BUSINESS BASICS
101

Starting your own business or earning an MBA?

Here's the "Basic" information that
successful companies and **students** use
to get it right!

Business 101:

THE BASICS

PREFACE

This book is intended to provide broad business guidelines on how to start or enhance your current business performance. It was written by an eye glass wearing, pocket protector toting poindexter with four constants and two vowels following his name (CPA and MBA) hence I am nerdy enough, ie, qualified to write a book about business basics.

I was the previous owner of a CPA firm that provided CFO, accounting and tax advice to more than 300 clients This book answers the questions I was frequently asked by clients every day and by my students while teaching accounting in the DeVry MBA program•.

MICHAEL J. MERRILL, CPA, MBA

"This book answers the questions I was frequently asked by clients every day and by my students"

"Invaluable."

Former DeVry Student

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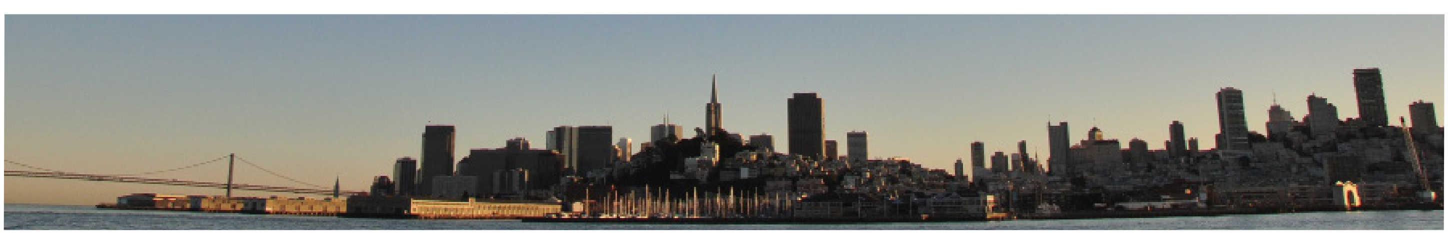


Getting Started

CHAPTER
1

So, you want to head out on your own? Congratulations, this could be the best decision you have ever made or my condolences because this is the worst decision you have ever made. Just because you went to business school or worked at a larger corporation does not mean you have the skills and savvy to be an entrepreneur. Entrepreneurs and employees are very different people. Successful entrepreneur's do not have nine to five office hours with a defined job description. You will work every hour of every day, seven days a week and 52 weeks out of the year. You will also wear different hats from sales to shipping to accounting and many more - sometimes all at once. You are the face of your business and if successful, will be in control of your own destiny.

Choose a product or service you know, understand the competition and ascertain the capital requirements (see business plan and budgets). Feasibility is the key to understanding whether your idea will work. The cheapest and easiest form of feasibility is to ask family and friends for their thoughts. This allows you to talk about your product or service with people who might buy it. You can also put together focus groups to solicit feedback.

Startup Do's and Don'ts

- Do your homework.
- Do make sure you know what you are getting into in terms of cash commitments and financial obligations.
- Do a business plan.
- Do consider buying an existing business or franchise to get your feet wet.
- Do pick an industry, product line or service you know something about.
- Do start a business to be excellent at what you do.
- Do develop a relationship with a commercial loan officer.
- Don't dive in head first.
- Don't invest in businesses that promise an immediate ROI.
- Don't overextend yourself financially and cognitively.
- Don't go into a business you know nothing about or you will spend all your time trying to learn the business instead of growing it.
- Don't start a business from a panic standpoint.
- Don't start a business with the sole purpose of making money.
- Don't start a business in which your strategy is to offer low prices and high volume. The key is not what you make but what you keep.

"Don't go into a business you know nothing about or you will spend all your time trying to learn the business instead of growing it."

"Invaluable."

Former Client

Start or Buy

CHAPTER
2

I am often asked "Should I start my own business or buy an existing one or franchise?" If you start you own, it will take longer but the costs are usually less. Most startup companies are comprised of consulting entities for which the owner is very knowledgeable. In contrast, buying an existing business or franchise will provide you a proven model as well as technical guidance to achieve success for an upfront price and future payments. Either way can be just as successful or detrimental and require hard work and determination.

Purchasing A Business

Buying a business can be very exciting. I recommend you hire a lawyer and accountant to help advise you on the transaction. General issues and questions that should be considered:

- Why is this person selling?
- What is the valuation or business worth?
- Are the key customers and employees staying?
- What is the nature/type of transaction to be used for this purchase: asset or stock? Buyers typically want to do an asset sale to reduce their potential liability while sellers typically want to do a stock sale for favorable tax purposes.
- Will the seller execute a non-compete agreement and for how long? You don't want the seller setting up shop next door providing the same product or service.
- Perform a title search on all assets and a background search and credit report on the seller.
- Who will be your competitors?
- Compile financial projections to ensure the business will be profitable and can pay the debt service.
- What kind of accounting software do they use?
- What type of internal control does the seller currently have in place?
- For a complete due diligence checklist, see the **BONUS** at the end of the book.

Franchises

Purchasing a franchise is a great way to ease into your own business. You get a proven business model, training and support to achieve success. Consider the following points before you decide on a franchise:

- Franchise History: examine the franchisors overall business backgrounds and their experience in running a franchise. Look at prior litigation involving the franchise and whether the franchisor or any of its executives have been in bankruptcy.

Start or Buy

Have an accountant review the franchisors financial statements and talk and visit with five to ten current franchisees.

• Cost: know the total investment required. In addition to the initial fee, there are often other costs to rent or buy a site and purchase inventory. Some franchises also require royalties based on a percentage of the businesses gross revenues as well as payments for advertising.

• Training and Support: assess whether the initial training and ongoing support offered by the franchisor will provide the necessary skills for running the business. Find out how many employees will be eligible for training. Compare the instructions to other franchisors of a similar product or service.

• Terms of the Deal: look at restrictions on what products and services you can sell and to whom. Understand when a franchisor can terminate the franchise and when you can sell it.

• Earnings Potential: franchisors are not required to make earnings claims. If they do, they must provide written documents that substantiate the claims.

Examine all documents carefully and hire a lawyer and accountant to effectively advise you through the transaction. Questions you should have answers for before purchasing a franchise:

General:

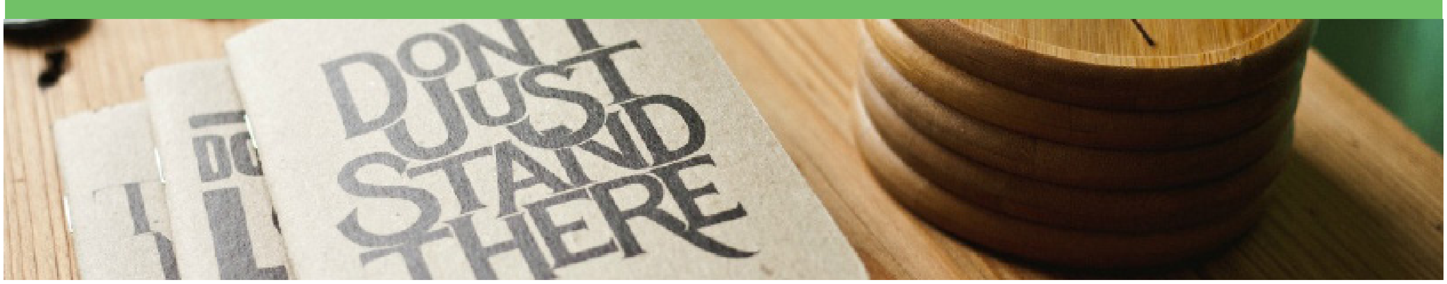
• Is it a good product or service?
• What is the reputation of the company?
• Who are my competitors?
• What will my market share be?

Ask Yourself:

• Do I have the skills needed to run this franchise on a daily basis?
• Do I have the temperament to follow the franchisors directions?
• Do I have the financial means to purchase, grow and reinvest in this business?
• Will the franchise help me reach my business and personal goals?

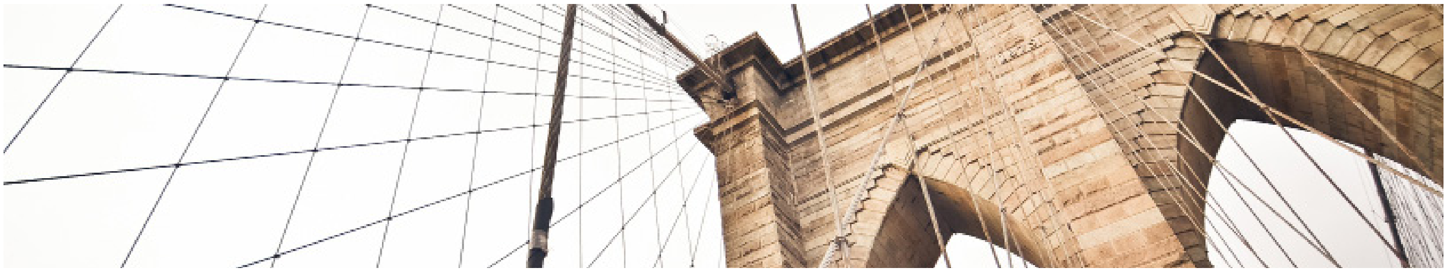
Ask Existing Franchisees:

• To what degree does the franchisor exert operational control over the franchisee?
• Ask "given what they know today, would they purchase the franchise again?"
• What did it actually cost them to develop the business in both money and time and is the working capital identified in the Franchise Offering Circular sufficient?



Business Plan

CHAPTER
3



A business plan is your roadmap for success. It is necessary to understand how, what and where your company will go. Before writing a business plan for a new business venture, consider and research the following issues:

- What makes your product or service special and what need does it fill?
- Who are your potential customers and what will make them purchase from you?
- How will you market your product or service?
- Where will you get the capital to start your business?

The 10 Steps to Building a Great Business Plan!

1. Begin with a cover sheet that includes the contact name, location and telephone number.
2. Keep it short and crisp without compromising the description of the venture. Include an executive summary with an overview of the most important aspects of the venture including the business's niche, marketing, management experiences and finances.
3. Include a table of contents.
4. Identify the target market for the business. Describe the market environment – is it growing, steady or shrinking? Provide extensive details about competitors, including their strengths and weaknesses, estimated market share and other pertinent information. Include your pricing strategy and detail how you plan to promote your business.
5. Explain the benefits of your product or service compared to your competitors.
6. Detail your current location, current and future space requirements and the area's demographics.
7. Show you have an effective management team. Detail the backgrounds of executives, their qualifications and how you plan to attract new personnel.
8. Focus the plan towards the future. Develop forecasts of industry trends over the next three to five years.
9. Highlight current and future problems and develop a strategy to overcome them.
10. Provide financial projections that include an income statement, balance sheet and statement of cash flow for the next 3 to 5 years as well as capital purchases, a break-even analysis and loan applications. Templates are available at www.companyprophets.com.

Budgets & Projections

CHAPTER
4

Budgets are useful for planning your finances, a specific project, an initiative or a future investment. A budget shows what you expect to earn (revenues) and expect to spend (expenses) over a specific time period. Amounts are categorized according to the type of business activity by specific accounts such as service revenue, auto expense, travel expenses, etc. Below is an example for you to use.

It is also useful to track your budget to the actual results. This will let you know how your business is doing and what issues may be ahead. For example, if your expenses are higher than your budget, you can try to adjust them before you encounter any cash flow shortfalls.

ANNUAL BUDGET TEMPLATE

ITEM	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	TOTAL
Revenues													0
Advertising and Marketing													0
Auto Expense													0
Bank Fees													0
Depreciation Expense													0
TBD - Equipment #1													0
TBD - Equipment #2													0
TBD - Equipment #3													0
Dues & Subscriptions													0
Home Office - SF/TSF													0
Rent													0
Utilities													0
Association Fees													0
Insurance													0
Insurance													0
Internet													0
Meals & Ent. - 50%													0
Office Supplies													0
Parking/Tolls													0
Postage													0
Printing and Duplicating													0
Professional Fees													0
Rent													0
Small Hand Tools													0
Taxes and Licenses													0
Telephone/Cell Phone/Pager													0
Travel (airfare, lodging, etc.)													0
Utilities													0
Wages:													0
Employee Compensation													0
Payroll Taxes													0
Total	0	0	0	0	0	0	0	0	0	0	0	0	0

This Excel spreadsheet as well as other budget/forecast templates can be downloaded at www.companyprophets.com

Selecting an Entity Type

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Choosing the right legal structure will determine what kind of taxes you will pay, who will be liable financially and legally and what form to file. There are four main types of entities:

• **Sole Proprietorship:** this type of entity is easy to setup and dissolve. Profits are taxed at the owner's federal tax rate and shown on the owner's Federal 1040 under Schedule C or Schedule CEZ. The disadvantage is that owners have unlimited liability. For more information, see IRS Publication 408.
• **Partnership:** this type of entity is easy to setup and allows two or more people to share resources and capital. Each partner has unlimited liability for the partnership and the actions by any partner. Always have an attorney draft an operating agreement. For more information, see IRS Publication 541.
• **Limited Liability Company:** this is a hybrid entity that combines elements of partnerships and corporations. It provides limited liability to its owners and can elect to be treated as a partnership or corporation for tax purposes. Always have an attorney draft an operating agreement. For more information, see IRS Publication 541 and 542.
• **Corporation:** this is a separate legal entity that must be formed under the appropriate State guidelines. It provides limited liability to its owners. For tax purposes, it can elect either C or S Corp status. C Corp provides double taxation – meaning corporate profits and dividends paid to its shareholders are taxed concurrently. S Corp allows the corporate income to be taxed at the owner's level only avoiding being taxed twice. In order to elect S Corp status (Form 2553), you must have 100 or fewer shareholders and all of them must be US citizens.

See the exhibit on the next page for a summary comparison of each entity type.

Anticipate Your Exit!

Choosing the right corporate structure isn't just about minimizing your current tax burden; it is also about looking ahead at your exit strategy. If, for example, you anticipate a public offering or merger, it will be most tax effective to do so as a C Corp. If you anticipate selling the business outright, an S Corp or LLC is the better vehicle because buyer's typically prefer (for tax and liability reasons) to structure the deal as an asset sale. The sale of assets under a C Corp is taxed twice while the owner of a pass-through entity like S Corp or LLC will only have to pay individual capital gains tax. LLC's are the best if your strategy is to dissolve the entity as the distribution of the property to its members is not recognized as a taxable event.

Selecting an Entity Type

Two or More Owners:

If you have two or more owners, partners, etc., I strongly recommend you hire a lawyer to draft an Operating Agreement. While everyone may be getting along today, you never know what tomorrow brings. I have seen best friends, relatives and even spouses become so upset that they can longer speak with each other and end up suing in court. This Agreement is what goes in front of the judge to determine the fate of the company and its assets, liabilities and customers.

"I strongly recommend you hire a lawyer to draft an Operating Agreement. While everyone may be getting along today, you never know what tomorrow brings."

"Invaluable."

Former Client

Financing

CHAPTER
6

A start-up or early stage company has little opportunity of getting a significant bank loan. SBA start-up loans are usually limited to $25,000 or less. So where will the money come from?

• Savings: if you are not confident enough to risk your own money do not expect anyone else to be willing to risk theirs. This means cashing in your stocks, selling the boat or taking a loan against your retirement account.

• Credit Cards: this is usually the easiest way to get credit and one of the most expensive. Be careful and cognizant of the interest rates being charged.

• Store Credit: apply for credit with the store vendors you are purchasing from.

• Home Equity Line: using the equity in your house to apply for a line of credit.

• Investors: if it is a small amount of money needed, your family and friends are going to be your best resource. You can solicit angel investors, venture capital and other investor groups.

Good Sites to Seek Capital

www.angelcapitalassociation.org

www.allianceofangels.com

www.crowdfunder.com

www.kickstarter.com.

Angel Investors and Venture Capitalists

I am often asked by entrepreneurs if they should seek funding from angel investors or venture capitalists. Here are a few guidelines for determining whether you should approach angels or VC's for your financing.

• Amount of initial money to be raised: if it is less than $1M, angels are usually the best unless you specifically target VC's that do seed rounds or you have a preexisting relationship.

• Amount of money to be raised over the life of the company: if you will require $3M or less to get your company cash flow positive, stick with angels.

• Type of company you are building: VC's love to fund businesses with potential to be enormous. Angels will love this too but they are more willing to fund smaller companies with smaller capital requirements. VC's tend to invest in entities that have scale (like software development companies) rather than linear entities (like a service company).

• Your experience: successful entrepreneurs always find it easier to raise VC monies because of their previous success. That does not mean as a first-time entrepreneur you can not approach a VC, it just means it is going to be harder.

• Your network: reach out to everyone you know and ask for references. As always a personal reference works much better than an unsolicited application.

Financing

Top 5 Items VC's Need to See:

1). Size of the opportunity

2). Quality of the Team

3). Long-term competitive differential

4). Reasonable capital requirements

5). Opportunity to make 3X-10X their investment

SBA PROGRAMS:

For existing companies, SBA lending can be very useful. Any owner of 5% or more will have to guarantee the loan. All owners must have good credit to qualify. The SBA offers the following programs:

• 7(a) Business Loans: this is the SBA's primary loan program and can loan up to $2 million. Fees start at 2% and increase based on the loan amount.

• SBA Express Loans: this type of loan is provided by the individual lender up to a max of $350K.

• Community Express: this is a pilot program used for working capital and can be up to $250K.

• 504 Loan Program: this program uses fixed, long-term financing to finance assets. The money can be used for equipment, machinery, land, buildings or any other physical asset. The max loan is $1.5M.

Cash Flow

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7

Positive cash flow is the lifeblood of any business. Maximizing company cash flow is more than invoicing early and watching what you spend. It is a combination of several strategies. Using the following tips can help you stay on top of your company's finances.

• Accept Credit Cards: place recurring service fees on a credit card to ensure fast payment.
• Request Direct Deposit: shave up to a week or more off by having funds deposited directly into the checking account instead of receiving and depositing mailed checks.
• Get Terms - On Both Ends: in your contracts, get clients to pay faster and push off terms for your payments to vendors. If the contract allows for twice-monthly invoicing or a certain amount up-front, that can greatly enhance your company's cash flow. Be careful not to rob Client B's prepayment to pay for Client A's work.
• Track Receivables: run a receivable aging report - anyone over 30 days make a polite call or send a friendly letter. Have them bring a check to you before starting service again.
• Get Credit: use a line of credit as a stop-gap between pay cycles. Once invoices are paid, pay down the line of credit.
• Run a D&B Credit Report: for a fee, have Dunn and Bradstreet credit management compile a report on a client which will tell their payment history or financial status ($30-$300).
• Bring in a Professional Bean Counter: whether it's your CPA or an outside CFO-for-hire, let a professional help set up a process to manage cash flow. This includes generating reports on aging invoices, monitoring collections, calling on clients - and generally improving cash flow.
• Factoring: selling your receivables, at a discount, for cash today.
• Be Persistent: have an employee - or anyone who interacts with clients - monitor and pursue payments on a regular basis.
• Build Relationships with Customers: Use the personal touch to help with collections.
• Offer Discounts: this will encourage quick payments. For example, offer a 2% discount if the invoice is paid within 10 days.
• Stagger Billing: this will maximize cash flow by having a steady "stream" of cash come in. For example, bill half your customers on the 1st and half on the 15th.
• Prompt Billing with a Follow-up: invoice your customer as soon as the service is complete or the product is shipped. Follow-up with the customer the following week to ensure they received the invoice.

Insurance

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8

Insurance is vital to any company. Always keep a record of the basics outside of your office. This includes the name of the insurance company, policy number and the telephone number.

Insurance Needs & Requirements:

• Liability: this coverage protects a business from a loss as a result of an injury, death or property damage caused by a businesses operations, employees or products. "Premises and operations" coverage pays when a business is legally responsible for an injury claim. For example, someone slips and falls on company property. "Products and completed operations" coverage pays for monetary losses that result from injury or damage caused by a company's products. I also recommend you have commercial automobile insurance to cover all company vehicles.
• Property: this coverage protects the value of your physical assets. The amount of the policy should be sufficient to replace or rebuild the office space and other property lost.
• Business Interruption: this coverage provides income in the event a business must close due to an insured property loss. The payment can be utilized to pay for rent, salaries and other expenses while the business is unable to operate.
• Directors' and Officers' Liability: this coverage protects both the company and individual executives in the event an employee, shareholder, government agency or others allege that the company has suffered financial losses due to company mismanagement.
• Key Man: this coverage provides insurance proceeds to the company in case of the death of an essential individual. It works by having the company purchase a life insurance policy with a specified amount on a specific individual.
• Flood: this coverage protects in case the business is flooded. Property insurance does not cover damages from floodwaters of any kind such as rivers, oceans, pools or any other body of water.
• Workers Compensation: most States require employers that are not in the construction industry and have four or more employees, either full or part-time, to have workers compensation coverage for their employees. In the construction industry, workers compensation coverage is required when there are one or more full or part-time employees. Corporate officers are included in the definition of "employee." Agricultural employers who have more than five regular employees and/or 12 or more seasonal workers (employed for at least 30 days) are required to have coverage.

Insurance Needs & Requirements:

It is the employer's responsibility to pay the premium for the workers compensation policy. There are several ways to obtain a workers compensation policy such as purchase the policy from an agent, qualify to be self-insured or contract with a professional employer organization that already has a policy in place.

Small steps that can save you big on workers compensation premiums include:
• Take your time to hire good employees. Use a formal application process and always perform background checks in order to prevent hiring someone who had problems at other jobs.
• Try and make arrangements with a nearby medical facility to treat employees in case of an injury. This can reduce confusion and minimize problems after an accident.
• Make sure independent contractors have their own workers compensation policies and request a copy for your records.
• Establish safety practices to ensure a better working environment.
• Report all incidents immediately to your carrier.

Disaster Planning:
Every business needs a disaster plan. The planning process should focus on preparedness, mitigation, response and recovery. To help you get started, here are some tips:
• Secure Computers: when a storm threatens, put computer equipment in waterproof bags or boxes. Make sure hard drives, software and equipment are stored off the ground at least at desk height. Back up all computer records and store them offsite.
• Put Financial Records in a Safe Place: if you have to evacuate, take a set of financial records with you. You may need them to apply for disaster assistance.
• Keep Up-to-Date Lists: compile employees home telephone numbers, cell numbers and other emergency contact information.

"Don't go into a business you know nothing about or you will spend all your time trying to learn the business instead of growing it."

"Invaluable."

Former Client

Accounting

CHAPTER
9

No one starts a business to learn accounting and become a bean counter however you need to understand the basics in order to operate your business effectively. In this and the next chapter, I will try and explain accounting terminology and how to read financial statements.

Accounting is a process that records historical data of an entity into predetermined categories or accounts. It is important to understand that the information recorded does not forecast the future but merely states how the business performed in the past. However this information can be used to provide future trends for a particular business if you make adjustments for future economic and environmental factors.

Accounting is balance; for every credit there must be a debit. The equation is Assets = Liabilities plus Equity or A=L+E. Assets are typically debited and liabilities and equity are typically credits to increase the account balances. Whatever is done on one side of the equation must be done to the other. For example, someone buys 100 shares of stock in ABC Corp for $100; ABC Corp will record the transaction as follows:

Cash (asset/debit)	$100
Common Stock (equity/credit)	$100

There are several types of accounting methods but the two most common are Generally Accepted Accounting Principles ("GAAP") and Cash Basis ("Cash"). Most large companies use GAAP while most small companies use Cash.

GAAP uses the matching concept on an accrual basis. Accrual/matching accounting record the revenues and expenses when they occur/are earned NOT when cash is received or paid. This is why at quarters end most public companies are scrambling to close sales deals so they can include it in their revenue amounts.
The cash basis of accounting records revenues and expenses when cash is received/paid. Most small business want to pay taxes only on monies they have received. If the accrual method was used and subsequently the customer never paid, you would pay taxes this year and receive a tax credit in the following year which equates to Uncle Sam has had use of your money for a year.

Accounting is full of unique terms so that you have to hire a nerdy accountant like me. A good understanding of accounting and its terminology is required before you can read and understand the financial statements. On certain accounts, I have enclosed the type of account it is and the typical entry (debit or credit) usually associated with it to increase the account balance.

Accounting

Accounts Receivable (asset/debit) – short-term liquid asset arising from sales to customers on credit. For example I provide some accounting services to you and then send you a bill. The entry is as follows:

Accounts Receivable (debit)	100
Sales (credit)	100

After I have received payment, I must clear the receivable because it is no longer owed to me. The entry is as follows:

Cash (debit)	100
Accounts Receivable (credit)	100

Accrual – the recognition of an expense or revenue in the period it has occurred. For example, on January 1st Newspaper Co receives $1,200 cash for an annual subscription. Since none of the subscription has been earned, Newspaper Co must treat this as a liability. The entry is as follows:

Cash (debit)	1,200
Deferred Revenues (credit)	1, 200

At the end of January, one-twelfth of the subscription has been earned so Newspaper Co makes the following entry to reduce the liability and record the revenues it has earned:

Deferred Revenues (debit)	100
Revenues (credit)	100

Accrual Basis – recording of revenues and expenses in the period in which they occur regardless of when cash is received or paid.

Accumulated Depreciation (asset/credit) – shows accumulation of past depreciation expense. This occurs after depreciation expense is recorded because we have stated the asset is worth less. Accumulated depreciation lowers the book value of our assets on the balance sheet. The entry is as follows:

Depreciation Expense (debit)	100
Accumulated Depreciation (credit)	100

Amortization (expense/debit) – periodic expense of an intangible asset taken over its useful life. The offsetting account is accumulated amortization (this reduces the book value on the balance sheet similar to accumulated depreciation).

Articles of Incorporation – a contract between the State and the incorporators forming the corporation.

Asset (balance sheet/debit) – an economic resource owned by a business that will benefit future operations (i.e. generate revenue). For example, you buy a delivery truck the entry is as follows:

Truck (debit)	100
Cash (credit)	100

Accounting

Auditing – the process of examining and testing the financial statements of a company in order to render an independent professional opinion as to the statement fairness in their presentation of a company's performance i.e. what the financial statements show is what actually occurred.

Authorized Stock – the maximum number of shares a corporation can issue.

Balance Sheet – a financial statement that shows the financial position of a company on a particular date.

Bank Reconciliation – process of accounting for the differences between the balance appearing on the bank statement and the balance of cash according to the company's records.

Bankruptcy – there are two types of business bankruptcies: Chapter 7 and Chapter 11. Chapter 7 is when the company is completely liquidated and the proceeds are distributed to creditors and shareholders. Under this scenario the company ceases to exist. The proceeds are normally paid in the following order: secured creditors (i.e. a specific property has been pledge to the creditor for example a bank who has the primary mortgage on a building), legal fees and other costs incurred to administer and operate the bankrupt company, wages due workers if earned within three months prior to filing for bankruptcy, taxes due, general and unsecured creditors, preferred stockholder and finally common stockholders. Chapter 11 is filed to allow a company to reorganize. During this time, the creditor's ability to foreclose and collect their debt is limited and the company must report everything to the bankruptcy court. Individuals file Chapter 13.

Bond – a security, usually long-term, representing money borrowed by a corporation from the investing public.

Book Value – total assets less total liabilities; owner's equity.

Break-even Point – that point where revenues equal expenses. If revenues generated are greater than the break-ever point there is a profit; if revenues are less that the break-even point there is a loss.

Budget – forecasting future cash inflows and outflows. A good way to develop a budget is by utilizing previous accounting data and making adjustments for expected economic and environmental trends.

Callable Bonds – bonds that can be redeemed by the offering company at any time prior to maturity.

Accounting

Cash Flow Statement – a financial statement showing the company's sources and uses of cash during a specific period. When evaluating a company, always use cash generated by operations as the benchmark. Net income can be adjusted and cash generated by acquiring more debt or selling assets does not show a company is viable. Cash generated from operations shows that the core strategy of the business is working.

Chart of Accounts – a scheme of accounts to record financial transactions.

Common Stock (equity/credit) – stock representing the most basic rights of ownership.

Consolidated Financial Statements – the combined financial statements of the parent company and its subsidiaries.

Convertible Bonds – bonds that may be exchanged for other securities of the corporation; usually common stock.

Convertible Preferred Stock (equity/credit) – stock that can be converted into common stock.

Corporation – a group of members granted a charter legally recognizing them as a separate entity having its own rights, privileges and liabilities separate from those of the members.

Cost of Goods Sold (debit) – expenses that can be directly attributed to the saleable product. An example would be a paper mill that buys lumber and office supplies. The lumber is directly used for the making of the paper and hence is classified as cost of goods sold. The office supplies are used by many people in the company and cannot be directly attributed to the product therefore it is classified as general and administrative costs.

Cumulative Preferred Stock (equity/credit) – preferred stock in which the dividends accumulate and must be paid prior to dividends paid to common stockholders.

Current Assets (balance sheet/debit) – cash or other assets that can be realized in cash within one year.

Current Liabilities (balance sheet/credit) – obligations that will become due/payable within one year.

Current Ratio/Quick Ratio – a measure of liquidity; current assets divided by current liabilities. Most financial institutions require a 1.5 ratio when making loans. This means your current assets on hand could pay all current liabilities due one and one-half times.

Deferral – the postponement of the recognition of an expense already paid or of revenue already received.

Accounting

Depreciation (expense/debit) – the periodic allocation of cost of a tangible long-lived asset over time. For example, you purchase a truck for $20,000 with an estimated useful life of 5 years which equates to $4,000 a year in depreciation. The entry would be as follows:

Depreciation Expense	4,000
Accumulated Depreciation	4,000

Dividends – a distribution of assets from a corporation to its shareholders.

Double taxation – referred to when a corporation is taxed on its earnings and the dividends received by shareholders are taxed. ABC Corp (a C corporation) makes $100K and subsequently pays income tax on that money. During the same period, it distributes, in the form of a dividend, $100K to its owners, and now the owners must include that as income on their tax returns and pay income tax. As you can see, the same $100K was taxed twice hence double taxation. If ABC Corp was classified as an S corporation, ABC would not have to pay income tax at the corporate level only the owners would have to pay income tax (taxed once).

Earning Per Share – net income of a corporation divided by the weighted average number of common stock outstanding during the corresponding period.

Equity (equity/credit) – the residual interest in the assets of a company that remains after deducting liabilities. Can also be called net assets.

Estimated Useful Life – the total number of service units expected from a long-term asset. This can be years, number of production runs, etc.

Expense (income statement/debit) – the cost of goods and services used in the process of obtaining revenue. Examples include general administrative costs, operating expenses, etc.

Extraordinary Item – events or transactions that are distinguished by their unusual nature and infrequency of their occurrence. For example, a Florida earthquake would be an extraordinary item but not a hurricane. Just the opposite would be the case in California as a hurricane would be considered extraordinary and not an earthquake.

Financial Position – the collection of resources belonging to a company and the sources of these resources or claims on them at a particular point in time (i.e. a Balance Sheet).

Financial Statements – predetermined reports that are used to communicate financial information to users (i.e. Income Statement, Balance Sheet, Statement of Cash Flows, etc.)

Accounting

Fiscal Period – any twelve month accounting period used by a company.

Fixed Assets (balance sheet/debit) – another term used for long-lived assets; assets with an estimated useful life of one year or more.

Fully Diluted Earnings Per Share – earnings per share but also includes all uses of common stock such as options in the denominator.

Generally Accepted Accounting Principles (GAAP) – the conventions, rules and procedures utilized by an accountant in recording financial transaction and preparing financial statements.

General Administrative Costs / G&A (income statement/debit): costs incurred by a company that are not directly attributed to the final product. An example would be a paper mill; the entity buys lumber and office supplies. The lumber is directly used for the making of the paper and hence is classified as cost of goods sold. The office supplies are used by many people in the company and cannot be directly attributed to the product therefore it is classified as general and administrative costs.

Going Concern – the assumption that unless something changes, a company will not be able to continue doing business.

Goodwill (balance sheet/debit) – the excess of the cost of a group of assets (usually an entire business) over the market value of the assets individually. For example, you purchase ABC Corp for $1M but the company only has $250K in physical assets. The other $750K will be classified as goodwill.

Gross Margin/Gross Profit – total revenues less cost of goods sold.

Income Statement – a financial statement that shows the amount of income earned by a business during a specific time period. Revenues less cost of goods sold less expenses.

Intangible Assets (balance sheet/debit) – long-lived assets that have no physical substance but have a value based on rights or privileges occurring to the owner. Examples would be goodwill, patents, royalties, etc.

Liability (balance sheet/credit) – a debt of the business; it can be an amount or an obligation to perform.

Liquidity – a company's position of having enough funds/cash on hand to pay for the company's expenses.

Long-term Liabilities (balance sheet/credit) – debts of a business that are due after one year. For example you purchase a truck with a $20,000 note payable in $5,000 per year for four years. The $5,000 due within the first year would be classified as a short-term liability and the remaining $15,000 would be classified as a long-term liability.

Accounting

Marketable Securities (asset/debit) – investments that can be turned into cash within 90 days and the fair market value can be easily obtained. For example, ABC Corp owns 100 shares of another company whose share are trading on the stock exchange for $25. The market value of that stock would be $2,500 (100 shares times $25 share price).

Matching Rule – the rule of accounting that revenue must be recorded in the period in which it was performed and expenses must be recorded in the period which they were used to produce the revenue regardless of whether cash was received or paid.

Materiality – a threshold predetermined as to whether something is important. Lets say your company has $1M in sales; a $10 discrepancy in your cash position would probably not be worth your time in resolving hence it is deemed immaterial. If there was a $10K discrepancy that would be worth your time in resolving and hence it is considered material.

Net Income – the increase in equity as a result of the company's profit operations; revenues less expenses equal net income where revenues are greater than expenses.

Net Loss - the decrease in equity as a result of the company's profit operations; revenues less expenses equal net loss where expenses are greater than revenues.

Operating Expenses (income statement/debit) – expenses incurred by the company that are not directly attributable to a product or service also known as general and administrative costs.

Partnership – an association of two or more members to carry-on as co-owners of a business. There are two types of partners; general and limited. General partners actively participate in the day-to-day management of the company and have unlimited liability in the event of a lawsuit. Limited partners can not participate in the operation of the company but there liability, in the event of a lawsuit, is limited to their respective investment in the company (similar to stockholders of a corporation).

Par Value – the amount printed on each share of stock. A stock can have no par value. When amount paid for stock is greater than the par value, the difference is recorded as additional paid in capital. For example, someone buys ABC Corp's stock for $10 and it has a par value of $1. The entry for ABC Corp is as follows:

Cash	10
Common Stock	1
Additional Paid In Capital	9

Period Costs – financial transactions that only affect a certain time period of a company i.e. revenue and expenses. These account balances go to $0 at the start of the new fiscal period.

Accounting

Perpetual Costs – financial transactions that affect the company over different fiscal periods i.e. balance sheet items like equipment, a liability or cash.

Preferred Stock (balance sheet/credit) – a type of stock that has some preference over common stock (usually dividends and proceeds from liquidation/bankruptcy).

Prepaid Expenses (asset/debit) – expenses paid that do not expire during the current fiscal period. For example, ABC Corp buys an annual insurance policy on 7/1. Assuming a calendar year fiscal period, as of December 31 only half of the expense has been incurred while the other half will be incurred the following year. The entries are as follows:

Initial purchase on 7/1:	Prepaid Insurance		100
Cash		100	
Entry as of 12/31:	Insurance Expense		50
Prepaid Insurance		50	
Entry on 6/30:	Insurance Expense		50
Prepaid Insurance		50	

Price/Earning (PE) Ratio – a ratio that measures the relationship of the current market price of the stock to its earnings per share.

Profit Margin – a measure of performance/profitability; net income divided by total revenues.

Retained Earnings (balance sheet/credit) – the accumulated net income of a company less net losses and dividends or transfer of capital.

Revenue (income statement/credit) – assets received from customers during a fiscal period i.e. the sales of goods and services.

Sales Returns and Allowances (income statement/debit) – represent refunds granted to customers or other allowances related to prior sales.

Accounting

Sole Proprietorship – a business formed by one person. This type of entity has unlimited liability for its owner i.e. if the entity is sued not only are the assets of the entity at risk but also the personal assets of the owner.

Tangible Asset (balance sheet/debit) – long-term assets that have physical substance.

Treasury Stock (balance sheet/credit) – stock that was issued/sold by the company and has been required by the company but has not been reissued or retired.

Unlimited Liability – a sole proprietor or partner that has a personal liability for all debt of the company i.e. personal assets are at risk.

Working Capital – amount by which total current assets exceed current liabilities.

"Don't go into a business you know nothing about or you will spend all your time trying to learn the business instead of growing it."

"Invaluable."

Former Client

Financial Statements

CHAPTER
10

To really understand the current and future conditions of your business, you have to understand the three basic financial statements – income statement, balance sheet and statement of cash flows. These statements are generated by organizing and analyzing numbers from your accounting activities.

The Income Statement (profit and loss) shows your overall profits by taking how much you have earned (revenues) less how much you spent (expenses). In essence, this statement gives you a sense for how well the business is operating during a specific time period.

ABC Corp Income Statement as of 12/31/15

Revenues:		
Sales	$9,500	
Sales Returns and Allowances	(500)	
Total Sales		$9,000
Cost of Goods Sold:		
Labor	$1,000	
Materials	1,000	2,000
Gross Profit		$7,000
General & Administrative Expenses:		
Automobile Expenses	$ 500	
Bank Service Charges	100	
Office Supplies	500	
Salaries and Wages	1,000	
Taxes: Payroll	250	2,350
EBITDA		$4,650
Amortization Expense	$ 50	
Depreciation Expense	100	
Income Tax Expense	100	250
Net Income		$4,400
		=====

- Gross profit percentage is 78% (7,000 divided by 9,000)
- Net income margin is 49% (4,400 divided by 9,000)

Financial Statements

The Balance Sheet shows the overall status of your finances at a specific date. It totals all your assets and subtracts all your liabilities to compute your equity which is the cumulative net worth (or net loss) of the business.

ABC Corp Balance Sheet as of 12/31/15

Assets:		
Cash	$ 1,000	
Accounts Receivable	4,000	
Prepaid Expenses	1,000	
Inventory	3,500	
Total Current Assets		$ 9,500
Computer Equipment	$ 1,000	
Furniture and Fixtures	4,500	
Accumulated Depreciation		
Total Fixed Assets		5,400
Security Deposit	$ 500	
Goodwill	5,000	
Accumulated Amortization	(50)	
Total Other Assets		5,450
Total Assets		$20,350
		======
Liabilities & Equity:		
Accounts Payable	$ 500	
Mortgage Payable (< 12 months)	250	
Total Current Liabilities		$ 750
Mortgage Payable (> 12 months)		5,000
Total Liabilities		$ 5,750
Common Stock	$ 600	
Additional Paid in Capital	9,600	
Retained Earnings (Income Stmnt)	4,400	
Total Equity		14,600
Total Liabilities and Equity		$20,350
		======

• As you can see Total Assets equal Total Liabilities and Equity and the net income of $4,400 is added to the retained earnings.

• The current/quick ratio for this entity would be 12.67 ($9,500 in current assets/ $750 current liabilities). Banks typically require a 1.5 times ratio to qualify for a loan.

Financial Statements

One of the biggest challenges for any business is managing cash flow which is shown on the Statement of Cash Flows. The overall purpose of managing your cash flow is to make sure that you have enough cash to pay current bills. The statement of cash flow includes total cash received minus total cash spent by only including actual cash transactions.

ABC Corp Statement of Cash Flows as of 12/31/15

Cash Flows from Operating Activities:		
Net Income		$4,400
Adjustments to reconcile Income to Cash:		
Increase in Accounts Receivable	$ (4,000)	
Increase in Accounts Payable	500	
Prepaid Expenses	(1,000)	
Increase in Inventory	(3,500)	
Amortization Expense	100	
Depreciation Expense	50	
Net Cash Flows from Operating Activities		(7,850)
Cash Flows from Investing Activities:		
Purchase of Computer Equipment	$ (1,000)	
Purchase of Furniture and Fixtures	(4,500)	
Security Deposit	(500)	
Purchase of Goodwill	(5,000)	
Net Cash Flows Used by Inv. Activities		(11,000)
Cash Flows from Financing Activities:		
Mortgage		$ 5,250
Sale of Stock		10,200
Net Cash Flows from Fin. Activities		5,450
Net Adjustments to Cash		$ 1,000
Beginning Cash Balance		0
Ending Cash Balance (Balance Sheet)		$ 1,000

"The overall purpose of managing your cash flow is to make sure that you have enough cash to pay current bills."

"Invaluable."

Former Client

- Accounts receivable: if your receivable balance increased you received less cash so it is shown as a negative i.e. it has an inverse relationship to cash.
- Prepaid expenses: inverse relationship; if this account increases cash was paid but the expense was not recorded.
- Inventory: inverse relationship; if this account increases, cash was paid but the expense was not recorded.
- Accounts Payable: if your payables increase that means you have more expense but less cash was paid therefore it is shown as a negative amount.

Payroll

CHAPTER
11

If your business has employees, then you are going to be incurring payroll and all the taxes associated with it.

• First have the employee fill-out a W-4. Once you determine his/her filing status and total allowance(s), use Publication 15 Circular E from the IRS (www.irs.gov) to determine the amount of income tax withholding that will be required.

• You must withhold social security or FICA taxes at a rate of 6.2% on the first $118,500 of wages (2017 cap amount). This amount is also due from the employer hence the total FICA tax rate is 12.4%.

• You must withhold Medicare taxes of 1.45% and there is no compensation limit. This amount is also due from the employer hence the total Medicare tax rate is 2.9%.

• The employer must pay Federal Unemployment on the first $7,000 of each employee's wages. The rate is 6.2% but you can take a credit for the amount paid to the State.

• The employer must pay State Unemployment on the first $7,000 of each employee's wages. The initial rate for new employers in most States is 2.7% with a max rate of 5.4% depending on future claims.

Forms to be Filed and Due Dates:

• W-2's must be mailed to recipient by January 31.

• Form 940 Federal Unemployment filing due by January 31.

• W-3 and copies of W-2's must be filed with Social Security by February 28.

• Form 941 Employers Quarterly Payroll Report due by January 31, April 30, July 31 and October 31. If your tax liability is less than $2,500 per quarter, you can pay with the filing. If your tax liability per quarter is more than $2,500 but less than $50,000 annually, you must make monthly deposits. If your tax liability is more than $50,000 per year, you must deposit weekly or semi-weekly depending on your payroll cycle. You may pay via the Electronic Federal Tax Payment System.

Employee Versus Independent Contractor

When a worker performs services and receives compensation, an important question for any business owner is whether the compensation is subject to employment taxes. The answer depends on whether the worker is an employee or independent contractor. This determination of the workers status depends on the facts which define the relationship of the parties and the nature of the services provided at the time such services are rendered.

Generally, a common law employee works and performs services under the control of the business that pays for said services. An independent contractor, on the other hand, is in business for himself/herself and performs the services free of control from the business that pays for said services.

Employment taxes are subject only to workers classified as employees. The employer's obligation is to deduct Federal income tax and "match" Social Security and Medicare taxes and pay Federal and State unemployment taxes. An independent contractor is responsible for their own taxes.

In addition, certain Federal and State laws regarding benefit participation plans, wage payment, working conditions and worker's compensation only apply to employees. For example, only employees can participate in a 401K plan.

When answering this question, the IRS reviews all evidence regarding the degree of control and independence of the worker. The IRS indicates that the degree of control and independence fall into three major categories: behavioral control, financial control and the type of relationship between the parties. A complete listing is available in Publication 15A on the IRS website at www.irs.gov.

Behavioral Control: facts that show whether the business has the right to direct and control how a worker performs the task for which he/she is hired including:
• Instructions the business gives the worker. An employee is generally subject to the business' instructions about when, where and how to work. Even if no instructions are given, please note that there have still been instances where sufficient behavioral control existed hence the employer controlled the worker.
• Training the business provides to the worker. An employee may be trained to perform services in a particular manner. Independent contractors normally use their own methods.

Employee Versus Independent Contractor

• Financial Control: facts that show whether the business has the right to control the aspects of a worker's job include:

- The extent to which the worker has unreimbursed business expenses which are more likely to occur with independent contractors.
- The extent of the worker's investment. An independent contractor often has a significant investment in the "facilities" used to perform services for someone else however this is not mandatory.
- The extent to which the worker makes services available to the relevant market. Employees tend to work for a single business.
- How the business pays the worker. An employee is generally paid by the hour, week or month. An independent contractor usually is paid by the job. However, it is common in some professions, such as accounting services, to pay an independent contractor at an hourly rate.
- The extent to which the worker can realize a profit or incur a loss. An independent contractor can make a profit or loss.

• Type of Relationship: facts that show the type of relationship between the parties include:

- Written contracts describing the type of relationship the parties intended to create.
- Whether the business provides the worker with employee type benefits such as insurance, pension plan, vacation or sick pay.
- The permanency of the relationship. If one engages a worker with expectations that the relationship will continue indefinitely, rather than for a specific time period or project, this is generally considered evidence that the intent was to create an employer-employee relationship.
- The extent to which the services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are key to the company's business activities, it is more likely the company can control the worker's activities hence it would indicate an employer-employee relationship.

Upon request, the IRS will determine whether a worker is an employee. You can request this by filing Form SS-8 Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

Taxes

CHAPTER
12

By being organized you can track to see how your company is doing and make informed decisions. Here are some useful tips for getting your business organized.
• Keep business and personal accounts separate by setting up a separate business checking account and separate credit cards. This is also essential for liability purposes if you have a separate entity.
• Create a system for record keeping. Keep records organized by filing receipts by expense type or vendor paid.
• Keep records up to date by purchasing an accounting software system such as QuickBooks, Quicken or Microsoft Business. There are also free templates available at www.companyprohets.com.

Tax Filings, Forms and Due Dates

• Form 1040 Individual Tax Return due by April 15.
• Form 1040ES estimated individual tax payment coupons due by April 15, June 15, September 15 and January 15.
• Form 1120S S Corporation Tax Return due by March 15 or the 15th day of the third month following the end of its tax year.
• Form 1120 and 1120A for C Corporation Tax Return due by March 15 or the 15th day of the third month following the end of its tax year.
• Form 1120ES estimated tax payment coupons if the corporation will owe over $2,500. Due dates are April 15, June 15, September 15 and January 15.
• Form 1065 Partnership Tax Return due by April 15 or the 15th day of the third month following the close of the partnerships fiscal year.
• Form 1120H Home Owners Association due by the 15th day of the third month following the end of its tax year.
• Form 990 Tax Exempt Organizations. If gross receipts and assets are less than $100K and $250K respectively, you can file a Form 990EZ. If receipts are less than $25K no filing is necessary.

Here are some useful Publications available from the IRS at www.irs.gov:

- Publication 17: Your Federal Income Tax
- Publication 1518: Tax Calendar
- Publication 334: Tax Guide for Small Businesses
- Publication 15: Circular E Payroll Withholding Tax Rates
- Publication 15A: Employer’s Supplemental Guide
- Publication 583: Starting a Business and Keeping Records
- Publication 541: Partnerships
- Publication 542: Corporations

Resources

CHAPTER
13

Below are some helpful online resources that can provide additional information.

Taxes:
- Internal Revenue Service @ www.irs.gov
- Motley Fool @ www.fool.com/taxes
- Kiplinger @ www.kiplinger.com
- Financial Web@ www.finweb.com/taxes

Starting a Business:
- Biz Stats @ www.bizstats.com
- Biz Miner @ www.bizminer.com
- U.S. Government Web Site @ www.usa.gov
- U.S. Census Bureau @ www.scensus.gov
- Catalog of Federal Domestic Assistance Grants @ www.cfda.gov
- Small Business Innovation Research Grants (SBIR) @ www.sba.gov

Legal Information:
- U.S. Patent and Trademark Office @ www.uspto.gov
- U.S. Copyright Office @ www.copyright.gov

Payroll:
- Social Security Administration @ www.ssa.gov
- U.S. Department of Labor @ www.dol.gov
- National Council on Compensation Insurance @ www.ncci.com

Financing:
- Angel Capital Association @ www.angelcapitalassociation.org
- Alliance of Angels @ www.allianceofangels.com
- SBA @ www.sba.gov

Other Business Information:
- Edward Lowe Foundation @ www.edwardlowe.com
- U.S. Export Assistance Centers @ www.export.gov

Due Diligence

BONUS

EXHIBIT A – COMPLETE DUE DILLIGENCE CHECKLIST

Due diligence checklist to be performed prior to the purchase:

- **Corporate Information:**
    - Original name and purpose of the Company
    - Date of original incorporation
    - Subsequent changes in corporate name or purpose
    - Brief description of present business
    - Copies of the Article of Incorporation/Organization, including all amendments to date
    - Reports to stockholders/members
    - List of all subsidiaries of the Company, including shares held and jurisdiction
    - List of states and countries where the Company and each subsidiary are authorized to transact business and evidence of such qualifications including business license(s)
    - Location of all facilities
    - All significant correspondence with principal lenders
    - Proxy statements (if applicable)
    - Plan of reorganization (if applicable)
    - Name of any finder in connection with the proposed underwriting
    - Minute books: minutes of the Board of Directors and/or Committees
    - Stock
    - Stock record books
    - Stockholder's voting and other agreements relating to capital stocks
    - All board members and officer shares owned by them, their families or controlled by them on a direct or indirect basis and all persons who own more the 5% of the Company
    List of current stockholders/members
    - Copy of the form of stock certificates currently used
    - Copies of all agreements related to any outstanding options or warrants
    - Classes of stock and types
    - Shareholder rights: disclose preemptive rights, notices required and rights of dissenting share holders
    - Copies of any private placement memorandum or other documents relating to the offering of securities during the past five years
    - Activity of shares and price ranges (if applicable)
    - Financials

Due Diligence

BONUS

o Tax Returns:

- Federal and State return for the last three years
- Statement describing any ongoing or resolved disputes with any taxing authority
- General ledger including:
- All cash receipts and disbursements
- Complete bank statement for three years; spot check to general ledger
- Balance sheet and all related supporting schedules (fixed assets, liabilities, etc.)
- Audited/reviewed/compiled financial statements for the last three years including all correspondence to accountants and management letters with responses
- List of accountants including address and telephone number
- All agreements including loan, LOC, trust, liens, etc.
- Compliance reports and other agreements (run a title search)

o Real Property Including:

- Description
- Owned or leased
- Copies of deeds, assignments, leases, titles, mortgages, contracts of sale and security agreements
- Copies of any budgets or forecasts for the company or its affiliates
- Machinery, equipment or other tangible properties with copies of the leases or sales agreements and depreciation schedules (cost method and life)
- Status of any unreported liabilities, title search on equipment, medical claims, pensions, etc.
- Copies of any analysis on the effects of proposed or recent accounting change(s)
- Summary of pension fund, type of plan, asset or liability balance and copy of most recent actuarial report what type of plan it is
- List of material customers including dollar amount
- Any agreements with vendors

Due Diligence

BONUS

o Marketing:

- Press releases in the past five years
- List of all persons who received commissions and copies of consultant finders fee agreements
- Copy of all patents, applications, copyrights, trademarks, etc.
- All marketing materials
- List of purchases from suppliers in the past three years

o Management:

- List of all directors and executive officers including titles, committees served on, bio and duties
- Related party transactions with description and nature
- Budgets, business plans, projections, etc.
- List of all consultants including name, contact info and copy of the contract (if applicable)
- Any joint ventures, partnerships, licensing agreements, franchises or conditional sales contracts
- Key employees – are they staying? Relationship with clients? Copies of employment contracts

o Insurance:

- Copies of all policies for property, liability, workers comp, etc.
- Key employee insurance
- Board of Directors insurance
- Facilities
- Appraisals for any building or land

o Employees:

- Number of full and part-time employees
- Employee agreements/contracts
- Compensation paid to Board members
- Employee benefit plans such as retirements, stock options and healthcare

Conclusion

This book is intended to provide broad business guidelines on how to start or enhance your current business performance. It was written by an eye glass wearing, pocket protector toting poindexter with four constants and two vowels following his name (CPA and MBA) hence I am nerdy enough, ie, qualified to write a book about business basics.

I was the previous owner of a CPA firm that provided CFO, accounting and tax advice to more than 300 clients This book answers the questions I was frequently asked by clients every day and by my students while teaching accounting in the DeVry MBA program•.

MICHAEL J. MERRILL, CPA, MBA

"This book answers the questions I was frequently asked by clients every day and by my students."

"Invaluable."

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Notes

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