



Financial Management Overview

Introduction

You didn't go into business to manage finances, but – whether you're a contractor or consultant, own a bike shop or a bakery – one thing is certain: to stay in business and thrive, it's critical to do some basic financial management.

Every day, your business completes various types of transactions. Money changes hands, purchases are made, goods are sold, and services are rendered. It's a good sign when there's money in the bank and cash in the register, but it isn't the whole picture. Many new businesses get into financial trouble because they don't have a solid understanding of basic financial management.

So, how do you know if your business is making money, or if your business is growing? And how do you find out?

Organizing your finances can seem overwhelming, but this overview is here to help you learn how easy it is to manage business finances as part of your daily routine. It's going to show you the basics of accounting, how these concepts relate to your day-to-day activities, and how financial software can make the whole process easier.

Financial management can help you:

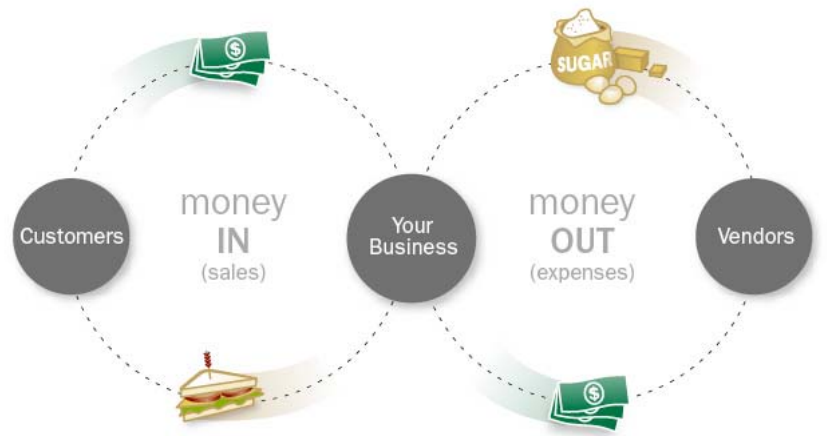
- Know where your money is coming from and where it is going
- See which customers or products are most profitable
- Save time by organizing your critical information in one place
- Prepare for tax time with accurate and complete records
- Make more informed decisions with financial reports
- Obtain bank financing or other sources of funding

Money Coming In and Going Out

The core financial activity of any business is money coming in and money going out. The cycle of money is called cash flow. Of course the goal of the bakery – or for any business – is to bring in more money than it's paying out. Let's follow the cash flow of the Avenue Bread and Deli.



Money comes in from sales: a customer buys a dozen pastries, another buys a sandwich for lunch, a student buys a croissant on the way to class, and a commercial order is shipped to a local grocery. Each of these **sales** adds money to the bakery's cash flow.



Now as heavenly as pastries are, they don't appear out of thin air. The bakery pays money out to purchase ingredients, like flour, sugar, and eggs for the goods that are sold. The bakery also buys supplies, pays utilities, and pays rent. Plus, Wendy, the bakery owner, pays herself and her employees. All of these transactions are **expenses** that take money out of the bakery's cash flow.

Avenue Bread & Cafe Profit & Loss Statement January 1-31, 2005	
Income	
Sales	
Total Income	16,392.20
Expenses	
Raw Goods	6,813.12
Supplies	1,102.89
Utilities	799.56
Rent	1,572.43
Payroll	4,821.27
Total Expense	15,109.27
Net Profit	<u>1,282.93</u>

The Profit & Loss Statement

The Profit and Loss Statement is how Wendy's accountant sees the same information. Also known as an income statement, the Profit and Loss Statement summarizes the money going in and out of a business over a specific period of time, a month, a quarter, or a year. All sales are recorded as income and all expenses are listed by type and totaled together. By subtracting the total expenses from the total income, the report shows the net profit—the money Wendy has to leave in the business or take for herself.

What's more, because the bakery used financial software to record all their sales and expenses, this Profit & Loss Statement can be compiled with

as little as one click. Now according to the Profit and Loss Statement, the bakery was profitable during the reporting period, which is great news, but it's only half of the picture.

Here's What We've Learned

- The cycle of money in and money out of a business is called cash flow
- A Profit and Loss Statement reports your net profit for a specific period of time
- The Profit and Loss Statement is only half of the picture

The Accounting Equation

In order to see the whole financial picture, we need to consider every transaction from the moment

Wendy invested her money in the bakery and took a loan from the

bank. While the bakery's Profit & Loss Statement showed a net profit for that month, there are other transactions that factor into the bakery's profitability. These transactions are categorized into three sections: assets, liabilities and owner's equity. Now, don't be scared off by these accounting terms. They are basic concepts I'm here to explain.

Assets = Liabilities + Owner's Equity



Assets are everything your business owns, like cash, bank accounts, accounts receivable (what customers owe you), and equipment. Liabilities are everything your business owes to others, like credit cards, sales taxes, and loans. Owner's equity is what the business is currently worth to you. It includes your original investment, called capital investment, and your retained earnings, which are simply the combined total of all sales less all expenses since you began your business.

Avenue Bread & Cafe Balance Sheet January 31, 2005	
Assets	
Current Assets	12,391.53
Checking/Savings	6,842.12
Accounts Receivable	19,233.65
Total Current Assets	38,788.64
Equipment	58,022.29
Total Assets	
Liabilities & Equity	
Liabilities	2,178.34
Current Liabilities	819.60
Credit Cards	2,997.94
Sales Tax Payable	32,782.35
Total Current Liabilities	35,780.29
Bank Loans	22,242.00
Total Liabilities	58,022.29
Equity	
Total Liabilities & Equity	

The Balance Sheet

The Balance Sheet is how Wendy's accountant views the same information. It categorizes the bakery's assets, liabilities, and equity to show the financial health of Wendy's business at a given point in time. It's called a Balance Sheet, because the total of all the assets must equal the total of all the liabilities and equity. They always balance, or have equal value, because the liabilities and equity were used to obtain the assets.

To determine the financial health of the bakery, the best place to look is the ratio of current assets to current liabilities. Current assets are assets that will be converted to cash within the next 12 months and current liabilities are liabilities due

within the next 12 months. A healthy business should have at least a 2 to 1 ratio, that is, twice as much current assets as current liabilities.

The Profit and Loss Statement and Balance Sheet together give you the overall picture of your business finances. The profit and loss statement reports your net profit over a specific period of time while the balance sheet shows you the overall health of your business from the moment it began.

Here's What We've Learned

- Assets are everything your business owns
- Liabilities are everything your business owes to others
- Owner's equity is the overall value of your business at a point in time
- The Profit and Loss Statement gives you the overall picture of your business finances

We've looked at the cycle of money through the business and how to get an overall picture. But where does all this information come from? And how do you know it's in the right place? To make sure your financial statements and reports are accurate, you need to understand where, why, and how each business transaction is categorized. The key is the Chart of Accounts.

The Chart of Accounts

The Chart of Accounts acts like folders where you file away your transactions. Income accounts include sales and other revenue accounts like fees and interest. Expense accounts are costs associated with running your business like supplies, rent, salaries, and raw materials. Asset accounts include your bank accounts, accounts receivable and equipment. Assets can also include buildings, land, and vehicles. Liability accounts include credit cards, sales tax payable, and bank loans. They may also include unpaid bills known as accounts payable and payroll liability accounts. Equity accounts include capital investment – the money you invested to start the company – and retained earnings accounts—the remaining profits since you started the company.

Income		Assets	
📁 Sales	16,392.20	📁 Checking/Savings	12,391.53
		📁 Accounts Receivable	6,842.12
Expenses		📁 Equipment	38,788.64
📁 Raw Goods	6,813.12		
📁 Supplies	1,102.89	Liabilities	
📁 Utilities	799.56	📁 Credit Cards	2,178.34
📁 Rent	1,572.43	📁 Sales Tax Payable	819.60
📁 Payroll	4,821.27	📁 Bank Loans	32,782.35
		Equity	
		📁 Capital Investment	15,000.00
		📁 Retained Earnings	22,242.00

The Chart of Accounts is the framework used to categorize the information you rely on to create Profit and Loss statements, Balance Sheets, and valuable reports that help you guide your business. The Chart of Accounts is made up of the income and expense accounts used by the Profit and Loss

statement; and the asset, liability, and equity accounts used by the Balance Sheet. These five account types are common to all businesses. Each time Wendy enters a transaction into her financial software, she categorizes it into one of these five types of accounts.

Setting Up Your Accounts

Most financial software products will make it easier by providing a basic chart of accounts for many types of businesses. You can customize the accounts to meet the specific needs of your business. Be careful to avoid these common mistakes:

- Don't create too many accounts. Too much detail can be burdensome. You can always see the details by running a detailed report.
- Be as descriptive as possible when naming your accounts. Descriptive names help you find the correct account quickly and easily.
- Be consistent when entering your transactions. For meaningful reports and comparisons, it's very important to use the same accounts for the same transactions each time.

A simple, straightforward Chart of Accounts is a great benefit when managing a large number of transactions in your busy business day.

Reports

One of the greatest benefits of financial management software is on-demand access to reports to see how your business is doing. For example, at the bakery, Wendy can instantly see information like:

What's selling? The sales report gives Wendy an overall view of the sales of her business. By clicking on a sales category total, like "bakery", Wendy gets an instant breakdown of the sales total by item.

Who is buying? Wendy can run a report to see the sales of each of her commercial accounts for a given period. She can compare periods to see which accounts are growing.

**Avenue Bread & Cafe
Total sales by item
January 8-15, 2005**

**Avenue Bread & Cafe
Total sales by customer
January 8-15, 2005**

**Avenue Bread & Cafe
Sales by item detail
January 8-15, 2005**

Item	Qty	Amount	% of Sales	Avg Price
Bread	269	628.50	15.8%	2.34
Pastry	98	256.00	6.4%	2.61
Specialty	61	403.00	10.1%	6.61
Total Charges		1,287.50	32.3%	

Who owes her money? Wendy can run a report detailing all of the invoices owed to her and when they are due.

Reports and financial statements provide a complete financial view of Wendy's business with increased visibility into her profitability and cash flow. Wendy can feel more confident about the decisions she makes because they are based upon solid financial management.

Conclusion

We hope this brief overview has helped unlock the mystery of good financial management and given you the confidence to get started. If you would like to learn more about how financial management applies to your business, consider these next steps:

Find a Certified QuickBooks ProAdvisor near you: <http://www.usequickbooks.com/locateadvisor/>

Visit your local Small Business Development Center: <http://www.sba.gov/sbdc/sbdcnear.html>

Learn about financial software options available from QuickBooks: <http://www.quickbooks.com/>

Accounting Terms

Profit & Loss Statement

A profit and loss statement, also called an income statement, shows income, expenses, and net profit or loss (equal to income minus expenses).

Balance Sheet

A balance sheet is a financial snapshot of your business on one date. It shows what you have (assets), what people owe you (accounts receivable), what your business owes to others (liabilities and accounts payable), and the net worth of your business (equity).

Assets

Assets include both what you have and what other people owe you. The money people owe you is called accounts receivable, or A/R. The rest of your company's assets may include checking accounts, savings accounts, petty cash, fixed assets (such as equipment or trucks), inventory, and undeposited funds (money you've received from customers but haven't deposited yet).

Liabilities

Liabilities are what your company owes to other people. The money you owe for unpaid bills is called accounts payable, or A/P. A liability can be a formal loan, an unpaid bill, or sales and payroll taxes you owe to the government.

Equity

Equity is the difference between what you have (assets) and what you owe (liabilities).

Equity = Assets - Liabilities

If you sold all your assets today, and you paid off your liabilities using the money you received from the sale of your assets, the leftover money would be your equity. Your equity reflects the health of your business, since it's the amount of money left after you satisfy all your debts. Equity comes from three sources: money invested in the company by the owners; net profit from operating the business during the current accounting period; and retained earnings, or net profits from earlier periods that haven't been distributed

The Chart of Accounts

When you keep books for a company, you want to track where your income comes from, where you put it, what your expenses are for, and what you use to pay them. You track this flow of money through a list of accounts called the chart of accounts.