CHAPTER 23
KNOW THE CONDITION OF YOUR FINANCES (e²)

WE ARE ADMONISHED TO KNOW THE CONDITION OF OUR FLOCKS

"Riches can disappear fast. And the king's crown doesn't stay in the family forever— so watch your business interests closely. Know the state of your flocks and your herds; then there will be lambs wool enough for clothing, and goats milk enough for food for food for all your household…" (Proverbs 27:23-27 LB).

"Any enterprise is built by wise planning, becomes strong through common sense, and profits wonderfully by keeping abreast of the facts" (Proverbs 24:3&4 LB).

HOW DO PEOPLE BECOME WEALTHY?

If I were to ask, "How do people become millionaires?" many would suggest they inherit it. Others might say they get a college education; still others might advocate that millionaires got a lucky break in life. But the truth is that most people became millionaires by a lifetime of hard work, perseverance, saving, investing and perhaps most importantly, self discipline.

In the mid 1980's two university professors, Dr. Thomas J. Stanley and Dr. William D. Danko, began investigating how people become wealthy. They attempted to do so by surveying people who lived in upscale neighborhoods and drove expensive cars. Amazingly they found that many of those people did not have much wealth. Even more amazing, they found that many of the people who have a great deal of wealth do not live in expensive homes or drive luxury cars. They reported the findings of their study in a book entitled *The Millionaire Next Door* (1) which was first published in 1996. They found that "usually the wealthy individual is a businessman who has lived in the same town all his adult life. This person owns a small factory, a chain of stores, or a service company. He has married once and remains married. He lives next door to a person with a fraction of his wealth. He is a compulsive saver and investor. And he has made his money on his own. *Eighty percent of America's millionaires are first-generation rich*." They went on to say, "Affluent people typically live well below their means; they allocate their time, energy, and money efficiently, in ways conducive to building wealth, and they believe that financial independence is more important than displaying high social status" (1).

THERE IS A DIFFERENCE BETWEEN WEALTH AND INCOME

You should understand that wealth is not the same as income. You may make a good annual income and still not be wealthy. Wealth is what you accumulate, not what you spend. Unfortunately because most people don't understand the difference between the two, their economics tend to be debt based and consumption oriented. They allow the desire for things to influence their purchasing decisions; they want instant gratification to their desires. To fulfill those desires they pile up debt and relegate the payments to the future, and by their example, they teach their children to do the same and to live in the same way they do.

LEARNING A NEW VOCABULARY

I've written this book as a guide to the small businessperson or the young men or women who are desirous of establishing enough wealth to accomplish what God has called them to do in this life and to allow them to live comfortably in their retirement years. But before we go further, I would like to make sure that we all understand some basic financial vocabulary.

When you were attending school, your report card told you how well you were doing academically. If you received a low or failing grade in a particular subject, the report card warned that you were in trouble and that you that you needed to make a correction in your study habits concerning that subject. Since you received your report card every three months, you generally understood where you stood academically. Once you graduate from school, your ***financial statement*** takes the place of your report card; it is designed to tell you how you are doing financially and to warn you of problems that may be developing in your personal or business financial life.

Unfortunately most people have never learned how to prepare or even read a simple financial statement. They don't understand how to borrow money, how to calculate interest on a loan or for that matter the difference between simple and compound interest. They simply don't understand the basic realities of personal finance. Therefore they never prepare a personal financial statement; they buy most of their possessions on credit and think as long as they're making their monthly payments to the finance company, they are succeeding in life. They may have a good paying job, a nice home and drive a late model car and yet receive a failing grade on their financial report card.

THE NEED FOR UNIFORM ACCOUNTING PRINCIPLES

Imagine for a moment that every school could develop its own grading standards. You go to a school where the teachers give an "A" for an excellent semester of work, and I go to a school where they give an "E" for excellent work? Comparing our academic performances would be quite difficult without a recognized standard of grading. The same would be true if every business could invent its own accounting methods and terminology for measuring profit and preparing their financial statements. Common sense tells us that financial statements like report cards should follow a uniform reporting standard. For this reason the accounting industry has developed uniform set of financial reporting standards. In America, these standards are called "Generally Accepted Accounting Principles" (GAAP). In the following paragraphs, I want to familiarize you with the standard financial reports maintained by most individuals and businesses.

When most people graduate from high school or college, their "financial I.Q." is quite low. Sadly the same is true of many small-business owners; they don't understand how to read or interpret their company's financial statement. To them it is just something they have to prepare to keep the government off their backs; but there are at least five other groups of people who have a vested interest in the accuracy of your financial statements: your **customers**, who buy the products and service you sell; your **employees**, who provide services to your business and are paid wages and provided with benefits; your **suppliers** and **sub-contractors**, who sell you a wide range of goods and services; your **sources of capital**, who loan money to the business and have to be repaid at definite dates in the future; and your **equity sources of capital**, the individuals or institutions who may invest money in your business.

When you were going to school in order to get good grades, you probably had to do some homework. It's the same in business. Most people, whether they are working for themselves or others, do not become wealthy by just working—although working is important; they become wealthy by doing their financial homework.

PROFIT IS NOT A DIRTY WORD

Go anywhere in the world and you will find that the primary way by which anyone evaluates management is the management's ability to produce a profit. Even if you were the manager of a collective farm or industrial plant in the former Soviet Union, your superiors would measure your success or failure by the profit you were able to produce. They wouldn't use a capitalistic term like *profit*; they would probably call it a *production quota*. But that quota would measure the amount of surplus that was left after all expenses had been paid. In capitalistic terms, they would judge you on your ability to make a profit.

Many small business owners shrug off the importance of generating a profit. I have observed a number of immature Christian businesspeople start a business with great fanfare, often emphasizing that they are going to operate their business on Christian principles. Many announce that they will donate a large percentage of the profits to God's work, apparently hoping that such a declaration will entreat God's favor. They understand reasonably well the product or service they plan to provide, but know little or nothing about the financial side of the managing a business. These individuals operate their business for a short time and find that instead of making a profit, they are going deeper and deeper into debt. They eventually end up owing a great deal of money, and some even find it necessary to file bankruptcy.

YOU MUST BE ABLE TO READ A FINANCIAL STATEMENT

Now that we understand the importance of the financial statement in living a prosperous and successful life, your first homework assignment is to learn how to prepare and read a financial statement**.** In fact, if you are in business you should know more about the operating side of your financial statement than your bookkeeper or your accountant. You simply cannot delegate the financial management of your company to others. If you delegate such responsibilities, it is very possible that one day one of your employees will give you the bad news that there is no money to make the payroll. Or worse yet, they may inform you that they have not paid the payroll taxes for the last three months because there was not enough money in the bank account.

If you understand how your financial statement works, you will have more confidence in your personal and business financial position, more control over your companies operations, and you will be able to make the corrections to your business that are necessary when you underbid a project or lose a big client.

Now let’s take a look at the basic elements of the financial statement:

Income Statement Diagram

Income
Expense
Profit or loss

Balance Sheet Diagram

Assets	*Liabilities*
	Owners Equity

There are two basic elements to a financial statement: they are the income statement (sometimes referred to as the profit and the loss statement) and the balance sheet. A third element, which is a part of the financial statement in large companies, is called a cash flow statement. **Cash flow is very important in the operation of a business. It is important because cash needs to flow smoothly if your business is to operate in a trouble-free manner.** The cash flow statement allows the business owner to track where the money came from, where it is currently being used, and how often it is turning over.

Now let’s take a more detailed look at the income statement and the balance sheet.

Income Statement

The income statement summarizes the profit- making activities of a business. In its simplest form, it is the revenue derived from the sale of goods and services, less the cost of producing the goods and services, which equals the net income, often referred to as profit or loss. The income statement should generally be developed monthly.

Income Statement

Revenue – Expense = Profit or Loss

****IMPORTANT****

In the operation of a your business the income statement should get most of your attention, as it will reveal the areas of your business or personal life that must be changed in order to maintain a healthy, financial condition.

Balance Sheet

The balance sheet summarizes the business or individual's assets, liabilities and equity accounts at the close of a particular accounting period. The balance sheet is also generally developed monthly.

The balance sheet derives its name from the fact that the business or individual's assets always balance their liabilities plus their equity.

Assets = Liabilities + Equity

Equity is sometimes referred to as the net worth. In the case of individual wealth, "net worth" is an accurate description. However, in the case of a company, net worth is not an accurate description as it rarely represents the company's actual value, which is generally based on a multiple of a company's annual profit.

The **Balance Sheet** is made up of the following sub-parts:

Assets = Cash in the bank + non-cash assets, such as the current value of computers, automobiles, and/or buildings owned by the business or individual.

Liabilities = Operating liabilities such as the telephone bill or the office rent + debt such as money you have borrowed from the bank to purchase the computers, equipment and/or buildings you listed as assets.

Equity = Invested capital, (money the owner invests to get the company started) + retained earnings (earnings from previous years that the owner allows to remain in the company for use as working capital).

Cash Flow Statement

Cash Flow Statement summarizes the sources and uses of cash during the accounting period. In a small business this statement may not be necessary as it is generally apparent to the small business owner where his cash has gone. In a larger business, however, it is a good idea to utilize this statement regularly. For instance, in my business, on a monthly basis, I would review a list of all major expenses before the checks were written. This gave me a good overview of where the money was being spent.

One thing about cash flow that the small business owner must watch carefully is the time it takes to collect the money once the invoice is sent to the customer. This is referred to as cash turnover. If the payment time gets two long, it can radically affect the amount of working capital it takes to operate your business. Cash turnover is defined as the number of days it takes to collect your money after you have billed the customer. As a rule of thumb, cash turnover in most businesses should not be allowed to exceed ninety days. A cash turnover of ninety days means you would need more than four times your monthly billings in working capital—the money you spend during the month in which you produce your product or service plus the three months (ninety days) it will take you to receive payment for your product or service—to operate your business comfortably.

Cash turnover can be calculated by dividing your total accounts receivable by your average daily income.

Cash turnover = $\frac{\textbf{Accounts Receivable}}{\textbf{Average Daily Income}}$

RELATING THE INCOME STATEMENT TO THE BALANCE SHEET

Income

Revenue causes an influx of money into the asset accounts.

Expense

Expense causes an outflow of money from the asset accounts.

(**Refer to Appendix A for a typical financial statement for a consulting firm.)**

CASH BASIS ACCOUNTING

Generally speaking, a business uses either *cash basis* or the *accrual basis* of accounting. The cash basis of accounting, as the name implies, is limited to recording only cash inflows and outflows. Under the cash basis, profit equals cash receipts from sales and other income less cash payments for expenses. But in the twenty-first century, we no longer operate in a cash basis world. Most businesses sell their products and services on credit rather than cash, and they usually don't collect all their sales revenue and pay all their expenses by the end of each accounting period. Under the cash basis of accounting, a manager might receive an extremely skewed view of a company's actual financial position, because items purchased on credit and work billed to customers are not accounted for until the cash is actually received.

ACCRUAL BASIS ACCOUNTING

Accrual basis accounting, which is the most accepted basis of accounting, goes way beyond recording only cash inflow and cash outflow transactions. Under the accrual method, purchases made on credit are recorded as soon as the purchase takes place, and revenue is recorded as soon as it is earned, even though the cash may not actually be received from the customer until several months later. Under the accrual basis of accounting, the manager always knows the profitability of his company at the close of each accounting period.

HOW DO WE DEFINE WEALTH?

The Old Testament patriarchs would have used a cash basis accounting system to define a man's wealth. They defined his wealth by the size of his herd or the bushels of grain that he had in his barns. For instance the Bible describes Job as follows —"He was also very wealthy-seven thousand head of sheep, three thousand camels, five hundred yoke of oxen, five hundred donkeys, and a huge staff of servants, the most influential man in all the East!" (Job 1:3 MSG).

During the time that Job lived on the earth, buying and selling transactions were cash deals. As soon as Job purchased a team of oxen, it belonged to Job; there was no mortgage on the oxen. But in the twenty-first century world, a man's team of oxen might be purchased in January of 2008, but the purchase price might be paid in twenty-four payments over the next two years. And we would never describe a man's wealth by listing the number of sheep, camels, oxen and donkeys or real estate that he owns. We would convert the value of his livestock and real estate into dollars (or the currency of the nation in which the individual lives) and enter that value into the asset section of his financial statement. Then we would subtract the debt that He owed to his creditors to determine his net worth. In the twenty-first century, in order to determine Job's wealth, we would determine his net worth.

Job's wealth (or his net worth) = Job's Assets – Jobs Liabilities

If Job's possessions were worth $10,000,000, and he owed his debtors $2,000,000…

…Then his net worth would be: $10,000,000 - $2,000,000 = $8,000,000

YOUR FINANCIAL STATEMENT DESCRIBES THE CONDITION OF YOUR BUSINESS

The writer of Proverbs admonishes us to know the condition of our business or personal finances, and the most efficient way to truly know the condition of your business or personal finances is to understand your financial statement. This is true because every element of your business or personal wealth may be translated into its dollar equivalent (the standard unit of the nation's currency) and accounted for on your financial statement. Materials, labor, equipment, cattle, corn, taxes and other elements of business and personal wealth may all be expressed in dollars. Units of measure such as pounds, tons, bushels, lineal feet, or cubic feet of materials and products may also be expressed in dollars. Thus the single controlling element by which you can know and understand the condition of your business or your personal financial standing is the financial statement.

Financial statements however, have many numbers in them, and the significance of many of these numbers will not be clear unless they are compared with other numbers. For instance you should:
1) Compare them to other numbers in your financial statement to determine the relative size of one number to another;
2) Compare them to the past financial history of your firm from previous months or years to understand how you are doing this month verses last month or this year versus last year;
3) And finally compare them to the performance of other firms in your industry or service sector by comparing them to key financial indicators and ratios reported for your industry or service sector. (These are available from financial consultants who accomplish financial surveys of industry of service sector groups; or they are often available from your own industry of service sector association.)

PROFIT IS THE LIFEBLOOD OF A BUSINESS

Profit is the main financial goal of a business. You have to understand the way the business operates and its strategies to account for its profit. At first glance, making profit may seem fairly simple – sell stuff and control expenses. Bring in more dollars from sales revenue than the dollars paid out for expenses. The excess of revenue over expenses is profit. What's the big deal?

But making a profit isn't nearly as simple as you may think. Business owners and managers must not only make sales and control expenses. They must understand which products or projects are making a profit or causing a loss, as well as determine where the profit went if the cash account doesn't increase by the same amount as your profit (and it usually doesn't).

Your financial reports should provide enough detail that you can put your finger on a problem without even leaving your office. You have to depend on your financial statements and other internal accounting reports to know how much profit you are making, how much loss you have suffered, and which projects or which products are producing that profit or loss. Therefore it is important that you design your financial reports so that they will provide you with the information you need to properly manage your business.

IT'S EVEN MORE IMPORTANT TO UNDERSTAND THE DYNAMICS OF YOUR BUSINESS

Every type of industry or service business is different, but every business has overhead expenses that are relatively fixed (they do not change, at least not in the short run), and direct expenses which are generally proportional to the quantity of products or services provided. Overhead expenses are the personnel and physical resources that are necessary to make your sales, design your product or service, house your staff and equipment, prepare your payrolls, bill your clients and prepare your financial records. They are generally fixed; they do not change with the volume of your production. Direct expenses are the personnel, equipment and raw materials necessary to actually produce your product or service; they are generally proportional to the quantity of products or services you accomplish.

Now let's say that last year your total annual sales were $1,100,000, your fixed overhead expenses were $600,000, your direct expenses were $400,000, and your profit was $100,000 (approximately 9 percent of your annual sales). If you were to increase your sales by 10 percent or by $110,000 over last year's sales, your profits would increase at a much greater rate than the 10 percent increase in sales. The converse is also true; if your sales were to decrease by 10 percent or by $110,000 under last year's sales, your profits would decrease at a much greater rate than the 10 percent decrease in sales. For example with a 10 percent increase in sales, your new sales total would become $1,210,000, and since your overhead expenses are fixed, they would remain at $600,000. Your direct expenses, however, will increase by 10 percent to $440,000, and your total expenses will increase to $1,040,000. Your new sales of $1,210,000 less your new expenses of $1,040,000 would leave you a new profit of $170,000 (14 percent of annual sales). You can see that a 10 percent increase in your sales actually resulted in a much larger 70 percent increase in profit.

But on the other hand, if your sales were to decrease by 10 percent to $990,000, your overhead expenses will not decrease; since they are fixed, they will remain at $600,000. Your direct costs to produce less products or services will decrease by 10 percent to $360,000 and your total expenses will decrease to $960,000. Your new sales of $990,000 less your new expenses of $960,000 would leave you a new profit of only $30,000 (3 percent of annual sales). You can see from the above example that a 10 percent decrease in sales actually resulted in a decrease in profit of 70 percent. Understanding the dynamics of your business can make the difference in your company becoming successful or for it to file for bankruptcy!

THE NEED FOR A COST ACCOUNTING SYSTEM

Let's say your company works on ten different projects or manufactures ten different products during the year. Reviewing a conventional income statement like the one presented earlier in this chapter will not tell you which project or product is making a profit or losing money. You will need a cost accounting system that can track your income and expense for each product or project in order to identify the profit or loss for each product or project.

Some expenses (costs) are easily identified as being directly required in the production of a product or the providing of a service. For instance, a company producing ten different products can easily segregate the direct labor and material components used on each product's assembly line. By collecting the direct cost for each assembly line and dividing by the number of units produced, we can calculate the direct cost to manufacture each unit. Similarly, a company providing a service can easily separate the direct labor, material and subcontract cost by a customer or a project. Company-wide costs, however, such as accounting, legal, office supplies, rent, and new business development cannot be easily distributed to the specific products or service. These costs are generally collected under the heading of *indirect* or *overhead* costs. They are then prorated to each product or project on some predetermined basis. For instance in my consulting firm we generally distributed overhead costs as a percent of direct labor. **(See Appendix B).** A manufacturing company on the other hand may distribute overhead as a percentage of direct product cost, each industry has their own unique method of distributing overhead costs.

One of the biggest mistakes that small business owners make is the failure to establish a cost accounting system; without this they are flying by the seat of their pants…they are flying blind, and it is only a matter of time until they crash. They may know that they are losing money, but they don't know which product or projects are causing the loss. Or on the other hand, they may be making money, but if they had the knowledge of which products or projects are making money and which are losing money, they could become even more profitable.

(1) *Millionaire Next Door* –Copyright © 1996 by Thomas J. Stanley and William D. Danko (Pg 1, 4)