Understanding Your Financial Statements

Business Smarts 2020
Understanding Your Financial Statements

INTRODUCTIONS
(Poll questions)

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

Keith
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

A Simple Balance Sheet

Total Assets
- Current Assets + Non-Current Assets

Total Liabilities
- Current Liabilities + Non-Current Liabilities

Total Shareholders' Equity
- Share Capital + Retained Earnings

Understanding your Financial Statements
The Accounting Equation

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

### Assets

#### Current Assets
- Cash: $22,500
- Accounts Receivable: $25,000
- Inventory: $8,000
- Other Current Assets: $3,500

#### Long Term Assets
- Machinery & Equipment: $50,000
- Furniture & Fixtures: $10,000
- Less: Accum. Depreciation: ($6,000)

#### Total Assets: $113,000

Dec. 31, 2019

Understanding your Financial Statements
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

### MFG Manufacturing Company

**BALANCE SHEET**

#### Dec. 31, 2019

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Current Portion of LT Debt</td>
<td>$12,000</td>
</tr>
<tr>
<td>Other Current Liabilities</td>
<td>$ 0</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>$17,000</td>
</tr>
<tr>
<td><strong>Long Term Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Long Term Debt</td>
<td>$41,000</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$58,000</td>
</tr>
</tbody>
</table>

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Understanding your Financial Statements
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.

\[
\text{business equity} = \frac{\text{net asset} - \text{liabilities}}{\text{business}}
\]

\[
\begin{align*}
\text{net asset} &= \$113,000 \\
\text{liabilities} &= \$58,000 \\
\text{business equity} &= \$55,000
\end{align*}
\]
Components of Owner’s Equity

1. Paid in Capital (initial and supplemental owner investments)
2. Common Stock (issuance)

2. Retained Earnings
Assets = Liabilities + Owner’s Equity

MFG Manufacturing Company
BALANCE SHEET

<table>
<thead>
<tr>
<th>ASSETS</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$59,000</td>
<td></td>
</tr>
<tr>
<td>Long Term Assets</td>
<td>$54,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$113,000</td>
<td></td>
</tr>
</tbody>
</table>

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</tr>
<tr>
<td></td>
<td>$58,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OWNER’S EQUITY</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid in Capital</td>
<td>$40,000</td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>$15,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$55,000</td>
<td></td>
</tr>
</tbody>
</table>

Total Liabilities & Owner’s Equity $113,000

Dec. 31, 2019
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)

MFG Manufacturing Company
Profit and Loss Statement

Jan – Dec 2019

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.

MFG Manufacturing Company
Profit and Loss Statement

<table>
<thead>
<tr>
<th>Description</th>
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<tr>
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<tr>
<td>Gross Profit</td>
<td>$140,000</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>$120,000</td>
</tr>
<tr>
<td>Operating Profit, EBIT</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Net Profit</td>
<td>$ 15,000</td>
</tr>
</tbody>
</table>

Jan – Dec 2019

Understanding your Financial Statements
Operating Expenses

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

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Profit and Loss Statement

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<td>$ 20,000</td>
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<tr>
<td>Taxes</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Net Profit</td>
<td>$ 15,000</td>
</tr>
</tbody>
</table>

Jan – Dec 2019

Understanding your Financial Statements
# Net Income (Loss)

MFG Manufacturing Company

## Profit & Loss Statement

Jan – Dec 2019

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
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<td>$120</td>
</tr>
<tr>
<td><strong>Operating Profit</strong></td>
<td><strong>$ 20</strong></td>
</tr>
<tr>
<td>Taxes</td>
<td>$ 5</td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
<td><strong>$ 15</strong></td>
</tr>
</tbody>
</table>

## Balance Sheet

12/31/2019

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$113</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$ 58</td>
</tr>
<tr>
<td>Owners Equity</td>
<td>$ 55</td>
</tr>
</tbody>
</table>

Includes $15 Ret. Earnings

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Understanding your Financial Statements
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).


Source: EduPristine
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
Understanding your Financial Statements

Typical Cash Flow Curve

- Costs exceed flow recovery
- Start-up revenues at first
- Business growth
- Business maturity

Maximum negative cash flow that needs to be financed

Break-even

Cumulative cash flow recovery

+ $ Cumulative cash
- $ Costs exceed revenues at first
0 $ Start-up costs
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

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

\[
\text{Accounts Receivable (Annual) \times 365} \quad \frac{\text{Sales}}{} \\
\frac{\$25,000 \times 365 = \$9,125,000}{\$350,000} = 26 \text{ days}
\]

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.

Current Assets
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?

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Hudson County Community College Continuing Education & Workforce Development
UCEDC - HCEDC
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