Discussion 2 week 1 impact of financial concepts

Finance

Running a small business means you are handling multiple responsibilities. The product or service you sell is only one part of the equation – there is an accounting and finance component to running a business that can differentiate a successful business from a struggling business.

The basic concepts are

1. Accrual vs. Cash basis

There are two ways you can choose to handle your accounting. First is cash basis. When you receive cash, or pay out cash, that influences your books and affects your tax liability. Accrual is very different. With accrual, you can have income on your books before you have actually been paid. This means you would be responsible for paying taxes on money that you may not have even received yet. On the flipside, expenses can be incurred before you actually pay them out – meaning you can reduce your tax liability before paying out.

2. Time Value of Money (TVM)

This is at the core of finance. The time value of money tells you that $1 today is worth more than $1 tomorrow. The reason is because you can invest that $1 today and have it be worth more tomorrow. What does this mean for your business?

You want to hold onto your money as long as possible and receive money as quickly as possible. You can do this by paying your bills right before they are due and finding ways to have your customers pay you as soon as possible. Keep in mind this ignores other psychological factors like your vendors being happy if you always pay them immediately (which could lead to more flexible payment terms or even discounts).

3. Risk and Return

The more risk you take, the more return you should expect. If given two options with the same return, you should always choose the option that has the least amount of risk. Likewise if given two options with the same level of risk, you should always choose the option that has the highest return.

4. Opportunity Cost

Opportunity cost is the cost associated with choosing one option and forgoing another. For example, a high school graduate has the option of going to college or working full time. If she chooses college, the cost of her decision isnt just the cost of tuition and books, but the money she is missing out on by not working fulltime for four years while she is in school. If she chooses to work full time, the opportunity cost is the amount of money she would have made (in excess of her regular pay) for having a college degree for the rest of her life. So lets say she can make $10/hr without a college degree, or $15/hr with a college degree. She needs to take into account the $5/hr she will lose out on for the rest of her life by not going to college now. There are also non-financial opportunity costs, like the free time she is giving up while she is doing homework or studying for exams.

Opportunity cost isnt an actual outflow of cash, but you should treat it as an actual outflow when comparing options.

5. Relevant Costs

Business decisions have relevant and irrelevant costs associated with them. Lets say you are considering fixing your old, beat up car or buying a new one. The amount of money you have put into your car over the last ten years is irrelevant (called a sunk cost). It makes no difference in your decision today. That money is gone. Psychologically this has a big impact on us when we make decisions but leaving these out ensures we make better decisions.

6. The Impact of Taxes

Taxes is a very real business expense. You cannot make the best possible decision for your business unless you take into account the impact of taxes. I give a lease vs. buy example towards the end of this post that shows how important this is. Similarly, you should consider how you can reduce your tax liability. Talking with an accountant could save you big money if he can help you make small changes that reduce your tax liability.