FINANCIAL STATEMENT MANAGEMENT

•WELCOME

PRESENTER INTRODUCTION

- Steph Albano
- Hatched Concepts, LLC
- Previously served as a Financial Analyst, Director of Distribution Center Operations, National Marketing Roles, and owned businesses of my own.
- Enjoy working with small business to ensure growth and profitability.
- Please feel free to ask questions and participate in today's conversation.

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INTRODUCTION

- An accurate financial statement package provides you with the tools to assess the financial health of your business
- Just as a doctor uses observation and diagnostic tools, you need to use your financial statements to monitor your business performance.
- In this seminar, you will learn how to use the statements to inform your business decisions.

HATCHED CONCEPTS

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PONDERING THOUGHT

- **WHAT DO YOU WANT TO DO WITH YOUR BUSINESS?**
- Do you have an exit plan?
- Sell some day?
- Grow? To what?
- Pass on to your children?
- When will this happen?
- How will this happen?
- In order to make the right business decisions, you need to have a plan

HATCHED CONCEPTS

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GETTING TRAPPED

- Dick and Jane (their real names) made short term decisions that haunted them in the long term:
- Intentionally understated inventory
- At sale, would have to recognize gains
- In the long term, were in a higher tax bracket

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THE "WHAT"

A good Financial Statement package contains:

a. Balance Sheet

b. Statement Of Earnings

(aka Profit & Loss Statement)

The *best* Financial Statement package also includes:

Cash Flow Analysis — Key Financial Indicators

Budget Comparison — Monthly Recap

& General Ledger Listing

HATCHED CONCEPTS

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THE "WHY"

Why do we need financial statements?

1. Keeps the owner informed of the financial performance of the business, and make decisions if changes are needed
2. Tracks the progress being made in reaching the owner's financial goals
3. Helps lenders determine the financial stability of the business
4. Justifies reporting to taxing and government authorities

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THE "WHEN"

- How often do you receive your financial statements?
- **You should receive monthly financial statements no later than the 20th of the following month**
- Why is timing important?

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THE BALANCE SHEET

- The Balance Sheet is a statement of Assets, Liabilities, and subsequent Net Worth as of a certain date

  (Net Worth is also known as Equity)

The Balance Sheet is a statement as to Where You Are, as of that date

(Think of the Equity vs balance owned on your home)

HATCHED CONCEPTS

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THE BALANCE SHEET

THE BALANCE SHEET

ASSETS			**$400,000**
LIABILITIES		**$300,000**	
NET WORTH/EQUITY			
INVESTMENT	**$75,000**		
CURRENT PROFIT	**25,000**		
		$100,000	
TOTAL LIABILITIES AND NET WORTH		**$400,000**	

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THE BALANCE SHEET

- Assets are items owned by, or due, the business.
- Assets would be Cash, Accounts Receivable, Inventory, Fixed Assets, Prepaid Expenses and Other Assets.
- The purpose of an asset is to support your business.

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WHY HAVE ANY ASSETS?

- **ASSETS ARE REQUIRED TO DRIVE SALES.**
- **GROWING SALES REQUIRES A GROWTH IN ASSETS.**
- **ANY ASSET BASE GROWTH REQUIRES CASH.**

HATCHED CONCEPTS

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THE BALANCE SHEET

- Asset reporting on the Balance Sheet should be done in order of liquidity.
- Assets should be segregated into three categories.

HATCHED CONCEPTS

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CURRENT ASSETS

- Also referred to as Liquid Assets.
- These are assets that are Cash,
  will be liquidated to Cash
  or, will be used within the next 12 months.

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FIXED ASSETS

- Fixed Assets are assets having an extended life, used to support the business, and not acquired with the intent of resale.
- Fixed Assets are generally depreciable in value.

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OTHER ASSETS

- Other Assets are those assets that do not qualify as a Current Asset (will not be used or liquidated within the next 12 months), or as a Fixed Asset.
- Examples would include Deposits for Rent or Utilities, Investment in another business, Goodwill, Non-Compete Agreements, etc.

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LIABILITIES

- Liabilities are obligations of the business.
- The purpose of the obligation is to fund the Assets of the business.
- The funding of Assets is accomplished through contributions of capital, profits, or through the capacity to utilize Liabilities.

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LIABILITIES

- Liability reporting on the Balance Sheet should also be done in order of liquidity.
- Liabilities should be segregated into two categories.

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LIABILITIES

- Current Liabilities are those liabilities that are to be paid within the next 12 months.
- Long Term Liabilities are those liabilities that are to be paid in 13 months and longer.

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BALANCE SHEET FORMULA

Remember:

Assets minus Liabilities equals Net Worth

it also works with:

Liabilities plus Net Worth equals Assets

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BALANCE SHEET FORMULA

- The point is that an owner must utilize Liabilities to fund Assets, which are needed to drive Sales
- If you want zero Liabilities, then **ALL** funding for your Assets must come from Net Worth
- Let's look at Net Worth

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NET WORTH

- Net Worth is the difference between Assets and Liabilities
- Net Worth is that funding of Assets **not** provided by Liabilities
- Net Worth is your "nest egg" – what you walk away with, after liquidating the Assets and paying all of the Liabilities

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NET WORTH

- **There are only two (2) ways to increase Net Worth**

- Which way would you prefer to increase your Net Worth? Profit or Investment?

- Profit is not a 4 letter word!!!

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NET WORTH ACCURACY

- Obviously, the accuracy of the Net Worth statement is important
- First, **you** can't make the correct decision if Net Profit is mis-stated
- The Net Worth value would impact a Banker's decision
- Over stated Net Profit would impact the amount of income taxes you have to pay

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NET WORTH ACCURACY

The decisions you want to make, if you plan to sell your business, might be very different than the decisions you would make if you are going to "gift" the business to your children, and very different if your plan is to be in business for many more years.

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CURRENT ASSET ACCOUNTS

- From ground level, let's examine some of the accounts, starting with Cash On Hand and Cash In Bank. Are you reconciling these to ensure accuracy each month?
- The purpose of Accounts Receivable is to support Sales.
- How would you know this is an accurate number?

  Are your accounts current and collectable?

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CURRENT ASSET ACCOUNTS

- Inventory might be your largest investment, therefore requires the utmost in management:
  a. Performing Classifications on schedule
  b. Having a firm policy on Special Orders
  d. Proper accounting of consigned merchandise
- How would you know this is an accurate number?

CURRENT ASSET ACCOUNTS

- There should be **only** a small difference between the computer total valuation and the book balance

FIXED ASSET ACCOUNTS

- The management of Fixed Assets is as important as any other type of asset
- Best practice would be to do an annual inventory to make sure the book amount is accurate
- After all, it affects your property tax, income tax, and statement of Net Worth

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ACCUMULATED DEPRECIATION

- Depreciation is the method of recording the use of a Fixed Asset during it's life.
- In other words, depreciation is the way to reduce the book value of a Fixed Asset over a period of time
- Depreciation is recorded by way of a journal entry to reduce the book value of Fixed Assets
- Depreciation is a non-cash entry

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ACCUMULATED DEPRECIATION

- Methods of depreciation vary greatly, but should be based on the expected life **for book purposes.**
- Uncle Sam's regulations dictate the depreciation write-off's for most of your Fixed Assets.
- Yes, you are allowed to have two depreciation schedules – one for book purposes and one for tax purposes.

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ACCUMULATED DEPRECIATION

- Your income tax liability is impacted by taking advantage of the quickest depreciation
- Where as your net book value of Fixed Assets needs to remain as high as possible for the visit to the Banker

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OTHER ASSETS

- Other Assets are those assets that do not qualify as a Current Asset, or as a Fixed Asset
- Examples would include Deposits for Rent or Utilities, Investment in another business, Goodwill, Non-Compete Agreements, etc.

CURRENT LIABILITIES

- Now, let's look at the second page of the Balance Sheet
- Notes Payable amounts should closely proximate the amount of principal to be paid in the next 12 months.
- This is not the total owed on a loan.

PAYABLES AND ACCRUALS

- **Payroll Taxes Payable** should represent the business' liability for payroll taxes and withholding not yet paid.

  This includes the employee and employer share.
- **Sales Tax Payable** should be the amount of sales taxes collected and owed.

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ACCRUED EXPENSES

- Accrued Expenses is the recognition of amounts (often an approximation) for an expense owed, but for which an invoice or bill has not been received (Think of the opposite of a Prepaid).
- Examples:

  Accrued Payroll – month-end is Wed., P/R is on Friday

  Accrued Property Tax – billed at the end of the year

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NET WORTH

- The Net Worth section will vary by type of business entity
- The Net Worth section will be comprised of at least 3 components:

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NET WORTH

- The original investment – Capital Stock

  This is the value of the shares invested when the corporation was first formed.
- The Retained Earnings is the accumulated and retained Net Profit/Loss, net of income tax, withdrawals, or dividends for all of the previous fiscal years, prior to the current year.

  This amount usually changes only once a year.

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NET WORTH

- The Current Earnings – is equal to the amount of Profit/Loss for this fiscal year

  As detailed in the Statement Of Earnings

- This amount is zeroed at the end of the year, and rolled into Retained Earnings

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NET WORTH VARIATIONS

- For a Sub S Corporation, an account for "**Sub S Distributions**" would contain the amount of draws used to pay the taxes for the corporation, by the shareholders
- For a Proprietorship, a Partnership, or a Limited Liability Company (LLC), an account for "**Owners Draw**" would contain the amount of draws used by the partners or members

HATCHED CONCEPTS

THE STATEMENT OF EARNINGS

- The Statement Of Earnings details the Sales Revenues, Cost Of Sales, Expenses and subsequent Net Profit/(Loss) of the operation for a set period of time.
- The Statement Of Earnings details the history of the Current Earnings reflected on the Balance Sheet.
- "Statement of How You Got There"

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THE STATEMENT OF EARNINGS

THE STATEMENT OF EARNINGS

SALES	**$300,000**
COST OF GOODS SOLD	**200,000**
GROSS PROFIT	**$100,000**
EXPENSES	**75,000**
CURRENT PROFIT	**$ 25,000**

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W.I.I.F.Y.

Understanding the Statement Of Earnings will:

- Assist in making decisions to maximize profitability
- Provide insight to areas that need improvement
- Enable ability to measure achievement of objectives

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SALES

- Sales are the vehicle with which to generate Gross Profit
  (not a Sales Manager's prospective)

- You do NOT pay expenses with Sales, rather Gross Profit **$$**

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SALES CATEGORIES

- Segregation permits visibility to Sales Mix
- Cash Sales mix is indicative of the amount of "retail" sales
- Charge Sales mix facilitates the ability to measure Accounts Receivable Currency

HATCHED CONCEPTS

COST OF GOODS SOLD

- Let's look at the Cost Of Goods Sold (C.O.G.S.)
- The amount of C.O.G.S. should equal the value of the merchandise **sold** in the current period

  That is SOLD, not purchased
- **Four different methods to calculate.**

HATCHED CONCEPTS

OPERATING EXPENSES

- Expenses should be segregated between Operating Expenses and Other Expenses.
- Operating Expenses are defined as costs of:

  Generating Sales

  Providing a Facility

  Protecting Assets

  Payroll and related costs

  Taxes on Payroll, Assets, and Facilities

  Operations for this accounting period

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OPERATING EXPENSES

- Some expenses are tax deductible –some are not
- There are General and Administrative expenses that deserve explanation:
- Amortization Expense and Depreciation Expense are ***non-cash*** entries

  These amounts will be subtracted from Expenses, when computing Cash Flow.

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CASH FLOW ANALYSIS

"My Statement Of Earnings reports that I have made $50,000 in Net Profit this year, but I look in my check book, and it is not there."

The Cash Flow Analysis report can show you what has used, or provided, the cash for the period being reported.

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CASH FLOW ANALYSIS

- A Cash Flow Analysis report is necessary to an owner to identify where your cash is being tied up due to increases in Asset base, or the decreases in Liabilities
- If your Asset Base growth out paces the available cash, then cash flow will be impacted

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TAKING ACTION

- You have ascertained what is providing and/or using your cash; now what do you do?
- Evaluate the course of action:

a. Is your Net Profit adequate?
b. Do your Accts. Rec. collections need improvement?
c. Is your Inventory level where it should be?
d. Is your Equity sufficient?
e. Is it time to review financing opportunities?

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KEY FINANCIAL INDICATORS

- One ratio (indicator) that we're all familiar with is miles per gallon (MPG) for vehicles.
- What value do we get from comparing MPG?

  It tells you about the fuel efficiency of the vehicle; not much else about size, horsepower, handling, etc.

  Keeping track of your fuel efficiency helps you decide what to do to improve that efficiency.

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KEY FINANCIAL INDICATORS

- We are now going to review a number of ratios that you can use to evaluate your business efficiencies.
- These indicators are certain ratios designed for quick reference, and are specific & important business indicators that will assist you in making the best business decisions.
- In most cases these indicators require monitoring to assure that the desired improvements are being realized.
- Improvements may not achieve immediate results, but by tracking you can make sure progress is being made.

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W.I.I.F.Y.

- Understanding these Key Financial Indicators will help you make the most informed decisions to improve your business.
- Understanding these Key Financial Indicators will help you measure your business against industry standards.

HATCHED CONCEPTS

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PROFIT PERCENTAGE TO SALES RATIO

- The Profit/(Loss) Percentage to Sales Ratio is a measurement of the current period's Profit or (Loss), before Income Tax, as a percentage of Sales.
- The formula is:

  Net Profit (or Loss), before tax, divided by Total Sales

Note: For proprietorships, partnerships, and Limited Liability Companies, deduct the Owner's Draw from the Net Profit before dividing by Sales.

HATCHED CONCEPTS

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PROFIT PERCENTAGE TO SALES REMEDIES

- When the ratio does not meet the target, you will need to implement this remedy:
- **INCREASE NET PROFIT**
- There are only 3 courses of action:

1. **Increase the Gross Profit margin on existing Sales**
2. **Increase Sales**
3. **Reduce Expenses**

HATCHED CONCEPTS

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NET WORTH RATIO

- The Net Worth Ratio is a measurement of the Asset base funding contributed by Net Worth, versus the funding by Liabilities
- **This ratio is the 1st thing a Banker examines**
- This ratio compares the Total Net Worth to the Total Assets
- Remember the Balance Sheet formula?

HATCHED CONCEPTS

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NET WORTH RATIO

Assets minus Liabilities equals Net Worth

Liabilities plus Net Worth equals Assets

HATCHED CONCEPTS

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NET WORTH RATIO

- The formula is:

  Total Net Worth divided by Total Assets

HATCHED CONCEPTS

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NET WORTH RATIO

- THE TARGET IS 25.0%, or GREATER
  (note the target says "or Greater")
  Does your "nest egg" have an upper limit?

  The ability to borrow is improved

HATCHED CONCEPTS

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NET WORTH RATIO

- If below the target:

  There is an inability to grow the Asset Base, which limits ability to grow sales, generate profit, etc.

  Cash Flow pressure will be high if the Net Profit is marginal.

  Or, if Sales and Revenues decline due to seasonality or economic conditions.

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NET WORTH RATIO REMEDIES

- When the ratio does not exceed the target, you need to implement these remedies:

1. **Increase Net Worth and use those funds to reduce Liabilities**
2. **Reduce Asset base and use those funds to reduce Liabilities**
3. **Increase your investment by contributing more Capital**

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NET WORTH RATIO

This ratio is so important!

- Let's relate to what the Banker sees:

  Put on your Banker hat, I'll be the business owner

  My Net Worth is right on the target (25%).

  What percentage of the risk do I have?

  25.0%

  What percentage of the risk do you have?

  75.0%

  Understand why your borrowing ability is impacted?

ACCOUNTS RECEIVABLE CURRENCY

- This ratio measures the portion of the Accounts Receivable balance that is the result of the current month's Charge Sales

- The formula is:

  This Month's Charge Sales divided by Accounts Receivable

ACCOUNTS RECEIVABLE CURRENCY

- THE TARGET IS 85.0%, or GREATER
  (note the target says "or Greater")

- The lack of collections is affecting Cash Flow.

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ACCOUNTS RECEIVABLE CURRENCY REMEDIES

- When the ratio for Accts. Rec. Currency does not meet the target, you may want to implement these remedies:
- Credit policies must be instituted and enforced
- Be strict on credit limits
- Offer a prompt payment discount
- Assess a Finance Charge for late payments
- Instigate weekly payment for slow paying accounts

Improve your collection efforts

HATCHED CONCEPTS

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GROSS PROFIT PERCENTAGE RATIO

- This ratio gives you a measurement of the Sales Gross Profit dollars in proportion to Net Sales of Parts.
- The formula is:

  Gross Profit divided by Sales

HATCHED CONCEPTS

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GROSS PROFIT PERCENTAGE RATIO REMEDIES

- When the ratio for Gross Profit does not meet the target, you need to implement these remedies:
- Review Customer Pricing schedules to verify that customers deserve the discounts received
- Take full advantage of quantity and seasonal discounts

HATCHED CONCEPTS

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GROSS PROFIT PERCENTAGE RATIO REMEDIES

- **Focus on the right things**
- **Increase the mark-up on existing sales**

- **DID YOU KNOW?**
- A 1.0% Increase in your Gross Profit percentage can yield the same amount of Net Profit dollars, as a 15%, & greater, increase in Sales

HATCHED CONCEPTS

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GROSS PROFIT PERCENTAGE IMPROVEMENT

- Let's discuss what you can do to gain an increase in Gross Profit. What ideas do you have?

(1.0% is $.01 on a dollar)

Price Rounding – that $2.84 widget can be rounded to $2.89

Stop permitting over-rides at P.O.S.

HATCHED CONCEPTS

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INVENTORY TURNS RATIO

- This ratio provides a measurement of the number of times the **average** inventory investment is sold during the year.
- The text book formula is:

  Annual Cost Of Goods Sold divided by Average Inventory

  Note: To calculate throughout the year, annualize the C.O.G.S. (Y.T.D. C.O.G.S. divided by # of months, times 12)

HATCHED CONCEPTS

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INVENTORY TURNS RATIO

- THE TARGET IS 2.5 to 3.0

  (note the target is **not** open ended, meaning this could be a double edge sword)
- Sample Auto Parts is below the target, which means that there is an overstocking for the level of Sales with an increased potential for loss due to obsolescence
- Typically, there are high storage and financing costs (Interest)

HATCHED CONCEPTS

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BUDGET COMPARISON

- It is a fact that business owners who use budgets to monitor their business out perform those who do not use budgets
- **If you don't know how to get where you want to go, how will you ever get there?**
- **Do any of you currently use a budget?**

BUDGET COMPARISON

SUCCESS DOES NOT JUST HAPPEN

- The more valid the Proforma, the more you can work the plan
- Focus on making a plan, based on what ***will*** happen
- Make your plan accountable

  Without accountability, the plan will have no value
- Based on the plan, **TAKE CONTROL OF YOUR BUSINESS**

BUDGET PREPARATION

- CREATE A SALES FORECAST – Look at the last 2 years of Sales history (best by monthly), coupled with all of the previously mentioned.

  Don't forget Seasonality impacts!

- Next, based on the number of work days, each month. Calculate the average daily Sales.

- CREATE THE GROSS PROFIT FORECAST – Begin with what % you have had historically, and forecast what changes you will make based what you've learned today.

HATCHED CONCEPTS

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BUDGET PREPARATION

- CREATING THE PAYROLL EXPENSE FORECAST –

  Think about how many additional sales would be needed to support an additional employee.

  What is your gross profit on those sales?

  If you can achieve that much gross profit…..

HATCHED CONCEPTS

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GENERAL LEDGER LISTING

- The General Ledger Listing shows all of the accounting transactions, for the current month, with a column reflecting the total account balance (year-to-date).

HATCHED CONCEPTS

FINANCIAL STATEMENT SEMINAR WRAP UP

THANK YOU

VERY MUCH FOR THE TIME AWAY FROM YOUR BUSINESS TODAY

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HATCHED CONCEPTS