Survive and Thrive Workshop Series

Where do I Stand Financially?
(understanding my financial statements)

26 February 2009

Workshop Series Hosts

- South Dakota Small Business Development Centers (SD SBDC)
- US Small Business Administration (SBA)
- University of South Dakota
- Regional Planning Districts & other Economic Development entities

Workshop Series Dates

- How can I better manage my expenses? (5 March)
- How can I increase my sales? (12 March)
- How do I manage and improve my cash flow? (19 March)
- Should I have a succession plan in place? (26 March)

Ready Talk Seminar

- For those at host locations, please sign in; for those on individual lines, you have already registered with the SBA
- Please note of any questions that you may wish to ask. These will be collected at the host locations, sent via Ready Talk Chat or can be sent directly to jean.rogers@sba.gov
- The presentation materials are available to download at www.sba.gov/sd This site also lists the contact info for host sites throughout South Dakota

Workshop Goals

Improve the viability of your business during this time of economic uncertainty by providing you insight as to your current position and empowering you to make financial and management decisions to increase the likelihood of survival

Session 2 Outline

- Description of the 3 main financial statements and their purpose
- Calculating Break Even Points
- Cash versus Accrual Basis of Accounting
- SIC and NAICS codes for business
- Sources of Statistical Information
- Financial Ratios

Income Statement

- The financial statement which captures revenues and expenses for a specific period of time
- Also referred to as a Profit & Loss statement “P&L”
- Used to drive tax returns
- Good for comparing performance month to month and year over year

Notable items on the P&L

- Gross Profit Margin
- Fixed Costs ($$$) versus Variable Costs (% of Sales)
- No Principal repayment on the loans, only interest expense
- The roll of Depreciation & Amortization
- Sole Proprietorships, Partnerships and LLCs typically do not reflect Owner Compensation

Balance Sheet

- The financial statement which reflects the financial health of a company as of a specific date

Notable items on the Balance Sheet

- Current Assets – Short term assets that convert to cash in a year or less
  - Cash and similar, Accounts Receivable & Inventory
- Fixed Assets – Long Term assets with a useful life in excess of a year
- Intangible Assets – Assets that have value but are not tangible (Goodwill, Franchise Fee, Loan Fees)
- Current Liabilities – Liabilities to be repaid within a year
  - Accounts Payable, Taxes, Short Term portion of Principal on Loan

Cash Flow Statement

- Financial Statement that captures information about cash inflows and outflows from operating, financing and investing activities over a period of time.
- Captures items such as Principal Repayment on loans and reconciles timing differences when using Accrual Basis of Accounting

Break Even Point

- The level of sales at which my business neither makes a profit or incurs a loss. Revenues minus expenses equals zero
  - Accounting Definition
    - Total of Fixed Expenses divided by (100% - Variable Costs %)
  - Real Life Definition
    - (Total Fixed Expenses + Principal Repayment – Depreciation – Amortization) divided by (100% - Variable Costs %)
- Can be calculated for any time period as long as revenues are consistent. Break Even Point calculated would be the revenue for like time.

Break Even Point - Accountants

Sales	$100,000	100%
- Cost of Goods	-$48,000	**48%**
= Gross Profit	$52,000	52%
- Credit Card Fees	-$2,000	**2%**
- Interest Expense	**-$2,000**	2%
- Depreciation & Amort.	**-$1,000**	1%
- Other Fixed Expenses	**-$41,000**	41%
= Profit	$6,000	6%

Ratio: $\frac{\text{Fixed Costs}}{(100\% - \text{Variable Costs\%})}$ $\frac{(\$2,000 + \$1,000 + \$41,000)}{(100\% - 48\% - 2\%)}$

Ratio: $\frac{\$44,000}{0.50}$ = $88,000 in sales

Break Even Point - Modified

Sales	$100,000	100%
- Cost of Goods	-$48,000	**48%**
= Gross Profit	$52,000	52%
- Credit Card Fees	-$2,000	**2%**
- Interest Expense	**-$2,000**	2%
- Depreciation & Amort.	**-$1,000**	1%
- Other Fixed Expenses	**-$41,000**	41%
= Profit	$6,000	6%

Loan Payments are $10,000 Annually

Modified: $\frac{\text{Total Fixed Costs + Principal Repayment – Depr \& Amort}}{(100\% - \text{Variable Costs\%})}$

Modified: $\frac{\$44,000 + \$8000 - \$1000}{(100\% - 48\% - 2\%)}$ = $\frac{\$51,000}{0.50}$ = $102,000 Sales

What would happen if my sales never grew past $100,000 annually?

Checklist: What is my Break Even Point?

Cash versus Accrual Accounting

- Cash Basis
  - Revenues are recorded when they are **collected**. Expenses are recorded when they are **paid**.
  - More simple method to use
- Accrual Basis
  - Revenues are recorded when they are **earned**. Expenses are recorded when they **occur**.
  - More accurate method to use

Cash vs. Accrual

CASH BASIS	Jan	Feb	Mar	Apr	Total
Sales	$40,000	$35,000	$38,000	$42,000	$155,000
-COGS	$14,800	$13,650	$15,200	$21,000	$64,650
=Gross Profit	$25,200	$21,350	$22,800	$21,000	$90,350
- Wages	$6,400	$5,950	$6,460	$8,400	$27,210
- Insurance	$12,000	$0	$0	$0	$12,000
- Rent	$3,500	$3,500	$7,000	$0	$14,000
- All Other Fixed	$5,000	$5,000	$5,000	$5,000	$20,000
= Profit	**-$1,700**	$6,900	$4,340	**$7,600**	$17,140

Which month was my best month?

Which month should I investigate?

Cash vs. Accrual

ACCRUAL BASIS	Jan	Feb	Mar	Apr	Total
Sales	$40,000	$35,000	$38,000	$42,000	$155,000
-COGS	$14,800	$13,650	$15,200	$21,000	$64,650
=Gross Profit	$25,200	$21,350	$22,800	$21,000	$90,350
- Wages	$6,400	$5,950	$6,460	$8,400	$27,210
- Insurance	**$1,000**	**$1,000**	**$1,000**	**$1,000**	**$4,000**
- Rent	$3,500	$3,500	**$3,500**	**$3,500**	$14,000
- All Other Fixed	$5,000	$5,000	$5,000	$5,000	$20,000
= Profit	**$9,300**	**$5,900**	**$6,840**	**$3,100**	**$25,140**

Which month was my best month?

Which month should I investigate?

SIC & NAICS Codes

- SIC (Standard Industrial Classification)
  - http://www.census.gov/epcd/ec97brdg/
  - Government assigned 4 digit number applied to industry. First number more general, each subsequent digit more specific industry
  - SIC 5812 – Restaurants
  - SIC 5813 – Bars
  - Used by RMA
- NAICS (North American Industrial Classification System)
  - http://www.census.gov/eos/www/naics/
  - 6 digit system with similar structure
  - Sometimes more specific
  - Used by Census Bureau
- Checklist: Find out the SIC and NAICS codes for your business

Sources of Statistical Information

- South Dakota Department of Revenue
  - Sales Tax data for Market Size, Growth and Seasonality
  - www.state.sd.us/drr2/businesstax/statistics/statistics.htm
- US Census Bureau
  - Labor Costs, Business Expenses, Line Sales, etc (extremely varied by industry)
  - www.census.gov/econ/census02/
- RMA
  - Financial and operating ratios
  - Banker will be happy to copy for your industry

Checklist: Get the RMA Ratios for your industry and compare them to your business

Sources of Statistical Information

- Industry Trade Associations
  - Varied information
- Publicly traded companies
  - SEC Corporate Filings
  - Available through Yahoo Finance, etc
- Internal Financials
  - Useful in determining shifts in business model

Financial Ratios

- Days Receivable (RMA)
  - Accounts Receivable Aging
- Days Payable (RMA)
- Days Inventory (RMA)
- Labor as % of Sales (Census & Trade)
- Debt Coverage Ratio (Banker)
- Current Ratio (RMA)

Days Receivable and A/R Aging

- Measure of how many days worth of sales you have tied up in Accounts Receivable on your balance sheet.
- The greater the number, the longer the collection cycle
  - Ties up cash flow
  - Risk of uncollectable
  - Think of this as an interest free loan to your customer if you do not charge a penalty
- The Ratio can vary at different times of the year if you have high degrees of seasonality. If so, compare to prior year, same month

Days Receivable

Ratio: $\frac{\$ \text{ Accounts Receivable}}{(\text{Annual Sales} / 365)}$

Accounts Receivable from Balance Sheet. Annual Sales from Income Statement

Lets say our company in slide 13 has $5,000 in Accounts Receivable

$$\frac{\$5{,}000}{(\$100{,}000/365)} = \frac{\$5{,}000}{\$273.97} = 18.3 \text{ Days}$$

Ratio High? Could be customers are falling behind, increasing risk

Ratio Low? Perhaps industry offers longer terms; may reduce customer base if they are seeking longer terms

Need to also look at my “Accounts Receivable Aging” report to ensure all customers are within compliant range

Days Payable

- Measure of how many days worth of Accounts Payable are on your books as a liability.
- Typically measured using annual figures
- Somewhat subject to seasonal fluctuations link to inventory

Ratio $\frac{\text{Accounts Payable Balance}}{(\text{Annual Cost of Goods Sold} / 365)}$

Accounts Payable from Balance Sheet.
COGS from Income Statement

Days Payable

Ratio: $\frac{\$ \text{ Accounts Payable}}{\text{(Annual Cost of Goods Sold / 365)}}$

Lets say our company in slide 13 has $4,000 in Accounts Payable

$\frac{\$4,000}{(\$48,000 / 365)} = \frac{\$4,000}{\$131.51}$ = 30.4 Days Payable

Ratio High? Could be a sign of trouble that you are not able to pay vendors and risk relationship.

Ratio Low? Could be that you are taking advantage of early payment discounts

Days Inventory

- Measure of inventory held relative to inventory used
- Typically measured using annual figures
- Somewhat subject to seasonal fluctuations

Ratio: $\frac{\$ \text{ Inventory}}{\text{(Annual Cost of Goods Sold / 365)}}$

Inventory figure taken from Balance Sheet. COGS taken from Income Statement

Days Inventory

Ratio: $\frac{\$ \text{ Inventory}}{\text{(Annual Cost of Goods Sold / 365)}}$

Lets say our company in slide 13 holds $8,000 in inventory

$\frac{\$8,000}{(\$48,000 / 365)} = \frac{\$8,000}{\$131.51}$ = 60.8 Days Inv.

Ratio High? Could be sign of too much inventory, old stock, low turnover

Ratio Low? Good for cash flow as long as minimizing risk of shortage and lost sales

Labor as % of Sales

Ratio: $\frac{\text{Labor Cost}}{\text{Total Sales}} \quad \frac{\$27,210}{\$155,000} = 17.6\%$

Useful for determining whether my labor is more of a fixed expense or variable if I calculate for each month over a period of time.

Can be compared to industry statistics through Census Bureau to determine if there is some area of potential improvement

Checklist: Calculate my labor by month for the last 12 months and annually for the past 3 to 5 years. How do I compare to industry? How do I compare to myself?

Debt Coverage Ratio

- Also known as Debt Service Ratio.
  - Measure of cash flow generated from operations compared to cash needed to service annual debt.
  - Below 1.0 indicates inability to service debt
  - Many lender seeking at least 1.50, though 1.25 may be ok if a very steady, stable business

Debt Coverage Ratio example

Profit Before Tax (from Slide 13)	$6,000
+ Depreciation & Amortization	$1,000
+ Interest	$2,000
+ Growth in Accts Pay. (grew from $2,000 to $4,000 at year end)	$2,000
- Growth in Accts Rec. (grew from $3,000 to $5,000 at year end)	-$2,000
- Equip bought out of cash flow	$0
= Cash Flow for Debt Service	$9,000
/ Debt Service	$10,000
= Debt Coverage Ratio	0.90

Is this business sustainable as it currently operates?

Current Ratio

- A liquidity ratio that tests the ability of a business to meet upcoming obligations.

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

Example:

Balance Sheet shows $10,000 in Current Assets (Cash, Accounts Receivables & Inventory) and $8,000 in Current Liabilities (Accounts Payable, Taxes Payable, Principal Repayment)

Ratio: $10,000 / $8,000 = 1.25

Businesses generally should try to stay above 1.0 or risk inability to pay, though this varies by industry. Consult RMA to determine industry norm.

Checklist Summary

- What is my Break Even Point?
- What are the SIC and NAICS codes for my industry?
- Compare key RMA ratios to your business (especially Days Receivable, Days Payable and Days Inventory)
- Calculate Labor Cost % by month for the last 12 months and annually for last 3 to 5 years
- Examine Accounts Receivable Aging to find overdue accounts. Contact these customers to work out a payment

Future Workshop Topics

- After each session, participants will be provided an opportunity for feedback through surveys. Based on survey results, future workshops may be developed to delve into greater detail in specific areas (i.e. factoring, Government Procurement, etc).

We Want Your Feedback!

- Please provide your feedback in the survey at your host site, or which will be sent to the email address that you provided. This will allow us to tailor upcoming events to best suit your needs!

Next Session:

How can I reduce my expenses?

Session 3

5 March 2009

Contact Jean Rogers to register

(605) 330-4243 ext 0

jean.rogers@sba.gov

Resources Available

- For a copy of this slideshow
  - www.sba.gov/sd
- Free Excel compatible software
  - www.openoffice.org
- For additional training and education, visit the SBA Resource Library
  - www.sba.gov/tools/resourcelibrary/index.html
  - (features Podcasts, Publications and Research)