

Building Financial Statements

Objectives

- While uncompetitive products, ill-suited strategies, and poorly performing teams influence failure, most companies fail due to:
 - *Lack of MONEY*
 - *Lack of TIME*
- Managing finances effectively can help you from running out of money prematurely and from spending money at the wrong time

Financial statements help...

- Investors understand
 - The profit potential of your firm
 - How much money you need to get there
 - On what timeline and for what purpose
- Entrepreneurs understand
 - Level of risk/reward for your venture
 - Value of your company (and in turn, your percent ownership) when it's time to raise capital for the venture

Financials statements typically exist in three general forms

- Income statement
 - Summarizes revenues and expenses
- Cash flow statement
 - Sum of retained earnings minus the depreciation provision made by the firm
- Balance sheet
 - Summarizes the assets, liabilities, and shareholders' equity at a specific point in time

1. Income Statement Definitions

- Revenue (Sales)
 - Money paid to the company by customers in exchange for the sale of a product or service by the company

1. Income Statement Definitions

- Costs of Goods Sold (COGS)
 - Direct costs to produce each product or offer each service
 - For a product, all components and manufacturing costs
 - For a service, all costs of fulfillment; all labor costs.
 - Costs of goods sold are often variable as component and manufacturing costs drop as volume increases.

Key questions to consider

- **Revenue forecasts:** What can we sell, given the market, our pricing, and our capability?
- **COGS forecasts:** How will our costs of goods sold change as our revenues change?

Key questions to consider (con't)

- **SG&A forecasts:** What marketing/sales effort do we need to reach our revenue goals? What infrastructure do we need to support our business?
- *How much money do we need to accomplish growth?*

Sales Forecast Example

From Dorf & Byers

Year 1

Month	1	2	3	4	5	6
Units	0	0	1,200	1,320	1,452	1,597
Price per unit	\$15	\$15	\$15	\$15	\$15	\$15
Sales dollars	\$0	\$0	\$18,000	\$19,800	\$21,780	\$23,955

Year 2

Month	1	2	3	4	5	6
Units	3,113	3,424	3,766	4,143	4,557	5,013
Price per unit	\$15	\$15	\$15	\$15	\$15	\$15
Sales dollars	\$46,695	\$51,360	\$56,490	\$62,145	\$68,355	\$75,195

Sales forecasts are influenced by your product, your marketing strategy, competition, and market size, among other factors.

Use the sales forecast and expected expenses to develop the Income Statement

Month	1	2	3	4	5	6
Revenues	\$0	\$0	\$18,000	\$19,800	\$21,780	\$23,955
Expenses:						
Author royalties	0	0	2,160	2,376	2,614	2,875
Credit card charges	0	0	180	198	218	240
Marketing	2,000	2,000	2,000	2,000	2,000	2,000
Depreciation	1,000	1,000	1,000	1,000	1,000	1,000
Interest	1,000	1,000	1,000	1,000	1,000	1,000
Office rent	1,500	1,500	1,500	1,500	1,500	1,500
Salaries	9,500	9,500	9,500	9,500	9,500	9,500
Social Security and benefits	1,425	1,425	1,425	1,425	1,425	1,425
Utilities, supplies, travel, communication	2,000	2,000	2,000	2,000	2,000	2,000
Profit (loss) before income tax	(18,425)	(18,425)	(2,765)	(1,199)	523	2,415
Income tax (credit)	(5,528)	(5,528)	(830)	(360)	157	725
Net profit (loss)	(\$12,897)	(\$12,897)	(\$1,935)	(\$839)	\$366	\$1,690

2. Statement of Cash Flows

- Reports cash receipts and payments
- Lists all cash going in and out by category
 1. Operating activities: Cash changes by operating the company
 2. Investing activities: Cash changes from buying/selling assets (equipment, building)
 3. Financing activities: Cash changes by borrowing funds, selling stock, paying dividends, reducing debt, etc.

Use the Income Statement to develop the Statement of Cash Flows

Year 1						
Month	1	2	3	4	5	6
<i>Operating activities</i>						
Net profit (loss)	(\$12,897)	(\$12,897)	(\$1,935)	(\$839)	\$366	\$1,690
Add: Depreciation	1,000	1,000	1,000	1,000	1,000	1,000
Add: Increase in royalties payable			2,160	216	238	261
Cash flow from operations	(11,897)	(11,897)	1,225	377	1,604	2,951
<i>Investing activities</i>						
Purchase of long-term assets	(48,000)					
<i>Financing activities</i>						
Bank loan	100,000					
Owners' cash contributions	140,000					
Increase (decrease) in cash	180,103	(11,897)	1,225	377	1,604	2,951
Beginning cash balance	0	180,103	168,206	169,431	169,808	171,412
Ending cash balance	\$180,103	\$168,206	\$169,431	\$169,808	\$171,412	\$174,363

Using the Cash Flow Statement

- The amount of money needed can be estimated by:
 - *(Start-Up Expenses)*
 - *(Operating Expenses)*
 - + *Revenues*
 - Cash Balance*
 - = *Minimum Funding Required*

3. Balance Sheet Definitions

Balance Sheet of XXX Corp. - 31 December of 201x (in thousand \$)

Current Assets (liquid in less than a year)	<ul style="list-style-type: none"> Cash and equivalents Accounts receivable Inventories 	Current Liabilities (payable in less than a year)	<ul style="list-style-type: none"> Accounts payable Accrued expenses Short term debt
Fixed Assets	<ul style="list-style-type: none"> Property, plant and equipment (minus Depreciation) 	Long-Term Liabilities	<ul style="list-style-type: none"> Bank loans Bonds issued
Other Assets	<ul style="list-style-type: none"> Intangibles (minus depreciation) Investment securities 	Shareholders' Equity	<ul style="list-style-type: none"> Common stock Additional paid-in capital Retained earnings

$$\text{Total Assets} = \text{Total Liabilities} + \text{Shareholder's Equity}$$

Balance Sheet Example

End of year 1

Assets

Cash	\$229,048
Equipment and furniture	48,000
Accumulated depreciation	<u>(12,000)</u>
Total assets	<u><u>\$265,048</u></u>

Liabilities

Royalties payable	\$5,094
Loan payable	100,000

Owners' equity

Owners' contributions	140,000
Retained earnings	<u>19,954</u>
Total owners' equity	<u>159,954</u>
Total liabilities and owners' equity	<u><u>\$265,048</u></u>

Summary

- Financials statements are a valuable tool to both investors and entrepreneurs
- Critical to determine *how* much money you need *when* and for *what* purpose
- Quantifying the risk and reward is an early step to determining *if* to launch the venture