Successful small business management frequently depends on the manager's knowledge in five key areas: profit planning, using financial statements, analyzing cash flow, maintaining a healthy financial structure, and the ability to control and plan for future capital needs.

If you have a good working knowledge in these areas, the financial aspects of your business should be successful. This publication briefly describes and illustrates these areas. They are important considerations, regardless of whether you are just thinking about starting a business or are a longtime business operator.

Planning for profit

Profit planning is a continuing process. It does not guarantee a profit, but profits are more likely to materialize when you plan for them. Profit planning usually does not account for such things as natural disasters or government intervention.

You should consider the following steps when planning for profit.

Analysis

First, you must analyze the existing operation of your business. This analysis will help to determine its strengths and weaknesses. You might discontinue unprofitable parts of your business.

It is frequently helpful if you can compare the analysis with those from businesses similar to yours. Doing this helps sometimes to show the strengths and weaknesses of your business.

Key performance areas (KPA's)

The next step is to determine these major elements of your business that influence profits, such as sales (receipts), expenses, and margins. It is a realistic projection for each.

For example, you expect sales to be down during the planning period because of such things as lower prices, a production, don't make the projected sales assumptions would be self-defeating. Be sure your KPA projections are realistic, measurable, and in writing.

Action plans

Next, make flexible action plans to achieve the KPA projections. Action plans are step-by-step procedures that spell out how you will achieve your projections within the specified time periods. These action plans should be flexible so that you can make adjustments for unexpected events.

Putting them to work

After you've made your action plans, try them out! You can evaluate the success of the action plans by comparing actual results with the planned KPA results.

Adjusting your plans

The next step in the profit-planning process is to make changes in your action plans as needed to achieve the KPA projections/objectives you previously established. In some cases, you may have to go back to the beginning of the profit-planning process and start all over again. You would probably not do this if you made grossly unrealistic projections or if there were unexpected disasters.

Using financial statements

To analyze the financial position of your business, there are three fundamental financial statements you should prepare and use: a balance sheet, a profit and loss statement, and a sources and uses of funds statement.

Balance sheet

The balance sheet also is called a financial statement, net worth statement, or statement of financial condition. Its purpose is, in part, to provide basic data for analysis of the liquidity, solvency, and net worth of your business at a specific moment in time. It tells you “where your business is” at that moment.

The balance sheet is a systematic listing of all the assets, all the liabilities, and the net worth of your business. Assets are what your business owns, liabilities are what the business owes, and net worth is your investment (equity) in the business. Prepare it on a regular basis (monthly, quarterly, or annually).

An example of a simple balance sheet is shown in Illustration 1. It lists the assets, liabilities, and equity for My Business as of a specific date, January 1, 19xx. Both the assets and liabilities are broken into current and long term categories.

Assets. Current assets are those that you expect to last 1 year or less; they’re typically listed in order of their cashlike quality. So cash itself is listed first. Accounts receivable are amounts owed to you. Total current assets in this example are $23,193.
### Illustration 1

**My Business**  
**Balance sheet**  
**January 1, 19xx**

#### Assets

<table>
<thead>
<tr>
<th>Current</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 2,748</td>
</tr>
<tr>
<td>Securities</td>
<td>2,345</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>2,000</td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
</tr>
<tr>
<td>Merchandise</td>
<td>12,600</td>
</tr>
<tr>
<td>Supplies</td>
<td>3,500</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>$23,193</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long term</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment (at cost)</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>1,015</td>
</tr>
<tr>
<td>Equipment (net depreciated value)</td>
<td>5,985</td>
</tr>
<tr>
<td>Buildings (at cost)</td>
<td>40,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>9,800</td>
</tr>
<tr>
<td>Buildings (net depreciation value)</td>
<td>30,200</td>
</tr>
<tr>
<td>Land (at cost)</td>
<td>1,800</td>
</tr>
<tr>
<td><strong>Total long term assets</strong></td>
<td>37,985</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$61,178</td>
</tr>
</tbody>
</table>

#### Liabilities

<table>
<thead>
<tr>
<th>Current</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Annual mortgage principal due (bank notes payable)</td>
<td>5,800</td>
</tr>
<tr>
<td>Accrued expenses payable</td>
<td>800</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>7,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long term</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage (less current portion)</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$32,600</td>
</tr>
<tr>
<td><strong>Owner's equity</strong></td>
<td>28,578</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$61,178</td>
</tr>
</tbody>
</table>
The long term assets in Illustration 1 consist of equipment, buildings, and land. They are asset categories that you expect to last more than 1 year. All are valued at cost. Accumulated depreciation (the sum of depreciation taken on an asset over its lifetime) is shown as a deduction from the value of all equipment and buildings that are depreciable.

From an accounting viewpoint, land is not a depreciable asset since it is not expected to wear out as other assets do. Total long term assets for My Business are $37,985 (net depreciated value). Total assets, the sum of current and long term assets, are valued at $61,178.

Liabilities in Illustration 1 also are divided into current and long term portions. As in the asset categories, current liabilities are those that you expect to pay within 1 year or less. In Illustration 1, total current liabilities are $7,600.

They consist of accounts payable, annual mortgage principal due, and accrued expenses payable. Accounts payable consists of amounts due to others for purchased goods and services. Bank notes payable typically includes the current portion of long term debt that you must pay within 1 year of the date on the balance sheet. Accrued expenses payable are those things as wages, interest, and taxes due that stand as a lien against the business.

The only long term liability in Illustration 1 is a mortgage of $25,000. If you include the current portion of this debt in bank notes payable (current liability), you should reduce the long term liability to reflect it. In general long term liabilities are those that you expect to pay after more than 1 year. The total liabilities of My Business are $32,600 as of the balance sheet date.

Owner’s equity in the business is listed at $28,578. This is the difference between total assets and total liabilities. Notice that the sum total of liabilities and owner’s equity equals $61,178, the value of total assets. This is a basic decomposition for your balance sheet to be in balance: assets always must equal the sum of liabilities and owner’s equity. In other words, what your business owns must equal the sum of what you have invested.

Illustration 2 shows the balance sheet for My Business as of March 31, 19xx, one quarter later. All the current and long term account categories are the same as in Illustration 1. All the values are calculated in the same manner. That is important, because consistency in calculations from one period to the next is needed to measure change properly in your business over time.

By looking at the values of the balance sheet accounts from one time period to the next, you will be able to track the financial progress of your business. As an example, Illustration 2 shows a reconciliation of change in owner’s equity.

The difference between owner’s equity at the beginning and end of the period is $2,915. The source of that change is net profit generated during the period as shown on the profit and loss statement for My Business, which we will discuss later.

Another example balance sheet (this time, for Sales Galore) is shown in Illustration 3. One of the reasons for including this information is to emphasize that there are a number of ways you can set up a balance sheet. Feel free to arrange things any way you see fit, provided that it has a basic breakdown into assets, liabilities, and equity. Again, once you have decided on the format, it is consistent from period to period.

In Illustration 3, assets as well as liabilities are broken down into current, intermediate, and long term. Current categories are still those that you expect to last no longer than 1 year. Intermediate are typically those that you expect to last 2 to 10 years. The long term is considered to be more than 10 years.

Note that intermediate and long term assets in this example are valued at current level, rather than on a cost less accumulated depreciation basis. That means that these values are estimates of current market value. For example, be sure to adjust accounts receivable for uncollectibles.

Profit and loss statement

This also is called an operating statement or an income statement. Its main purpose is to measure the earnings from your firm’s business activity during the accounting period. It is a listing of the receipts and the expenses of the business.

The profit and loss statement tells you “how your business got to where it is. “ Provided you prepare it using cost values, the profit and loss statement links your periodic balance sheets over time.

An example of a profit and loss statement for My Business is shown in Illustration 4, for the period January 1, 19xx, to March 31, 19xx. It shows gross margin first, which is the difference between net sales and cost of goods sold.

Assuming that you are selling goods that you buy from another source, cost of goods sold reflects the wholesale cost of the merchandise to you, including any service charge such as delivery. Net sales are total sales adjusted for customer returns and allowances.

Offsetting gross margin are two types of expense, variable and fixed.
# Illustration 2

## My Business

### Balance sheet

**March 31, 19xx**

### Assets

**Current**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,748</td>
</tr>
<tr>
<td>Securities</td>
<td>2,345</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,000</td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
</tr>
<tr>
<td>Merchandise</td>
<td>13,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>3,300</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td><strong>$25,393</strong></td>
</tr>
</tbody>
</table>

**Long term**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$7,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>-1,300</td>
</tr>
<tr>
<td>Equipment (net depreciated value)</td>
<td>5,700</td>
</tr>
<tr>
<td>Buildings</td>
<td>40,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>-10,000</td>
</tr>
<tr>
<td>Buildings (net depreciation value)</td>
<td>29,900</td>
</tr>
<tr>
<td>Land</td>
<td>1,800</td>
</tr>
<tr>
<td><strong>Total long term assets</strong></td>
<td><strong>37,400</strong></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$62,793</strong></td>
</tr>
</tbody>
</table>

### Liabilities

**Current**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$900</td>
</tr>
<tr>
<td>Bank notes payable</td>
<td>4,900</td>
</tr>
<tr>
<td>Accrued expenses payable</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td><strong>$6,800</strong></td>
</tr>
</tbody>
</table>

**Long term**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td>24,500</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>$31,300</strong></td>
</tr>
<tr>
<td><strong>Owner’s equity</strong></td>
<td><strong>31,493</strong></td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>$62,793</strong></td>
</tr>
</tbody>
</table>

### Reconciliation of change in owner’s equity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner’s equity January 1, 19xx</td>
<td>$28,578</td>
</tr>
<tr>
<td>Owner’s equity March 31, 19xx</td>
<td>31,493</td>
</tr>
<tr>
<td><strong>Change in owner’s equity</strong></td>
<td><strong>$2,915</strong></td>
</tr>
</tbody>
</table>
### Illustration 3

**Sales Galore**  
**Balance sheet**  
**January 1, 19xx**

**Assets**  

**Current**
- Cash in hand: $100  
- Cash in bank: 1,200  
- Inventory: 2,800  
- **Total current assets**: $4,100  

**Intermediate (market value)**
- Machinery: $8,000  
- Livestock: 2,500  
- **Total intermediate assets**: 10,500  

**Long term (market value)**
- Buildings: $4,350  
- Land: 10,000  
- **Total long term assets**: 14,350  
- **Total assets**: $28,950

**Liabilities**  

**Current**
- Current portion of noncurrent loans: $2,000  
- Wages payable: 1,000  
- Supply bills: 1,000  
- **Total current liabilities**: 4,000  

**Intermediate**
- Machinery debt: 2,200  
- Personal loan: 5,000  
- **Total intermediate liabilities**: 7,200  

**Long term**
- Real estate loan: 8,000  
- **Total liabilities**: $19,200  
- **Net worth**: 9,750  
- **Total net worth and liabilities**: $28,950
Variable expenses are those that are associated with the volume of business you are doing. If you are not doing any business, variable expense equals zero.

On the other hand, the fixed expense categories are those that exist regardless of whether you have any volume of business or not. Interest expense in this example is listed as a separate item following total operating expense.

Notice that the net income of $2,915 in Illustration 4 relates directly back to the reconciliation of net worth in Illustration 2. The profit and loss statement in Illustration 4 provides the link between the balance sheets for My Business in the first two illustrations.

The profit and loss statement for Sales Galore in Illustration 5 is another example of how you might design yours. Operating receipts are simply the cash sales for the period. No attempt is made to divide offsetting operating expenses into variable and fixed categories.

Rather than net income, the difference is return to operator labor, management, and capital because no specific costs for these items have been included in operating expenses.
Illustration 5

Sales Galore
Profit and loss statement
for period January 1, 19xx, to March 31, 19xx

Operating receipts
- Crops $8,200
- Livestock 3,500
Total operating receipts $11,700

Operating expenses
- Livestock $1,725
- Machine maintenance 1,015
- Crop seed and fertilizer 3,400
- Labor, hired 2,050
- Depreciation 1,200
- Property taxes 220
- Insurance 30
- Rent 450
- Utilities 100
- Interest 300
- Miscellaneous 60
Total operating expenses $10,550

Return to operator labor, management, and capital (before-tax cash basis) $1,150

Sources and uses of funds statement

This statement can be an important management tool for you. Prepare it at the same time you do your balance sheet. It shows how cash is generated in your business and how it is used. Simply put, it is a comparison between the dollar amount of each account on your balance sheet at the beginning and at the end of the accounting period.

A source of funds is defined as a decrease in the dollar amount of an asset account during the period or an increase in any liability or net worth account. In contrast, a use of funds is defined as an increase in any asset account during the period or a decrease in any liability or net worth account. Sources must equal uses.

Keeping these definitions in mind, Illustration 6 may be helpful to show you the construction of a sources and uses of funds statement. It compares all the accounts for My Business between the January 1, 19xx, and March 31, 19xx, balance sheets.

Notice that each set of accounts balances properly—that is, total assets equal total claims on assets. Both total liabilities and owner’s equity are included in total claims on assets.

The difference for each account is then calculated and the value indicated as a source or use of funds based on the definitions we described earlier. As an example, accounts receivable (an asset account) was reduced by $1,000 during the quarterly period. That released $1,000 to be used in other ways in the business (a source of funds).

The bank notes payable account (a liability) was reduced by $900 during that same time (a use of funds). Another way of looking at it is to say that $900 of funds in the business was used to reduce that current liability account.

Earnings generated in the business during that period increased owner’s equity. These dollars became a source of funds for use in the business.
During the quarter, $4,900 was generated in the business as a source of funds. It came from reduced accounts receivable and supply inventories, depreciation, increasing payables, and profits. Those funds were used to generate cash, increase merchandise inventory, and reduce current and long term liabilities. Over time, analyzing sources and uses of funds statements for your business will help you track where funds are being generated and how well you’re using them for growth and profit generation.

These statements also can be a good tool to help in planning future directions for your business, including identifying where funds are needed and possible internal or external sources for those funds. The analysis and interpretation of balance sheet and income statements can help you. You can use them to determine the profitability of the business during specific time periods. You can project your future ability to service debt requirements as well as determine if expansion is possible.

From these statements, you can obtain information on trends in receipts, gross income, expenses, and returns in relation to past decisions. You can identify the causes of a strong or weak financial condition and of low or high profitability. You also can pinpoint changes that will make your business more profitable and improve its financial condition.

In addition, the statements can help you compare your firm’s financial condition and profitability to the operating results of similar businesses. If you’re going to analyze these statements properly, they must be timely and accurate. As a manager, you need to know how well the resources of your business have been used to produce a return.
Cash flow analysis

Forecasting cash flow is an important part of good financial management. It involves the preparation of a cash flow budget to estimate future cash requirements necessary for your business operations. Cash flow budgeting involves forecasting all expected cash flow receipts and disbursements on a monthly, quarterly, or annual basis. It can help you to identify periods when there may be surplus cash and when to expect cash deficits.

A cash flow budget can be one of the most valuable financial planning tools available to you as a manager. It can help you make the most efficient use of cash. You also can determine any financing requirements for seasonal cash needs. Then you can develop a sound borrowing program.

Your cash flow budget can help determine when to make debt repayments and when you may have funds available for expansion purposes. Furthermore, a cash flow budget can help identify the availability of any surplus cash for investment in other profitable enterprises.

Another benefit from the preparation of a cash flow budget is that it allows you to review many aspects of your business that might otherwise be receiving inadequate attention or that you may have overlooked during your day-to-day activities.

Illustration 7 shows an example cash flow worksheet format for Sales Galore. It is called a “pro forma” statement, one that projects cash inflows and outflows by quarter for the remainder of the year 19xx.

Your own cash flow worksheet won’t necessarily have only the categories shown in the example. You may need more or fewer, depending on the unique situation for your business. The objective is to identify every flow of cash, regardless of its source or use.

In the example, line 20 is a minimum cash balance that you establish as an amount needed to handle contingencies. You as the manager-owner need to make a judgment about the level of reserve. Once you establish it, maintain that level.

A shortfall is expected for Sales Galore (as shown in line 21) for the July 1 to September 30, 19xx, period. It is anticipated that a cash-over (excess cash) position greater than the shortfall will exist in the fourth quarter ending December 31, 19xx. Thus, Sales Galore is expected to end the year with a positive cash balance.

The business will use new short term borrowing to make up the third quarter deficit and maintain an acceptable cash balance (line 22). The new short term debt plan calls for complete payoff in the last quarter (no carryover). On the bottom of the worksheet you design for your own use, you can project accumulated new short term and long term borrowings and track them for the year.
# Illustration 7

## Sales Galore

Quarterly cash flow worksheet for the period April 1 to December 31, 19xx

<table>
<thead>
<tr>
<th></th>
<th>April 1 to June 30, 19xx</th>
<th>July 1 to Sept. 30, 19xx</th>
<th>October 1 to Dec. 31, 19xx</th>
<th>3-quarter total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash inflows</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Net cash sales</td>
<td>$3,000</td>
<td>0</td>
<td>$16,000</td>
<td>$19,000</td>
</tr>
<tr>
<td>2. Collection of acct. rec.</td>
<td>0</td>
<td>0</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>3. Capital sales</td>
<td>0</td>
<td>0</td>
<td>3,500</td>
<td>3,500</td>
</tr>
<tr>
<td>4. Other</td>
<td>0</td>
<td>0</td>
<td>700</td>
<td>700</td>
</tr>
<tr>
<td>5. Total cash inflows</td>
<td>3,000</td>
<td>0</td>
<td>24,200</td>
<td>27,200</td>
</tr>
<tr>
<td><strong>Cash outflows</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Hired labor</td>
<td>1,600</td>
<td>3,500</td>
<td>3,000</td>
<td>8,100</td>
</tr>
<tr>
<td>7. Family labor</td>
<td>0</td>
<td>1,500</td>
<td>0</td>
<td>1,500</td>
</tr>
<tr>
<td>8. Supplies</td>
<td>1,000</td>
<td>500</td>
<td>0</td>
<td>1,500</td>
</tr>
<tr>
<td>9. Utilities</td>
<td>0</td>
<td>30</td>
<td>30</td>
<td>200</td>
</tr>
<tr>
<td>10. Insurance</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>90</td>
</tr>
<tr>
<td>11. Taxes, licenses, and fees</td>
<td>0</td>
<td>0</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>12. Capital expenditures</td>
<td>0</td>
<td>0</td>
<td>4,500</td>
<td>4,500</td>
</tr>
<tr>
<td>13. Loan principal due</td>
<td>0</td>
<td>0</td>
<td>8,680</td>
<td>8,680</td>
</tr>
<tr>
<td>14. Loan interest due</td>
<td>300</td>
<td>470</td>
<td>1,070</td>
<td></td>
</tr>
<tr>
<td>15. Other expenses</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>180</td>
</tr>
<tr>
<td>16. Total cash outflows</td>
<td>3,040</td>
<td>5,940</td>
<td>17,340</td>
<td>26,320</td>
</tr>
<tr>
<td><strong>Cash balance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17. Net cash from operations (5–16)</td>
<td>(40)</td>
<td>(5,940)</td>
<td>6,860</td>
<td>880</td>
</tr>
<tr>
<td>18. Beginning cash balance</td>
<td>1,300</td>
<td>1,260</td>
<td>1,000</td>
<td>1,300</td>
</tr>
<tr>
<td>19. Net cash available (17 + 18)</td>
<td>200</td>
<td>(4,680)</td>
<td>7,860</td>
<td>2,180</td>
</tr>
<tr>
<td>20. Minimum acceptable cash balance</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>21. Cash surplus (deficit) (19–20)</td>
<td>260</td>
<td>(5,680)</td>
<td>6,860</td>
<td>1,180</td>
</tr>
<tr>
<td>22. New short term borrowing for operating expenses necessary to maintain minimum cash balance</td>
<td>0</td>
<td>5,680</td>
<td>(5,680)</td>
<td>0</td>
</tr>
<tr>
<td>23. New long term borrowing for capital expenditures necessary to maintain minimum cash balance</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>24. Owner capital added (withdrawals)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>25. Ending cash balance (19 + 22 + 23 + 24)</td>
<td>1,260</td>
<td>1,000</td>
<td>2,180</td>
<td>2,180</td>
</tr>
</tbody>
</table>

**Accumulated new borrowings for year**

|                          |                          |                          |                             |                 |
| Short term              | 0                        | 5,680                    | 0                           | 0               |
| Long term               | 0                        | 0                        | 0                           | 0               |

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Maintaining your financial health

As a manager, you can maintain a healthy capital structure by giving attention to four basic factors: liquidity, leverage, profitability, and asset usage.

Liquidity

This relates to your ability to pay bills on time, and it involves maintaining an adequate working capital position. Working capital is the amount by which current assets exceed current liabilities. It’s essentially a financial cushion, and you can use it to take advantage of things like trade discounts and expansion opportunities.

Profits constitute a principal source of working capital. You also may use long term borrowings and the sale of fixed assets such as land, buildings, and equipment to increase working capital.

Naturally, it’s not usually a good idea to increase your working capital through fixed asset sales. You shouldn’t use long term borrowing, either, unless you expect your business to grow or the value of your assets to appreciate.

So, to maintain a good liquid position, focus your attention (at least at first) on making profits to provide adequate working capital.

Common measures of liquidity include a working capital calculation and current ratio. In the case of My Business for March 31, 19xx (Illustration 2), we determine the level of working capital by subtracting current liabilities from current assets:

\[
\text{working capital} = 25,393 - 6,800 = 18,593
\]

We determine the current ratio (another way of looking at working capital) by dividing current assets by current liabilities:

\[
\text{current ratio} = \frac{25,393}{6,800} = 3.7
\]

Remember that these values by themselves are not very meaningful; they become significant only when you compare them with other values for your business over time, or with average values for similar businesses. A value in one setting may be good, but in another setting it may be bad. This is true for any calculated value of this type.

Leverage

The mix of debt and equity capital you use in your business is called leverage. If the capital structure of your business is highly dependent on debt, you run the risk of being unable to meet the fixed interest charges associated with that debt if sales should fall off and cash flow not materialize as planned.

As the amount of debt increases relative to your equity capital investment in the business, the financial risk within your business tends to increase. If your business should incur a loss, you might be unable to meet its principal repayment obligations as well as the associated interest charges.

Typical measures of leverage include the debt-to-asset ratio and the debt-to-equity ratio. In the case of My Business for March 31, 19xx, the debt-to-asset ratio equals total liabilities divided by total assets:

\[
\text{debt-to-asset ratio} = \frac{31,300}{62,793} = 0.50
\]

To find the debt-to-equity ratio, divide total liabilities by total equity:

\[
\text{debt-to-equity ratio} = \frac{31,300}{31,493} = 0.99
\]

The debt-to-equity ratio measures the total debt of your business as a percent of the equity capital you have invested in your business.

Profitability

The profitability of your business refers to its net income return to total capital invested in the business (assets), equity capital invested in the business (net worth), and receipts (gross returns). These measures of profitability frequently are calculated as return on assets, return on equity, and return on sales.

For the My Business example in Illustrations 2 and 4, to calculate return on assets, divide the net income amount from the profit and loss statement (Illustration 4) by the total assets from the balance sheet (Illustration 2):

\[
\text{return on assets} = \frac{2,915}{62,793} = 4.6\%
\]

To find the return on equity, divide net income (Illustration 4) by owner’s equity (Illustration 2):

\[
\text{return on equity} = \frac{2,915}{31,493} = 9.3\%
\]
The values that go into the return on sales calculation both come from the profit and loss statement. Divide net income by net sales:

\[
\text{return on sales} = \frac{2,915}{16,979} = 17.2\% 
\]

You need to establish reasonable objectives for each of these three indicators of profitability. To help establish these objectives, consider at least four factors.

The **interest rate on borrowed capital**, the first factor, will impact the total capital you have invested in your business. It can lower net receipts due to interest payments made on the borrowed capital. You want returns on your assets to be greater than the interest rate for the borrowed funds used in your business.

The **degree of risk** associated with the possibility of a financial loss of the equity capital invested in your business is the second factor you should include in your analysis. Can you afford to lose your equity if your business has a high probability of failing? If not, a higher return to your equity may be necessary as a risk-taking reward to justify its use.

The **rate of inflation** is an important third factor. If the rate is high, it would require a higher dollar return to maintain real (purchasing power) returns. It also may influence your replacement decisions on depreciable fixed assets. As an example, the purchase price of new assets might be increasing also.

The **opportunity cost of your equity** is the final factor to consider. Opportunity cost is the return you could be earning from investment of your equity in the next best alternative.

### Asset usage

As in the case with the other categories of performance measurement, there are a number of additional ratios that you could calculate. How many depends on the situation for your business and the measurements you feel are useful. Here are three examples:

1. **Inventory turnover**:

\[
\text{inventory turnover} = \frac{\text{cost of merchandise sold}}{\text{merchandise inventory}} = \frac{6,196}{13,000} = 0.48 
\]

2. **Asset turnover**:

\[
\text{asset turnover} = \frac{\text{net sales}}{\text{total assets}} = \frac{16,979}{62,793} = 0.27 
\]

3. **Working capital turnover**:

\[
\text{working capital turnover} = \frac{\text{net sales}}{\text{working capital}} = \frac{16,979}{18,593} = 0.91 
\]

The working capital value was calculated earlier as a measurement of liquidity (page 12).

### Management control and planning

You can help keep the capital structure of your business healthy by doing a number of things. It is important to maintain the business in a liquid position so you can meet debt obligations and pay bills on time.

You should maintain a reasonable and safe mix between debt and equity capital, to keep the business going in case an adverse situation should occur. You also need to determine adequate levels of return on total capital, equity, and receipts. Try to be as efficient as you can in using your business assets.

You as the manager must control the financial aspects of your operation if you are to achieve your financial objectives. For example, you must control each of the key performance areas (KPA’s) you determined in your profit-planning process (page 2). In general, this involves keeping plans on target and on schedule—and taking corrective action or making adjustments when these are needed to ensure that your objectives are met.

More specifically, controlling involves the process of measuring actual results and comparing these to your planned results. Planned results are those that should have happened if events had occurred as you projected.

When actual results fail to meet planned results, corrective action may be needed to control the...
process. This management technique can be summarized in these four steps:

1. Establish measurable planned results for each KPA.
2. Measure the actual KPA results.
3. Compare actual results to planned results.
4. Take action to correct deviations when actual results are not within your acceptable tolerance levels for each KPA.

You may want to operate by the principle of management by exception when you apply the control process. This requires that you set up an acceptable performance range for each KPA planned result. Actual results then may fluctuate within this range without the need to take corrective action.

Only when the actual results are out of this predetermined range would you take corrective action. In this way, you implement your management action plans and accomplish your objectives.

Preserving your capital investment is just as important as any other financial matter related to your business. Failure to take precautionary measures to preserve your investment could result in undesirable consequences.

The worst of these would be to go out of business (bankruptcy) or not to ensure beforehand a smooth transfer of the business to your heirs. There are a number of ways to preserve the capital investment in your business. These may include:

1. Maintaining adequate business and liability insurance coverage
2. Implementing an ongoing employee management development training program to make better business decisions
3. Estate planning for transferring the business to other parties
4. Divesting into other areas of operation, when appropriate, to spread business risk

Planning to obtain the capital you’ll need to remodel existing facilities, acquire new facilities, replace equipment, or diversify into new areas of operation is an important aspect of financial management. In planning the capital needs of your business, you need to determine five things:

1. How much capital you’ll need
2. When you’ll need it
3. What type of financing to use (equity, short term debt, trade credit, long term debt)
4. The source where you can obtain it at the best terms
5. How, if necessary, you’ll repay the funds (your cash flow budget will be helpful here)

In addition, when planning for your future capital needs involves the securing of debt capital, it’s important not to become overly indebted, given your risk preference and profitability analysis—that is, not to borrow more than you require to effectively operate your business.

In part, this involves maintaining a good working relationship with the lenders who are providing the financing. It also involves accurately forecasting the cash flow requirements of your business.

For further reading

These books are only examples of good texts that provide more advanced information on financial concepts and tools. Other good texts and publications on this subject may be available from your local library or bookstore.


Johnson, Robert W., Financial Management, 5th ed. (Boston: Allyn and Bacon, 1982).


Ordering instructions

If you would like additional copies of EC 1222, Managing a New Business: A Beginner's Guide to Financial Concepts and Tools, send $1.50 per copy to:

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