Book VI

Planning and Budgeting for Your Business

Acme Trucking Annual Budget			
Expense Category	**Planned**	**Actual**	**Variance**
Office Rent/Lease	$25,000	$32,500	$7,500.00
Warehouse Rent/Lease	41,700	39,250	(2,450)
Fleet			
Maintenance	72,500	77,874	5,374
Repairs	115,750	122,645	6,895
Licenses	21,750	24,478	2,728
Tolls	32,500	41,793	9,293
Administration			
Office supplies	1,500	1,738	238
Copies/Fax	750	832	82
Postage/shipping	3,200	2,965	(235)
Other	1,000	1,079	79
Operations			
Utilities	14,500	16,232	1,732
Phone	1,100	1,148	48
Insurance	16,500	15,875	(625)
Training/education	8,750	9,783	1,033
Marketing			
Website maintenance	950	875	(75)
Advertising	1,650	1,590	(60)
Brochures	575	498	(77)
Business cards	175	215	40
Sales			
Mileage	8,500	9,245	745
Parking	1,200	1,325	125
Meals	3,250	2,987	(263)
Other	1,000	527	(473)

Managing inventory can boost profits. Discover various strategies for managing inventory cost-effectively by visiting `www.dummies.com/extras/accountingaio` for free guidance.

In this book...

- Structure a business to attract capital and issue stock shares to raise capital. Find out more about what potential investors really want to see in a company's financials.
- Choose the appropriate legal structure for a business — sole-proprietorship, partnership, LLC, C-corp., S-corp., or something else. The right legal structure provides valuable legal protection and potential tax savings.
- Draft a business plan that increases your chances of securing loan approval or attracting eager investors. Tell your company's growth story to prospective shareholders.
- Build a budget to help executives and managers make better business decisions and boost their organization's bottom line. Budgeting not only keeps your business on track financially but also helps inform spending decisions so you get the most bang for your buck.
- Tweak your budget to accommodate different levels of production and other potential variables. Play "what-if" with different production and product-development scenarios to plan production and sales and maximize profit.
- Get a handle on long-term debt to reduce interest and improve cash flow. Make informed decisions about how much cash your business needs to operate and how much of that cash you'll generate through debt.

Chapter 1

Incorporating Your Business

In This Chapter

- Structuring the business to attract capital
- Taking stock of the corporate legal structure
- Issuing and managing stock shares

The obvious reason for investing in a business rather than putting your money in a safer type of investment is the potential for greater rewards. Note the word *potential.* As an owner of a business, you're entitled to your fair share of its profit, as are the other owners. At the same time, you're subject to the risk that it could go down the tubes, taking your money with it.

Ignore the risks for a moment and look at just the rosy side of the picture: Suppose the doohickeys that your business sells become the hottest products of the year. Sales are booming, and you start looking at buying a five-bedroom mansion with an ocean view. Don't make that down payment just yet — you may not get as big a piece of the profit pie as you're expecting. Some claims to that profit may rank higher than yours, and you may not see *any* profit after all these claims are satisfied, because the way the profit is divided among owners depends on the business's legal structure. This chapter shows how legal structure determines your share of the profit — and how changes beyond your control can make your share less valuable.

Securing Capital: Starting with Owners

Every business needs capital. Capital provides money for the assets a business needs to manufacture products, make sales, and carry on operations. Common examples of assets are the working cash balance a business needs for day-to-day activities, products held in inventory for sale, and long-life operating assets (buildings, machines, computers, office equipment, and so on).

Assume a typical business in your industry needs capital equal to one-half of annual sales revenue. You would plan your financing efforts to raise that amount of capital. Of course, this ratio varies from industry to industry. Many manufactures need a high ratio of capital to sales, so they're described as being *capital intensive.*

One of the first questions that providers of business capital ask is how the business entity is organized legally. That is, which specific form or legal structure is the business using? The different types of business legal entities present different risks and potential rewards to business capital providers.

Whatever its legal structure, a business gets the capital it needs from two basic sources: debt and equity. *Debt* refers to the money borrowed by a business, and *equity* refers to money invested in the business by owners plus profit earned and retained in the business (instead of being distributed to its owners). No matter which type of legal entity form it uses, every business needs a foundation of ownership (equity) capital. Owners' equity is the hard-core capital base of a business.

In starting a new business from scratch, its founders typically must invest a lot of *sweat equity,* which refers to the grueling effort and long hours to get the business off the ground and up and running. The founders don't get paid for their sweat equity, and it doesn't show up on the balance sheet.

Contrasting two sources of equity

Every business — regardless of how big it is, whether it's publicly or privately owned, and whether it's just getting started or is a mature enterprise — has owners. Virtually no business can get all the capital it needs by borrowing. Your firm can obtain equity financing from two sources:

- **Investors:** Outside investors can provide the business with both start-up and a continuing base of capital, or *equity.*
- **Owners:** The firms' founders may provide their own capital in exchange for equity.

Without the foundation of equity capital, a business wouldn't be able to get credit from its suppliers and couldn't borrow money. As they say in politics, the owners must have some skin in the game.

Considering what investors want

The equity capital in a business always carries the risk of loss to its owners. So, what do the owners expect and want from taking on this risk? Their expectations include the following:

- **Share in profits:** They expect the business to earn profit on their equity capital in the business and to share in that profit by receiving cash distributions from profit and from increases in the value of their ownership shares, with no guarantee of either.

- **Participate in management:** They may expect to directly participate in the management of the business, or they may plan to hire someone else to manage the business. In smaller businesses, an owner may be one of the managers and may sit on the board of directors. In very large businesses, however, you're just one of thousands of owners who elect a representative board of directors to oversee the managers of the business and protect the interests of the non-manager owners.
- **Share in sales proceeds:** Looking down the line to a possible sale of the business or a merger with another business, they expect to receive a proportionate share of the proceeds if the business is sold or to receive a proportionate share of ownership when another company buys or merges with the business. Or they may end up with nothing in the event the business goes kaput and nothing's left after paying off the creditors.

When owners invest money in a business, the accountant records the amount of money as an increase in the company's *cash* account. And, using double-entry accounting, the amount invested in the business is recorded as an increase in an *owners' equity.* (See Book I, Chapter 2 to find out about double-entry accounting.) Owners' equity also increases when a business makes profit. See Book IV, Chapter 2 for more on why earning profit increases the amount of assets minus liabilities, which is called *net worth,* and how this increase in net worth (due to profit) is balanced by recording the increase in owners' equity.

Dividing owners' equity

Certain legal requirements often come into play regarding the minimum amount of owners' capital that a business must maintain for the protection of its creditors. Therefore, the owners' equity of a business is divided into two separate types of accounts:

- **Invested capital:** This type of owners' equity account records the amounts of money that owners have invested in the business, which could have been many years ago. Owners may invest additional capital from time to time, but generally speaking they can't be forced to put additional money in a business (unless the business issues *assessable* ownership shares, which is unusual). Depending on the legal form of the entity and other factors, a business may keep two or more accounts for the invested capital from its owners.
- **Retained earnings:** The profit a business earns over the years that has been retained and not distributed to its owners is accumulated in the retained earnings account. If all profit is distributed every year, retained earnings has a zero balance. (If a business loses money, its accumulated loss causes retained earnings to have a negative balance, which generally is called a *deficit.*) If none of the annual profits of a business are distributed to its owners, the balance in retained earnings is the cumulative profit the business has earned since it opened its doors (net of any losses along the way).

Whether to retain part or all of annual net income is one of the most important decisions that a business makes; distributions from profit have to be decided at the highest level of a business. A growing business needs additional capital for increasing its assets, and increasing the debt load of the business usually can't supply all the additional capital. So, the business *plows back* some of its profit for the year into the business, rather than distributing it to its owners. In the long run, this may be the best course of action, because it provides additional capital for growth.

Leveraging equity capital with debt

Leverage refers to the idea of using debt to add capital to your business. Leverage is a good strategy if the company can generate more in earnings than it pays in interest expense and fees on the debt. If a business is interested in leverage, the first consideration is how much of the balance sheet should include debt.

Suppose a business has $10 million in total assets. (You find assets in the balance sheet of a business — see Book IV, Chapter 3.) The balance sheet equation (in Book I, Chapter 1) is Assets less Liabilities equals Equity. $10 million in total assets doesn't mean that the company has $10 million of *equity.* You have to subtract liabilities from assets to compute equity. Assuming the business has a good credit rating, it probably has some amount of trade credit extended for purchases, which is recorded in the *accounts payable* liability account (see Book IV, Chapter 4). Other kinds of operating liabilities may also come into play. Suppose its accounts payable and other operating liabilities total $2 million.

At this point, you've identified $10 million in total assets, less $2 million in liabilities. That leaves $8 million to account for. The $8 million could represent other liabilities. Some of the $8 million may be equity. In a sense, you're filling in the numbers in the balance sheet equation:

> $10 million total assets – $2 million liabilities = $8 million to be identified (either more liabilities or equity)

Some businesses depend on debt for more than half of their total capital. In contrast, others have virtually no debt at all. You find many examples of both public and private companies that have no borrowed money. But as a general rule, most businesses carry some debt (and therefore, have interest expense).

The debt decision isn't really an accounting responsibility as such; although once the decision is made to borrow money, the accountant is very involved in recording debt and interest transactions. Deciding on debt is the responsibility of the chief financial officer and chief executive officer of the business.

In medium-sized and smaller businesses, the chief accounting officer (controller) may also serve as the chief financial officer. In larger businesses, two individuals hold the top financial and accounting positions.

The loan contract between a business and its lender may prohibit the business from distributing profit to owners during the period of the loan. Or the loan agreement may require that the business maintain a minimum cash balance. Generally speaking, the higher the ratio of debt to equity, the more likely a lender is to charge higher interest rates and insist on tougher conditions. That's because the lender has higher risk that the business may default on the loan. A high debt-to-equity ratio means the company has more debt for every dollar of equity.

When borrowing money, the president (or another officer in his or her capacity as an official agent of the business) signs a note payable document to the lender. In addition, the lender may ask the major investors in a smaller, privately owned business to guarantee the note payable of the business *as individuals* in their personal capacities — and it may ask their spouses to guarantee the note payable as well. The individuals may endorse the note payable, or a separate legal instrument of guarantee may be used.

The individuals promise to pay the note if the business can't make payments. You should definitely understand your personal obligations if you're inclined to guarantee a note payable of a business. You take the risk that you may have to pay some part or perhaps the entire amount of the loan from your personal assets if the business is unable to honor its obligation.

Recognizing the Legal Roots of Business Entities

The U.S. legal system enables *entities* to be created for conducting business activities. These entities are separate and distinct from the individual owners of the business. Business entities have many of the rights of individuals; for example, the rights to own property and enter into contracts. In starting a business venture, one of the first tasks the founders must attend to is to select the type of legal structure to use — which usually requires the services of a lawyer who knows the laws of the state in which the business is organized.

A business may have one or more owners. A one-owner business may choose to operate as a *sole proprietorship,* a *limited liability company,* or a *corporation*; a multi-owner business must choose to be a *partnership,* a *limited liability company,* or a *corporation.* The most common type of business is a corporation (although the number of sole proprietorships would be larger if part-time, self-employed people were included in this category). No legal structure is inherently better than another; which one is right for a particular

business is something that the business's managers and founders need to decide when starting the business. The following discussion focuses on the basic types of legal entities that owners can use for their business.

Incorporating a Business

The law views a *corporation* as a real, live person. Like an adult, a corporation is treated as a distinct and independent individual who has rights and responsibilities. (A corporation can't be sent to jail, but its officers can be put in the slammer if they're convicted of using the corporate entity for carrying out fraud.) A corporation's "birth certificate" is the legal form that it files with the Secretary of State of the state in which the corporation is created (incorporated). A corporation must also have a legal name. You're not allowed to use certain names, such as the State Department of Motor Vehicles. Consult a lawyer when choosing a name for your corporation.

The corporate legal form offers several important advantages. A corporation has *unlimited life;* it stays alive until the shareowners vote to terminate the entity. The ownership interests in a corporation, specifically the shares of stock issued by the corporation, are generally *transferable.* You can sell your shares to another person or bequeath them in your will to your grandchildren. You don't need the approval of the other shareholders to transfer ownership of your shares. Each ownership share typically has one vote in the election of directors of a business corporation. In turn, the directors hire and fire the key officers of the corporation. This provides a practical way to structure the management of a business.

Just as an adult child is an entity separate from his or her parents, a corporation is separate from its owners. For example, the corporation is responsible for its own debts. Assuming you didn't cosign for one of your parents' loans, the bank can't come after you if your parents default on their loan, and the bank can't come after you if the corporation you invested money in goes belly up. If a corporation doesn't pay its debts, its creditors can seize only the corporation's assets, not the assets of the corporation's owners.

This important legal distinction between the obligations of the business entity and its individual owners is known as *limited liability* — that is, the limited liability of the owners. Even if the owners have deep pockets, they have no legal exposure for the unpaid debts of the corporation (unless they've used the corporate entity to defraud creditors). The legal fence between a corporation and its owners is sometimes called the "corporate shield" because it protects the owners from being held responsible for the debts of the corporation. So when you invest money in a corporation as an owner, you know that the most you can lose is the amount you put in. You may lose every dollar you put in, but the corporation's creditors can't reach through the corporate entity to grab your assets to pay off the business's liabilities. (But to be prudent, you should check with your lawyer on this issue to be sure.)

Issuing stock shares

When raising equity capital, a corporation issues ownership shares to people who invest money in the business. These ownership shares are documented by stock certificates, which state the name of the owner and the number of shares. (An owner can be an individual, another corporation, or any other legal entity.) The corporation has to keep a register of how many shares everyone owns. Many public corporations use an independent agency to maintain their ownership records. Stock shares are commonly issued in *book entry form,* which means you get a formal letter (not a stock certificate) attesting to the fact that you own so many shares. Your legal ownership is recorded in the official books, or stock registry of the business.

The owners of a corporation are called *stockholders* because they own stock shares issued by the corporation. The stock shares are *negotiable,* meaning the owner can sell them at any time to anyone willing to buy them without having to get the approval of the corporation or other stockholders. *Publicly owned corporations* are those whose stock shares are traded in public markets, such as the New York Stock Exchange and NASDAQ.

The stockholders of a private business have the right to sell their shares, although they may enter into a binding agreement restricting this right. For example, suppose you own 20,000 of the 100,000 stock shares issued by the business. You have 20 percent of the voting power in the business (one share, in this case, has one vote). You may agree to offer your shares to the other shareowners before offering the shares to someone outside the present group of stockholders. Or you may agree to offer the business itself the right to buy back the shares. In these ways, the continuing stockholders of the business control who owns the stock shares of the business.

Offering different classes of stock shares

Before you invest in stock shares, you should ascertain whether the corporation has issued just one class of stock shares. A *class* is one group, or type, of stock shares all having identical rights; every share is the same as every other share. A corporation can issue two or more classes of stock shares. For example, a business may offer Class A and Class B stock shares, giving Class A stockholders a vote in elections for the board of directors but not granting voting rights to Class B stockholders.

State laws generally are liberal in allowing corporations to issue different classes of stock shares. A whimsical example is that holders of one class of stock shares could get the best seats at the annual meetings of the stockholders. But whimsy aside, differences between classes of stock shares are significant and affect the value of the shares of each class of stock.

Common stock and *preferred stock* are two classes of corporate stock shares that are fundamentally different. Here are two basic differences:

- **Fixed dividend amount:** Preferred stockholders are promised (though not guaranteed) a certain amount of cash dividends each year, but the corporation makes no such promises to its common stockholders. (The company must generate earnings to pay any type of dividend, including dividends on preferred stock.) Each year, the board of directors must decide how much, if any, cash dividends to distribute to its common stockholders.
- **Claims on assets:** Common stockholders have the most risk. A business that ends up in deep financial trouble is obligated to pay off its liabilities first and then its preferred stockholders. By the time the common stockholders get their turn to collect, the business may have no money left to pay them. In other words, the common shareholders are last in line to make a claim on assets.

Neither of these points makes common stock seem very attractive. But consider the following points:

- Preferred stock shares are promised a *fixed* (limited) dividend per year and typically don't have a claim to any profit beyond the stated amount of dividends. (Some corporations issue *participating* preferred stock, which gives the preferred stockholders a contingent right to more than just their basic amount of dividends. This topic is too technical to explore further in this book.)
- Preferred stockholders may not have voting rights. They may not get to participate in electing the corporation's board of directors or vote on other critical issues facing the corporation.

The advantages of common stock, therefore, are the ability to vote in corporation elections and the unlimited *upside potential:* After a corporation's obligations to its preferred stock are satisfied, the rest of the profit it has earned accrues to the benefit of its common stock. Although a corporation may keep some earnings as retained earnings, a common stock shareholder may receive a much larger dividend than a preferred shareholder receives.

Here are some important points to understand about common stock shares:

- Each stock share is equal to every other stock share in its class. This way, ownership rights are standardized, and the main difference between two stockholders is how many shares each owns.
- The only time a business must return stockholders' capital to them is when the majority of stockholders vote to liquidate the business in part or in total. Otherwise, the business's managers don't have to worry about stockholders withdrawing capital. If one investor sells common stock to another shareholder, the company's capital balance is unchanged.

- A stockholder can sell his or her shares at any time, without the approval of the other stockholders. The stockholders of a privately owned business, however, may agree to certain restrictions on this right when they first become stockholders in the business.
- Stockholders can put themselves in key management positions, or they may delegate the task of selecting top managers and officers to the *board of directors,* which is a small group of people selected by the stockholders to set policies and represent stockholders' interests.

  Now don't get the impression that if you buy 100 shares of IBM you can get yourself elected to its board of directors. On the other hand, if you have the funds to buy 100 million shares of IBM, you could very well get yourself on the board. The relative size of your ownership interest is key. If you put up more than half the money in a business, you can put yourself on the board and elect yourself president of the business. That may not be the most savvy business decision, but it's possible. The stockholders who own 50 percent plus one share constitute the controlling group that decides who's on the board of directors.

Note: The all-stocks-are-created-equal aspect of corporations is a practical and simple way to divide ownership, but its inflexibility can be a hindrance. Suppose the stockholders want to delegate to one individual extraordinary power, or to give one person a share of profit out of proportion to his or her stock ownership. The business can make special compensation arrangements for key executives and ask a lawyer for advice on the best way to implement the stockholders' intentions. Nevertheless, state corporation laws require that certain voting matters be settled by a majority vote of stockholders. If enough stockholders oppose a certain arrangement, the other stockholders may have to buy them out to gain a controlling interest in the business. (The limited liability company legal structure permits more flexibility in these matters.)

Determining market value of stock shares

When you consider selling your shares of stock in a company, you probably want to know the market value of each of your shares. There's a world of difference between owning shares of a public corporation and owning shares of a private corporation.

Public means an active market exists for the stock shares of the business; the shares are *liquid.* You can convert your shares into cash in a flash by calling your stockbroker or going online to sell them. You can check a daily financial newspaper — such as *The Wall Street Journal* — for the current market prices of many large publicly owned corporations. Or you can go to one of many websites (such as finance.yahoo.com) that provide current market prices. But stock shares in privately owned businesses aren't publicly traded, so you need to take a different approach to determine the value of your shares.

Stockholders of a private business rarely worry about putting a precise market value on their shares — until they're serious about selling their shares or something else happens that demands putting a value on the shares. When you die, the executor of your estate has to put a value on the shares you own for estate tax purposes. If you divorce your spouse, a value is needed for the stock shares you own, as part of the divorce settlement. When the business itself is put up for sale, a value is put on the business; dividing this value by the number of stock shares issued by the business gives the value per share.

Other than during events like these, which require that a value be put on the stock shares, the shareowners of a private business get along quite well without knowing a definite value of their shares. This doesn't mean they have no idea regarding the value of their business and what their shares are worth. They read the financial statements of their business, so they know its profit performance and financial condition. In the backs of their minds they should have a reasonably good estimate regarding how much a willing buyer may pay for the business and the price they would sell their shares for. So even though they don't know the exact market value of their stock shares, they're not completely in the dark about that value.

Generally speaking, the value of ownership shares in a private business depends on the recent profit performance and the current financial condition of the business, as reported in its latest financial statements. The financial statements may have to be *trued up,* as they say, to bring some of the historical cost values in the balance sheet up to current replacement values. For more about performing business valuations, see Book V, Chapter 1.

Business valuation is highly dependent on the specific circumstances of each business. The present owners may be very eager to sell, and they may be willing to accept a low price instead of taking the time to drive a better bargain. The potential buyers of the business may see opportunities that the present owners don't see or aren't willing to pursue. Even Warren Buffett, who has a well-deserved reputation for knowing how to value a business, admits that he's made some real blunders along the way.

Keeping alert for dilution of share value

Watch out for developments that cause a dilution effect on the value of your stock shares — that is, that cause each stock share to drop in value. Specifically, *dilution* means that your earnings per common stock share have declined. If this *earnings per share* figure declines, investor interest in the common stock also is likely to decline. The most basic level of measuring earnings per share involves common stock, as explained in this section.

Sometimes the dilution effect may be the result of a good business decision, so even though your earnings per share decreases in the short term, the long-term profit performance of the business (and, therefore, your value of the common stock shares) may benefit. But you need to watch for these developments closely. The following situations cause a dilution effect:

- **Issuing additional shares:** A business issues additional stock shares at the going market value but doesn't really need the additional capital — the business is in no better profit-making position than it was before issuing the new stock shares. For example, a business may issue new stock shares in order to let a newly hired chief executive officer buy them. The immediate effect may be a dilution in the value per share. Total earnings are the same, but those earnings are spread over more common stock shares. Over the long term, however, the new CEO may turn the business around and lead it to higher levels of profit that increase the stock's value.
- **Offering additional shares at a discount:** A business issues new stock shares at a discount below its stock shares' current value. For example, the business may issue a new batch of stock shares at a price lower than the current market value to employees who take advantage of an employee stock-purchase plan. Issuing stock shares — at any price — has a dilutive effect on the market value of the shares. But in the grand scheme of things, the stock-purchase plan may motivate its employees to achieve higher productivity levels, which can lead to superior profit performance of the business. Finally, keep in mind that issuing shares at a discount means that you don't raise as much capital for the business.

Now here's one for you: The main purpose of issuing additional stock shares is to deliberately dilute the market value per share. For example, a publicly owned corporation doubles its number of shares by issuing a two-for-one *stock split.* Each shareholder gets one new share for each share presently owned, without investing any additional money in the business. As you would expect, the market value of the stock drops in half — which is exactly the purpose of the stock split. The lower stock price may attract more investors. After all, 100 shares of a $20 stock cost less than 100 shares of a $40 stock.

Note that a stock split doesn't change the total market value of the company. When the number of shares is doubled in a two-for-one stock split, the value of each share is cut in half. As a result, the total market value stays the same.

Recognizing conflicts between stockholders and managers

Stockholders are primarily concerned with the profit performance of the business; the dividends they receive and the value of their stock shares depend on it. Managers' jobs depend on living up to the business's profit goals. But whereas stockholders and managers have the common goal of optimizing profit, they have certain inherent conflicts of interest:

- **Manager compensation:** The more money that managers make in wages and benefits, the less stockholders see in bottom-line net income. Stockholders obviously want the best managers for the job, but they don't want to pay any more than they have to.

  Most public business corporations establish a compensation committee consisting of *outside* directors that sets the salaries, incentive bonuses, and other forms of compensation of the top-level executives of the organization. An outside director is one who has no management position in the business and who, therefore, should be more objective and shouldn't be beholden to the chief executive of the business. This scenario is good in theory, but it may not work out all that well in practice — particularly if the top-level executive of a large public business has the dominant voice in selecting the people to serve on its board of directors. Being a director of a large public corporation is a prestigious position, to say nothing of the annual fees that can be fairly substantial at many corporations.

- **Control over the business:** The question of who should control the business — managers who are hired for their competence and are intimately familiar with the business, or stockholders who may have no experience relevant to running this business but whose money makes it tick — can be tough to answer. Ideally, the two sides respect each other's contributions to the business and use this tension constructively. Of course, the real world is far from ideal, and in some companies, managers control the board of directors rather than the other way around.

As an investor, be aware of these issues and how they affect the return on your investment in a business. If you don't like the way your business is run, you can sell your shares and invest your money elsewhere. (However, if the business is privately owned, there may not be a ready market for its stock shares, which puts you between a rock and a hard place.)

Chapter 2

Choosing a Legal Structure for a Business

In This Chapter

- Partnering with others in business
- Gaining legal protections with an LLC
- Looking out for number one in a sole proprietorship
- Considering the tax ramifications of your choices

Forming a business can be easy as pie or extremely complicated, depending on the type of business entity being created. If you're flying solo, you're a business unto yourself and really don't need to do anything to establish yourself as a sole proprietorship. Unless you say otherwise, the IRS considers your business a sole proprietorship. With a little extra effort, you can establish your business as a partnership, to share duties and profits among owners, or create a limited liability company (LLC) to provide your business with some extra legal protection. With a little more effort, and a lot more paperwork, you can establish your business as a full-fledged corporation.

This chapter presents the ABCs of the three types of business entities: partnerships, LLCs, and corporations. First, you get a brief overview of sole proprietorships and partnerships. Then you find out all you need to know about the different types of corporations — C corporations and S corporations — and the tax considerations for each.

Differentiating between Partnerships and Limited Liability Companies

Suppose you're starting a new business with one or more other owners, but you don't want it to be a corporation. You can choose to create a *partnership* or a *limited liability company* (*LLC*), which are the main alternatives to the corporate form of business.

A partnership is also called a *firm.* You don't see this term used to refer to a corporation or limited liability company nearly as often as you do to a partnership. The term *firm* connotes an association of a group of individuals working together in a business or professional practice.

Compared with the relatively rigid structure of corporations, the partnership and LLC forms of legal entities allow the division of management authority, profit sharing, and ownership rights among owners to be very flexible. The following sections highlight the key features of these two legal structures.

Partnerships

Partnerships avoid the double-taxation feature that corporations are subject to (see "Choosing the Right Legal Structure for Income Tax," later in this chapter for details), because all profits and losses "pass through" the business to its partners. Partnerships also differ from corporations with respect to owners' liability:

- **General partners** are subject to *unlimited liability.* If a business can't pay its debts, its creditors can reach into general partners' personal assets. General partners have the authority and responsibility to manage the business. They're roughly equivalent to the president and other high-level managers of a business corporation. The general partners usually divide authority and responsibility among themselves, and often they elect one member of their group as the senior general partner or elect a small executive committee to make major decisions.
- **Limited partners** escape the unlimited liability that the general partners have hanging around their necks. Limited partners aren't responsible, as individuals, for the liabilities of the partnership entity. These junior partners have ownership rights to the business's profit, but they don't generally participate in the high-level management of the business. A partnership must have one or more general partners; not all partners can be limited partners.

Many large partnerships copy some of the management features of the corporate form — for example, a senior partner who serves as chair of the general partners' executive committee acts in much the same way as the chair of a corporation's board of directors.

In most partnerships, an individual partner can't sell his interest to an outsider without the consent of all the other partners. You can't just buy your way into a partnership; the other partners have to approve your joining the partnership. In contrast, you can buy stock shares and thereby become part owner of a corporation without the approval of the other stockholders.

Limited liability company (LLC)

The LLC is an alternative type of business entity. An LLC is like a corporation regarding limited liability, and it's like a partnership regarding the flexibility of dividing profit among the owners. An LLC can elect to be treated either as a partnership or as a corporation for federal income tax purposes. Consult a tax expert if you're facing this choice.

The key advantage of the LLC legal form is its *flexibility,* especially regarding how profit and management authority are determined. For example, an LLC permits the founders of the business to put up, say, only 10 or 20 percent of the money to start a business venture but to keep all management authority in their hands. The other investors share in profit but not necessarily in proportion to their invested capital.

LLCs have a lot more flexibility than corporations, but this flexibility can have a downside. The owners must enter into a very detailed agreement that spells out the division of profit, the division of management authority and responsibility, their rights to withdraw capital, and their responsibilities to contribute new capital as needed. These schemes can get very complicated and difficult to understand, and they may end up requiring a lawyer to untangle them. If the legal structure of an LLC is too complicated and too far off the beaten path, the business may have difficulty explaining itself to a lender when applying for a loan, and it may have difficulty convincing new shareholders to put capital into the business.

Limiting liability: Professional corporations and LLPs

Professional partnerships — physicians, CPAs, lawyers, and so on — may choose to become *professional corporations (PCs),* which are a special type of legal structure that state laws offer to professionals who otherwise would have to operate under the specter of unlimited partnership liability. States also permit *limited liability partnerships (LLPs)* for qualified professionals (such as doctors, lawyers, CPAs, and dentists), in which all the partners have limited liability.

These types of legal entities were recently created in reaction to large damage awards in malpractice lawsuits against partners. The professionals pleaded for protection from the unlimited liability of the partnership form of organization, which they had traditionally used. Until these types of legal entities came along, the code of professional ethics of the various professions required that practitioners operate as a partnership (or as sole practitioners/proprietors). Today, almost all professional associations are organized as PCs or LLPs. They function very much as partnerships do but without the unlimited liability feature, which is like having the best of both worlds.

Understanding how partnerships and LLCs distribute profits

A partnership treats salaries paid to partners (at least to its general partners) as distributions from profit. In other words, profit is determined *before* the deduction of partners' salaries. LLCs are more likely to treat salaries paid to owner-managers as an expense (as a corporation does). Accounting for compensation and services provided by the owners in an LLC and the partners in a partnership gets rather technical and is beyond the scope of this book.

The partnership or LLC agreement specifies how to divide profit among the owners. Whereas owners of a corporation receive a share of profit directly proportional to the number of common stock shares they own, a partnership or LLC doesn't have to divide profit according to how much each owner invested. Invested capital is only one of three factors that generally play into profit allocation in partnerships and LLCs:

- **Treasure:** Owners may be rewarded according to how much of the *treasure* — invested capital — they contributed. So if Jane invests twice as much as Joe, her cut of the profit may be twice as much as his.
- **Time:** Owners who invest more time in the business may receive more of the profit. Some partners or owners, for example, may generate more billable hours to clients than others, and the profit-sharing plan reflects this disparity. Some partners or owners may work only part-time, so the profit-sharing plan takes this factor into account.
- **Talent:** Regardless of capital and time, some partners bring more to the business than others. Maybe they have better business contacts, or they're better *rainmakers* (they have a knack for making deals happen), or they're celebrities whose names alone are worth a special share of the profit. However their talent impacts the business, they contribute much more to the business's success than their capital or time suggests.

A partnership needs to maintain a separate capital (ownership) account for each partner. The total profit of the entity is allocated into these capital accounts, as spelled out in the partnership agreement. The agreement also specifies how much money each partner can withdraw from his or her capital account. For example, partners may be limited to withdrawing no more than 80 percent of their anticipated share of profit for the coming year, or they may be allowed to withdraw only a certain amount until they've built up their capital accounts. The capital that remains in the partnership is used to operate the business.

Going It Alone: Sole Proprietorships

A *sole proprietorship* is basically the business arm of an individual who decides not to do business as a separate legal entity (as a corporation, partnership, or LLC). It's the default when you don't establish a legal entity.

Describing a sole proprietorship

A sole proprietorship isn't a separate entity; it's like the front porch of a house — attached to the house but a separate and distinct area. You may be a sole proprietor of a business without knowing it! An individual may do house repair work on a part-time basis or be a full-time barber who operates on his own. Both are sole proprietorships. Anytime you regularly provide services for a fee, sell things at a flea market, or engage in any business activity whose primary purpose is to make profit, you're a sole proprietor. If you carry on business activity to make profit or income, the IRS requires that you file a separate Schedule C "Profit or Loss From Business" with your annual individual income tax return. Schedule C summarizes your income and expenses from your sole proprietorship business.

Understanding liability and financial reporting

As the sole owner (proprietor), you have *unlimited liability,* meaning that if your business can't pay all its liabilities, the creditors to whom your business owes money can come after your personal assets. Many part-time entrepreneurs may not know this or may put it out of their minds, but this is a big risk to take. Some part-time business consultants operate their consulting businesses as sole proprietorships. If they're sued for giving bad advice, all their personal assets are at risk — though they may be able to buy malpractice insurance to cover these losses.

Obviously, a sole proprietorship has no other owners to prepare financial statements for, but sole proprietors should still prepare these statements to know how their businesses are doing. Banks usually require financial statements from sole proprietors who apply for loans.

One other piece of advice for sole proprietors: Although you don't have to separate invested capital from retained earnings as corporations do, you should still keep these two separate accounts for owners' equity — not only for the purpose of tracking the business but also for the benefit of any future buyers of the business.

Choosing the Right Legal Structure for Income Tax

When deciding which type of legal structure is best for securing capital and managing their business, owners should also consider the income tax factor. They should know the key differences between the two alternative kinds of business entities from an income tax point of view:

- **Taxable-entity, C corporations:** These corporations are subject to income tax on their annual taxable income. Plus, their stockholders pay a second income tax on cash dividends that the business distributes to them from profit, making C corporations and their owners subject to double taxation. The owners (stockholders) of a C corporation include in their individual income tax returns the cash distributions from the after-tax profit paid to them by the business.
- **Pass-through entities — partnerships, S corporations, and LLCs:** These entities don't pay income tax on their annual taxable income; instead, they pass through their taxable income to their owners, who pick up their shares of the taxable income on their individual tax returns. Pass-through entities still have to file tax returns with the IRS, even though they don't pay income tax on their taxable income. In their tax returns, they inform the IRS how much taxable income is allocated to each owner, and they send each owner a copy of this information to include with his or her individual income tax return.

Most LLCs opt to be treated as pass-through entities for income tax purposes. But an LLC can choose instead to be taxed as a C corporation and pay income tax on its taxable income for the year, with its individual shareholders paying a second tax on cash distributions of profit from the LLC. Why would an LLC choose double taxation? Keep reading. The following sections explain the differences between the two types of legal structures in terms of income taxes. These examples assume that the business uses the same accounting methods in preparing its income statement that it uses for determining its taxable income — a realistic assumption, though there are many technical exceptions to this general rule. To keep this discussion simple, the examples focus on differences in federal income tax, which is much larger than any state income tax that may apply.

C corporations

A corporation that doesn't qualify as an S corporation (explained in the next section) or that doesn't elect this alternative if it does qualify, is referred to as a *C corporation* in the tax law. A C corporation is subject to federal income tax

based on its taxable income for the year, keeping in mind that a host of special tax credits (offsets) could reduce or even eliminate the amount of income tax a corporation has to pay. Suppose a business is taxed as a C corporation. Its abbreviated income statement for the year just ended is shown in Figure 2-1. (See Book IV, Chapter 2 for more about income statements.)

Figure 2-1: Abbreviated annual income statement for a C corporation.

Sales revenue	$26,000,000
Expenses, except income tax	($23,800,000)
Earnings before income tax	$2,200,000
Income tax at 34%	($748,000)
Net income	$1,452,000

Given the complexity and changing nature of the income tax law, the following discussion avoids going into details about income tax form numbers and the income tax rates used to determine the income tax amounts in each example. By the time you read this section, the tax rates probably will have changed, but the following discussion does use realistic income tax numbers.

Refer to the C corporation income statement example again (Figure 2-1). Based on its $2.2 million taxable income for the year, the business owes $748,000 income tax — assuming a 34 percent tax rate for this level of corporate taxable income. (Most of the annual income tax should have been paid in installments to the IRS before year-end.) The income tax is a big chunk of the business's hard-earned profit before income tax. Finally, don't forget that net income means bottom-line profit after income tax expense.

Being a C corporation, the business pays $748,000 income tax on its profit before tax, which leaves $1,452,000 net income after income tax. Suppose the business distributes $500,000 of its after-tax profit to its stockholders as their just rewards for investing capital in the business. The stockholders include the cash dividends as income in their individual income tax returns. Assuming that all the individual stockholders have to pay income tax on this additional layer of income, as a group they would pay $75,000 in income tax to Uncle Sam (based on a 15 percent rate on corporate dividends).

A business corporation isn't legally required to distribute cash dividends, even when it reports a profit and has good cash flow from its operating activities. But paying zero cash dividends may not go over well with all the stockholders. If you've persuaded your Aunt Hilda and Uncle Harry to invest some of their money in your business, and if the business doesn't pay any cash dividends, they may be very upset.

S corporations

A business that meets the following criteria (and certain other conditions) can elect to be treated as an S corporation:

- It has issued only one class of stock.
- It has 100 or fewer people holding its stock shares.
- It has received approval for becoming an S corporation from all its stockholders.

Suppose that the business example presented in the previous section qualifies and elects to be taxed as an S corporation. Its abbreviated income statement for the year is shown in Figure 2-2. An S corporation pays no income tax itself, as you see in this abbreviated income statement. But it must allocate its $2.2 million taxable income among its owners (stockholders) in proportion to the number of stock shares each owner holds. If you own one-tenth of the total shares, you include $220,000 of the business's taxable income in your individual income tax return for the year regardless of whether you receive any cash distribution from the profit of the S corporation. That's likely to push you into a high income tax rate bracket.

Figure 2-2: Abbreviated annual income statement for an S corporation.

Sales revenue	$26,000,000
Expenses, except income tax	($23,800,000)
Earnings before income tax	$2,200,000
Income tax	$0
Net income	$2,200,000

Considering the pros and cons

When its stockholders read the bottom line of this S corporation's annual income statement, it's a good news/bad news thing. The good news is that the business made $2.2 million net income and doesn't have to pay any corporate income tax on this profit. The bad news is that the stockholders must include their respective shares of the $2.2 million on their individual income tax returns for the year.

The total amount of individual income tax that would be paid by the stockholders as a group is tough to pin down. Each investor's tax situation is different. An S corporation could distribute cash dividends to its stockholders, which would provide them with the money to pay the income tax on their shares of the company's taxable income.

Choices regarding taxation

The main tax question concerns how to minimize the overall income tax burden on the business entity and its stockholders. Should the business be an S corporation (assuming it qualifies) and pass through its taxable income to its stockholders, which generates taxable income to them? Or should the business operate as a C corporation (which always is an option) and have its stockholders pay a second tax on dividends paid to them in addition to the income tax paid by the business?

Here's another twist: In some cases, stockholders may prefer that their S corporation *not* distribute any cash dividends. They're willing to finance the growth of the business by paying income tax on the taxable profits of the business — without taking a distribution from the S corporation. This strategy relieves the business of making cash distributions to pay the income tax. Many factors come into play in choosing between an S and C corporation. Choosing the best option isn't easy. Consult a CPA or other tax professional before making your final decision.

Partnerships and LLCs

The LLC type of business entity borrows some features from the corporate form and some features from the partnership form. The LLC is neither fish nor fowl; it's an unusual blending of features that have worked well for many business ventures. A business organized as an LLC has the option to be a pass-through tax entity instead of paying income tax on its taxable income. A partnership doesn't have an option; it's a pass-through tax entity by virtue of being a partnership.

Following are the key income tax features of partnerships and LLCs:

- **Pass-through tax entity:** A partnership is a pass-through tax entity, just like an S corporation.

  When two or more owners join together and invest money to start a business and don't incorporate and don't form an LLC, the tax law treats the business as a *de facto* partnership. Most partnerships are based on written agreements among the owners, but even without a formal, written agreement, a partnership exists in the eyes of the income tax law (and in the eyes of the law in general).

- **Making a choice:** An LLC has the choice between being treated as a pass-through tax entity and being treated as a taxable entity (like a C corporation). All you need to do is check off a box in the business's tax return to make the choice. Many businesses organize as LLCs because they want to be pass-through tax entities (although the flexible structure of the LLC is also a strong motive for choosing this type of legal organization).

The partners in a partnership and the shareholders of an LLC pick up their shares of the business's taxable income in the same manner as the stockholders of an S corporation. They include their shares of the entity's taxable income in their individual income tax returns for the year. For example, suppose your share of the annual profit as a partner, or as one of the LLC's shareholders, is $150,000. You include this amount in your personal income tax return.

Summing up the legal structure issue

Choosing the best legal structure for a business is a complicated affair that goes beyond just the income tax factor. You need to consider many other factors, such as the number of equity investors who will be active managers in the business, state laws regarding business legal entities, ease of transferring ownership shares, and so on. After you select a particular legal structure, changing it later isn't easy. Asking the advice of a qualified professional is well worth the money and can prevent costly mistakes.

Sometimes the search for the ideal legal structure that minimizes income tax and maximizes other benefits is like the search for the Holy Grail. Business owners shouldn't expect to find the perfect answer — they have to make compromises and balance the advantages and disadvantages. In its external financial reports, a business has to make clear which type of legal entity it is. The type of entity is a very important factor to the lenders and other creditors of the business, and to its owners of course.

One other thing bears mentioning here. In this Internet age, many people form their own entities, whether it be a corporation or an LLC, through the assistance of online software and websites, with the assumption that they now have the limited liability asset protection afforded that entity. However, forming an entity and keeping it legal can be a complex task, and every state has different rules. One little misstep can make it easy for the corporate shield to be pierced in the event of a lawsuit. Hire a competent business attorney to make sure you're protected. Consider it a form of insurance.

Chapter 3

Drawing Up a Business Plan to Secure Cash

In This Chapter

- Examining the four basic parts of a business plan
- Creating a business plan, from idea through development
- Including reliable third-party info in your business plan
- Remembering to use data that's complete, accurate, reliable, and timely

Whether a business is a start-up or a mature operation, a clear and concise business plan is an essential tool to assist businesses with securing cash, managing their operations, and protecting their interests.

This chapter provides the basic understanding and tools needed to develop a viable business plan, which is translated into economic value via the production of financial forecasts and projections. The planning process described in this chapter includes numerous elements. This chapter discusses obtaining current market information (on the potential demand for a new product and what price the market will support) and evaluating personnel resources (to ensure that proper professionals are available to support a business). Another issue addressed is determining how great operational constraints (such as manufacturing space availability or environmental regulations) may be in terms of expanding into a new location.

Outlining the Basic Business Plan

All too often companies proceed with strategies anchored in the past instead of evaluating and investigating the markets in which they operate and looking to the future. Management's reason for doing something a certain way often sounds like this: "We've always done it like that" or "This is how the industry has operated for the past umpteen years." Developing a business plan compels management to be more future focused.

A solid business plan should represent management's foundation and justification for birthing, growing, operating, and/or selling a business based on present economic and market conditions and future projections. Without a solid plan, a business is destined to operate by trial and error — an approach that often leads to failure.

Business plans come in a variety of shapes, sizes, forms, and structures and often take on the characteristics of the business founder(s). It may resemble its creators by emphasizing certain traits or areas of expertise the founders have. For instance, a type-A personality may use a number of bold adjectives to describe the massive, huge, unlimited, exceptional potential of a future market opportunity. As for unique areas of expertise, different sections of the business plan may be developed in depth, whereas other sections may be presented in quasi-summary format because the needed information isn't readily available (for presentation).

Herein lies the first lesson of developing a business plan: The business plan should be built from the outside looking in so that any reasonable party can clearly and quickly understand the business concept.

The business plan can come in a multitude of formats and include all types of information, data, graphs, charts, analyses, and more. The basis of every business plan, however, is in four main sections, as explained in the following sections.

The executive summary

The *executive summary* is a brief overview of the business concept in terms of the market opportunity, the operational logistics required to bring a product and/or service to market, the management team that's going to make it happen, the amount of capital needed to execute the plan, and the potential economic return. This section of the business plan is really nothing more than a condensed summary of the entire business concept, presented in a neat and tidy overview of five pages or (hopefully) fewer. The general idea is that the executive summary should capture the critical content of each of the three primary areas of the business plan in an efficient and easy to digest manner.

Although the meat of the business plan resides in the remainder of the document, this section is the most critical in terms of attracting interest from capital sources and/or management. The reader of the business plan must be able to conceptualize, understand, and justify the business concept from the information presented in the executive summary. This section must gain the reader's interest, generate some type of excitement, and move him with a sense of urgency to pursue the business opportunity at hand.

Although the executive summary is the first section of the business plan, consider writing it last, so you can draw information from the other sections of the plan. If you write it first, you're probably going to need to rewrite it later to make it consistent with information in the remaining sections.

The market assessment

The *market assessment* substantiates the present or future need for a product or service that's not being met in the current marketplace. Although this section of the business plan isn't necessarily more important than the others, it takes precedence because without a market for the product or service, a business has no reason to provide it.

You support the business concept by quantifying the size of the market in coordination with qualifying the market need, but that step is only half the battle (and often the easier of the two halves). Beyond providing information and supporting data on the market size, characteristics, and trends, the market assessment must also present a clear understanding of the business's competitive niche, target market, and specific marketing strategies. Identifying the specific niche and target market and developing an effective marketing strategy to capitalize on the opportunity present is often more challenging and critical to the future success of the business venture. And to top it all off, locating reliable and meaningful data essential to supporting your conclusions on the market opportunity can often be difficult.

All marketing sections should include a summary of the competition that savvy entrepreneurs or business managers can use to their advantage in several ways:

- By including an overview of the competition, the business establishes credibility with the readers (because it indicates that you've done your homework).
- By reading in-depth competitor assessments, managers may identify weaknesses in competitors' plans that can be exploited.
- By evaluating competitors' strengths and weaknesses, managers can better understand business risks.

For more about competitive analysis, check out *Competitive Intelligence For Dummies* by Jim Underwood (Wiley).

The operational overview

Following the market segment of the business plan is a well-developed company operating overview. This segment of the business plan addresses a number of operational issues, including personnel requirements, technological needs, locations (for offices, production/manufacturing, warehouses/distribution centers, and so on), company infrastructure requirements, international considerations, professional/expert counsel resources, and the like. This segment drives various business-operating elements in terms of the resources needed to implement and execute the business plan. For example, if a company is planning on expanding into new foreign markets where the local government still "influences" the distribution channels, then the operating segment needs to address how the product will be distributed and which international partners will be essential to the process.

Business plans often dedicate a large portion of the operational overview to providing an overview of the management team. The overview covers the members' past credentials as well as their responsibilities with the new business concept. The market may be ripe and capital plentiful, but without a qualified management team, the business concept will sink more times than not. In today's challenging economic environment, management qualifications and credibility have taken on an entirely new level of importance, given the heightened sensitivity to management accountability and transparency.

The management team responsible for executing the business plan is a key component of the business plan. Initially, financing and capital sources are lured in by business plans and may turn over any concept in the plan to a slew of professionals for further due diligence, reviews, evaluations, and critique. For example, if a capital source has concerns over the technological basis within a biomedical company, then medical- or technology-based professionals can be brought in to complete additional research and analysis and either approve or dismiss the idea. However, the management team standing behind the business plan and its execution is really what the capital and financing sources invest in. The integrity, experience, determination, passion, commitment, and competence of the management team are of utmost importance. Any weakness in this area is likely to drive away investors and their capital.

The financial summary: Performance and required capital

In a sense, the financial summary brings all the elements of the business plan together from an accounting and financing perspective. In the financial summary, financial forecasts project the anticipated economic performance of

the business concept based on the information and data presented earlier in the business plan:

- The market segment drives the revenue portion of the forecasts, because the information accumulated and presented there substantiates items such as potential unit sales growth (in relation to market size), pricing, and revenue sources by product and service.
- The operational overview drives the expense element of the forecast, because it addresses the business cost structure in terms of personnel, assets, company infrastructure, and so on.

You can look at the financial summary as a projected financial report that includes a forecasted income (profit and loss) statement, balance sheet, and cash flow statement. All this information quantifies the capital required to execute the business plan.

Developing a Business Plan

Accounting is more art than science, especially when it comes to developing a business plan. Nobody can tell you precisely what to put into your business plan, but the following sections provide valuable guidance and tools to explain the process and get you started.

Business plans shouldn't be reserved for new companies just starting out or an existing business looking at launching new products. All companies should implement formal business-planning processes to ensure that their business interests are properly managed and protected.

Recognizing the evolution of business plans: BOTE, WAG, and SWAG

The real start of developing any business plan is coming up with the initial concept, idea, or thought. Over time, the plan evolves usually in line with the following progression:

- BOTE: Back of the envelope
- WAG: Wild-ass guess
- SWAG: Scientific wild-ass guess

These acronyms on developing business plans and projections are presented somewhat in jest, but at the same time, they do help you understand the evolution of a business plan and projection model from how an idea is born to how it's communicated in financial language to various parties.

Whether you apply these acronyms and follow this logic or rely on another creation and development cycle, the same key concept holds. Business plans and projection models should continue to evolve, improve, and strengthen over time as more and more effort is invested to bring the idea to life.

BOTE

BOTE usually represents the very first financial projection developed for a business plan: back of the envelope (or back of a napkin at a restaurant). Yes, even the majority of the most astute and experienced business professionals and entrepreneurs can attest to jotting down the basic concepts, needs, potential sales, costs, and profits of a business idea or concept on a random piece of paper (or with a simple mobile communication device application). Sometimes you need to get it out of your head and down in writing just to see whether it makes any sense to begin with. You'd be amazed at how often BOTE estimates are used.

WAG

If the idea passes the BOTE test, the next step in the evolution of the planning process is the ever-present *WAG* (or wild-ass guess). The WAG is somewhat more sophisticated than the BOTE in that it tends to incorporate more thought and some basic research. WAGs are usually produced by using software tools such as Microsoft Excel and incorporate the basic economic structure of the business, starting with sales and then moving through the remainder of the income statement by capturing costs of sales, operating expenses, and overhead or general and administrative costs. You can then draw two simple conclusions:

- How profitable the idea will be
- More importantly, how much capital or cash the idea needs in order to achieve success

These conclusions aren't overly sophisticated, but they're an early attempt to assign numbers to the idea.

SWAG

If your idea has passed both the BOTE and WAG stages, congratulations are in order because you now can use the much more powerful tool, *SWAG* (scientific wild-ass guess) to further the development of your business plan. In other words, the business plan and supporting projection model are actually getting some serious attention and logical consideration. You can begin to use external sources (or third-party data/information) to actually start to substantiate and corroborate the idea's potential. The first real form to the business plan and projection models are taking shape. You may be incorporating the use of technology tools to draft the business plan (for example, Microsoft Word), to build version 1.0 of the projection model (perhaps with Microsoft Excel), and to begin to prepare a presentation to summarize the plan (for example, with Microsoft PowerPoint).

Getting the process going

After the business's executive management teams or new company founders have decided that the concept for the new business endeavor has merit (which is by no means a small task), you can begin drafting the business plan. You can prepare a draft by following four simple steps:

1. **Delve into historical business information.** In order to start the budgeting process, you should have a good understanding of your company's prior financial and operating results. Review as much history as is available and relevant to the current idea, whether it stretches back three months, one year, five years, or longer. Of course if you're planning an entirely new business, the availability of internal historical information is limited, but plenty of external information is usually available from similar businesses.

   

   Remember that although the history of a company may provide a basic foundation on which to develop a budget, by no means is it an accurate predictor of the future.

2. **Involve key management.** You must ensure that all key management team members are involved in the planning process, covering all critical business functions, to produce a reliable projection. The accounting and financial departments actively participate in the planning (and rightfully so, as these are the people who understand the numbers the best) and they produce the final forecast. Critical business data comes from numerous parties and sources, and all of that data must be included in the planning process to produce the most reliable projections possible.

3. **Gather reliable data.** The availability of quality market, operational, and accounting data represents the basis of the budget. A good deal of this data often comes from internal sources. For example, salespeople may pick up on customer needs that aren't being met in the marketplace or a company executive may hear about pending legislation that's likely to lead to new opportunities. With this information and some research, you can begin to determine sales volumes, personnel levels, wages rates, commission plans, and so on.

   The internal information is certainly of value, but it represents only half of what you need, because external information and data are just as critical. Having access to quality and reliable external third-party-produced information is absolutely essential to the overall business planning process and the production of reliable forecasts. Market forces and trends that aren't apparent in internal data may be occurring and set to impact your new business, product, or service over the next 24 months. (For more about gathering information from external sources, see "Incorporating Third-Party Information into Your Plan" later in this chapter.)

4. **Coordinate the start of the planning process.** Most companies tend to start the planning process for the next year in the fourth quarter of their current calendar year. This way, they have access to recent financial results on which to support the budgeting process moving forward.

   The closer the date of the financial data is to when the projection is made, the more detailed the information and results being produced. If you prepare a budget for the coming fiscal year, then you can reasonably include monthly financial statement forecasts (with more detailed support available). Looking two or three years out, you can produce quarterly financial statement projections (with more summarized assumptions), and so on.

When preparing your company's budgets, try to use information that's as complete, accurate, reliable, and timely as possible. Though you can't be 100 percent sure about the data and information gathered for your plan (because by definition, you're attempting to predict the future with a projection), with proper resources (including appropriate internal management, external subject-matter experts or consultants, and allocating financial resources to secure critical information that's not readily available or free), you can avoid large information "black holes."

What worked two years ago may not provide management with the necessary information today on which to make appropriate business decisions. Just ask any retailer that formerly relied on brick-and-mortar stores and print-based advertising campaigns how the Internet and e-commerce have reshaped their business models. Although management has put forth the effort to restructure the company's operations in a changing market environment, a plan based on an old projection model with outdated assumptions doesn't capture the essence of the new market realities. Remember, the planning process represents a living, evolving thing that must constantly be updated and adapted to changing market conditions.

Analyzing and streamlining information with SWOT and KISS

If you're not careful, the data-accumulation process can engulf the entire planning effort. And if you get too much data, you can't digest it or draw any type of meaningful conclusion. Fortunately two simple but powerful planning tools are available to make sense of the data and present it in an easily accessible format: SWOT and KISS.

The SWOT analysis

Strengths, weaknesses, opportunities, and threats: A SWOT analysis is an effective planning and budgeting tool used to keep businesses focused on critical issues that may lead to wonderful successes or horrible failures. The SWOT

analysis should be as comprehensive as possible and capture both relevant information for the specific idea as well as incorporating more broad-based data about the company, the industry, and the competition. The simple SWOT analysis (or matrix) in Figure 3-1 provides a better understanding of how it works.

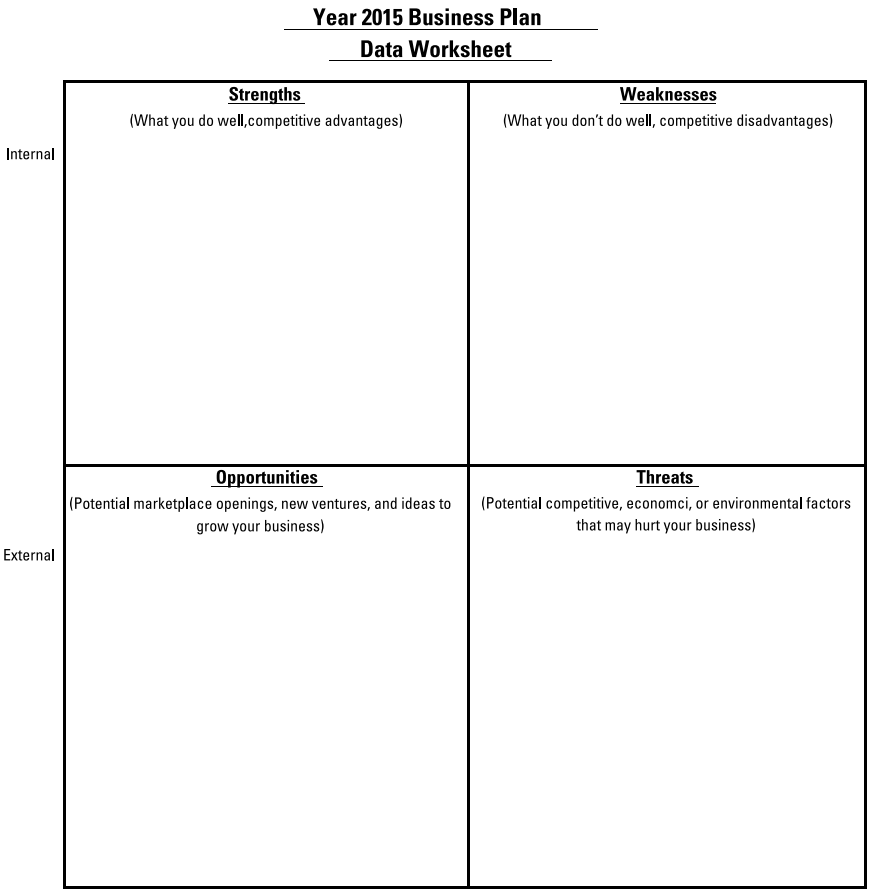

Figure 3-1: A simple SWOT analysis.

A SWOT analysis is usually broken down into a matrix containing four segments. Two of the segments are geared toward positive attributes (for instance, a company's strengths and its opportunities) and two are geared toward negative attributes (weaknesses and threats). In addition to illustrating these categories, Figure 3-1 makes reference to the terms *internal* versus *external.* This distinction highlights the fact that certain attributes tend to come from internal company sources (namely, strengths and weaknesses) and other attributes from external sources (typically opportunities and threats).

Used correctly, a SWOT analysis not only provides invaluable information to support the planning process but also (and more importantly) helps identify the type of management a business has in place. The success of any business plan hinges on having the right leaders driving the bus to take the opportunity from a concept to reality. A frontline manager in need of direction can assist with this process but generally isn't qualified to lead. You need a bona fide businessperson to lead the charge.

A variety of different parties may conduct SWOT analysis. In a larger or well-established business, the management team assigned to complete a project or pursue an opportunity may take the lead. The SWOT analysis is then evaluated and interpreted by the company's executives, who consider whether it's viable and whether the right people are in place. On the other hand, two founders just starting a business may complete a SWOT analysis. When the SWOT is complete, company executives may ask a third-party consultant to review the document. An outside expert can provide management with an unbiased view on whether the analysis is realistic.

Remember to KISS

You know what KISS stands for: Keep it simple, stupid. Used in the marketing world for years, the concept of KISS also applies to business plans. When developing a business plan, be as clear and direct as possible. Summarize the data, use images and graphs wherever necessary to illustrate points, and present clear directives for moving forward. And follow the credo "When in doubt, leave it out." That is, if information isn't essential to making a point, omit it. Don't make the end user of the business plan sift through it to extract meaning.

If you're an executive or owner of a business, you must be able to understand the big picture and the key economic drivers of your company's success in order to prepare proper business plans, strategies, and, ultimately, forecasts. The ability to understand and positively affect the key economic drivers of your business and empower the management team to execute the business plan represents the end game. Getting lost in excessive amounts of detail ("Why did you spend an extra $500 on the trip to Florida?") generally isn't the best use of senior management's time, because every level of detail adds more and more complexity to the plan, which can get overwhelmed with TMI (too much information).

Incorporating Third-Party Information into Your Plan

When building reliable and credible business plans, don't underestimate the importance of accumulating data and information from reliable independent third parties (including various trade and industry sources). The following sections explain how and where to gather the information you need and the importance of starting with solid data.

Gathering the info

Not so long ago, valuable third-party market, industry, and technological information was gathered via archaic methods such as researching in a library, subscribing to trade journals and magazines, and attending seminars or educational trade shows. Today, most of the information you need is available electronically over the World Wide Web, which has improved the efficiency of accumulating information significantly. Most industries' trade organizations now regularly produce and provide content via the web, but you have to be prepared to pay for it, because reliable information costs money.

Incorporate trade shows, seminars, and educational events into your efforts to accumulate third-party data. These events can not only offer a great source of information, but also (and potentially more importantly) be places to make contacts with potential future employees, vendors, customers, and funding sources that can assist with the execution of the business plan.

The third-party information you gather should cover multiple aspects of your business. Following are three examples of data sources for a jewelry company:

- The World Gold Council provides an excellent overview of consumer gold-buying trends and patterns by price points, types of jewelry, and different sales channels. This information can support the marketing segment of the business plan.
- If the production of jewelry is required, then information on available manufacturing sources is needed. Because a large majority of jewelry is produced globally (from Southeast Asia to Europe to Central America), the company needs to make sure that it has a good handle on the political, social, and economic stability of any foreign suppliers.
- In addition, if the jewelry company is going to sell products through retail storefronts, then an overview of commercial real estate rental rates, trends, and so on can be incorporated (for a specific geographical area) to support a critical expense driver in the business.

Riding the CART concept: Complete, accurate, reliable, and timely

During the planning process, evaluate your data to make sure it's complete, accurate, reliable, and timely (CART). Actually, you should apply the concept of CART to all business segments; whether you're developing a business plan, analyzing periodic operating results, or evaluating an employee benefit plan. Business owners and managers must have complete, accurate, reliable, and timely information to make savvy business decisions. Whether the information

and data is coming from internal or external sources, from the marketing or manufacturing departments, the basis of the budget is having access to complete, accurate, reliable, and timely information.

- **Complete:** Financial statements include a balance sheet, income statement, and a statement of cash flows (see Books IV and V for more on these statements). All three are needed in order to understand the entire financial picture of a company. If a projection model is incorporating an expansion of a company's manufacturing facility in a new state (to keep up with rising demand), all information related to the new facility needs to be accumulated to prepare the budget. This info includes the cost of the land and facility, utility costs in the area, potential environmental issues, whether a trained workforce is available, and so on. Overkill isn't the objective; having access to all "material" information and data is.
- **Accurate:** Incorporating accurate data is absolutely essential for preparing the business plan. Every business plan needs to state the price your company charges for the goods or services it sells, how much employees are paid, what the monthly office rent is, what evolving patterns exist in sales channels, and every other relevant detail. Accumulating accurate information, whether from internal sources or external third parties, represents a critical and ongoing management endeavor.
- **Reliable:** The concepts of reliability and accuracy are closely linked, but they differ as well. A piece of information may be accurate without being reliable. For example, you may conduct some research and find that the average wage for a paralegal in San Diego, California, is $24 per hour. This data sounds accurate, but if the business model you're developing requires paralegals with special training who demand $37 per hour, the information isn't reliable.
- **Timely:** Finally, the information and data must be accumulated in a timely fashion. Data provided six months after it was needed doesn't do management much good. Companies live and die by having access to real-time information on which to make business decisions and change course (and forecasts) if needed.

An old phrase that's often quoted, "Don't put the cart before the horse," means you shouldn't buy a cart before you have a horse to pull it; in other words, you should do things in the proper order. However, the CART principle is a case in which the "cart" always needs to come first. You must put the CART information and data before the horse (the business plan). If you attempt to offer a business plan that hasn't been created through CART data, the end result will be nothing short of disastrous.

Chapter 4

Budgeting for a Better Bottom Line

In This Chapter

- Getting up to speed on budgeting fundamentals
- Gathering accurate information and projections
- Drawing up a budget — the essential budget documents

You need accurate information to make smart decisions about your business. A well-planned budget may be the most important piece of information you use. Budgeting is a proactive process. It's the thinking person's accounting. You anticipate future outcomes and can maximize them. You anticipate problems and may be able to minimize or eliminate them. That's a lot better than operating in ignorance and reacting to events as they arise. In this chapter, you look at budgets, consider how to anticipate costs, and work through some essential budget documents.

Brushing Up on Budgeting Basics

A *budget* is a financial plan that includes both financial and non-financial information. Its most obvious features are revenue and expense projections — how much you anticipate earning and spending. The budget can also contain non-financial information, such as how many employees you think you need.

A budget is a forecasting document, but businesses also use it as a financial control tool to monitor activities in their business. One control is to review spending and ensure that you don't exceed your budgeted spending. Often, a company (or a division or a department within it) isn't allowed to spend more than has been budgeted. Budgets cover a specific period of time, most commonly a year, and they look into the future. Although you use historical information to develop a budget, the activities you plan happen in the future.

Meeting the master budget

The *master budget* is a comprehensive picture of your plans for the future and how the plans will be accomplished. It's a summary of your financial and operating plans:

- The *financial plan* (financial statements, really) is what you share with outside parties who need your budgeted information, including lenders, stockholders, and perhaps even government regulatory agencies.
- The *operating plan* (also known as the *operating budget*) is used internally, mostly by managers, to set sales goals and develop their own budgets. You hand out the operating plan to each manager, and the managers implement the plan.

Operating plans can contain non-financial information. Decisions about production, hiring, and selling efforts are components of operating plans.

Understanding key budgeting concepts

Budgeting forces you to plan how to use your assets wisely to generate revenue. (*Assets* are resources, including cash, buildings, machinery, office equipment, and anything else your businesses uses to conduct business.) As you develop your budget, keep the following key concepts in mind:

- **Depreciation:** Long-term assets, such as trucks and machinery, depreciate; that is, they wear out and are worth a little less every day as you use them up. You need to budget for operating costs and depreciation, so you have sufficient cash to replace these assets when they're used up or no longer useful. (Head over to Book III, Chapter 1 for more on depreciation.)

  

  Milk all the revenue you can from an asset before disposing of it, unless maintenance of that asset exceeds the cost of replacing it or a newer model would improve efficiency to the point of at least paying for itself.
- **Opportunity cost:** When you use an asset to manufacture product A, you give up the opportunity to use that asset to produce product B, which would have generated revenue, too. When developing a budget, consider opportunity cost, and make choices on how to use assets that minimize these costs.
- **Cash flow:** When you conduct business, cash flows through your business. It flows in as revenue and flows out as expenses. One of your primary goals when developing a budget is to make sure you have at least as much cash flowing in as you do flowing out. Book V, Chapter 2 goes into more detail on cash flow.

Planning strategically

Whether you're starting a new business, launching a new division or a new product line, or simply preparing for the future, you need to develop a *strategic plan* — your business's road map to the future. The plan reminds you, your employees, and third parties what you do, how you do it, the customers you do it for, and maybe even how you'll do it in a superior way. Your strategic plan summarizes where your business is, where it wants to go, and how it's going to get there.

Your budget, of course, is an important part of strategic planning. The budgeting process forces you to think, make decisions, and come up with reasonable forecasts. You can't sidestep potential negatives, either. That would be like a farmer overlooking the possibility of a drought.

If you're trying to attract financing to fuel your business venture, you'd better have a strategic plan (business plan) in place that lays out exactly how the business is going to generate sufficient revenue to cover its bills and either make payments on its loans or produce a return on any investments in the business. Nobody will lend money or invest in a business without seeing how that business plans to make money.

Strategic planning methods exist in abundance and seem to be a thriving cottage industry. They contain more letters than ten cans of alphabet soup, and include SWOT, PEST, STEER, EPISTEL, ATM, and RCA. Be cautious, and use common sense before embracing a planning methodology. For additional guidance in developing a strategic plan, check out *Strategic Planning For Dummies* by Erica Olsen (Wiley).

Recognizing Factors That Impact Your Budgeting Process

Whether you're developing a budget for a business or a household, one of the biggest challenges is coming up with good ballpark estimates. Consulting a fortune teller or staring into a crystal ball probably won't help. Useful information comes from your experience, what you know about timing, the facts and figures your staff supplies, and your own sales projections.

Experience counts

Business owners with little experience in an industry often plan poorly, in part because they don't have much personal history to go on. Also, some people have trouble accepting the reality of their business prospects. For example, they really want the business to grow 30 percent and can't accept the fact that 10 percent is more realistic.

Consider three brothers who were opening a pizza-parlor franchise. The franchise was successful in other parts of the county. The brothers were opening a store in a new area of town. All good. None of the brothers had any restaurant industry experience. Two of the brothers sold business envelopes, and the third was a professional golfer. Not so good.

The brothers performed an analysis and determined that the profit margin was only 5 percent, barely enough to pay each of them a meager salary. They went forward with the business anyway. Perhaps they thought that 5 percent figure was wrong or that they could somehow increase it. Within a few years, the brothers closed the business. If the brothers had experience in the pizza business, they probably wouldn't have bought the parlor, or they would have at least had more realistic expectations.

Timing is everything

Different business decisions have different timelines that depend, in part, on the dollar amount of the decision you're making. Understanding your timeline helps you make intelligent decisions about spending.

For example, if you decide to use a different supplier for your materials, you could start buying materials from that company immediately. No problem. On the other hand, completing a move into a newly constructed building may take a year or more. You need to consider timelines for your more expensive business decisions. If you're building a new office, determine how long the construction will take. Based on the timeline, you can plan your payments for the building and how you'll generate cash to make the payments.

Explain your timeline in your business plan. If you're providing financial statements (discussed later in this chapter) for one year, you may need to explain payments for a building (asset) that isn't yet completed. It's perfectly reasonable to expect a business to pay for major assets over a long period. Just be sure to explain it to your investors or lenders. You may have a one-year *operating* budget, along with a *capital expenditure budget* for three to five years. The capital expenditure budget is the big-things-I'll-buy-and-pay-for-long-term budget. This budget helps you and others visualize your long-term plans and spending.

People get you headed in the right direction

The budgeting process isn't only about numbers; it also involves people. A budget is something that a group of people typically reviews and eventually comes to an agreement on. Involve people, consider their opinions, and get their buy-in on the budget. If the company's managers don't generally agree on where you're headed in your budget, you may need to revise it.

Talk to your staff. If you're concerned about wasting material in the manufacturing process, talk to people on the factory floor. Maybe you'll find out that poor quality is the reason some material is wasted during production. Maybe some denim you use to make jeans tears too easily, and you need to find a new supplier. You may never find out about that if you don't spend some time on the factory floor.

Talk with the sales staff to plan sales for the year. Good salespeople know their clients. They may know about a client's purchasing plans for next year. They may even know a client's budget to buy your product! Also, a good salesperson knows the customer's financial condition. If the customer's business is growing, he or she may buy more from you. If the business is in financial trouble, sales may decline.

Have a conversation with the accountant during planning. She knows how cash flow turned out last year. You can look at the data on how quickly you collected cash for sales. Also, your attorney may remind you of any legal issues that could possibly generate expenses during the year. There may be costs for legal services or costs to settle litigation. Those costs require cash, and you need to include them in your plan.

When your budget is in good shape, present it to your staff and explain where the company is headed. They'll feel more confident knowing the company's direction and prospects, especially if they played a role in developing the budget.

Sales projections pay off

Sales projections help answer the question of how you earn a reasonable level of profit. Of course, the answer is complicated if competitors are selling the same product or service, because it suggests you may have to lower prices to stay competitive. If you want to cut prices to attract business, you need to plan your costs so your profit level remains reasonable. Another possibility is to improve the design of your products and not change prices.

If you do that, you add the cost of design to product costs. But increased sales without cutting prices may offset the cost of design.

Good planning is useful, and poor planning leads to projections (of profit, sales, and company growth) that aren't useful. If you base decisions on inaccurate projections, you're likely to use assets in ways that won't maximize your profits. Simply put, you end up spending time and money on the wrong activities.

Coming up with accurate sales projections often begins with market research. Suppose you're selling running shoes in the United States, and you discover that 10 million people buy running shoes each year in the U.S. On average, they spend $80 for a pair. Fortunately, you've priced your shoes at $78, so you're right around the average.

Next, you estimate that your firm can capture 10 percent of the U.S. running-shoe market. That means a total sales volume of 10 percent of a 10 million-unit market, or 1 million units sold in a year. At $78 a pair, you project your sales to be $78 million. Finally, you consider whether the market is growing or shrinking. If the running-shoe market is growing at 10 percent per year, you could reasonably increase your sales projection by 10 percent each year, also. Of course, market growth is impacted by the overall economy and the specific industry (sporting goods, in this case). Competitors may also impact your growth. You'd need to project all these contingencies before coming up with a reasonable sales forecast.

The sales growth rate drives decisions about spending, employee hiring, and cash planning. If you're selling 30 percent more, you can plan to increase your spending and hire employees to manufacture 30 percent more of your product. You also probably can expect a 30 percent increase in cash inflow as a result of growth.

But wait! If a more careful review indicates 10 percent growth, your 30 percent projection creates some problems for you. You increased your spending and hiring assuming the 30 percent level, but the sales and cash inflows will only come in at 10 percent. Put simply, you're planning on spending 20 percent too much. Whether you're building homes or selling running shoes, the numbers still apply.

The Nuts and Bolts of Budgeting

Begin the budgeting process by deciding which company entities require a budget and how detailed it needs to be. You may decide to develop a budget for the entire company or for each division or department within it.

In budgeting, you begin with some assumptions. The assumptions are called *standard costs* and are the specific planned levels of cost and activity. For example, you may assume a standard labor rate (cost) of $20 per hour for

a sewing-machine operator. You may assume a standard material rate of $75 per square foot for marble for kitchen countertops.

When you create your budget (based on reasonable assumptions) and start the year's business, you have actual costs and levels of activity to review. A difference between an actual cost and standard cost is a *variance.* A variance is a scorecard that tells you how close your budget assumptions were to actual results. Fortunately, you can make modifications to your budget to deal with variances. (See Book VII, Chapter 4 for more about variance analysis.)

Understanding the budgeting financials

Your budget becomes a set of *pro forma* financial statements. Pro formas are what-if statements, filled with budgeted, planned, and forecasted items. Unless you have a crystal ball, your budget is always a collection of educated best guesses about the future.

To keep things simple, a budget uses three basic financial statements: the balance sheet, the income statement, and the statement of cash flow (head over to Books IV and V for more on financial statements). Another aspect is an explanation of your source of funds.

Source of funds

Your budget determines whether you have enough funds to run your business. Hopefully, you get all the money you need from selling products or services, but that's not always the case.

The *financial plan* (also loosely called the *business plan*) explains the source of funds to run the business. You can raise money by borrowing cash (debt) or by offering investors ownership in the business (equity) in exchange for cash. (See Chapter 1 for guidance on raising funds.) For now, consider how you budget for the process.

If you borrow, you repay a creditor the original amount borrowed (principal) and interest on the loan, usually on a written schedule. The interest cost and principal repayment must be included in the budget.

You can also raise funds by selling ownership in your business, offering investors equity. Equity investors are rewarded in two ways: *stock appreciation* and *dividends.*

The most common way to sell ownership is to sell common stock. Investors expect you to explain (through your budget) how you plan to generate a profit for the year. If the company is profitable, the value of their ownership in your business increases. They could eventually sell their ownership interest to someone else for a profit.

You also need to consider whether to pay dividends. *Dividends* are a share of the profits earned by the company paid to equity investors. Of course, without any company earnings, you can't pay dividends.

Using the balance sheet

The *balance sheet* lists the company's *assets, liabilities,* and *equity* (essentially the difference between assets and liabilities) as of a certain date. Think of the actual balance sheet as a snapshot in time; think of the budgeted balance sheet as a pretty good estimate of the actual financial statement.

Liabilities are claims on your assets. A *liability* means that you owe someone money. Liabilities include items such as unpaid utility bills and payroll costs you haven't yet paid. Future interest and principal payments on a loan are also liabilities. When you pay a liability, you use an asset (cash, in most cases) to make payments.

This gets you to the balance sheet equation, introduced in Book I, Chapter 1:

Assets – Liabilities = Equity

Consider this scenario: Assume you own a little shop. You sell all your assets — your inventory, furniture, and your building. You use the cash you receive to pay off all your liabilities — utility bills, payroll, and bank loan. Whatever cash remains after you pay off your liabilities is your equity. Equity is the true value of your business. So now you can see the logic behind the balance sheet formula: Assets less liabilities equals equity.

Working with the income statement

The *income statement* shows revenue, expenses, and net income (profit) or loss. For most business owners, the income statement is the most important report. It shows whether a business was profitable over a period of time (such as a month, quarter, or year), whereas the balance sheet shows assets, liabilities, and equity as of a specific date. The nice thing about modern accounting software is that it can generate an income statement almost instantly. Think of the budgeted income statement as a pretty good projection of your company's sales, expenses, and profit.

The income statement formula is incredibly simple:

Revenue – Expenses = Net income or loss

Analyzing the statement of cash flows

The *statement of cash flows* analyzes sources of cash (cash inflows) and uses of cash (cash outflows) over a period of time. Stroll over to Book V, Chapter 2 for more on cash flows. Cash flows are grouped into three categories:

operating, financing, and investing activities. When an accountant puts together a cash flow statement, she reviews every transaction that affected cash. A very simple model is what's in your checkbook. If inflows are good, you probably have enough cash to operate. If the checkbook shows that you're overdrawn, outflows have exceeded inflows, and you've got trouble.

The goal is to assign every cash transaction to one of three categories, although most of your cash activity is in the operating activities section. To simplify the process, find the financing and investing activities first — because they represent fewer transactions. The remaining transactions are operating activities.

The three cash flow categories are:

- **Operating activities** occur when you run your business each day. You buy material, pay for labor, ship goods, pay interest on loans, and collect cash from customers.
- **Financing activities** occur when you raise money for your business, and when you pay lenders or investors. You receive cash when you sell equity, and you receive cash when you borrow. You pay cash when you pay dividends, and you pay cash when you pay down a loan (pay back some of the principal).
- **Investing activities** occur when you buy or sell assets. Writing a check for a new vehicle and receiving cash when you sell equipment are investing activities.

The statement of cash flows lists the beginning cash balance; all the cash activity for the period, grouped into three categories; and the ending cash balance:

> Ending cash balance = Beginning cash balance +/– Net cash flow of operating activities +/– Net cash flow of financing activities +/– Net cash flow of investing activities

A simpler formula is

> Ending cash balance = Beginning cash balance + Cash inflows for the period – Cash outflows for the period

The ending cash balance in the statement of cash flows equals the cash balance in the balance sheet (well, it's supposed to, anyway). For example, if the statement of cash flows is for March, the ending cash balance should equal the balance sheet cash balance for the last day of March.

When you create your budget, it should include all three financial statements (balance sheet, income statement, and statement of cash flows).

Reviewing revenue and production budgets

Revenue and production budgets, put simply, forecast how many units you plan to produce and how many units you plan to sell.

Say you're budgeting to manufacture garage doors. You need to forecast how many sales you expect. Then consider how many garage doors you already have in inventory and plan how many you need to manufacture to meet the sales forecast. Ta da! When you know the number of doors you need to make, you can budget for material and labor costs. Material and labor costs are considered *direct costs,* because they can be traced directly to your product.

Indirect costs are those that can't be directly traced to the product. Repair and maintenance costs for a machine, for example, are indirect costs. You may assign these costs by dividing the total cost incurred by the number of hours the machine ran during the month. That would give you a rate per machine hour. If you incur two hours of machine time to make one unit of product, you would multiply two hours by the machine rate per hour. That indirect cost total would be added to the unit of product.

Revenue, production, inventory, direct materials, direct labor, indirect costs (overhead), and cost of goods sold all are budgeted items.

Applying the revenue formula

Suppose you forecast selling 200 garage doors in March. Consider how many garage doors you need to manufacture. Assuming a sales price of $300 per door, here's your revenue budget:

Revenue budget = 200 units × $300

Revenue budget = $60,000

Using the inventory formula

And now for the famous inventory formula:

Ending inventory = Beginning inventory + Production – Sales

Your production will change based on how many garage doors you already have in inventory. So if you already have 75 completed garage doors in beginning inventory, you won't need to manufacture all 200 units you plan to sell. (For more about inventory, see Book II, Chapter 2.)

But wait! Do you want any garage doors in ending inventory? If you think you'll have orders during the first few days of the next month, you probably want to have at least a few garage doors left at the end of this month. So maybe you decide on an ending inventory of 50 garage doors.

Take the inventory formula and calculate the garage door production you need. Assume x is production in units, and solve for x:

Ending inventory = Beginning inventory + Production – Sales

$50 = 75 + x - 200$

$50 - 75 + 200 = x$

$x = 175$

This simple algebra problem shows that production should be 175 units. Table 4-1 shows a production budget.

Table 4-1 Garage Door Production Budget

Cost	*Quantity*	*Price*	*Total*
Direct material (wood)	80 square feet	$1 per square foot	$80
Direct labor (labor)	2 hours	$25 per hour	$50
Indirect costs allocated	1 hour	$15 per hour	$15
Cost per unit			**$145**
	Units	**Unit cost**	**Total cost**
Production cost	175	$145 (above)	**$25,375**

The production budget includes direct materials, direct labor, and indirect costs (overhead). In this example, the indirect cost is allocated based on machine hours. Add the costs to get a unit cost. Then multiply units to be produced by the cost per unit. That amount is the total cost of production of $25,375.

Assessing cost of goods sold

The goods you produce for customers end up in one of two places: You either sell them (cost of goods sold), or they're still on the shelf (finished goods inventory). Beginning inventory and production don't matter.

What costs should be attached to the goods you sell? How much did they cost to produce? (If you're a retailer, how much did they cost to get?) To continue with the garage door manufacturing example, assume the first goods you sell are from beginning inventory. Because all 75 units of beginning inventory are sold, use a formula to determine how many units of the March production are sold:

March production sold = Total sales – Beginning inventory

March production sold = 200 – 75

March production sold = 125

Assume also that the cost per unit of beginning inventory is $143. That cost is different from the March production cost of $145. (Why the change? Because the costs of materials and labor to make a garage door rose.) Table 4-2 displays the cost of goods sold budget.

Table 4-2 Garage Door Cost of Goods Sold Budget

	Units	*Cost Per Unit*	*Total Cost*
Beginning inventory	75	$143	$10,725
March production sold	125	$145	$18,125
Total	200		$28,850

The total cost of goods sold is higher ($28,850) than total production cost in Table 4-1 ($25,375). That makes sense, because Table 4-1 deals only with producing 175 units. You sold 200 units, but 75 units were from inventory. Because of adjustments for beginning and desired ending inventory, you don't always need to produce in a month the number of units you sell in a month.

One more calculation. (There's always one more calculation.) Now calculate your ending inventory budget:

Ending inventory budget = Units × Per unit cost

Ending inventory budget = 50 × $145

Ending inventory budget = $7,250

You've planned revenue, production, and inventory. Great! Now you need to figure out how to pay for it all. If you don't have a budget for an adequate cash amount to operate, you can't do business. See Chapter 5 for guidance.

Chapter 5

Mastering and Flexing Your Budgeting

In This Chapter

- Applying accrual accounting to the budget process
- Producing a budgeted income statement and balance sheet
- Creating a flexible budget

You can master budgeting basics and figure out how to budget for sales and production in Chapter 4. Then you're ready to tackle more detailed aspects of budgeting, weigh the pros and cons of budgeting with cash-basis or accrual accounting, and develop a flexible budget.

This chapter explains how to use the information from your budget for sales and production to create a budgeted income statement and balance sheet. It also reveals how to put together a flexible budget that accommodates different levels of production. But the first order of business is to understand why accountants use accrual rather than cash-basis accounting to create budgets.

Budgeting with Cash or Accrual Accounting

Nearly every large corporation uses accrual accounting both to record transactions and to budget. Small businesses have a choice: They can use cash basis accounting or accrual basis accounting:

- **Cash basis accounting** posts revenue and expenses to the financial statements based solely on cash transactions. Nothing happens until you take cash in or pay it out. It's a simple way of doing things — no accounts receivable and no accounts payable.

- **Accrual basis accounting** states that expenses are matched with revenue, regardless of when cash moves in or out of the checkbook. The accrual basis is a better method to account for profits, because revenue and expenses are matched more precisely. See the section "I accrue, you accrue, we all accrue with accrual accounting."

You can use either method to produce a budget, but accrual is better and is used by all large organizations. (See Book I, Chapter 4 for more about cash and accrual accounting.) This section discusses these concepts in the context of the budgeting process.

A useful budget uses accrual accounting, which matches revenue with expenses. Using the cash method — budgeting based on cash inflows and outflows — doesn't provide an accurate picture of your budgeted profit level.

Cash basis accounting: Using your checkbook to budget

On a very basic level, your cash budget is a reflection of your checkbook. It's the sum of the deposits you make (revenue) and the checks you write (costs). The budgeting result of cash basis accounting is a *cash budget.*

Such a budget assumes that all your customers pay for sales in cash during the month of sale and that you pay all costs during the month that the goods are sold. This scenario is highly unlikely for most businesses.

It's more likely that you write a check in February for materials for a product you sell in April. Similarly, you may pay an employee in December for work to make a product that's sold in January.

Assume you own a shop that sells greeting cards, flowers, and gifts. Your beginning cash balance for the month is $100,000. Table 5-1 displays a cash budget for a gift shop.

Table 5-1 Gift Shop Cash Budget — Month of March

	Amount
Beginning cash balance	$100,000
Add customer payments for sales	$50,000
Less:	
Inventory purchases	$20,000

	Amount
Payroll costs	$10,000
Utilities costs	$1,000
Lease cost	$3,000
Ending cash balance	$116,000

This cash budget has a $16,000 increase in cash during the month ($116,000 – $100,000). You had $50,000 in sales. If you hadn't collected any cash from customers during March, your cash balance would decrease by $34,000, the total of all the cash outflows. If that happened, you'd start the next month with $34,000 less cash. You need to consider whether your April cash budget (next month) would work with a lower beginning balance in cash. You don't want to start in the red.

If you don't think you'll have enough cash for a period, you can consider how to get it.

The cash budget is similar to the statement of cash flows. Table 5-2 shows an example statement of cash flows for the gift shop.

Table 5-2 Gift Shop Budgeted Statement of Cash Flows

	Amount
Beginning cash balance	$100,000
Cash flow from operations	$16,000
Cash flow from financing	$0
Cash flow from investing	$0
Ending cash balance	$116,000

Note that the beginning and ending cash balances in Table 5-2 agree with the cash budget ($100,000 at the beginning and $116,000 at the end). The cash flow calculation from operations is

Net cash inflow from operations = Customer payments – Cash outflows

Net cash inflow from operations = $50,000 – $34,000

Net cash inflow from operations = $16,000

All the cash flows for the gift shop are related to day-to-day operations. None of the cash activity is related to financing or investing.

I accrue, you accrue, we all accrue with accrual accounting

An effective budget applies the *matching principle.* The principle states you should match the timing of the expenses of creating and delivering your product or service with the timing of getting revenue from the sale. This is *accrual basis accounting* (as opposed to *cash basis accounting*). *Accrual accounting* ensures that revenue is more precisely matched with the expenses incurred to generate revenue.

With accrual accounting, when you create an invoice, the accounts receivable (A/R) system generates a *receivable,* even though the customer may not pay for, say, 30 days. When the payment arrives, the receivable is adjusted to zero, meaning it's been satisfied by the payment. Accrual accounting is considered to provide a more accurate reflection of business activity than cash accounting. By the way, the system still allows for straight cash sales — where you sell *now* and the customer pays *now.*

The same is true of purchases you make. When you buy now and pay later, you create a *payable.* When the bill comes and you pay it, the payable is adjusted to zero. Of course, the system allows you to make straight cash purchases — where you buy and pay your vendor *now.*

Suppose you manage a catering business. The food, preparation cost, and delivery expenses related to the Jones family reunion should be matched with the revenue from the Jones family. Ideally, you want the expense and the revenue to be posted in the same time period. You wouldn't want the Jones expenses posted in March and the Jones revenue posted when they paid (say, in April). That's not the best reflection of your business activity.

The downside of accrual accounting is that your income statement revenue and expenses rarely match your cash inflows and outflows. You can be rich in receivables and darned poor in cash. But most companies still prepare a cash flow statement even if they're using accrual accounting.

Budgeting to Produce the Income Statement and Balance Sheet

A final step in the budgeting process is to create a budgeted balance sheet and budgeted income statement. Your balance sheet and income statement, whether budgeted or actual, are the two great financials. They reflect the bottom line, showing how the business is doing.

The well-balanced balance sheet

Your balance sheet is a fine indicator of business health. Table 5-3 shows a healthy balance sheet.

Table 5-3 Budgeted Balance Sheet

	Amount
Assets	$100,000
Less liabilities	$50,000
Equals equity	$50,000

As you review your balance sheet budget, keep in mind the goal is to maintain enough assets to run your business, which includes production (if you make things), buying inventory (if you're a retailer), or employing people (for manufacturing, retailing, or service businesses).

The balance sheet should include assets needed for selling and distributing your products. Managing your business generates liabilities, too (accounts payable, long-term debt, and so forth). That's okay, as long as you have a plan to pay them.

If revenue doesn't supply you enough of the best asset — cash — you need a plan to raise capital. Capital represents an investment in your business. If a business owner invests $20,000 into his business, the $20,000 is considered capital for the business. That means you're probably either issuing debt (taking out a loan) or selling equity (shares of the company) to stockholders.

The incredible income statement

Most business owners are most interested in the income statement. The owner typically plans this budget document first.

Table 5-4 shows a budgeted income statement that projects a healthy net income.

Table 5-4 Budgeted Income Statement

	Amount
Revenue	$50,000
Less expenses	$25,000
Equals net income	$25,000

Here's the thought process: You figure out how much revenue the company can generate. Then you subtract likely expenses from the revenue, and the result is your net income. After that, think about how cash will "move" (the cash flow statement) and where your company will get sufficient assets to operate (the balance sheet).

As you move forward in managing your business, don't be surprised if cash flow becomes the most important budget item for you. Without enough cash flow, not much happens.

Flexing Your Budget: When Plans Change

Regardless of how carefully you budget, plans may change. Assume you plan a cross-country family camping trip. You diligently create a budget spreadsheet based on your research and assumptions. Unfortunately, nearly everything costs more than you estimated.

A 30-percent increase in the price of gas adds more than $1,000 to the cost of the trip. And although you timed the trip to drive 600 miles per day, you don't take into account stops for coffee, restrooms, or motion sickness.

As the road trip attests, budgets don't have to be set in stone. This section explains how to use flexible budgets to manage your business's operations.

Controlling your business

Budgeting helps you plan your business's operations. However, you also need to *control* your business — to monitor what's actually happening. Controlling involves constantly comparing actual activity to your budget and carefully analyzing and understanding any differences. To accomplish this task, you need budget reports that compare your budgets (what should have happened) to what actually happened.

For example, suppose your company budgeted $100,000 for sales in the first quarter. Actual sales for the quarter fall short, at only $70,000. First, call the sales manager to find out what happened. (Maybe a computer snafu accidentally canceled customer orders.) Then, take corrective action. (Fix your computer and call your customers to apologize.) Finally, adjust your future plans. (Cut next quarter's production estimates.)

Chapter 4 provides the basic template for budgeting, offering projections for sales, expenses, production levels, and cash flows to help you plan for future periods. However, its major flaw is that it's *static* — it projects only one scenario based on a single set of sales estimates. It can't change.

Therefore, a $30,000 difference throws off more than just your sales budget. It also necessitates changing your production, purchases, direct labor, overhead costs, and selling and administrative expenses, ruining the entire planning process and making it impossible for you to make future comparisons between your budgets and actual results.

Enter the flexible budget. As activity levels change, you can easily adjust a flexible budget and continue to use it to plan and control your business.

Dealing with budget variances

One of the benefits of flexible budgeting is that it helps you to understand the reasons for your company's *variances,* the differences between actual and budgeted amounts. Chapter 4 introduces the concept of a variance. The next section gives you the lowdown on the flexible budgeting process, but first you should delve a little deeper into the issue of variances.

Always indicate whether a variance is favorable or unfavorable. A variance is usually considered *favorable* if it improves net income and *unfavorable* if it decreases income. Therefore, when actual revenues exceed budgeted amounts, the resulting variance is favorable. When actual revenues fall short of budgeted amounts, the variance is unfavorable. On the other hand, when actual expenses exceed budgeted expenses, the resulting variance is unfavorable; when actual expenses fall short of budgeted expenses, the variance is favorable.

Management should investigate the cause of significant budget variances. Here are some possibilities:

- **Changes in conditions:** For example, a supplier may have raised prices, causing the company's costs to increase.
- **The quality of management:** Special care to reduce costs can result in favorable variances. On the other hand, management carelessness can drive up unfavorable variances.
- **Lousy budgeting:** An unrealistically ambitious budget is likely to cause unfavorable variances.

Many managers use a system called *management by exception.* They investigate the largest variances, whether favorable or unfavorable, and ignore the rest. This strategy helps managers prioritize potential problem areas in operations.

Implementing a flexible budget

To compute variances that can help you understand why actual results differed from your expectations, creating a flexible budget is helpful. A *flexible budget* adjusts the budget for your actual sales or production volume. For example, your budget may have assumed that you'd produce 5,000 units; however, you actually produce 5,100 units. The flexible budget accommodates this new number, making all the appropriate adjustments to sales and expenses based on the unexpected change in volume.

To prepare a flexible budget, you need to have a budget, really understand cost behavior, and know the actual volume of goods produced and sold.

Consider Kira, president of the fictional Skate Company, which manufactures roller skates. Kira's accountant, Steve, prepares the overhead budget shown in Figure 5-1.

Skate Company
Overhead Budget
For the Year Ended December 31, 2015

Budgeted production	100,00	units
Indirect materials	$50,000	
Indirect labor	40,000	
Supervisory salaries	100,000	
Rent	80,000	
Utilities	40,000	
Depreciation	20,000	
Total overhead	$330,000	

Figure 5-1: Skate's static overhead budget.

Skate had a great year; actual sales came to 125,000 units. However, much to the disappointment of Steve and Kira, the overhead budget report, shown in Figure 5-2, reports major overruns. For each category of overhead, Steve computes a variance, identifying unfavorable variances in indirect materials, indirect labor, supervisory salaries, and utilities.

Skate Company
Overhead Budget Report
For the Year Ended December 31, 2015

	Budget	Actual	Variance	Favorable / Unfavorable
Production (units)	100,000	125,000		
Indirect materials	$50,000	$60,000	($10,000)	Unfavorable
Indirect labor	40,000	45,000	(5,000)	Unfavorable
Supervisory salaries	100,000	105,000	(5,000)	Unfavorable
Rent	80,000	80,000	-0-	
Utilities	40,000	45,000	(5,000)	Unfavorable
Depreciation	20,000	20,000	-0-	
Total overhead	$330,000	$355,000	($25,000)	Unfavorable

Figure 5-2: Skate's overhead budget report.

Skate's total overhead exceeds budget by $25,000. Steve makes the elementary mistake of treating variable costs as fixed. After all, portions of overhead, such as indirect materials, appear to be variable costs. If Skate increases production from 100,000 units to 125,000 units, these variable costs should also increase. In other words, comparing the $60,000 actual indirect cost of making 125,000 units to the $50,000 budgeted indirect cost of making just 100,000 units makes no sense. You're comparing apples and oranges. Different levels of activity (units) generate a different level of variable costs (indirect costs).

Instead, Steve should flex the budget to determine how much overhead he should have, assuming that the company makes more or less than the budgeted number of units. The following sections show you how.

Separating fixed and variable costs

Some costs are *variable* — they change in response to activity levels — while other costs are *fixed* and remain the same, regardless of activity level. For example, direct materials are variable costs because the more goods you make, the more materials you need. On the other hand, some overhead costs, such as rent, are fixed; no matter how many units you make, these costs stay the same. To determine whether a cost is variable or fixed, think about whether or not the total cost changes when the level of activity changes.

For Skate, an analysis indicates that indirect materials, indirect labor, and utilities are variable costs. On the other hand, supervisory salaries, rent, and depreciation are fixed. Steve recomputes variable costs with the assumption that the company makes 125,000 units, as shown in Figure 5-3.

	Original Budget	Variable Cost per Unit	Flexible Budget
		Original budget/ 100,000	Average cost x 125,000
Production	100,000 units		125,000 units
Indirect materials	$50,000	$0.50	62,500
Indirect labor	40,000	0.40	50,000
Utilities	40,000	0.40	50,000
Total	$130,000	$1.30	$162,500

Figure 5-3: Flexing variable overhead costs.

In the original budget, making 100,000 units results in total variable costs of $130,000. Dividing total cost of each category by the budgeted production level results in variable cost per unit of $0.50 for indirect materials, $0.40 for indirect labor, and $0.40 for utilities.

To compute the value of the flexible budget, multiply the variable cost per unit by the actual production volume. Figure 5-3 indicates that the variable costs of producing 125,000 should total $162,500 (125,000 units × $1.30).

Comparing the flexible budget to actual results

The final step is to combine the variable and fixed costs in order to prepare a new overhead budget report, inserting the new flexible budget results into the overhead budget report as shown in Figure 5-4.

Skate Company
Overhead Budget Report (Flexible)
For the Year Ended December 31, 2015

	Flexible Budget	Actual	Variance	Favorable/ Unfavorable
Production (units)	125,000	125,000		
Variable Costs				
Indirect materials	$62,500	$60,000	$2,500	Favorable
Indirect labor	50,000	45,000	5,000	Favorable
Utilities	50,000	45,000	5,000	Favorable
Total variable costs	$162,500	$150,000		
Fixed Costs				
Supervisory salaries	100,000	105,000	(5,000)	Unfavorable
Rent	80,000	80,000	-0-	
Depreciation	20,000	20,000	-0-	
Total fixed costs	$200,000	$205,000		
Total overhead	$362,500	$355,000	$7,500	Favorable

Figure 5-4: Skate's flexible overhead budget.

Look at that! After you adjust for the change in production level, Skate's variance is suddenly favorable. Actual overhead of $355,000 was $7,500 less than the $362,500 flexible budget.

Chapter 6

Planning for Long-Term Obligations

In This Chapter

- Discovering how a company raises cash
- Identifying long-term liabilities
- Accounting for notes payable
- Reporting gain or loss on debt extinguishment
- Considering bonds

If you own a car or house you financed, you're probably all too familiar with *long-term debt:* loans that won't be paid off by the end of the next 12-month period. Well, companies have long-term debt, too. A company usually uses current debt as a vehicle to meet short-term obligations like payroll and incurs long-term debt to finance company assets.

This chapter gives you the lowdown on two types of long-term debt: notes and bonds payable. *Notes payable* are debt a company takes on typically through lending institutions, such as banks, to finance asset purchases. Asset purchases include cars, equipment, and buildings. *Bonds payable* are typically issued by hospitals and municipalities to fund expansion (although corporations can issue them too). Here you find out all you need to know about this complicated topic.

Managing Long-Term Debt

An immutable fact of running a business is that at some point the company will have to take on long-term debt to grow its operations. After all, unless the business owners are running the business just for fun, they want to expand operations in the hopes of making more money.

The way you structure long-term debt affects the expense of borrowing the money. When you finance a vehicle or home purchase, you probably shop around for interest rates and evaluate the options of financing the loan for a shorter or longer term. Businesses do the same, but they may carry millions of dollars of debt on their balance sheet, and they have to service this debt. *Debt service* is the process of making principal and interest payments on debt. Managing the debt service is crucially important because minute differences in terms can have a large effect on interest and the bottom line.

A company may raise cash to purchase assets, expand existing operations, or maybe even buy another company. If the firm decides to do so by accumulating long-term debt, management evaluates the relative merits of available forms of long-term debt. The most common types of long-term debt are mortgages, notes payable, and bonds payable. The next few sections discuss mortgages and notes payable. See "Accounting for Bonds," later in this chapter, for coverage of bonds.

The many faces of notes payable

Notes payable are formal written documents that spell out how money is being borrowed. This type of agreement between a lender and a borrower specifies *principal* (amount borrowed), *rate* (interest percentage the company pays to borrow the money), frequency of payments, and *term* (the amount of time the company has to pay off the loan).

Notes payable are issued in three different ways: face; no-face, no-interest; and no-face, interest. These terms may make lending and borrowing seem like a silly game of peek-a-boo, so take a look at their definitions in the following sections.

Keep in mind that *face* refers to *face amount* — a specific dollar amount stated on the face of the note payable. It represents the principal amount that the borrower must repay. The note payable document should list everything that the borrower and lender need to know about the liability, including the principal amount owed.

Face

Face is the easiest type of note to account for. With this type of note, the present value of the note payable is the same as its *face,* which is the amount stated on the note. (For more about present value, check out Book V, Chapter 1.) This sameness results because the *effective* interest rate, which is the market interest rate, and the *stated* interest rate (what's printed on the face of the note payable) are the same.

Market is the interest rate for a note of similar risk. The level of risk refers to the creditworthiness of the borrower — the ability to repay principal (face amount) and interest on time. For example, if one company loans another company $5,000 at an effective and stated rate of 10 percent due in three years, the journal entry for the borrower to record issuance of the note is to debit cash and credit notes payable for $5,000.

Each year, the borrower records interest expense at $500 ($5,000 × 0.10). The journal entry is to debit interest expense and credit cash for $500. When the company pays off the debt at the end of the three years, the borrower records a credit to cash and a debit (reduction) to notes payable for $5,000.

No-face, no-interest

A no-face, no-interest note payable is issued for the present value of the amount the borrower receives from the lender, which is less than the face value (future value) of the note. The difference between the face value and present value of the note is called a *discount,* which represents the total interest to be paid over the life of the loan.

To determine the present value of the amount borrowed and figure the discount, use a present value of $1 table. This table assumes a single payment and that you need to compute the present value of that payment. Search the web to find present value tables for a single payment and for multiple payments (annuities). Take the following steps, which assume a single payment:

1. **Using a present value of $1 table, find the factor at the intersection of the loan percentage and period, as shown in Table 6-1.** For example, for a five-year loan at 8 percent annual interest, skim down the Periods column (on the left) until you find 5, and then follow that row to the right until you hit the 8.00% column. In this case, the factor inside the intersection of row 5 and column 8.0% is 0.6805. If the decimal is extended one more place, the more precise factor is 0.68058. Use that more precise factor for this analysis.
2. **Multiply the present value factor you found in Step 1 by the future value of the loan amount to find the present value.** In this example, the face amount (future value) of the loan amount is $20,000, so to find the present value of $20,000, take $20,000 × 0.68058 = $13,611.60 (rounded to $13,612). This is the present value of $20,000, discounted at 8 percent for five years.
3. **Subtract the present value from the future value to determine the discount.** The discount is $20,000 face amount (future value) – $13,612 (present value) = $6,388.

Figure 6-1 shows how to journalize this transaction.

Table 6-1 Present Value of $1 Lookup Table

Periods	*7.0%*	*7.5%*	*8.0%*	*8.5%*
1	0.9345	0.9302	0.9259	0.9216
2	0.8734	0.8653	0.8573	0.8494
3	0.8162	0.8049	0.7938	0.7829
4	0.7628	0.7488	0.7350	0.7215
5	0.7129	0.6965	0.6805	0.6650

Figure 6-1: Journalizing a zero-rate-interest-bearing note payable.

Cash	13,612	
Discount on notes payable	6,388	
Notes payable		20,000

The discount on a notes payable account is a contra liability account. It follows the note payable, amortized over the five-year life. The process of amortization moves the discount balance (in the balance sheet) to the income statement via interest expense by using the effective interest method. Figure 6-2 gives you a bird's-eye view on how this works, assuming that the effective interest rate is 8 percent.

Journalize the first year by debiting interest expense for $1,089 and crediting discounts on notes payable for the same amount. For the second year, debit interest expense for $1,176 and credit discounts on notes payable for the same amount — and so on for the remaining three years. Note these points regarding amortization:

- The carrying amount of the note increases to face amount ($20,000) over the life of the note payable (five years).
- The entire discount balance ($6,388) is moved to interest expense over the same five-year life of the note payable.

No-face, interest bearing

Now that you've tackled zero-interest-bearing notes payables, you can dig into interest-bearing notes. Going back to the $20,000 example from the "No-face, no-interest" section, assume the note payable has a stated (face) interest rate of 6 percent. At that stated rate, interest is $1,200 per year ($20,000 × 0.06). The borrower pays interest to the lender at the end of each year.

Schedule of Discount on Notes Payable Amortization
Effective Interest Method
0% Note Discounted at 8%

	Interest Expense	Discount Amortized	Carrying Amount
Date of Issue			$13,612
End of year 1	$1,089**	$1,089	14,701
End of year 2	1,176	1,176	15,877
End of year 3	1,270	1,270	17,147
End of year 4	1,372	1,372	18,519
End of year 5	1,481	1,481	20,000
	$6,388	$6,388	

** $13,612 × .08 = $1,089. $13,612 + $1,089 = $14,701.

Figure 6-2: Discount amortization schedule: zero-rate-interest-bearing note.

Note that the stated interest rate on the note payable is 6 percent. However, both the cash interest payments ($1,200 per year) and the principal amount are discounted based on an 8-percent rate.

You know that the present value of the principal is $13,612. However, you also need to figure out the present value of the interest portion of the note. Use Table 6-2 to find the present value of an annuity of $1 table. Because the interest paid is a series of payments for the same amount, the payments are referred to as an *annuity*. When you calculate the present value of the note payable (Table 6-1), it's the present value of a single amount.

Table 6-2 Present Value of an Annuity $1 Lookup Table

Periods	*6%*	*8%*	*10%*
1	0.9434	0.9259	0.9091
2	1.8334	1.7833	1.7355
3	2.6730	2.5771	2.4869
4	3.4651	3.3121	3.1699
5	4.2124	3.9927	3.7908

The factor at the intersection of 8 percent and five years in the present value of an annuity of $1 table is 3.9927. The present value of the interest is $4,791 (rounded) ($1,200 × 3.9927). Add the two present value figures to get the carrying value of the note, which is $18,403 ($13,612 + $4,791). Subtract $18,403 from the face value of the note payable to get the discount of $1,597 ($20,000 – $18,403).

Figure 6-3 shows how to journalize this transaction, and Figure 6-4 gives you the lowdown on the amortization table used to prepare the journal entry.

Figure 6-3: Recording discounted note payable.

Cash	18,403	
Discount on notes payable	1,597	
Note payable		20,000

Note Payable Discount Amortization
Effective-Interest Method
6% Note Discounted at 8%

	Cash	Interest Expense	Discount Amortized	Carrying Amount
Date of Issue				$18,403
End of year 1	$1,200	$1,472**	$272	18,675
End of year 2	1,200	1,494	294	18,969
End of year 3	1,200	1,518	318	19,287
End of year 4	1,200	1,543	343	19,630
End of year 5	1,200	1,570	370	20,000
	$6,000	$7,597	$1,597	

** $18,403 × .08 = $1,472. $1,472 – $1,200 = 272. $18,403 + $272 = $18,675.

Figure 6-4: Discount amortization schedule: interest-bearing note payable.

To record the borrower's interest payment at the end of each year, journalize the first year by crediting discounts on notes payable for $272 and debiting interest expense for $1,472. The credit goes to cash for $1,200. For the second year, you credit discounts on notes payable for $294, debit interest expenses for $1,494, and credit cash for $1,200 — and so on for the remaining three years.

Discussing mortgages payable

The most common type of note payable is a *mortgage,* which is used to finance the purchase of real property assets such as land and buildings. The property *collateralizes* the mortgage, which means the property is held as security on the mortgage. If the company defaults on the mortgage, the lending institution seizes the property and sells it in an attempt to recover as much of the loan balance as possible.

Mortgages require a formal closing procedure that's typically done at the offices of a *title company,* an independent middleman that coordinates the rights and obligations during the sale for the buyer, seller, and mortgage company. As in the purchase of a personal residence, reams of paperwork (such as the mortgage document and the transfer of the property's title) are passed back and forth among the buyer, seller, and closing agent for approval and signature.

Another type of long-term debt involves capitalized leases. A company doesn't always buy its fixed assets — sometimes it leases them. In this scenario, the *lessee,* the person leasing the property, records the capital lease as both a leased asset and a leased liability. Read more about accounting for leases in Book VIII, Chapter 4.

Treasury bonds defined

Treasury bonds are debt the government of the United States issues to pay for government projects. As with any bond, repayment of principal is accompanied by a fixed (or variable in some new, inflation-proof U.S. bonds) interest rate.

Treasury bonds have nothing to do with *treasury stock,* which is corporate stock the issuing corporation buys back from investors. See Book IV, Chapter 5 for more about treasury stock. To understand how to account for corporate bond debt, see the "Accounting for Bonds" section in this chapter.

The dark side of debt-free

If a company pays off a debt (whether a note or a bond) early, the company must determine whether a gain or loss was incurred on the transaction. (Paying off a debt early is also referred to as *debt extinguishment.*) With an early payoff, any unamortized discount or premium on the debt payable is removed from the books. Because the debt is removed, any remaining discount or premium related to the debt should also be removed. This transaction may generate a gain or loss.

When computing a gain or loss related to an early payoff, keep these points in mind:

- The liability is always debited (reduced) for the face amount of the debt.
- Cash is credited (reduced) for the amount paid to remove the debt.
- An unamortized discount is credited to adjust the remaining balance to zero.
- After you post the first three entries, consider the remaining amount you need in the journal entry to balance debits and credits. If you need a debit, it's a loss on bond extinguishment. A credit entry would be posted as a gain.

Imagine that a company repurchases a note payable for $104,000; the face value is $100,000. It was issued at a discount, and $3,000 of the discount isn't yet amortized at the date of repurchase. Here's the journal entry:

- Debit bond payable $100,000 and loss on bond extinguishment $7,000
- Credit cash (paid to lender) $104,000 and discount on bond payable $3,000

Remember that a business can remove the debt from its balance sheet only if one of the following occurs:

- The debtor pays the creditor and is totally relieved of the obligation. For example, the debt was for $10,000 and the debtor paid the creditor the full $10,000 plus all required interest.
- The creditor legally releases the debtor from any further obligation. For example, the creditor agrees to cancel a portion of the debt.

This chapter doesn't discuss troubled debt restructuring, which is an advanced financial accounting topic. This takes place when terms of the debt are modified for market or legal reasons. A good example is when the financial institution lowers the interest rate. Another example is a *short sale* of a home, in which the lender allows the homeowners to sell the home for less than the balance due on the loan, so the homeowners can get out from under a home they can't afford and the borrower can recoup a portion of the principal.

Accounting for Bonds

Bonds are long-term lending agreements between a borrower and a lender. For example, when a municipality (such as a city, county, town, or village) needs to build new roads or a hospital, it issues bonds to finance the project. Corporations generally issue bonds to raise money for capital expenditures, operations, and acquisitions.

The selling price of bonds, like publicly traded stock, is normally set by what the market will bear. The issuer of the bond sets the interest rate, which is known as the stated, coupon, face, or nominal rate. All four terms mean the same thing — the interest rate stated in the bond indenture.

A bond indenture is similar to any type of legal financing document that you may have signed to finance a house or car. It describes the key terms of the bond issuance, including maturity date and interest rate.

The people who purchase a bond receive interest payments during the bond's term (or for as long as they hold the bond) at the bond's stated interest rate. When the bond *matures* (the term of the bond expires), the company pays back the bondholder the bond's face value.

A bond is either a source of financing or an investment, depending on which side of the transaction you're looking at. Because this is a chapter on long-term liabilities, most of the text looks at this transaction from the source of financing viewpoint.

Valuing bonds payable

A company can issue bonds either at *face value* (also known as *par value*), which is the principal amount printed on the bond; at a *discount,* which is less than face value; or at a *premium,* which means the bond sells for more than its face value. Usually face value is set in denominations of $1,000.

Understanding premiums, discounts, and yields

To understand the value placed on a bond, you need to know the relationship between bonds prices and yield to maturity. *Yield to maturity* can be thought of as an investor's total return on a bond. The total return has two components:

- Interest income earned on the bond.
- If the bond is purchased at a discount, the investor is paid the face amount at maturity. The difference between the discount and the face amount is a gain. The gain adds to the total return on the bond. A bond purchased at premium results in a loss when the investor is paid the face amount. The loss reduces the investor's total return on the bond.

Going over the effective interest rate

Generally accepted accounting principles (GAAP) prefers the effective interest method when accounting for bonds issued at a discount or a premium. When using the *effective interest* method, you amortize by using the carrying value of the bonds, which is face amount plus unamortized premium or minus unamortized discount.

You see the effective interest method used to amortize the no-face, no-interest note payable (see "No-face, no-interest" earlier in this chapter). In that instance, the discount represents the interest earned by the lender over time. Check out Figure 6-2. The carrying amount started as the cash received by the issuer when the note payable was issued. That amount can also be stated as the face amount less the unamortized discount, or $20,000 – $6,388 = $13,612.

Over time, the carrying amount is increased by the discount amortization each year. At the note's maturity, the carrying amount is equal to the face amount, $20,000. If you're the borrower, the amortization of the discount generates more interest expense to you (see Figure 6-2). For the investor, amortization of the discount generates more interest income. In either case, amortization increases the carrying amount until it equals the face amount.

GAAP allows the straight-line method if the result is materially the same: straight-line method versus effective interest rate method. Keep in mind that International Financial Accounting Standards (IFRS) requires use of the effective interest method.

Figuring out the present value of a bond

In many ways, this present value process is the same as the concepts used for notes payable. Assume a company issues a $100,000 bond due in four years paying seven percent interest annually at year-end. Here are the steps to compute the present value of the bond:

1. **Compute annual interest expense.** The interest expense is $100,000 × 0.07 = $7,000 interest expense per year.
2. **Find the market interest rate for similar bonds.** You can check a financial publication, such as *The Wall Street Journal,* for current market rates on bonds. The market interest rate may differ from the rate actually being paid. You want the market rate, because in the next step you use the market rate to look up the present value factor for the interest payments.

   Assume that the market rate for similar bonds is 11 percent. Specifically, similar bonds (with similar credit rating, stated interest rate, and maturity date) are priced to yield 11 percent. Because the stated rate is 7 percent, the bond must be priced at a discount. The discount is amortized into income, which increases the yield to maturity (see "Understanding premiums, discounts, and yields" earlier in this chapter for details).

3. **Find the present value factors for the face value of the bond and interest payments.** Use the present value of $1 table to find the present value factor for the bond's face amount. Use the present value of an annuity table to find the present value factor for the interest payments. In each case, find the factor for four periods (years) at 11 percent interest. In this example, the present value factor for the bond's face amount is 0.65873, and the present value factor of the interest payments is 3.1025.

Search the web to find a present value of $1 table and a present value of an annuity table. Look for tables that list the factors out to the fifth decimal place.

4. **Use the present value factors to calculate the present value of each amount in dollars.** The present value of the bond is $100,000 × 0.65873 = $65,873. The present value of the interest payments is $7,000 × 3.10245 = $21,717, with rounding.
5. **Add the present value of the two cash flows to determine the total present value of the bond.** In this example, $65,873 + $21,717 = $87,590.

Issuing at face value

This one is the easiest type of bond transaction to account for. The journal entry to record bonds that a company issues at face value is to debit cash and credit bonds payable. So if the corporation issues bonds for $100,000 with a five-year term, at 10 percent, the journal entry to record the bonds is to debit cash for $100,000 and to credit bonds payable for $100,000.

Face value (or face amount) refers to the amount of debt stated on the face of the bond certificate. It represents the amount that must be repaid at maturity. For bonds, *par value* has the same meaning as face value. This section uses the term face value, because that term refers to the amount stated on the bond certificate.

Mulling over bond pricing

Bond prices are expressed as a percentage of par value (face amount). A bond with a face amount of $1,000 may have a bond price of 100, or 100 percent of par value ($1,000). Bonds issued at a premium have a bond price of more than 100. For example, a price of 102 means 102 percent of par value. In this case, a $1,000 bond's price would be $1,020. A bond priced at 98 (a discount), would have a price of $980 per $1,000 bond.

Calculating interest payments

Interest payments don't change, regardless of whether the bond is priced at par, a premium, or a discount. To calculate interest payments on a bond, multiply the principal amount by the interest rate stated on the face of the certificate (stated rate). For example, suppose the stated rate of a bond

is 10 percent, interest is to be paid semiannually (every six months), the bonds are issued on July 1, and the first interest payment isn't due until December 31. The interest payment is principal multiplied by interest rate multiplied by time; in this case, $100,000 × 0.10 × ½ = $5,000. So your journal entry on December 31 is to debit bond interest expense for $5,000 and credit cash for $5,000. The interest *expense* may change, depending on whether the bond is priced at a premium or a discount. However, the *cash payment* for interest is fixed.

See Book IV, Chapter 4 for examples of issuing bonds at both a premium and a discount.