

Chapter 3 :: Business Management and Leadership

Section 3.4 ~ Financial Resources Management

Jump Start

Brianna is good at working with figures and likes to keep records. She handles the financial management for the Triad Bakery. When they first started the business, she determined how much money it would take to buy the basic things they needed to begin operations. Now that the business is operating soundly, she keeps records of income from sales, and expenditures for supplies, materials, wages, taxes, insurance, and other items. Brianna and Chen, the company accountant, use computer technology and software to prepare budgets, income statements, and balance sheets. How often should each of these financial records be prepared?

Financial Management

One of the reasons why small businesses often fail is that they do not manage their finances properly. Money management is a serious issue for all businesses regardless of size. You have learned that a financial plan is an important part of a business plan. Businesses must wisely manage the money they take in and pay out to become profitable and to stay in business.

Financial Planning

Profit is what is left over after the business pays all of its expenses. It takes most businesses a year or two before they begin earning a profit. It is important for business owners and managers to know what their financial position is and where they are heading financially.

One financial planning document is called a business budget. A **business budget** is a detailed plan for meeting the financial needs of the business. It has two main purposes: (1) anticipating sources and amounts of income, and (2) predicting the types and amounts of expenses for a specific business activity or for the entire business.

The money that a business receives is called *income*, or revenue. Most of a business's revenue comes from sales of its products or services. The way in which the revenue comes in is important. Most businesses rely on credit, and therefore, many sales are not paid for until 30 days or longer after the sale. Financial managers use a *statement of cash flow* to show the actual cash a business receives and has available on a daily basis.

Businesses cannot operate without spending money. The operating costs of a business are referred to as *expenses*. Expenses can include employee wages and benefits, advertising, rent, utilities, and supplies.

The business must be able to identify and predict the amount of each source of income and each type of expense. Budgeting is an important part of that process. The budget process requires an understanding of financial information, computer skills, basic math abilities, and effective communication skills. Basic steps to follow in creating and effectively using a budget are

- Determining the type of revenue and expenses to be included
- Gathering information from business records and other sources

- Creating the budget using available technology
- Distributing and discussing the budget with those who will use the information for decision making



Types of Budgets

Budgets provide detailed plans for the financial needs of individuals, families, and businesses. A business budget projects the amounts of income and expenses.

Budgeting is an important step in financial planning. A well-prepared budget helps a business avoid costly financial mistakes. A budget lets managers know how the business is doing in terms of meeting its financial goals. Three types of business

budgets are the start-up budget, operating budget, and cash budget.

Start-Up Budget The *start-up budget* is used to plan income and expenses from the beginning of a new business or a major business expansion until it becomes profitable. Buildings and equipment must be purchased. Most start-ups require very large expenditures of capital to begin. Materials, supplies, new employees, licenses, and advertising are examples of what are needed before a company can begin to sell its product or service. The start-up needs for new businesses can cost hundreds of thousands of dollars.

Money to pay for start-up costs comes from many sources. Obtaining capital through loans from a financial institution is common. Before lending any money, a lending institution will want to see a budget and business plan.

Operating Budget The financial plan for the day-to-day operations of the business is called the *operating budget*. It covers a specific period of time: three months, six months, or a full year. This budget follows this equation:

$$\text{Revenue} - \text{Expenses} = \text{Profit (or Loss)}$$

All anticipated revenues and expenses are listed, and the planned net profit or loss is shown.

Cash Budget The *cash budget* is an estimate of the money expected to be received and paid out over a specific period of time. It lets the manager know if there is a period when cash must be borrowed to meet expenses. Even profitable businesses may have times when adequate cash is not available because of high expenses or a delay in receiving payments from customers. Nevertheless, money must always be on hand to pay expenses.

Financial Records

Budgets are the financial plans, or forecasts, for a business. To find out if the plans have been achieved, the business needs financial records. A **financial record** shows the financial performance of a business. The following records are commonly maintained to document the performance of a business.

- Asset records name the buildings and equipment owned by the business, their original and current value, and the amount owed if money was borrowed to purchase the assets.
- Depreciation records identify the amount that assets have decreased in value due to their age and usage.
- Inventory records identify the type and number of products on hand for sale.
- Payroll records contain information on all employees' compensation and benefits.
- Cash records list all cash received and spent by the business.
- Records of accounts identify purchases made using credit. An accounts payable record shows credit purchases made by the company, including the amount purchased, paid, and owed. An accounts receivable record identifies credit purchases by customers and the status of each account.
- Tax records show all taxes collected, owed, and paid. There are many payroll and other taxes that a business must pay, including taxes withheld from employees' paychecks and, in some cases, sales taxes.

Financial records are used to prepare two important financial statements: the income statement and the balance sheet. These statements are important not only to the managers of the business but also to investors and lenders.

The Income Statement

An **income statement** is a financial statement that shows revenues, expenses, and net income (profit) or loss for a period of time. The income statement usually covers a period of six months or a year but may cover shorter periods, such as a month, in a new business. The income statement prepared at the end of the year is important because it shows how the business did for the entire year. It is the basis for the payment of taxes and decision-making.

The income statement for the Overland Design Company illustrates some of the categories of revenue and expenses that are shown in a typical statement. Also, an income statement often has accompanying notes that explain items in the statement. For instance, if charge sales in a period are substantially

Overland Design Company		
Income Statement		
For the Year Ended December 31, 20—		
Revenue		
Cash sales	\$ 38,200	
Charge sales	180,600	
Other revenue	<u>12,900</u>	
Total Revenue		\$231,700
Expenses		
Salaries and wages	\$ 70,800	
Marketing	22,250	
Administrative costs	31,900	
Materials and supplies	24,800	
Other expenses	<u>19,100</u>	
Total Expenses		<u>168,850</u>
Net Income		<u>\$ 62,850</u>

greater than they were in previous periods, the notes will explain why.

The Balance Sheet

A **balance sheet** is a financial statement that lists a business's assets (what a company owns) and liabilities (what a company owes). It also shows the owner's equity, which is the value of the owner's investment in the business (sometimes called net worth). The equation for owner's equity is

$$\text{Assets} - \text{Liabilities} = \text{Owner's Equity}$$

In a balance sheet, the two sides of the statement must be in balance. As shown in the balance sheet for Schreiber Automotives, Inc., below, the right-hand side adds the total of the liabilities and the owner's equity to show that they equal the value of the assets on the left-hand side. The basic equation for the balance sheet is

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Schreiber Automotives, Inc.			
Balance Sheet			
December 31, 20—			
Assets		Liabilities	
Cash	\$35,850	Accounts payable	\$103,300
Investments	40,000	Payroll taxes	22,000
Accounts receivable	42,375	Mortgage	<u>126,800</u>
Buildings	250,000	Total Liabilities	\$252,100
Equipment	<u>120,000</u>	Owner's Equity	<u>\$236,125</u>
Total Assets	<u>\$488,225</u>	Total Liabilities and Owner's Equity	<u>\$488,225</u>

The balance sheet does not give a picture of the business over a period of time. Instead it shows what the business is worth on a particular date, usually the end of a year. One of the uses of the balance sheet is to compare the owner's equity of the business with previous years. If the business is doing well, the owner's equity will tend to increase from year to year. Some businesses include comparative data from previous years in their balance sheets.

Both the income statement and the balance sheet are important financial reports. Business managers review these reports and discuss them to determine how the business is performing. Comparisons of the company's operations, as well as comparisons with similar businesses, are made from period to period. Improving the profitability of the company is the primary objective when managing financial resources.

Maintaining Financial Records

Keeping financial records and statements accurate and up to date is not the problem today that it was in the past. Preparing and maintaining financial documents used to be an expensive and time-consuming process. Often done manually using paper documents, it took special care to complete, save, and protect the records.

Technology today is changing the way financial information is collected. Much information is now collected using point-of-production and point-of-sale technology, such as scanners, touch screens, and personal digital assistants (PDA's). Data files are transferred from the places where information is collected and sent to the computers of the people who prepare the financial records.

Technology is also changing the way financial records are prepared and maintained. Businesses use computerized financial systems that have templates for each financial record. The software completes the necessary mathematical calculations, updates records, and makes comparisons of those records with budgets. The software can even complete what-if comparisons to help managers determine the impact of changes in budgets and financial performance.

Think Critically

1. Why is a business budget an important tool in managing financial resources?
2. Why do businesses need a cash budget and an operating budget?
3. You are interested in becoming a partner in a business that has been operating for the past five years. Which of the financial statements would be the most important for you to see? Why?
4. Why would a business manager want to compare the company's financial statements with those of similar companies?
5. **Business Math** Revenue and expense figures for Lisa's Boutique for the past three months are as follows. Using Excel, create a spreadsheet to compute the net income or loss for each month.
 - **Month 1:** Cash sales, \$7,890; charge sales, \$11,300; other revenue, \$250; salaries, \$9,600; advertising, \$1,500; rent, \$1,800; supplies, \$500
 - **Month 2:** Cash sales, \$8,820; charge sales, \$12,360; other revenue, \$300; salaries, \$10,120; advertising, \$1,500; rent, \$1,800; supplies, \$350
 - **Month 3:** Cash sales, \$9,540; charge sales, \$2,450; other revenue, \$300; salaries, \$9,840; advertising, \$2,500; rent, \$1,800; supplies, \$900