Chapter 11

Financial statements in New Ventures

Financial Statements

[‘fə-ˈnan(t)-shəl ˈstāt-mənts]

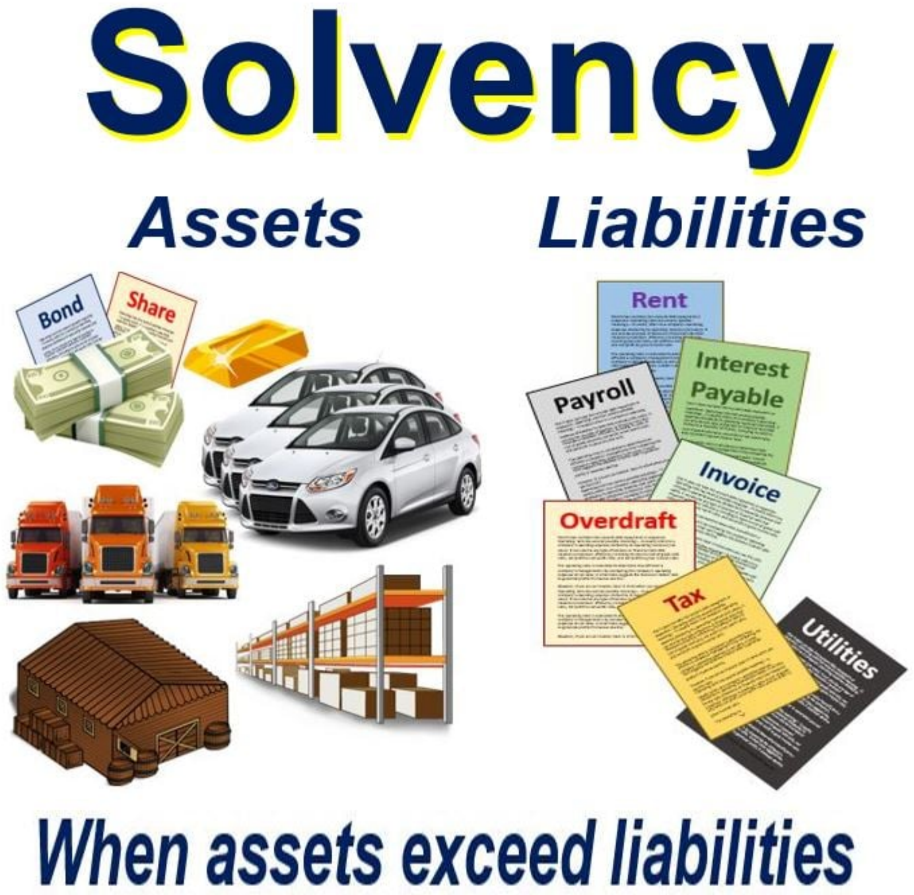
Written records that convey the business activities and the financial performance of a company.

Importance of Financial Statements

Solvency

[ˈsäl-vən(t)-sē]

The ability of a company to meet its long-term debts and financial obligations.



Solvency
Assets
Liabilities
Bond
Share
Rent
Interest Payable
Payroll
Invoice
Overdraft
Tax
Utilities
When assets exceed liabilities

Liquidity
A firm's ability to meet its short-term obligations
Solvency
A firm's ability to sustain its activity into the long-term
Long-Term

A Financial Glossary for the Entrepreneur

1. Accrual System of accounting
2. Asset
3. Balance sheet
4. Capital
5. Cash flow
6. Cash system of accounting
7. Collateral
8. Cost of goods sold
9. Current assets
10. Current liabilities
11. Depreciation
12. Equity
13. Expense
14. Financial statement
15. Gross profit
16. Income statement
17. Interest.
18. Liability.
19. Loss.
20. Net Profit.
21. Net Worth.
22. Personal Financial Statement.
23. Profit
24. Profit and Loss Statement (Income statement)
25. Variable Cost.
26. Working Capital.
27. Cash flow statement.
28. Pro-Forma Balance Sheet.
29. Pro-Forma Income Statement.
30. Pro-Forma Cash Flow Statement.

Balance Sheet

[ˈba-lən(t)s ˈshēt]

A financial statement that reports a company's assets, liabilities, and shareholder equity at a specific point in time.

Understanding the balance sheet

Table 11.2 Kendon Corporation Balance Sheet for the Year Ended December 31, 2010

Assets		
Current Assets		
Cash		$200,000
Accounts receivable	$375,000	
Less: Allowance for uncollectible accounts	$25,000	350,000
Inventory		150,000
Prepaid expenses		35,000
Total current assets		$735,000
Fixed Assets		
Land		$330,000
Building	$315,000	
Less: Accumulated depreciation of building	80,000	
Equipment	410,000	
Less: Accumulated depreciation of equipment	60,000	
Total fixed assets		915,000
Total assets		$1,650,000
Liabilities		
Current Liabilities		
Accounts payable	$150,000	
Notes payable	25,000	
Taxes payable	75,000	
Loan payable	50,000	
Total current liabilities		$300,000
Bank loan		200,000
Total liabilities		$500,000
Owners' Equity		
Contributed Capital		
Common stock, $10 par, 40,000 shares	$400,000	
Preferred stock, $100 par, 500 shares Authorized, none sold	----------	
Retained earnings	750,000	
Total owners' equity		1,150,000
Total liabilities and owners' equity		$1,650,000

Why the Balance Sheet Always Balances?

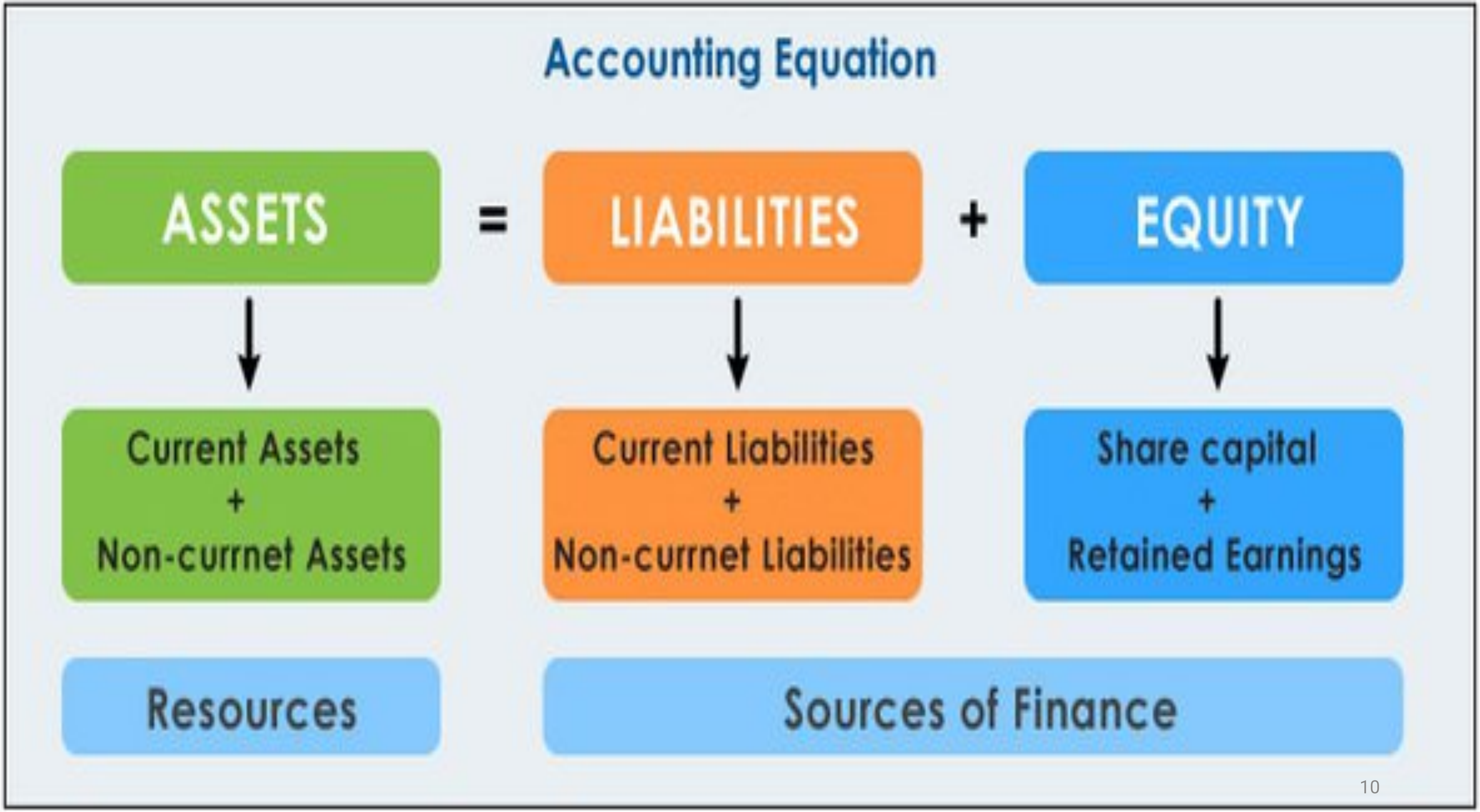
Balance Sheets

- "The balance sheet is an accounting statement that shows an organisation's **ASSETS (what the business owns)** and **LIABILITIES (what the business owes)** at a precise point in time, usually the last day of the accounting year."

  = **SNAPSHOT**
- The balance sheet balances NET ASSETS with CAPITAL AND RESERVES OR CAPITAL EMPLOYED.
- The balance sheet will always balance since every asset must always have a corresponding source of finance.

THE BALANCE SHEET
STRUCTURE

ASSETS	CAPITAL
	LIABILITIES + SHAREHOLDERS' EQUITY
How does the company use the pile of money?	Where did this pile of money come from?


Accounting Equation
ASSETS
=
LIABILITIES
+
EQUITY
Current Assets
+
Non-currnet Assets
Current Liabilities
+
Non-currnet Liabilities
Share capital
+
Retained Earnings
Resources
Sources of Finance

Internal Sources of Finance

Examples

1. Profits and Retained Earnings

2. Sale of Assets

3. Reduction of Working Capital

EXTERNAL SOURCES OF FINANCE

LONG TERM	**Equity Shares**	A key feature of equity share is the 'sharing of ownership rights'. The return is in the form of a dividend or bonus shares.
	Debentures	Debt is considered to be the cheaper mode of finance compared to equity. It does not share control with investors.
	Term Loan	It is given by some bank or financial institutions. These loans are also secured by some assets.
	Preferred Stock	The characteristics of both common equity stocks and debt. they have got priority over common equity shares in terms of payment.
	Venture Capital	They normally invest in a new company at an initial stage and do a rigorous analysis of a company before investing.
	Leasing / HP	Can help businesses delay its cash payment which is equal to having its goods financed
SHORT TERM	**Bank Overdraft**	Businesses need money for their day to day requirement which arises due to a time gap between their collections and payments.
	Trade Credit	The credit given to a business by their creditors/ suppliers. The credit given to a business by their creditors/ suppliers
	Debt Factoring	An arrangement whereby the business sells its account receivables/ debtors at a discount.

Table 11.3	Kendon Corporation Income Statement for the Year Ended December 31, 2010	
Sales Revenue	$1,750,000	
Less: Sales returns and allowances	50,000	
Net sales		$1,700,000
Cost of Goods Sold		
Inventory, January, 2000	$ 150,000	
Purchases	1,050,000	
Goods available for sale	$ 1,200,000	
Less: Inventory, December, 2000	200,000	
Cost of goods sold		1,000,000
Gross margin		$ 700,000
Operating Expenses		
Selling expenses	$ 150,000	
Administrative expenses	100,000	
Total operating expenses		250,000
Operating income		$ 450,000
Financial Expenses		$ 20,000
Income before income taxes		$ 430,000
Estimated Income Taxes		172,000
Net profit		$ 258,000

Cash Flow Statement

[ˈkash ˈflō ˈstāt-mənt]

A financial statement that aggregates a company's cash inflows and outflows from operations, investing, and financing over a set period of time.

Purpose of Cash Flow Statements

- The Explanation for the Changes in Cash
- Information about Non-Cash Investing and Financing Activities
- Financial Condition of the Firm
- Provides a View of Management Strategy
- Legal Requirements

CASH FLOW STATEMENTS

CASH FLOW FROM OPERATING ACTIVITIES

I.E. SALES (INCREASE) AND EMPLOYEE SALARIES (DECREASE)

CASH FLOW FROM INVESTING ACTIVITIES

I.E. SELLING EQUIPMENT (INCREASE) AND BUYING EQUIPMENT (DECREASE)

CASH FLOW FROM FINANCING ACTIVITIES

I.E. INVESTMENTS (INCREASE) AND DIVIDENDS (DECREASE)

NET INCREASE OR DECREASE IN CASH

Innovative Products, Inc.
Statement of Cash Flows (Indirect Method)
For Year Ending December 31, 2012

Operating Activities	
Sales Receipts	$50,00,000
Payments for Products	($25,00,000)
Payments for Operations	($20,00,000)
Interest Payments	($1,00,000)
Taxes	($2,27,500)
Extraordinary Items	$2,00,000
Net Cash Flow from Operating Activities	***$3,72,500***
Investing Activities	
Purchase of New Fixed Assets (Property/Machinery)	($21,00,000)
Interest Received	$50,000
Net Cash Flow from Investing Activities	***($20,50,000)***
Financing Activities	
Short-term Debt	$7,00,000
Long-term Debt	$11,00,000
New Equity Issued	$5,00,000
Net Cash Flow from Financing Activities	***$23,00,000***
Net Increase (Decrease in Cash)	$6,22,500
Cash at the Beginning of the Year	$1,00,000
Cash at the End of the Year	**$7,22,500**

Monthly Cash Flow Statement Format

For the Year 2021 Ended December 31

Particulars	Oct	Nov	Dec
Beginning Balance	$ 84,477	$ 90,709	$ 103,980
Operating Activities			
Cash Receipts from Customers	$ 12,540	$ 21,352	$ 10,800
Cash Paid for Inventory	$ 950	$ 1,200	$ 1,400
Cash Paid for Selling & Administrative Expenses	$ (2,850)	$ (4,510)	$ (4,620)
Cash Paid for Income Taxes	$ (3,564)	$ (4,651)	$ (5,654)
Net Cash Flow from Operating Activities	**$ 7,076**	**$ 13,391**	**$ 1,926**
Investing Activities			
Sale of Property, Plant & Equipment	$ -	$ -	$ -
Sale of Long-term Investments	$ -	$ -	$ 1,450
Purchase of Property, Plant & Equipment	$ -	$ -	$ (1,650)
Purchase of Long-term Investments	$ -	$ -	$ (1,254)
Net Cash Flow from Investing Activities	**$ -**	**$ -**	**$ (1,454)**
Financing Activities			
Issuance of Bonds Payable	$ -	$ -	$ -
Issuance of Common Stock	$ -	$ -	$ -
Repaying Principal on Bonds Payable	$ (844)	$ (120)	$ (450)
Paying Dividends	$ -	$ -	$ -
Net Cash Flow from Financing Activities	**$ (844)**	**$ (120)**	**$ (450)**
Net Cash Increase/Decrease in Cash	**$ 6,232**	**$ 13,271**	**$ 22**
Ending Cash Balance	**$ 90,709**	**$ 103,980**	**$ 104,002**

Pro Forma

'prō 'forme

A method of calculating financial results using certain projections or presumptions.

Pro-Forma Balance Sheet

XYZ Corporation

Previous 4 Years

(all numbers in $000)

ASSETS	**2010**	**2011**	**2012**	**2013**
Current Assets				
Cash	$54	$57	$59	$64
Net accounts receivable	$367	$396	$426	$435
Inventory	$177	$191	$203	$205
Temporary investment	$12	$12	$12	$12
Prepaid expenses	$2	$2	$2	$2
Total Current Assets	$612	$658	$702	$718
Fixed Assets				
Long-term investments	$42	$43	$43	$46
Land	$656	$656	$684	$727
Buildings (net of depreciation)	$903	$928	$983	$1021
Plant & equipment (net)	$608	$631	$642	$654
Furniture & fixtures (net)	$61	$65	$68	$72
Total Net Fixed Assets	$2270	$2323	$2420	$2520
TOTAL ASSETS	$2882	$2981	$3122	$3238
LIABILITIES				
Current Liabilities				
Accounts payable	$246	$252	$258	$277
Short-term notes	$24	$25	$26	$28
Current portion of long-term notes	$14	$14	$14	$15
Accruals & other payables	$14	$14	$14	$14
Total Current Liabilities	$298	$305	$312	$334

Pro-Forma Income Statement

- **17-4**

a.	2005	Forecast Basis	2006
Sales	$700	× 1.25	$875.00
Oper. costs	500	× 0.70 Sales	612.50
EBIT	$200		$262.50
Interest	40		40.00
EBT	$160		$222.50
Taxes (40%)	64		89.00
Net income	$ 96		$133.50
Dividends (33.33%)	$ 32		$ 44.50
Addit. to R/E	$ 64		$ 89.00

- **b.** ΔDividends = ($44.50 – $32.00)/$32.00 = 39.06%.

c. Cash Flow Statement	millions of ¥		
	2012	**2013**	**2014**
Cash flow from operating activities			
Cash generated from operations	2,772	3,199	3,565
Income tax paid	(346)	(382)	(435)
Net cash generated from operating activities	2,426	2,817	3,131
Cash flow from investing activities			
Proceeds from disposal of PP&E (including leases)	40	311	75
Purchases of PP&E (including leases and intellectual property	(1,507)	(1,881)	(2,793)
Interest received	2	3	14
Government grants received relating to PP&E	83	151	93
Net cash used in investing activities	**(1,383)**	**(1,417)**	**(2,612)**
Cash flows from financing activities			
Borrowings and repayments	(380)	(186)	741
Dividends paid to the company's shareholders	(801)	(1,001)	(1,001)
Interest paid	(197)	(209)	(254)
Capital Injections	14	0	4
Net cash used in financing activities	(1,364)	(1,396)	(511)
Net (decrease)/increase in cash and cash equivalents	**(320)**	**5**	**7**
Cash and cash equivalents at beginning of the period	808	487	492
Cash and cash equivalents at end of the period	**487**	**492**	**499**

Break-Even Analysis

[ˈbrāk ˈē-vən ə-ˈna-lə-səs]

The process of calculating the number of units of a good or service a company must sell to cover all of its costs.

When there is a profit

Revenue > Variable cost + Fixed cost

At break even-point

Revenue = Variable cost + Fixed cost

When there is a loss

Revenue < Variable cost + Fixed cost

Ratio Analysis

[ˈrā-shē-ˌō ə-ˈna-lə-səs]

A method of quantifying a company's liquidity, operational efficiency, and profitability to evaluate its performance over time and relative to its peers.

LIMITATIONS OF RATIO ANALYSIS

LIMITATIONS

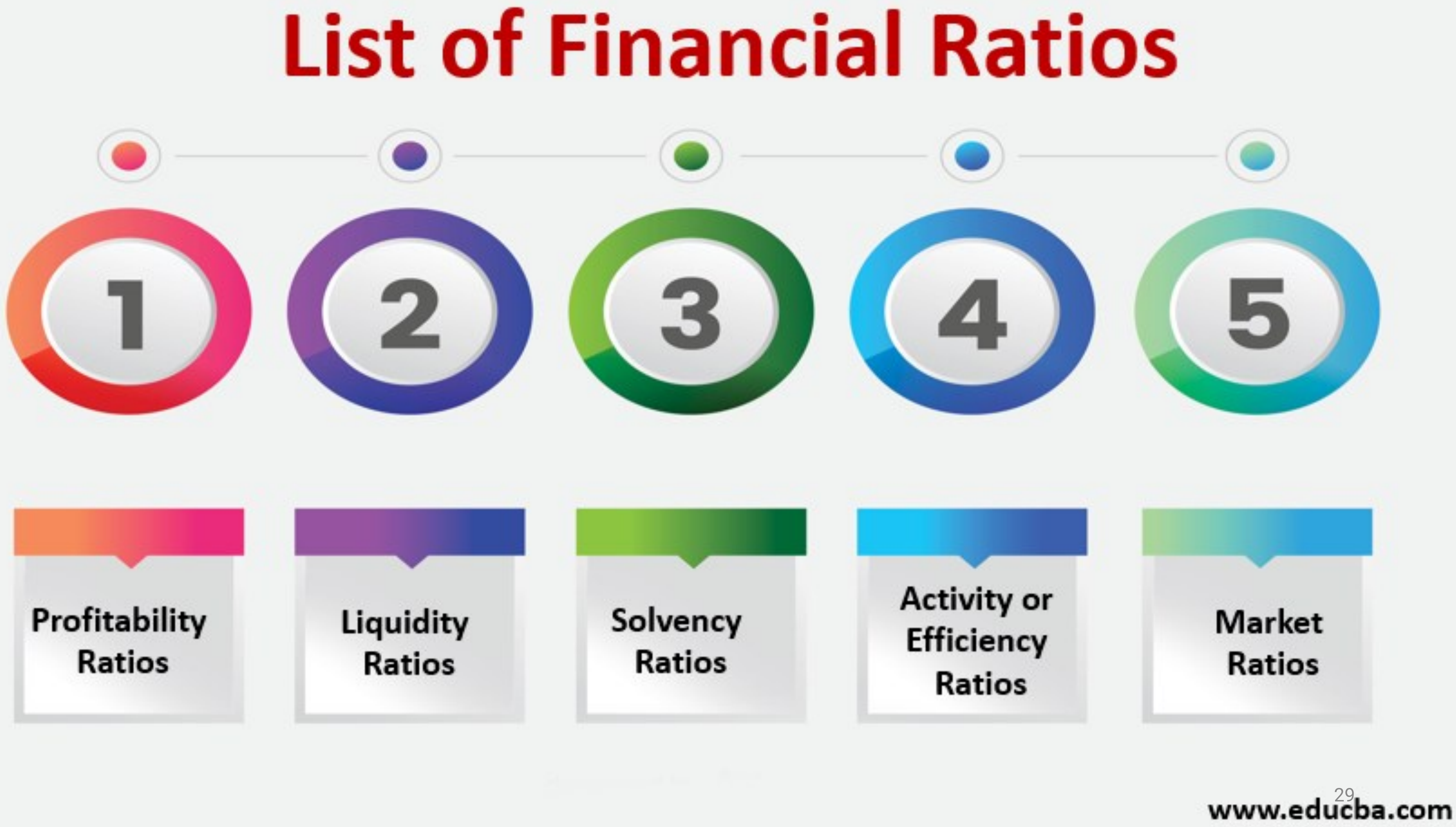
- Doesn't take into consideration Inflationary Effects.
- Not useful while comparing companies of two different industries
- Window Dressing
- Difference in Accounting Practices
- A Quantitative measure & not a Qualitative one

Importance of Ratio Analysis

- Analysis of Financial Statements
- Helps in Understanding the Profitability of the Company
- Analysis of Operational Efficiency of the Firms
- Liquidity of the Firms
- Helps in Identifying the Business Risks of the Firm
- Helps in Identifying the Financial Risks of the Company
- For Planning and Future Forecasting of the Firm
- To Compare the Performance of the Firms

Advantages/Importance/Significance - Ratio Analysis

- Analytical Tool for **measuring performance**.
- Ratios makes **Comparison Easy**.
- **Inter firm Comparison** possible.
- Ascertainment of **Short term Liquidity** & **Long term Solvency position** possible.
- Analysis about the **STRENGTHS** & **WEAKNESSES** of the firm's operations.
- Analyze **Past Performance** & **make further projections**.


List of Financial Ratios
1
2
3
4
5
Profitability Ratios
Liquidity Ratios
Solvency Ratios
Activity or Efficiency Ratios
Market Ratios
www.educba.com

4 TYPES OF RATIOS

PROFITABILITY RATIOS

How well does the company generate profits?

LEVERAGE RATIOS

How extensively is the company using debt?

LIQUIDITY RATIOS

Does the company have enough cash to pay the bills?

EFFICIENCY RATIOS

How efficiently does the company use its assets and capital?

Ratio Analysis Formula

- **Liquidity Ratios**

  Current Ratio = Current Assets / Current Liabilities

- **Solvency Ratios**

  Debt Ratio = Total Debt / Total Assets

- **Efficiency Ratios**

  Debt Ratio = Total Debt / Total Assets

- **Profitability Ratios**

  Net Margin = Net Income / Sales

Accounting Ratios

Liquidity Ratios

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

$$\text{Cash Ratio} = \frac{\text{Cash + Marketable Securities}}{\text{Current Liabilities}}$$

Asset Turnover Ratios

$$\text{Receivables Turnover} = \frac{\text{Annual Credit Sales}}{\text{Accounts Receivable}}$$

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Financial Leverage Ratios

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

Profitability Ratios

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Total Assets}}$$

$$\text{Gross Profit Margin} = \frac{\text{Sales – Cost of Goods Sold}}{\text{Sales}}$$

Dividend Policy Ratios

$$\text{Payout Ratio} = \frac{\text{Dividends per Share}}{\text{Earnings per Share}}$$

$$\text{Dividend Yield} = \frac{\text{Dividends per Share}}{\text{Share Price}}$$

Profitability Ratios

[ˈprä-fə-tə-bəl-i-tē ˈrā-shē-ˌō]

A class of financial metrics that are used to assess a business's ability to generate earnings relative to its revenue, operating costs, balance sheet assets, or shareholders' equity over time, using data from a specific point in time.

Investopedia

Profitability Ratios Formula

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Sales}} \times 100$$

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Assets}} \times 100$$

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

Liquidity Ratio

['li-kwəd 'rā-shē-ˌō]

A class of financial metrics used to assess a debtor's ability to pay current debt obligations without raising external capital.

Investopedia

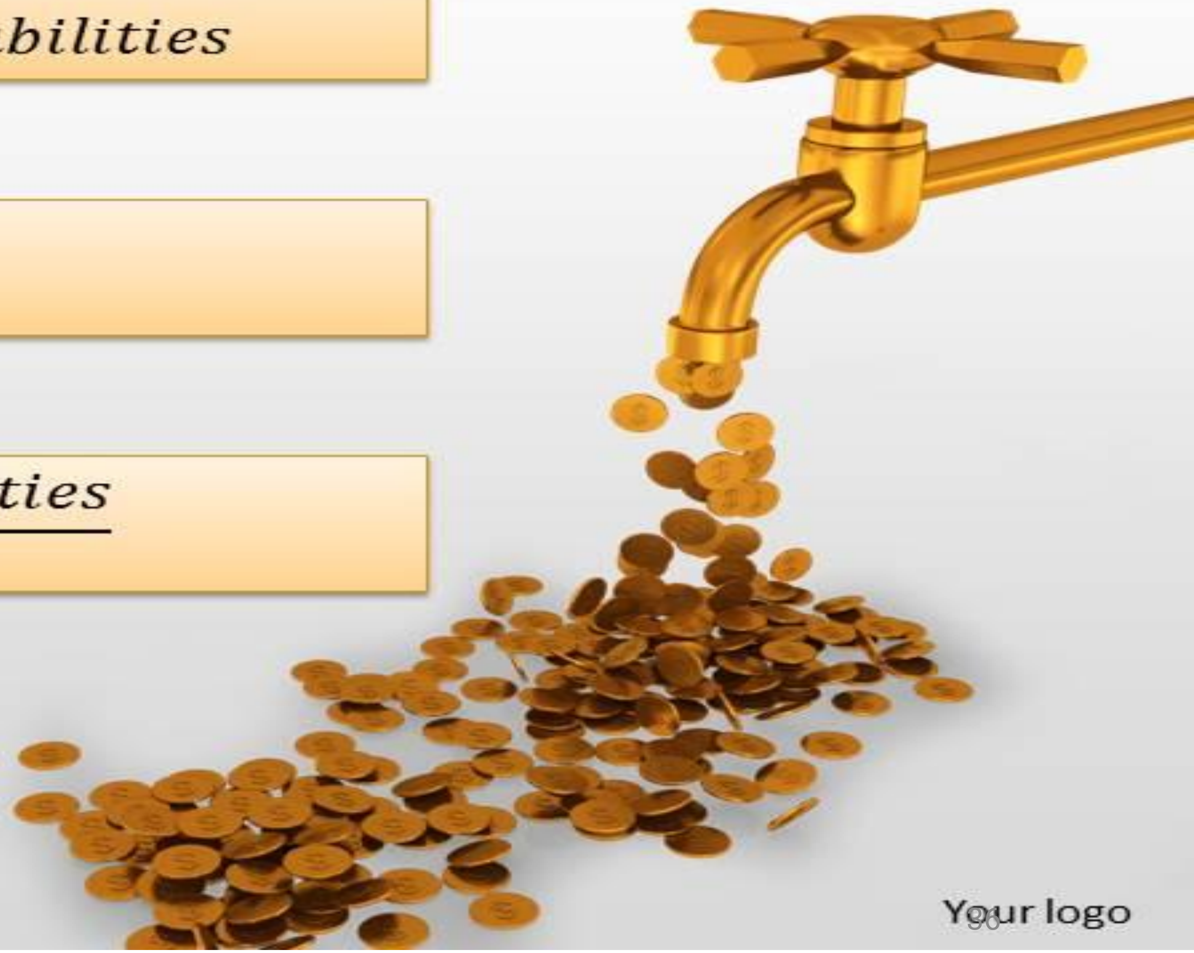
Liquidity Ratio

Liquidity Ratios

Working Capital
$$= Current\ Assets - Current\ Liabilities$$

$$\textbf{Current Ratio} = \frac{Current\ Assets}{Current\ Liabilities}$$

$$\textbf{Quick Ratio} = \frac{Current\ Assets - Liabilities}{Current\ Liabilities}$$



Your logo

Solvency Ratio

[ˈsäl-vən(t)-sē ˈrā-shē-ˌō]

A key metric used to measure an enterprise's ability to meet its long-term debt obligations and is used often by prospective business lenders.

Investopedia

Solvency Ratios

Debt to Equity Ratio

Shows the percentage of company financing that comes from creditors and investors.

Total Liabilities

— Divided By —

Total Equity

Equity Ratio

Shows how leveraged the company is with debt.

Total Equity

— Divided By —

Total Assets

Debt Ratio

Shows a company's ability to pay off its liabilities with its assets.

Total Liabilities

— Divided By —

Total Assets

If you don't have any particular skill then.....

The Entrepreneur

The entrepreneur leads the firm or organization and also demonstrates leadership qualities by selecting managerial staff. Management skill and strong team building abilities are essential leadership attributes for successful entrepreneurs.


Thank You!