
• Also, if you are not the sole owner of the business, think twice before providing a personal guarantee – you are taking personal risk for a business that you do not fully control

A loan / line of credit may be “secured” or “unsecured”
• A secured loan is loan in which the borrower pledges some asset as “collateral” for the loan
• The collateral could be real estate, factory, car, stocks, bonds, or other property
• In a mortgage loan, the home used as the collateral, and if the borrow fails to repay the mortgage, the bank takes over the home; Similarly, in a business loan, the collateral could be equipment, factory, real estate, etc., and if the business fails to repay the loan, the lenders might “repossess” the collateral
• A secured loan has better terms than an unsecured loan
What Do I Need to Get A Small Business Loan?

Different lenders have different requirements for a small business loan; however, many lenders are likely to ask for the following:

For the Business:
- Name
- Business street address (no P.O. Boxes) and date moved to current address
- Phone number
- Tax ID
- Nature of business
- Date the business was established
- Business acquisition date of current ownership
- Number of employees
- **Annual net profit**
- **Annual gross sales**
- **List of outstanding obligations / loans, if any**
- Information on equipment / real estate to be financed (if applicable)

For Owners / Guarantors:
- Name
- Home street address (no P.O. Boxes)
- Home phone number
- SSN
- Date of birth
- Personal income
- Rent vs. own and monthly housing payment

Different lenders have different requirements for a small business loan, so please speak with your bank / financial advisor so that you can provide the right information.
Importance of a Business Plan
Why is a Business Plan Important?

- A business plan is a formal document which states:
  - The goal of the business
  - Why/how the goal will be met
  - The route a company intends to take to grow
- A business plan is a living, breathing document - *It changes as the marketplace evolves over time*
- A business plan serves as:
  - Internally: a road map for the company
  - Externally: information for potential investors
What to Address in Each Section:

- What is the market problem?
- What are the current attempts at solving the market problem?
- Why are these solutions inadequate?

- Describe the solution
- **State the value proposition**
- **Why/how does the solution solve the market problem?**
- Why is it superior to other solutions?

- Define the total market
- Define target customer profile
- Set pricing strategy
What to Address in Each Section:

**The Industry**
- Who are the current competitors & competing products?
- Are there any barriers to entry in this industry?
- How scalable is your product?
- **Address your competitive advantage (this is how you will sustain your place in the industry)**

**Operational Plan**
- Manufacturing
- Distribution
- Market entry strategy
- Advertising plan
- **Funding required**

**Financials**
- Income Statement
- Income projections
- Balance Sheet
- Cash management / budgeting
Hot Tips: Make Sure You Answer These Questions

1. What is your **market problem** – and what is your **solution you are offering for this problem** (AKA **Value Proposition**)?

2. Who is your **target market**?
   1. Primary market, secondary, and even tertiary market

3. What is the layout of your **industry**– and what is the ‘**competitive advantage**’ that will make you successful within it?
Guideline to write 1-2 sentence value proposition:

“FOR (TARGET CUSTOMER) WHO (NEED/OPPORTUNITY), THE (PRODUCT) IS A (PRODUCT CATEGORY) THAT (BENEFIT). UNLIKE (COMPETITION) OUR PRODUCT (PRIMARY DIFFERENTIATION)”
Financial Statements & Business Budgeting
Income Statement
Purpose of the Income Statement

- Shows the activity of a company over a given time period
- Answers two questions:
  - What did the company bring in?
  - What costs did it incur in the process?
Income Statement Components

- Revenues
  - Money company makes from *core activities*

- Operating Expenses
  - Cost the company incurs from running its *operating activities*

- Non-Operating ‘Expenses’
  - Gains (not an expense; added into statement)
    - Money company makes from *peripheral activities*
  - Losses
    - Cost the company incurs from *peripheral activities*

- Interest Expense
  - Companies don’t need to use debt to run their operations
<table>
<thead>
<tr>
<th>Revenue</th>
<th>Operating Expense</th>
<th>Gain</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Sample Statement

Core Operations

Operating Activities

Peripheral Activities

‘Net’ Income

Revenues
- COGS
=Gross Profit

Operating Expenses:
- Rent
- SGA
- Marketing
- R&D
=Operating Profit

Non-Operating Expenses:
+ Gains on _____
- Losses on _____
- Interest Expense
=Pre-Tax Income

- Taxes
=Net Income
Cory's Tequila Co.
Consolidated Income Statement
(in millions, except per-share amounts)

<table>
<thead>
<tr>
<th>YEARS ENDED</th>
<th>1999</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>NET SALES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$12,154</td>
<td>$8,488</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>4,240</td>
<td>2,924</td>
</tr>
<tr>
<td></td>
<td><strong>7,914</strong></td>
<td><strong>5,564</strong></td>
</tr>
<tr>
<td><strong>Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Research and development</td>
<td>1,594</td>
<td>1,026</td>
</tr>
<tr>
<td>Sales and marketing</td>
<td>2,447</td>
<td>1,572</td>
</tr>
<tr>
<td>General and administrative</td>
<td>418</td>
<td>262</td>
</tr>
<tr>
<td>Purchased research and development</td>
<td>471</td>
<td>594</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td><strong>4,930</strong></td>
<td><strong>3,454</strong></td>
</tr>
<tr>
<td><strong>OPERATING INCOME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,984</td>
<td>2,110</td>
</tr>
<tr>
<td>Realized gains on sale of investment</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Interest and other income, net</td>
<td>332</td>
<td>196</td>
</tr>
<tr>
<td>Income before provision for income taxes</td>
<td>3,316</td>
<td>2,311</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>1,220</td>
<td>956</td>
</tr>
<tr>
<td><strong>NET INCOME</strong></td>
<td><strong>$ 2,096</strong></td>
<td><strong>$1,355</strong></td>
</tr>
</tbody>
</table>
Balance Sheet
Purpose of the Balance Sheet

• Shows financial position at *a given point in time*
• Answers two questions:
  - What does a company have?
  - Where did its things come from?
Balance Sheet Components

- **Assets**
  - Everything of value owned by the company

- **Liabilities**
  - Amounts owed by the company

- **Equity**
  - Amounts invested in the company
The Accounting Equation

Assets = Liabilities + Equity
Example Assets

Current Assets
- Cash
- Accounts Receivable
- Inventory
- Prepaid Expenses
- Investment Securities

Long Term Assets
- Long Term Investments
- Property, Plant, Equipment
- Intangible Assets
# Example Liabilities

## Current Liabilities
- Accounts Payable
- Short term notes payable
- Current portion of long term debt
- Unearned revenue

## Long Term or Non-Current Liabilities
- Long term notes payable
- Bonds payable
- Deferred income tax liability
Example Equity

- Contributed Capital
  - Capital Stock
  - Paid-in Capital
- Retained Earnings
<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Current Assets</em></td>
<td><em>Current Liabilities</em></td>
</tr>
<tr>
<td>Cash</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>Short Term Notes Payable</td>
</tr>
<tr>
<td>Inventory</td>
<td>Current Portion of Long Term Debt</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>Unearned Revenue</td>
</tr>
<tr>
<td>Investment Securities 0</td>
<td><strong>Total Current Liabilities</strong></td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td><em>Long Term Liabilities</em></td>
</tr>
<tr>
<td><em>Long Term Assets</em></td>
<td>Long Term Notes Payable</td>
</tr>
<tr>
<td>Long Term Investments</td>
<td>Bonds Payable</td>
</tr>
<tr>
<td>Plant, Property, Equipment</td>
<td>Deferred Income Tax Liability</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td><strong>Total Long Term Liabilities</strong></td>
</tr>
<tr>
<td><strong>Total Long Term Assets</strong></td>
<td><em>Stockholders’ Equity</em></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>Contributed Capital</td>
</tr>
<tr>
<td></td>
<td>Retained Earnings</td>
</tr>
<tr>
<td></td>
<td>Treasury Stock</td>
</tr>
<tr>
<td></td>
<td><strong>Total Stockholders’ Equity</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Total Liabilities &amp; Equity</strong></td>
</tr>
</tbody>
</table>
Statement of Cash Flows
Purpose of the Statement of Cash Flows

- Interpret the transactions reflected in the Balance Sheet and Income Statement
- Categorize incoming and outgoing cash flows
Cash Basis vs. Accrual Basis

- **Cash Basis (CASH FLOW STATEMENT)**
  - Revenues recorded when cash is received
  - Expenses recorded when cash is paid
  - Barely used

- **Accrual Basis (INCOME STATEMENT)**
  - Revenues recorded when they are earned
  - Expenses recorded when they are incurred
  - Nearly universal
Examples

- T-Shirt Company’s employees complete a full months work, but have not yet been paid.
  - Recorded on Accrual Basis, not Cash Basis
  - When employees are PAID, it will then be recorded for both Cash and Accrual

- Johns Hopkins paid for $500 worth of T-Shirts in advance of their incoming freshman event
  - Recorded on Cash Basis, not Accrual
  - When service is rendered (shirts delivered) it will be accounted for in the accrual basis
Cash Flow Equation

\[ \text{Change in Cash} = \text{Beginning Cash Balance} + \text{Operating Cash Flows} + \text{Investing Cash Flows} + \text{Financing Cash Flows} \]

\[ \text{Ending Cash Balance} \]
# Categories of Cash Flow

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Operating activities</td>
<td>Converts the items reported on the income statement from the accrual basis of accounting to cash.</td>
</tr>
<tr>
<td>2. Investing activities</td>
<td>Reports the purchase and sale of long-term investments and property, plant and equipment.</td>
</tr>
<tr>
<td>3. Financing activities</td>
<td>Reports the issuance and repurchase of the company’s own bonds and stock and the payment of dividends.</td>
</tr>
</tbody>
</table>
# Emerson Corporation

## Statement of Cash Flows (Indirect Approach)

**For the Year Ending December 31, 20X5**

## Cash flows from operating activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Add (deduct) noncash effects on operating income</td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>$ 120,000</td>
</tr>
<tr>
<td>Gain on sale of land</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(250,000)</td>
</tr>
<tr>
<td>Decrease in inventory</td>
<td>40,000</td>
</tr>
<tr>
<td>Increase in accounts payable</td>
<td>70,000</td>
</tr>
<tr>
<td>Decrease in wages payable</td>
<td>(30,000)</td>
</tr>
<tr>
<td></td>
<td>(200,000)</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$ 800,000</td>
</tr>
</tbody>
</table>

## Cash flows from investing activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of land</td>
<td>$ 750,000</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Net cash provided by investing activities</td>
<td>600,000</td>
</tr>
</tbody>
</table>

## Cash flows from financing activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from issuing stock</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Dividends on common</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Repayment of long-term loans</td>
<td>(900,000)</td>
</tr>
<tr>
<td>Net cash provided by financing activities</td>
<td>(870,000)</td>
</tr>
</tbody>
</table>

## Net increase in cash

$530,000

## Cash balance at January 1, 20X5

170,000

## Cash balance at December 31, 20X5

$700,000
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