Understanding Your Financial Statements

Business Smarts 2020

A Non-profit Economic Development Corporation

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Understanding Your Financial Statements

INTRODUCTIONS

(Poll questions)

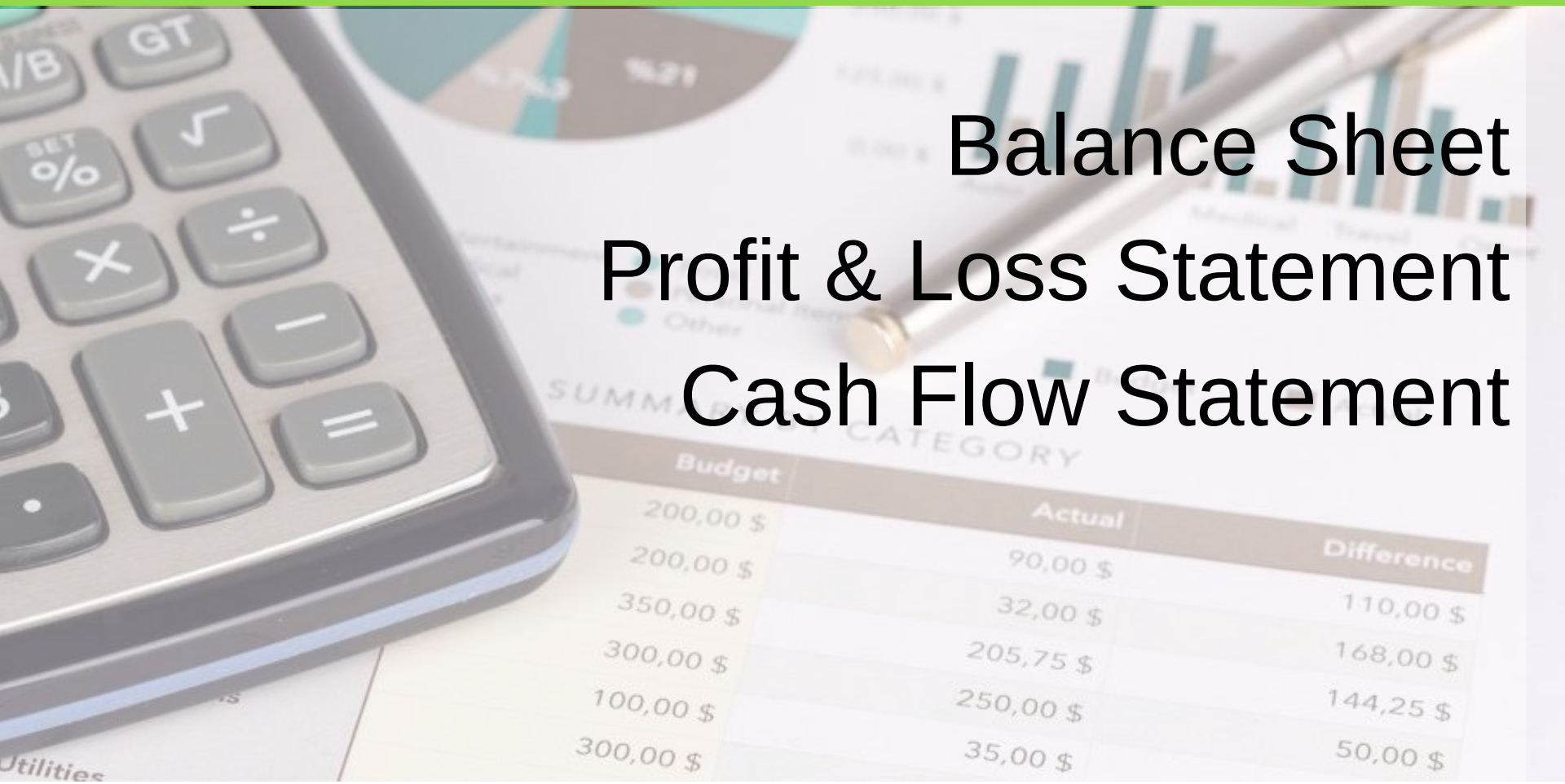
- New or existing business
- Type of business
- Primary job skill or function
- First HCEDC event?

Understanding Your Financial Statements

Workshop Objectives

- Define the basic types of Financial Statements
- Learn how to interpret and make sense of your financial statements
- Learn how to use financial statements to make key business decisions

Types of Financial Statements

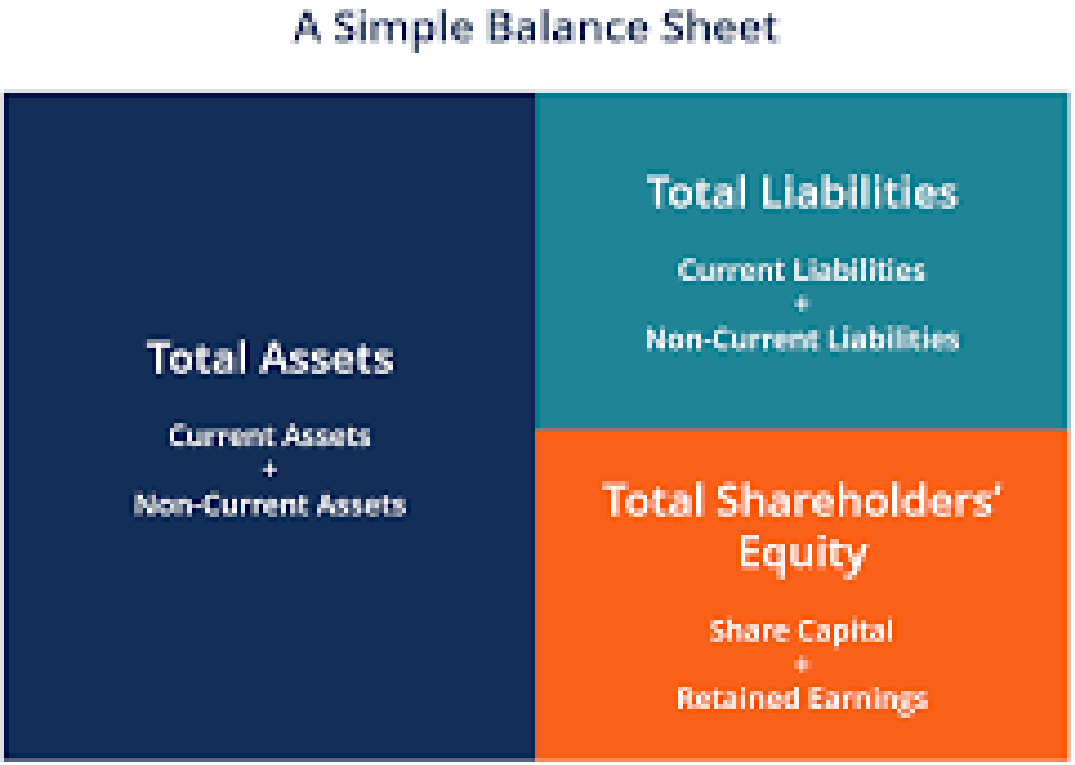


Balance Sheet

Profit & Loss Statement

Cash Flow Statement

The Balance Sheet



The Accounting Equation

Assets – Liabilities = Owner's equity

Balance Sheet shows the financial strength of your business as of a FIXED date (usually at close of an accounting period). A snapshot.

Assets

An asset is an item of value owned by the company…It's the stuff you own!

Assets can be tangible or intangible.

- Cash
- Inventory
- Machinery & Equipment
- Real Estate
- Accounts Receivable
- Prepaid Expenses
- Patents
- Goodwill

Categories of Assets

Current Assets - Assets that can be converted into cash within 12 months of the balance sheet date.

Long Term Assets - Assets that can be converted into cash in a period longer than 12 months of the balance sheet date.

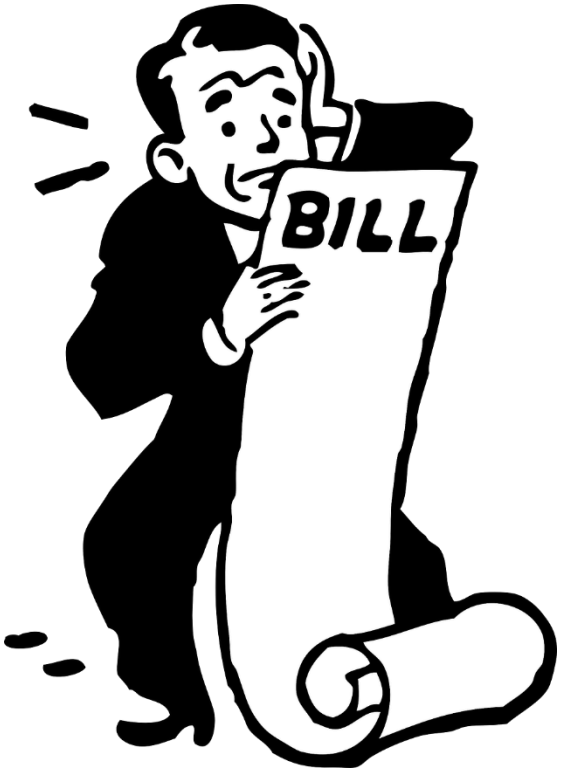
Assets

Dec. 31, 2019

MFG Manufacturing Company
BALANCE SHEET

ASSETS		
	Current Assets	
	Cash	$22,500
	Accounts Receivable	$25,000
	Inventory	$ 8,000
	Other Current Assets	$ 3,500
		$59,000
	Long Term Assets	
	Machinery & Equipment	$50,000
	Furniture & Fixtures	$10,000
	Less: Accum. Depreciation	($ 6,000)
		$54,000
	TOTAL ASSETS	**$113,000**

Liabilities



A liability is an obligation of the business…It's the stuff you owe!

- Loans
- Accounts Payable
- Credit Cards Payable
- Payroll Accrual
- Taxes Payable

Categories of Liabilities

Current Liabilities - those obligations which can be expected to be liquidated or satisfied within 12 months of the balance sheet date.

Long term Liabilities - those obligations which can be expected to be liquidated or satisfied longer than 12 months of the balance sheet date.

Liabilities

Dec. 31, 2019

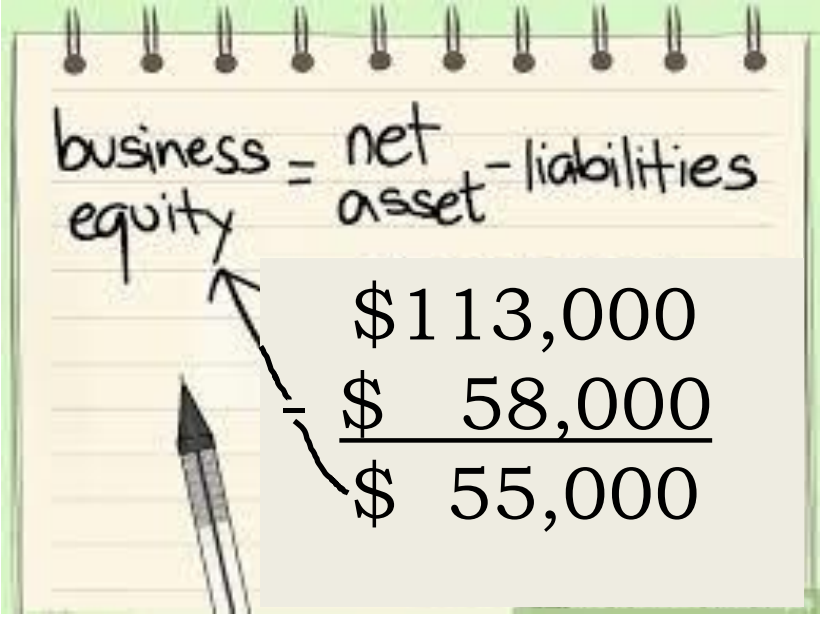
MFG Manufacturing Company
BALANCE SHEET

LIABILITIES		
Current Liabilities		
	Accounts Payable	$ 5,000
	Current Portion of LT Debt	$12,000
	Other Current Liabilities	$ 0
		$17,000
Long Term Liabilities		
	Long Term Debt	$41,000
		$41,000
	TOTAL LIABILITIES	**$ 58,000**

Owners Equity

Owner's Equity is the amount of money the owner has invested and retained in the business.

It's also the net value remaining after liabilities have been met.



Components of Owner's Equity

1 a. Paid in Capital (initial and supplemental owner investments)

1 b. Common Stock (issuance)

2. Retained Earnings

Assets = Liabilities + Owner's Equity

Dec. 31. 2019

MFG Manufacturing Company
BALANCE SHEET

ASSETS		
Current Assets	$59,000	
Long Term Assets	$54,000	
		$113,000
LIABILITIES		
Current Liabilities	$17,000	
Long Term Liabilities	$41,000	
	$58,000	
OWNER'S EQUITY		
Paid in Capital	$40,000	
Retained Earnings	$15,000	
	$55,000	
Total Liabilities & Owner's Equity		**$113,000**

Profit & Loss Statement

P&L Statement, or Income Statement, shows your business's financial activity over time (e.g., 1 year). A *flow*.

Includes non-cash expenses (e.g., depreciation)

Jan – Dec 2019

MFG Manufacturing Company
Profit and Loss Statement

Revenue (Sales)	$350,000
Cost of Goods Sold	$210,000
Gross Profit	**$140,000**
Operating Expenses	$120,000
Operating Profit, EBIT	**$ 20,000**
Taxes	$ 5,000
Net Profit	**$ 15,000**

Gross Profit

Gross Profit (or Gross Margin)
= Revenues – Cost of Goods Sold

Revenues - the money generated by a company from sales and other business activity.

Cost of Goods Sold - costs directly related to the manufacture or production of goods for sale

Jan – Dec 2019

MFG Manufacturing Company
Profit and Loss Statement

Revenue (Sales)	$350,000
Cost of Goods Sold	$210,000
Gross Profit	**$140,000**
Operating Expenses	$120,000
Operating Profit, EBIT	**$ 20,000**
Taxes	$ 5,000
Net Profit	**$ 15,000**

Operating Expenses

Operating Expenses
- Advertising
- Marketing materials production
- Sales force salaries
- Travel & entertainment
- Administrative salaries
- Rent
- Utilities
- Insurance
- Office supplies
- Depreciation of fixed assets…

Jan – Dec 2019

MFG Manufacturing Company
Profit and Loss Statement

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Net Profit	**$ 15,000**

Net Income (Loss)

MFG Manufacturing Company

Profit & Loss Statement
Jan – Dec 2019

Revenue	$350
Cost of Goods Sold	$210
Gross Profit	**$140**
Operating Expenses	$120
Operating Profit	**$ 20**
Taxes	$ 5
Net Profit	**$ 15**

Balance Sheet
12/31/2019

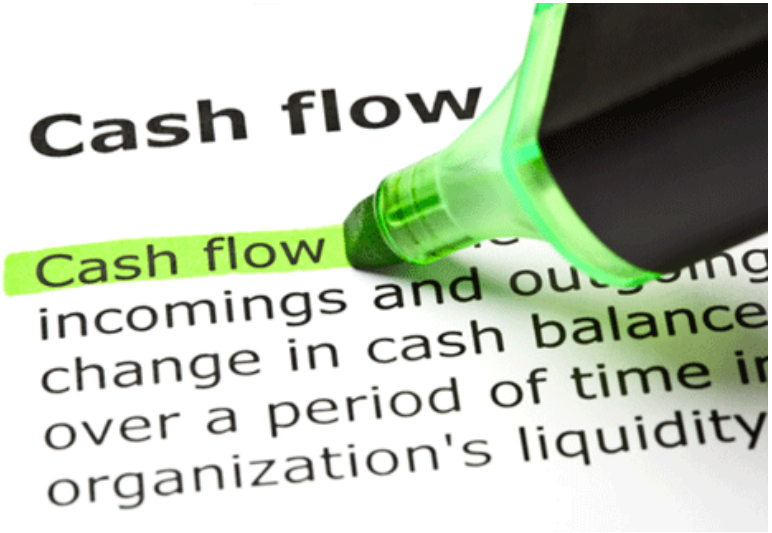
Assets	$ 113
Liabilities	$ 58
Owners Equity	$ 55

Includes $15 Ret. Earnings

Cash Flow Statement

The cash flow statement shows how much money flows into and out of the business during a period of time, usually a tax year (but broken down by month).

Profitability (P&L Statement) determines valuation. Cash flow determines solvency.



Source: EduPristine

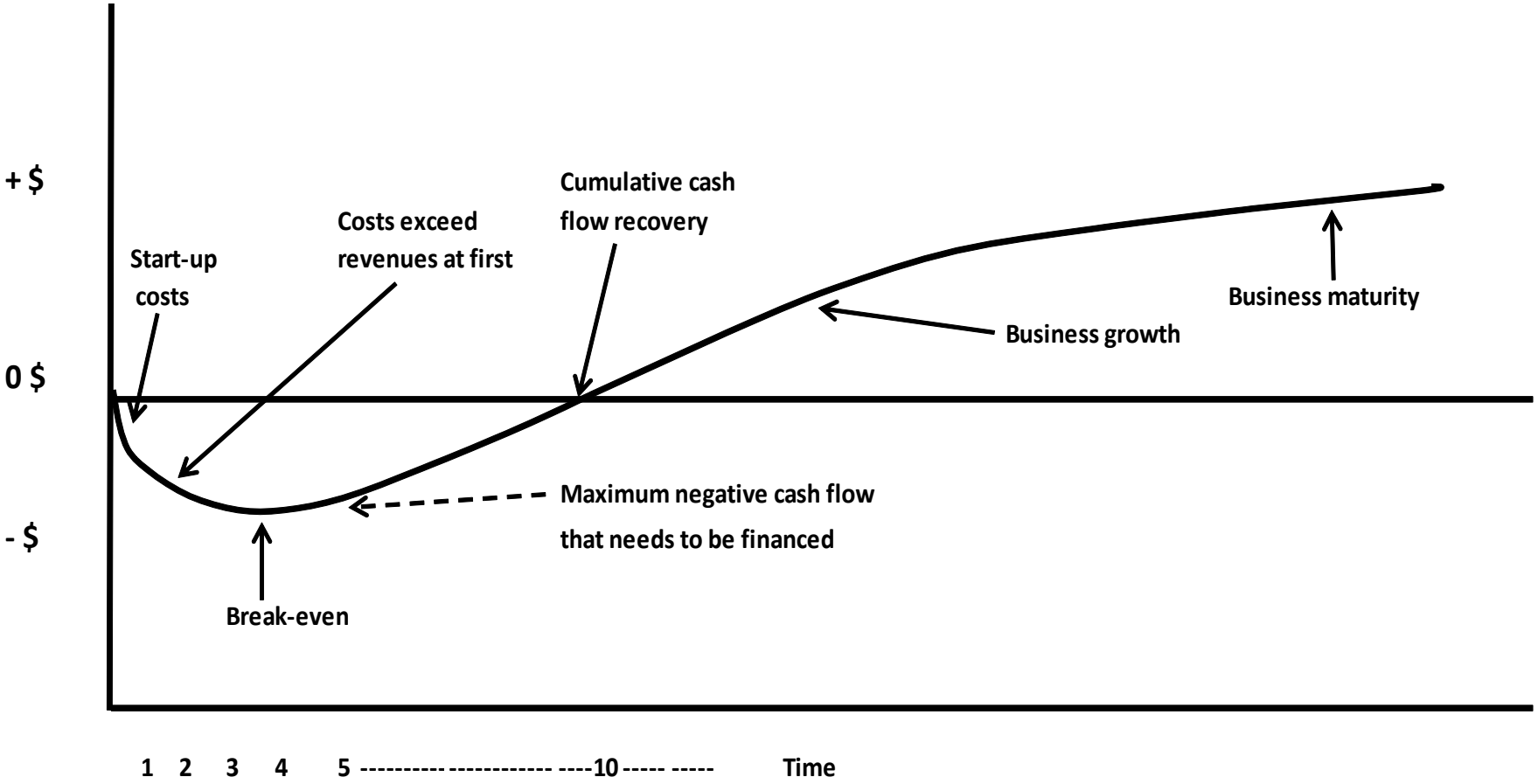
Cash Flow Statement

Cash Flow Statement deals only with *actual cash transactions*, not depreciation, amortization of goodwill or other non-cash expense items.

Prepared on a monthly basis for the next year (or more)

Analyze and revise quarterly to reflect actual performance vs. projections

Typical Cash Flow Curve



Sources and Uses of Cash

Sources of Cash

- Cash on hand
- Revenue from sales (product and service)
- Assets to be liquidated, if any
- Loan injections
- Owner or investor equity contributions

Uses of Cash

- Inventory purchases
- Variable expenses (sales and marketing-related)
- Fixed expenses (general, administrative, overhead)

Cash Flow Statement

	Startup (12/31/18)	January	February
Beginning Cash Balance	$ 0	$ 36,500	$ 8,000
CASH IN FLOW			
Sales Receipts		$ 0	$ 25,000
Loans	$ 60,000		
Other – Owner's Equity Investment	$ 40,000		
TOTAL CASH IN FLOW	$100,000 $	$ 0	$ 25,000
CASH OUT FLOW			
Advertising		$ 900	$ 900
Capital Purchases	$ 60,000		
Raw Materials		$ 8,000	$ 5,000
Payroll		$ 15,600	$ 15,600
Loan Principal and Interest		$ 1,300	$ 1,300
Rent	$ 3,500	$ 1,750	$ 1,750
Utilities		$ 950	$ 950
TOTAL CASH OUT FLOW	$ 63,500	$ 28,500	$ 25,500
CASH BALANCE	$ 36,500	$ 8,000	$ 7,500

All Businesses Experience Cash Flow Shortages Periodically

…which is why cash flow management is so important.

And why projecting future cash flow prepares you to cover the shortfalls *in advance.*

Possible Causes for Low Cash Flow

- Carrying too much inventory or wrong inventory
- Slow/inadequate accounts receivable collection procedures
- Liberal customer credit terms
- Lack of bank financing for working capital needs
- Undercapitalized: low equity, high debt possibly due to:
  - insufficient initial investment
  - too much profit distributed to owners
- Low profits or even losses possibly due to seasonality &/or management decisions

Strategies for Managing Cash Flow in Ongoing Business Operations

1. Collect Accounts Receivable Faster
2. Secure Sufficient Short-Term Financing
3. Use Long-Term Financing Effectively

Analyzing Your Financial Statements with Ratios

- Profitability ratios
- Asset Management ratios
- Liquidity ratios
- Debt Management ratios

Profit Margin on Sales

Shows the percentage of net profit for every dollar of sales

$$\frac{\text{Net Profit}}{\text{Net Sales}}$$

$$\frac{\$15{,}000}{\$350{,}000} = .043\%$$

The higher the number the better

Accounts Receivable Turnover

Calculates how many days worth of sales you have in your accounts receivable at a given time.

$$\frac{\text{Accounts Receivable (Annual)} \times 365}{\text{Sales}}$$

$$\frac{\$25{,}000 \times 365 = \$9{,}125{,}000}{\$350{,}000} = 26 \text{ days}$$

Should be within a reasonable range of the terms you give your customers.

Current Ratio

A quick measure of liquidity of a firm. It represents the margin of safety or cushion available to the creditors.

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\frac{\$59{,}000}{\$17{,}000} = 3.5 : 1$$

A current ratio of 2:1 is considered normal

Debt to Equity (or Leverage) Ratio

A measure of a company's financial leverage.
Shows how much money owners have invested in the business vs. lenders.

$$\frac{\text{Total Liabilities}}{\text{Owners Equity}}$$

$$\frac{\$58{,}000}{\$65{,}000} = 0.89$$

Lenders use to determine if company has enough equity.
Lower is better (3 or less is preferred)

Understanding Financial Statements Q&A Panel Discussion

Questions? Comments? Feedback?

SBDC at New Jersey City University

Hudson County Community College Continuing Education & Workforce Development

UCEDC - HCEDC

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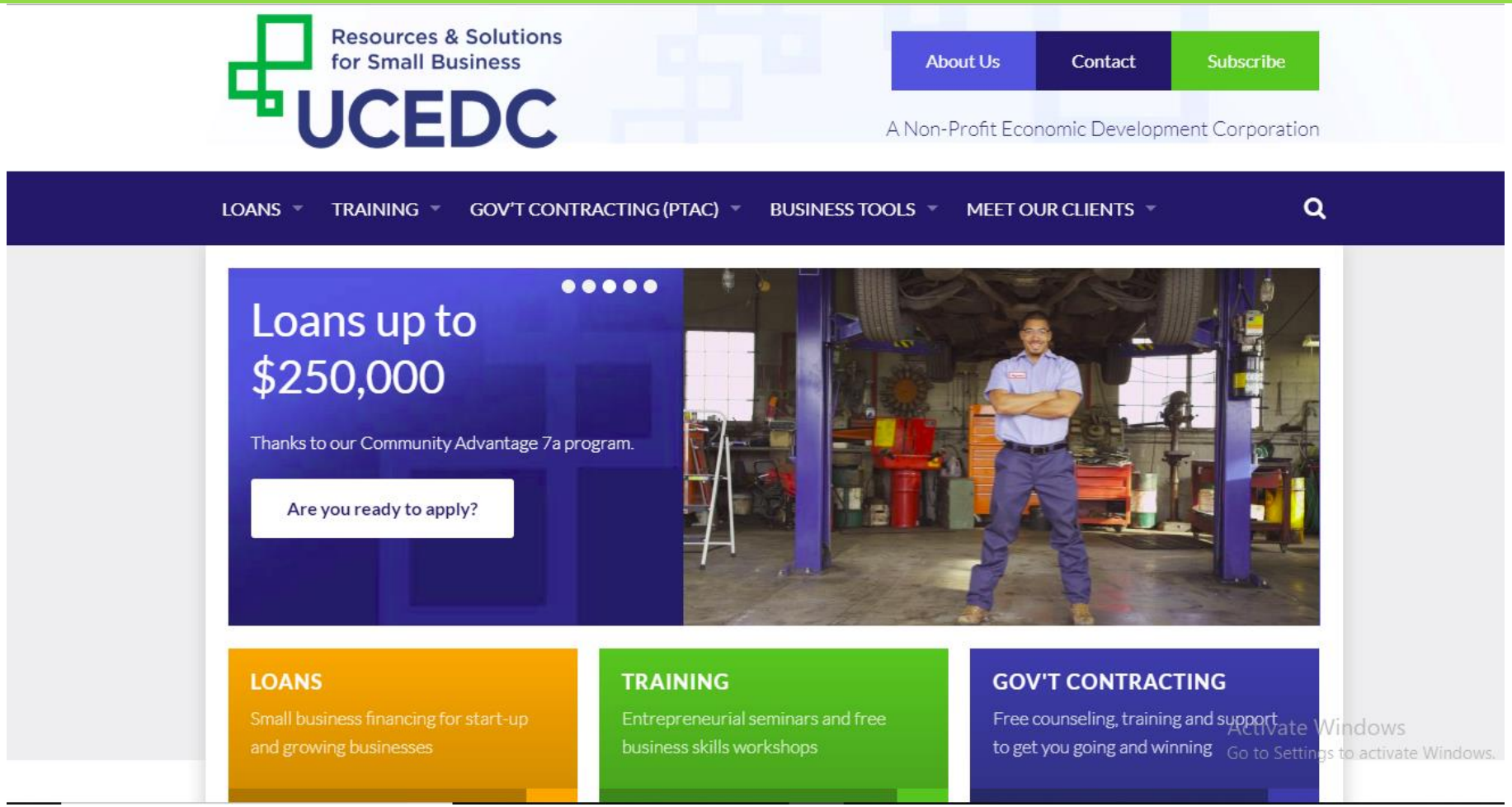

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