Ann's Lecture on Financial Statements (Business Finance 101)

Ann picked up the first document. "The Income Statement is the one you'll use the most. Let me start by defining the major terms. You are probably already familiar with most of them, but lets go through them anyway just to make sure we're on the same page.

Company XYZ - Income Statement

		Month 1	Month 2	Month 3	Month 4	---	Month 12	Annual Totals
SALES	ASP							
Product 1	$--	$0	$0	$0	$0		$0	$0
Product 2	$--	0	0	0	0		0	0
Product 3	$--	0	0	0	0		0	0
	Total Sales	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
COST OF GOODS								
Materials	$--	$0	$0	$0	$0		$0	$0
Labor	$--	0	0	0	0		0	0
Overhead	$--	0	0	0	0		0	0
Other	$--	0	0	0	0		0	0
	Total COGS	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
	GROSS PROFIT	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
	Gross Margin	--%	--%	--%	--%		--%	--%
OPERATING EXPENSE								
Payroll								
Wages & Salaries		$0	$0	$0	$0		$0	$0
Payroll Taxes		0	0	0	0		0	0
Benefits		0	0	0	0		0	0
	Sub-Total	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
General & Administrative								
Rent & Utilities		$0	$0	$0	$0		$0	$0
Communications		0	0	0	0		0	0
Insurance		0	0	0	0		0	0
Business Taxes		0	0	0	0		0	0
Maintenance/Repairs		0	0	0	0		0	0
Office Supplies		0	0	0	0		0	0
Equipment Rental		0	0	0	0		0	0
Interest		0	0	0	0		0	0
Depreciation		0	0	0	0		0	0
Other		0	0	0	0		0	0
	Sub-Total	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
Sales & Marketing								
Advertising		$0	$0	$0	$0		$0	$0
Tradeshows		0	0	0	0		0	0
Travel & Entertainment		0	0	0	0		0	0
Other		0	0	0	0		0	0
	Sub-Total	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
	Total Expense	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**
	GROSS PROFIT/[LOSS]	**$0**	**$0**	**$0**	**$0**		**$0**	**$0**

"*Sales* represent the revenue you receive for delivery of goods and services. *Cost of Goods,* or 'COGS', is what you paid to acquire or produce those goods and services. *Gross Profit* is the difference between Sales and COGS and is the amount you have left over to pay the company's operating expenses. *Operating Expenses* are all the costs of doing business not included in COGS, such as payroll, general and administrative expenses, and sales and marketing costs. The last row, *Profit,* is how much you made or lost during the period.

"Income Statement projections usually span a two or three year time horizon; numbers are shown monthly for the first two years and quarterly for the third. Occasionally someone will ask for a five-year projection, and then you'd show an annual total for the fourth and fifth years. The reason for these shifting 'time buckets' is that accuracy declines the further out in time you go. Frankly, it's very difficult for a business, particularly a new one, to predict their financial performance more than a few months in advance; it's virtually impossible to see several years out.

"As a side note, for companies that have been in business awhile, we'll often show their actual performance for the past two or three years. This lets people assess trends and evaluate the company's projected performance in the context of its past performance.

"When you're preparing your business plan, you should try to be as conservative as possible. There's a canon among veteran entrepreneurs, known as the '2x4 Rule' – everything takes twice as long and costs four times as much as you expect. Most entrepreneurs have learned this rule the hard way, and you're probably going to learn it firsthand too. In many respects, it's unavoidable, but you can minimize the damage by including large allowances for error in your plans and budgets.

"But inclusion of large contingency allowances in your budget is a fine line to walk, particularly if you're trying to attract investors. You don't want to be so conservative or pessimistic that the business looks unattractive, but you also don't want to show numbers that can only be achieved if everything goes perfectly right. Just remember, people expect you to meet or exceed your plan, not miss it by a mile."

Ann paused, "OK that was a pretty quick overview of the Income Statement. I didn't talk about any of the sub-accounts but I can if you'd like."

Bill smiled and said, "I don't think we need to do that. I'm pretty familiar with statements like this because it's similar in many ways to the budget Olivia and I use at home. We track our income and all of our personal expenses. I've also had some experience with sales forecasting and expense budgeting at Templeton, so I'm familiar with most of the terms and concepts. The only thing that's going to be new is putting numbers together for an entire business."

Ann nodded, "I agree, that usually is the biggest challenge. Many new entrepreneurs have had experience with departmental forecasts and budgets, but have never had to do it for a whole company. Now you have to consider every facet of company operations, and it's not that easy to do. But these planning templates I'm going to give you will make the job easier. And again, if you have questions, you can give me a call."

She put the Income Statement aside and picked up the Cash Flow Statement.

Company XYZ – Cash Flow Statement

	Month 1	Month 2	Month 3	Month 4	---	Month 12
STARTING CASH						
Cash	$0	$0	$0	$0		$0
Securities	0	0	0	0		0
	$0	**$0**	**$0**	**$0**		**$0**
Total Cash						
CASH RECEIVED FROM OPERATIONS						
Net Profit / (Loss) from Operations	$0	$0	$0	$0		$0
Increase in Accounts Payable	0	0	0	0		0
Decrease in inventory	0	0	0	0		0
Increase in accruals	0	0	0	0		0
Increase in reserves	0	0	0	0		0
Other	0	0	0	0		0
	$0	**$0**	**$0**	**$0**		**$0**
Total Funds Received						
CASH CONSUMED BY OPERATIONS						
Increase in inventory	$0	$0	$0	$0		$0
Increase in Accounts Receivable	0	0	0	0		0
Prepayments	0	0	0	0		0
Capital expenditures	0	0	0	0		0
Decrease in reserves	0	0	0	0		0
Other	0	0	0	0		0
Total Funds Consumed	**$0**	**$0**	**$0**	**$0**		**$0**
OTHER CASH ACTIVITY						
Equity infusion	$0	$0	$0	$0		$0
Bank debt	0	0	0	0		0
Other	0	0	0	0		0
	$0	**$0**	**$0**	**$0**		**$0**
Total Other Activity						
ENDING CASH						
Cash	$0	$0	$0	$0		$0
Securities	0	0	0	0		0
Total Cash	**$0**	**$0**	**$0**	**$0**		**$0**

Ann continued, "This is a statement that might be new to you. The Cash Flow Statement is used to track the flow of cash into and out of the business, and I think it's the owner's most important tool for running the company.

"A way that helps me understand cash flow is to think of the business as a bucket with holes in the bottom. Cash pours in the top when customers buy products and pay their bills; it then runs out through a series of holes representing inventory purchases, operating expenses, capital expenditures, and so on. It is the owner's job to make sure there is always plenty of cash in the bucket. If sales drop off or customers are slow to pay, the owner must reduce the rate of outflow by reducing the size of one or more holes. If he or she doesn't act quickly enough, and cash continues to pour out faster than it pours in, the bucket will run dry.

"I've said it before, but it's something I can't emphasize enough -- cash is the lifeblood of the business. You always have to know your cash position, not only this week and this month, but also many months ahead. If you see cash getting low, you've got to take whatever actions are necessary to correct the situation, whether it's getting customers to pay faster, reducing inventory, cutting expenditures, or investing additional capital into the business. Just remember, if the bucket runs dry, you're out of business."

Ann then picked up the Income Statement and held it up in front of her along with the Cash Flow Statement.

"Another thing that's important to understand is that 'profit' is not the same thing as 'cash.' Just because the income statement shows you have earned a profit of $100 at the end of the month, that doesn't mean you have $100 to put into your pocket. In the operation of a business many things occur that don't show up on the income statement. These things may have little or no impact on profits, but they can have a big impact on cash.

"For example, there are lead-times and lag-times in the way cash flows. Many companies have to buy materials in advance of a sale and hold them in inventory; this means they may have to pay for goods in period 1 that won't sell until period 3. Then, when they're sold, the customer doesn't pay for them until 30 or 60 days later. The income statement shows the revenue and profit from the sale in period 3, but it doesn't show that the cash used to support that sale was paid out of the business in period 1 and be won't come back into the business until period 4 or 5.

"This is what a Cash Flow Statement does -- it shows the cumulative affect of all these lead- and lag-times and other activities that affect cash. It helps the owner keep track of their cash position and alerts them to imbalances between the inflow and outflow.

"This disparity between profits and cash flow explains how a growing, "profitable" company can go bankrupt. As sales grow, the amount of money tied up in inventory and accounts receivable also grows. If the owners aren't paying attention, they'll wake up one day and find they don't have enough cash in the bank to pay their bills. Their profits may look great, but without cash, they can't keep the doors open.

"There are many other factors that affect cash and contribute to the disparity between cash flow and income statements, but I'm not sure we need to spend time on them today.

After I learn a little more about what you're going to be doing with your company, we may have to come back and cover these items. But let's hold off for now. Do you have any questions?"

Bill shifted in his chair and smiled ruefully. "That was a very interesting description of how cash flow works. It helps me understand a little better how Templeton Supply got into trouble. They weren't paying enough attention to the water supply. When the economy turned, sales dipped and collections slowed, but management didn't move quickly enough to curtail spending, and before long they were out of cash. Maybe if they'd been watching things more closely, they could have avoided some of the cutbacks they had to make just to keep the doors open."

Ann nodded. "Yes, I think you're right. They definitely took their eyes off the ball. I'm pretty familiar with the situation because several of my clients were vendors to the company. When Templeton stopped paying its bills, it had a ripple effect through the whole business community. I know of several companies that depended on Templeton for a large part of their business; they ended up going through cash flow crises of their own. Fortunately, none have gone under, but they're all going to be struggling for quite some time to get back on their feet."

Ann set the form aside and said, "Would you like to take a break? It's going on 5:00 pm and we've been going at it for nearly three hours."

Bill looked at his watch and was amazed to see it was that late. They'd been working so intensely, he'd lost track of time. But he wasn't ready to stop yet. He responded, "I've got to be out of here by 5:30, so why don't we keep going until then."

Ann replied, "That sounds good to me. We're not going to finish today, but we should be able to get through the balance sheet. Then we can finish up tomorrow by talking about how to apply all of this to your business plan."

Ann picked up the third form on the table and continued, "The Balance Sheet is a statement of a company's wealth or financial position at a fixed point in time. It shows the assets and liabilities of the company and the difference between these two, which is the shareholder's equity. Let's start by defining some terms.

"Assets are what the company owns and what it is owed. They are grouped into two categories -- 'current' or 'liquid' assets and 'fixed' or 'long term' assets. Current assets are things that can be converted into cash relatively quickly such as cash in the bank, securities, inventory, and accounts receivable. Fixed assets are things that would take longer to convert to cash, such as real estate, furnishings, equipment, and intellectual property.

Company XYZ – Balance Sheet

(As of [date])

ASSETS		
CURRENT ASSETS		
Cash in Bank and On Hand	$0	
Accounts Receivable	0	
Inventory (at cost)	0	
Total Current Assets		**$0**
FIXED ASSETS		
Capital equipment, furnishings	$0	
Other	0	
Total Fixed Assets		**$0**
TOTAL ASSETS		**$0**
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts Payable	$0	
Revolving Credit (current portion)	0	
Payroll	0	
Taxes Payable	0	
Total Current Liabilities		**$0**
LONG-TERM LIABILITIES		
Bank loans	$0	
Other	0	
Total Long-Term Liabilities		**$0**
TOTAL LIABILITIES		**$0**
SHAREHOLDER'S EQUITY		
Paid-in Capital	$0	
Retained Earnings	0	
Total Equity		**$0**
TOTAL LIABILITIES AND EQUITY		**$0**

"Liabilities are obligations the company has to pay others. These too are grouped into two categories -- 'current' and 'long term' liabilities. Current liabilities are debts or obligations that must be paid within the next year, such as bills from vendors, tax obligations, and the principal on a portion of the company's long term debt. Long-term liabilities are typically the balances on bank loans or other debt that will be paid in future years.

"Shareholder's Equity is the net worth of the company. It consists of two components – 'paid-in capital' and 'retained earnings.' Paid in capital is the value of assets contributed to the company by investors; it can be in the form of cash, real property, equipment, intellectual property, and so on. Retained earnings are profits the company keeps instead of paying out as dividends to shareholders. The company's net worth is calculated by subtracting total liabilities from the total assets.

"The numbers on a balance sheet are always in a constant state of flux as customers pay their invoices, you pay your bills, you add to inventory, and so on. So the statement only represents a 'snapshot' in time, and by itself doesn't indicate trends in the business. However it does provide a clear picture of the company's financial condition at that instant.

"That's why it's widely used by bankers, investors, credit agencies, vendors, and others to evaluate the company's financial health. They'll use the balance sheet to compute various financial ratios and compare them to average ratios for other companies in your business or industry. The way your company stacks up in these comparisons is often a key factor in a banker's decision to loan you money, an investor's decision to buy stock, and a vendor's decision to extend you trade credit."

Ann set the form down on the table and looked at Bill. "Well, I think that about does it for today. We've covered a lot of ground and I hope it hasn't been too confusing or overwhelming. As you start putting the financials together for your business, I think this will become a lot clearer.