KEEPING THE BOOKS

Managing & Understanding Company Financials for Entrepreneurs and Investors

-Clay Simsee

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Managing & Understanding Company Financials for Entrepreneurs and Investors

A book that will arm the entrepreneur & investor with the financial acumen needed to have an edge over 80% of Small Business owners in America.

By Clay Simsee

"Written for my smoking hot wife and 3 pretty decent kids."

By the end of this book, you will:

- Know exactly how to keep your business ledger, where the data comes from, and how to arrange it.
- Know exactly how to build your company Income Statement (also called a Profit & Loss sheet), where the data comes from, what it means, and how to read & interpret an Income Statement.
- Know exactly how to build your company Balance Sheet, how to keep it in balance, where the data comes from, what it means, and how to read & interpret a Balance Sheet.
- Know exactly how to build a Discounted Cash Flow analysis to put a cash value on your company, where the data comes from, and how to interpret a DCF.
- Have a strong, non-nonsense understanding about what company financials are, how to read and interpret them, and how to keep your books with minimum effort.
- Most of all, you will be astonished at how simple it is and have lots of questions as to why everyone doesn't have this kind of understanding.

If I can deliver on these promises in less than 100 pages, I ask of you this humble favor: don't share this eBook with others. You paid good money for the skills that you will learn from this book. You will value this book and the skills you receive because you paid good money for them. If this is given away for free, people will not value the lessons and they will forget them because they were free. I know it's easy to share an eBook. However, you would be reducing its value to zero and it will undermine the goal of these books: Teach People Business.

These books will transform your mind to speak the language of business, understand financials, and be able to offer these skills as a money-making service to others. I want you to have the best chances of success in your business just as much as I want your friends to have the best chances of success in their business. In fact, I would love nothing more than to have all the families in America safe and financially secure in their own businesses. It would improve the nation, how people treat each other, and quality of life across the board. They have their journey. This is yours. Send them the link but if they trade nothing for these skills then these skills will be nothing to them.

Solid Business

P&L, Balance Sheet, Bookkeeping, and how to understand the health and efficiencies of any business by the numbers for investment and/or managing your own business.

Clay Simsee

Disclaimer: I'm not an attorney nor a CPA. I'm simply a businessperson. I've built companies from scratch, secured Venture Capital (VC) funding in excess of $10m, started over, did it again, and have generated all of my own documents and records along the way. I've learned from professionals and have read many legal, investing, and business books. This is an extremely "approachable" explanation of business fundamentals designed to get what is in my head into your head. It's strongly advised that you discuss these topics and ideas with your CPA and tax attorney prior to implementing any strategies or ideas expressed in this book.

Purpose of this book: To train you on how to understand the health of a company, understand the investment value of a company, where that value comes from, and how this applies to making investment decisions, running your own business, or simply for dinner conversations with captivated audiences.

By the end of this book: you'll be able to Read, Understand, and Create, on a very comprehensive and appliable level, a Profit & Loss Statement (P&L), a Balance Sheet, and a Discounted Cash Flow Analysis (DCF) to determine the health and value of any company, public or private, and determine if your idea for a business would be a successful one or not.

While learning about these documents, you will also learn how to "Keep the books" of your company, reverse engineer P&L statements, Balance Sheets, and DCF's, to determine what ownership is trying to communicate or "get away with". You'll also be able to apply these principles to the general stock market to find "sleeper" stocks that have not yet exploded. Avoid bad investments in overvalued companies, start & run a proper company of your own.

2nd Disclaimer: While I have day-traded, swing traded, and value traded as an income for multiple years, I'm not currently an accredited investor, nor do I guarantee success in the stock market. I'm here to provide you with the tools, how to think, and where to find answers to intelligent questions that will flow from you like a seasoned investor. No matter how skilled you are, the market is often given to its own animal instincts, anomalies, errors, and is full of risk. Investing is a personal choice and I only recommend investing with money that you can lose. There is no guarantee of investment performance from the skill I am about to give you.

Each of you that reads this book will absorb different bits of information and it will mean different things to you. That's good. That's how it's supposed to work. You have thoughts and values; those are your compass. I'm showing you how to build a compass, how that compass works, what the truth of the compass is, and how to build a better compass. Some of you will be sharks. Some of you will be angels. All of you will be savvy. If you're ready to get a good business head on your shoulders, let's begin.

Last Disclaimer: I am not an author. I did not use ChatGPT to write this, like so many other business books out there. I'm not a teacher that has zero stake in the game. I'm a businessperson with my whole life in the game. After my enlistment in the military, I climbed the ranks of a Fortune100 company to senior management for 10 years, went to night school for an MBA from the University of California system that teaches the Harvard MBA Curriculum with many Harvard Ph. D teachers and instructors in the program, then jumped out of the corporate world to be a small business owner and entrepreneur for the past 10 years. I've grown companies from filing the initial LLC docs, all the way to VC investment, and sold more than one. I needed to understand the numbers, operations, people, environment, and many other things to accomplish this. I'm a well-rounded and aggressive business builder but none of these skills include spelling or grammar. I'm relying completely on MS Word to make me sound intelligent. I'll refer you to the point of this book once again, is to get what is in my head into your head. I didn't say that it needed to be in perfect sentences. It will not be, and I'm not going to try to convince my wife to proofread this thing before I publish the first version. However, this version is raw and will flow with the speed and detail of a businessperson. Here we go.

Table of Contents

Some things to quickly glean from this Table of Contents (ToC):

1. I'm likely to use a lot of acronyms to try to save time and cut down on the bulk of this book.

2. Business uses a lot of acronyms like Return on Investment (ROI), Line of Credit (LOC), Wild Ass Guess (WAG), and many others, both official and unofficial. Yes, WAG is an investing acronym. When we build a DCF for a Small to Medium Size Enterprise (SME), it will be a WAG. FYI.

3. For the last few chapters, that have no structure to them, I'm going to try to provide some of the wisdom and experiences that I've learned over my life in business.

4. This book contains a lot of information, so I recommend that you do one of these two options:

    - Buy the print version of this book where I have left margins on the side of each page for you to make BRIEF AND MEANINGFUL notes. We all know why I capitalized those words.
    - Copy the text from this .pdf into a word document, CHANGE THE FONT COLOR, and type your notes inside of the words and paragraphs of this book. THEN SAVE IT with a meaningful name in a place that you won't forget.

Do not take my all-caps and bold as me yelling. It's more like a professor stomping on the floor when they say something that will be on the test.

INTRODUCTION

Do people keep good books and good numbers?

- Do most small businesses keep good books? Nope. 80%+ do not.
- Do most small businesses separate their personal expenses from their business expenses? Nope. Same statistic as above.
- Do they at least create operating entities to separate their business activities from their normal life? Nope. Same as above.
- Do they at least deduct their business expenses from their taxable income? Nope. Same statistic as above.

Holy Smokes, that's terrible! Yup. It's a crying shame. For this reason, 99% of them are doomed to failure. No matter how good your product or service is, it will fail. It will fail for financial reasons and missed opportunities. I will explain.

The truth is, and today more than ever, people just buy some stuff from Alibaba and setup an Amazon Seller account, start paying for Amazon PRIME placement, give free stuff away for people to write reviews on it, and put in countless hours learning modern Social Media hacks to get more eyeballs on their products in hopes of improving their sales.

First, I want to say, "Good on you!" Even doing that much is miles ahead of most people! 99% of people in America won't even do that much. If I were expanding this statistic to the world, it would be closer to 99.99%. That is a WAG but it's a solid one. I should have included this in one of the disclaimers, but I will use infinitives, generalizations, and WAG's throughout this book. They're not intended to deceive or mislead you; I use them because they're going to be generally close to the mark. Precision in these estimates does not add value nor are they the purpose of the book. The purpose of the book is to get what's in my head into yours. So, if you disagree with a generalization, over-simplified statistic, or WAG, please write your objection in the margin of the book, in a different font color in your MS Word doc, or yell it to the Heavens so that you can get past it and absorb the rest of the value in the book. Like a contract, any part of this book may be proven to be invalid and that will not have any effect on the entire document. The rest remains valuable, so push onward.

Small tangent completed, now back to it: Why don't people create any kind of business entity around their business, separate their expenses from their personal life, and keep normal business financials? The short answer is: it's a hassle, they think it takes a long time, they don't understand the importance of it, they don't know how to do it, they think they will "Catch up" later (which never happens), or they think they'll need to hire someone else to do it and they don't have the money. All these reasons are false. You'll be able to keep your books on a napkin by the end of this book. Not only that, but you'll be able to take those notes on that napkin all the way to real P&L's, Balance Sheets, and Valuations that could be submitted to Venture Capital (VC's), Angel investors, and even the SEC for public filing of your small business. These are the skills you are about to absorb.

I would like to take a minute to shamelessly plug my other books, that are either written by now or I'm still writing them, but they'll fill in more areas of business outside of this book about company financials. Here they are:

1. **Business Structures:** Public and Private. How to set up your business structure for success by using Trusts, Holding Companies, Operating Entities, what types of entities to use, and why to use them. It will also include how to create these entities along with some big tax items that you should speak with your tax professional about immediately. It will shock you to learn how easy it is to build a multi-tiered business structure that protects your assets and provides for a safety net in the case of failure.

2. **Products & Branding:** A comprehensive book of understanding Innovation as it applies to products and services, how to do it, how to create valuable business, and how to approach branding. This will open your eyes to the limitless possibilities of products and services available to you today. It will change your world view.

3. **eCommerce today:** What changed in 2020 and why is eCommerce so captivating right now? From Affiliate marketing, drop-ship, branded products, authorized retailers, and

Fulfilled by Amazon (or any 3rd party warehouse) to Shopify, Clickfunnels, ActiveCampaign, and the plethora of ai tools available. I recommend you read this book absolutely last for the best chances of success. The exception only being the book on actually building a traditional business with a physical storefront and employees.

4. **Traditional Business Building:** I might write one on the steps of building, permitting, licensing, and operating an actual brick & mortar business in the manufacturing & industrial space. There are many reasons I shouldn't write this book, mostly because if people understand a thing, they feel compelled to do a thing, and I will strongly encourage people not to do this thing until they have a lot of pieces in place. There will be plenty of business cash-flow long before you're ready to sign a lease on a 50k sq.ft. warehouse in NYC. I probably will not sell this one publicly and will require that we speak on the phone prior to purchasing this one. It's dangerous but also has the most upside potential. You will need to know business, at least as well as me, before you even consider it. I'll probably need to read your business plan prior to considering providing this book. It will also only be available in print, no eBooks that could be shared around out there and really get people in over their heads. Ok, enough warning on that. However, that does bring me to my 5th and last book.

5. **Starting a Business:** Writing your Business Plan, Marketing Plan, Pitch Decks, and structuring your new company for investment and launch. Taking what you have learned from this book, books 1, 2, and 3 on this list, and getting ready to launch your own business with bank or investment money. I will show you how to write your Operating Agreement, complete with examples and methods of how to structure ownership, what happens in the event of a disagreement, and things to include that will keep you out of lengthy legal proceedings.

When I complete the series, everyone will have what they need to be successful in nearly any business in America. Ok, at least you'll understand business better than 99.99% of the world. No other promises outside of that one. Business is risky and from a guy who has "lived Skinny" for years at a time, I will not encourage you to do the same. The safest thing you can do is **GET A REGULAR JOB**, learn, and build on the side, and for the sake of all that is Holy, **DON'T SPEND ANY MONEY**. Make sure you're ready before you jump into anything. The things I bold and all-cap should, at a minimum, be in the margins and in your MS Word notes. These are words to live by. They are the most important thoughts that should always be forefront in the mind of an entrepreneur.

The Number 1 killer of business is under capitalization. What that means is: the business didn't have enough cash to make it past the first year and into profitable sales. This will make more sense when we break down the P&L and the Balance sheet but always remember that a business is an animal that eats money and grows. You'll need to feed it until it can hunt and kill its own food (Money). That could take a few months, or it could take over a year. If it takes 2 years or more, may have to take it out behind the shed and put it out of its misery. This will likely lead to you taking job interviews to start over with the whole get a regular job and build this at night and on the weekend's thing. You can always start over. You never fail unless you choose to quit. That is the only way in which you fail: if you choose to quit. There is no failure outside of that choice. Read that. Understand that. In the business entities book, I will show you how to build and remove businesses from your holding company quickly to reduce losses and set you up for maximum success. You will absolutely need to know how to do that to avoid personal bankruptcy resulting from any business failures.

INTRODUCTION

Why are business numbers important?

If you're using this knowledge for investing, the answer is simple: to understand the health, profitability, and future potential of a company for investment purposes.

If you're using this knowledge for starting your own company then there are more applications: to understand if your business is a good idea, if you are making your product or service efficiently, if you are pricing it appropriately, if the business itself is bloated and over-spending, to understand where and how to improve your business, and most of all, to communicate your business value to investors and potentially sell your company for lots of money.

You can then do it again or put it all in an annuity, under your holding company, and dedicate your life to exploring the world and its cuisines or whatever floats your boat. I'll go into all the holding company, annuities, and non-operating business stuff in the business structures book.

Here is the bit that 80%+ of small businesses in America miss: investors are looking for places to put their money. They're looking for people who know how to build and manage a business so that they can profit with minimal effort. They will look at the health of your product or service, the efficiency of your business, the competition in your category, and the ease of scaling. All this information will come from the P&L, the Balance Sheet, and the DCF. You need to ace these things to have any hope of investment, going public, or even just getting a LOC from the bank. I'll give that one to you for free: Line of Credit (LOC). From now on, if you forget an acronym, you're going to be flipping back through the book to remember what it was. You know, you can make notes that look like yellow sticky notes off to the side of the document in MS word. It's under the "Review" tab and click "Make new note. If you cut and copy this whole eBook into MS Word, you can probably make a million notes on the side of the page.

Benefit #2 and just as important: You're losing a boatload of cash on taxes! Somewhere between 12% and 34% of your potential monthly earnings are leaving your account as taxes. This will make growing and funding your business that much harder. Remember that the #1 killer of small business is under-capitalization, which means running out of cash. Well, that's why 75% of all small businesses fail is because over 80% of them are just using their personal credit cards and buying their supplies and paying their labor with their own income from their regular job that has already had taxes taken out. They're also counting their business income in the same checking account and now they're paying personal income taxes on their business income before they can even pay their labor, services, subscriptions, and the cost of all that Alibaba stuff they're selling on Amazon. You are giving 12% to 34% of the cash that you could be buying more Alibaba stuff to the government in taxes! Stop doing that. I will say that if you are currently doing that, get my business structures book, read it now, make a mark in this book to come back once you have your entities created, and your business savings and checking accounts set up. Just go set up the entities now so that you can start walking back all this mess next week.

If you haven't started your business yet, awesome! You can continue reading this book, buy the business structures book, the products and branding book, and then write your business plan, DCF, go get an LOC from the bank, and get started. Remember: your idea needs to be "Old and Cold" before you act on it. Acting on impulse to buy 100 ice baths on Alibaba and use FBA (Fulfilled By Amazon) to sell them, will end in ruin and debt. Do not do it. I don't care if it's those cheap stress bubble poppers for $0.10 each or a personal home sauna that you're sure you'll get $1k in profit on, do not do it. It will not end well. The ONLY exception to this advice is if you are truthfully just doing it to learn how the process works and you're completely comfortable just throwing away any amount of money you spend learning a process. There is value in that. I've built Shopify stores just to figure out how to set the background for the entire website as an image. Keep in mind: you will lose 100% of that investment in exchange for the thing that you want to learn.

I mentioned that I don't understand grammar, run-on sentences, I can't help but tangent, and this will happen frequently. If you have an issue with tangents, then line them out and highlight the important bits for a fast desk-reference later.

INTRODUCTION:

What are the benefits of keeping good numbers?

The main one is to understand if you should continue with your business or cut & run! You've heard a lot of businesspeople say, "Fail fast, fail early." Well, that doesn't help very much without any context and how-to instruction on how to fail and not lose your house!

I'm packing a bit of actual business strategy and structure into the introduction in this part. If you already know this, then skip ahead. I'll go into more detail in the business structures book.

Ok, let's say that you're keeping good books on your new business, and you start to see your Gross Profit (GP = Total Sales minus Cost Of Goods Sold "CoGS") is getting smaller and smaller. This could be that your shipping costs from China are going up due to Tariffs, Ocean Freight Rates, the Price of Fuel is increasing your overland shipping costs to from Mexico, Canada, or across the US, the underlying parts in your product are increasing in price and the competition in your industry is too fierce to raise your prices and hope to sell a single one. You're about to get pinched out of the market! Your costs are increasing, and you can't raise your price because then nobody will buy your item, they will buy from the competition. What to do? How do you survive this?!

Option 1: Sell your company to your competition. If you've been successful and **KEPT GOOD BOOKS**, you can clearly show the value of your company, then make them an offer to own 2 valuable products in the market. That will decrease the competition, increase their sales, it gives them a fun play-off-the-other-brand opportunity, or they can just take you out of the market if they believe that they will absorb most of your orphaned customers. A little endorsement on your webpage, post-acquisition, directing your customers to buy the new company's products instead because all the value from your product has been absorbed into theirs, might do the trick!

When finding someone to sell to, you want to find who will benefit the most. Maybe that means selling to one of your suppliers, maybe it means selling the next brand below you, so they can increase their market share. Maybe it means selling to the 800lb gorilla in your industry, to give their brand more authenticity. Pitch to all of them. You need to exit gracefully & profitably. You don't know if they have a better supply chain and marketing than you do. If they do, then they will not suffer the same squeeze you're suffering. You are getting pinched out because your numbers told you that your process isn't competitive. Bigger companies can move a full 40' container and 53' TruckLoads (FTL) of product at a time resulting in much greater cost efficiencies. If you sell your product and brand to them, they will use their supply chain, avoid getting pinched out, and grow their business. You should be rewarded for bringing all your customers and your brand value to them. We will discuss how much you should be rewarded in the DCF section.

OPTION 2: You grow and push for more efficiency to reduce your costs. You need a cash infusion for that new production machine, larger building, or simply to buy more of your item at a time to increase your supply chain efficiencies (this means ship more things in a single shipment so that the price-per-item of shipping to your business is reduced).

There are many reasons why you might want to go for outside funding. If you can't communicate the health and potential of your business in numbers, then you won't be getting any money. Plain and simple. You cannot go into a bank and beg the branch manager to believe in you. It won't work. It doesn't happen. However, you can go into a bank, show your P&L, and convince them that your Gross Margins and Operating Effícencies are so tight, it would be a mistake not for them to take the easy money on interest on a 5-year loan request. If you buy more trucks, you can deliver more goods with your super-tight P&L. Just remember, your increase in income must be far greater than the monthly loan payment or you will lose money.

OPTION 2b: Adjacent investment. That's my term. If you use it, you may need to explain it. Basically, it means a non-direct investment. Let's say that you're a bakery and you have a hot product like Cronuts (Doughnuts made with croissant dough). You can show that your sales have been steadily growing and you're at the maximum your current facility can produce. You run a tight operation and if you had a larger commercial kitchen, you could increase your sales even more! You might want to take this idea to a commercial property investment firm. They would look at the area, determine if an investment in a commercial kitchen in that area makes sense (is there a university nearby? Is the property undervalued? Are there a lot of upper-middle income homes around that might buy your Cronuts (I'm probably not spelling that correctly or someone has trademarked it. If they have, this is free publicity!) The commercial lender will run their own model and perhaps, buy the commercial kitchen and allow you to sign a 5-year lease on it. Now, you need to pay the lease and grow your business. Be sure you have saved enough money from the previous location before doing this because your sales might not grow along your projected path as quickly as you had assumed. Shoot for 10x growth but plan for <10% growth. Have cash in the bank to cover before making this move. Save your earnings to show the investor that you're responsible, even if this means operating out of your smaller site for another year. The #1 killer of small business is under capitalization.

OPTION #3: Bankruptcy. Don't get scared. Here is how you do it gracefully. I will go into more detail in the business structures book but if your operating company is an LLC. This is the company doing the work. It's the one in financial trouble. This operating company only has a single owner. The owner that has 100% of the equity in this Operating LLC is a Holding Company. That Holding Company has an agent that registered it and it only has 1 member as well. That 1 member is a Living Trust. That Living Trust isn't named after your family. It has a cool name like Venture Horizons Trust or something awesome like that. Your personal name isn't anywhere on any of the ownership documents of any of these companies. Since a Trust is a private entity, it isn't registered anywhere. There is no information on you. Therefore, you can have the Operating Company declare bankruptcy, since you tried to get a bank loan to expand and lower your costs. You tried to get a competitor to buy your company. Nobody was willing to do it. Your company has run out of money and Revenues have fallen below monthly expenses. Time to pull the plug. Honestly, it's better to pull the plug early and let your landlord and suppliers recover before the debts get big. File the bankruptcy for the company, provide copies to all the company creditors, landlords, and suppliers. Inform them that you have been fired and that if they have any questions, contact the Holding Company that owned your Operating Company. Your Holding Company's contact information is a law firm that is acting as your agent for that company. They will know exactly what to do in cases like this and won't provide any more information than is required by law. Your name is nowhere on the bankruptcy. Your credit does not take a hit. You do not lose your home and put your family on the streets. You can get a job at this point and start saving to give it another shot when you're ready. Keep in mind, from the moment you file your Operating Company, everything you sign, any public records, checking accounts, leases, loans, or anything else that is being done in the name of the company, sign as the CEO and not as an individual. Do not sign personal guarantees for company business. Just don't do it. Not for loans, leases, or anything else. Be vigilant in this process. If all goes well and you've got a great product or service, everyone gets paid + interest and they all make money from your hard work. If it should fail, they should not have the ability to take it out of your hide. Your debtors cannot expect to earn the upside potential without any downside liability. That's like going to a casino and the dealer says, if you win, you pay and if I win you pay. It's a bit one-sided and in very little time, nobody would go to the casino anymore. This is how to properly set up your business structures but either buy the business structures book or go sit with an attorney that knows how to file entities properly before you do it on your own. You should always try your hardest to succeed. However, if elements outside of your control cause your business to fail, America doesn't want a broken businessperson. They want you to learn and bounce back better. This time, you'll grow a massive company and pay the government a lot of taxes. You'll employ people and you'll pay payroll taxes, your employees will pay income taxes, they will buy homes and pay real-estate taxes, and they will buy stuff and pay sales taxes! America wants her taxes. If you're someone who can help them get their taxes, they will tolerate your bankruptcies. Never design a company structure or business endeavor in fraud. Always try your best to succeed.

If you're reading this as an investor and you were listening in on an earnings call and they started talking about shrinking gross margins, you have to start asking some questions. Is the company cautious and responsible or are they running like their hair is on fire? Running at a high speed and growing YoY (Year over Year) at greater than 50% is extremely dangerous and there are likely a lot of debts, aging AP (Accounts Payable), and the company is in financial distress (Negative Operating Income). Avoid companies that behave like this. They are time bombs and will explode, cratering your investment. If you're a small business and want to have organic, safe, growth, then move slowly and stockpile as much cash as possible. Do not spend it on that new truck with the marketing wrap on it. It is so much more valuable as "Cash Assets" in your balance sheet.

These are a couple of reasons why keeping goods numbers is critical. It is important to you, the investor, as much as it is important to you, the business owner. If you keep good books, you will have access to capital and tools that you otherwise wouldn't have access to if you're running on personal credit cards and your own BofA checking account (You should know BofA is Bank of America). I should mention that large banks aren't always beneficial for small businesses, and you should GO AND SPEAK with the businesspeople that have cubicles just off the main lobby in every bank and credit union in your town. Listen to their focus. Listen to what additional services they have for small business accounts and if they have a path to a LOC and other funding services if you hit certain milestones with your business. Will they be there to support your growth? Will they consider commercial real estate investments or investments in your company if you show certain Gross Margins and Operating Income levels or simply maintain a minimum balance for over 2 years? Do they really understand small business and are they really going to be there to support you? Take notes. Collect documents they offer you. Highlight what they do. Choose wisely.

INTRODUCTION:

How easy is it to simply do it correctly?

We need to get into the meat of this book, so I'm going to keep this one short. Hopefully you're starting to develop a picture of how business health works by now. That will make the information in the following sections easier to absorb. Your brain will be ready for it and curious as to how the mechanics of it works. There is a lot of truth in learning something when you are ready for it. You've heard lessons and phrases your whole life, but they've never landed until that one time, when you're in the middle of something, and you hear that phrase again and a light goes off. You have an "Ah Ha!" moment and now you understand that phrase on a fundamental level. That's when you need to and are ready to learn.

I am jumping around a little bit and providing ideas without enough supporting explanations in this introduction to make your brain curious. It's akin to improving reading memorization by going through a chapter and reading only the first line, not the first sentence, only the first line of each paragraph. Then going back and read the entire chapter. By doing that, unconsciously, you've set your brain into an inquisitive state. You may not feel it, but the ideas are incomplete and when you read the whole chapter, your brain will store a lot more of it. I'm doing something like that for your brain now. Some of you may feel irritated by these tangents but I assure you, that suspense and impatience will lodge a lot more of the following information into your head, permanently. The more irritated = the more satisfied your brain will be. One of the things I tell mentees and other businesspeople I work with is: I'm going to drag you, kicking and screaming, into success. They usually laugh, thinking this to be a joke. It is not a joke. It's unpleasant. In the following weeks and months, there is typically a solid amount of yelling, threats, and other unpleasant events as old thoughts and beliefs are extracted from their brains and replaced with doubts, and then eventually grown into comprehension and confidence. The longer you've been failing at something, the more violent this will be. I envy the newbies, who have no bad habits or ideas. I wish I had taken golf lessons in high school. While my golf game may be beyond repair, if you're willing, your business acumen is salvageable.

The short answer to this section is: it's extremely easy when the transactions are manageable. However, when you get up to over 500 bank transactions per month, you probably want to start using software more sophisticated than Excel, like QuickBooks. When you get to over 5,000 transactions per month, you might want to look at Enterprise Resource Management software for making your entire business more software based. This is a dream and a goal for most people, but it is achievable with a reasonable amount of effort, if you walk the path I will be laying out.

In order to walk this path, you will need a business entity, I recommend a Limited Liability Company in nearly all cases, and a dedicated bank account for this company. I will recommend reading my business entities book again at this time. While you can go back and restructure your business later, it's easy to set up from the beginning, and there is no reason to not to do it correctly. It's the pressure sale again: go buy that book, read it, and set up your business according to your needs. You will be happy that you did.

Once you have this business account set up, you'll need to fund it. In most cases, this is a cash investment from you directly. Usually, that comes in the form of money that you've saved for years to begin your own business. Be sure to have a business checking account that is small business friendly (no fees or minimum balance), because you don't want to be nickel-and-dimed to death. You can sell assets, take out loans that you can afford from the income of your regular job, borrow from family, sell ownership stakes in your company, and many other initial funding options. However, I should make a very important note here: **NEVER SHARE LEADERSHIP IN YOUR COMPANY**. You can sell equity in your company, but you are the visionary and ultimately, the responsible party for the business's success. Do not have equal partners or even people who have sway or influence over how you manage the company. If you're going to have any "partners" in your business, make sure they're very small shareholders with no decision power. I'm going to go back to my list of books now and include a part in the company setup book that says how to write your Operating Agreement to protect yourself from greedy, lazy, dishonest, or otherwise bad partners. 100% of the partners you have will fall into one of those categories. Do not do it.

Going back to the comment on how a new business is usually funded, by you directly, and you're ultimately the one who will lose the most if the business fails, why would you give anyone else any ability to make you fail and lose all your money? Do not have partners. That doesn't mean that you can't bring in money from other people, you can! However, give them what's called "preferred shares" which means they will receive their investment back first, before anything else, in the event of a sale or any profit distributions. Structure it so that they get their money back quickly and then enjoy profits for the life of the company and a percentage of the sale price of your company, if you sell it. You want to provide extreme value to anyone who believes in your business, but you cannot give them a say over how the business is run. If they insist on a board position because they want to provide you with mentorship, industry connections, and other resources, then put them on your board of advisors. You can talk about them in your pitch deck to build additional confidence in your business but even if it's Warren Buffet himself, and I hope he will appreciate this, do not let him control your future nor the future of your company. It's your future. It's your company. The purpose of this tangent is to remove complexity. Start it yourself, register the entity, open the bank account. If you need outside funding, structure the payback and benefits accordingly.

Now, once you start operating, be sure you're able to download the current transactions from your checking account and credit card into Excel. Save them in a folder, so that you always have access to the unedited files. Copy the data from these files and paste it into a new spreadsheet that we will begin building called your General Ledger. Create these columns in your General Ledger: Date, Source, Type, Description, Debit, Credit, and Notes. Try to format them in a way that it is easy to paste additional transactions to the bottom of the list from the file type that your bank provides. Ask these questions to the small business representative when you're talking with them: is the transactional data easy for me to download and add to my company ledger?

Honestly, just keeping this General Ledger is about 80% of keeping good books. It's just downloading the transactions from the bank account and credit card at least twice per month and keeping the ledger updated as needed. A ledger is just a diary of all transactions, in and out, of your company. It's simple and the primary building block of all your important company documents. I believe that you can even link Excel directly to some checking accounts and credit cards these days, much like how QuickBooks can login and automatically update the ledger. I don't use this function, however if you choose to, be sure to check the accuracy of how Excel classifies your expenses on a regular basis.

Let's start getting all the parts in this workbook. I will put my Balance Sheet on one tab, my P&L on another tab, my company checking account ledger on another tab, and if I have a company credit card, I will paste those transactions on another tab. I use separate tabs to keep the data organized and make it easy to just paste in the monthly transactions from each account. These transactions will feed into my General Ledger tab and that will feed into the P&L tab as well as the Balance Sheet and DCF tabs. The basic data is just the transactions. All the transactions will populate the General Ledger and that will put the data into the more advanced financials.

On the next page, there is an example of the expenses in a P&L or "Income Statement". I had to cut it in half and place it side-by-side because it was too long to put on one page. Imagine that the second column is the bottom of the first column. You can use these categories for your P&L. I would suggest only using the ones that pertain to your business. If you don't have any rental income, then don't include that line and so forth. If you want to take a quick look at the P&L on the next page to get an idea of what it looks like, do so now and come back.

In order to make our workbook more automated and functional, create a tab called "Data" and copy all the categories from the sections of your P&L into one big list. It should have all your incomes, then all your COGS, all your Expenses, and leave a few lines blank at the bottom of the list and call all of them OTHER. This will be where you can add things in later. Then, come back to your P&L and use the "=" sign to replace the text in each field with a reference to the list you just made on the other tab. So, by changing a field in your Data tab, you will update the field in your P&L.

Now, go back to your bank account tab and in the "Type" column, use the "Data Validation" function to "Pick from List" and highlight this entire list of categories in your "Data" tab. If you're not familiar with that function, you may need to Google or YouTube it. Basically, you're creating a drop-down menu, based on the categories in your P&L, to assign to the transactions in your Bank Account tab. When you paste in this month's transactions, all you will need to do is drag the corner of this field down and select the kind of expense or credit that each line item in your Checking Account Ledger is assigned to. Do the same for your Credit Card tab. This will assign all incomes and outflows to one of these categories.

Sample Company, LLC
Income Statement (P&L)
January - October, 2023

Income		**Total**
Sales Revenue		20,300.00
Service Income		0.00
Interest Income		0.00
Rental Income		0.00
Dividend Income		0.00
Commission Income		0.00
Royalty Income		0.00
Other Income		0.00
Total Income	**$**	**20,300.00**

Cost of Goods		
Direct Materials		0.00
Direct Labor		0.00
Manufacturing Overheads		0.00
Factory Rent or Lease (CoGS)		0.00
Shipping & Freight Cost (CoGS)		0.00
Packaging Materials		0.00
Quality Control & Testing		0.00
Total Cost of Goods Sold	**$**	**0.00**
Gross Profit	**$**	**20,300.00**

Expenses		
Advertising & marketing		700.00
Bad Debts		0.00
Bank fees & service charges		0.00
Building & property rent		1,200.00
Business licences & fees		0.00
Conferences & Tradeshows		880.00
Consulting/Prof. Services		0.00
Depreciation and Amortization		-200.00
Employee Benefits		0.00
Equipment rental		0.00
Insurance		650.00
Interest paid		0.00
Legal & accounting services		0.00
Memberships & subscriptions		178.00
Miscellaneous Expenses		0.00
Office Furniture & Fixtures		1,200.00
Office Equipment		220.00
Office expenses		770.00
Office supplies		680.00
Printing & photocopying		0.00
Repairs & maintenance		0.00
Research & Development (R&D)		0.00
Salaries & Wages		3,000.00
Shipping & Postage		0.00
State Franchise Taxes Paid		0.00
Subcontractor expenses		0.00
Supplies		0.00
Taxes paid		1,000.00
Travel & Entertainment (Meals)		405.00
Vehicle Expenses		0.00
Utilities		250.00
Total Expenses	**$**	**10,933.00**
Net Operating Income	**$**	**9,367.00**

Other Income		
Rebates		0.00
Govt. Grant		0.00
Total Other Income	**$**	**0.00**

Other Expenses		
SBA Loan Payment	$	1,200.00
Late Tax Filing Penalty	$	-
Net Other Expenses	**$**	**1,200.00**
Net Income	**$**	**8,167.00**

Once you've assigned the status of all your new transactions, go to the General Ledger tab, in the next available row under the "Date" column, select the first cell and hit the "=" sign, click back over to your bank account tab, and select the date of the first transaction and hit enter. The date of that transaction should now appear in the date column of your general ledger. Grab that cell by the bottom-right corner and drag it to the left so that all the fields in the General Ledger are now showing the data from the row you selected in your bank account tab. Then, highlight that entire row, grab the bottom right corner of the right-most cell, and drag down, so that all of the new entries from your bank account tab now show up in your General Ledger. Take note that this is not text that you have entered, it is linked with the "=" sign to the data in the bank account tab. If you change the data in the bank account tab, the data in the Master Ledger automatically changes.

Do the same process for your credit card tab. If you properly formatted the columns the same way in both tabs, they should paste in the General Ledger tab easily. You will note that the chronological order of these entries is not in order since the credit card transactions were pasted in below all the bank transactions. Ensure that there are no empty rows and click on the column heading for "Date" and, in the buttons at the top, click "Sort from Oldest to Newest on bottom". It will ask if you want to expand the selection, click "Yes". This will automatically arrange all the ledger entries by date, blending the bank account and credit card entries. No worries, all the information is still linked to the respective entries in your bank account and credit card tabs. They are now in chronological order.

Every month, when you download your bank and credit card transactions, you will paste the data into the bank and credit card tabs, format it neatly, assign the expense or income category, and use the "=" sign to link them to the next available rows in the General Ledger and then sort the General Ledger by date. This is how you can build this General Ledger in a few minutes each month. Don't add things to the bottom of this ledger like summing up the columns and things like that because you are going to be constantly linking this back to the new entries in your bank account and credit card tabs. The only modifications I would say to make here are to either delete the credit card debits from your bank account and the credit card credits from your credit card because that's going to mess up the automation. If you don't want to delete them, then go back to your "Data" tab and change one of those "OTHER" fields that you put at the bottom of that list to "CC payments". Now, assign that status to the cc debits and credits in the 2 tabs. That will isolate these values from being double counted on your financial documents. Now that you know how to construct and maintain your General Ledger, let's get out of the introduction and into the financial documents.

CHAPTER 1

The Profit & Loss Statement (A.K.A. "Income Statement")

What do the sections mean and what do they tell you about the company?

In the introduction, you saw a sample Profit & Loss Statement. One thing to note is that a Profit & Loss statement covers a period of time. It's meant to show the health of the company over a period of time. It can also show how competitive an industry is based on how small or big the profit margins are. It can show how frugal or careless the management team is at incurring additional expenses that are not directly associated with the product that the company is selling or the operation of the company.

In my P&L, I leave a blank column to the right and then I have a "Notes" column where I can make percentages or take notes about each line. These notes and equations are not printed or provided when I print my P&L statement. They are just in the worksheet for my own convenience and understanding.

If you're unfamiliar with a P&L statement, this may be a lot of information to take in. There is no need to understand it all right now. To begin understanding how to look at the numbers in a P&L, I simply want you to look at 2 parts.

The first part that I want you to look at is the Gross Profit. In this part, there will be total income broken out by what kinds of incomes. It will also list the direct costs to produce these incomes. Not all the costs apply to all the incomes. In fact, most of the costs, if not all of them, are only applicable to income from sales. The rest of the income is extra incomes or incomes not directly related to the product or service your business is centered around. Look at the cost of producing the sales of the items the company is selling. Some questions to think about are:

- Is this company dependent on the additional income to be successful?
- Does the ratio of what the item costs to produce make sense as compared to the income from sales?
- Ask if the materials, labor, and manufacturing overhead costs make sense or do they seem high or low?
- Do the shipping costs account for an abnormal amount of the costs in the sale of these products?
- How healthy would this company be if they had to depend on only sales and no other incomes?

The example I provided has a lot of zeros in it, so I recommend going on Google Finance, selecting any stock, and scrolling down to their financial statements. Most should have P&L's readily available for you to download. In most cases, it will be a link to "Company Financials" or Company Data or something like that. IF you like Yahoo Finance or even NASDAQ.com, you should be able to find the financials of every publicly traded company. Download a few of their P&L's (Sometimes called an Income Statement) and start comparing their numbers.

Read the categories and think about how much that percentage is of the total sales or expenses. Just by doing this, some things may pop up at you and cause you to ask questions or be suspicious of ownership trying to hide something or draw attention away from something. Basically, do the numbers pass the "Sniff test" or are they rotten?

Keep in mind, watching this section change over time will tell you if your industry is getting more competitive, if your CoGS are increasing or decreasing, if you're getting pinched out of the market with rising CoGS and no ability to raise your sale price, and what policy decisions, like tariffs and rising fuel costs, will do to your company. In fact, if you model these numbers out, you can run a series of "what-if" scenarios. An example would be "What if I used electric delivery vehicles?", "What if the US put a tariff on Mexico of 25%?", or "What if my state dramatically increased the minimum wage?". This section alone is a great tool to understand a company, its environment, and the competition. I recommend reading a number of P&Ls from companies in different sectors and try to see if you can "Tell the story" of those companies by reading their P&L.

The second part that I want you to look at is the expenses. While the previous section on Gross Profits will inform you all about the product the company is selling, the competitive environment it is in, and how various direct costs could change the health of the product & industry, it will not tell you anything about how well the company is managed outside of if they know how to negotiate labor rates, find cheap manufacturers of their products, and if they're ordering their inputs in quantities that result in savings on shipping. Gross Margins tells the story about how healthy the industry is and how efficient the company is at making the products, but it doesn't show you how well the company is being managed. Is management taking lavish vacations on the company dime? Did all the owners buy new trucks and expense it to the company? Are they having steak dinners with their clients every week? What kinds of business decisions are the managers making? That will be found in the Expenses section.

When you go through this section and read some of the numbers, consider the period. This P&L is for an 8-month period. It's not for a full 12-month year. Divide some of these numbers into 8 months and wonder, "Could I spend that much on food and entertainment for my customers in a month?"

As you go through this section and break down each expense into an understandable figure, ask yourself if it makes sense. In my notes section, to the right of my P&L, I divided each number into total expenses. While these ratios aren't widely used or even considered much in business, to entrepreneurs looking to save money, they're critical.

Keep in mind, things like the lease on a warehouse could be expressed as either a direct cost to produce your goods, if you're renting a commercial kitchen and you can relate the cost directly to production, or as an Expense, if you've signed a lease and you're there every day. Depending on how your business runs, this can be either an expense or included in the Cost of Goods Sold. On the next page, you can see an example P&L with all the notes and ratios on the right side. You don't have to read all of them but skimming through a few, you might notice that expenses like Bad Debt is a huge part of the expenses for the period. If you see that on a P&L, you had better ask what it is on the next earnings call! Typically, this is an unrecoverable expense that has no impact on sales or future performance. An example would be, if you made product A for 3 months and nobody wanted any, then you trash product A and make product B. If product B takes off, how do you represent all the work and supplies that went into the product that flopped? Bad Debt. It's an expense during the period but it shouldn't be divided into sales to understand your CoGS of product B. It's more of a managerial oops and should be recorded in the Expenses section. Even with the bad debt, expenses only total 80% of the gross profit. That's not bad at all! You're not overspending and even with a $150k stone in your expenses called bad debt, you're still putting money in the bank over the period. While I would ask about the bad debt, I might even congratulate the management team for shifting so quickly and maintaining a positive Operating Income in the face of a failed product. That's pretty skilled!

Sample Company, LLC
Profit and Loss Statement
January - October, 2023

Income		Total	This is my Notes section and not in a P&L
Sales Revenue		564,233.16	Sales Revenue is 77.77% of Total Income
Service Income		23,226.40	Service Income is 3.20% of Total Income
Interest Income		516.26	Interest Income is 0.07% of Total Income
Rental Income		12,000.00	Rental Income is 1.65% of Total Income
Dividend Income		112.18	Dividend Income is 0.02% of Total Income
Commission Income		114,000.00	Commission Income is 15.71% of Total Income
Royalty Income		11,332.67	Royalty Income is 1.56% of Total Income
Other Income		100.00	Other Income is 0.01% of Total Income
Total Income	**$**	**725,520.67**	**Total Income is 62.39% of Gross Profit (below). This is your 'Gross Profit Margin'**
Cost of Goods			
Direct Materials		126,452.87	Direct Materials is 46.34% of Total Cost of Goods Sold
Direct Labor		22,439.12	Direct Labor is 8.22% of Total Cost of Goods Sold
Manufacturing Overheads		16,144.22	Manufacturing Overheads is 5.92% of Total Cost of Goods Sold
Factory Rent or Lease		36,000.00	Factory Rent or Lease is 13.19% of Total Cost of Goods Sold
Shipping & Freight Costs		57,601.88	Shipping & Freight Costs is 21.11% of Total Cost of Goods Sold
Packaging Materials		2,241.70	Packaging Materials is 0.82% of Total Cost of Goods Sold
Quality Control & Testing		12,000.00	Quality Control & Testing is 4.40% of Total Cost of Goods Sold
Total Cost of Goods Sold	**$**	**272,879.79**	**Total Cost of Goods Sold is 48.4% of Sales Revenue (above) or your 'CoGS Ratio'**
Gross Profit	**$**	**452,640.88**	
Expenses			**Is your business running "Tight Expenses" or is it Bloated and over-spending"?**
Advertising & marketing		5,000.00	Advertising & marketing is 1.39% of Total Expenses
Bad Debts		150,000.00	Bad Debts is 41.77% of Total Expenses
Bank fees & service charges		1,200.00	Bank fees & service charges is 0.34% of Total Expenses
Building & property rent		2,250.00	Building & property rent is 0.63% of Total Expenses
Business licences & fees		1,200.00	Business licences & fees is 0.34% of Total Expenses
Conferences & Tradeshows		3,300.00	Conferences & Tradeshows is 0.92% of Total Expenses
Consulting/Prof. Services		1,500.00	Consulting/Prof. Services is 0.42% of Total Expenses
Depreciation and Amortization		24,000.00	Depreciation and Amortization is 6.68% of Total Expenses
Employee Benefits		1,200.00	Employee Benefits is 0.34% of Total Expenses
Equipment rental		5,000.00	Equipment rental is 1.39% of Total Expenses
Insurance		3,500.00	Insurance is 0.98% of Total Expenses
Interest paid		870.00	Interest paid is 0.24% of Total Expenses
Legal & accounting services		10,000.00	Legal & accounting services is 2.79% of Total Expenses
Memberships & subscriptions		2,100.00	Memberships & subscriptions is 0.59% of Total Expenses
Miscellaneous Expenses		100.00	Miscellaneous Expenses is 0.03% of Total Expenses
Office Furniture & Fixtures		6,000.00	Office Furniture & Fixtures is 1.67% of Total Expenses
Office Equipment		5,000.00	Office Equipment is 1.39% of Total Expenses
Office expenses		2,200.00	Office expenses is 0.61% of Total Expenses
Office supplies		9,000.00	Office supplies is 2.51% of Total Expenses
Printing & photocopying		1,200.00	Printing & photocopying is 0.34% of Total Expenses
Repairs & maintenance		5,500.75	Repairs & maintenance is 1.53% of Total Expenses
Research & Development (R&D)		25,000.00	Research & Development (R&D) is 6.96% of Total Expenses
Salaries & Wages		45,000.00	Salaries & Wages is 12.53% of Total Expenses
Shipping & postage		560.00	Shipping & postage is 0.16% of Total Expenses
State Franchise Taxes Paid		800.00	State Franchise Taxes Paid is 0.22% of Total Expenses
Subcontractor expenses		13,224.00	Subcontractor expenses is 3.68% of Total Expenses
Supplies		2,200.00	Supplies is 0.61% of Total Expenses
Taxes paid		21,000.00	Taxes paid is 5.85% of Total Expenses
Travel & Entertainment (Meals)		1,200.00	Travel & Entertainment (Meals) is 0.34% of Total Expenses
Vehicle Expenses		3,840.00	Vehicle Expenses is 1.07% of Total Expenses
Utilities		6,144.00	Utilities is 1.71% of Total Expenses
Total Expenses	**$**	**359,088.75**	**Total Expenses is 79.33% of the money coming into the business.**
Net Operating Income	**$**	**93,552.13**	**For the period of this P&L, you have had $93,552.13 of cash into your business.**
			You are 'Net Positive' for Net Operating Income
Other Income			
Rebates		22,000.00	
Govt. Grant		5,000.00	
Total Other Income	**$**	**27,000.00**	What income didn't fit into Total Income?
Other Expenses			
Foreign Exchange Loss	$	2,319.00	
Late Tax Filing Penalty	$	523.00	
Net Other Expenses	**$**	**2,842.00**	What expenses didn't fit into CoGS and Expesnes?
Net Income	**$**	**117,710.13**	This is your true net income

Go ahead and pop back and forth a few times between that P&L and some of the questions in the previous section since the earlier P&L was mostly zeros. This one provides a bit more conversational fodder. Does anything stand out? What are your thoughts on the profit margin for the product itself? What about all those other incomes? What if they went away? When will they go away? Will the company be negative if they went away right now? Do the production costs and the lease rate make sense? Did they sign a lease on a warehouse that was way too big to pay for?

The questions are nearly limitless. However, this is the method for understanding the health of the product and skill of the management. Take some time to fully digest the layout and the purpose of a P&L statement. Keep in mind, this doesn't show you how these numbers change over this period of time, these are summaries for the entire period. They could have made all their sales in the last month and have nearly vertical sales growth! They could have all been in the first month and died. This generalization is useful in some ways, but it hides other truths.

In the public investing world, these are the questions you listen for on earnings calls. What was your percentage of sales in the last month? OMG! You're skyrocketing! BUY-BUY-BUY!! In the small business world, "You spent how much on meals & entertainment?!" That's probably one the IRS will be asking, and you'd better have saved your receipts, and have good reason for all that entertainment outside of improving your golf handicap.

Take your time on this. Ask yourself as many questions as you can about these numbers. Try to visualize a typical month of business for this company. Are they shipping 10k items and running around like crazy trying to package and ship them all, or are they shipping 10 items and leaving at noon each day? The better you can visualize all the details of a company, the more confident you will be in investing or growing your company.

If I were selling my company, I would make my Gross Profit as big as possible. The buying company probably doesn't care how much I spent on my truck wrap or Google ads. They have their own internal processes. They have their own machines and factories. So, put the depreciation of your machines in the Expenses section instead of the CoGS under Manufacturing Overheads. This will widen the gross margins and make your product and the industry look healthier in the gross margins section at the expense of making you look unhealthy in the actual management of the business. There are many items that can be moved around but if you're going to do this, work directly with a tax attorney to ensure that how you represent your company is legal and accepted.

However, you choose to represent your company, stay consistent and have a clear reason that you record your financials in a certain way, otherwise you could be accused of running 2 sets of books and even charged with crimes. Always work with tax professionals when making these kinds of changes. Do not ever try to deceive or hide incomes, expenses, or just guess at numbers. This could lead to the buyer backing out of the deal and potential IRS investigations and penalties to include incarceration. I don't mean to scare you, but business needs to be honest and clear. You never need to fudge the numbers to be successful. That will only end in ruin. Instead, I will show you ways to mitigate risk, fail early before it leads to bad situations, and how to close and get out of a business that isn't growing. These are all legal methods that businesses have been using for decades. I will explain the methods, show you how to do them, but it is your responsibility to ensure that your ideas and how they are applied are legal prior to presenting them to buyers, the IRS, or anyone else.

The last note is at the bottom: Other Incomes and Expenses. These are things that don't fit perfectly into the above sections. In most cases, you can find categories for all your income and expenses, so this is more if you wanted to call attention to something. Let's say that you had some old debt from a previous product that failed, and you chose to carry that forward with your current business instead of declaring bankruptcy on the previous business and starting new. You're now in a position where you're selling your company and wish to be open and honest about the bad debts you have. You could call out the "Bad Debts" in the Other Expenses section instead of burying it in the regular Expenses section. This will likely lead to a conversation in which you can explain why you have bad debts. Most businesspeople will understand the situation and if the potential profit margins and the DCF cover the additional debts, it's likely that the sale will go through, you will be highly regarded as an honest businessperson, and your old debts will be included in the sale of your company. If you wanted to call out a fine for a city permit violation or any 1-off expense that may require some explaining, then put it in the other expenses section. Just be sure to discuss this with your CPA and attorney prior to publishing.

In the end, all your business income and all your business expenses have been expressed in your P&L. There is nothing left out. Depending on who or why you are presenting a P&L, you can legally move some items around as long as your intent is to accurately portray your company and not to deceive. There are many legal and CPA resources available to help you with this, I'm simply stating that the methods exist and not telling you how to record your numbers. From understanding a P&L, what ratios are important, and working with a CPA and tax attorney, you'll be amazed at how you can represent your company in a legal and GAAP way (Generally Accepted Accounting Principles).

Don't let that last bit scare you. It is rare that anyone gets into hot water when they have honest intent. The IRS will work with you if you're forthcoming with all information and inform them that your intent is to cooperate. Never thumb your nose or resist the IRS. That leads to bad things what we don't need to discuss. Consult an attorney, should you ever find yourself in any of these situations. My advice is to avoid them with good books. Now, let's talk about where the numbers for the P&L come from.

CHAPTER 1: P&L Function

Where do the numbers come from?

They come from your general ledger. When you download your transactions each month from your company checking account and any company credit cards, you're going to want to link them in your General Ledger as explained in the Introduction. You're going to want to keep this document and the downloaded statements in a folder on your computer and maybe even printed copies at certain times for records retention. Download the transactions in both .csv format and .pdf format. The .pdf format is for records retention and the .csv format is for working with them in your ledger.

In the beginning, it's easy for you to manage these documents yourself using Excel or even the free versions online like Google Sheets. While I reference Excel and MS Word, I am aware that there is another world out there of Apple products and that they have comparable programs. Use them if you must. I'm a PC/Android person and will likely never change.

While I don't use a "Double-Entry" format in my ledger, it is a popular method. Using double-entry accounting may make your Balance Sheet more understandable but it isn't absolutely required that you record your transactions in this format. As the name implies, when you record a transaction, you record 2 entries. You will have a debit entry and a credit entry. This will make a lot of sense when you look at it in terms of something like buying a desk for your office. Here is what that a simplified version of that entry would look like:

Ledger Representation:

Account Title	**Debit ($)**	**Credit ($)**
Office Equipment	5,000	
Cash		5,000

On your P&L, you have an expense called "Office Furniture & Fixtures". On your balance sheet, you will have a section called "Cash". On your P&L, the ledger entry will be calculated as an Expense of managing the company. However, on the Balance sheet, it will be shown as an asset of the company. Yes, you spent company money buying a nice desk (P&L) and your company owns a nice desk (Balance Sheet) that you could sell if you needed to.

If you buy a desk with cash that is in your company checking account, you must remove the cash from your company checking account and add that value to the company in terms of an asset.

I don't do the double-entry method. Instead, I link the value of all the office furniture, machines, and property into the PP&E line (Property, Plant, & Equipment) in the balance sheet and I just keep a running balance of my bank checking account in the bank account tab. I link that balance to the "Cash" line of my Balance Sheet. It accomplishes the same outcome but doesn't have all the double entries. I would probably do the double-entry method if my bank offered that format when I download my monthly transactions.

Something to keep in mind is the path of progression of your personal financial growth. As your company grows, you'll first manage these books in Excel/Google Sheets, once transactions start to get burdensome, move into QuickBooks. Your understanding of where these numbers come from and where they go in a P&L and Balance sheet will make you a very informed user of QuickBooks. There are some nice things built into QuickBooks that will save you time and provide more functionality than Excel. Some of the big ones are automating daily tasks like paying bills and invoicing clients. The invoicing feature looks professional and saves you a lot of time typing customer information into Purchase Orders (PO's). QuickBooks connects directly to your bank and credit cards so that you don't have to download and format your transactions each month. It has a lot of tax preparation features, and if you have the online access version, you can get dashboards of your company health on your phone, authorize payments, and other functions that you would otherwise have to sit down at your computer to do. In short, it's worth it, but I recommend you understand your numbers, expense categories, COGS, and Balance Sheet before you jump into QuickBooks. I recommend the kind of fundamental understanding of what the numbers mean and how you can move them that only comes from managing your books manually for a while.

Let's talk about how to sort your ledger into categories so that you can link them all to your P&L.

First, leave a blank column to the right of the categories in your General Ledger. This will prevent this next part from shuffling every time you link in new ledger entries and sort by date. Then, I will use the "=" sign to link the titles of each column back to that list of assets and expenses in your "Data" tab. This means that all the "Type" field entries will match one of these new column headers. Then, I will set up "If" functions below these titles that state that if the field under "Type" matches the field at the top of this column, then record the amount in the cell. If it doesn't match, then leave it blank. There are plenty of videos on YouTube on how to do this, you can also ask ChatGPT to walk you through how to do it. The point is, as I link entries in my general ledger from the entries in my checking account and company credit card tabs, as long as the categories are correct in those other tabs, not only will the General Ledger put everything in chronological order, but it will sort and sum the amounts in each category.

Sum the values at the bottom of these columns and link them to their respective fields in the P&L. This will automatically keep your P&L updated and accurate. If you're really crafty, make a summary tab in your workbook and feed the numbers into charts and graphs for a visual understanding of your company's health & ratios!

These methods are not difficult, and anyone can learn them in a few hours. These are also skills that you can teach others, and just knowing what you know already will provide a dramatic improvement in your company's chances of success. If you're an investor, I hope these simple explanations have opened news ideas in your mind about how to evaluate different securities.

Let's wrap this up with a little due diligence on the P&L then jump onto the Balance Sheet.

Chapter 1: Diligence

What to be cautious of when reading a P&L

For your business, the first thing that jumps into my head is that the cash balance of your general ledger in Excel or QuickBooks should be the exact amount you have in your bank account. If it isn't, then look for where you missed a bank fee, interest payment, or missed charge. The best way to handle this is to have separate tabs for your business checking account, your business credit cards, and your general ledger entries. Have the entries in your checking and credit card tabs automatically link to your general ledger tab. By keeping the checking account and credit cards on their own tabs, your balances should always be exact. With this method, you should be able to troubleshoot any inconsistencies easily.

When you're reading a P&L on a public company or if you're looking to buy or sell a company, ask a lot of questions! Keep in mind that 80%+ of SMEs in America are just running their business out of their personal checking account, on their personal credit cards, and don't even keep a ledger. How can they determine their actual tax rates, interest paid, or separate their personal from their company expenses?

For public companies, they have highly paid attorneys and CPA's that are on top of any annual changes in the IRS codes, and they take full advantage of them. The only confidence you have is that all the income and all the expenses are disclosed in public documents, but they may not be in the places you are expecting them to be. This is why listening to earnings calls, reading their financial statements, and understanding how to determine the health of their industry and the health of their business are critically important.

You should have a good understanding of what you can read from a P&L, where the data to create a P&L comes from, how to upload and manage that data, how that data can be represented in a number of ways, and the importance of understanding how and why a company chose to represent that data in the way that they did.

There are many books out there on P&L's and different ways to manage them. This one has given you the fundamental purpose of a P&L, explained why it is important to keep an accurate one, and explained how easy it is to keep them updated and accurate. Read this chapter as many times as necessary to plant the methods and ideas in your head. Play with your spreadsheets and workbooks to create better ways to link and automate the entries. Understanding company financials is critical for running a business as well as investing in one. Now, on to the Balance Sheet!

Chapter 2: Balance Sheet:

What do the sections mean and what do they tell you about the company?

The purpose of the Balance Sheet is to show you a current snapshot of where the company is at a single point in time. It's going to show how much cash is in the bank, what the owner's equity is, if they owe a lot of people money, if a lot of people owe the company money, how much value is wrapped up in machines and office furniture, any loans, leases, and other liabilities the company has, as well as link the Net Operating amount from the P&L. That's a lot of stuff that isn't in the P&L!

Again, there will be a few sections on this one, just like the P&L. The main areas are Assets, Liabilities, and Equity. In a nutshell, a balance sheet needs to show:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Some easy functions to extrapolate from this equation are that when liabilities increase, in order to balance with Assets, Owner's Equity goes down. Also, if there is a negative Net Operating Income carried over from the P&L, then the Owner's equity is going to go up.

Just like a P&L, you can model this in Excel and see how the numbers react based on "What if" scenarios. Also, like the P&L, there are some ratios that will tell a little bit of the story of how well this company is doing right now. One of them is the Current Ratio. This ratio divides Current Assets (cash and items that can quickly be converted to cash) by Current Liabilities (The bills that are due). The Current Ratio tells you if the company is currently able to pay their current debts in the next 30 days.

Let's start with the only value that is carried forward from the P&L: Net Income. This number shows how much money, over the period of the P&L, came into the company. Let's say that $10k came into the company over the period. That would be added to any existing balance that the company had in its checking account. One thing to keep in mind, if you're printing a Balance Sheet, it should always be on the last day of the current P&L to avoid double-counting cash. In nearly every case, that will be today. No matter when you read this, that statement will still be accurate. If the Net Operating Income is already in the bank, then the bank balance needs to reflect that. If you do a balance sheet for the previous day, how could you back the cash out of the current bank balance or represent only the expenses that occurred up to that date in the past. Perhaps there is software that can do this, but Excel can't. If you're printing a P&L and a Balance Sheet, update your General Ledger, double-check the transactions and categories, and then print one for the current day.

In our example of a Balance Sheet a few pages ahead, there is $108k in the bank for this company. The Net Income for the period was $117K. That means that when the period started, they were overdrawn! Are they beyond these troubles? What happened in between now and then that helped them overcome this problem? Was there owner cash injection? Did they take out a loan?
By understanding both documents, you can get a clear picture of the path of the company, the current financial situation, and determine what the likelihood of future success is.

On the next page, I'm going to provide a sample of a balance sheet with notes. I want you to look at all 3 portions of this balance sheet. Each will tell a different story and raise different questions. The focus of this next part is to paint a picture in your mind of what the numbers mean for a business.

Here are the sections and the questions I want you to think about. Feel free to pop back and forth so that you can paint a clear picture of what this balance sheet is saying. Again, keep in mind, a balance sheet is for a specific point in time. It does not cover a range of time like a P&L would.

Current Assets: This covers cash and things that can be converted to cash within 30 days. This is known as Liquidity. Liquidity provides a lot of benefits to a company like if they had a spike in orders, could they quickly order all the materials to fill that order? This is also called Operational Flexibility. Can they pay their bills (current liabilities) easily? Having a lot of cash on-hand also increases investor/owner confidence in the business. You can see if the company is effective at collecting debts in Accounts Receivable, if inventory is aging or becoming obsolete in the inventory section, and how efficient the company is at turning assets into sales (asset turnover ratio).
Basically: do they have cash to stay flexible to meet new opportunities, is there a normal amount of inventory or are they having problems selling their products, and are their customers paying them on time?

Outside of current assets, it could be beneficial to look at PP&E (Property, Plant, & Equipment) to see how much they have tied up in machines and commercial real estate. If the machines are new and efficient, it might give the company an automation advantage that would cut down on labor costs or if they own their building, it could be appreciated with the real estate market. Listen to what they say about their Balance Sheet on the Earnings Calls. Ask questions if something isn't clear. Examples would be what they are factoring into their "Goodwill" or how they are valuing their intrinsics (trademarks and patents). These kinds of things will provide insight into how ownership thinks if they're trying to overvalue something to cover rising liabilities and keep owner equity high. Keep in mind, if liabilities increase and assets do not go up by the same or more, then the owner's equity decreases. It is a function of Assets = Liabilities + Equity. Examples would be if the owner's equity is low, that could mean the company is taking advantage of more debt to increase sales and boost returns. Debt is also more tax friendly than equity. However, if equity is high then it provides confidence in company stability and flexibility. The company could take on more debt if needed to take advantage of an opportunity. Depending on what the balance sheet is being used for, these changes could be good or bad but all you need to do is make sense of them. The owner's equity is listed below liabilities and not in the Assets section.

Liabilities: Liabilities tell 2 stories: how much does the company owe right now and how much are they obligated to pay over the next few years? Did they take out a lot of debt for inventory and sales? Are they over leveraged with debt? This can be identified with the Debt-to-Equity ratio. You will need to know what the average ratio is for the industry the company is in, but ChatGPT or BARD can probably help you with that. By the time you read this, there will likely be more ai search services out there that can scan a balance sheet and tell you everything you want to know about the company.

For the entrepreneur, you want to keep a high balance in the bank account, monitor it regularly to see if you're losing Operational Flexibility/Liquidity, and replenish it as often as you can. Cash in the bank = stability. Sell as much as you can to keep it high. Keep your liabilities down. Don't over leverage yourself with expensive loans. If you feel you need to take out a big loan to grow your business, then slow down. If you're profitable now, just keep doing what you're doing and grow your cash balance. You want to manage your business safely and responsibly. It's not a race to leverage as much debt as you can to make as much revenue as you can and keep as much of the profits as you can. If you run at that pace, the debt will win. Rather, a slow and safe pace wins the race. Buy your inputs, produce your inventory, keep your costs down, grow sales at a manageable pace, and put more cash in the bank. That is what you're looking for, not hot heads.

Equity: Owner's equity and Net Operating Income round out the balance sheet. I mentioned what high or low owner's equity could symbolize and some of the questions around running a large amount of inventory. If you see large debts and low owner's equity, ask yourself if they are a seasonal company? Are they building a bunch of Razor scooters right before Christmas? Did they just take out a loan and buy a whole 40' container of swimsuits and sandals? The numbers don't tell you enough without understanding the why. If you're the business owner, you know why. If you're an investor, you need to understand why. Keep in mind how an owner's equity reacts to high net incomes, low assets, and high liabilities. Make your spreadsheet and see how the Balance Sheet reacts in "What if" scenarios.

By looking at these 3 sections, one at a time, and asking yourself hypothetical questions about numbers that seem high or low, you will be painting a picture of the company's health at a single moment in time. Do this exercise on the next page and try to understand what the numbers in the Balance Sheet tell you about the company. Is this company a safe investment? If it's your company, is that bank balance keeping you up at night or is your Net Operating Income providing for sound sleep? Is the company heavy in debt as compared to their income and bank balances? Are they able to pay this month's bills? What skeletons do they have in the closet and monsters are under the long-term liability line? Do you think they have a chance of growing or are their growing liabilities going to put them out of business before they turn profitable? What was the #1 reason most companies fail? Under-Capitalization. If that bank balance runs out before they can make their sales profitable, they're done. How far off is this company from crossing that line?

Sample Company, LLC
Balance Sheet
As of October 31, 2023

			Notes section and not in a Balance Sheet
			This is for a specific point in time. Not a range.
ASSETS		**Total**	
Current Assets			
Cash & Cash Equivalents			
Business Checking Account		108,921.50	How much cash is in the bank?
Money Market Fund		15,000.00	Does the compnay have any cash investments?
Total Cash & Cash Equivalents	**$**	**123,921.50**	This is quickly accessilble cash only
Other Current Assets			
Accounts Receivable		88,938.00	
Inventory		25,992.10	The 'Acid Test' ratio is 250.52%
Prepaid Marketing Budget		14,000.00	
Total Other Current Assets	**$**	**128,930.10**	
Total Current Assets	**$**	**252,851.60**	The 'Current Ratio' is 279.22%
			This is the company's ability to pay debts
Non-Current Assets			
Office Furniture & Fixtures		22,944.10	
PP&E		146,223.20	Property, Plant, & Equipment
Total Non-Current Assets	**$**	**169,167.30**	
Other Non-Current Assets			
Patenets & Trademarks		10,000.00	
Goodwill		150,000.00	
Total Other Non-Current Assets	**$**	**160,000.00**	
TOTAL ASSETS	**$**	**582,018.90**	The 'Equity Ratio' is 33.44%
LIABILITIES AND EQUITY			
Liabilities			
Current Liabilities			
Credit Cards			
Credit Card #1		12,628.92	
Credit Card #2		7,222.21	
Total Credit Cards	**$**	**19,851.13**	
Other Current Liabilities			
Accounts Payable		18,554.20	
Accrued Expenses		52,150.00	
Total Other Current Liabilities	**$**	**70,704.20**	
Total Current Liabilities	**$**	**90,555.33**	
Non-Current Liabilities			
Small Business Loan		110,823.60	
Lease Obligation (5 year)		186,000.00	
Total Non-Current Liabilities	**$**	**296,823.60**	
Total Liabilities	**$**	**387,378.93**	The 'Debt Ratio' is 66.56%
Equity			
Owner's Equity		76,929.84	The 'Debt to Equity' ratio is 503.55%
Net Income		117,710.13	The 'Return on Equity' or ROI is 153.01%
Total Equity	**$**	**194,639.97**	
TOTAL LIABILITIES AND EQUITY	**$**	**582,018.90**	

Take your time. Look at the numbers again. Think of those ratios. Mastery isn't a race. Just knowing what you've read already gives you a much better understanding of the health of a business and how to create these documents. When you're ready, continue to understand where the numbers come from in your Balance Sheet.

Chapter 2: Balance Sheet:

Where do the numbers come from?

Unlike the P&L, most of these numbers do not come from your Company Ledger. However, if you're making a balance sheet for your company, a few of the items can be functions of your P&L, so create it under a new tab in the same workbook as your ledger and P&L.

The numbers that feed into this Balance Sheet are the Net Operating Income from the bottom of your P&L statement and if you're keeping a running balance in your checking account tab, you can link that right to the cash balance on this Balance Sheet. The same goes for the debts on your credit card/s. The rest of it is going to be manually entered by getting current loan balances, looking at your accounts receivable and accounts payable reports. It's probably a good idea to have tabs for those in this workbook as well. While you're at it, add a tab for inventory, and one for making manual financial entries like accrued marketing expenses, lease obligation, and what you feel the value of your trademarks and patents are. That way, all of those separate calculations can be done in their own tab, and they feed into the Balance Sheet. This will enable you to print out a balance sheet at a moment's notice. If all of the functions of your balance sheet are from other tabs in the workbook, simply put in the cell by the word "Date" this equation "=Today()" and any time you look at the Balance Sheet tab, it will have today's date on it and be ready for you to print it. You should do that at least monthly to save copies of them so that you can track your progress over a period of time. Obviously, there is software to do that but we're being frugal!

After you've stared at the balance sheet for a few minutes and gone over the numbers, it should be pretty evident what goes in each field and where to get that information. I'll encourage you again to have the actual data entry under other tabs in this workbook so that the Balance Sheet tab is dynamically updated with your business progresses. If you have fields that you have to manually change in the Balance Sheet tab, you run a high risk of the data not making sense when you need it.

Here are the functions that are inside of the balance sheet itself:

Owner's Equity = Total Assets – Total Liabilities – Net Operating Income

That means that Owner's equity is fluid and will change. Since your assets are your assets and your liabilities are clear, the only thing that adjusts on the balance sheet to keep it in balance is the Owner's Equity. Don't get into the habit of artificially increasing the perceived value of intangible assets to keep your equity up. If you increase your goodwill or the value of your trademarks and patents to artificially increase Total Assets a few things will happen. The first and most dangerous thing will be that you will start to believe it! You will be building your own delusions. When you are trying to understand your own Goodwill value, you need to document what your methodology is for that value. For example, in your financial diary tab, where you are keeping things like Goodwill and the value of other intangible assets like trademarks and patents. Honestly, a lot of these values are subjective, but you need to be reasonable and responsible in your method for determining these values. Here is the basic equation to determine the value of Goodwill:

Goodwill = The fair market value of your business – ((Fair value of tangible & intangible assets) – liabilities)

Yup, Goodwill is an intangible asset, and it's on both sides of that equation. Let's first understand how to find the fair market value of your company. There are 2 major methods to determine the value of an SME, they are a Discounted Cash Flow analysis (DCF) or a Comparative Company Analysis (CCA). Both are also very subjective and depend on a lot of WAG's. Welcome to business.

We will get into a DCF in the next section but let's say that a business just like yours sold for $1m last week. That would make you confident in your company's value. Just like when you buy a house, the realtor will present you with several "Comps" in the area. A house sold in downtown NYC is going to be a bit more expensive than a house sold in rural Oklahoma. Keep this idea in mind when considering eCommerce. If all your business is online and using 3rd party warehouses, does it make sense to use 3rd party warehouses in Miami? Is there really a big difference between an eCommerce company located in NYC and one located in Lincoln, Nebraska? When thinking about eCommerce business ideas, if the value of the business is independent of location, then go for the cheaper area with low commercial real estate rates, access to Interstates, and low hourly wage requirements. In today's business world, you can disproportionately sell to large markets from cheap places. You don't need prime real estate on Rodeo Dr. in California to sell designer clothing. You no longer need to incur the high expense to reach big markets. Foot traffic is now Amazon, Etsy, eBay, and quickly becoming Temu.

Ok, back to where the numbers come from. Suspend for a minute the DCF valuation because we will cover that shortly. The rest of the numbers in that Goodwill equation are the sale price of tangible assets like machines, office furniture, and even electronic assets like a 1m subscriber email list. Now, you must add your theoretical trademark and patent values to the cash you could get from selling off all your stuff and subtract all your liabilities from that amount. The remaining amount will be Godwill.

Here is an example:

The value of my company	
DCF analysis	$ 2,314,220.94
The value of my real stuff	$ 44,350.10
The value of my intangibles	$ 50,000.00
My total liabilities	$ 550,344.23
The value of my Goodwill	$ 2,770,215.07

We will do a 5-year DCF and show you where that value came from in the next section. Let's say I've got a few machines and a nice office worth about $44k. I've got about $550k in small business loans and lease commitments.

If I only value all my intangibles at $50k (patents, trademarks, brand reputation) then my Goodwill is worth $2.7m!! Who is going to believe that?

Let's first look at what constitutes Goodwill:

1. **Brand Reputation and Recognition:** A strong, well-known brand can be a significant driver of goodwill. A reputable brand often commands customer loyalty, allows for premium pricing, and can be a key factor in a company's overall valuation.
2. **Customer Relationships:** Established and stable relationships with a loyal customer base contribute to goodwill. This includes customer loyalty, the company's customer list, and the relationships it has built over time.
3. **Employee Skills and Expertise:** The collective skills, experiences, and expertise of a company's workforce, particularly if the team includes highly skilled or hard-to-replace individuals, can be a part of goodwill.
4. **Intellectual Property:** While identifiable intellectual property like patents and trademarks are valued separately, the broader value of a company's intellectual capital, including unpatented technology, proprietary processes, and trade secrets, can contribute to goodwill.
5. **Market Position and Competitive Advantage:** A strong position in the market, such as having a dominant market share, favorable supplier relationships, or a unique business model, can be a source of goodwill.
6. **Synergies and Future Growth Potential:** The expected synergies from combining the acquired company with the acquirer, such as cost savings, increased market reach, and potential for future growth, also contribute to goodwill.
7. **Licenses, Permits, and Regulatory Approvals:** Hard-to-obtain licenses or regulatory approvals that a business possesses can be factored into goodwill, as they can provide a competitive edge.
8. **Location and Demographics:** A favorable business location and the demographics of the area served can also be a part of goodwill, especially for businesses like retail or restaurants where location is crucial.

Ok, so… if you've got a lot of experience and connections and you can really make this business pop, let's say that you've got $1m in goodwill. Let's look at how that moves the numbers:

The value of my company	
DCF analysis	$ 2,314,220.94
The value of my real stuff	$ 44,350.10
The value of my intangibles	$ 1,000,000.00
My total liabilities	$ 550,344.23
The value of my Goodwill	$ 1,820,215.07

We've increased the intangibles from the previous list and now Goodwill is $1.8m. If you're confused, that is normal. If you're not confused then you're too willing to fudge the numbers and need to spend a lot more time with a CPA, a tax attorney, and your therapist.

Here is the basic way to look at it: If you're calculating Goodwill for selling a company or for understanding the numbers of a public company, it's the value that someone would pay in excess of the actual market value of the company. You may ask yourself, why would anyone pay above the market price for a company? There are many good reasons to do that. The least of which is how much the purchasing company could grow your sales with their supply chain and manufacturing resources.

Imagine if they could take your brand equity and products and integrate them into their sophisticated global supply chain and manufacturing machine. They would take your business to levels that you never could have done on your own. They want that expansion. They want those profits. They will pay in excess of fair market value for your company if they have a chance at serious money. This is also why you need to read my products and branding book so that you know how to create this value so that you can sell your company for above fair market value.

There are other reasons like, will taking you out of the market result in significantly higher profits for themselves? If they have larger margins and you're the only one beating them on price, each customer they take from you isn't worth the same $1 in profit you made from those sales, it's worth $1.50 to them because they are bigger and more efficient than you were. They will pay up to 50% more than market value for the potential of increased sales for them now and to remove the threat of the #2 player while you're still affordable. Honestly, there are many reasons why a company would pay more than fair market value for your company.

If you're an investor and you're staring at that Goodwill number on a public company's Balance Sheet during an earnings call and nobody is addressing it, ask them what's included in that number and if it has gone up or down over the past quarter and what contributed to the movement. If they get defensive, walk away. Frankly, if you, them, or anyone has a reasonably standard method to understanding intrinsic value, then go with it. It's the same principle as our own currency: it's worth that much because we all agree it's worth that much.

That was a lot of talk about intrinsic values. Nearly everyone I've met in business agrees that intrinsic values are a WAG. The formulas for determining the intrinsic values are the best we can come up with. In my opinion, if your company is in high demand, then your intrinsic values are higher. If your company is in low demand, then you're hoping your intrinsic items have some value. Otherwise, your shareholder equity is about to take a dive. Remember how those are connected? Assets = Liabilities + Equity. Your intrinsics are in your Assets. If your liabilities go up and your assets don't, you could be looking at diminishing shareholder equity. My advice: grow at a reasonable pace, don't over-extend yourself, keep as much money in the bank as possible, and keep your intrinsics low. You'll get a lot more respect from CPA's, tax attorneys, and potential buyers/investors if you have low and easily explainable intrinsics. The rest of the numbers come from bank statements and your P&L. If it's all in the same workbook, you'll have them linked and automated in no time.

Chapter 2: Balance Sheets:

What to be cautious of when reading a Balance Sheet

I've covered a lot of the reasons why numbers move on your balance sheet, how they are connected, and what happens if one area goes up and another area doesn't. Now, let's talk about what to scrutinize on a Balance Sheet and what could be gamed.

Starting with Assets, it's basic where the current assets come from: account balances. If you put in something other than reality, you risk committing fraud. That will lose the deal and give you a lot of problems. Always state the real numbers. They're plain as day and any buyer would be able to validate those in 5 minutes. Accounts Receivable (AR) is what invoices are issued and customers haven't paid yet. You could also have Promissory Notes in that section and a few other items but there are numbers on those items that will turn up at some point, so just put the real numbers down. The inventory is the MSRP of the item. In this case, you can count all the inventory at the non-discounted MSRP, even if you often must run sales to clear it all out. You can count the quantity of your inventory X the MSRP.

Prepaid things like marketing and legal fees are what they are. There will be a digital trail of those payments. There isn't much wiggle room there. Getting into non-current assets like office furniture, property, plant, & equipment, you can depreciate some of it and take the losses if you want to offset some taxable income or you can claim them at higher values (7-year depreciation instead of a 5-year accelerated). If you're going to claim them at higher values, I recommend having them appraised by a credible service and keeping your CPA and tax attorney informed of your desires. They can provide the guidelines for these methods. If you're in an industry that uses a lot of automation or heavy machinery, be sure to discuss your strategy with the professionals (i.e. CPA and Tax Attorney). These items can impact the balance sheet considerably but anything like that needs to be done according to GAAP.

We've hashed out the intrinsics. No need to go deep into what might be going on here. If it sounds a bit high, ask about it. If you're recording your own intrinsics a bit high, be ready to explain your method of evaluating them. It would be tough to explain why the brand equity of your landscaping business is $2m if you're making $4k a month mowing lawns.

Other than checking receipts and bank statements, it's easy to validate assets in a Balance Sheet. Liabilities are even more straightforward. There will be balances on credit cards, loans, and leases.

Either you're the business owner and you know them, or you can ask for copies of them for companies you're thinking about investing in. Either way, the numbers are the numbers. If the business owner delays or makes excuses as to why those statements aren't available, be suspicious. Don't move until the liabilities are validated. They could be a lot more than what they're reporting! Equity is dynamic. The main figure in this space is the Net Operating Income that comes right from the P&L statement. Liabilities, which we easily validate, plus equity, plus Net Operating Income must be equal to Assets. The best way to make sure this is always the case is to make Owner's Equity a function. It adjusts as the other numbers change.

If this is a public company, that regular fluctuation is what causes the daily stock price to go up and down. If sales increased tomorrow and Assets went up (bank balance) and liabilities stayed the same, then your equity is headed up! Divide that equity by the number of shares they have on the market and that is your share price. If they must pay rent tomorrow and their bank account takes a hit and there is no increase in sales, then your equity is headed South. Divide the new equity value by the number of shares they have on the market and that's your new stock price. This is an over-simplification of what influences actual stock price, but it is a top-level view of how Assets and Liabilities directly impact share price. If that company is being crushed because they took out way too much debt at high interest rates, then you know that when it's time to pay the piper, and they haven't increased sales like they had hoped, equity is going to drop. Time to sell before it turns.

Armed with this kind of understanding, it might be interesting to pull some of the financial documents from public companies, plug them into a spreadsheet, and take a look at how much Goodwill Apple has or what Amazon's CoGS are. How much is Tesla spending on travel & entertainment? What companies run tight expenses and who is inflated and over-spending? If you're looking for a fun job, go work in sales for a company that is way over-spending on meals & entertainment! If you're looking to make some decent money on the stock market, use sophisticated trading platforms that have real-time access to public company's financials and sort by Gross Margin, cash in the bank, and Leverage (debt to equity ratio). See if you can find some stocks that have a hockey stick for sales but haven't had an earnings call yet. Watch what happens to their stock when the market opens the next day. These are all the things that any investor could figure out, if they just knew what to look for. May do. Most don't.

I should remind you that investing is risky, and I'm not giving you a secret sauce to trading. I'm literally explaining what financial experts do every day. There are thousands of people out there who know, in their bones, what EBIT means and when a company is in financial distress. Often, the fundamentals (which means the information gleaned from the company financials) are not the driving force of stock price movement. There is irrational exuberance on the part of investors, large pension funds pulling the price up or down, and plenty of other market trends that add to the volatility of stock performance. For the most part, the value of a stock, at any current time, is taking everything into account to include the rumors about their newest product, the massive debt that is sitting in their liabilities, and the thread on Reddit that is driving Robbinhood investment to their ticker: it's all baked into the cake. My advice is to look for healthy companies that have large gross margins, cash in the bank, and spend plenty on Quality and R&D. Look for stocks that grow steadily and spread your money across multiple industries. If you're new to investing, there is a book called Seeking Alpha that lays out all the various investment vehicles and the probability of winning with each one. Spoiler alert: the book ends with a recommendation to just find a good money manager, that invests their own money along with yours, and let them handle your investments.

Read the financials, know your financials, go slow, save money, improve efficiencies, that's it for diligence. Let's get into determining the value of your SME.

Chapter 4: Discounted Cash Flow analysis:

What do the sections mean and what do they tell you about the company?

Let's start this one the same way we've started the others, by looking at a DCF and understanding the numbers. Again, there are going to be a few places to focus your attention.

The DCF I'm going to use is a free downloadable template. I got it so long ago, I forget where I got it, but it was good looking and the math worked, so I've been using it for a while. The important part is for us to understand the numbers, why they are what they are, where we got them from, and why they make sense.

Let's start with the basic equation of a DCF analysis:

$\mathbf{DCF}$ = discounted cash flow
CF_i = cash flow period i
r = interest rate
n = time in years before the future cash flow occurs

$$\mathbf{DCF} = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \cdots + \frac{CF_n}{(1+r)^n}$$

Let's break this down. The DCF is the value of your company. That is the sum of the free cash flows for the next number of years. In general, people use a 5-year DCF. This means the value of your company is the free cash it will return to your pocket over the next five years. There are some things to think about here:

1. Is 5 years a reasonable amount of time to make back the purchase price of the company and then enjoy profits from that time forward? Should it be shorter? Longer?
2. What interest rate should you discount these future cash-flows by? This means, how risky is it that you won't hit those projections?

These are the basic arguments for or against a valuation based on a Discounted Cash Flow analysis. Let's look first at the period of the valuation. For some industries like car manufacturing and steel mills, the industry is old and established. The demand is known. The margins are obvious. Nearly anyone can be trained to work on the production line. This is a very stable and secure industry. The DCF for an industry like these could be 10 years. The purchasing company should reasonably be comfortable with the idea that it will take 10 years to recuperate the purchase price of that company before they can reasonably be expected to start booking profits of their own. Large and stable industries like this can also use the Risk-Free Rate of Return as their "r" or "discount rate". Here it is referred to as "Interest rate". Let me first define what this value is and where to find it.

The Interest Rate is a judgement call. For established companies in established industries, it is the 3-month Treasury Bill rate of return. Currently, that rate is sitting at 5.39%. Consider if you bought a 3-month US Treasury Bill; It will pay out 3% interest in only 3 months and it's backed by the US Government. The people who control inflation and interest rates. The risk that you will lose your money on a 3-month US Treasury Bill is remarkably low. This is considered "Risk-Free". That is the rate at which you will discount your cash flows by.

Now, what does "Discount your cash flows" mean? It means that future cash flows are worth less today due to risk. If I asked you if you would like $10 today or $15 in 30 days, you would likely take the $10 today. Perhaps you could do more with $10 in 30-days than wait for an additional $5. This is known as the present value of money. The amount is less today but it is in your hand right now. A cash flow of $1m in 5 years may only be worth $650k today. The discount rate goes up depending on how volatile your industry is, how new your company is, and the likelihood of your sales following a reasonably predictable growth pattern.

How do you calculate these discounted cash flows? It's simple: Divide the anticipated cash flow for that year by 1 + your interest rate to-the-power-of the number of years it is from today. Let's look at a simplistic example of this idea:

Growth Rate	25.0%					
Discount Rate	5.0%					
Years	**Today**	**1**	**2**	**3**	**4**	**5**
Projected Cash Flows	$ -	$100,000.00	$125,000.00	$156,250.00	$195,312.50	$244,140.63
Discounted Cash Flows	$ -	$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$191,290.57
Total of the Cash Flows	**$ 695,566.05**					

As you can see, today we have zero dollars, but we expect to make $100k after all CoGS and Expenses (Free Cash Flows = FCF's) in the first year. We anticipate that the FCF will increase by 25% YoY for at least the next 5 years.

I should make a note here that Free Cash Flows are often just your Earnings Before Interest & Taxes (EBIT) from your P&L Statement. To find this figure add back your Interest and Taxes Paid to your Net Income at the bottom. This will be your EBIT or FCF number.

Continuing… Now, I discount those FCF's to today by dividing by (1+r)^year. So, 1 + 5% = 105%. 105%^1 still equals 105%. 100k/105% = $95,238.10.

In year 2, the FCF looks like this: $125,000 is a 25% growth from the previous year. We will divide that by our new discount rate (1+r)^year. 1 + 5% = 105%. 105%^2 = 110.3%. Now divide the new FCF of $125k by the new discount rate of 110.3% = $113,378.68.

Continue this method for 5 years. The math is broken down in the example below.

Growth Rate	25.0%					
Discount Rate	5.0%					
Years	**Today**	**1**	**2**	**3**	**4**	**5**
Projected Cash Flows	$ -	$100,000.00	$125,000.00	$156,250.00	$195,312.50	$244,140.63
Discounted Cash Flows	$ -	$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$191,290.57
Total of the Cash Flows	**$ 695,566.05**					
	Rate	105.0%	105.0%	105.0%	105.0%	105.0%
	Exponent	105.0%	110.3%	115.8%	121.6%	127.6%
		$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$191,290.57
Total of the Discounted Cash Flows	**$ 695,566.05**					

This is just the basic principle of discounted cash flows. Let's add the other parts.

Well, we must start somewhere, and somewhere usually has some debts on the books. So, in order to get the true value of a company, you must subtract any current debts from the DCF. If my balance sheet shows $387,379 in total liabilities, then that's my debt. It would make sense to start another tab in that company workbook for the DCF and just link the numbers from your P&L and Balance sheet into this math so that you can have a running value of your company. EBIT is from your P&L. Just add Interest and Taxes back to your Net Income at the bottom as mentioned before. Total Debt is from your balance sheet represented as your total liabilities. Your current share price is your owner's equity divided by the total number of shares you have in your company. Usually, the Operating agreement outlines 100k or 1m shares. It's up to you. You could have 1,000 shares. It's just going to make the shares cost more. It's not going to change the value of the company. You will still be dividing the Owner's Equity from your Balance Sheet by some number of stocks. Adding up all the stock is just going to equal the Owner's Equity.

In this formula, "Cash" is the Current Assets from your Balance Sheet and "Capex" is usually your PP&E from your balance sheet, but it could include more items like security deposits on leases, office furniture, and other costs. It's supposed to represent the retained value in trucks, forklifts, automation machines, the production facility, and real property + office furniture and other physical things that have value. Just add them up from your P&L and Balance Sheet and link them into this tab. The goal is to make most of these numbers auto-adjust from your monthly uploads of transactions from your bank and CC.

Lastly is Depreciation (the YoY loss in the value of machines & equipment) & Amortization (The amount you have paid back on loans). It's on your P&L. Plug that into the D&A spot on your DCF. If you know the depreciation schedule, usually 7-year flat but could be 5-year accelerated, and you know the amortization schedule for your loan, how much you will pay back for how long until it's paid off, you can calculate the D&A for as many years out as you like.

Capex is your capital expenses as outlined above. Something to keep in mind is that if you're buying a lot of machines in the first year, it's going to be high as compared to the next few years. If you think you might buy a machine or 2, each following year, then use your best estimation as to what those costs are going to be in each year going forward. They should come with a marked improvement in production & sales or maybe put off buying them if they're not necessary. The first year's Capex is your PP&E and other big physical items as described above.

It's difficult to estimate changes in Net Working Capital (NWC), which is your Liquidity or Current Assets – Current Liabilities. To know this, you will need a Balance Sheet completed for a specific date each year, usually on 1-JAN of each year. That will show the differences over time in NWC. In many cases, that number is just left blank. This means that you're trying to always maintain a constant cash balance in your accounts. It might be a little high one year and a little low the next, but outside of any significant sales or purchases, changes in NWC could be very minor.

If you're not over-leveraged (too much debt) and you have access to debt, like a Line of Credit, you can supplement any highs and lows in your NWC with a Line of Credit or short-term loans to maintain liquidity.

Now you can begin to see how your FCF's are anticipated over the next 5 years. This brings us to the big one, the exit multiplier. Every industry has a different exit multiplier, but the idea is: what do you multiply the discounted FCF in year 5 by in order for you to happily sell your company and exit the industry. In my equation, I also calculate the constant growth of the company = how much will your company grow YoY if you were to run it for eternity. This value is usually between 2% to 3% per year. I then average the 5-year DCF + the exit multiplier and the value of the company if I ran it for eternity. This helps paint the picture of what the acquiring company can reasonably expect from this company if they were to run it as good or better than I can.

Below, I have added the Rate and Exponent rows so that you can see how the discount rate is applied each year and what the increasing exponent (based on each sequential year) does to reduce the value of each year's expected Free Cash Flows. If you look at year 5, you can see that the FCF is anticipated to be $244,140.63 and it has been reduced to a value of $191,290.57.

It then adds all the discounted cash flows together and subtracts all current liabilities. This example does not have any cash in the bank being added to this figure. The next step will be to add in the exit multiplier. Take this process step at a time, to understand what each step is doing and where the numbers are coming from.

Growth Rate	25.0%					
Discount Rate	5.0%					
Years	**Today**	**1**	**2**	**3**	**4**	**5**
Projected Cash Flows	$ -	$100,000.00	$125,000.00	$156,250.00	$195,312.50	$244,140.63
Discounted Cash Flows	$ -	$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$191,290.57
Total of the Cash Flows	**$ 695,566.05**					
	Rate	105.0%	105.0%	105.0%	105.0%	105.0%
	Exponent	105.0%	110.3%	115.8%	121.6%	127.6%
		$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$191,290.57
Total of the Discounted Cash Flows	**$ 695,566.05**					
Total Liabilities	**$ 387,378.93**					
Valuation without exit multiple	**$ 308,187.12**					

If we simply used the Discounted FCF model above and subtracted out current debt, the company would only be worth $308k! I'm projecting that I will make $695k in cash over the next 5 years while paying myself handsomely. Why would I give up this cash generating machine for $308k?? This is where the exit multiplier comes in. What makes it worth it? Well, in many industries, an exit multiple of 7 is standard. If someone else wants to pay themselves handsomely and put $695k in their bank over the next 5 years, they will need to pay the "Make me move" rate of 7x the last year of your DCF. Let's add in that multiplier and see how it changes the valuation of the company.

Growth Rate	25.0%					
Discount Rate	5.0%					
Exit multiplier	7.0					
Years	**Today**	**1**	**2**	**3**	**4**	**5**
Projected Cash Flows	$ -	$100,000.00	$125,000.00	$156,250.00	$195,312.50	$ 244,140.63
Discounted Cash Flows	$ -	$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$ 191,290.57
Total of the Cash Flows	**$ 695,566.05**					
	Rate	105.0%	105.0%	105.0%	105.0%	105.0%
	Exponent	105.0%	110.3%	115.8%	121.6%	127.6%
		$ 95,238.10	$113,378.68	$134,974.62	$160,684.08	$ 191,290.57
Total of the Discounted Cash Flows	**$ 695,566.05**					
Total Liabilities	**$ 387,378.93**				**Exit Multiple**	**$ 1,339,033.98**
Valuation without exit multiple	**$ 308,187.12**					
Valuation with exit multiple	**$ 1,647,221.10**					

With the exit multiple, now you're selling your company for $1.6m. If you put that in a 5% Payout annuity, you will make $82k for the rest of your life and the principal will always grow. If you put that annuity into a holding company that is owned by a living trust with legacy provisions, then your kids, their kids, and all the future generations will make at least that much every year as the principal grows to eternity. I talk all about that in the business structures book. That legacy is probably worth selling your company for $1.6m today. The exit multiplier makes selling your company compelling.

There are a few more figures and ideas in this DCF. Let's look at how to determine the Intrinsic value (Objective value of the company). To find this value, take the sum of your discounted cash flows + the value of the exit multiplier, shown below on the (Entry/Exit) line as $3.3m = your "DCF Enterprise Value" add any cash you have in the bank to this number (Balance Sheet) subtract all of your debts (Balance Sheet, Total Liabilities) and you get an Equity value of $3m. Divide that by the number of shares outstanding and you get a new share price of $30.97 per share. What this is showing is the "Upside" potential if your company actually grows along the 15% YoY growth rate and is worth a 5x exit multiplier of your 5th year Discounted Cash Flow. Stock traders will use this equation to find undervalued stocks. Using a DCF with conservative numbers, a reasonable exit multiplier, adding your current assets and subtracting all your liabilities is one of the most common ways to determine the value of a Small to Midsize Enterprise. It will be how you determine the value of your company. Now that you understand the numbers and where they come from, be sure to use the "=" to link as much data in your DCF tab to your Balance Sheet, P&L, and General Ledger. Check the math frequently and walk through the numbers and linked data in your head to "sanity check" your DCF whenever you use or present it.

Look at the full DCF below. Notice things like the tax rate, discount rate (Current 3-month Treasury Bill rate: is that accurate for a new company? Volatile industry?), the perpetual YoY anticipated growth rate until the end of time (Is that realistic? Should it be a lot more? Less?), the 5x exit multiplier, the number of shares outstanding and how that equals $0.77 from dividing the Owner's Equity from our Balance Sheet by the 100,000 shares in the company, the debt, cash, and Capex numbers. Do you understand it all? Do you know where those numbers came from? Do you feel the numbers are reasonable and accurate? Is this company that is $387k in debt today and only $123k in the bank worth $3m in cash?

Again, pop back and forth between the questions above and the DCF below until you feel that you know and understand the questions. Once you're comfortable with the first part, then start looking at the YoY D&A and Capex. Are summary numbers ok? Do you want the seller to be more precise? Does it really have a big impact on the value of the company?

If you're looking to buy a company, what parts of this DCF would be most important to you? If this DCF were handed to you along with the P&L and Balance sheet of a company, what kinds of questions would you dig into? Would you agree with the assessment? Would you just give it 3 months until they're running low on cash and in financial distress then offer them half of this DCF? Would you risk their sales taking off and paying double for the company in 6 months or simply missing out on the opportunity?

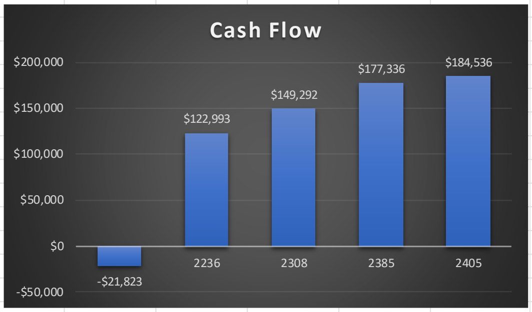
What if you were the business owner? Would you sell this company? What would compel you to sell it or keep it? In most cases, there are no wrong answers. Many investors and business owners will use this tool differently. Some will say that any business is risky and increase the discount rate to over 20%. Some will see opportunity in how fast the inventory is moving and pay a lot in Goodwill to make the machine theirs. Nobody can predict what will happen next year or even next month. Past performance is not an indicator of future performance. These tools exist to help you understand a company. They are not here to make any guarantees.

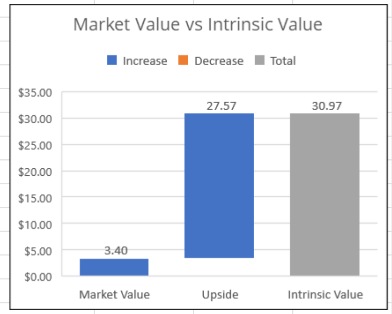
Take your time. There is no rush. Look at each number. Think about what the fundamental purpose of that number is, what it represents, what happens if it goes up or down, what factors could make it go up or down, is it a reasonable number, is it a WAG, and try to listen to your instincts about if a number doesn't feel right to you. Your brain can comprehend faster than you can calculate. If you get a gut feeling about something, walk it out. It could be the hidden business guru in your brain cautioning you to move slowly.

If you learn these numbers well, my hope is that you will be able to recognize when someone is trying to conceal something, hustle you into a deal, or hide the actual health of a company. This will help you with your investment decisions as well as operate your own companies. When used properly, financial analysis will tell you when to enter or exit an investment position, predict changing market trends, and hopefully give you the edge you need to beat the statistics and become the next successful company in your sector. Below is a DCF. The questions are above. You know the routine. Take your time.

DCF Model

Assumptions	
Tax Rate	24%
Discount Rate	5.4%
Perpetural Growth Rate	2.2%
Growth Rate for DCF	15%
EV/EBITDA Mulltiple	5.0x
Transaction Date	12/9/2023
Fiscal Year End	12/31/2023
Current Price	0.77
Shares Outstanding	100,000
Debt	387,379
Cash	123,922
Capex	169,167





Discounted Cash Flow	Entry	2024	2025	2026	2027	2028	Exit
Date	*12/9/2023*	*6/30/2024*	*6/30/2025*	*6/30/2026*	*6/30/2027*	*6/30/2028*	*6/30/2028*
Time Periods		*1*	*2*	*3*	*4*	*5*	
Year Fraction		*0.56*	*1.00*	*1.00*	*1.00*	*1.00*	
EBIT		139,580	160,517	184,595	212,284	244,127	
Less: Cash Taxes		33,499	38,524	44,303	50,948	58,590	
Plus: D&A		24,000	24,000	24,000	24,000	24,000	
Less: Capex		169,167	23,000	15,000	8,000	25,000	
Less: Changes in NWC		-	-	-	-	-	
Unlevered FCF		(39,086)	122,993	149,292	177,336	184,536	
(Entry)/Exit	(340,387)						3,617,128
Transaction CF	-	(21,823)	122,993	149,292	177,336	184,536	3,617,128
Transaction CF	(340,387)	(21,823)	122,993	149,292	177,336	184,536	3,617,128

Terminal Value		
Perpetural Growth Value		5,893,623
EV/EBITDA	**Exit Value**	1,340,633
Average		3,617,128

Rate of Return	
Target Price Upside	810%
Internal Rate of Return (IRR)	81%

Intrinsic Value	
DCF Enterprise Value	3,360,449
Plus: Cash	123,922
Less: Debt	387,379
Equity Value	3,096,992
Equity Value/Share	30.97

Market Value	
Market Cap	76,930
Plus: Debt	387,379
Less: Cash	123,922
Enterprise Value	340,387
Equity Value/Share	3.40

Market Value vs Intrinsic Value	
Market Value	3.40
Upside	27.57
Intrinsic Value	30.97

Chapter 4: DCF

Where do the numbers come from?

You've got nearly all the functions of a DCF. There are still a few items to break down, so let's get this one wrapped up and move on to becoming a bookkeeping ninja and more general ideas of applying these fundamentals to running your business or improving your investment decisions.

The first item I would like to point out, that was touched on in the previous chapter, is the intrinsic value of the company. The intrinsic value (objective/true value) of the company is made up of a lot of things:

1. **Financial Performance:** This includes analysis of the company's balance sheet, income statement, and cash flow statement. Key metrics like revenue, profits, cash flow, and growth rates are crucial.
2. **Assets and Liabilities:** The company's tangible and intangible assets, as well as its liabilities, are assessed to determine their contribution to the overall value.

3. **Business Model and Competitive Advantage:** The sustainability and strength of the company's business model, its position in the industry, and its competitive advantages (or moats) are important considerations.
4. **Management Quality:** The effectiveness and track record of the company's management team can significantly impact on its intrinsic value.
5. **Growth Prospects:** The potential for future growth, expansion opportunities, and industry trends are factored into the intrinsic value.
6. **Discounted Cash Flow (DCF) Analysis:** One common method to estimate intrinsic value is the DCF analysis, which involves forecasting the company's free cash flows and discounting them back to their present value, using a discount rate that reflects the risk of the investment.
7. **Market Conditions and Economic Factors:** Broader market and economic conditions can also influence intrinsic value, as they can impact the company's future performance.

The first thing that is probably popping in your mind right now is, "Aren't 90%+ of these covered in the P&L, Balance Sheet, and DCF?". Yes! They are! Financial Performance is literally the P&L. It can tell you tons about the competitive nature of the industry by the Gross Margins. It can tell you about how disciplined the company is in the Expenses. However, you need some experience to know what items to divide to find what ratios, if those ratios are high or low, and what a high or low ratio means. Does it mean the industry is getting tougher? Does it mean the management is careless with their expenses?

Assets & Liabilities are laid out in the Balance Sheet, and we've gone at length about understanding the value of intangibles.

For the most part, the business model and any competitive advantage is "Baked into the Cake" in your financials. The Management quality can be measured by EBIT. Growth prospects are summarized in your DCF YoY growth projections. A DCF could be conservative or ambitions. Market Conditions and Economic Factors are difficult to predict. Will a war or a natural disaster impact your business? Will they increase your business?

There are many things both inside and outside of your control that determine the value of your company. These are the places you'll find them. If you've been keeping a company ledger and auto populating the fields in your P&L and Balance sheet, then feeding those ratios and values into your DCF, you're head and shoulders ahead of 80%+ of all small business in America.

Any missing information can easily be understood and found with today's tools like ChatGPT and BARD. Do you need to change the Risk-Free Rate of Return? Check the 3-Month Treasury Bill rate and update it. Are market conditions impacting your projected YoY growth rate? Have a system for determining that, use the same method consistently, and put it in the DCF tab of your company workbook.

Just to wrap up this section, the Market value of your company is your owner's equity (Owner's Equity from the Balance Sheet divided by the 100k shares in the company = $0.77 per share or

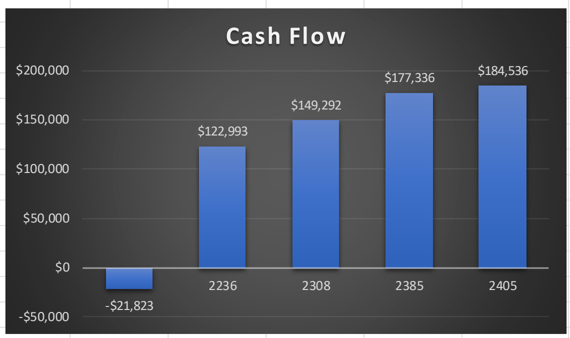
$76,930) + debts (Total Liabilities from the Balance Sheet) – Cash (Cash & Cash Equivalents from the Balance Sheet) = the Total Enterprise Value of $340,387. Divide that value by the 100k shares in the company and you get $3.40 per share. That is the current Market Value of the company.

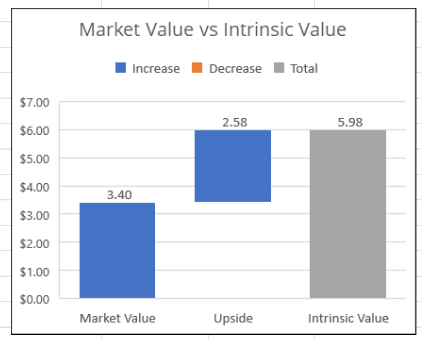
The Intrinsic value of the company is based on if the next 5 years will look like this model. If you believe that your projections are accurate, and you agree with the exit multiplier, then add the cash back in, subtract the debts, and you get $3m or $30.97 per share. If the market value is $3.40 per share and the Intrinsic value is $30.97 per share, then the "Upside Potential" is $27.57 per share. Those numbers can be followed along in the previous DCF graphic. In the next one, we will try a "what if" scenario.

Let's look at what happens if we adjust the discount to a volatile industry and a start-up company (under 2 years old). Conservatively, let's boost this discount rate up to 20%.

DCF Model

Assumptions	
Tax Rate	24%
Discount Rate	20.0%
Perpetural Growth Rate	2.2%
5yr DCF YoY Growth Rate	15%
EV/EBITDA Mulltiple	5.0x
Transaction Date	12/9/2023
Fiscal Year End	12/31/2023
Current Price	0.77
Shares Outstanding	100,000
Debt	387,379
Cash	123,922
Capex	169,167





Discounted Cash Flow	Entry	2024	2025	2026	2027	2028	Exit
Date	*12/9/2023*	*6/30/2024*	*6/30/2025*	*6/30/2026*	*6/30/2027*	*6/30/2028*	*6/30/2028*
Time Periods		*1*	*2*	*3*	*4*	*5*	
Year Fraction		*0.56*	*1.00*	*1.00*	*1.00*	*1.00*	
EBIT		139,580	160,517	184,595	212,284	244,127	
Less: Cash Taxes		33,499	38,524	44,303	50,948	58,590	
Plus: D&A		24,000	24,000	24,000	24,000	24,000	
Less: Capex		169,167	23,000	15,000	8,000	25,000	
Less: Changes in NWC		-	-	-	-	-	
Unlevered FCF		(39,086)	122,993	149,292	177,336	184,536	
(Entry)/Exit	(340,387)						1,200,080
Transaction CF	-	(21,823)	122,993	149,292	177,336	184,536	1,200,080
Transaction CF	(340,387)	(21,823)	122,993	149,292	177,336	184,536	1,200,080

Terminal Value		
Perpetural Growth Value		1,059,528
EV/EBITDA	**Exit Value**	1,340,633
Average		1,200,080

Intrinsic Value	
DCF Enterprise Value	861,913
Plus: Cash	123,922
Less: Debt	387,379
Equity Value	598,455
Equity Value/Share	5.98

Market Value	
Market Cap	76,930
Plus: Debt	387,379
Less: Cash	123,922
Enterprise Value	340,387
Equity Value/Share	3.40

Rate of Return	
Target Price Upside	76%
Internal Rate of Return (IRR)	52%

Market Value vs Intrinsic Value	
Market Value	3.40
Upside	2.58
Intrinsic Value	5.98

The risk inherent in a volatile industry and the risk of investing in a start-up company has reduced the sale price of this company to $598k from $3m, significantly shrinking the upside potential. This is a more realistic view of how an SME would be valued. This is a major change in what you could sell the company for, and many shrewd and experienced investors will take this approach.

Build your own DCF from what you have learned in this chapter. Get the numbers from your Balance Sheet and your P&L. Adjust the assumptions to what you believe are reasonable for your industry and how long you've been in business.

The last part I want to discuss in this chapter is how to use a DCF if you're 10 years old, 4 years old, or zero years old. The same principles are applied but the risk goes way up, reducing the value like in the example above. Conversely, if you've been operating for 10 years, you don't need to use 5 years of projected sales, you can use the past 3 years of actual sales and 2 years of anticipated sales that follow the curve of your historical growth. If you have those numbers to use, your DCF valuation is a lot more compelling! You can lower your risk factor significantly with a few years of growth and sales behind you. In fact, your risk factor, measured by your discount rate, should be at 5% or less if you've shown consistent YoY growth and have been very responsible with your expenses.

If you're brand new and trying to use a DCF based on only future performance, then your risk factor could be as high as 30% to 35%. If you're that new and trying to find investment, investors are going to be looking at other things like what your product is, what is the market size, how efficient are your at producing your product, do you have any sales and marketing experience, what is your plan to get sales, and more business comprehension questions. It's tough to show the value of a new company with only projections but combined with a good business plan, sales and marketing resources, a solid board of advisors from the industry you're in, and a dazzling pitch deck, you've got a really good chance at securing the capital you need to exceed your goals.

Chapter 4: DCF:

What to be cautious of when reading a DCF

Growth Rate	15.0%					
Discount Rate	25.0%					
Exit multiplier	5.0					
Years	**Today**	**1**	**2**	**3**	**4**	**5**
Projected Cash Flows	$ -	$ 50,000.00	$ 57,500.00	$ 66,125.00	$ 76,043.75	$ 87,450.31
Discounted Cash Flows	$ -	$ 40,000.00	$ 36,800.00	$ 33,856.00	$ 31,147.52	$ 28,655.72
Total of the Cash Flows	**$ 170,459.24**					
	Rate	125.0%	125.0%	125.0%	125.0%	125.0%
	Exponent	125.0%	156.3%	195.3%	244.1%	305.2%
		$ 40,000.00	$ 36,800.00	$ 33,856.00	$ 31,147.52	$ 28,655.72
Total of the Discounted Cash Flows	**$ 170,459.24**					
Total Liabilities	**$ 150,000.00**				**Exit Multiple**	**$ 143,278.59**
Valuation without exit multiple	**$ 20,459.24**					
Valuation with exit multiple	**$ 163,737.83**					

The first thing I am looking for is the discount rate and if it is appropriate for the industry and maturity of the company. In this example, the discount rate is 25%, which is very high. What that says is that there is a lot of risk that the future cash flows will not be met. In year 5, you've stated that you are expecting $87k of FCF's but the 25% compounded discount rate says that cash flow is only worth $28k today! That's only 33% of the projected free cash flow!

If you are using an exit multiplier of 5x the last year's FCF and you're anticipating investing $150k to build this business, the sale value of this business is only $13k above your investment. I would not advise selling at this time. You will need a few months, if not a few years, to hit the gas on sales, reinvest the profits into more marketing and inventory, and work on reducing that discount rate with a couple of years of profitable operation under your belt. Let's see what that might look like:

Growth Rate	25.0%					
Discount Rate	15.0%					
Exit multiplier	7.0					
Years	**Today**	**1**	**2**	**3**	**4**	**5**
Projected Cash Flows	$ -	$ 75,000.00	$ 93,750.00	$117,187.50	$146,484.38	$ 183,105.47
Discounted Cash Flows	$ -	$ 65,217.39	$ 70,888.47	$ 77,052.68	$ 83,752.92	$ 91,035.78
Total of the Cash Flows	**$ 387,947.24**					
	Rate	115.0%	115.0%	115.0%	115.0%	115.0%
	Exponent	115.0%	132.3%	152.1%	174.9%	201.1%
		$ 65,217.39	$ 70,888.47	$ 77,052.68	$ 83,752.92	$ 91,035.78
Total of the Discounted Cash Flows	**$ 387,947.24**					
Total Liabilities	**$ 150,000.00**				**Exit Multiple**	**$ 637,250.45**
Valuation without exit multiple	**$ 237,947.24**					
Valuation with exit multiple	**$ 875,197.69**					

In the above example, you ran your business for one year and you exceeded your 1-year FCF goal of $50k. In fact, it was a good year and you booked $75k in free cash! This has reduced your perceived risk from a discount rate of 25% to 15%. This growth has also convinced you that you can achieve 25% YoY sales and you're able to pay yourself a decent wage, which reduces your desire to exit the industry. This will increase your exit multiplier because you've got a good thing going and anyone who buys it will have a good thing. That's worth something!

In this example, you stayed inside of your budget and only spent $150k. Your new valuation is $875k and significantly up from last year's valuation of only $163k. Now, let's look at what happens if you clear the 2-year mark with continued growth.

Growth Rate	30.0%					
Discount Rate	8.5%					
Exit multiplier	7.0					
Years	Today	1	2	3	4	5
Projected Cash Flows	$ -	$ 75,000.00	$125,000.00	$162,500.00	$211,250.00	$ 274,625.00
Discounted Cash Flows	$ -	$ 69,124.42	$106,181.91	$127,222.57	$152,432.57	$ 182,638.10
Total of the Cash Flows	**$ 637,599.57**					
	Rate	108.5%	108.5%	108.5%	108.5%	108.5%
	Exponent	108.5%	117.7%	127.7%	138.6%	150.4%
		$ 69,124.42	$106,181.91	$127,222.57	$152,432.57	$ 182,638.10
Total of the Discounted Cash Flows	**$ 637,599.57**					
Total Liabilities	**$ 250,000.00**				**Exit Multiple**	**$ 1,278,466.70**
Valuation without exit multiple	**$ 387,599.57**					
Valuation with exit multiple	**$ 1,666,066.26**					

In this example, you've booked $125k of above-board profits in your second year! This reduces the risk factor of your company to ~8%, increases your YoY growth projections, but you had to spend another $100k to get there. However, the confidence built from running your business for 1 more year has increased the basic DCF value of your company to $1.6m. It's a 10x gain in only 2 years! This should be a good example of how investing in yourself is the best investment you can make.

Now that you know how to build and track your own DCF, what the numbers mean, where they come from, and how time can lower risk, improve growth projections, and build confidence in your business, you should also have a good idea of how people can fudge these numbers. They can easily put a too low discount rate in there based on their industry and the age of their company. They could have unreasonable YoY growth expectations. They could have an exit multiplier out of this world! Don't jump on people who have these things backwards, instead just ask them about how they arrived at their numbers. What research did they do? Why do they think it's reasonable? They might have very compelling reasons for these numbers. Maybe they have an exclusive patent or just married into the Kardashian family.

You now know the basic framework of company financials and valuations. You have already begun to think like a businessperson. The phrases in your head about current ratios, gross margins, and EBT is the same language you will hear on Wall St. and in board rooms around the world. In no time at all, you will be regarded as a savvy businessperson. It's up to you to continue your education in these areas so that you can live up to your new title.

Chapter 5: Bookkeeping

Where do I get the information from?

Bookkeeping can be easy. In the modern world, nearly all the work is done for you. Banks and credit cards keep track of your transactions. In most cases, all you need to do is download the transactions in .csv format, paste into Excel, and do a little formatting and organizing maybe twice a month. For small businesses, this should take no longer than 2 hours a month at maximum. It's a lot easier if you do it more frequently and not let it get backed up for 3 or 4 months but even then, you can usually download ranges of transactions and work them into your spreadsheets with minimal effort.

Let's talk about where nearly everyone in small business is right now: using personal credit cards and personal checking accounts. If this is you, it's time to begin healing. Let's pick a point in time, usually beginning from the period of your last tax filing or the first of the most recent month and begin separating your business from your personal life.

Step 1: Create a business entity. In my book about business structures, I will show you how to create a living trust, have that as the sole member of a holding company, and that holding company as the sole member of your operating companies. In order to save time, let's just start with a normal Limited Liability Company (LLC) and get a checking account open. We can build the rest of the business structure later, once you've already read the Business Entities book and are familiar with the how and the why of a multi-layered business structure.

Whatever state you're in, use Google to search for "Start and LLC in [Insert State], .pdf form download" In the first few links, you're going to get a link that opens a .pdf file. The first page or 2 will be instructions of how to fill it out, where to mail it, and how much it will cost. These forms are usually 1-to-2-page forms consisting of extremely basic information like the name of your company and the name and address of the manager (you). Complete the form, include a check, and mail it in.

It usually takes 1 to 2 weeks to get a letter back from your Secretary of State confirming that your business entity has been created. The next step is to go online and register the business for an Employer Identification Number (EIN). This is done online and only takes a few minutes. Now, you will have 2 important numbers: Your Secretary of State entity registration number, that is stamped on your Articles of Incorporation that you get back from the state, and your EIN. I recommend creating a Word document to store all the important numbers that you will need for your business. Keep copies of this file on your computer and perhaps your phone. Keep a printed copy in your company files.

Let's talk about those company files. You're going to need an Operating Agreement for your LLC. There are many templates online that you can modify for your company, or you can just have ChatGPT write you one. Be sure to give it some context for your business, what you're going to be selling, the business address, etc. One of the most important parts of this document is the ownership section, usually at the end. It shows who owns how much of the company. When you open a bank account for this company, you will need to present your Secretary of State filing, your EIN, and your Operating Agreement, so that the bank knows who can use the account. You'll also have to present an ID to show that you are the person listed as the owner in the Operating Agreement.

In some cases, you will need to open a Sales Tax account or specialty tax account with your State Board of Equalization (BoE). This is how you will pay your sales taxes, use taxes, and any specialty excise taxes if you're in an industry that requires them. The easiest way to open a BoE account is to simply call them and have them walk you through setting up your account and logging in for the first time. It usually takes less than 10 minutes.

Now you're ready to go to the bank. If you haven't already done so, start with a little online research about what banks in your area are welcoming to small business. You may be surprised to learn about how different banks are when it comes to supporting small business. Armed with your research, go sit down with the small business representatives at no less than 3 different banks and/or credit unions. Have them pitch their small business program to you. Ask them about assistance as you grow. Will there be access to any lines of credit, loans, or any other services that would make their bank the best choice. Pick one and open a savings account, a checking account, get a debit card, and see if they will give you a business credit card.

While you're there, ask if the bank provides credit card processing services or point of sale machines to help your business grow. These days, most are using SquareUp or Stripe. Both are fine for accepting credit card payments for your business, if accepting payments in person is part of your business. These are the most common ways to receive payment for your products and services and both have apps that easily run on any mobile phone or tablet. Now, you have the financial tools you will need to keep good books, make paying your business easy for your customers, and separate your personal life from your business life.

You will need to fund the account. My suggestion is to save up enough for at least 1 month's business expenses and deposit it into your new business checking account. Begin using the credit card and the debit card for all your business expenses and have your customers start depositing their payments, wires, ACH transfers, credit card transactions, and checks to your new business name. Keep these incomes separate from your personal banking. I also recommend that you create a .pdf file that you can give customers that has your ACH/Wire information on it, the name and address to send a check to, and any other business information that might make paying you easy. Easy payment = prompt payments.

As a minor note: Automated Clearing House (ACH) payments are an internal bank process that can take 24 to 48 hours to process. Wires are backed by the US Treasury and are usually instant. When accepting payment, I prefer wires, credit cards, and then checks, in that order.

From now on, only collect business incomes into that account and only use that account to pay business expenses. If you need to deposit more of your personal cash into the business account to keep it afloat, then do so. The transaction will be recorded in your bank's ledger, and you will download it later for your records.

As a last note, and very important note, take your new business information and your new bank information and go set up a payroll service like ADP or Paylocity. There are a number of these services available, read about the features of each, pick one that has good reviews, doesn't cost much money, and provides you with online access to run your payroll, issue bonuses, and run reports any time you want. It is critical to get you on payroll so that you can take advantage of more tax savings strategies in this book and in my other business books. Through this payroll service, this is how you will get paid from now on. Have it deposit a monthly paycheck into your personal checking account and mail you a paper statement monthly. Throw all those statements throughout the year into a folder for your tax preparer at the end of the year. This will be your only source of income. If you receive income from any other source or sell anything, make sure that it goes into your company account and then you can either bonus it out to yourself or just let it go into payroll at some point.

This process of having all income go into your business account and then use a payroll service to control exactly how much money you make every year will open the door to many ways of making your life easier and richer. It is my opinion that your operating company should be classified as a

"Consulting Company" to give you the widest range of possibilities of claiming expenses and receiving incomes. Try not to put to narrow a focus on what you say your business activities are because they might change. A lawn service could be a snow removal service or a gutter cleaning service. If you're a business consultant, you can perform any of those tasks without much resistance from tax professionals or the IRS.

The other option to separate incomes between your business entities is to have a holding company that is the sole member of your operating company. The holding company can be classified as business consulting and your operating company can be Andy's Lawncare or named for your industry. In this method, all normal incomes for the lawncare business go to the checking account of Andy's Lawncare, of which you are on payroll via Paylocity or ADP. All other kinds of income that you may receive are deposited in your holding company's checking account and those are for your "Consulting Services", business services, sales services, marketing services, or whatever caused that income to come to you. The point is: don't take your income directly into your personal checking account or your options for using it prior to your taxes being determined will be extremely limited. This multi-tier business structure is a bit more complicated, and I will cover it in detail in my business entities book. If you're not familiar with establishing various kinds of entities, I recommend reading that book as well and, in all cases, discuss your ideas with your tax/business attorney, CPA, or other insured professional before filing official government documents.

Chapter 4: Bookkeeping: How should I organize it?

This is a matter of personal preference, but I'm happy to talk about how I organize my accounts. For SME's that are making under $2m per year, I keep my books in Excel. This provides me with the best understanding of how my business is doing, my key metrics, and the ability for me to make various graphs, charts, keep my Balance Sheet, P&L, and DCF current and usable. This method doesn't provide the easiest access to dashboards from my phone but that is a small trade-off for the functionality of personally managing the ledger and financial documents.

I created a new Excel workbook and made tabs for: DCF Valuation, Balance Sheet, P&L, General Ledger, Business Checking Account, Business Credit Card, and Journal Entries. I usually have a tab called "Scratchpad" for side calculations or notes from day to day on the far right.

I then download the .csv file from the bank and my business credit card, paste them into their respective tabs, sort from oldest on top to newest on the bottom, allowing for me to easily paste next month's transactions to the bottom for nearly eternity. I format the columns of the ledger, the bank account, and the credit card to have these titles across the top: Date, Source, Type, Description, Debit, Credit, and Notes.

	A	B	C	D	E	F	G	H	I
1	DATE	SOURCE	TYPE	DESCRIPTION	DEBIT	CREDIT	Balance		Notes
2	1/1/2023	Biz CHK	Capital Account	Owner Funding		$ 500.00	$ 500.00		Initial deposit to have a balance in the checkin
3	1/3/2023	Biz CHK	Office supplies	Office Supplies Purchase	$ 150.00		$ 350.00		Printer paper, cleaning supplies, k-cups
4	1/5/2023	Biz CHK	Sales Revenue	Client Invoice #1023 Pay		$4,300.00	$ 4,650.00		Customer A paid their bill!
5	1/7/2023	Biz CHK	Office expenses	Internet Service Payment	$ 100.00		$ 4,550.00		Internet for the Office
6	1/10/2023	Biz CHK	Office supplies	Coffee Supplies	$ 75.00		$ 4,475.00		Coffee, Sugar, Creamer, flavored creamer (Pun
7	1/12/2023	Biz CHK	Utilities	Utility Bill Payment	$ 250.00		$ 4,225.00		Gas & Electricity for the Office
8	1/15/2023	Biz CHK	Sales Revenue	Client Invoice #1024 Pay		$2,200.00	$ 6,425.00		Customer A bought more!
9	1/18/2023	Biz CHK	Building & property rent	Office Rent Payment	$1,200.00		$ 5,225.00		Rent for the office
10	1/20/2023	Biz CHK	Office expenses	Website Hosting Fee	$ 50.00		$ 5,175.00		Monthly website hosting service

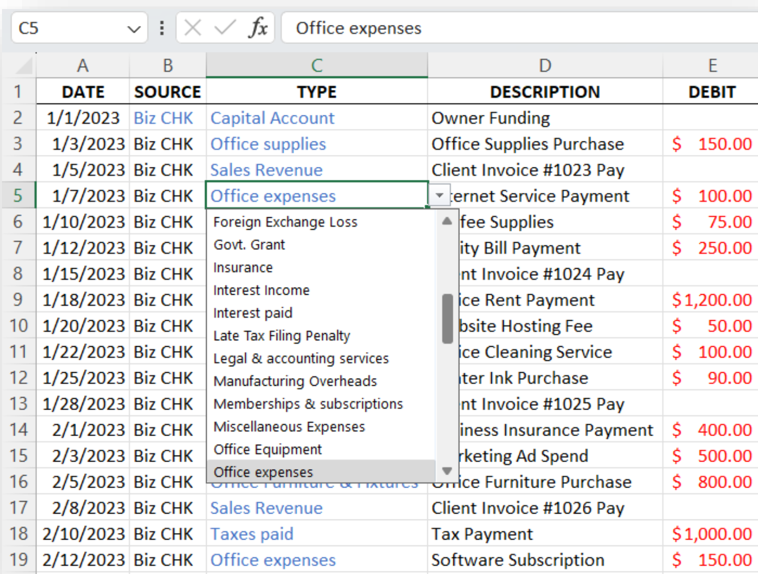
Even with the credit card, of which there will be little to no Credits, I make the columns the same way for easy integration into the general ledger.

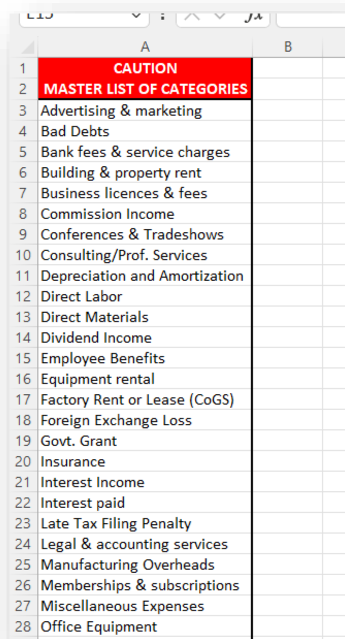
When you download your .CSV file from your checking account, use a new tab to paste the raw data into for easy formatting prior to pasting the transactions into your bank account or credit card tabs.

Provide the appropriate amount of columns so that the data fits easily into your bank account and credit card tabs. The date, description, and debit or credit will all come from your downloaded .csv file that you do once every 2 weeks or as needed.

The Source will be the same for every transaction on a given tab. If it is from my checking account tab, the Source column will always say "Biz CHK". If it is in my credit card tab, the source column will always say "Biz CC".

The Type field is where a little Excel skill comes in. I use the "Pick from list" option for that field and select all the expense categories from my P&L tab. If you haven't populated the expense categories of your P&L tab, a good place to start is to copy the ones from the P&L in chapter 2.





If the Pick from List function was done properly, you should be able to drag the corner of that box all the way down for as many lines as you need, and that Pick from List option will copy itself into all the cells in the Type column. After you past the transactions into these tabs from the .csv files downloaded from your online bank and credit card accounts, don't forget to select the kind of expense that falls into.

Pro-Trick: Have a tab in your spreadsheet called "Reference Data". Cut & copy all your expense categories into that. Add CoGS, Sales, and a few blanks at the bottom for categories that you may need later. Then, have the fields in your P&L and Balance Sheet reference this new list on this tab called "Reference Data", so that if you change the name of something in this list, it automatically updates the names in the P&L and Balance sheet. Use this list for the Pick from List function in your credit card and bank account tabs. This will enable you to easily modify your ledger and financial documents if you need to in the future.

Now, go through all your transactions and select the appropriate drop-menu item beside each one of them. I also make a brief note in the Notes column for anything specific. If I had dinner with a client, I would type "Dinner with [client name]" in the notes tab to help jog my memory if audited.

The last note I will make about downloading your ledger entries from your credit card and checking accounts is to also download the .pdf's for your official records. Print them, store them in a file cabinet, and save the electronic copies in a folder on your computer. Also, double-check the dates and amounts from the .pdf to your entries for that month. Sometimes, the posting dates change or maybe you forgot to copy one, etc.

Once all of your entries are entered neatly to the bottom of the list in each of your bank and credit card tabs, use the "=" sign to reference them from your General Ledger Tab. You will be combining all transactions from all bank accounts, all credit cards, and all journal entries (that should be formatted the same as the other tabs), into your General Ledger tab. Do not simply cut & paste these entries into this tab. They will not dynamically change in the general ledger if you do it that way. Instead, go to the first cell under "Date" in your General Ledger tab and hit "=" and click back to your bank account tab and select the date of the first transaction and hit enter. Now, go back to the General Ledger tab and grab the corner of that box and drag it across all the fields in the General Ledger tab. Now, highlight all the fields you just linked and drag the bottom right corner of the whole row of them down. This will dynamically link all your bank transactions into your General Ledger tab. Delete any empty spaces at the bottom so that you can link your credit card entries next.

Now, starting right below all those linked cells, do the same too with your credit card and journal entries. You have now dynamically linked all your other tabs into the General Ledger. To organize them, click on the cell above the column named "Date" and click in the title bar "Sort by Date" and have the oldest first. It will ask if you want to expand the selection, click Yes. This will now sort all your bank, credit card, and journal entries by date. They will still all be dynamically linked back to their respective tabs, so that any changes you make to your bank account or credit card tabs, they will automatically update in the General Ledger. Let's say that you later realize that you miscategorized an expense, by simply changing the drop menu in the checking account tab, it will automatically update the category in the General Ledger tab. Once formatted, you should never type data directly into your General Ledger tab. It either comes from validated transactions from your .csv downloads or it comes from your Journal tab.

If you ever mess up your General Ledger, simply highlight all the fields below the titles and delete them. Then reconnect the data with the "=" sign from your bank, credit card, and journal tabs, then sort by date. Boom, the entire ledger has been rebuilt. When you have new entries for the month, just link them with the "=" sign to the new entries in your other tabs and then hit Sort by Date again and boom, they all fall into place. You have now built your General Ledger and it should get pretty easy to update it, once you get comfortable with how it works.

This next part is going to be a little tedious, but you should only have to do it once. You're going to use "If" statements to pull apart your expenses, sales, and CoGS. It is important to leave a single column empty to the right of my General Ledger entries, before I get into this sorting function.

In your General Ledger, you have the headings: Date, Source, Type, Description, Debit, Credit, and Notes. Then you have a blank column, now, you will link, across the top of the page, all the fields in that list you made under the "Deference Data" tab. Use the "=" sign to reference the items in that list and include the 2 or 3 blanks you have at the bottom of the list, just in case you need to use them later.

You can ask ChatGPT how to do this or you can just do it manually by clicking the next box over, hit "=", jump to the Reference Data tab, and click on the next item in the list. When you are done, you will have all the items in the list across the top of the columns to the right of your General Ledger entries. If you email me, I will give you my formatted workbook, so all you need to do is modify it for your business and start pasting in the transactions. Always double-check that the links and math are working properly.

It will look like this:

D35 ='Biz CHK'!D17

	A	B	C	D	E	F	G	H	I	J	K	L	
1	DATE	SOURCE	TYPE	DESCRIPTION	DEBIT	CREDIT		Advertising & marketing	Bad Debts	Bank fees & service charges	Building & property rent	Business licences & fees	Commis
2	1/1/2023	Biz CHK	Capital Account	Owner Funding	$ -	$ 500.00							
3	1/3/2023	Biz CHK	Office supplies	Office Supplies Purchase	$ 150.00	$ -							
4	1/3/2023	Biz CC	Office supplies	Office Supply Store	$ 120.00	$ -							
5	1/4/2023	Biz CC	Travel & Entertainment (Meals)	Gas Station	$ 60.00	$ -							
6	1/5/2023	Biz CHK	Sales Revenue	Client Invoice #1023 Pay	$ -	$4,300.00							
7	1/6/2023	Biz CC	Travel & Entertainment (Meals)	Business Lunch at City Diner	$ 85.00	$ -							
8	1/7/2023	Biz CHK	Office expenses	Internet Service Payment	$ 100.00	$ -							
9	1/8/2023	Biz CC	Memberships & subscriptions	Online Marketing Tool Subscr.	$ 49.00	$ -							
10	1/10/2023	Biz CHK	Office supplies	Coffee Supplies	$ 75.00	$ -							
11	1/10/2023	Biz CC	Conferences & Tradeshows	Airline Ticket to Conference	$ 350.00	$ -							
12	1/12/2023	Biz CHK	Utilities	Utility Bill Payment	$ 250.00	$ -							
13	1/12/2023	Biz CC	Conferences & Tradeshows	Hotel Booking for Conference	$ 500.00	$ -							
14	1/15/2023	Biz CHK	Sales Revenue	Client Invoice #1024 Pay	$ -	$2,200.00							

You now have the basic framework for automating your company financials. This next part will take a little time to do and maybe a little Excel training on YouTube. You're going to use "IF" statements H2 through BI2 to sort the values in columns E & F into the appropriate cells. Here is the line for H2:

=IF($C2=H$1,IF($F2<>0,$F2,$E2),"")

This means that IF $C2 ($C means column C won't change when we drag this formula) = H$1(This Row won't change when we drag the formula), and IF $F2 (This column won't change) "does not equal" <> 0, fill in $F2 (Column doesn't change), however if F2 does equal zero, then fill in $E2 (Column won't change).

What this basically means is that you can drag this equation all the way across the entire row 2 to the last category and then you can select H2 to BI2 and drag the row of equations all the way down to the most current journal entry. This saves a lot of programming!

Now, when you change the categories or values in your bank, CC, and journal tabs, these categories and values will dynamically update across the page.

Sum all the values at the bottom of the journal entries and link them to your P&L.

8	2/10/2023	Biz CC	Travel & Entertainment (Meals)	Client Gifts	$ 110.00	$ -						
9	2/12/2023	Biz CHK	Office expenses	Software Subscription	$ 150.00	$ -						
0	2/12/2023	Biz CC	Advertising & marketing	Online Advertising Campaign	$ 200.00	$ -	$ 200.00					
1	2/15/2023	Biz CHK	Sales Revenue	Client Invoice #1027 Pay	$ -	$5,200.00						
2	2/15/2023	Biz CC	Insurance	Business Insurance Premium	$ 250.00	$ -						
3	2/18/2023	Biz CHK	Salaries & Wages	Employee Salaries	$ 3,000.00	$ -						
4	2/18/2023	Biz CC	Office expenses	IT Support Services	$ 180.00	$ -						
5	2/20/2023	Biz CHK	Office supplies	Miscellaneous Expenses	$ 200.00	$ -						
6	To add more lines, Insert complete blank lines above this bar, link transactions, & drag formulas down on Right.						$ 700.00	$ -	$ -	$ 1,200.00	$ -	$
7	Always double-check that all entries are in and the math functions work properly.						Advertising & marketing	Bad Debts	Bank fees & service charges	Building & property rent	Business licences & fees	Com
8												
9												
0												

Link to the P&L and Balance Sheet where appropriate like this (look in the formula box at the top):

Clipboard | Font | Alignment | Number

B6 | ='General Ledger'!AW46

	A	B	C	D
1	**Sample Company, LLC**			
2	**Income Statement (P&L)**			
3	**January - October, 2023**			
4				**This is my Notes section and not in a P&L**
5	**Income**	**Total**		
6	Sales Revenue	20,300.00		Sales Revenue is 100.00% of Total Income
7	Service Income	0.00		Service Income is 0.00% of Total Income
8	Interest Income	0.00		Interest Income is 0.00% of Total Income
9	Rental Income	0.00		Rental Income is 0.00% of Total Income
10	Dividend Income	0.00		Dividend Income is 0.00% of Total Income
11	Commission Income	0.00		Commission Income is 0.00% of Total Income
12	Royalty Income	0.00		Royalty Income is 0.00% of Total Income
13	Other Income	0.00		Other Income is 0.00% of Total Income
14	**Total Income**	**$ 20,300.00**		**Total Income is 100.00% of Gross Profit (below). This is your 'Gross Profit Margin'**
15				
16	**Cost of Goods**			

Through a little trial and error, you will be able to update, sort, calculate, and feed the numbers from your General Ledger entries into your P&L, Balance Sheet, and your DCF. If done correctly, they should all dynamically update when you update your General Ledger twice per month. Keeping these numbers in your head, printing them, reading them at night, and thinking about the trends you see week over week and month over month, will keep your finger on the pulse of your company, enable you to anticipate seasonality, understand how much cash you need to keep in the bank, and many other insights. This is how you learn and understand your business.

CHAPTER 4: Bookkeeping

How can I make it functional?

Every business lives and dies by the numbers. Understanding yours, and the ratios they provide, will not only give you instinctual reactions to the offers on Shark Tank, but will allow you to model "What-if" scenarios. What if you took out an SBA loan for $500k at Prime + 3% Interest over 10 years? Do you know what that payment would do to your current business? If the interest is 8.5% (Current Prime + 3% in 2023) then your monthly payments would be $6,155.68. That's nearly $74k per year in just loan payments. In 10 years, you're going to pay back $738k. $238k of that is just interest on the loan. You had better have a really good plan, that you completely understand, how to spend that $500k ($480k after closing fees and bank commissions) to dramatically increase your sales volumes. They need to exceed at least an additional $6,200 per month for the next 10 years! That is a huge gamble to make and yet, I see people run head-long into SBA loans all the time and they can't really tell me how they are going to use that money to generate at least the monthly loan payment for the next 10 years. I'm not discouraging you from taking out a big loan early on in your business, I'm just saying that you had better have a good plan on how it will lead to extreme amounts of sales.

What other functions will maintaining good books and up-to-date company financials provide?

Here is a short list of extremely useful things!

1. **Improved Financial Management and Control**: Regularly updated financial statements provide a clear picture of the business's financial health. This helps in making informed decisions about budgeting, spending, and investment.
2. **Easier Access to Financing**: Banks and investors often require up-to-date financial records to assess the viability and creditworthiness of a business. Accurate financial statements can increase the chances of obtaining loans and investments.
3. **Efficient Tax Planning and Compliance**: Accurate records ensure that a business can efficiently plan for tax liabilities and comply with tax regulations. This can also help in identifying potential tax deductions and credits.
4. **Better Cash Flow Management**: A well-maintained ledger and financial statements help in tracking cash inflows and outflows, which is crucial for managing day-to-day operations and ensuring the business doesn't run out of cash.
5. **Enhanced Decision Making**: Accurate financial data provides insights into revenue streams, cost centers, profitability, and financial trends, aiding in strategic planning and decision-making.
6. **Increased Credibility with Stakeholders**: Reliable financial information enhances the credibility of the business with suppliers, customers, investors, and other stakeholders.
7. **Risk Management**: Regular financial analysis can help in identifying and mitigating risks related to credit, market fluctuations, and operational inefficiencies.
8. **Facilitates Growth and Expansion**: Accurate financial records are essential for planning and executing growth strategies, such as market expansion, product development, or scaling operations.
9. **Streamlines Auditing Processes**: Good financial records make the auditing process smoother and less time-consuming, reducing the risk of errors and compliance issues.
10. **Helps in Benchmarking and Performance Evaluation**: By maintaining consistent financial records, SMEs can benchmark their performance against past records and industry standards, helping to identify areas for improvement.

We could write a book on just tax planning, data analytics, capacity planning, and improved business controls. The fun thing will be having the ability to use all these modern cloud-based business management apps! By having good company financials and knowing how to integrate your financial documents into modern apps, you get all kinds of dashboards on your phone, order alerts, shipping alerts, warehouse and inventory integration, and lots more whiz-bang functionality that will make you feel like you're running a space-age company, even if it's just a carwash.

Keeping the books and knowing the company's financials is where it all starts. It will improve you as a businessperson, provide access to capital for your company, and keep you in front of developing problems before they threaten the livelihood of your business. It will earn you a lot of credit with the bank, when you can speak clearly about these topics and provide company financials at a moment's notice or even from your phone or tablet.

I must say that some will read this approach and believe me to be a dinosaur for working in Excel. They will point out that you can manage these a lot easier with Quickbooks integration to your bank account and credit cards. They will point to even more modern cloud-based apps that can automate your taxes, financials, and ledger and I will agree with them! There is a lot of software out there that can do your job for you but how will you learn? How will you develop those business animal instincts if someone else's software application is doing all the understanding and processing for you? Will you be able to understand a pie chart or a series of bars on a graph that software puts on your phone? Will you really understand those ratios without having lived it?

In my opinion, it is a necessary step, to work your own numbers. I would have you do it for at least a year before handing it over to the software. You're going to have to sanity-check the software anyway when an investor asks you for an updated P&L. At a minimum, you're going to have to go through all the ledger entries for accuracy, if you haven't been validating them monthly. Will you understand what the software gave you if you don't know the ledger? Will you be able to answer any questions the investor might have, if you haven't looked at your current ratio or gross margins in months?

Will the software tell you if your industry is commoditizing and putting the squeeze on gross margins? Will the software tell you that you should shop your shipping rates around or find a better supplier? No. Software can't do this for you yet. You can't put a plug in the back of your head and learn Kung-Fu. You must walk this path to be the pro you want to be. When people brag otherwise, remember: A dreamer thinks about what they will do with all the money once they have it. A visionary sees all the steps from here to success. I've never met a successful dreamer, but they will always tell me all about the latest integrations in business.

CHAPTER 4: Bookkeeping: How do I become a bookkeeping samurai?

You're going to be an executive. You will hire a bookkeeper within the first few years of your business. So, why do you want to become a bookkeeping ninja? The short answer is because in order for me to know the way of business, I need to know the way of the financials. Bushido is the way of the warrior. The sword is a tool of the samurai warrior. The warrior has many tools, but they must be excellent with the sword first. Financial acumen is the sword in business. If you are not proficient with the sword, you will be defeated by any warrior that you face.

Business can be likened to war and the business leader can be likened to a warrior. Many business leaders that have come before you have studied The Art of War by Sun Tzu. Below are some of the most revered lessons from The Art of War that business leaders employ today. These are not in order of importance. In fact, I feel that #10 has a huge impact on company success. It is critical to hire employees with a good personality fit for your organization. Good people can make or break a company. Here are the principals, notice how many of these depend on understanding your financials, your access to capital, what resources you have available, and other critical pieces of information that only come from company financials:

1. **Know Yourself and Your Enemy**: Understanding your own strengths and weaknesses as well as those of your competitors is crucial. This knowledge can inform strategy and decision-making in a business context.
2. **The Importance of Strategy**: Planning and strategy are essential. Without a solid strategy, even the strongest business can falter. Strategic planning helps in navigating competitive markets. Always be thinking about what you will build or do in the next year and 5 years.
3. **Adaptability**: Being flexible and adaptable to changing market conditions is vital. Sun Tzu emphasized the importance of being fluid in tactics and strategies, much like in business where adaptability can be a key to survival and success. Liquidity is your agility.
4. **Leadership Excellence**: Effective leadership is about making the right decisions at the right time and inspiring and guiding teams towards achieving common goals. Teaching your team the financials will install a responsibility and obligation in all of them.
5. **Use of Resources**: Efficient utilization of resources, whether it's human capital, finances, or technology, is critical. Mismanagement of resources can lead to failure. Always run a tight ship.
6. **The Element of Surprise**: In business, innovation and the element of surprise can give a competitive edge. This could mean introducing a new product, entering a new market, or employing a unique marketing strategy. Play your business close to your vest. Don't let anyone know what you plan until your plan is already executed.
7. **Avoiding Unnecessary Conflict**: Sometimes, avoiding direct confrontation with competitors and focusing on building your own business can be more beneficial than engaging in destructive competition. You are only in competition with how well you did last month. You must always beat your competition.
8. **Importance of Intelligence and Information**: Gathering and correctly interpreting market data, customer feedback, and competitive intelligence is crucial for informed decision-making.
9. **Winning Without Fighting**: Sun Tzu believed in winning battles with minimal conflict. In business, this translates to achieving objectives with the least amount of friction and resource expenditure.
10. **Moral Influence and Team Cohesion**: Building a strong, cohesive team with high morale and a shared vision can lead to greater efficiency and success in business endeavors.

While bookkeeping can be boring and tedious, when viewed through the proper lens, bookkeeping is quietly sharpening your blade and practicing your strikes. A warrior's sword must always be sharp and ready for battle. View your financials in this context. While you may not always be the person doing the data entry, updating the ledger, and double-checking the Balance Sheet, you will need to know how those tools work, what they mean, and understand them on a very deep level. Your accountant may never understand this level of information, but you will need to in order to succeed.

How do you become a bookkeeping samurai? The same way every warrior becomes a samurai: practice and time. Do your numbers from scratch. Keep them in Excel for a year. Hire a bookkeeper and upgrade to QuickBooks. You should validate the data entered, the proper categories, and sanity check your P&L. If it all looks good, let the bookkeeper upload data per your instructions. Then, integrate your QuickBooks into a cloud-based financial app that can give you dashboards on your phone. Configure those dashboards to watch critical factors for what state your company is at: Startup? Current ratio, Net Sales, and Gross Margins. Medium to large enterprise? Operating Margin, RoS, and EBIT to tighten the belt on your operating efficiencies. Large Enterprise? Then it's P/E, EPS, and RoE. These are your dashboards, not the default ones that come with the software.

- Understand debt and leverage and use it to grow swiftly.
- Widen your gross margins with global supply chain, temp labor, and 3PL's.
- Rapidly increase your sales with modern SEO, ad words, and social media funnels.
- Pay off your debt, load cash in the bank, boost your P&L, and exit for a fortune.
- All of this is only available if you are a financial warrior. No software for you…yet.

80%+ of small businesses running in America that are using personal credit cards, personal checking accounts, not keeping any kind of books, have no idea how to build a P&L, Balance sheet, or a DCF are all doomed to failure. They can't see the obstacle until it is on top of them. Their answer is always to take on more debt until the whole thing is completely bankrupt and they will continue to pay off those business debts for years, crushing their hopes and dreams.

This book and these principals are my attempt to help. This is my offering to help people reach their goals. I must plug my book on business entities again at this time: the proper way to set up a business is an operating LLC company where 100% of ownership is held by a holding company. 100% of the equity of that holding company is held by a living trust. You are the grantor of this living trust, the designated manager of the holding company, and an employee of the operating company. You have Paylocity or ADP set up through your operating company and you are managing your income and tax withholdings in accordance with the state you are operating in. Your loans and leases are with the operating company.

All monthly retained earnings (profits after all the bills are paid) are transferred to the holding company that holds 100% equity in the operating LLC. This means that month after month, you only maintain a minimum balance in the operating company. You put forth all efforts to be successful with the business of your operating company. You truly reach for success and try as hard as you can. However, if you should not succeed and you are looking at debts, loans, and leases that would otherwise ruin a person, destroy their credit, and put them on the street, you simply close the business and file for business bankruptcy. This has no impact on your credit, the debts of the company do not follow an employee, leaving you open to begin again without the mark of a previous failure.

Some would take that advice and structure as a sneaky way to cheat the system or trying to avoid responsibility. This is not the case at all. The government wants you to be successful. It wants you to make loads of money because it taxes every transaction. If you're successful, the government wins. The government understands that only a small portion of the public has the vision and desire to grow a business and they want you to! The loss that they may suffer for a small loss in your early stages is nothing compared to the year over year taxes that Tesla, Apple, Microsoft, and other giants pay. They keep the country running! The government wants more big companies! You will learn more ways to be successful if your first loss doesn't destroy you as a person. The only way to protect yourself from that fate is to set up your business entities correctly. A critical part is ensuring that, should the worst happen, that you are able to survive and return with the lessons you have learned to do it again. Your odds of success on your second venture are far greater than your first. Your odds on your third are even greater! In fact, most successful businesspeople have had an average of 6 bankruptcies. Let's not go for that many but now you know how they are able to return to the business world so quickly. Those 80%+ of American companies that are taking on business debt to their personal accounts are getting backed into corners. If they don't succeed, it will destroy their credit and they will never return to the business world. They're trapped. They can't quit. They will lose their house. They know it. Don't get backed into a desperate situation. Become a bookkeeping samurai, build a safe structure in which to conduct your business inside of, and your chances of success in business are already in the top 20% of all business owners.

I must stress this again, if you have never setup a trust or multi-tiered business structure with the intent of protecting your assets, you should first read my book on business structures and then take your ideas to a legal professional so that you can establish your entities correctly and insulate yourself from your business.

Chapter 5: Musings, Thoughts, and Guidance

How to apply this knowledge to the Stock Market

Here are the easy ones:

Use your understanding of company financials to guide your stock search functions. If you're using an L2 trading platform, you'll have access to all company data. You can sort it by company efficiencies like gross margins, current ratios, and liquidity. This will build your lists of potentially undervalued investments. Then apply your stochastics, pattern analysis, earnings calls, and moving averages. This is literally how market timing works. You can have the best market timing with a company that is over leveraged and carries obsolete inventory, it's not going to make you any money. You can usually completely miss the market timing and still make a lot of money with companies that have good financials. Cash is King!

Compare the financials over time to see if a management change increased operating efficiencies or did they just fire 33% of their employees and a drop in sales will be coming in next quarter's earnings call. Are inventory levels growing and AR going down? Their product may be getting pinched out of the market by a more aggressive player with better gross margins. While the numbers alone won't tell the whole story, asking about the numbers on an earnings call will.

The most important thing in investing is managing a position you're already in. Is EBIT improving? Are cash reserves decreasing? You should never have hope in the stock market. You should always know. If you don't know, get out now. A great sign of a growing company is the rapid growth of current assets, big increases in PP&E (new factories), and big gross margins stating that they're a leader in the industry. These things together, not individually, can signal explosive growth. If the company is putting cash in the bank and investing in new production for a product that already has a big gross margin and lots of sales tells me that they're about to flood the market and make a killing. If they're doing all this stuff and current assets are not going up and sales are not going up, then they're trying to get people excited and look for a buyer before their business explodes in their face. Start paying a lot of attention to their leverage ratios. If those are going up, that means they are taking out more debt to keep up the rouse. Business tells a story, and the numbers are the strings you can pull on to get the whole story.

Take your newly found knowledge and build a stock list on Google Finance or some other platform that allows you to trade in "paper money" (not real money), just to see how your picks would have performed. Try to manage these positions as if they were real and you had real money on the line. If they go down, try to find the answer in the Fundamentals (Company "Fundamentals" are their financials as opposed to the "Technicals" = trading patterns). When someone says they are a fundamentals trader, that means they are trading on the company financials. If someone is trading on Technicals, that means they are trading on stock trends. The markets move for both reasons. There may not be financial reasons why a stock is going up. A stock can also have great financials and be going down. Stocks can also, and frequently do, break out of trading patterns. The market is unpredictable and until you have a formula that works for you, my advice is trading in "Paper money" until you have consistent performance. Successful traders don't focus on how much money they can make in a single trade, they focus on not losing money. If all your focus is on not losing money, you will naturally begin to make money. Obviously, there are hundreds of books on stock trading. This is not the end-all guide to understanding the market. Do your due diligence before risking your savings. In the end, you're the only person liable for your investing performance.

Chapter 5: Musings, Thoughts, and Guidance

How to apply this knowledge to running your own business.

You're probably eager to put this book down and go download your checking account and credit card transactions and start modeling your business. That's exactly what I was hoping to inspire! Don't let me stop you. Come back to this spot once you're all organized and ready.

I hope that I've explained clearly how these transactions feed into your General Ledger and how those numbers feed into your P&L and Balance Sheet, and finally how those documents feed into your DCF Analysis. You can't really get a feel for your company performance by looking at the General Ledger. You can see what your balance is but it's difficult to determine if that is going to go up or down over the next 30 days without categorizing all the expenses, looking at your sales, and understanding what numbers are going up or down. We've talked about what is happening if your Gross Margin is shrinking, but what is EBIT, what does it mean, and what does it mean if that number is going up or down?

In general terms, Earnings Before Interest and Taxes (EBIT) is how you measure the operating efficiency of your company. If it's a big company or a publicly traded company, EBIT will tell you how responsible your managers are. EBIT starts with Net Income. That is the number at the bottom of your P&L statement. That number comes from you're the net profits you made between the sale price of your product and the cost of making your product. Then all the stuff your company spent money on are removed (Expenses). The equation is (Gross Profit + Other Income) – (Total Expenses + Other Expenses). This is your Net Income, sometimes referred to as Month-Over-Month Retained Earnings or just Retained Earnings. Then, we add back to this number any Interest or Taxes that you paid during the period. Since your managers have minimal impact on those 2 items, we want to remove them from Net Income so that we can have an accurate picture of how responsible the management is with their spending. If your managers are playing golf every day and flying all over the country, those expenses are going to go way up and eat all the Gross Profits from selling your widgets. If they're overspending on Marketing & Sales, if they have mounting legal bills, if they signed a lease for a building that is too big or too small, if they are paying themselves too much, and all kinds of other choices they have made to spend the profits from selling your widgets. It is a measurement of how efficiently the company is being managed. EBIT has little to do with the products or services you are selling.

How do you use this EBIT ratio to compare how healthy your company is? You divide it into total revenue. Total revenue is all the income that came into your company, not just the profits after you subtract the CoGS. You take your EBIT (Net Income + Interest & Taxes), and you divide it into total revenue (Everything that came into the company for the period). If it's between 10% and 20% you're a healthy company. If it's over 20%, you're a very healthy company! If it's under 10%, you need to tighten the belt on those expenses before you run out of cash. This is an over-generalization of the EBIT ratio and I recommend you do a little industry research for your industry to see what the normal EBIT ratio is. A great place to start is ChatGPT, Google BARD, and other search engines and ai platforms. Then sit your managers down and tell them about their spending as it relates to the total amount of cash they're bringing in.

We've covered Gross Margins a little bit, but let's jump in a little further to see if we can break it down a bit more. Let's start with understanding what Gross Profits are and what Gross Margin is. Gross profit is the cash you keep between the sale price of your widget and only the direct costs it took to make it. To get the gross margin, we start with total revenue and subtract the CoGS (this is gross profit) then we divide that by the Revenue. A bit simpler is just to divide Gross Profit by Revenues and you'll get a percentage figure. That is your Gross Margin. Before we talk about what a healthy Gross Margin is for your business, here are a few things to keep in mind:

1. **Industry Standards**: Different industries have different average gross margins. For example, software companies often have very high gross margins (sometimes 70-90%), as their cost of goods sold (COGS) is low once the software is developed. In contrast, retail and grocery businesses typically operate on much thinner gross margins, often in the range of 10-20%, due to higher COGS.
2. **Comparison with Competitors**: It's important to compare a company's gross margin with that of its competitors in the same industry. A healthy gross margin should be at or above the industry average.
3. **Stability and Trends**: Consistent or improving gross margins over time can be a sign of good management and healthy business. Declining gross margins may indicate rising costs, pricing pressure, or other market challenges.

4. **Business Model**: The business model greatly influences what is considered a healthy gross margin. For instance, luxury goods manufacturers typically have higher gross margins than mass-market producers due to premium pricing.
5. **Economic Factors**: Economic conditions, including inflation, supply chain dynamics, and market demand, can also impact what is considered a healthy gross margin.

The important parts are to first, keep a good ledger of your business transactions, know how to build your P&L from that ledger, and start tracking what your gross margin is. Once you're confident that your number is accurate, then you must consider your industry, the competition, and the product itself as it pertains to the list above. Keep a record of your gross margin. If it is going up, this could mean you're getting better at producing your widget. If it is going down, you could be experiencing supply chain price hikes, increased logistics costs, or the competition is mounting.

Tracking this figure over time can alert you to potential difficulties ahead and help shape how you will respond to those difficulties. Keep in mind that 80%+ of small businesses in America don't keep any books, let alone know how to read into a gross margin. You have a serious advantage over the shop down the street. Use it wisely and you'll be adding their business to yours for pennies on the dollar.

I can't wrap this section up without expressing how important the Current Ratio is. This measures your ability to pay your near-term bills with the cash you have in the bank. I don't know how many companies are constantly surprised by bills each month, even after operating for years, and they get overwhelmed with unexpected expenses and sometimes fall behind or need to take out loans. If you're keeping a good ledger, you'll be able to see what your month over month expenses are very easily. You'll be able to see if you have the cash in the bank to pay your debts months before there is a problem. This will give you time to have a sales event, push more marketing, drop your price to increase sales, or whatever you need to do to bring that cash balance up. The current ratio is on your balance sheet. To find it, simply divide your near-term liabilities by your current assets (cash and things you can turn into cash within 30 days). Personally, if top end revenue is my most important metric, then the current ratio is my second most important metric. Let me explain why.

We've all heard that you could starve your salespeople to keep them hungry and performing. While I feel that is cruel and unusual punishment, it is somewhat of a business trend. Well, never apply that method to a business! Starving a company will cause it to underperform. You must always try to run your business as if it were cash rich. Let me explain. This doesn't mean that you should be careless with your expenditures. You must keep a good EBIT after all. However, in this philosophy, you do want to spend on advertising, marketing, R&D, and perhaps conferences as if you were rich. These items frequently return disproportionate revenues for the expenditures. If you spend $1 on advertising, it can lead to $5 in revenue. If you're running the company like it's broke, you will refrain from spending on advertising, which will lead to lower sales or you will refrain from spending on R&D, which will mean you don't have any new products or innovations to sell in the future. If you starve a company, it will die. I may have mentioned in the beginning of this book that a company is a living animal that eats cash and grows. If you're not feeding it revenues, it will wither and die.

Chapter 5: Musings, Thoughts, and Guidance

How to apply this knowledge to starting a business

This is the best time to use the information you have learned. Model your business before you spend your first dollar.

There are many industries out there and nearly every product or service can be upgraded, innovated, improved, and branded for you to make your mark in the world. I have a book completely dedicated to explaining those very principles. Literally every single product and service on the planet is ripe for innovation and branding. Now is your time to understand your costs, margins, expenses, and build your strategies.

Let's say that you're looking at hot selling items on Amazon and click on over to Alibaba to find manufacturers of that item. Let's say it's a microwave. Lots of people use microwaves every day. So, you know there is a market for them. However, the competition is fierce! This means that it's unlikely that you will be able to price your branded microwave at a price that can pay your bills and grow your business. You're going to be up against some titans who order microwaves by the ship load. They might even own their own ships and manufacturing plants! How are you going to compete with that? By modeling and innovating.

I will go more into innovation in my other book that is dedicated to brands and innovating but I'll give you a taste of it now. Let's take this boring microwave and innovate it. First, innovation is the gap between what you expected/wanted and what was delivered. This happens all the time! You saw that ad for the drone flying over real estate properties and you knew that if you bought it, that you could use it to improve your real estate business. So, you went on Temu (be honest), and bought a drone. In the advertising and videos, it looked so easy to fly and the video quality was amazing but when you got it, you crashed it immediately and the video is grainy. Expectations were not met. If you're a pro, you go one step further to say that you didn't get the value you wanted from the drone.

The value you wanted was to improve your real estate company, not just that the features were supposed to be better. Start looking at products and services as what they were supposed to do for you, not just as items. The gap between what you had envisioned and what showed up is the innovation gap. Do you have the resources and skills to put gyroscopes in that drone and program it to auto-correct 10 times a second so that a child could fly it? Can you replace the camera and wires in that drone with a 4k or 8k camera, upgrade the storage capacity, and add a stronger Wi-Fi band to transmit high-definition video to your phone? For most of us the answer is, nope! However, for all of us, we can go to the next industry conference to which all the manufacturers of these drones will be in attendance. We can all go on Alibaba and sort by Trusted Suppliers and get the email of companies that have been selling drones on Alibaba for over 5 years with lots of reviews. We can all send them an email asking how much it would cost to make these upgrades and if they would stencil our brand on the drone and packaging. We can all put these costs + shipping costs, warehouse rental, Google Ads, and an office coffee machine in a "mock-up" ledger. We can link those numbers to a P&L and a balance sheet. We can figure out our CoGS, margins, and leverage (how much debt you need). We can model "what if" scenarios of increasing sales based on advertising spend. Are your margins big enough to rapidly grow this business? How about modeling it into a DCF right now? Your company is still an idea and already you have figured out how much debt you will need and what the 5-year value of your branded drone is. That's a good way to use these skills for a startup. You might even be able to convince your local credit union to give you an SBA loan to get off the ground.

Now, that's a modern item like a drone. Modern things are easy to innovate. What about something that has been around so long that it must be at the peak of its innovation curve like that microwave we talked about? They've been around forever and they're cheap. They must be the most efficient they can be by now, right? Not even close. Thermal cameras have come down in price over the past 10 years to nearly nothing. Bluetooth transmitters are cheap and built directly into most computer boards these days and the only thing that has dropped in price faster than those things is flat screen LCD display. Here is how to innovate a microwave: Put the thermal camera right in the top-center of the microwave, facing down at your burrito. Replace the window on the door with the LED screen. Show your blue, frozen burrito on the door screen when you put your lunch in there and it starts turning. As it starts to get warmer, you can see the glowing red nuclear center. You can use software to stop the cooking when the middle of the burrito is a light shade of red or 180 degrees, instead of guessing how long you should put it in for. This will lead to much tastier microwave food that is perfectly cooked and easy to market online (It's got a thermal camera and an LCD door… yeah, people are going to throw out their old microwaves). It also has a cool factor to it. Now, add Bluetooth. Connect to an app on your phone that shows the blue log turning red over time. Have a few buttons on it like, Add 30sec., half power, and emergency stop. Now, when your teen is zombie scrolling TikTok, the burrito lets him know there are 10 seconds left and if the inner core is radioactive enough for him/her or if they want to add 30 seconds. Make an app for Meta/Oculus Quest and you can save your R&D budget for 10 years. That is how you innovate a kitchen appliance that everyone thinks they know, into something that everyone wants. The marginal increase in manufacturing costs to add these 3 items and build a basic Bluetooth application will be a small percentage of the sale price if you're a first mover in the space. This will put your gross margins in the stratosphere and likely get bought out by Samsung for untold millions in your first year of business.

You can innovate nearly any product or service you can imagine. However, I don't want to give more of how to find/make new products and services that will widen your gross margins and destroy the competition in this book, or you won't feel compelled to buy my other book! The basic idea is: if an industry is too competitive for your new business modeling to make sense of, then move the goal post. Create a new market. Destroy the old players. I will always give this advice: don't tell anyone your plan until it's too late. Don't let rumors of your product or service get out and allow your competition to plan and adjust before you make your move, or you will find that it happened while you were at the bank.

I can't overstate this phenomenon enough: play it close to the vest. Loose lips sink ships. Don't tell anyone. To that point, and possibly at my own cost, don't tell anyone about these books. Don't tell them that you've aced bookkeeping, product innovation, company valuations, and you're about to exchange them for richer friends. In my book on business entities, I talk about the difference between private and public entities. I show you how to make your living trust, start a holding company, and position your operating companies to protect your assets, cash, and future. When you make private entities, you are not announcing that you're involved. In fact, you're not registering your private entities anywhere except in your own safety deposit box or fireproof safe. If you're a loudmouth, you need to learn how to be private and quiet. A big advantage that you never want to lose in business is the advantage of surprise. Don't let them know you're coming. Don't let them know your plan. I have a straight razor that I shave with and on one side it is engraved with the acronym NSA. On the other side it says, Never Say Anything. This will be your credo. This will be your advantage. Never Say Anything.

Chapter 5: Musings, Thoughts, and Guidance

What tools are available to automate this work and where to find new ones?

You're in the Golden Age of Artificial Intelligence! Right now, you can find products, design companies, create any kind of media from text and photos to videos and ai avatars, chat-bots, and call centers. There are ai call centers today that are so smooth and fluid that you can't tell if it's human or not. If you're starting a local business that is contacting every business in your city for food truck service, then automate a call center. Have the bot that sounds exactly like a human tell the customer that it's connecting them to their manager, and it only forwards you calls with eager customers on the other side of the phone.

I've been thinking about writing an entire book about how business changed in 2020 and how it will never be the same again. There is a rift right now where young people, who know how to use social media, are making six figures a month by selling products on TikTok, YouTube, Instagram, Google, and Pinterest. These are non-traditional sales models that are exponentially outperforming traditional business. The boom of online sales tools and methods started in 2020 but really grew in 2021. The demo and prototype stages are wrapping up and there are new tools coming online almost daily. The usable tools, that you don't need to be a programmer to run, are just now becoming available.

I'm not going to make an exhaustive list of all the ai-enabled apps that are ready for prime-time but here are a few:

1. **Hootsuite Insights**: Utilizes AI to analyze social media trends and consumer sentiment, helping businesses tailor their social media content and strategy.
2. **Buffer**: An AI-powered social media management tool that assists in scheduling posts, analyzing performance, and managing multiple accounts.

3. **Canva**: Offers AI-driven design tools for creating professional-looking social media graphics, presentations, and marketing materials with ease.
4. **Chatbot by LivePerson**: AI-driven chatbots for customer service, enabling businesses to automate responses and handle customer queries efficiently.
5. **Zendesk Answer Bot**: Uses AI to provide instant customer support via chat, email, and messaging, helping to resolve common customer issues quickly.
6. **Grammarly**: An AI-powered writing assistant that helps in creating error-free, clear, and engaging content for emails, reports, and social media posts.
7. **Crisp**: An AI tool for real-time social media monitoring and crisis management, helping businesses track and respond to relevant social media conversations.
8. **Talkdesk**: AI-powered cloud contact center that provides intelligent routing, analytics, and customer service automation.
9. **HubSpot Marketing Hub**: Uses AI for inbound marketing, content management, and customer relationship management, streamlining marketing efforts.
10. **Sprout Social**: An AI-enabled platform for social media management, offering content scheduling, analytics, and engagement tools.
11. **Mailchimp**: An all-in-one marketing platform with AI features for email marketing, audience segmentation, and performance analytics.
12. **Khoros Marketing**: AI-driven social media marketing and management tool for creating, scheduling, and measuring social media content.
13. **Pipedrive**: A sales CRM with AI features for sales forecasting, deal prediction, and automating repetitive administrative tasks.
14. **Drift**: Offers AI chatbots for website visitor engagement, lead qualification, and scheduling meetings, enhancing the sales process.
15. **Audiense**: AI-powered audience analysis tool for social media, helping businesses understand and segment their audience for targeted marketing.
16. **BuzzSumo**: Uses AI to analyze what content performs best for any topic or competitor, aiding in content strategy and creation.
17. **Zoho Social**: An AI-enabled tool for managing social media, tracking engagement, and scheduling posts across different platforms.
18. **Cortex**: An AI tool for optimizing social media content, analyzing historical data to recommend the best content types and posting times.
19. **Brand24**: Provides AI-driven social media monitoring and analytics, helping businesses track and analyze online conversations about their brand.

20. **Yext**: An AI-powered platform for managing online presence, ensuring business information is consistent and up to date across various platforms.

You may feel a little overwhelmed with all this information and wonder how someone can possibly know all this stuff. Well, I don't. I didn't even read the list. I read the crisis management one and the messaging automation one, but I didn't even read the rest. I just typed this into ChatGPT:

"Use your plugin to research all the most popular ai enabled applications and what their function is, then create a bulleted list for me that states the function and the name of the application. List 25 popular ai enabled applications and what they are used for."

Then it gave me a bunch of stuff I didn't ask for, so I said, "list more business focused ones. list only 20"

Then it proceeded to list ones for programmers and technical people, so I corrected it again with, "I mean ones for creating social media content, call centers, and business focused ai services that automate real business tasks for business owners. They are not programmers."

Then it gave me the list I just copied and pasted above. I know that I said that I didn't write this book with ai in the beginning. Well, I didn't. I just made all the lists in this book with ai. The rest is all me. Ai would have written it a lot better than me, had better grammar, and wouldn't have had so much personality! However, ChatGPT would probably have been able to explain all that Excel programming a lot easier than I did in the previous chapter. No worries, I made a template for you that has all the ledger math in it already. Just send me an email and I'll send you my pre-built Excel template. You'll still need to work with it a little until you're comfortable adding new entries but 90%+ of it is already done for you.

To wrap up this section about what products are out there to help you build your business, I will say that they are moving too quickly to keep up with them all. By the time you read this, there will be 10 more. The way to keep up is to ask the ai what is new. Have it do the work for you. Use Bard for real-time web access or, if you have a ChatGPT pro account and you can enable plugins in your settings, then add the web searching plugins and give it access to live data. Then just ask what the new air-enabled business applications are for whatever job you're working on. I even put the Capcut plugin in my ChatGPT and I ask it to make videos of topics for me. I then just upload those to social media instead of shooting endless camera footage, editing video clips, add in text and icons to it and yadda yadda yadda. There are probably already 2 or 3 more automatic content creating solutions published in the time it took me to write about them. That's how fast it moves. You don't need to know, learn, or master them all. Just find a pain-point and then find an app that will do it for you. Get good at that one thing and don't think about the rest. You don't need to use the latest and greatest. Your advantage comes from mastering just one. Let everyone else chase the latest and greatest thing. They'll constantly be restarting. Find one that helps your business, be it a scheduler, personal assistant, content writer, financial software, or wherever you're spending the most time on and automate your work with ai.

I also follow a few ai pages on Instagram. They seem to post new ai faster than I can even find it on Google. I've found a few new apps from Instagram posts that I still can't find with a Google search. However, if you install Instagram on your phone, be careful of how much time disappears from your day. It is highly addictive.

Chapter 5: Musings, Thoughts, and Guidance

General ideas about business.

This is the summary chapter. I've written a lot. I still need to go through it all and make it pretty, correct punctuation, unscramble confusing paragraphs, add lots of pictures of spreadsheets for you to have a visual idea of what I'm talking about while you're reading it, and other tedious editing tasks, so this chapter might be quick. However, I've got a few things to say about business.

1. What is business? It is controlling a process in which you deliver a product or service to your customers for a price. Managing it entails making sure it is efficient, generates money, and has a future. You should always be thinking about how you will exit your business. This usually means selling it. When your most conservative DCF's are showing over $5m on a 5-year growth projection of only 15% growth YoY and a 20% discount rate, you're ready to look for buyers. The rest of your time in that company will be rapidly increasing sales, saving as much cash as possible to pump up the shareholder equity, and getting through your due diligence. That's how you exit. Always begin your business knowing how and when you will exit it.
2. Don't have partners. You can do this on your own. If you need cash, then offer preferred shares but you should always keep the common shares. I will talk about the different kinds of shares and how to write Operating Agreements in my entities book but for now, just remember to never have partners. I have heard about people saying that they have family as partners and it works out, but to me, the fastest way to end a marriage is to become business partners. You can have minority shareholders, you can put them on your board of advisors, and all kinds of other things, but you're the one with the vision, you're the one that will bring your business to fame, you're the one that calls the shots. You will need to pay special attention to the How to Write Operating Agreements section of the Entities book if you're adamant about having partners. I've seen best friends take each other to court and families divide because they were business partners. I don't need to say it again. Don't do it. If you do, and it gets ugly, you will learn, and you will never do it again. This may be the only lesson that I am begging you to learn from someone else's experience. You will learn everything I have shown you in this book when you get an audit by the IRS. Until then, it will just be plugging in numbers and making excel formulas. When it means something, you will learn it and not before. You'll thank me for the tools and the wisdom, but you won't really know these numbers until you've lost $50k on an investment, got audited, or got sued. Then you will "feel" this knowledge. Just don't have partners. Learn that one from words and save yourself a decade of your life.
3. Are you too old, young, dumb, ugly, fat, oily, gluten intolerant, or vegan to start a business? Nope. In fact, all those things are benefits to starting a business. Nobody wants to be those

things (except young, but young people don't want to be that either!), and if you provide solutions to those things, you'll make a lot of money. What is the solution to old do you say? It's sharing. If you're old, you've done some things. You've seen some things. Even if you've never left your house in 20 years and wear a Muumuu. That was the premise of one of the most successful sitcoms in all of television: Rosanne. Reboot Rosanne with an ai writer. Continue to sit around the house all day but figure out how to use ai to make yourself an avatar and start making short videos about your days. Model it off the old television series. Get a following. Then start affiliate marketing things on Amazon to the countless thousands of people that are going to do the same thing for the next 20 years. You know your audience. Sell them stuff. Innovate products. Brand them. Sell more. Start with affiliate marketing because that doesn't cost much to do. Did I mention I've got a book on how to do eCommerce? That one might be for you. In all seriousness though, the thing you have is time. If you're really home all day in a Muumuu, then you have the one asset that people need to run eCommerce: time. Everything is an advantage. The Obstacle Becomes the Way. If you're dumb, then focus on all the new learning things that can make you not dumb anymore. Document your growth. Put it on Insta and TikTok. Post at least 3 times a week. Go for funny, educational, heartfelt, and real. You'll have a huge following within a year. Then read about how to monetize (turn into money) that following. Selling attention is wildly profitable these days. There are no excuses. If you don't get off your ass, it's because you chose not to get off your ass. If you don't change how you think, it's because you chose not to change. Nobody is holding a gun to your head and telling you not to change your mind. You are free to choose. Choose to do business. Anyone can. Children can. If you're confined to a bed, write a book. If you're not creative, have ChatGPT write the book for you. You will need to learn how to master the prompts, but after a few days of trial and error, you'll have it figured out. I wrote a 68k word novel on a Sunday afternoon and I was just trying to figure out how to do it. The novel sucked but if I wanted to, I could go back and edit it to be decent. There are no excuses.

4. The hardest thing about business is staying motivated. This takes some work. It separates successful people from the rest. It's hard to stay motivated. I'm not saying that you must always be cheery or enthusiastic. All I'm saying is that you must continue to put one foot in front of the other. You can complain as much as you like. You can cry, cuss, throw stuff, or whatever your rebellion routine is but you must continue to put one foot in front of the other. It's a choice to quit. It's a choice to continue. You must always choose to continue. It won't be easy. It will have highs and lows. You will want to quit. I'm not going to sugar coat it. It will test you. I find that going to the gym, getting 8 hours of sleep or more, eating healthy, and other good routines all promote each other. However, so do bad habits. Fast food leads to binge Netflix, leads to sleeping in, leads to drinking, leads to more bad routines. It's a conscious choice to break the cycle and replace your routines. There is no magic fix. There is no pill or prescription. It's all in your head. You can wake up tomorrow and choose to have good routines. All you must do is choose to have good routines for 1 day. Nobody is asking for a week or a month, just for the day. Make it to lunch and then make it to dinner, then make it to bed. If it gets hard, go to bed early and end the suffering. When you wake up in the morning, choose to make it through the day. Just 1 day. Nobody is asking for a week. Just make it to lunch, then make it to dinner, then make it to bed. If you

> fail and fall back to your old routines, no problem. There is no judgement. You're human and forgiven. Done. Go to bed happy. When you wake up the next day, all you must do is choose to have good routines for 1 day. Nobody is asking for a week. You get it. Go day by day. If that's too hard, then go hour by hour. If you miss an hour, then restart the next hour. Nobody is asking for 4 hours. All you must do is make it to the next hour. Then the next. Then the next. If you slip, no problem. There is no judgement. When that clock strikes the next hour, all you must do is try to keep up some good routines for 1 hour. In time, your resistance will diminish, and you'll understand that you have become what you say you are. If you say that you're disciplined and you have good routines, you will be. If you say that you're a fast learner and you get after it day by day (hour by hour if you need to), before you know it, you'll be the thing you said you were. Speak it. Do it. If you slip, forgive yourself immediately. Don't think about it again. Recommit to what you said you are, just for the next hour. Are you a content creator? Did you last 15 minutes creating content yesterday? Go for 30 minutes today. No problem if you don't make it. Give it a shot again tomorrow. You only fail when you choose to quit. You can do anything you set your mind to. That is how you set your mind. If you choose not to set your mind, then don't waste any more money on any more of my books. Save your money for whatever brings you happiness.

That last bit was a bit of life coaching, and I know most of you probably didn't buy this book for self-help, so I'm going to put a cork in it. Forgive me if I just wasted 10 minutes of your day when you could have been getting after it. With that said, go get after it!

-Clay