Entrepreneurship Development

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Assessing a New Venture's Financial Strength and Viability

Chapter Objectives

1. Explain the two functions of the financial management of a firm.
2. Identify the four main financial objectives of entrepreneurial ventures.
3. Explain the difference between historical and pro forma financial statements.
4. Explain the purpose of an income statement.
5. Explain the purpose of a balance sheet.

Chapter Objectives
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6. Explain the purpose of a statement of cash flows.
7. Discuss how financial ratios are used to analyze and interpret a firm’s financial statements.
8. Discuss the role of forecasts in projecting a firm's future income and expenses.
9. Explain what a completely new firm bases its forecasts on.
10. Explain what is meant by the term percent of sales method.

Financial Management

- Financial Management
  - Financial management deals with two things: raising money and managing a company's finances in a way that achieves the highest rate of return
  - This chapter focuses primarily on:
    - How a new venture tracks its financial progress through preparing, analyzing, and maintaining past financial statements.
    - How a new venture forecasts future income and expenses by preparing pro forma (or projected) financial statements.

Financial Management

The financial management of a firm deals with questions such as the following on an ongoing basis:

- How are we doing? Are we making or losing money?
- How much cash do we have on hand?
- Do we have enough cash to meet our short-term obligations?
- How efficiently are we utilizing our assets?
- How does our growth and net profits compare to those of our industry peers?
- Where will the funds we need for capital improvements come from?
- Are there ways we can partner with other firms to share risk and reduce the amount of cash we need?
- Overall, are we in good shape financially?

Financial Objectives of a Firm

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Profitability	Liquidity	Efficiency	Stability
A company's abilityv to make a profit	A company's ability to meet its short-term obligations	How productively a firm utilizes its assets	The overall health of the financial structure of the firm, particularly as it relates to its debt-to-equity ratio

Financial Objectives of a Firm

- Profitability
  - Is the ability to earn a profit.
    - Many start-ups are not profitable during their first one to three years while they are training employees and building their brands.
    - However, a firm must become profitable to remain viable and provide a return to its owners.
- Liquidity
  - Is a company's ability to meet its short-term financial obligations.
    - Even if a firm is profitable, it is often a challenge to keep enough money in the bank to meet its routine obligations in a timely manner.

Financial Objectives of a Firm

- Efficiency
  - Is how productively a firm utilizes its assets relative to its revenue and its profits.
    - Southwest Airlines, for example, uses its assets very productively. Its turnaround time, or the time its airplanes sit on the ground while they are being unloaded and reloaded, is the lowest in the airline industry.
- Stability
  - Is the strength and vigor of the firm's overall financial posture.
    - For a firm to be stable, it must not only earn a profit and remain liquid but also keep its debt in check.

The Process of Financial Management

- Importance of Financial Statements
  - To assess whether its financial objectives are being met, firms rely heavily on analysis of financial statements.
    - A financial statement is a written report that quantitatively describes a firm's financial health.
    - The income statement, the balance sheet, and the statement of cash flows are the financial statements entrepreneurs use most commonly.
- Forecasts
  - Are an estimate of a firm's future income and expenses, based on past performance, its current circumstances, and its future plans.

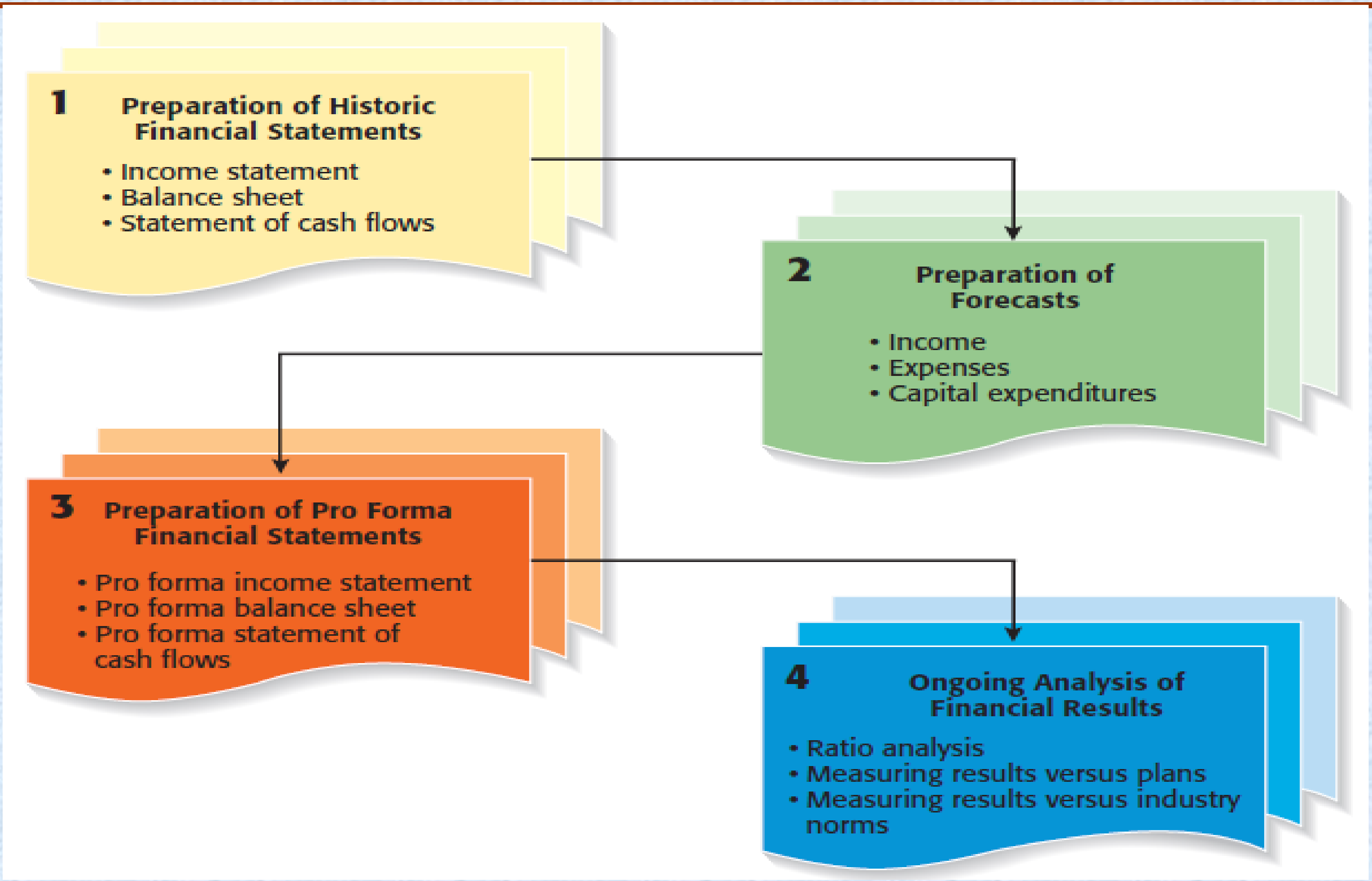
The Process of Financial Management

- Forecasts (continued)
  - New ventures typically base their forecasts on an estimate of sales and then on industry averages or the experiences of similar start-ups regarding the cost of goods sold and other expenses.
- Budgets
  - Are itemized forecasts of a company's income, expenses, and capital needs and are also an important tool for financial planning and control.

The Process of Financial Management

- Financial Ratios
  - Depict relationships between items on a firm’s financial statements.
  - An analysis of its financial ratios helps a firm determine whether it is meeting its financial objectives and how it stakes up against industry peers.
- Importance of Financial Management
  - Many experienced entrepreneurs stress the importance of keeping on top of the financial management of the firm.

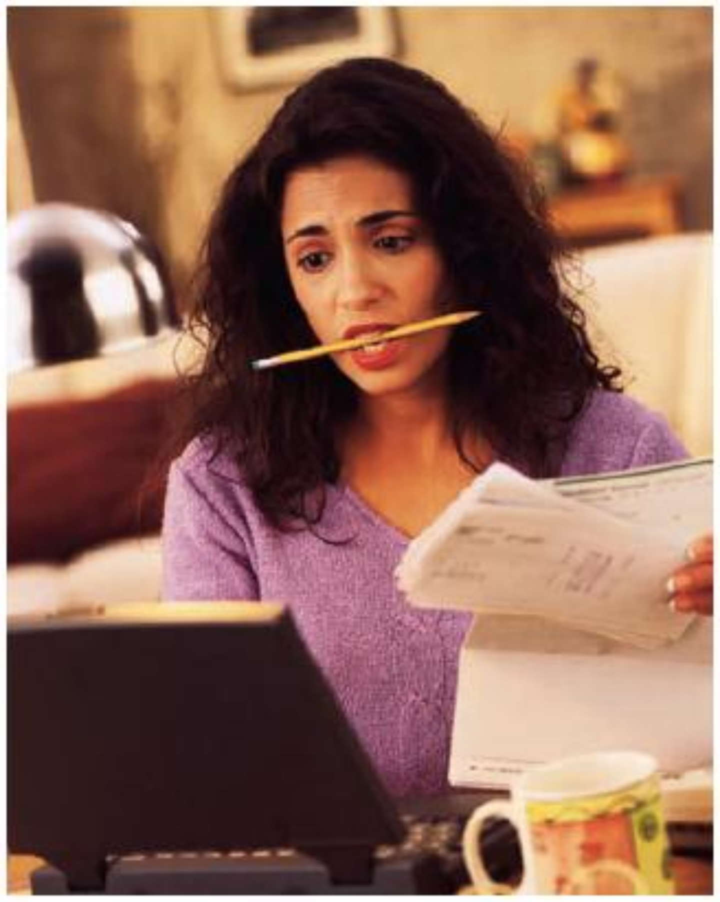
The Process of Financial Management



Financial Statements

- Historical Financial Statements
  - Reflect past performance and are usually prepared on a quarterly and annual basis.
    - Publicly traded firms are required to prepare financial statements and make them available to the public.
- Pro Forms Financial Statements
  - Are projections for future periods based on forecasts and are typically completed for two to three years in the future.
    - Pro forma financial statements are strictly planning tools.

Importance of Keeping Good Records



The first step towards prudent financial management is keeping good records.

Historical Financial Statements

Three types of historical financial statements

Financial Statement	Purpose
Income Statement	**Reflects the results of the operations of a firm over a specified period of time. It records all the revenues and expenses for the given period and shows whether the firm is making a profit or is experience a loss.**
Balance Sheet	**Is a snapshot of a company's assets, liabilities, and owners' equity at a specific point in time.**
Statement of cash flows	**Summarizes the changes in a firm's cash position for a specified period of time and details why the changes occurred.**

Historical Income Statements

Table 8.1 Consolidated Income Statements for New Venture Fitness Drinks, Inc.

	December 31, 2008	December 31, 2007	December 31, 2006
Net sales	$586,600	$463,100	$368,900
Cost of sales	268,900	225,500	201,500
Gross profit	317,700	237,600	167,400
Operating expenses			
Selling, general, and administrative expenses	117,800	104,700	90,200
Depreciation	13,500	5,900	5,100
Operating income	186,400	127,000	72,100
Other income			
Interest income	1,900	800	1,100
Interest expense	(15,000)	(6,900)	(6,400)
Other income (expense), net	10,900	(1,300)	1,200
Income before income taxes	184,200	119,600	68,000
Income tax expense	53,200	36,600	18,000
Net income	131,000	83,000	50,000
Earnings per share	1.31	0.83	0.50

Historical Balance Sheets

Table 8.2 Consolidated Balance Sheets for New Venture Fitness Drinks, Inc.

Assets	December 31, 2008	December 31, 2007	December 31, 2006
Current assets			
Cash and cash equivalents	$63,800	$54,600	$56,500
Accounts receivable, less allowance for doubtful accounts	39,600	48,900	50,200
Inventories	19,200	20,400	21,400
Total current assets	122,600	123,900	128,100
Property, plant, and equipment			
Land	260,000	160,000	160,000
Buildings and equipment	412,000	261,500	149,000
Total property, plant, and equipment	672,000	421,500	309,000
Less: accumulated depreciation	65,000	51,500	45,600
Net property, plant, and equipment	607,000	370,000	263,400
Total assets	729,600	493,900	391,500

Historical Balance Sheets

Liabilities and Shareholder’s Equity

Liabilities and shareholders’ equity Current liabilities			
Accounts payable	30,200	46,900	50,400
Accrued expenses	9,900	8,000	4,100
Total current liabilities	40,100	54,900	54,500
Long-term liabilities			
Long-term debt	249,500	130,000	111,000
Long-term liabilities	249,500	130,000	111,000
Total liabilities	289,600	184,900	165,500
Shareholders’ equity			
Common stock (100,000 shares)	10,000	10,000	10,000
Retained earnings	430,000	299,000	216,000
Total shareholders’ equity	440,000	309,000	226,000
Total liabilities and shareholders’ equity	729,600	493,900	391,500

Historical Statement of Cash Flows

Table 8.3 CONSOLIDATED STATEMENT OF CASH FLOWS FOR NEW VENTURE FITNESS DRINKS, INC.

	December 31, 2008	December 31, 2007
Cash flows from operating activities		
Net income	$131,000	$83,000
Additions (sources of cash)		
Depreciation	13,500	5,900
Decreases in accounts receivable	9,300	1,300
Increase in accrued expenses	1,900	3,900
Decrease in inventory	1,200	1,000
Subtractions (uses of cash)		
Decrease in accounts payable	(16,700)	(3,500)
Total adjustments	9,200	8,600
Net cash provided by operating activities	140,200	91,600
Cash flows from investing activities		
Purchase of building and equipment	(250,500)	(112,500)
Net cash flows provided by investing activities	(250,500)	(112,500)
Cash flows from financing activities		
Proceeds from increase in long-term debt	119,500	19,000
Net cash flows provided by financing activities		19,000
Increase in cash	9,200	(1,900)
Cash and cash equivalents at the beginning of year	54,600	56,500
Cash and cash equivalents at the end of each year	63,800	54,600

Ratio Analysis

- Ratio Analysis
  - The most practical way to interpret or make sense of a firm's historical financial statements is through ratio analysis, as shown in the next slide.
- Comparing a Firm's Financial Results to Industry Norms
  - Comparing a firm's financial results to industry norms helps a firm determine how it stakes up against its competitors and if there are any financial "red flags" requiring attention.

Historical Ratio Analysis

Table 8.4 RATIO ANALYSIS FOR NEW VENTURE FITNESS DRINKS, INC.

Ratio	Formula	2008	2007	2006
Profitability ratios: associate the amount of income earned with the resources used to generate it				
Return on assets	ROA = net income/average total assets[a]	21.4%	18.7%	14.7%
Return on equity	ROE = net income/average shareholders' equity[b]	35.0%	31.0%	24.9%
Profit margin	Profit margin = net income/net sales	22.3%	17.9%	13.6%
Liquidity ratios: measure the extent to which a company can quickly liquidate assets to cover short-term liabilities				
Current	Current assets/current liabilities	3.06	2.26	2.35
Quick	Quick assets/current liabilities	2.58	1.89	1.96
Overall financial stability ratio: measures the overall financial stability of a firm				
Debt	Total debt/total assets	39.7%	37.4%	42.3%
Debt to Equity	Total liabilities/owners' equity	65.8%	59.8%	73.2%

[a] Average total assets = beginning total assets + ending total assets ÷ 2.
[b] Average shareholders' equity = beginning shareholders' equity + ending shareholders' equity ÷ 2.

Forecasts

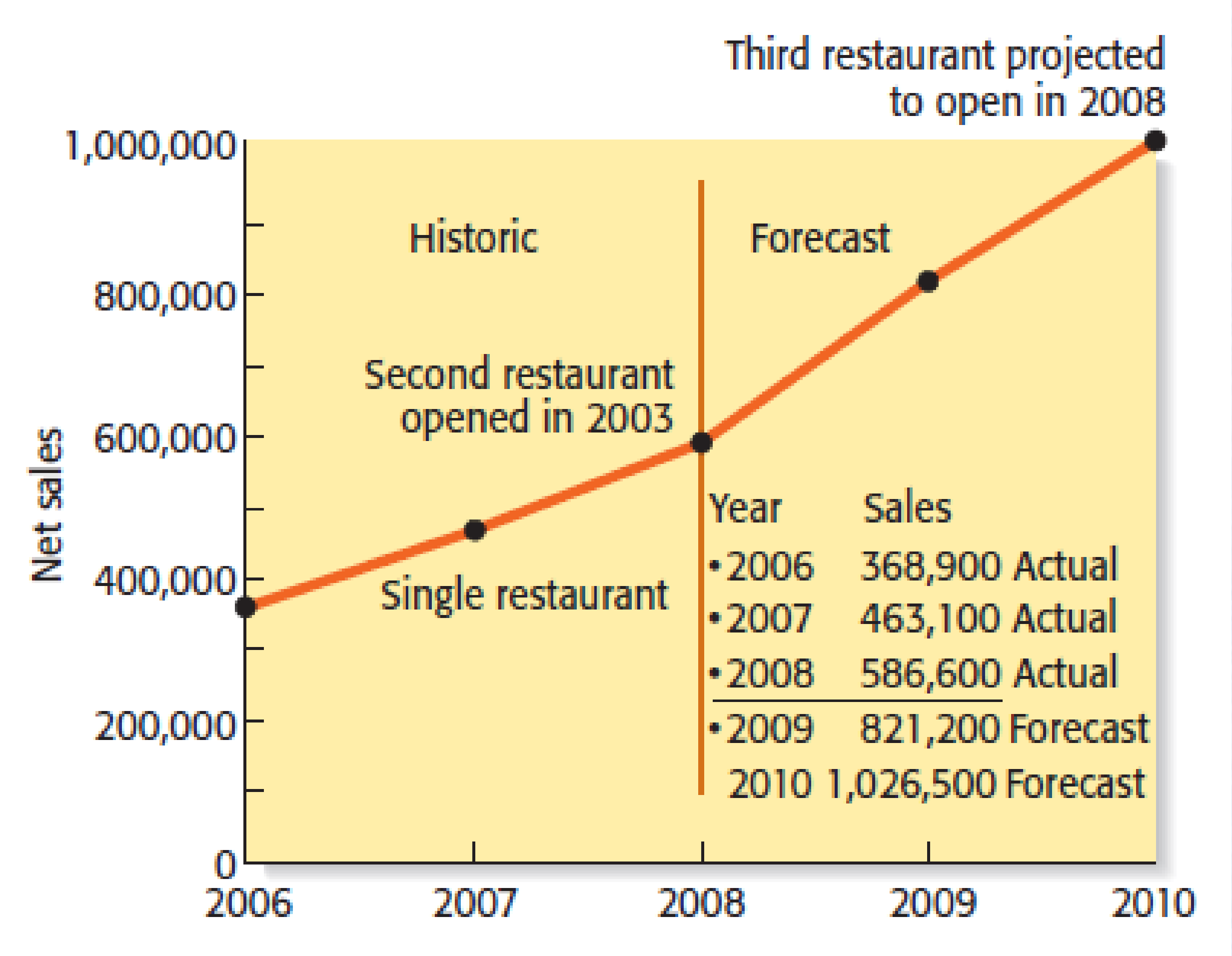
- Forecasts
  - The analysis of a firm's historical financial statements are followed by the preparation of forecasts.
  - Forecasts are predictions of a firm's future sales, expenses, income, and capital expenditures.
    - A firm's forecasts provide the basis for its pro forma financial statements.
    - A well-developed set of pro forma financial statements helps a firm create accurate budgets, build financial plans, and manage its finances in a proactive rather than a reactive manner.

Forecasts

- Sales Forecast
  - A sales forecast is projection of a firm's sales for a specified period (such as a year).
  - It is the first forecast developed and is the basis for most of the other forecasts.
    - A sales forecast for a new firm is based on a good-faith estimate of sales and on industry averages or the experiences of similar start-ups.
    - A sales forecast for an existing firm is based on (1) its record of past sales, (2) its current production capacity and product demand, and (3) any factors that will affect its future product capacity and product demand.

Forecasts

Historical and Forecasted Annual Sales for New Venture Fitness Drinks



Forecasts

- Forecast of Costs of Sales and Other Items
  - Once a firm has completed its sales forecast, it must forecast its cost of sales (or cost of goods sold) and the other items on its income statement.
  - The most common way to do this is to use the percentage-of-sales method, which is a method for expressing each expense item as a percentage of sales.
    - If a firm determines that it can use the percent-of-sales method and its follows the procedures described in the textbook, then the net result is that each expense item on its income statement will grow at the same rate as sales (with the exception of items that can be individually forecast, such as depreciation).

Pro Forma Financial Statements

- Pro Forma Financial Statements
  - A firm's pro forma financial statements are similar to its historical financial statements except that they look forward rather than track the past.
  - The preparation of pro form financial statements helps a firm rethink its strategies and make adjustments if necessary.
  - The preparation of pro forma financials is also necessary if a firm is seeking funding or financing.

Types of Pro Forma Financial Statements

Financial Statement	Purpose
Pro Forma Income Statement	Shows the projected results of the operations of a firm over a specific period.
Pro Forma Balance Sheet	Shows a projected snapshot of a company's assets, liabilities, and owner's equity at a specific point in time.
Pro Forma Statement of Cash flows	Shows the projected flow of cash into and out of a company for a specific period.

Pro Forma Income Statements

Table 8.6 PRO FORMA INCOME STATEMENT FOR NEW VENTURE FITNESS DRINKS, INC.

	2008 Actual	2009 Projected	2010 Projected
Net sales	$586,600	$821,200	$1,026,500
Cost of sales	268,900	390,000	487,600
Gross profit	317,700	431,200	538,900
Operating expenses			
Selling, general, and administrative expenses	117,800	205,300	256,600
Depreciation	13,500	18,500	22,500
Operating income	186,400	207,400	259,800
Other income			
Interest income	1,900	2,000	2,000
Interest expense	(15,000)	(17,500)	(17,000)
Other income (expense), net	10,900	20,000	20,000
Income before income taxes	184,200	211,900	264,800
Income tax expense	53,200	63,600	79,400
Net income	131,000	148,300	185,400
Earnings per share	1.31	1.48	1.85

Pro Forma Balance Sheets

Table 8.7 Pro Forma Balance Sheets for New Venture Fitness Drinks, Inc.

Assets	December 31, 2008	Projected 2009	Projected 2010
Current assets			
Cash and cash equivalents	$63,800	$53,400	$80,200
Accounts receivable, less allowance for doubtful accounts	39,600	57,500	71,900
Inventories	19,200	32,900	41,000
Total current assets	122,600	143,800	193,100
Property, plant, and equipment			
Land	260,000	260,000	360,000
Buildings and equipment	412,000	512,000	687,000
Total property, plant, and equipment	672,000	772,000	1,047,000
Less: accumulated depreciation	65,000	83,500	106,000
Net property, plant, and equipment	607,000	688,500	941,000
Total assets	729,600	832,300	1,134,100

Pro Forma Balance Sheets

Liabilities and Shareholder's Equity

Liabilities and shareholders' equity			
Current liabilities			
Accounts payable	30,200	57,500	71,900
Accrued expenses	9,900	12,000	14,000
Total current liabilities	40,100	69,500	85,900
Long-term liabilities			
Long-term debt	249,500	174,500	274,500
Total long-term liabilities	249,500	174,500	274,500
Total liabilities	289,600	244,000	360,400
Shareholders' equity			
Common stock (100,000 shares)	10,000	10,000	10,000
Retained earnings	430,000	578,300	763,700
Total shareholders' equity	440,000	588,300	773,700
Total liabilities and shareholders' equity	729,600	832,300	1,134,100

Pro Forma Statement of Cash Flow

Table 8.8 PRO FORMA STATEMENT OF CASH FLOWS FOR NEW VENTURE FITNESS DRINKS, INC.

	December 31, 2008	Projected 2009	Projected 2010
Cash flows from operating activities			
Net income	$131,000	$148,300	$185,400
Changes in working capital			
Depreciation	13,500	18,500	22,500
Increase (decrease) in accounts receivable	9,300	(17,900)	(14,400)
Increase (decrease) in accrued expenses	1,900	2,100	2,000
Increase (decrease) in inventory	1,200	(13,700)	(8,100)
Increase (decrease) in accounts payable	(16,700)	27,300	14,400
Total adjustments	9,200	16,300	16,400
Net cash provided by operating activities	140,200	164,600	201,800
Cash flows from investing activities			
Purchase of building and equipment	(250,500)	(100,000)	(275,000)
Net cash flows provided by investing activities	(250,500)	(100,000)	(275,000)
Cash flows from financing activities			
Proceeds from increase in long-term debt	119,500	—	100,000
Principle reduction in long-term debt		(75,000)	
Net cash flows provided by financing activities			
Increase in cash	9,200	(10,400)	26,800
Cash and cash equivalents at the beginning of the year	54,600	63,800	53,400
Cash and cash equivalents at the end of the year	63,800	53,400	80,200

Ratio Analysis

- Ratio Analysis
  - The same financial ratios used to evaluate a firm's historical financial statements should be used to evaluate the pro forma financial statements.
  - This work is completed so the firm can get a sense of how its projected financial performance compares to its past performance and how its projected activities will affect its cash position and its overall financial soundness.

Ratio Analysis Based on Historical and Pro-Forma Financial Statements

Table 8.9 Ratio Analysis of Historical and Pro Forma Financial Statements for New Venture Fitness Drinks, Inc.

	Historical			*Projected*	
Ratio	**2006**	**2007**	**2008**	**2009**	**2010**
Profitability ratios					
Return on assets	14.7%	18.7%	21.4%	19.0%	18.9%
Return on equity	24.9%	31.0%	35.0%	28.9%	27.2%
Profit margin	13.6%	17.9%	22.3%	18.1%	18.1%
Liquidity ratios					
Current	2.35	2.26	3.05	2.07	2.24
Quick	1.96	1.89	2.58	1.60	1.78
Overall financial stability ratios					
Debt	42.3%	37.4%	39.7%	29.3%	31.8%
Debt to equity	73.2%	59.8%	65.8%	41.5%	46.6%

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