Proven Processes Developed and Validated in 20+ Years of Real-World Experience Supporting Hundreds of Small Businesses. Sequel to best-seller version 1.0.

THE FINANCIAL OPERATING SYSTEM® Version 2.0

EMPOWERING BUSINESS OWNERS TO TAKE CONTROL OF THEIR FINANCES AND IMPROVE THEIR FINANCIAL FITNESS

BY CALVIN WILDER

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The Financial Operating System®

This book is dedicated to business owners

Too many business owners are struggling:

1. They are not making the money they hoped to be making when they started their business
2. They don't know why
3. They don't know what to do about it

Other business owners are doing OK now, yet want to know how to better use financial information to manage and scale their businesses for profitable growth.

I've helped many business owners overcome these challenges, empowering them to:

- ☑ Understand the financial performance of their businesses
- ☑ Take control of their finances
- ☑ Make more informed decisions
- ☑ Improve profitability

This book lays out a proven, 6-Step process for business owners to improve their financial fitness. This book also presents basic accounting principles and practices every small business owner needs to know.

This book is intended as a do-it-yourself guide. If you would like assistance implementing The Financial Operating System® including upgrading your bookkeeping, accounting and finance function, please contact me:

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Chapter 22

Step 6: LEARN, ITERATE, AND IMPROVE

Prior chapters have been heavier on content and tactics. This chapter is shorter and is about mindset more than anything else. Once you've completed the first 5 Steps of The Financial Operating System®, the key to whether you succeed or fail to hit your goals largely rests on your ability to learn, iterate, and improve.

Why is this? Because running a business is not a linear path. There is no predefined start and finish to your job. Rather it is a circular loop that feeds back on itself. With a loop, you can get better and better as you complete more cycles. With your eyes and ears and mind open, you are constantly learning about your company's strengths, weaknesses, opportunities, and threats. You have endless opportunities to adapt your next navigation through the loop based on what you've learned in prior loops, what you observe in the marketplace, and what you see your competitors doing.

I've been fortunate in my career to work in jobs where I've been constantly able to learn and grow. While I've made no shortage of mistakes, and sometimes gotten lucky through no brilliance of my own, I've always sought to learn from

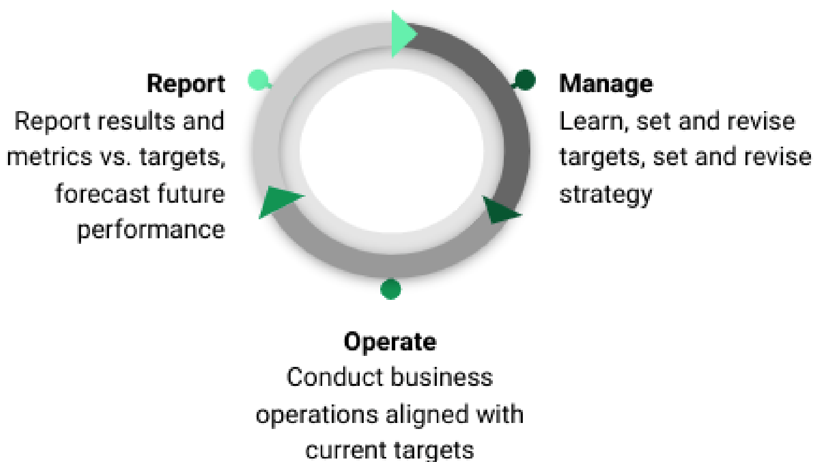
those experiences and then apply those learnings to improve myself and my businesses going forward.

As a growth-oriented businessman, I am a firm believer that if you and your people are not making mistakes, then you are not trying hard enough. Business is hard. Mistakes should happen. Hopefully they're not too big and the same mistake is not often repeated.

The key is identifying those mistakes as fast as possible so you can make an informed decision about what to change and how to proceed. Systems, process, data, and an ROI mindset are key.

Keep in mind the words of Charles Darwin: "It is not the strongest nor the smartest who survive, it is those who are most responsive to change."

Step #6 of The Financial Operating System® can be summarized as a 3-phase loop:



What do these 3 phases really mean?

Operate

Your people conduct business based on the guidance and goals provided by executive management, combined with the inertia of how they have always done things. Good, clear, relevant metrics must be in place for operations staff to organize and manage the marketing, sales, production and delivery of goods and services. Operations staff should be encouraged to provide feedback to executive management about what they learn while interacting in the marketplace.

Operations are a key part of the Learn-Iterate-Improve step. Operations should not be blinding following SOPs or doing things the way they've always been done. Rather, operations should be learning what works and what does not work to produce results, and providing suggestions for how to improve the business.

Report

You report results to inform operations staff as well as executive management and ownership. Your reporting function must do more than just report historical financial statements. It must also distill performance metrics and forecast future results so that financial reports are insightful and actionable.

Reporting is a key part of the Learn-Iterate-Improve step as it provides the cold, hard facts people need to do their jobs well.

Manage

Owners and managers must value and ruminate on the feedback and reports provided by operations and accounting. Company strategy and associated metrics must be considered and revised based on the best information available combined with entrepreneurial creativity. The goal is to learn and apply those learnings to improve your business.

Managing is the final key part of the Learn-Iterate-Improve step as it requires a commitment to making the changes required to improve results, whether through incremental tactical improvement or wholesale changes to company strategy.

Chapter 23

Agile Approach

Agile refers to a method of project management that is characterized by the division of responsibilities into short phases of work with frequent feedback, reassessment, and adaptation of plans so that the end result of the project most effectively meets its purpose. First formalized in the software development realm, Agile now is used broadly throughout many different functions. An Agile approach can be key to learning and improving results.

Agile is more of a mindset than a tool. While you could “do Agile for project management”, it is more effective to strive to “be Agile as an organization.” This means you:

- ☑ Break down goals and projects into components and manage those components on short timeframes to ensure you make regular progress. We’ve all seen goals being reported as “on track” during a quarter only to fall “off track” at the end of the quarter. This is often because the manager did not map out everything that needed to be done, understanding dependencies on other people for parts of the project, and failed to make regular progress as needed over the course of the quarter. He got to the last couple weeks of the quarter and realized no matter how hard

he worked, the project simply could not be completed in such a short time.

- ☑ Seek frequent feedback from others along the way and improve and tune work based on feedback received. There is nothing worse than spending an entire quarter on a project, only to deliver it at the end of the quarter to find out that the project deliverable fails to meet user requirements, is not done at the required level of quality, or has a huge component you spent a lot of time developing that your users don't really care about. If you had used an Agile approach, you would have received feedback and collaborated periodically over the course of the quarter and produced a project deliverable that better met your users' requirements with less wasted work.

- ☑ Keep your eyes and ears on the market. Understand why prospects buy and do not buy from your business, and why existing customers stop buying or buy more. Understand new competition and technologies impacting the market. A healthy paranoia is helpful. This goes for everyone, not just the CEO or senior managers. Everyone in the company has their own perspective to see what is going on in the market and is responsible for observing and sharing information. Conduct SWOT Analyses (assessment of Strengths, Weaknesses, Opportunities and Threats) annually.

- ☑ Do not let Perfection get in the way of Good. Make time the constant. In a given amount of time, define what can be realistically completed to meet 80% of user needs. Delivering something that is viable and

meets user needs is better than delivering nothing while toiling away in the background working on something better, while not yet meeting any user needs in the meantime. Some tasks need to be done at 95%-100% quality, though most of the time 80% quality is appropriate to release and get feedback and improve for the next release.

Dare to Think Differently

If you do the same things as everyone else, you will achieve about the same results as everyone else unless you get particularly lucky or unlucky. If your business objectives are ambitious and you aim to outcompete your peers and have above-average profit margins and/or growth rates, then you'll need to do some things differently than other businesses.

Even if you think Zero-Based Budgeting is not for you, spend a couple days going through the exercise once to see what thoughts it may trigger. Also think about how you would structure your business if you started it again from scratch with zero customers and zero employees.

Spend a couple days working through the Strategy Cascade (available to download at www.TheFinancialOS.com) to get clarity on your target market segment and what you need to be doing in order to win in that market segment.

My point here is not that you need to completely overhaul your business. Rather, that taking the time to think differently often pays huge dividends even if the outcome of

these thought exercises is usually incremental change to your current business, not radical overhaul.

Chapter 24

Re-Evaluate Your Finance Department

After having gone through the process of evaluating and potentially upgrading your Finance Stack in Step #4, and then going through at least a couple monthly close cycles in Step #5, it is time to re-evaluate the performance of your finance function. The purpose is to ensure it is properly supporting your business objectives.

Ask yourself how confident you are that:

- ☑ The monthly close is complete with financial reports timely delivered every month, by at least the 15th-20th of the following month. Faster is better but this time frame is a good standard and usually represents an upgrade from prior practices, especially if you are doing a true close with some accrual accounting.

- ☑ Financial statements accurately reflect the performance of the business. This includes an appropriate level of accrual accounting (GAAP). Refer to Chapter 26 for a practical solution.

- ☑ Your reporting package provides useful insight into business performance beyond just the financial statements. This often includes AR aging and credit risk, metrics, actual vs budget analysis, forward-

looking forecasts, and explanation of revenue and expense accounts that deviated significantly from prior trends.

- ☑ Systems and processes run efficiently, consistently, and accurately.
- ☑ Technology is utilized to be efficient with finance-related tasks.
- ☑ Internal controls prevent and catch mistakes and fraud.

If you are not comfortable making this assessment, you can engage a CFO on a project-basis to assist.

Other things to look for:

- ☑ Your bookkeeper or accountant holds monthly meetings to present and explain the numbers to you, more than just emailing you reports or telling you that QuickBooks is closed.
- ☑ You get actionable information, not just backward-looking financial statements.
- ☑ Documentation of accounting policies and procedures exists and you are capable of following the documentation to do the work yourself, or onboarding a new bookkeeper using the documentation.
- ☑ Your tax returns are filed on time without extension. You are provided tax projections and opportunities to manage your tax exposure during the year.

- ☑ Your current solution is largely self-managed requiring little time from you and other managers beyond those things that finance staff can't reasonably be expected to know or do.

If you, like too many business owners, conclude that you are not getting what you need from your finance function, then you need to make a change to your Finance Stack. There are two options:

1. Keep the current functions of your Stack but replace the people in those functions with people who can better perform the functions. For example, if you employ a controller and are not consistently closing the books each month, then you may need a new controller.

2. Add more higher-level components to your Stack. For example, if you have a bookkeeper or accountant doing a good job with accounting and basic financial reporting, but you want budgeting, forecasting, and metrics, then you may need a controller or CFO.

Upgrading Your People

Inevitably trying to manage and improve the results of your people leads to human resources challenges. Your goal is to fill every seat in your organization with A-players who are driving the company to its quarterly, annual and 3-year goals. A-players are defined as the top 10% of talent available in the marketplace willing to work at the pay range of the position at your company. This is aspirational, though the closer you get to this state, the better your performance will be.

Upgrading your people ideally is achieved by training and developing your current people. It provides your people career advancement opportunities, while providing you the continuity of a tenured team that knows your business and has developed relationships with your customers.

Unfortunately, people can hit their ceiling as the needs of the company evolve over time. Someone who was an A-player in their position when the company had annual revenue of $1-$2 million and their role was primarily bookkeeping may be a C-player in the position when the company has annual revenue of $5 million and needs an accounting manager. The expanding or differing requirements of the position may outpace the abilities of the employee. In a company historically managed without attention to financial metrics, a bookkeeper or accountant may not be able to make the shift to proactively thinking and helping you manage by metrics. Fortunately, The Financial Operating System® provides a framework for performance standards and a number of tools that an enterprising accountant can employ to do his job supporting the financial needs of the business.

Recap of Steps in The Financial Operating System®

Step #1: Identify Your WHY

- ☑ Why are you in business?
- ☑ What are you trying to accomplish with your business?
- ☑ What is your business model?

Step #2: Assess Current Finances

- ☑ How well capitalized is your business?
- ☑ Is revenue growing or shrinking, and at what rate?
- ☑ What percent of revenue is dropped to the bottom line as net profit or loss? Is that trending up or down?
- ☑ Is the business producing positive cash flow?

Step #3: Define Metrics and Targets

- ☑ Which metrics best indicate achievement of your company's financial objectives and successful execution of your strategy over the next 1 month to 3 years?

Step #4: Upgrade Accounting Operations

- ☑ Determine required Finance Stack functions and who will perform those functions
- ☑ Define accounting policies and procedures to produce required financial reporting

Step #5: Manage The Business

- ☑ Use a framework to track metrics
- ☑ Operationalize metrics
- ☑ Forecast future performance

Step #6: Learn, Iterate, and Improve

- ☑ Operate-Report-Manage loop with Agile mindset

APPENDIX: OTHER FINANCIAL MANAGEMENT PRINCIPLES

The following chapters present important principles, many of which will be useful to you in financially managing your business. They are the result of 20+ years of experience managing finance departments for hundreds of small businesses including my own businesses. These practices along with the practices previously reviewed in Steps 1 through 6 of The Financial Operating System®, will empower you with the information needed to run a healthy business.

If you have questions, feel free to reach out to me at cal@TheFinancialOS.com or cwilder@smartbooks.com.

Chapter 25

Budgeting versus Forecasting: What Really Matters

This topic is one of the most frustrating topics I see small businesses grappling with. I believe the frustration is rooted more in terminology than in anything else.

Suppose an employee poses a simple question: “Is hiring another customer service person in the budget?” This kind of question can result in argument and hurt feelings and even distrust. The person who asked the question may remember there was a budget set at the beginning of the year that included a new customer service hire and now simply wants to follow through on a perceived operational need that was budgeted. The business owner may sense the business can’t afford the hire, and delay or refuse the request but not be able to clearly explain his reasoning. Even worse, the business owner may approve the hire without regard to financial impact because of a recollection that such a hire was in the budget.

Arriving at a correct answer is complicated by a number of factors to consider:

- ☑ Is there an annual budget defined including profit metrics?

☑ How are sales pacing versus the budget? Are we bringing in more, less, or the same revenue as we budgeted? If more, then we may have the financial resources and the need to expand our customer service team to service more customers. If less, then we may not be able to spend as much on operating expenses as we anticipated nor would we need as much customer service capacity as initially budgeted.

☑ How is Pre-Labor Gross Profit pacing versus the budget? While top-line sales may be better, worse or the same, COGS also impacts the analysis. Ultimately Pre-Labor Gross Profit is the money we have available to spend on business operating expenses.

☑ How is Labor Value Multiple (LVM) pacing versus budget? As we saw in Chapter 7, LVM is a great tool to use to make hiring decisions. LVM significantly above target may reflect the need for a new hire if current staff are maxed out, while LVM at or below target may indicate the need for more revenue and PLGP or better productivity from existing staff before making a new hire.

☑ How are other operating expenses pacing versus the budget? We may have already allocated more or less spending in other areas which impacts what is available for customer service staff.

☑ If we have room in the budget to hire another customer service person, it still may not be a good use of resources unless based on current information we project a good return on the investment.

As you can see, whether or not the hire was in the original budget at the beginning of the year is largely irrelevant to making a good decision later in the year.

If you are a huge, slow growing public company with a stable business and a phalanx of analysts in your accounting and finance departments, you may be able to predict future results with a high degree of accuracy. Your annual budget may be very close to your actual results.

For the rest of us in small and midsize businesses, our actual results often start deviating from the annual budget by a significant margin once we get several months into the year. The priorities and needs of our small businesses can change quickly. We may experience:

- A few large orders from new customers
- An unexpected loss of a big customer
- A new offering fails to attract any takers, or meets more demand than can be fulfilled
- An opportunity arises to expand into a new market or make an acquisition

Whether something was or was not in the budget several months ago may have little bearing on whether to spend the money on it today.

Here is the approach that is most effective. It is geared to using target metrics, not a fixed budget, to drive decisions:

☑ Create an annual plan (aka “budget”) with the understanding that this plan/budget represents your

best guess at one point in time for how the next year will play out. We'll refer to this plan as your "budget" to keep things simple.

- ☑ Define associated metrics targets that align costs with revenue to yield target profit margins. This way if and when revenue deviates from your budget you have metrics to guide spending decisions. For example, if your budget is based on a 45% Labor-Loaded Gross Margin, that may correlate to a 2.5X Labor Value Multiple (LVM). Your Performance Metric to hit is the 2.5X LVM. If revenue is higher or lower than budget, you must hit the 2.5X LVM metric by matching staffing costs with Revenue and Pre-Labor Gross Profit.
- ☑ Maintain a rolling 12-month income statement forecast, updated monthly based on the best available information, and include associated performance metrics in the forecast.
- ☑ Make decisions based on performance metrics in the forecast. The question about whether to hire another customer service person can be answered by looking at the forecast LVM. The answer is not whether the hire was in the initial budget, but rather whether after making the hire will the company still achieve a 2.5X LVM. You can hire more or less capacity depending on how much you sell using the 2.5X LVM metric as your guide.
- ☑ Compare actual results against the budget and against performance metrics. Learn, iterate and improve your

ability to manage the business to achieve financial metrics.

Other examples of decisions that can be guided by performance metrics include making a sales or marketing hire, or a management or administrative hire, or engaging an outsourced firm to alleviate the burden on internal staff. In these kinds of hiring questions, there can be a sense that current staff are at their limits and need assistance to get their jobs done well. Metrics are key to validate gut feelings. If metrics are at odds with gut feelings, then there are deeper operational or strategic challenges to resolve.

As you can see, budgets are not a license to spend money. While people default to thinking of budgets in terms of how much they can spend on various line items, the budget starts with revenue and ultimately is a plan to achieve a certain level of profit. Spending is a means to an end of producing profit. You've got to get your people thinking differently about budgets.

For example, the COO of a $12 million annual revenue customer told me that his business unit managers wanted to know how much of their budget was left to spend on a couple different line items. These were large 6-figure line items that were somewhat discretionary. There was no mention of how much revenue or profit those managers were responsible for producing and how they were pacing with their profit-related metrics. There was no discussion about whether spending all the money was necessary nor the expected ROI if spent. I tried to help the COO frame the budget discussion with these

managers, who really needed to earn their paychecks by producing profit rather than spending money.

We need to shift our thinking about budgets to think of budgets in terms of revenue, profit, and performance metrics, not just expenses.

We also sometimes need to think about budgets for cash flow and the balance sheet. businesses usually focus on income statement metrics when budgeting, which makes sense as the starting point. P&Ls are easy enough to budget without much finance expertise, while it takes more accounting skill than most businesses have to forecast the balance sheet and cash flow statement. If your business carries large accounts receivable balances, or you are looking at a large expenditure for example to build out a new office, launch a new service line, make an expensive management hire, or make an acquisition, then you also need to budget and forecast cash flow and the balance sheet and keep an eye on return on invested capital.

Chapter 26

Accrual Accounting versus Cash Accounting and the Power of the Cash Flow Statement

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Accrual Accounting and GAAP

Accrual accounting is often discussed in conjunction with GAAP, Generally Accepted Accounting Principles. GAAP requires accrual accounting, which is why GAAP and accrual accounting are linked. GAAP is defined by national and international accounting standards organizations such as the Financial Accounting Standards Board (FASB) in the United States and the International Financial Reporting Standards (IFRS) governing bodies internationally.

Accrual accounting is eventually required by growing businesses and by any business wanting to better understand and manage its financial performance. The more a small business grows into a midsize business, the more important adherence to accrual accounting becomes. It may be required by lenders or investors. A business looking to be acquired often needs to present its financials on the accrual basis as many buyers expect it, or at least be able to explain how its practices differ from GAAP. As discussed in Chapter 14, GAAP is expensive and complicated overkill for most businesses.

The Financial Operating System® focuses on reasonable accrual accounting practices to inform management decisions and not on dotting i's and crossing t's as public companies must do.

Why exactly is accrual accounting preferred? It provides the following benefits:

- Revenue is recognized as goods and services are delivered to customers. This is a measure of business volume throughput, not just what happened to be invoiced or collected in a period. You want to know what volume of services you delivered in a month, not just what you invoiced or what customers paid. If a customer takes a few extra days to pay its monthly bill, you still get credit for doing the work.
- Expenses are recognized as they are incurred or consumed. This captures the true expenses you had in a period regardless of when bills were received or paid. If you delay paying a monthly bill, you still incurred the expense that month.
- The balance sheet includes things like accounts receivable that you need to collect, inventory on hand to sell, accounts payable that you need to pay, prepaid expense assets, payroll liabilities owed to employees not yet paid, depreciation on equipment, and customers invoiced in advance for services not yet delivered. These accruals provide further accuracy around actual financial performance. In the case of accounts receivable, collections metrics are very important to keep cash flowing.

- The Cash Flow Statement can be employed to understand what is driving changes in cash. The Cash Flow Statement provides more comprehensive insight into how cash is flowing through your business than does a cash-basis Income Statement.

Note that while you can run a report in QuickBooks with the button selected to use the "accrual" basis, QuickBooks does not know anything about accrual accounting. QuickBooks does not consider anything other than customer invoice dates and vendor bill dates when reporting revenue and expense. QuickBooks does not know when you actually did the work for customers or received services from your vendors. This label in QuickBooks can be misleading to small business owners who are not familiar with what true accrual accounting means.

While it is impractical for most businesses to produce true GAAP accrual-basis financial statements, there is a simple solution that gets you 80% of the way to GAAP with 20% of the effort and cost. Thus I often recommend the Management Accrual accounting practices described in Chapter 27 as the best, most practical and cost-effective method of accounting and financial reporting for small businesses.

The Cash Flow Statement

When books are kept using the accrual basis, the Cash Flow Statement provides a comprehensive report of factors impacting the net change to cash in the bank. The cash flow statement takes some practice to get comfortable with. It is divided into 3 sections:

Operating Activities:

This section considers the cash impact of changes in balance sheet accounts involved in day-to-day operations such as accounts receivable, prepaid expenses, accounts payable, payroll liabilities, deferred revenue, and other routine operating expenses when the core economic profit of the business differs from the receipt or expenditure of cash in a period of time. This section reports the core cash flow produced by operating activities and is the primary measure of cash flow. It tells you how much of your reported net profit on the income statement went into your bank as cold hard cash prior to any investment or financing activities.

Investing Activities:

This section considers the purchase or sale of assets, acquisitions of other businesses, or other investments. These tend to be sporadic, and apart from the need to replace any critical fixed assets at the end of their useful lives, largely discretionary.

Financing Activities:

This section considers dividends or distributions paid to owners, proceeds from borrowings, loan repayment, and sale or repurchase of company stock. These are non-operating activities tied to how you choose to fund your business's capital and how much of your profits you distribute.

Real World Example:

A law firm client of mine did not want to see accrual financial statements and only wanted to see a cash-basis income statement. I disagreed and told her she needed to review the accrual-basis income statement and the cash flow statement for the following 2 reasons:

1. Why wouldn't she want to see as revenue her client billings which represented the volume of services delivered in a month since her firm billed monthly for services provided each month? She could then compare that to staff costs for the month to understand profit margins. She could also compare service volumes this year versus last year to understand the growth of her firm. She could also benefit from more meaningful actual versus budget reporting that is not skewed by inconsistent timing of client payment receipts and vendor payments.

2. The cash-basis income statement does not include the impact of loan proceeds and loan repayments as well as owner distributions-- all of which she had in her business. She would be blind to these major cash flow events if she only looked at the income statement and would not be able to see what caused cash in her firm's bank account to increase or decrease each month. This client benefited from using the Cash Flow Statement to understand the full picture of cash flows at her firm, while using an accrual-basis income statement to monitor operating performance.

Cash-Basis Accounting

Cash-basis accounting is often the initial default bookkeeping method for new businesses who don't know much about accounting and financial reporting or who don't derive much value in the early years from investing in accounting. It also is usually a favorable income tax election, though as we discuss in Chapter 29 we don't want to mix income tax reporting with financial statement reporting as tax-basis reporting does not accurately represent business performance.

What exactly is cash-basis accounting?

- Revenue is recognized when customers pay you (not when you do the work or deliver the goods or when you invoice them).
- Expense is recognized when you pay your vendors and employees (not when they provides goods and services or when they bill you).

While it is the default method for startups and often a favorable way to file taxes, neither of these reasons make cash-basis accounting a good way to manage your business. Businesses should be managed for core economic profit and sustainable positive cash flow. Thus, all but the most small and simple businesses should utilize accounting practices that help managers to understand and drive core performance. Looking at a cash-basis income statement is nearly useless in understanding core performance as it reflects the quirks of when customers pay you and when you pay vendors without regard to when anyone actually did any

work. Often only over a very long aggregate measurement period of multiple years will cash-basis reports converge on accrual-basis reports as the ebbs and flows of cash payment timing even out. In any given month or quarter or often even a year, the two reports will present different pictures of financial performance.

Furthermore, as in my client example above, a cash-basis income statement does not actually reflect the cash produced or consumed by the business. Some sources of cash receipts and cash expenditures are not included in a cash-basis income statement. Things like loans or borrowings from a line of credit, repayment of that debt, purchase of equipment, and dividends or owner distributions.

Cash basis income statements can also be misleading and easily manipulated. While this may be helpful in filing cash basis tax returns when businesses are growing with mounting accounts receivable (perhaps amplified by playing the cash basis tax game at year-end), for management purposes it obscures actual performance with no benefit. Just because you waited to pay some vendor bills until the following month did not mean you had a profitable prior month. It just means you incurred a real cost but waited until the following month to pay for that cost. For this reason, the Cash Flow Statement is best used to understand the overall flows of cash into and out of a business.

Note that QuickBooks does not provide a true cash-basis income statement when you click the button to select "cash"

basis on the P&L report. While theoretically possible if transactions are entered in a very specific way, I don't recall ever seeing an accurate cash-basis financial statement from QuickBooks. Perhaps as QuickBooks continues to improve its product, that day will come.

Working Capital Management

Working Capital as a general term refers to the amount of cash a business has tied up in current assets such as accounts receivable compared to current liabilities such as accounts payable. It is a measure of the ability of a business to cover its short-term obligations and avoid a cash crunch.

Please don't interpret my dislike of cash-basis financial statements to mean that working capital management and managing the cash cycle are not important. In fact, they can be critical. It's just that you need to understand and manage the basic profit economics of your business before you invest time adding a whole new layer of financial management. If you are interested in taking that next step to dig into working capital and the cash cycle, then you can read a book such as *Guide to Management Accounting Cash Conversion Cycle* by Shigeaki Takai. You can also utilize tools at cashflowstory.com to which I was introduced by founder Alan Miltz.

Or you could focus on the Trade Capital concept that Greg Crabtree outlines in his book *Simple Numbers 2.0* which is perhaps the simplest (no pun intended) approach to identifying whether your business consumes or generates

cash as it grows. Put another way, whether your cash from operations exceeds or is in deficit to the net income reported on your income statement. The definition of Net Working Capital includes cash and the current portion of debt, which makes it a challenging metric to use by itself as the desire to minimize working capital conflicts with the desire to have a healthy cash balance and debt is a financing decision separate from operating cash flow. The Trade Capital concept solves these challenges. Trade Capital is defined as traditional working capital but excluding cash and debt. In a super simple balance sheet, it could just be accounts receivables minus accounts payable. If positive, you effectively are financing the work you do for customers, and depressing cash flow. If negative, you collect from customers before you need to pay your vendors and are producing cash flow in excess of reported profit. If zero, your AR offsets your AP and your cash flow from operations matches your reported net profit.

Comparing Trade Capital as a percentage of revenue to your net profit margin indicates whether you tend to consume cash as you grow, with cash flow being a potential constraint to growth, or if you can sell as much as you can without worrying about receivables-driven negative cash flow.

Chapter 27

Management Accrual Accounting: The Small Business Solution

Given the strict nature of GAAP, and the skill and cost required to comply, most small businesses are best served by using a standard I have defined as Management Accrual. Note that this Management Accrual standard is not an official protocol recognized by any governing accounting body. Rather, it is a standard geared to managing small and midsize businesses.

This standard strives to deliver an 80/20 solution. Businesses get 80% of the benefits of GAAP with 20% of the effort and cost.

The primary tenets are:

1. Date customer invoices in the month you deliver goods and services to your customers.
2. Date vendor bills in the month goods and services are delivered to you.
3. Capitalize and amortize or depreciate only any particularly large asset purchases, perhaps those over $5,000. Avoid the make-work accounting of capitalizing small transactions that don't move the needle on your financial reports.

4. If possible, pay employees on a semi-monthly basis to avoid 3-payday or 5-payday months that arise from bi-weekly or weekly payroll. If bi-weekly or weekly payroll is legally required, then accrue the few days of stub period cost at the end of each month.

The Management Accrual accounting standard is not concerned with finer points of GAAP and FASB proclamations. It delivers reasonably accurate financial statements reflecting the performance of the business, which can be timely produced at a reasonable level of effort and cost.

Chapter 28

Owner Compensation and Reported Company Profitability

This is one of the most important accounting concepts in this book. How owner compensation is accounted for has a huge impact on a business's financial statements. We could debate how important it is to keep your books on an accrual basis versus a cash basis, but ultimately for most businesses how owner compensation is booked has a much larger impact on how profitable the business looks on its P&L and the ability of the business to manage its finances.

If your business is a corporation (s-corp or c-corp) or taxed as a corporation, then you should be taking a market salary that is booked as an expense on your income statement along with the wages of your other employees. You may take additional profit distributions beyond your salary, with those distributions booked as equity distributions or dividends on the balance sheet. If you are doing this, then you could skip the rest of this chapter as it does not apply to you.

If your business is a partnership or an LLC taxed as a partnership, then this issue can literally be the difference between beautiful profits and ugly losses. I've seen this problem more times than I'd like to remember. If your

business is taxed as a partnership, read this section a couple times and then talk with your bookkeeper or accountant to understand how your compensation is being reported in your financial statements. Get it done right so that you have the most accurate and useful financial reports to manage your business.

As a business owner-operator you show up to work every day like your employees. You get paid every two weeks along with your employees. If you retired from operating the business, or you started another business and shifted to working in your new business, you would need to hire someone to do your job and pay them a market salary. The work you do obviously is valuable and has a cost to the business, whether you do it or someone else does it. Whether your compensation is called salary, draw, or distribution, it is effectively wages to you for your work as an employee in the business. For our purposes we'll simply call it salary.

Many businesses are organized as LLCs and elect to be taxed as partnerships. That is the default LLC tax classification assigned by the IRS, though an LLC can elect to be taxed as a corporation. If you are the only owner of the LLC, you have a "single-member LLC" which is "disregarded" for income tax purposes unless the LLC elects to be taxed as a corporation. None of these tax elections change the fundamental salary cost to the business of its owners working as employees in the business (though there are payroll tax differences).

The issue starts when, on partnership tax returns, payments to owners are reported as "distributions" of equity capital. They are not tax-deductible expenses of the business.

The problem manifests itself on the financial statements of the business when the bookkeeper or accountant posts owner compensation as a distribution of equity. Booking owner salary this way skips the P&L and books it straight to the balance sheet. This results in none of your compensation being reported as an expense of the business. This doesn't make any sense!

Here's an illustration of the problem:

	Company A	Company B
Revenue	2,000,000	2,000,000
COGS & Direct Labor	1,200,000	1,200,000
Labor-Loaded GP	800,000	800,000
SG&A	900,000*	700,000*
Operating Profit	(100,000)	100,000
	*incl 200k owner salary	*incl no owner salary

Table 27.1

This is the same company with the same revenue, the same operating expenses, the same owner salary, and the same real profitability. Yet this accounting decision is the difference between reporting $100,000 of profit and a $100,000 loss. Imagine looking at your P&L every month and thinking you're having a good year because the P&L shows profit, only to find out later that you really lost $100,000 because of how your salary was booked.

I’ve seen this issue arise in a $500,000 annual revenue marketing business and in a $20 million annual revenue private jet brokerage business.

Salary payments to an owner of an LLC taxed as a partnership that are made to compensate the owner for her work as an employee in the business should be booked as wage expense on the income statement so that it counts as an operating expense of the business. You can call it owner draw on its own line on the P&L if you want to highlight it. When you meet with your tax accountant, inform him how you are accounting for your owner salary, and he will report it however it needs to be reported on the tax return.

Once you get your arms around how to account for owner compensation, consider the amount of owner compensation. The key question is: If you hired someone else to do the job currently being done by an owner, what would you need to pay the person? That is your market rate and should be reflected as an expense on the income statement.

By all means pay yourself bonuses above and beyond your market rate salary, and account for the additional compensation in excess of the market rate as distributions to owners on the balance sheet. This approach captures the salary cost in the P&L, and treats the additional compensation as dividends on the balance sheet. This additional compensation really represents a distribution of some of the profit of the business, which in a corporation structure would be paid out as dividends to the owners of the corporation.

Chapter 29

Taxes & Just Say No to Adjusting Entries

This section is not intended to provide specific tax advice for your business. Consult your tax advisor for that. Instead, this chapter discusses common conflicts between financial performance reporting and income tax reporting. This book focuses on financial reporting and how to evaluate and manage the financial performance of your business. Tax minimization is important to many business owners, though managing core profitability is what really drives business value.

As you'll see, the theme of this chapter could be summarized as: "Don't let the tax tail wag your business dog."

Pass-Through Taxation

Pass-through entities are the norm in small businesses, which usually organize as an LLC electing to be taxed as a partnership or s-corp or as a corporation electing to be taxed as an s-corp. These elections mean owners are taxed personally on their share of the business's profit or loss, which is "passed through" to owners. There is no federal income tax paid at the entity level.

Once the business becomes profitable, the single layer of tax passed through to owners is usually less than the total tax burden of a c-corp. A c-corp pays tax on its profits at the company level, and then owners pay additional tax on dividends received from the c-corp.

Notes that some states do impose taxes on s-corps and other pass-through entities. These taxes may be called excise taxes or franchise taxes or other names, and in effect can function as income tax on the business.

Cash-Basis Taxation

Many small businesses elect to be taxed using the cash basis. This means you pay tax primarily on the difference between your inbound customer payments and your outbound vendor and employee payments. This intuitively makes sense, to pay tax on the net cash you receive. This is safer than paying tax using the accrual basis because, using the cash basis, you should have the cash to pay the tax. If you file taxes on the accrual basis, it is possible that you report a profit yet have not collected it in cash. Your tax bill could be calculated on much larger accrual-basis profit than you realized in cash and, worst case, you can have a tax bill and not enough cash to pay it.

Utilizing the cash basis for taxes can lead some owners to play a tax game to minimize cash-basis taxable income realized in the current year. There is an incentive to avoid receiving or depositing customer payments at the end of the year. There is an incentive to pay vendor bills before the end of the year, even if due in January. Some companies even draw down lines

of credit in order to pay bills early. There is a limit to what can be prepaid and deducted, so if you are inclined to minimize your cash-basis taxable income, consult your tax advisor to stay out of trouble.

This practice does not eliminate tax, it only defers tax. However, if you can successfully defer it year after year, then it effectively eliminates the tax by deferring it indefinitely. Once you start the game, it can be hard to stop. This is because stopping would result in an extra large tax bill the year you stop as the deferred cash-basis profit is realized in the year you stop playing the game.

Perspectives on Paying Taxes

There are competing schools of thought about managing the amount of income tax you pay.

On one extreme, some folks view taxes as an evil theft of their hard-earned money and want to pay the absolute minimum amount of tax. They will elect cash basis taxation and will play the cash basis income game at the end of the year to bring down taxable income as close to zero as possible. There is a limit to this, however. Assuming the business pays out a hefty chunk of its profit as distributions to its owner, that cash is not available to pay vendors and it is very hard to avoid paying tax on that distributed income over the course of multiple years. Aggressive owners could borrow funds from a line of credit or personally lend their business cash to replace distributed cash and use debt to pay vendors at year-end, though distribution amounts in excess of your tax cost basis in your business are taxable. If you successfully defer a large

amount of tax for successive years, and then something happens and you can't defer it for another year, you can find yourself with a monster tax bill.

On the other extreme, some folks argue that the amount of tax that you pay is a good measure of how profitable your business is and you should be happy to have a large tax bill. Focus all your effort on building a highly profitable company, and don't worry about taxes. Put aside part of your profits and pay your taxes every year. Time you spend worrying about and managing tax tactics is time you are not spending building the best business you can build which is ultimately how you build wealth.

The reality is probably somewhere in the middle. Tax should not be the tail that wags the business dog. If you have a nicely profitable business, you'll end up paying tax on much of that profit. Ensure you are taking all available deductions and tax credits and participating in retirement plans. Develop and follow an annual tax plan developed with your tax advisor to take advantage of tax savings opportunities, ensure you have a projection of how much you will owe in taxes, and avoid penalties and interest by making quarterly estimated tax payments. If there are easy tax moves to make at year-end that don't stress the business or waste money, perhaps you play that game to some extent.

Don't spend money foolishly in a misguided attempt to reduce taxes. If your marginal combined federal and state tax rate is 40%, then for every $1 of taxable income you reduce, you save 40 cents in tax. You're still out 60 cents on net

though. Don't spend cash on anything that you would not buy anyway, as it makes no sense to spend $1 on something you don't really need in order to save 40 cents. All that does is lose you 60 cents that could otherwise go into your pocket.

Book-Tax Differences

Because many businesses keep their books using the accrual basis (whether the QuickBooks version of accrual or something closer to actual accrual), while filing tax returns using the cash basis, there will be differences between the financial statements used to run the business and the financial statements in their tax return. These differences are called "book-tax differences."

Many CPA tax preparers push their small business clients to post "adjusting entries" at the end of the year. After the tax return has been filed, they send clients a list of journal entries to post in QuickBooks dated December 31st of the prior year. The tax preparer's objective is to make Quickbooks match the tax return and eliminate book-tax differences.

This is a pet peeve of mine. These adjusting entries are done for the convenience of the tax preparer without regard to the fact they skew the financial reports their clients use to manage their businesses. You usually end up with hugely distorted monthly financial reports in December as well as for the full year.

Here's a good example related to our earlier discussion of accounting for owner compensation. You and your business partner co-own an LLC, actively work full-time in the

business, and receive regular semi-monthly salary draws alongside the wages paid to your other employees. At the end of the year, if the business produces enough profit, it pays out a chunk of the profit to you and your partner. To reflect the cost of your work as employees, your semi-monthly payroll cost is booked as an expense on the income statement. Your year-end profit shares are booked as distributions of equity capital, effectively like dividends. These distributions are reported on the balance sheet and cash flow statement but don't appear on the income statement as they are not operating expenses. This all makes perfect sense and you've had accurate financial reports to manage the business over the course of the year.

Then tax season rolls around. Your LLC has elected to be taxed as a partnership. Thus on your company tax return, all compensation paid to owners is reported as a distribution of capital to owners on the tax return. That's what the tax code requires.

However, your CPA then provides year-end adjusting entries that include reclassifying your salary draws as distributions of equity capital. If you post that entry, you move a big chunk of expense out of the income statement and are left with the profit reporting problem discussed in the previous chapter. Review Table 27.1 if you need a refresher. You did everything right over the course of the year and had good reporting to manage the business, and the adjusting entry undid all that.

Here's another example. Your company buys a vehicle that costs $90,000. You expect it to last 10 years (120 months), so

your diligent accountant sets up a depreciation schedule to recognize $750 of depreciation expense every month for the next 10 years. This makes sense that you recognize expense as you use the equipment over its useful life. If you want to understand the effect on your cash flow, your accountant can walk you through your cash flow statement to show you the impact of the equipment purchase along with receivables, payables, loans, and anything else that drives your cash flow.

Tax law may allow you to deduct 100% of the cost of the vehicle in the year you buy it via accelerated depreciation provisions in the tax code. That might be a good tax move, to reduce your tax bill this year and defer the tax into future years.

So far so good. You have good monthly financial reports to run the business, and you have optimized your tax bill.

But then your tax accountant sends you an adjusting entry to post that $90,000 of expense on December 31st. What does that do to your financial statements? You will have a big loss that month, with the December financial statements way off. Then you'll have zero depreciation expense for the next 9-10 years. Whatever monthly depreciation expense your diligent accountant set up will be written off the following December 31st when your tax accountant sends you another big adjusting entry to post to eliminate that year's depreciation. If you want accurate monthly financial reports and performance metrics, and the ability to do meaningful year-over-year comparisons, you are out of luck.

There is nothing wrong with having financial statements that are different from the figures in the tax return. In fact, it is very common and is always the case for larger companies. Expect it. Push back if your tax preparer wants you to post tax-based adjusting entries to your financial statements. You own your books and need them to accurately reflect your operations in order to run your business. If the purpose of the adjustments is to make QuickBooks match the tax return, say no thanks. Any good CPA tax preparer is used to working with book-tax differences.

Chapter 30

Sales and Use Tax: A Compliance Challenge

Sales Tax

Sales tax is designed for vendors to charge customers, and then remit to taxing authorities, the prescribed sales tax rate on sales of most goods and some services.

Sales tax has gotten increasingly complex over the years, and states have increased the scope of transactions subject to sales tax in order to raise additional tax revenue. Big companies are used to filing sales tax in all 50 states. After the Wayfair ruling of the U.S Supreme Court in 2018, small companies now also face more onerous filing requirements.

The first step in complying with sales tax laws is to determine in which states your business has what is called nexus. Nexus refers to conducting business in a state. Whether you have nexus is typically determined by:

1. Where your employees work
2. Where you own or lease property
3. Where your customers are

After determining where your business has nexus, determine filing requirements in those states. Some states exempt up to a certain volume of sales in their state, and require filing only if you exceed that threshold.

If you exceed the filing threshold for a state, then determine which specific goods and services that you sell are subject to sales tax in that state. Some states tax services, others tax only tangible products, and most states have exemptions for certain kinds of sales.

After you have established that you need to be filing in a state, the next step is to determine the tax rate structure in the state. Some states such as my home state of Massachusetts have one fixed rate for the entire state. Other states such as my neighbor New York have different tax rates depending upon the local jurisdiction and street address of the customer or vendor.

If you are unlucky enough to have to file in more than a handful of states or in any state with multiple intra-state tax rates, you'll want to utilize technology to automate the process. Solutions like Avalara and TaxJar maintain databases of every tax rate and kind of taxable good or service in every jurisdiction in the country. Integrating such a solution with your invoicing system applies the proper tax rate at the time of invoice creation. At the end of the month these solutions will prepare and file sales tax returns and remit the associated sales tax to tax businesses.

Certain kinds of customers are exempt from paying sales tax, such as nonprofits, government agencies, and resellers who resell your goods and services product to end customers. If you sell to tax exempt customers and do not charge them sales tax, collect and retain sales tax exempt certificates from those customers to prove their exemption. States put the onus on you as the vendor to prove you have documentation supporting any exceptions when you did not charge sales tax on your invoices.

Use Tax

Use tax is self-assessed sales tax. If a company purchases a good or service that is subject to sales tax in the company's state, and the seller does not assess sales tax as part of the sale, then the buyer is obligated to self-assess use tax and remit it to the state. Whether the tax dollars are paid by the seller as collector, or by the buyer on a self-assessed basis, the state wants its tax dollars.

Use tax compliance requires identifying purchases of goods and services subject to sales tax in your home state, and in other states if you purchase items for delivery and use in company offices in other states. Flag any invoices or payment receipts that do not include sales tax. After factoring in filing amount thresholds, file use tax returns in required states. Use tax returns are often combined with sales tax returns in one unified sales and use tax return.

If you are in business long enough, you might be audited by your home state's department of revenue for sales and use tax compliance. Having been through such an audit myself,

the inspector will literally look at vendor invoices and see if sales tax was assessed and if not, if that invoice was included in the calculation of your use tax returns. You will be presented with an assessment (a tax bill) of use tax that was not paid, along with any sales tax that should have been paid on sales to your customers, plus of course penalties and interest.

Personal Property Tax

Personal property tax is assessed by cities and towns on a local level, often as part of a standard state-wide process. For purposes of this tax, personal property is defined as all movable property not attached to a building. Things like computers, furniture, etc.

Typically companies provide an annual list of personal property to each city or town in which the company has an office or otherwise owns property. The list includes a description of each item, year of manufacture, purchase date, purchase cost, and estimated market value. The city or town then sends a tax bill.

Many cities and towns will have assessors inspect office buildings to identify businesses that should be filing personal property tax returns, and to validate the property in use at the location.

Chapter 31

Adequate Capitalization: Can You Sleep at Night?

When we say a business is well capitalized, we mean that it has raised and retained enough cash in the business to be able to cover all operating activities without having to micromanage cash, make small-to-medium sized investments out of cash on hand, and weather temporary adverse events without having to conduct major cost cutting or raise additional capital. Essentially, that the business has a healthy cash balance and little or no short-term debt.

Capitalization pain is a symptom of a business that has struggled to be profitable or that has not retained enough profit in the business. It can also result from events that test a company's capitalization. These can be good or bad events, such as:

- The unexpected loss of a few customers or one huge customer
- The need to hire new employees to support growth
- Some bad debt expense
- The opportunity to invest in new software or other assets having longer term benefit but short term cost

- Expanding into new office space or production facilities to grow the business
- A couple of bad sales quarters with reduced revenue
- A cyclical downturn in your industry
- The opportunity to launch a new offering
- The chance to make a small opportunistic acquisition

The business's level of capitalization determines how well a business can weather negative events and take advantage of positive opportunities.

Capitalization directly correlates with how well owners can sleep at night. Meaning how stressed they are about being able to pay bills and make payroll and whether their company can continue operating without having to take dramatic cost cutting actions; without owners forgoing salaries, contributing more cash to business, or providing a lender a mortgage on their house; or having to decline a great investment opportunity for lack of capital to invest.

Being undercapitalized also introduces a new set of costs that distract from time otherwise spent growing and innovating and making the business more successful longer term. Fielding and triaging inbound collections calls from vendors takes time and energy, and a supplier suspending services or product deliveries is disruptive. Time spent chasing collections from customers to get them to pay extra fast is time not spent creating long term value. Early pay discounts erode profits. Modeling weekly cash flow, managing weekly cash flow plans, and figuring out how to make payroll all take

time and energy. There is a real cost of people's time spent doing these things and a real cost to the mental energy and stress related to tactical cash management versus strategically managing and growing the business.

Put another way, do you want your team spending time triaging vendor collections calls and figuring out how to make payroll, or do you want your team selling new customers and improving your service offerings and increasingly profits?

Capitalization can be expressed in a number of different ways. The simplest way, especially for small businesses to manage, is to compare cash in the bank versus monthly operating expenses. This is expressed as a number of months. For example:

$75,000	Cash in the bank
$150,000	Monthly Operating Expenses
$75,000 / $150,000 = 0.5 months	Number of months of cash in the bank

Table 31.1

The standard for most businesses is 2 months of cash in the bank. Capitalization needs can vary by business model. businesses with mostly recurring monthly revenue from a stable, diverse customer base at a healthy labor-loaded gross margin may be OK with 1 month of cash in the bank. Project-based businesses and businesses serving cyclical industries

will need more. businesses with high fixed costs will need more than businesses with a mostly variable cost model.

From my experience, if I can get customers to 1.0, then a lot of the weekly stress and distraction around cash flow management goes away. They may continue building to a 2.0 target, while the negative distractions mostly go away at 1.0.

This does not mean that once you get to 1 or 2 months of cash in the bank you can relax your collections focus, loosen payment terms, or buy things you don't really need. The discipline around cash flow management and profitability must remain in place. It's just that cash management becomes a regular part of managing the business and is not a priority above other important objectives which drive business value.

Note that capitalization is not the same as access to capital. Having an undrawn line of credit in place is prudent, though it is not the same as having a company that can finance itself without relying on outside capital. Lending commitments can come and go, often must be renewed annually, and may not be available when you really need them after things have gone South in your business. Plus, they almost always need to be personally guaranteed and whatever is borrowed must be repaid out of future profits and cash flow which weakens your future financial position. Small businesses typically can't rely on external equity investors as most small businesses do not have an investment profile attractive to angel and venture investors.

Building Capital

Where does this capitalization come from? It comes from owner capital contributions initially and then from retained profit.

When launching a business, owners often bootstrap the business, meaning they invest as little cash up front as possible and try to pay expenses out of cash income. If they take out a loan to open the business or to acquire an existing business, the loan does not include much extra cash beyond what is initially required to open or to buy the business. As a result, most small businesses begin life undercapitalized.

After launch, there are competing claims on where to allocate cash flow. This assumes the business is profitable and there is cash flow to allocate.

Profit and cash flow can go to:

1. Taxes. This is mandatory. Taxes can be managed to some extent, but profitable businesses inevitably have to pay income tax or their owners have to pay it for pass-through entities.
2. Debt principal repayment. This may be mandatory for fixed amortizing term loans, or somewhat discretionary for the balance on lines of credit or credit card debt.
3. Retained Earnings. After paying taxes, leaving the remaining profit in the business builds capital. It will accumulate in the bank account and in an equity account on the balance sheet called Retained Earnings

(or Member or Partner Capital if retained profit is allocated to specific member GL accounts at the end of every year). This is ultimately where the equity and cash capitalization of the business will come from. If the business carries debt, retained earnings can be used to pay down debt.

4. Maintenance investments to replace or refresh large assets. As most businesses are "asset-light", there aren't many large assets to maintain. Perhaps a refresh of the office or a renewal of an expensive multi-year software license.

5. Growth investments for the business. This is not the same as incremental spending decisions that are required to operate and grow the business at a modest rate or to replace or refresh current assets. Those are operating expenses, not investments. Here I'm talking about big investments such as a manager hire, office buildout, launching new service offerings, acquisitions, etc.-- things that will substantially increase the growth of the business.

6. Owner distributions. These are obviously desirable, especially to business owners who have previously invested significant cash in the business and paid themselves a below-market wage for some number of startup years. When the business starts to have the ability to pay distributions, these owners feel like they need to recoup their initial investment and get a return on all the stress and risks they bear as business owners. They also have the same extra cash needs and wants that non-business owners have--buying a

house, paying kids' college bills, taking a nice vacation, etc.

Profit Allocation Planning

I've found most business owners benefit from a profit allocation plan to help guide them between these capital allocation options. The following progression assumes the business is not in dire straits and has some capitalization to build from, with at least half a month of cash in the bank. It also assumes the business has annual cash flow that approximates its reported net profit on the income statement. If cash flow lags reported profit, then expanded modeling is needed.

Step #1: Allocate Tax Payments

Meet with your tax advisor to project what percentage of your business's profit to earmark for taxes. Tax as a percentage of total business profit is often in the 30%-45% range depending on the personal tax bracket of the business owner and any self-employment tax. I use 40% as the default until a tax advisor provides more specific guidance.

Remember that if your business is taxed as a partnership, your salary (member/partner draw) that is booked to the income statement as discussed in Chapter 28 is subject to self-employment tax because there is no payroll tax withheld on those payments. You'll need to earmark a portion of your salary to taxes as well as a portion of your business's profit. Your tax advisor can help you determine how much in total you need to allocate to taxes.

By all means, implement strategies to minimize your tax liabilities if you are so inclined. Ultimately your tax advisor will provide a quarterly estimated tax schedule. The first thing you do with your cash flow is to pay quarterly estimated taxes. Not only are there often penalties and interest for underpaying your quarterly estimated taxes, you run the risk of not having cash to pay taxes when they are due the following March or April if you do not pay quarterly installments. Cash has a way of leaking out of business and personal bank accounts, as letting it sit there is hard and it often ends up being spent on something.

To mitigate the risk of cash earmarked for taxes being spent on something else, it can be helpful to have a separate savings account to house that cash rather than letting it co-mingle in the operating checking account. At the end of every month, transfer a percentage of your profit to the tax savings account. Then you can make tax payments from funds in the the savings account.

At least once per year between September and November, meet with your tax advisor to update the projection and tweak remaining estimated tax payments and your profit allocation plan as needed.

When paying personal taxes associated with income from a pass-through entity, the payments are made out of distributions to owners. If for convenience you have the business make these payments directly to tax businesses on your behalf instead of first distributing the cash and then paying them out of your personal bank account, be sure they

are booked as distributions and not as a tax expense of the business.

Step #2: Schedule Debt Repayments

If your business carries debt, schedule any mandatory principal payments over the next year, plus any optional principal repayments if you prioritize debt reduction. Remember, debt principal repayments are not tax deductible expenses and do not appear on the income statement and are paid with after-tax profits.

Step #3: Build Capitalization with Retained Earnings

Review your business's current capitalization level. Based on commitments to taxes, debt repayment, and any required asset replacements, around 35%-65% of annual profit could be retained in the business. Do the math to see how many months of cash in the bank the business would end the year with if 35%-65% of profit were retained in the business. If the business has cash representing less than 1 month of operating expenses in the bank, then aim to retain enough profit to bring that multiple up to at least 1.0 by the end of the year, preferably more. Beyond 2 months of cash in the bank, ownership may be able to distribute most of the after-tax annual profit to itself as distributions unless a high growth rate and negative cash flow cycle or a desire to save up for a large future investment requires the business to retain additional cash in the bank.

Step #4: Review Investment Requirements and Opportunities

Some businesses are "asset-light", meaning they don't have much by way of equipment that needs to be replaced. If you do have large required expenditures that exceed the threshold of expensing them on the income statement, such as real estate buildout or heavy equipment purchases, schedule those out for the next year. Then list out other optional opportunities to make large investments in the next year. Analyze the cash requirements, projected return on investment, and risks and probability of success for each opportunity. Force rank the investments from best to worst. Calculate what percentage of annual profit is represented by each of these investments. Make no investment commitments yet unless there is a critical asset that must be replaced in the next year.

What is the expected ROI required to justify retaining profit in the business to make an investment? The analysis can be complicated by strategic and tax factors, but one rule of thumb is 50% pretax as measured in year 2 after making the investment. Earlier in this book in the discussion of the Return on Invested Capital metric (ROIC), I illustrated that a business operating at a 10% profit margin with a healthy cash balance produces a pretax ROIC of at least 50%.

You want future investments to yield at least a 10% profit margin with a reasonable amount of capital supporting them, which results in a 50%+ pretax ROI.

I can be a little bit more lenient with my hurdle rate based on alternative investment options, and I also consider if the investment is being made with tax-deductible expenses or

with money you have already paid tax on, and consider how the ROI on the initial investment might climb in years 3+. We need to be careful, though, about accepting a low ROI for too long as heavily back-weighted investment cases can reflect wishful thinking more than reality.

You could argue 50% or even 20%-30% ROI is a very high hurdle rate compared to the public stock market return of around 10% annually for an S&P 500 index fund over the last century. However, not all your investments will work out. Some will fail miserably, some will cost more than you planned, and some will work out OK but not as well as you expected. These scenarios reduce your actual average realized ROI. You could argue some investments will exceed initial plans, though business owners tend to be optimistic and new initiatives tend to underperform more than they overperform. And you have to pay annual income tax on your profits while investors in the S&P 500 defer tax for many years or decades until they sell their investment, allowing it to compound tax-free, and then they pay a much lower long term capital gains tax rate when they eventually sell their stock.

Another big factor to consider is that big public companies have easy access to capital and can finance periods of low margins or losses and negative cash flow, whereas that often puts a small business out of business or requires owners to forgo salary and dip into their savings to put cash back into their business. Big public companies also engineer the use of debt to magnify return on equity and chase marginal returns to maximize shareholder value, which reduce ROIC. They

have the scale to operate that way, whereas small businesses do not.

Step #5: Allocate Take-Home Distributions

Take-home distributions are distributions in excess of distributions earmarked for taxes. They represent after-tax profits paid out to owners. They function as dividends to owners to provide owners a return on their invested capital. business owners financially profit from business ownership in two ways: 1) income from take-home distributions; and 2) an increase in the value of their equity in the business (which derives from future increases in take-home distributions made possible by profit growth.) Unless you sell your business to realize the value of your equity all at once, it is these take-home distributions that provide your return on investment.

In theory, owners do not depend on distributions beyond their salaries in order to pay personal living expenses. That is the best practice. In reality, that is often not the case. You might be playing the payroll tax game by keeping your W-2 wages low and taking distributions to make up the balance of your salary, or you might have temporarily elevated expenses such as children' s college tuition bills, or you might have splurged on home remodeling or a vacation home. If you need a certain amount of distributions beyond salary to pay bills for your family, then budget those.

If, after budgeting taxes, debt service, investments, and minimum take-home distributions, there is profit left over to allocate, then increase take-home distributions-- you've

earned it! If the business has a good year and is well capitalized, by all means celebrate with big distributions.

Step #6: Complete the Profit Allocation Plan

The profit allocation planning process is iterative based on competing priorities. Profits must be spread between making the balance sheet healthier through building capitalization and paying down debt on one hand, and investing in growth initiatives and compensating owners on the other hand. Healthy debate and assessments of opportunities and risks all go into deciding between competing alternative allocations of capital. There is no right answer for every business, though I strongly encourage a large majority of annual profit after taxes to be allocated to capitalization until the business has at least 1 month of expenses in cash in the bank.

The resulting plan will look something like the table below, with an associated monthly payment schedule for each of these items (except Retained Earnings which requires no payment action).

Sample Profit Allocation Plan:

ANNUAL PROFIT ALLOCATION PLAN		
Annual Revenue Forecast		$3,000,000
Annual Net Profit Forecast		$ 300,000
	% of Profit	Allocation
Income Tax	40%	$120,000
Debt Reduction	5%	$15,000
Retained Earnings	30%	$90,000
Investment	15%	$45,000
Take-Home Distributions	10%	$30,000
	100%	$300,000
	Current	End of Year
Cash	$150,000	$240,000
Monthly Opex	$225,000	$247,500
Cash Multiple (months)	0.7X	1.0X

Table 31.2

In this example, the business balances the need to build capitalization (improving the cash multiple to 1.0X) with paying down debt, making investments, and paying a bonus to the owner. An Excel template of this plan can be downloaded from TheFinancialOS.com.

Profit Allocation Approach for Distressed Businesses

If your business is fighting for its financial life to stay in business, then modify the approach. There is likely little tax liability to pay as the business has little profit. Owner distributions are probably off the table, and it would be a win

if the owner were able to maintain a salary. There is not enough capital for growth investments, so that is also off the table. Only minimum required debt payments would be made, as cash needs to be kept in the business to fund operations. The focus in this case is all about improving profitability and retaining as much cash as possible. There is usually a core profit problem to be solved, which has resulted in lack of cash generation. Without profit it is impossible to generate positive cash flow over an extended period of time.

Chapter 32

When Sales Go South: Managing Cost Structure Through Downturns

This chapter originated as a white paper in the midst of the 2020 coronavirus outbreak that shut down a lot of businesses. The following practices are applicable whenever your business is facing a downturn. Perhaps your business serves political customers with financial peaks and valleys driven by election cycles or has customers concentrated in another cyclical industry. Perhaps there is a periodic economic recession and customers scale back their marketing spending in general. Whenever a business is grappling with a high degree of uncertainty and fear about future revenue, profit, and cash flow--whether due to a pandemic, cyclical industry downturn, or company-specific circumstances--the business must systematically assess and manage its cost structure.

Here I outline a 5-Step process for modeling and managing the financial impact of declining sales. While there is a natural knee-jerk reaction to cut any costs that you can when facing a downturn, it's more effective to utilize this systematic framework to prioritize what to cut.

Step #1: Assess Sales Scenarios

First, assess each revenue stream and the risk that it declines. Also assess individual customers and the risk they curtail purchases. The more concentrated sales are to a small number of large customers, the more important it is to assess individual customer risk. Forecast a few realistic scenarios ranging from what would be a modest decline in sales from current volumes to what would be a large decline. You might end up with the following scenarios:

	Current	-15%	-25%	-40%
Monthly revenue	$300,000	$255,000	$225,000	$180,000

Table 32.1

Step #2: Assess Direct Cost Structure

Second, assess the variable and fixed direct costs of delivering your services. An example of a variable cost would be third party services that are resold. If there is no sale, there is no such cost incurred. While on paper you don’t need to cut variable costs, in reality you do need to manage those vendor relationships and contracts to reduce or cancel them. An example of a fixed cost would be a salaried project manager. If there are no projects to deliver, you still pay the salary.

Project those variable and fixed costs across your revenue forecast scenarios. You might end up with the following direct cost and margin scenarios:

	Current	-15%	-25%	-40%
Monthly revenue	**$300,000**	**$255,000**	**$225,000**	**$180,000**
Variable direct costs	$90,000	$76,500	$67,500	$54,000
% of revenue	30.0%	30.0%	30.0%	30.0%
Fixed direct costs	$85,000	$85,000	$85,000	$85,000
% of revenue	28.3%	33.3%	37.8%	47.2%
Total direct costs	$175,000	$161,500	$152,500	$139,000
% of revenue	58.3%	63.3%	67.8%	77.2%
Labor-Loaded Gross Profit	**$125,000**	**$93,500**	**$72,500**	**$41,000**
% of revenue	41.7%	36.7%	32.2%	22.8%

Table 32.2

Step #3: Assess SG&A Cost Structure

Third, look at your Marketing & Sales and General & Administrative expenses, and separate the fixed costs from the variable costs. Project those variable and fixed costs over your revenue forecast scenarios. You may end up with the following SG&A cost scenarios:

	Current	-15%	-25%	-40%
Monthly revenue	**$300,000**	**$255,000**	**$225,000**	**$180,000**
Variable Marketing & Sales	$15,000	$12,750	$11,250	$9,000
% of revenue	5.0%	5.0%	5.0%	5.0%
Fixed Marketing & Sales	$30,000	$30,000	$30,000	$30,000
% of revenue	10.0%	11.8%	13.3%	16.7%
Variable General & Admin	$0	$0	$0	$0
% of revenue	0.0%	0.0%	0.0%	0.0%
Fixed General & Admin	$45,000	$45,000	$45,000	$45,000
% of revenue	15.0%	17.6%	20.0%	25.0%
Total M&S and G&A	**$90,000**	**$87,750**	**$86,250**	**$84,000**
% of revenue	30.0%	34.4%	38.3%	46.7%

Table 32.3

Step #4: Compile Full P&L Scenarios

Fourth, compile all this data into a set of full P&L scenarios. This illustrates your profitability at varying levels of revenue decline. There will be a point at which the business becomes unprofitable, in this example around a 17%-18% revenue decline.

	Current	-15%	-25%	-40%
Monthly revenue	**$300,000**	**$255,000**	**$225,000**	**$180,000**
Variable direct costs	$90,000	$76,500	$67,500	$54,000
Fixed direct costs	$85,000	$85,000	$85,000	$85,000
Total direct costs	$175,000	$161,500	$152,500	$139,000
Labor-Loaded Gross Profit	**$125,000**	**$93,500**	**$72,500**	**$41,000**
% of revenue	41.7%	36.7%	32.2%	22.8%
Variable Marketing & Sales	$15,000	$12,750	$11,250	$9,000
Fixed Marketing & Sales	$30,000	$30,000	$30,000	$30,000
Variable General & Admin	$0	$0	$0	$0
Fixed General & Admin	$45,000	$45,000	$45,000	$45,000
Total M&S and G&A	$90,000	$87,750	$86,250	$84,000
% of revenue	30.0%	34.4%	38.3%	46.7%
Operating Profit	**$35,000**	**$5,750**	**-$13,750**	**-$43,000**
% of revenue	11.7%	2.3%	-6.1%	-23.9%

Table 32.4

Step #5: Plan and Prioritize Cost Cuts

Because variable costs naturally drop when sales drop, cost cutting efforts focus mostly on reducing fixed costs. Certainly chisel away at variable costs the best you can to reduce variable costs as a percentage of revenue. However, if a business shrinks significantly in size it is inevitable that fixed costs will be too high as a percentage of revenue. Those fixed costs were built up over time to support larger volume levels, and a much smaller company simply cannot support that level of fixed costs nor does it need them any longer.

Cost cutting is a matter of deciding which costs can be cut with the minimum impact on:

1. Serving existing customers
2. "Keeping the lights on" from an administrative perspective
3. Preserving the ability to bring in new customers now and in the future when sales activity picks up

The largest fixed cost in businesses is payroll. Eliminating salaries is a painful decision though may be necessary. Sometimes there are alternatives to permanently terminating employees, such as temporarily moving certain positions to part-time or an across-the-board salary reduction or an unpaid furlough for certain positions.

How aggressively to cut costs is largely a function of:

1. How profitable the business is to begin with, and how far sales need to decline in order to lose money.

2. How much cash reserve the business has and is willing to spend down.

3. How confident the business is in its sales forecasts and resulting P&L forecasts.

4. How much tolerance ownership has for losing money, including its ability to reduce or forego its own compensation for some period of time.

Cash Flow Management in a Downturn

In dire economic times, cash flow vigilance is more important than ever. Here are a few basic cash management practices:

1. Create a rolling cash flow forecast containing at least 13 weeks. The monthly P&L forecast is not enough to manage the business when cash is tight. You need to know what your cash will be each week as cash flow differs from reported net income on the P&L and there are large intra-month swings when payroll and other large expenses need to be paid.

2. Identify how much cash you have on hand relative to monthly operating expenses. There is a level at which you can't go below and still be able to make payroll. That may be around half of one month's operating expenses. If you forecast approaching that level, rapid cost cutting and/or borrowing is critical.

3. Be extra diligent on collecting accounts receivable. Identify bad debt risk before those customers get into you for too much, especially if you incur third party cost of goods sold that you must pay even if your customer does not pay you. In the best of times small

businesses don't have much insight into the financial condition of their customers. In the midst of an economic downturn, assume any customer could be in financial distress and unable or unwilling to pay you. Naturally you want to be accommodating to good customers, but you also need to protect your own business and your ability to pay your employees and stay in business.

4. Negotiate extended payment terms with your largest creditors. If you can get an extra 15 or 30 days to pay a large vendor, that gives you an extra 15-30 days to collect from your customers.

5. If you are going to be delinquent in paying bills, communicate with vendors. Consider making a partial payment or implementing an extended payment plan. Good faith communication with vendors can delay or prevent service suspensions and collections activity up to and including getting sued.

Businesses that do not have a healthy cash reserve sometimes consider borrowing money. As the old saying goes, the best time to borrow money is when you don't need it. While it might be too late to line up new capital once a downturn begins, review your current borrowing capacity and the covenant terms of your line of credit (if you have one). If you have drawn down a large amount on a line of credit and don't expect to repay it anytime soon, consider trying to convert it into a term loan which locks in a fixed interest rate for several years and is not subject to annual renewal.

You don't want to borrow money to cover operating losses, only to plug temporary cash shortfalls due to the timing of collecting receivables and paying bills or short seasonal lulls. Borrowing to cover extended operating losses is very risky both to the business and for the personal guarantees usually provided by owners, and owners need to think hard before doing so.

Sources of Capital

There are various sources of capital small businesses can draw upon. There tend to be 4 categories, in increasing order of interest rate cost:

1. Owners contributing more capital or foregoing wages. This is nominally free with no direct interest expense, though there is opportunity cost and risk to ownership of investing more capital in the business and in reality this is expensive capital.

2. Bank line of credit or term loan including SBA-backed term loans. Interest rates are reasonable, though personal guarantees are required and sometimes liens on owners' homes.

3. Mezzanine lenders outside traditional bank loans. Credit cards and factoring fall into this category, as do other non-bank lenders who are comfortable lending in higher risk situations with less collateral in exchange for higher interest rates of 20%+.

4. Online lenders including QuickBooks Capital which connect to QuickBooks and use the data to very quickly underwrite and advance loans. I've seen

interest rates range from 24% to 40% or more, so these should be a last resort.

Family and friends can also be a source of capital, often on terms more flexible and favorable than unaffiliated third-parties. Not everyone has family and friends willing to invest in their business, and there can be terrible consequences if you lose the money of your family and friends, though this is a commonly used source of capital.

Note that selling equity is not usually an option for businesses, especially not in the midst of a downturn. Most businesses do not have an investment profile attractive to angel and venture investors seeking 30%+ annual returns.

About The Author

Calvin Wilder

Cal's passion is empowering small business owners to run healthy businesses and to become more financially fit. As a CFO, he partners with businesses to assess and manage the financial metrics which drive equity value for business owners. As an investor, he analyzes financial metrics to drive investment decisions.

Not a traditional CPA, Cal brings a refreshing mindset to small business accounting and finance. Having worked with hundreds of small businesses, Cal is an expert at operationalizing financial management, with a knack for effectively balancing accounting needs, reporting priorities, operational requirements, and budget constraints.

An entrepreneur himself, Cal has founded or co-founded 8 companies so far in his career including one that was acquired by Staples in 2006. Recruited to serve on various corporate Boards, he has advised Intacct (acquired by Sage for $850M), MineralTree (raised >$70M in VC funding and acquired by Global Payments for $500M), and G2 Technology Group (bootstrapped, acquired by private equity firm Great Hill Partners and subsequently CDW).

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