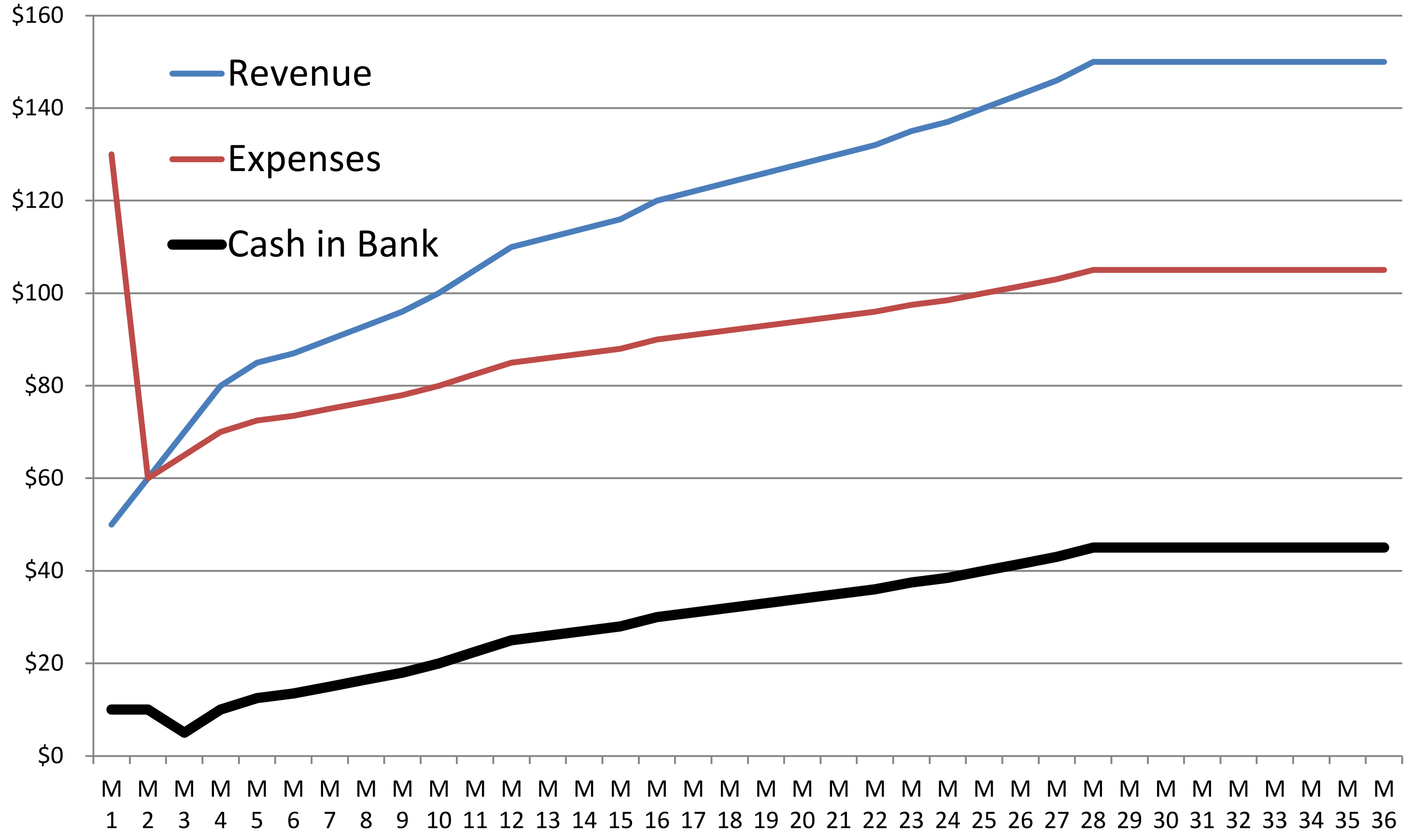
Understanding Your Financial Statements

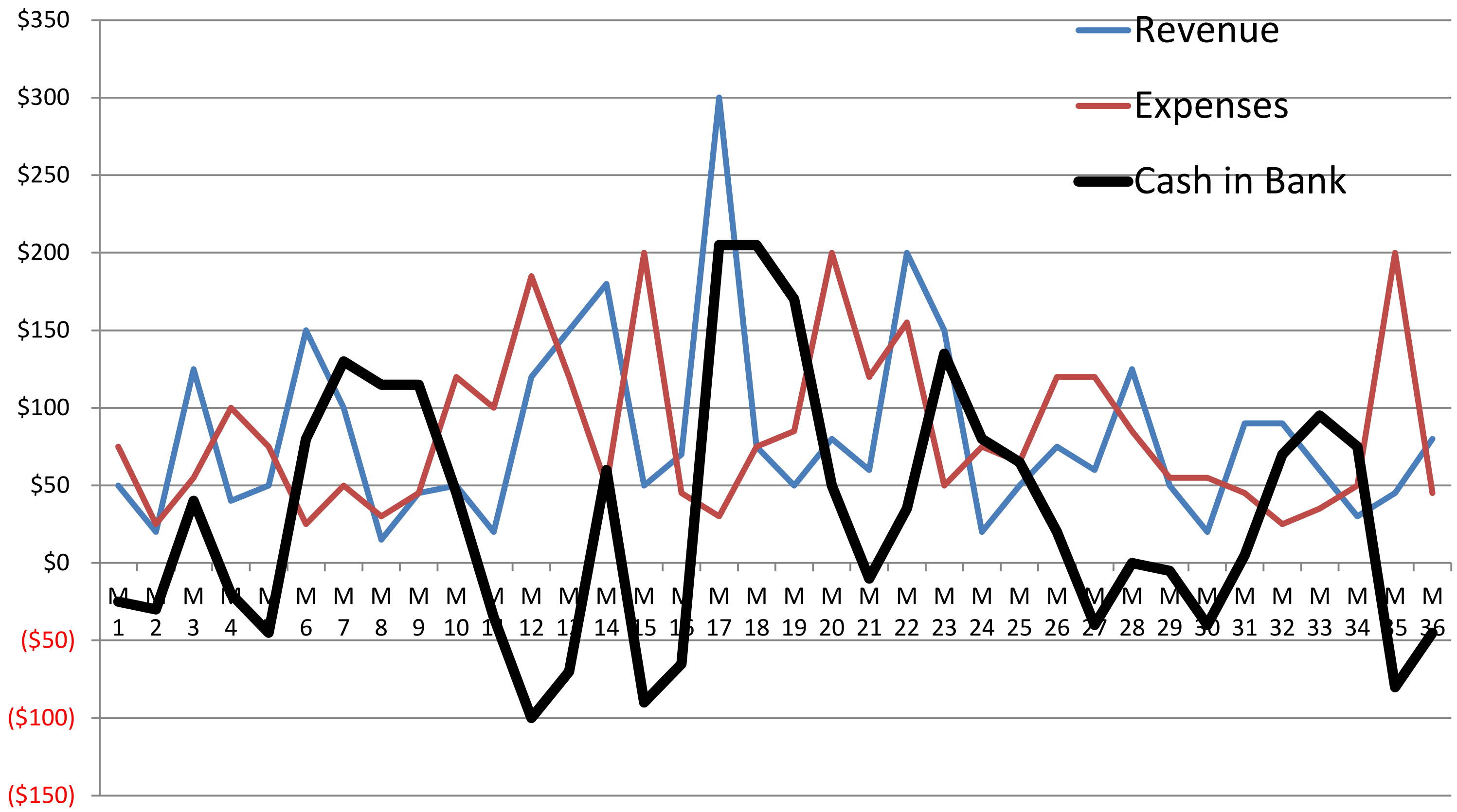
PRESENTATION

RKFISCHER AND ASSOCIATES

What Most People Think of Small Business Financials



The Reality of Financials in a Small Business



Why Care about Financial Statements?

Provides information:

1. To Financial Institutions such as Credit Unions and Banks
2. Competitive & peer comparability for best practices
3. Basis required for computation of income taxes
4. On how well the company is doing compared to previous years
5. As input for making long term decisions
6. For business valuation purposes in case you want to sell or seek additional investors
7. Large customers and suppliers may need to see in order to ensure stability

What Stakeholders Look For

- Risk Assessment (likelihood that you can pay the loan back)
- Can you meet your obligations as they come due
- Do you carry too much debt for the size of your business?
- Are you generating enough cash to pay your bills over time?
- How healthy is your company to generate cash?

What Stakeholders Look For

- They answer these questions by looking at:
- Current Assets and Current Liabilities
  - Cash & cash equivalents to current liabilities (>1)
  - Working Capital (Positive)
- Debt to Equity (no higher than 2:1)
- Earnings before Interest, Depreciation & Taxes (ve positive)
- Profitability 1) Net Income 2) Gross Margin (Net Income +’ve, gross margin industry related)
- All found on your financial statements

Cash versus Accrual Accounting

- The main difference between accrual and cash basis accounting is timing of when revenue and expenses are recognized.

- The cash method accounts for revenue only when the money is received and for expenses only when the money is paid out.

- The cash method is most for personal finances (and the Government). Many small business account on a cash basis.

- On the other hand …

“Cruel Accounting”

- Accrual Accounting matches expenses with the earned revenues in the period in which the expense should have taken place
  - Manufacturing Inventory
  - Retail Inventory
  - Rents paid for the year
  - Insurances paid for the year
  - Revenue earned based on deliverables
- In each case, these expenses are held on the balance sheet as an Asset that can be used within the next year

Pros and Cons

CASH		ACCRUAL
Good at tracking cash flow		Good at tracking profits
Easy to understand (wallet)		More rules based
Lets you know what you can afford today		Lets you and others know what capacity you have to afford something
Not widely accepted by lenders		Lenders understand and rely on it
Not usable where Credits are used (buy /sell now & pay/collect later)		Recognizes that customers owe you money
		Recognizes that you owe others money
		Recognize the event when it occurs (non-cash deals)

Financial Statements – 4 Types

Balance Sheet	A balance sheet is a detailed snapshot of the condition or financial health of a company on a specific date. Balance sheets show the dollar amount of assets (what the business owns) and liabilities (what a business owes) in relation to net worth or owner's equity (what the owner, principals or stockholders own)
Income Statement	The income or profit and loss statement is a detailed computation of the money a business makes or loses it incurs over a specific time period. Sales or service income is offset against expenses- operating and production costs
Statement of Retained Earnings	Displays the changes in the owners' interest in the company, and in the impact of current retained profits or losses from one accounting cycle to the next.
Statement of Cash Flows	Essentially, the cash flow statement is concerned with the flow of cash in and out of the business. The statement shows how changes in balance sheet accounts and income affect cash and cash equivalents based on operating, investing, and financing activities throughout the accounting cycle.

Supporting Notes to Statements

- Notes to the statement contain relevant information that can provide insight to how the company operates and the how decisions are made. It may also highlight problems or expected problems that are not explicitly contained in the above statements.

- Notice To Reader (NTR) is a very important notice to look for. It highlights how the statements were compiled and if there are any expressed concerns. Financial institutions may want to see that they were compiled by a professional accountant such as a CPA, CA, CMA or CGA.

How To Think About Financial Statements

1. You start out with 4 cups of water
2. You don't have enough water to fill the bucket, so
3. You borrow 12 cups from a friend to fill the bucket
4. You now have 16 cups of water in the bucket

Your "bucket" balance sheet would look like:

Assets (what is available to use)	
Water	16 cups
Liabilities (what you owe)	12 cups
Equity (your interests)	4 cups

Assets = Liabilities + Equity
16 cups = 12 cups + 4 cups

How to Think About Financial Statements

Balance Sheet

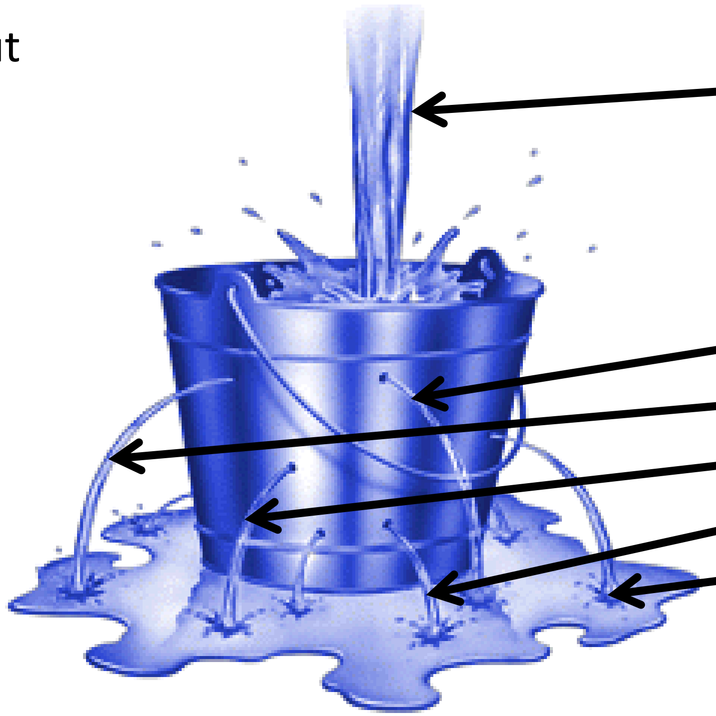
Revenues (Cash Inflows)

Expenses (Cash Outflows)

- Cost of sales
- Marketing
- Rent
- Wages
- Loan retirement

How to Think About Financial Statements

If your expenses flow out faster than your **inflows of revenue**, then eventually your bucket will empty and you will **lose all your water** including the water you borrowed

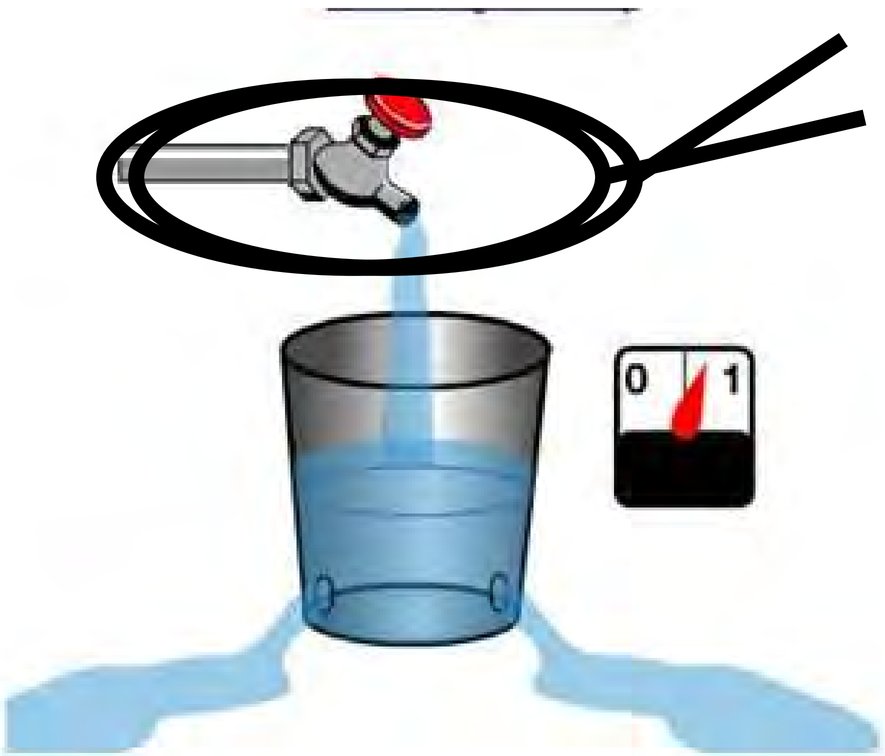


Revenues (Cash Inflows)

Expenses (Cash Outflows)

- Cost of sales
- Marketing
- Rent
- Wages
- Loan retirement

Note on Revenue



Look at this as your **Sales and Marketing** efforts.

Definitions – Balance Sheet

Top half of the Balance Sheet

- Current Assets – Typically with 1 year or current accounting cycle
  - Cash, Accounts Receivable, Inventories
- Long Term Assets
  - Plant, Property, Equipment, Cars & Trucks etc.

Definitions – Balance Sheet

Bottom half of the Balance Sheet

- Current Liabilities
  - Accounts payable
  - Taxes payable
  - Current portion of a long term debt
- Long Term Liabilities
  - Mortgages
  - Note payable
- Equity
  - What is left for the owners once all Liabilities are subtracted from all Assets.

Top Half always equals bottom half

Balance Sheet

The left side		The right side	
Assets		**Liabilities**	
Current	Cash	Current	Accounts Payable
	Accounts Receivable		Short term loans
	Inventory		Other payements due
Fixed	Land	Long term	Mortgage
	Buildings (net)		Other Notes
	Equipment (net)		Shareholders loan
	Vehicles (net)		
Total Assets		**Total Liabilities**	
		Owners Equity	

Assets Current – Liabilities Current = **Working Capital**

Measures how well you can meet your current obligations

Always want **positive working capital**

Income Statement

The left side		The right side	
Revenues	Line of Business 1	Expenses	Cost of Goods Sold
	Line of Business 2		
			Owners salary
			Salaries
			Rent
			Utilities
			Insurance
			Marketing
			Travel
			Depreciation
			Interest Expense
			Income tax
Total Revenues		**Total Expenses**	
		Net Income	

Lets Study the Balance Sheet

The left side		The right side	
Assets		**Liabilities**	
Current	Cash	Current	Accounts Payable
	Accounts Receivable		Short term loans
	Inventory		Other payements due
Fixed	Land	Long term	Mortgage
	Buildings (net)		Other Notes
	Equipment (net)		Shareholders loan
	Vehicles (net)		
Total Assets		**Total Liabilities**	
		Owners Equity	

WORKING CAPITAL
VERY VERY IMPORTANT

Current Assets – Items such as cash that you can use within 1 year

Fixed Assets – Items that provide you with benefits beyond the next year

Current Liabilities – Items that you need to pay within 1 year

Long Term Liabilities – Items that you need to pay beyond the current year

Lets Study the Income Statement

The left side		The right side	
Revenues	Line of Business 1	Expenses	Cost of Goods Sold
	Line of Business 2		Owners salary
			Salaries
			Rent
			Utilities
			Insurance
			Marketing
			Travel
			Depreciation
			Interest Expense
			Income tax
Total Revenues		**Total Expenses**	
		Net Income	

GROSS MARGIN
Differs by industry

Revenues: This is what you and your sales people do

Expenses: Those costs that get incurred as they occur (?) Matching Principle

Cost of Goods Sold: Those costs to produce products you can Inventory

Net Income: The prize you earn by doing things right

Close Look at Inventory

You buy 10 cars for $800,000

You now need to pay Frank a total of $60,000 to get the cars legal and ready for sale

What is the **total value** of your inventory?

$860,000

What is the **total value** of each Car?

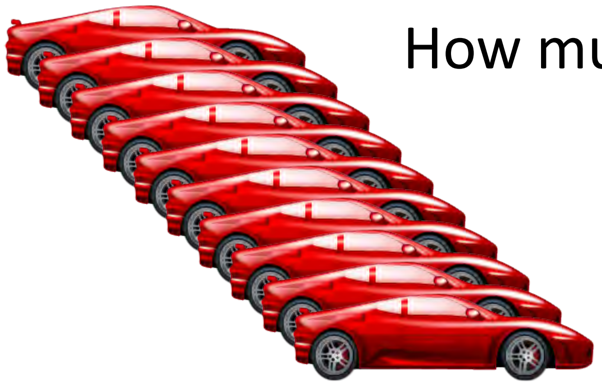
$860,000 / 10 = **$86,000**

Question

- If “Vehicles” are considered Fixed or Long term Assets, why did I just classify these “cars” as a Current Asset under Inventory?

- Because my intent is to convert these assets into cash within the next year.

Close Look at Inventory



You sell 4 cars for a total of $490,000

How much did you make? -$344,000 (4 x $86K)

$146,000

One of the biggest mistakes I see is people treating the purchase of inventory as a Period Expenses versus as Inventory on the Balance Sheet

What is the total value of your inventory? (10-4=6 x $86K) $516,000

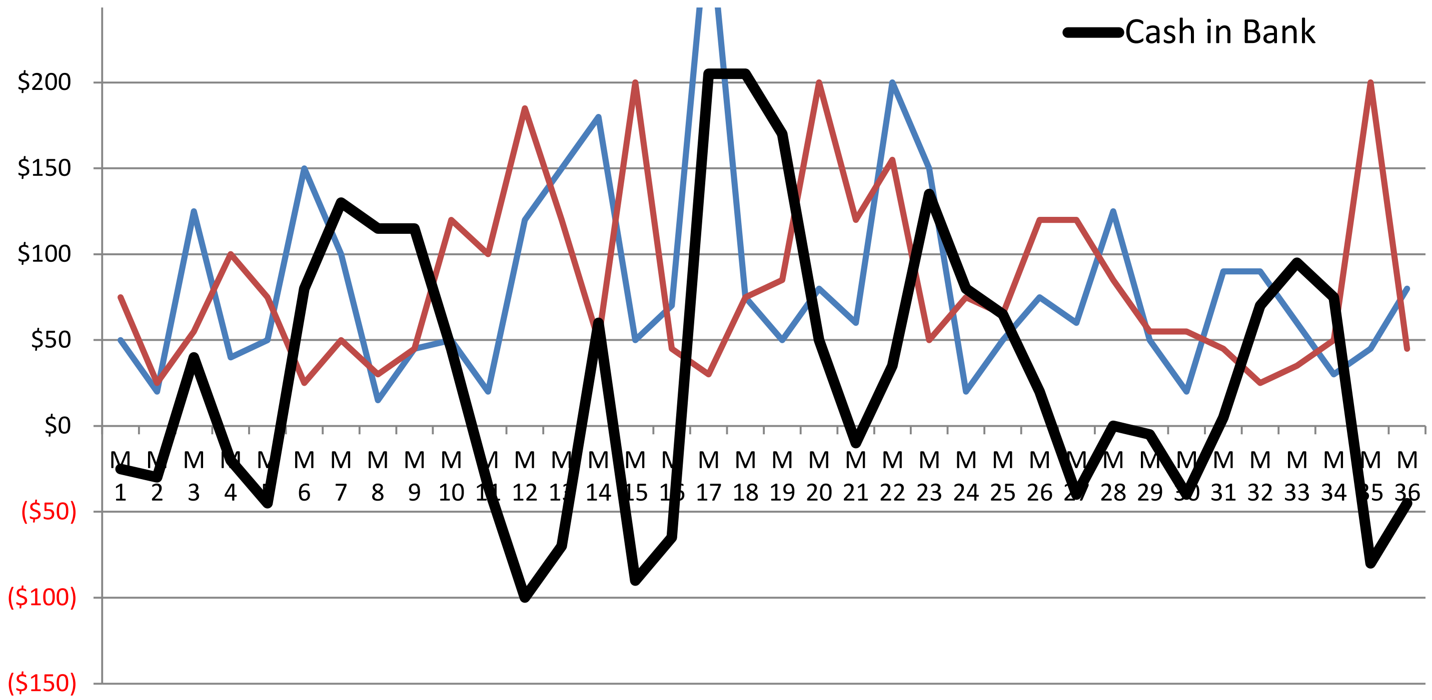
What is the total value of each Car? $516,000 / 6 = $86,000

Gross Margin on the deal was $146,000, but is that what you really made?

What about commissions, rent, salaries, insurance, etc? These are called 'period expenses'

Result of Mistake

One of the biggest mistakes I see is people treating the purchase of inventory as a Period Expenses versus as Inventory on the Balance Sheet;
It leads to Income Statements that look like …



The Accounting Cycle

BALANCE SHEET START of YEAR 1
10 cars $860,000
You owe $860,000

BALANCE SHEET START of YEAR 2
Cash of $490,000
6 cars $516,000
You still owe $860,000

Revenue
- CoGS
Gross Margin
- Expenses
Income
- Taxes
Next Income

And you still made
Sales of $490,000
Expensed $344,000
Income $146,000 (before taxes)

Statements from Operations

Start of Year 1		During Year 1		Start of Year 2	
Cash	$0	Revenue	$490	Cash	$490
Inventory (Cars)	$860	Cost of Goods	$344	Inventory (Cars)	$516
Total Assets	$860	Gross Margin	$146	Total Assets	$1,006
Owe Car supplier	$800			Owe Car supplier	$800
Owe Frank	$60			Owe Frank	$60
Total Liabilities	$860			Total Liabilities	$860
Equity	$0	Retained Earnings	$146	Equity	$146
Working Capital	$0			Working Capital	$146
Debt to Equity	N/A			Debt to Equity	5.89

F/S Improvements

Start of Year 1		**During Year 1**		**Start of Year 2**	
Cash	$0	Revenue	$490	Cash	$50
Inventory (Cars)	$860	Cost of Goods	$344	Inventory (Cars)	$516
Total Assets	$860	Gross Margin	$146	Total Assets	$566
Owe Car supplier	$800			Owe Car supplier	$410
Owe Frank	$60			Owe Frank	$10
Total Liabilities	$860			Total Liabilities	$420
Equity	$0	Retained Earnings	$146	Equity	$146
Working Capital	$0			Working Capital	$146
Debt to Equity	N/A			Debt to Equity	2.88

Take $440,000 of your $490,000 in cash to pay down debt

See improvement in you Debt to Equity ratio from 5.89 to

Example: Income Statement

INCOME STATEMENT, SAM'S APPLIANCE SHOP

	SALES REVENUE		$1,870,841.00
Cost of Goods Sold:			
Beginning Inventory 1/1/8X		$ 805,745.00	
Purchases		939,827.00	
Goods Available for Sale		1,745,572.00	
Less Ending Inventory 12/31/8X		455,455.00	
COST OF GOODS SOLD		1,290,117.00	
	GROSS MARGIN		$ 580,724.00
Operating Expenses:			
Advertising		$ 149,670.00	
Insurance		56,125.00	
Depreciation			
Building		18,700.00	
Equipment		9,000.00	
Salaries		224,500.00	
Travel		4,000.00	
Entertainment		2,500.00	
TOTAL OPERATING EXPENSES			$ 464,495.00
General Expenses			
Utilities		$ 5,300.00	
Telephone		2,500.00	
Postage		1,200.00	
Payroll Taxes		25,000.00	
TOTAL GENERAL EXPENSES			$ 34,000.00
Other Expenses			
Interest		$ 19,850.00	
Bad Check Expense		1,750.00	
TOTAL OTHER EXPENSES			$ 21,600.00
TOTAL EXPENSES			$ 520,095.00
NET INCOME			$ 60,629.00

Contact Us

Business Consultants and Business Coaches

www.rkfischer.com

Phone: (877)504-2049

Email: sales@rkfischer.com