Accounting and Finance:

The Backbone of Balancing Any Budget and Important Skills for Business.

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1. Accounting

"Accounting is not only about numbers, but how wisely you spend your money and how smartly you increase your income. That is real accounting."
—Ehab Atalla

To be a great businessperson, you don't need to be an accountant. You do, however, need to be familiar with accounting principles and tools, such as understanding your margins and being able to review financial statements (the income statement and balance sheet). You need to understand general ledgers, bank reconciliation, how to prepare papers for your accountant, and how to make a financial plan for loans and investors.

If you can't communicate with accountants and investors, measure profitability, follow budgets, and make financial goals for your businesses, how do you expect to be successful with money? How will you be successful with money if you can't account for it?

Even the most creative design and product-oriented people, like Steve Jobs and Mark Zuckerberg, learned how to go through financial statements. As the CEO, or owner/manager of a business, part of your responsibility *is to understand the financial health of your organization, which requires you to know basic accounting.*

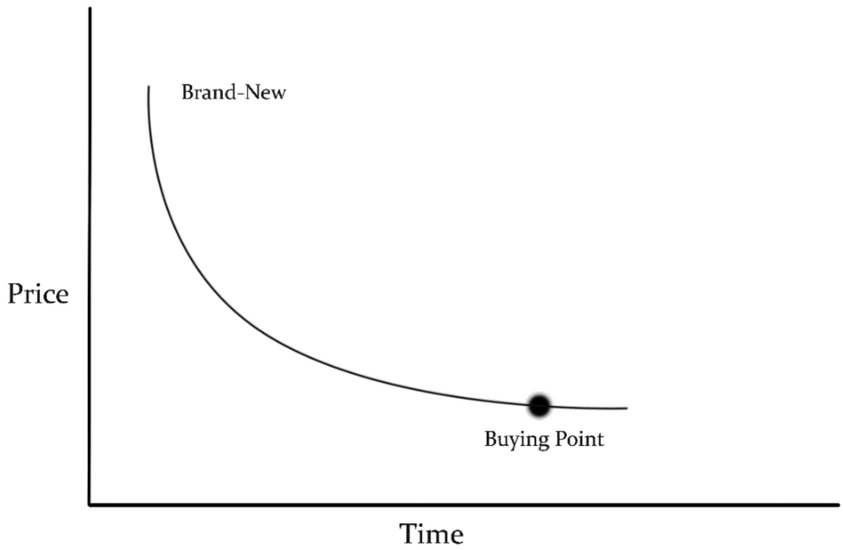
I believe that everyone should be familiar with QuickBooks, or any accounting software that makes bookkeeping easy. Being able to stay on top of your finances—both personal and professional—and provide the right information to your accountant will make your life much easier.

Depreciation Calculation— The Power of Buying Used Goods

When you buy a brand-new, expensive, durable product, its value drops significantly during the first two years. After several years, the value begins to level off, and the drop in price occurs at a much slower rate. Since the value drops by too much during the first few years, it's to your advantage to buy used products for major purchases: cars, jewelry, homes, etc.

In business, you need to learn how to spend money wisely. If you are buying furniture for your office, it is to your advantage to buy used furniture in excellent condition. If you are buying computers, it is to your advantage to buy computers on clearance. If your business needs a truck, it is to your advantage to buy a used truck that's around three years old. Not only will this lower your out-of-pocket expenses, ***but you will limit your exposure to depreciation. Used products depreciate much less than new products***.

Typical Depreciation Schedule



Most durable products follow this curve. For some products, the curve is steeper; for others, the curve is flatter. It depends on the market for that product and specific depreciation schedules created by the industry. For example, a Honda will depreciate slower than a Ferrari.

As a hypothetical example, imagine that you buy an expensive, brand-new watch for $12,000. ***The day you put the watch on your wrist, it becomes a used watch****. Within a few weeks, the price will drop to around $9,000 because it's no longer brand-new. The price will continue to go down, but at a slower and slower pace. Eventually, after 10 or so years, it will not go down in value any more. That's when it reaches the bottom of the depreciation curve. In some cases, the price of the good actually starts to go up (like classic cars).*

So the buying point—as noted on the graph—is after the major depreciation has taken place. This is a smart principle to follow so you don't personally experience this drop in value after buying a product. Realize that when you buy any durable product, you are exchanging cash for an asset. Your net worth at that moment hasn't changed—only the way in which your net worth is represented.

> *Let's say, as a hypothetical example, that you have $20,000 in the bank. That's all you own. If you were to buy a car that's worth $20,000 with that cash, you are still worth $20,000 after purchasing the car, even though you no longer have the money. Why? Because the car is worth $20,000.*
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> ***If the car that you bought for $20,000 is brand new, the second you buy it from the dealership, the value of that car drops significantly—and so does your net worth****. But if you buy a used car that has already been depreciated, then your net worth will not go down by that much.*
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> ***And if you buy a used car for under the market price, then you are literally driving that car for free (except for gas and maintenance)****. Why? Because your net worth is not going down. You are buying the car below the depreciation curve, meaning depreciation is not affecting you (until you drive the car for a certain amount of time).*

Am I saying to buy everything used? No. Some items, like clothing, should be bought brand new because it's not usual to buy used clothing, you can buy new clothing relatively cheaply, and good used clothing is not worth the headache to search for. But what I am talking about are the expensive items in your business and personal life. For example, if you are going to buy a car, watch, or house, you should pay attention to the depreciation graph of those particular items and buy them when the price begins to flatten. If you have enough money to drive a luxury car, it may be in your interest to lease it rather than buy it. Always pay attention to ***depreciation because it is a non-cash expense that dramatically eats away at your net worth***.

> *Brand-new houses are offered at a premium over older houses, but as time goes by, that premium is reduced—as illustrated by the depreciation graph.*

Financial Statements

Financial statements are the language of money; understanding them is a skill that helps you manage money in an accurate and reliable way and accounts for transactions that have already occurred. Financial statements keep track of the amount of money coming into a business (sales) and the amount of money going out of a business (costs and expenses). Subtracting costs and expenses from sales allows you to determine the profitability of your business, or how much money is going into your pocket.

When it comes to costs, you should understand the difference between variable costs and fixed costs to get a better understanding of your business. ***Variable costs, such as the cost of goods sold, are costs that change with the amount of business you do***. The more sales you make, the higher your variable costs.

> *Imagine you create an app and are selling it on Apple's app market. Apple charges 30% for every app that is sold. So if you sell an app for $1.00, you have to pay Apple $0.30. That $0.30 is the variable cost. The more apps you sell, the more money you will pay Apple, and the higher your*

> *variable cost will be. Your variable cost per app stays the same ($0.30), but the total variable cost increases when more apps are sold ($0.30 times the number of apps you sell).*

Unlike variable costs, ***fixed costs don't increase with more sales***. Fixed costs, as their name suggests, stay the same regardless of sales volume. It doesn't matter if sales go up or down, fixed costs remain the same, like rent, loan payments, and office salaries for example.

What Are Your Margins?

In *The Secrets of Business*, I went over the importance of understanding your margins when you start a business. Understanding your margins will answer the following questions: How much money are you personally making every time you sell a product? How many products do you have to sell to break even? Is it even profitable to start the business you have in mind?

There are three types of margins you need to be concerned with: gross profit margin, net operating profit margin, and net profit margin. All of these margins are represented as percentages, or fractions. In this chapter, we will cover gross profit margin. I don't want to get into the others because they are more complicated and involve taxes and depreciation, which varies from business to business.

Gross profit is the amount you make per product sold before your general and administrative expenses. The reason why it's called gross is because it doesn't take into account all of your expenses, just your direct variable costs (cost of merchandise or product). To calculate your gross profit margin, you must first calculate your gross profit, and then divide your gross profit by sales.

Gross Profit = Sales — Variable Costs

$$\textbf{Gross Profit Margin} = \frac{\textbf{Gross Profit}}{\textbf{Sales}}$$

Going back to the app examples earlier, gross profit and gross profit margins for selling one unit are:

App Gross Profit Margin

Sale	$1.00
Variable Cost	$0.30
Gross Profit	**$0.70**
Gross Profit Margin	**70% ($0.70/$1.00)**

The Three Major Statements

I highly recommend that you learn as much as you can about financial statements. ***They are really the blood of any business, just as marketing is the heart of any business.*** Let's discuss them briefly.

Ledger Accounts

In accounting, we make a separate ledger account for every expense and income. We call them "T accounts." These accounts summarize all the activities for a specific expense or income so you can calculate the final balance.

Company Car General Ledger
(One Year)

	Debit	Credit
Car	$20,000.00	
Maintenance	$200.00	
Gas	$1,200.00	
Total	$21,400.00	

Profit and Loss Statement

This could be the most important document in accounting because it evaluates your performance and your end results. This statement starts with your income; then you deduct all of your costs of goods sold to get to your gross profit; then you deduct all of your expenses to get to your net income, then you deduct your depreciation and taxes to get to your net profit.

There is too much to go into when it comes to the income statement. For now, at least you understand those terms.

The Balance Sheet

The balance sheet is one of the most important statements because it shows everything in the company from accounts receivable (AR) to accounts payable (AP) to the owner's equity to all ledger accounts. It's the summary of your company's financial condition.

Example Balance Sheet

Assets		Liabilities	
Cash	$30,000	Accounts payable	$55,000
Accounts receivable	50,000	Loans payable	125,000
Inventory	35,000	Total Liabilities	180,000
Land	125,000	Owner's Equity	
Buildings	400,000	Capital stock	$120,000
Equipment	250,000	Retained earnings	600,00
Other assets	10,000	Total Owner's Equity	$720,000
Total Assets	$900,000	Total Liabilities and Equity	$900,000

On the left side of the balance sheet you list your assets. These include what you own and what other people owe you. For example, accounts receivable (shown above under cash) is the amount of money customers owe you for goods or services that you provided to them, but that they haven't paid for yet. Even though it's not cash in the bank, it's considered an asset because it's money you will receive at a future date.

On the right side you list your liabilities and owner's equity. Liabilities are what you owe people. The most common types of liabilities are accounts payable and loans. For example, if you receive products from a supplier free for thirty days, then that would show up as an accounts payable item on the liabilities side of your balance sheet (it would also show up as inventory on the asset side of the sheet).

This is a very brief example to give you an idea of what a balance sheet looks like. In my upcoming accounting book ***The Master of Accounting***, I will go into details on the power of financial statements—how to monitor your companies' health, how to combine different financial statements into one, and how to automate your bookkeeping.

At this point I want you to know the following equation:

Assets = Liabilities + Owner's Equity

Which is the same as

Assets - Liabilities = Owner's Equity

I believe that every business person should know this equation; it's the means to calculating your net worth—owner's equity is the same as net worth.

Taxes

One of the main benefits of business ownership is your ability to take full legal advantage of the tax code. ***The way the system is set up is that business owners experience the greatest tax deductions, while employees pay the most taxes***. Why is this the case? At first, it seems unfair that employees—who typically make less than business owners—have to pay more in taxes. But when you consider the risks business owners take and the amount of value they create in terms of jobs, products, and services, it makes sense that they should get more deductions. If opening a business meant you would pay more in taxes, what incentive would you have to open a business?

Taxes are one of the largest, if not the largest, business expense. You will deal with taxes on a company level and on a personal level every year. Even though taxes take a large portion of our income, it's common for people to take a passive role in preparing their taxes. They rely on accountants or financial services for an hour a year and think that's enough. Perhaps they are overwhelmed with other responsibilities in life, and figure they are saving time by not being strategic on their taxes.

You should leverage a responsible accountant, and at the same time, actively participate in your overall tax strategy. Contrary to what most people believe, taxes aren't something to be handled once a year right before they are due—they are something to be handled on a daily basis. Are you, on a daily basis, spending money in a way that is tax deductible? Are you putting money aside every month to pay for taxes at the end of the year? Do you keep your records organized and up to date? Are you actively educating yourself on the IRS code? If you don't have systems in place for these activities, how do you expect to grow wealthy?

There are many different kinds of taxes that you have to become familiar with. For example, there's sales tax, payroll tax, city tax, excise state tax, specialty tax (taxes on certain products, such as fuel), income tax, etc.

Deductibility

Perhaps the most important part of taxes is deductibility, or writing off business expenses that reduce your taxable income. Every time you spend money on your businesses, you experience a reduction in taxes. Or, in other words, you experience a return on investment. "How is this a return on investment?" you may be thinking. Well, suppose your income is taxed at 20%. Every dollar you spend on your businesses saves you $0.20 in taxes, which you can think of as a 20% return on your money. Over time, as your income increases and you reach the highest tax bracket (around 39%), deducting expenses will dramatically increase your income.

> ***Taxes are designed to improve the economy****. If I spend money on my business—buying new office equipment or hiring new employees, for instance—I am taxed less because my money is circulating in the economy. By spending money on my business, I am creating income for other people, and so the government rewards me.*

I highly recommend that you read the IRS codes on deductibility and depreciation. They can be found online at www.IRS.gov. The code goes over what you can deduct in different areas of your business and personal finances.

The more you know about the tax code, the more you will learn that many business expenses that you are not aware of are tax deductible from your income. ***So don't wait till the end of the year for your CPA to tell you that; you have to keep the receipts from the beginning of the year in order to verify these tax deductible expenses***.

5. Finance

Finance means raising money for an opportunity or investment. Why is a knowledge of finance important in order to start a business? Because finance will make you more creative in how you raise money to get a business started. Are you going to save money over time to invest in your business? Are you going to take a loan out from a bank or the government to start a business? Are you going to partner with someone who will finance the startup? Are you going to start the business through your own effort, get customers, and then look for financing?

> *In the movie, The Social Network, Mark Zuckerberg brought in a partner, Eduardo Saverin, to finance a server*

Facebook needed to get up and running. Without someone to buy the server, Mark would have been stuck at step one—buying the infrastructure needed for the business. He could have saved money over time to buy it, but he chose to move quickly by partnering with someone to finance what the business needed.

How to Raise Money to Start Your Business

When you start a business, I don't want you to limit yourself by worrying about money. There is no need to worry because you don't need money to start a business. Money should be the least of your concerns. Sounds crazy, right? We are all taught from a young age that "It takes money to make money." This statement is partly correct, but it leaves out an important part—what do you do if you don't have money? Most people think they must save their whole lives to start a business or begin investing. They don't consider what financial resources are available to them. If you don't have money to start a business, ***don't think that your only option is to work hard and save money. If you don't have money, someone else does, and you can leverage them to get into a business.***

To be able to leverage others for money, however, you must first develop your business skills. You can't expect someone to give you money by just asking them. Think about it from their perspective. Ask yourself, "Who would I give money to for the purpose of starting a business?" More than likely, you would give it to someone who, at the very minimum, had a good idea and a business plan—***a business plan that was strategic and covered all angles of the business***. You wouldn't just throw money at some random person who came up to you and said, "Hey, I've got a great idea for a business. Give me money," when he didn't have a complete business plan. So why expect someone to give you money if you do the same thing?

Along with a business plan, you're more likely to give money to someone who has experience in running that kind of business. This will greatly reduce your risk because you're dealing with someone who knows what they are doing. If you're the one who's asking for money, and you don't have any experience in that business, then that can present a problem. But don't worry, there are other ways to get money for your business.

> ***Watch my sequence: I took advantage of my jobs to save money and gain experience. I then started small businesses (swap meet) to accelerate my savings so I could buy my first gas station. From there, I partnered with someone to raise capital for a big deal, and so on.***
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> *I was able to attract an investment partner to get three gas stations at once because of my experience. I was successfully running two gas stations at the time, and he was confident in my abilities to manage and restore the stations. I was able to get into the gas station business in the first place by working in a gas station. It was very easy for me to get my gas stations up and running because I knew the ins and outs of how to operate the businesses.*

You are more likely to attract investors if you have proof of concept—if you can verify that there is demand for your product or service. ***Better yet, try to establish the business on a small scale so you have proof of paying customers***. If your business is already working on a small scale, there's a greater possibility that it will work on a large scale, and it's more likely that investors will give you money to expand your business.

Ways to Finance Your Business

A. Credit Cards

Most people use credit cards to buy luxury items like TVs, clothes, computers, and furniture. Very few consider using credit cards to start businesses. If you need access to quick capital, using a credit card is a great option. The interest you pay is very high, but you can use this money to start a business and then get a revolving line of credit from a bank to pay off the higher interest credit card loan.

B. Hard Money Lenders (High Interest Loans)

If commercial banks like Bank of America, Wells Fargo, Citi Bank, etc. won't issue you credit cards or revolving lines of credit, then another option is to use hard money lenders. Another word for hard money lenders is loan sharks, and that's exactly what they are—people who prey on others who need money. They charge very high interests rates to people who need money quickly. Based on the opportunity you're going after, this can be a good or bad thing. It's good if you're experiencing positive leverage, or you're making a higher return than the hard money lender is charging you. However, it's really bad if you're experiencing negative leverage, or making less of a return than the hard money lender is charging you.

As with credit cards, you want to use hard money lenders for the short term cash you need to start a business. Use it to quickly make a business profitable, and then pay off the loan as soon as possible.

C. Take Out Collateral Loans

If you own a car, home, or other valuable asset, you can get a loan against it to start a business. Again, these loans tend to be high interest, except if you get a loan against your home from a commercial bank. The idea is to use the money quickly to get the business started, and then pay the loan off.

D. Have the Seller Carry the Loan

If you're buying an existing business that has growth potential, ask the seller to carry the cost. This means that instead of paying them everything up front, you pay them in monthly payments over time. The incentive for them to do this is that they get rid of the business quickly and charge you interest. They are acting like the bank in this case.

If you're buying a piece of real estate that you want to restore, you can ask the seller to carry the cost of the property (to finance you). This strategy also works in all types of businesses, including online. For example, did you know you can buy websites online that are already making money (such as flippa.com and other auction websites)? Think of websites like retail businesses. In retail, you increase the value of a business by bringing in more paying customers. For example, if you buy a rundown convenience store and increase its yearly sales, you can sell this increase in cash flow as goodwill. Likewise, if you buy a website and increase the number of website visitors, you increase the value of the website. Just as you can buy and sell real estate or retail businesses, you can buy and sell websites.

E. Friends and Family

If need be, you can ask your family and friends for startup capital. They may be willing to do you the favor if you've found a great opportunity and include them in the business. However, this can also cause tension in the relationship because their money is now on the line. If your business turns out to be unprofitable, that may end the relationship. You'll be surprised at how the closest relationships can turn sour when money becomes an issue.

If you do leverage family members and friends, be open and upfront about the potential downside of their investment. Work to keep them informed of everything, and better yet, include them in the operations of the business. Get them involved in strategy and develop business skills with them. ***If you don't include them in the business, then you're putting too much responsibility on yourself, and they will hammer you if things go wrong***.

F. Loans from Suppliers

In any business that deals with suppliers (trade, retail, wholesale, manufacturing, farming, real estate development, etc.), you can leverage your suppliers by asking for credit. Instead of paying suppliers up front, you can arrange to pay them 30 to 90 days after they give you raw materials or products. This, of course, depends on your credibility. They will likely check your credit score and business income. If they are unwilling to give you credit, you can be creative by leveraging other credit sources as collateral. For example, you can give them your credit card to use in case you don't pay on time. Or you can use an asset you own as collateral for the products they give you.

The idea, again, is to limit your out-of-pocket expenses as much as possible. If you can buy and sell products within 30 days for free, then you're experiencing positive leverage. Continue to pay your suppliers on time, and you can ask for a credit increase. This will allow you to grow your business, for example, without having to put additional money into the business. You can then use your money for other opportunities.