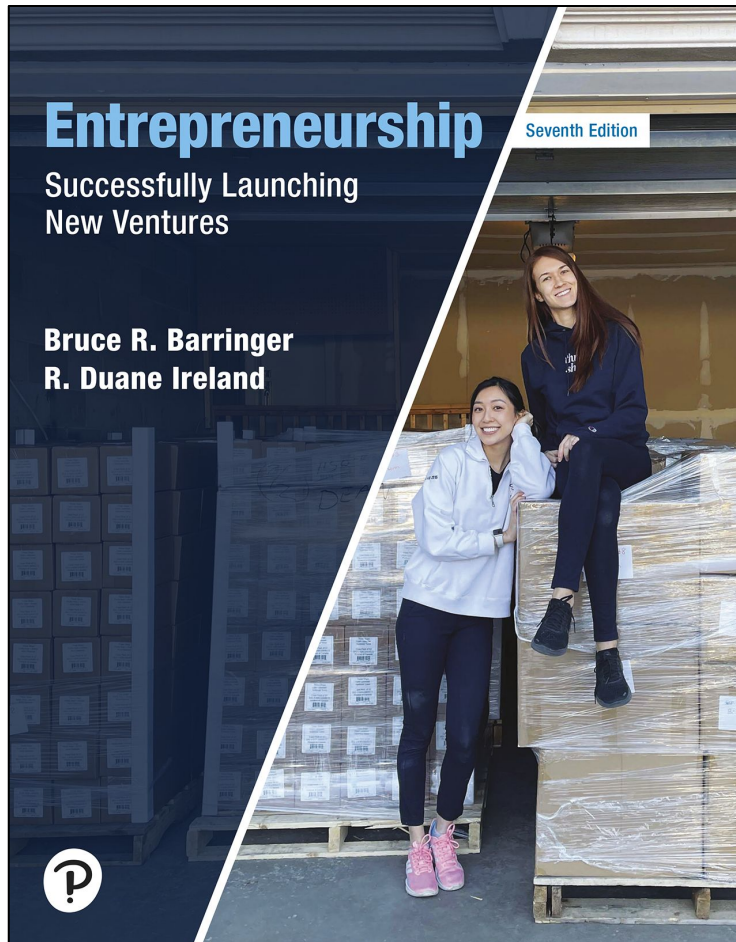


Entrepreneurship: Successfully Launching New Ventures

Seventh Edition



Chapter 8

Assessing a New
Venture's Financial
Strength and Viability

Learning Objectives (1 of 2)

8.1 Learn about the importance of understanding the financial management of an entrepreneurial firm.

8.2 Identify entrepreneurial ventures' four main financial objectives.

8.3 Describe the financial management process entrepreneurial firms use.

8.4 Explain the difference between historical and pro forma financial statements.

8.5 Describe the different historical financial statements and their purpose.

Learning Objectives (2 of 2)

8.6 Discuss the role of forecasts in projecting a firm's future income and expenses.

8.7 Explain the purpose of pro forma financial statements.

8.1 Introduction to Financial Management (1 of 2)

- 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.
 - Chapter 10 focuses on raising money. This chapter focuses primarily on:
 - How a new venture tracks its financial progress through preparing, analyzing, and maintaining past financial statements.
 - How both existing firms and new ventures forecast future income and expenses by preparing pro forma (or projected) financial statements.

8.1 Introduction to Financial Management (2 of 2)

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 do 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?

Figure 8.1 Primary Financial Objectives of Entrepreneurial Firms

Profitability

A company's ability to make a profit

Liquidity

A company's ability to meet its short-term obligations

Efficiency

How productively a firm utilizes its assets

Stability

The overall health of the financial structure of the firm, particularly as it relates to its debt-to-equity ratio

8.2 Financial Objectives of a Firm (1 of 2)

- Profitability
 - Is the ability to earn a profit.
 - Many startups 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.

8.2 Financial Objectives of a Firm (2 of 2)

- Efficiency
 - Is how productively a firm utilizes its assets relative to its revenue and its profits.
 - Because planes do not earn money while sitting idle, airplane carriers try to increase their efficiency by reducing actual turnaround times.
- 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.

8.3 The Process of Financial Management (1 of 3)

- 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.

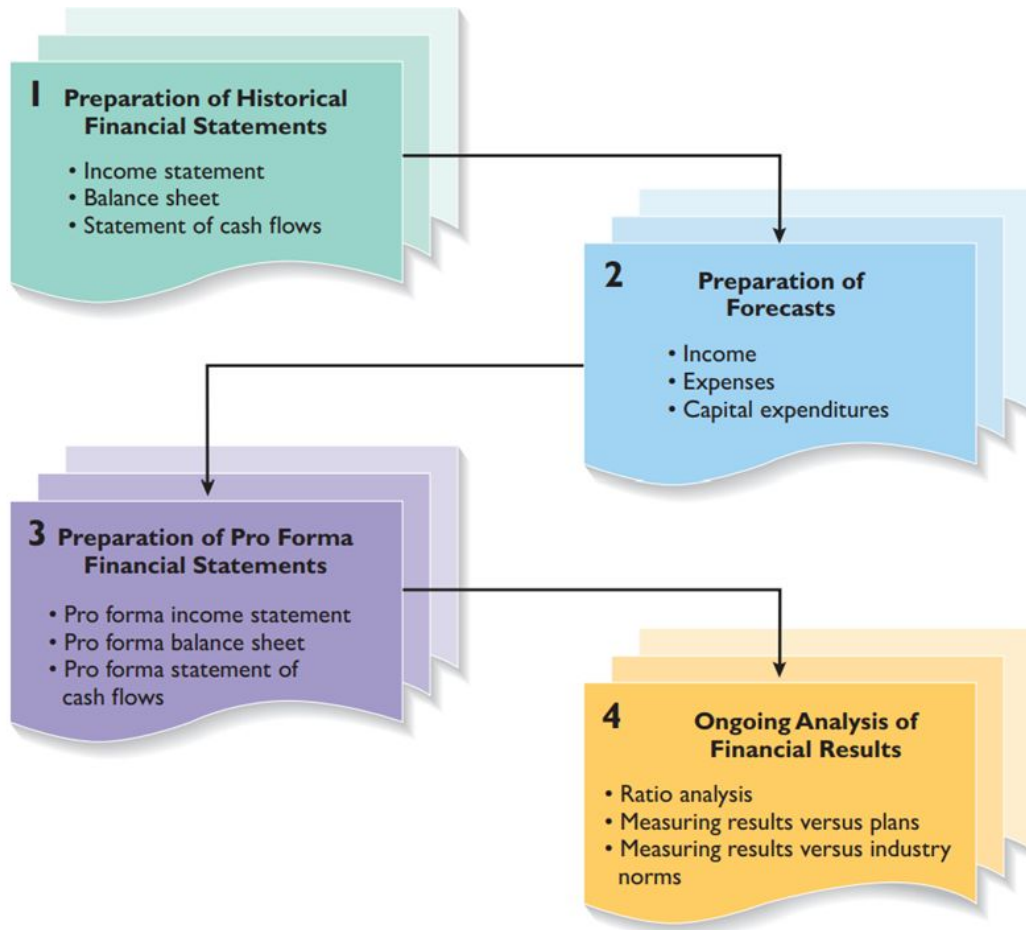
8.3 The Process of Financial Management (2 of 3)

- Forecasts (continued)
 - New ventures typically base their forecasts on an estimate of sales and then on industry averages or the experiences of similar startups 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.

8.3 The Process of Financial Management (3 of 3)

- 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 stacks 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.

Figure 8.2 The Process of Financial Management



8.4 Financial Statements (1 of 3)

- Historical Financial Statements
 - Reflect past performance and are usually prepared on a quarterly and annual basis.
 - Publicly traded firms are required by the SEC to prepare financial statements and make them available to the public.
- Pro Forma 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 and are not required by the SEC.

8.4 Financial Statements (2 of 3)

- New Venture Fitness Drinks
 - To illustrate how financial statements are prepared, we used New Venture Fitness Drinks, the fictitious sports drink company introduced in Chapter 3.
 - New Venture Fitness Drinks has been in business for five years.
 - Targeting sports enthusiasts, the company sells a line of nutritional fitness drinks.
 - It opened a single location in 2022, added a second location in 2024, and plans to add a third in 2025.

8.4 Financial Statements (3 of 3)

- New Venture Fitness Drinks (continued)
 - To illustrate how financial statements are prepared, we used New Venture Fitness Drinks, the fictitious sports drink company introduced in Chapter 3.
 - The company's strategy is to place small restaurants, similar to smoothie restaurants, near large outdoor sports complexes.
 - The company is profitable and is growing at a rate of 25 percent per year.

8.5 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 experiencing a loss.
Balance Sheet	Is a snapshot of a company's assets, liabilities, and owner's 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.

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

	December 31, 2024	December 31, 2023	December 31, 2022
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

	December 31, 2024	December 31, 2023	December 31, 2022
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

	December 31, 2024	December 31, 2023	December 31, 2022
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

Table 8.2 Consolidated Balance Sheets for New Venture Fitness Drinks, Inc. (1 of 2)

Assets

Current assets

Assets	December 31, 2024	December 31, 2023	December 31, 2022
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

Assets	December 31, 2024	December 31, 2023	December 31, 2022
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

Table 8.2 Consolidated Balance Sheets for New Venture Fitness Drinks, Inc. (2 of 2)

Liabilities and Shareholders' Equity

Table 8.2 (continued)

Liabilities and shareholders' equity Current liabilities

Assets	December 31, 2024	December 31, 2023	December 31, 2022
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

Assets	December 31, 2024	December 31, 2023	December 31, 2022
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

Table 8.3 Consolidated Statement of Cash Flows for New Venture Fitness Drinks, Inc. (1 of 2)

	December 31, 2024	December 31, 2023
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	-	-

Table 8.3 Consolidated Statement of Cash Flows for New Venture Fitness Drinks, Inc. (2 of 2)

	December 31, 2024	December 31, 2023
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	119,500	19,000
Increase in cash	9,200	(1,900)
Cash and cash equivalents at the beginning of each year	54,600	56,500
Cash and cash equivalents at the end of each year	63,800	54,600

Ratio Analysis (1 of 2)

- 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 stacks up against its competitors and if there are any financial “red flags” requiring attention.

Table 8.4 Ratio Analysis for New Venture Fitness Drinks, Inc. (1 of 2)

Ratio	Formula	2024	2023	2022
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

Table 8.4 Ratio Analysis for New Venture Fitness Drinks, Inc. (2 of 2)

Ratio	Formula	2024	2023	2002
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.

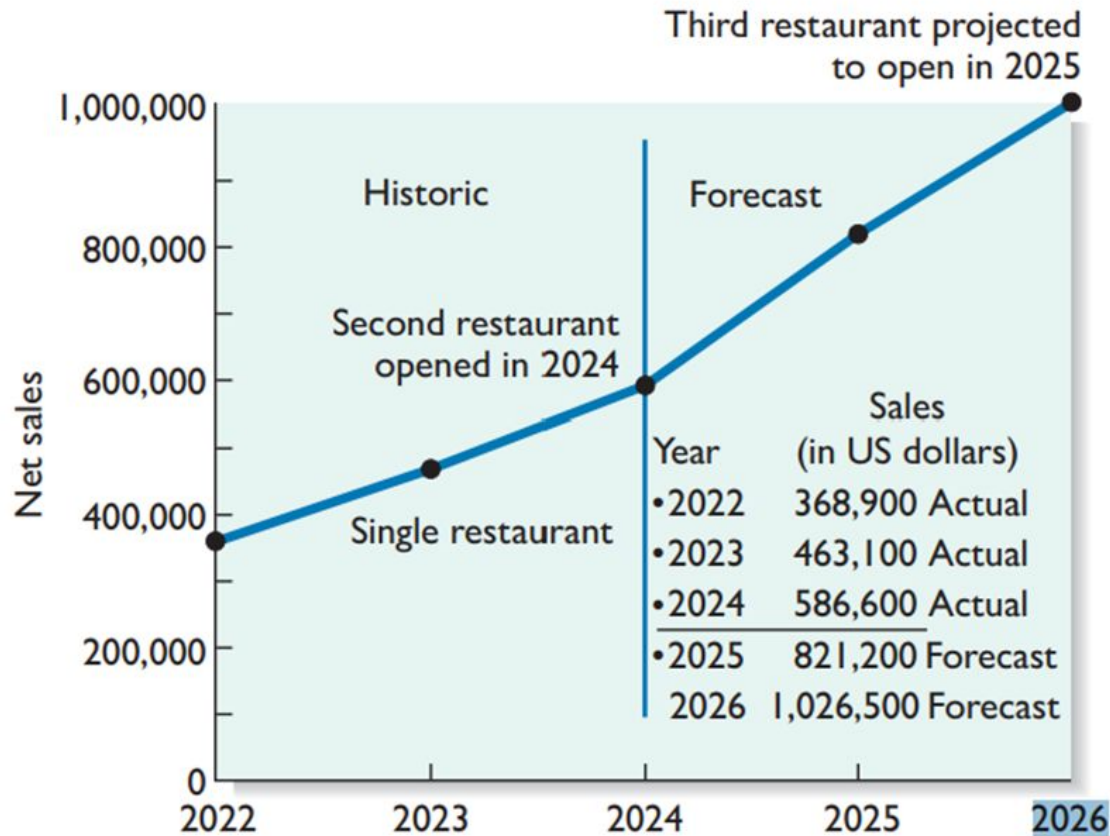
8.6 Forecasts (1 of 3)

- 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.

8.6 Forecasts (2 of 3)

- Sales Forecast
 - A sales forecast is a 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 startups.
 - 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 production capacity and product demand.

Figure 8.3 Historical and Forecasted Annual Sales for New Venture Fitness Drinks



8.6 Forecasts (3 of 3)

- 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 percent-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 it 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).

8.7 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 forma 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 financial 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.

Table 8.6 Pro Forma Income Statement for New Venture Fitness Drinks, Inc

	2024 Actual	2025 Projected	2026 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

	2024 Actual	2025 Projected	2026 Projected
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

	2024 Actual	2025 Projected	2026 Projected
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

Table 8.7 Pro Forma Balance Sheets for New Venture Fitness Drinks, Inc. (1 of 2)

Assets

Assets	December 31, 2024	Projected 2025	Projected 2026
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

Table 8.7 Pro Forma Balance Sheets for New Venture Fitness Drinks, Inc. (2 of 2)

Assets	December 31, 2024	Projected 2025	Projected 2026
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

Table 8.8 Pro Forma Statement of Cash Flows for New Venture Fitness Drinks, Inc. (1 of 2)

Operating Activities

	December 31, 2024	Projected 2025	Projected 2026
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

Table 8.8 Pro Forma Statement of Cash Flows for New Venture Fitness Drinks, Inc. (2 of 2)

Investing Activities and Financing Activities

	December 31, 2024	Projected 2025	Projected 2026
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 (2 of 2)

- 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.

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

Profitability ratios

Ratio	Historical 2022	Historical 2023	Historical 2024	Projected 2025	Projected 2026
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

Ratio	Historical 2022	Historical 2023	Historical 2024	Projected 2025	Projected 2026
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

Ratio	Historical 2022	Historical 2023	Historical 2024	Projected 2025	Projected 2026
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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