Accounting, Budgeting & Cash: ABCs of Business Finance

Financial Workshop

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Important Information

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About Me

I have served as Counsel for BNY Mellon's Wealth Management business since August 2019. Prior to that time, I was an attorney at BlackRock for over six years. I began my career working at a couple law firms located in South Florida before starting my own law firm in 2009, where I soon learned how critical budgeting is for a small business.

I graduated from the University of Florida for undergraduate studies (Mathematics and Business Administration) and from Florida State University's College of Law.

I am a CFA charterholder as of 2018.

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Topics

- Setting up a budget
- Accrual vs. Cash accounting
- Lines of credit
- Financing best practices

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Setting up a budget

“50/30/20 Rule”

- Coined by Elizabeth Warren, U.S. Senator from Massachusetts
- High-level, personal budgeting (as opposed to business budgeting)
- **Wants (30%)**
  - Shopping
  - Dining out
  - Hobbies
- **Savings (20%)**
- **Needs (50%)**
  - Groceries
  - Housing
  - Utilities
  - Health insurance
  - Car payment (or, here in NYC, subway payment)

Track your finances

- Fortune 500 companies dedicate entire departments to budget forecasting and monitoring to ensure they remain on course.

- Consider letting an app do the work for you; free apps are available to track your or your business' revenues and expenses.

- Microsoft Excel is a great tool to track revenues and expenses, as well.

- Garbage in, garbage out: your budget will only be as good as the data you input.

How to set up a budget (think of it as your “plan”)

1. Set your budget’s timeframe

Monthly budgeting does not require the micromanagement of daily budgeting, nor the amount of time that weekly budgeting entails.

More than one budget is acceptable (e.g. a monthly budget and corresponding annual budget) to help keep you on track.

How to set up a budget (think of it as your “plan”)

2. Estimate your income

- Sales
- Loans
- Savings
  - While savings are not new income, they are important to keep track of for purposes of a contingency plan, to determine what you can afford to spend, and even for qualifying for a loan or line of credit (discussed further later).
- Other (e.g. a second job)

How to set up a budget (think of it as your “plan”)

3. Calculate your fixed costs

Fixed costs are those costs that are set in stone; they are unlikely to change month-to-month. They do, however, tend to rise on an annual basis.

- Rent
- Salaries, if any, for employees
- Loan payments
- Website hosting
- Phone
- Internet

How to set up a budget (think of it as your “plan”)

4. Estimate your variable costs

- Employee or independent contractor wages for hourly services, if any
- Commissions
- Advertising/Marketing costs
- Transportation
- Raw materials

How to set up a budget (think of it as your “plan”)

5. Don’t forget (likely) one-time expenses

- Laptop
- Office supplies (which may also be a variable cost)
- Furniture
- Advertising (if not an ongoing expense)
- Travel
- Printing costs
- Professional services (legal, accounting)

Putting it together (EXAMPLE)

- Bill is an artist looking to get his business off the ground. He wants to grow his business, but is not sure how much money he can expect to earn in 2020, which will factor into such decisions as how much to pay himself, how much money he has available to spend on advertising, and whether he should quit his job to paint full-time.
- Expected income: $3,000/month in sales while he keeps his side job.
- Expected expenses: $1,800/month in rent (he paints from his home). No salaries for other persons. Bill spends approximately $200/month on website hosting, phone, and Internet services. Bill spends $150/month on health insurance and another $300/month on advertising. His profit margin is 75%. Bill spends $127/month for substandard service on the subway, and currently has savings of $25,000.
- Bill estimates he can increase his productivity by 33% if he did not work his side job and focused exclusively on painting.

Putting it together (EXAMPLE)

<u>Let's work backwards</u>:

- If Bill expects $3,000/month in revenues and believes he can increase productivity by 33% if he focuses solely on painting, Bill's revised 2020 forecast anticipates $4,000/month of revenues.
- Since Bill believes his profit margin is 75% on his sales: $4,000 x .75 = $3,000 net profit.
- Subtract expenses: $1,800 (rent), $150 (health insurance), $300 (advertising), $127 (subway), $200 (phone/Internet/website).

  $3,000 - $2,577 = <u>$423</u>.
- As you can see, this does not yet forecast the expenses of any one-time expenditures such as a laptop or equipment. It also does not account for the fact that Bill needs to pay for food and may or may not have a family to provide for.
- If Bill is single, does not have kids, and commits to living frugally to get his business off the ground, does he have enough money to devote to his artwork full-time?

- The answer is it depends. How comfortable is Bill with dipping into his savings, if necessary? How quickly could he return to supporting himself with another job? How confident is Bill with his revenue estimates? How sure is Bill that he will be able to collect the income from his sales without having to write-off any account receivables? Can Bill cut back some of his variable expenses and increase his profit margin? Will Bill's industry (discretionary) experience an unexpected upturn/downturn? Etc. Etc.

Budgeting tips (1 of 3)

- **Revisit your budget regularly, budgets are fluid.**
  - Think back to our example of Bill. If suddenly Bill experiences a surge in popularity and his paintings are now selling for double than previously, Bill’s budget requires updating.
- **Pay attention to your sales cycle.**
  - A monthly budget during the “off-season” may look quite disparate from a monthly budget during the peak season.
  - The off-season varies from industry to industry and is not uniform.
- **Overestimate expenses and underestimate revenues.**
  - Factor in some slack.

Budgeting tips (2 of 3)

- **Involve your partners and relevant employees, if any, in the budgeting process.**
  - Keeping partners and relevant employees informed lets them know of any expected changes going forward and fosters a sense of ownership and camaraderie.
  - It's also much easier to confront a business partner about their expenses if you both agreed to allocate a particular amount to, say, supplies or advertising beforehand.

- **Shop around for services/suppliers for lower costs.**
- **Spreadsheets are your friend.**
  - Whether good or bad, track your income and expenses.
  - Review actual bottom line against your forecasted budget.
    - It is tempting to ignore your financials during bad times. However, that is precisely when it is most important to review your financials.

- **Establish an emergency fund and create a contingency plan.**

Budgeting tips (3 of 3)

- **Using past financial figures (if any) as a starting point may be helpful**
  - The key is to adjust expectations, accordingly.
  - Be realistic. Historical information will almost assuredly need to be updated from year to year, and likely from month to month.

- <u>Startup business</u>:
  - May only need one overall operating budget which sets forth how much money is needed to run the business over a given period.
- <u>Established business</u>:
  - The total operating budget is likely to be comprised of numerous department or product budgets.
    - > E.g. a separate marketing budget and advertising budget.
    - > The sum should be greater than its parts, allowing for an emergency fund or contingency plan.

Review your budget

- Budgets are only effective if you frequently review and revise them.
- Analyze the reasons for any budgeting shortfall (e.g. lower sales, a downturn in the industry, etc.).
- Likewise, analyze reasons why perhaps your forecasts were too low.
- Timing of cash received (as opposed to the point of sale) can indicate collections issues.
- Check your forecasts against reality. Analyze why any disparities occurred.
- How did your fixed costs compare to your forecast?
- Did variable costs seemingly align with sales volume? Generally, they should.
  – E.g. an artist spends more money purchasing canvas and paint when they sell more artwork.

Positives of budgeting

- Documents the process so that all pertinent owners/employees are aware of the budgeting process and can be held accountable.

- Track company performance against predictions (the **“benchmark”**).

- Identifies opportunities to cut costs.
  - If you don’t budget, you may not be aware that your advertising costs are inordinately excessive whereas your supplies are costing less than you forecasted.

- There is flexibility to revise forecasts based upon performance.

Budgeting pitfalls

- Don’t miss out on opportunities by imposing rigid, fixed budgets in place.

- Don’t cut costs at the expense of quality.

- Don’t think of budgeting as an exact science. It’s more of an art.

Accrual vs. Cash accounting

Timing is everything

- The main difference lies in the timing of when revenues and expenses are recognized.
  - The cash method is a more immediate recognition of revenues and expenses.
  - The accrual method focuses on anticipated revenue and expenses.
    - Typically, revenue is recorded before any money changes hands.
- These two methods of accounting are **mutually exclusive**. You cannot freely alternate how you elect to record some revenues/expenses versus others. You also may not switch methods from month-to-month or year-to-year, with limited exceptions.

EXAMPLE #1

- You sell a painting for $2,000 on December 28th and ship it to a client with an invoice requesting payment within 10 days. Your client pays you $2,000 on January 6th.

- Under the **cash method of accounting**, no revenue is recorded until you receive the $2,000 payment on January 6th.

- Under the **accrual method of accounting**, you record $2,000 revenue on December 28th.

EXAMPLE #2

- You receive an invoice for studio time in the amount of $1,000.
- Under the **cash method of accounting**, you do not record the $1,000 expense until you pay it.
- Under the **accrual method of accounting**, you record $1,000 expense the day you receive the invoice.
- The key takeaway is that cash accounting recognizes revenue and expenses only when money changes hands, but accrual accounting recognizes revenue when it's earned, and expenses when they're billed (which is not necessarily when they're paid).
- Cash accounting does not recognize accounts receivable or accounts payable.

Cash vs. Accrual: Why does it matter?

- **Manipulation can distort reality**
  - A company that has $50,000 cash on hand, but an impending payable expense of $100,000 due months down the road looks good on paper under the perspective of the **cash method of accounting**.
  - In such a scenario, only the $50,000 cash appears on the books, not the expense.

- **Taxes**
  - Taxes must be reported consistently year over year.
  - No switching from the **cash method** to the **accrual method** from one year to the next without approval from the IRS (Form 3115 and a fee are required).
    - > If the total amount of the change in recognized revenue is less than $25,000, the IRS allows businesses to make the entire adjustment during the year of change. Otherwise, the IRS permits the adjustment to be spread out over four (4) consecutive tax years.

Cash vs. Accrual: which method should I use?

- The accrual method is more commonly used by companies, particularly larger companies.

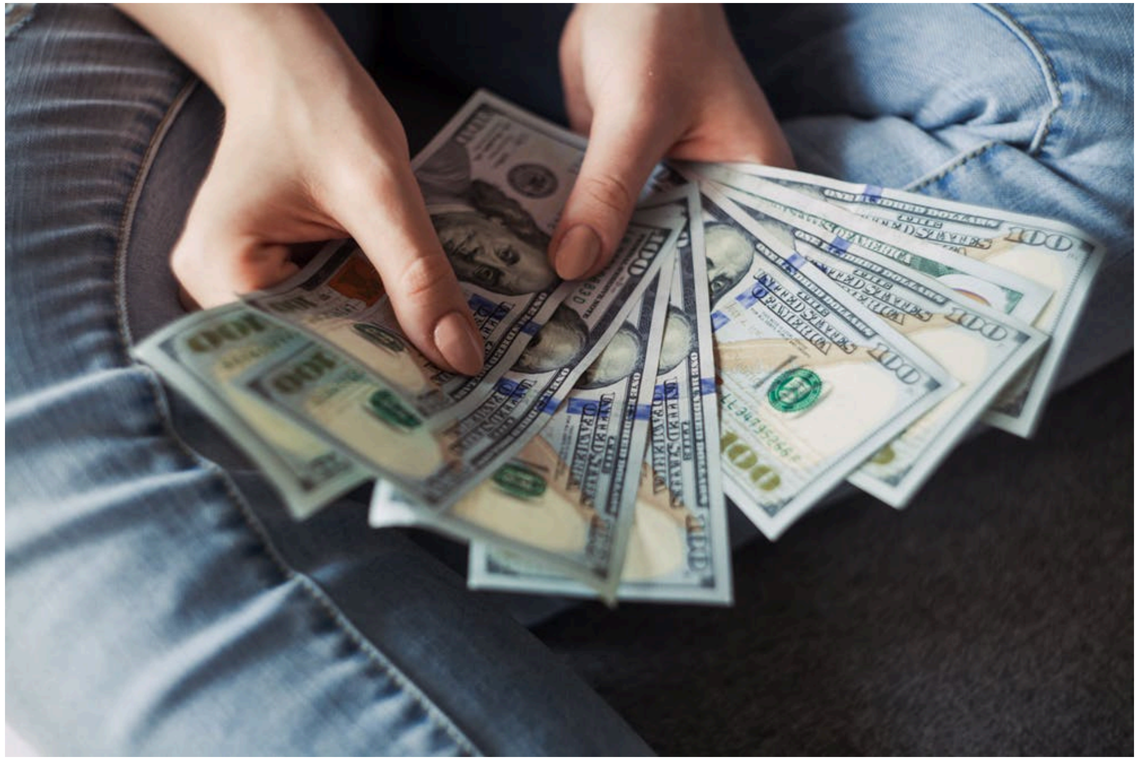
- The accrual method provides a more accurate picture of how a business is performing over the long-term than the cash method.

- Accrual method disadvantages:
  – It is more complex than the cash method.
  – Income taxes may be owed on revenue before payment is actually received.

Lines of credit

What is a line of credit?

- A line of credit is a preset amount of money that a bank or credit union agrees to lend a borrower based upon the borrower's credit score, proof of employment, credit history, etc.
- A borrower draws upon the line of credit *when needed*, up to the maximum amount of the line of credit.
- Borrowers only owe interest on the amount that they borrow, not the entire amount of the line of credit.



Line of credit versus traditional loan

Line of Credit

- You only pay interest and fees on the portion of funds you borrow.
  - If your line of credit is $10,000 and you do not withdraw any funds, you will not owe interest (but you may owe fees).
  - The $10,000 balance is available for qualified purchases at any time.
  - Treated similar as a credit card, but is usually cheaper for large purchases.

Traditional Loan

- A borrower receives an influx of cash and immediately starts making payments on the balance owed.
- Regardless of whether loan proceeds are spent, once loan proceeds are disbursed, the borrower owes interest on the total amount of the loan.

Home equity line of credit (HELOC)

- Intended for home improvement projects, repairs, and fixes, but you can often use the money for whatever purpose you choose, subject to the below caveat (and any lender covenants you may enter into).
- HELOCs are offered at lower interest rates than traditional lines of credit because they are secured by a lien on the underlying house.
- You must, however, own your home to qualify.
- HELOCs are risky to use to fund your business because if your business fails, you can lose your home.
- Generally, homeowners may deduct interest paid on HELOC debt up to $100,000, but the proceeds must be spent on home improvement (e.g. adding solar panels, remodeling the kitchen). You cannot deduct HELOC interest to fund your lifestyle or start a business. This is a recent change in tax law.

Secured vs. Unsecured

- “Secured” means the funds provided by a lender to a borrower are backed by collateral, such as a HELOC, which is backed by an underlying home.
  - > As such, secured loans are offered at much lower interest rates than unsecured lines of credit.
- “Unsecured” means the funds provided by a lender to a borrower are not backed by collateral.
  - > Offer less recourse to lenders
  - > Associated with higher interest rates to account for greater risk taken by the lender.

– NOTE: Some lines of credit require borrowers to bring their balance back to zero and “settle up” when a bank “calls” your loan.
  - > Thus, you should always carefully review all paperwork from your lender to ensure you are aware when payments are due.

You decide a line of credit is for you, what now?

- **Review your credit report**
  - Creditworthiness is a key criterion to obtaining a line of credit (there is no hard and fast requirement, but usually at least a credit score of 550 is needed). If not, you may need a guarantor or collateral to secure your loan or line of credit.
  - Gather your financial records (these “expire”, so it is important to gather everything at once to avoid processing delays):
    - > Past tax returns
    - > Employer information
    - > Investments
    - > Bank statements
    - > Any permits/licenses
- Compare, compare, compare
  - Shopping around for lower rates can save significant money.
- Don’t use any more credit than is absolutely necessary? Why? Credit is expensive.

Small Business Administration (SBA)

- Government agency (www.sba.gov) that offers a variety of services since 1953
- Loans range from $500 to $5.5 million
- The SBA is the only cabinet-level federal agency that is fully dedicated to small businesses
- Offers free business counseling
- SBA *guaranteed* business loans
  - The SBA itself does not offer loans; rather, it provides guarantees to lenders as a way to entice them to offer a line of credit or a loan to a small business.
  - Such guarantees are 85%-90% of the line of credit or loan to the lender if the loan defaults.
  - The SBA only steps in *after* the bank has tried to collect from all corporate and personal guarantors.
- The most popular SBA program is the **7(a) Loan Program.**

SBA 7(a) loan

- A 7(a) loan-guarantee is provided to lenders to make them more willing to lend money to small businesses that have weaknesses in their loan applications.
- EXAMPLE: A business startup does not have the requisite cash flow history to provide a lender with assurance of loan repayments. The SBA 7(a) loan provides the lender with an increased likelihood against default.
- However, lenders do <u>not</u> have to accept 7(a) loans.
- What is the maximum loan amount and guarantee amount?
  - $2 million, with SBA loan guarantees of no more than 75% ($1.5 million max)
  - Average 7(a) loan was $425,500 in 2018
- Interest rates may vary.
- Purpose of 7(a) loans?
  - Purchasing land or buildings, equipment, machinery, supplies, working capital (current assets minus current liabilities), or purchase of an existing business
- You must locate an SBA-approved lender. The lender will ask you to complete a 7(a) loan application.

SBA 7(a) loan eligibility requirements

- What types of businesses may 7(a) proceeds be used for? It's easier to see a non-exhaustive list of companies that 7(a) proceeds may *not* be used for. These include:
  - No real estate or speculative businesses
  - No lending companies
  - No pyramid sales companies
  - No non-profit companies

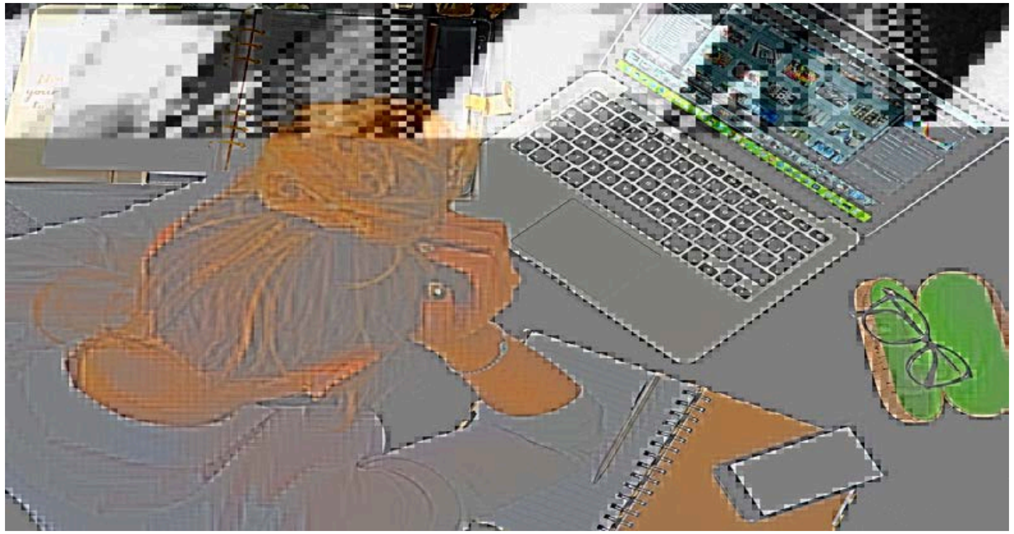
- As noted earlier, the SBA does <u>not</u> directly lend money to small businesses. Instead, it guarantees the loan (similar to a co-signer).
- **SBA Express loan:** smaller dollar amount loans and quicker application turnaround times, sometimes within a few days of paperwork being completed.
  - NOTE: An SBA loan may take weeks, or even months, from application start until proceeds are disbursed. Speed is often predicated upon borrowers having their personal and business finances in good shape and all paperwork completed.

SBA loans continued

- **SBA 504 loan program**
  - Purposes: funds for purchasing land, machinery, facilities
  - Federally guaranteed up to $5 million
- **Microloans**
  - Purposes: funds for working capital, inventory, equipment, starting a business, etc.
  - Federally guaranteed loans of up to $50,000
- **SBA eligibility requirements:**
  - Be a for-profit business
  - Conduct business in the U.S. (physically located and operated in the U.S. or its territories)
  - Have invested equity (the business owner invests his/her own time or money into the business)
  - Exhaust financing options: the business cannot get funds from any other financial lender
  - The SBA requires a personal guarantee from every business owner with at least a 20% ownership stake and from others who hold top management positions.

Getting a line of credit is difficult

- Most business owners will not be able to satisfy the requirements, even with SBA backing.
- Lenders want to loan money to companies and their owners that have assets, cash flow, and a good credit score.
- Not available for pure startups. Why? Startups lack a proven history of assets and cash flow.
- The process may take weeks for approval/denial.



Business Qualification Requirements

- **Time in business**
  - Usually, lenders extend business lines of credit to companies that have been operating for 2+ years.
    - Exceptions: owner has good personal credit, solid collateral, personal guarantee, etc.
- **Collateral:** any type of asset that can be used to repay the loan, if default occurs.
  - Accounts receivable
  - Inventory
  - Machinery
  - Real estate (e.g. Macy's outright owns its store on 34th Street worth ~$4B, more than the company itself)
- **Revenues and profits**
  - To qualify, your business must have revenues and be profitable.
- **Financial ratios:** lenders examine financial ratios as part of their due diligence prior to extending credit (see next slide for some of the more common financial ratios lenders analyze).

Ratios lenders may look at before lending money

- **Fixed charge coverage ratio:** tells whether a company can pay its debt after paying its fixed expenses.
  - > (EBIT + FCBT)/(FCBT + i)
    - EBIT = earnings before interest and taxes
    - FCBT = fixed charges before taxes
    - i = interest

- **Current ratio:** a liquidity ratio that tells whether a company can pay its short-term obligations.
  - > (Current assets)/(Current liabilities)
- **Debt service coverage ratio:** tells whether a company generates enough revenue to pay its debt.
  - This might be, say, 1.2x which means the net operating income for a period exceed the total debt payments (interest and principal) payable to the bank during the same period by 20%.
  - EXAMPLE: If the total debt payments for the period are $100,000, then the business needs to have income equal to or greater than $120,000 to maintain the bank's debt service coverage ratio.
- **Debt to equity ratio:** tells whether a company has too much debt.
  - > (Total liabilities)/(Shareholder's equity)
  - > Total liabilities = short-term debt + long-term debt + other fixed payments

Covenants

- Covenants are rules that borrowers must adhere to in order to keep a line of credit active.
- Loans will also usually be accompanied by covenants, too.
- Defaulting on a covenant may result in additional fees and even termination of the line of credit.
- Covenants vary from lender to lender, but may include:
  - Maintain a certain net worth
  - Maintain a certain amount of liquidity
  - Cannot exceed a certain level of debt (no forum shopping to take on excessive debt)
  - Must comply with financial ratios
  - Must repay the line in full periodically (e.g. once per year)
  - Must advise the lender of any material changes (e.g. you move your business to Alaska)
  - *<u>**Confession of Judgment Clause**</u>**:** essentially gives the bank permission, in the event of a loan default, to file a judgment against the business and any individual guarantors *without* filing a lawsuit. Alternatively, many banks will include a mandatory, binding arbitration provision and waiver of court proceeding.

Line of credit pros and cons

Pros

- **Flexibility:** you do not need to commit to borrowing a certain amount of money upfront. This is helpful if you're not sure how much a project will cost.
- **Convenience:** lenders may provide borrowers with checks, account transfers, and debit card access to money.
- **Gap filler:** if, say, the check is in the mail but you need the funds now.
- **Short-term needs:** a revolving line of credit is mostly relevant to businesses with short-term needs.
- **May be secured:** unlike a credit card, but similar to a HELOC. Remember, secured loans are accompanied by lower interest rates.

Cons

- **Impulse spending:** unlike with a loan, you do not have a rigid schedule of where your money will go, so discipline is important.
- **Unpredictability:** since there is a lack of certainty as to the amount you will borrow, there is also an inability to predict the amount of loan payments.
- **Fees:** there may be maintenance fees even if you do not use the line of credit. There may also be withdrawal fees.
- **Variable interest rates:** usually, the interest rate you owe varies depending on market conditions.
- **Lower credit limits:** compared to traditional loans.
- **Personal guarantee:** oftentimes required
- **Unilaterally changed terms:** almost always in favor of the lender (e.g. financial ratios).

Alternatives to a line of credit

- **Personal loans**
  - Unlike a line of credit, a personal loan grants you a lump sum of money.
    - Locked-in interest rates that are usually lower than the interest rates for a line of credit.
- **Credit cards**
  - Extremely expensive borrowing rates (between 20% and 30%, about twice as high as personal loan interest rates).
  - No additional application process if you already have the account.
  - No upfront financing costs.
  - You likely will not have the amount of available credit as you would with a line of credit, however.
- **Manufacturer and dealer financing**
  - If, say, you are looking to purchase a vehicle for your business and the dealer offers its own financing.
  - Typically repayment terms of 2-10 years.
  - Secured by the product you're purchasing → lower interest rates than an unsecured line of credit.

Financing Best Practices

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Credit cards

- Charge exorbitant interest rates because borrowers tend to default at a higher rate than other types of loans.
  - Credit card debt is unsecured.
  - Compare to mortgage loans or other asset-backed securities where there is underlying collateral to protect the lender in the event of default. This explains why mortgage interest rates are significantly lower than credit card interest rates.
  - Depending on your credit score, you could be paying somewhere around 25% APR (Annual Percentage Rate). This amounts to ~2% per month, but remember interest compounds! (Average daily balance x daily rate = interest owed)
  - Late fees apply on top of the interest (~$35/month)
- **Credit card bonus points are misleading**
  - Use cash or debit cards, if possible, unless you're certain you can pay down the balance each month in full and thus just reap any rewards/points. Or, if you cannot pay in full, pay more frequently, which will lower your average daily balance.
  - Oftentimes, people up spending more money to accrue more points. When they wish to redeem points, they realize the gift card they redeemed points for doesn't cover the entire purchase, so they spend even more money that they might not have otherwise spent.

Student Loans (and other loan types, too)

- Currently, more than 45 million student loan borrowers owe student loan debt (~34% of adults between ages 18 to 29 have outstanding student loans).
  - This totals to over $1.6 trillion dollars.
  - Student loans have seen almost 157% in cumulative growth over the last 11 years. By comparison, auto loan debt has grown 52% while mortgage and credit card debt actually fell by ~1%.
    - Source: Bloomberg, *The Student Loan Debt Crisis is About to Get Worse*, October 17, 2018.
- They never go away, with few exceptions (e.g. becoming a public school teacher in a low-income area, joining the military, etc.)
- **You cannot discharge student loans in bankruptcy.**

Student (and other) loans: the real cost

- **Example 1 (10 year length):**
  - A $30,000 student loan at a rate of 4.53% (which is very low) with monthly payments of $311 actually results in a total of $37,311 repaid, including interest. Why, if 4.53% of $30,000 is only $1,359? The power of compound interest.
    - “Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn’t, pays it.” – Albert Einstein
- **Example 2 (25 year length):**
  - That same $30,000 student loan, extended to 25 years, reduces the monthly payment from $311 to $167, but results in a total of $50,027 to be repaid.
    - The Education Department has a Repayment Estimator tool online to help you better understand the true repayment costs (studentloans.gov).
    - **Truth in Lending Act (TILA)** – a disclosure provided to borrowers with the *actual cost* they will repay – the total may surprise you.
- **Remedies?**
  - Consolidate your loans into one lower interest rate.
  - Only borrow the funds you *need*.
  - Use discretionary income to pay down the balance early.

Little things add up!

- Paying for a cab instead of taking the subway/bus (particularly if you have an unlimited pass) when able.
  - Or, buying an unlimited subway pass when you're only taking 30 rides per month adds up.
  - Or, not utilizing your company's tax-free transit benefits.
- 401(k) company matching (discussed further on the next slide).
- Avoid ATM machines that incur fees.
- Brewing your coffee at home/work instead of $5 lattes.

- This is not to suggest we avoid all of life's little pleasures, but when attempting to grow a startup business, sacrifices are necessary.
- Shop online for discretionary purchases that you don't need right away.
  - The odds of the store you're physically at offering the lowest price for the same item you can find online is very unlikely (partly why Forever 21 filed for bankruptcy protection in September 2019 and other brick and mortar shops close).
  - For online shopping, choose the cheapest shipping method unless necessary.
    - > It might not amount to much in the short-term, but shipping costs alone can amount to thousands of dollars over the course of a year.

401(k) savings

- What is a 401(k)? It is a defined contribution plan utilized for tax deferral retirement savings.
- Many employers offer some degree of 401(k) matching.
  - You should always, if able, take advantage of the <u>full employer match</u>.
- 401(k) contributions are **tax deferred.** Not to be confused with tax exempt.
- The intent is that by the time you withdraw retirement savings from your 401(k), you are in a lower tax bracket than you would have been at the time you earned the money and it would otherwise be taxed as ordinary income.
- Even without an employer match offered, you should still contribute as much as possible, up to the maximum amount permitted by your plan because a 401(k) operates equivalent to the government giving you an interest-free loan that you get to compound for decades before having to pay it back.
- You are also less likely to spend money that has gone into a 401(k) than if it went into your bank account.
  - 10% withdrawal penalty before age 59.5
    - **Rule of 55** (ages 55-59.5 may avoid the 10% penalty if quit or laid off *for money in recent employer's plan*).
  - Required Minimum Distributions at age 70.5

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