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Accelerated Innovation & Entrepreneurship Bootcamp

Session 23
Startup Financials 2

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Agenda

- Pricing
- Profit
- Review accounting basics to understand the information on your financial statements
- Understand how to read and analyze your:
  - Income statement
  - Balance sheet

“ No one can advise you on how to manage your business without first reviewing and understanding your financial statements.”

Product Pricing

- **Prices of products and/or services:**
- Pricing is the monetary value of a product or services that you charge to cover your total costs (direct and indirect costs) and profit that you desire on each unit of product or service.
- **Mark Up**
- When you add a certain percentage of profit desired on the sale of a product or service, it is called a mark up. For example: If you desire to mark up the cost of a wooden cupboard by 20% and it cost you 13,000 to make, the following is the calculation;

Your Cost	= 13,00
Mark up – 20%	= 2,600
Selling Price	**15,600**
Your Selling Price	**15,600**
Cost	**13,00**
Profit	**2,600**

- Price is important in all business ventures. This is because it determines the profits that the entrepreneur will make. In setting the price, one has to make marketing mix decisions, estimate the demand curve, calculate the cost, understand the environmental factors, set pricing objectives and determine the selling price. A formula that articulates how to estimate the selling price is:

Selling price = cost of goods sold/unit + Operating costs/Unit + Desired profit/ Unit

Factors that Influence Pricing

1. Nature of the market: open market with little competition - abundant supply and low demand normally means low prices, and vice versa

2. Consumer demand for a product; customers generally buy more of a product when prices are low.

3. Costs in the distribution channel; If a product is sold through a middle-person the price charged will be affected by how that middleperson treats the product.

Definitions

- **Profit:** is net income: total earnings after expenses are considered. Profit is the money a business makes after accounting for all expenses. Making profit is the goal of every for-profit company.
- **Revenue:** the total amount of sales during a specific period, including discounts and returned merchandise.
- **Price:** the sum or amount of money or its equivalent for which anything is bought, sold, or offered for sale.
- **Sales Volume:** quantity or number of goods sold or services rendered in the normal
- operations of a firm in a specified period.
- **Expenditure:** actual payment of cash or cash-equivalent for goods or services

simple formulas

- **Profit =** Revenue **-** Expenditures
- **Revenue =** Price **x** sales volume
- **Expenditure =** Material **+** Labour **+** Transportation...
- **Price =** Cost + Profit

What you should know?

- Bank Balance
- Money coming in
- Money going out

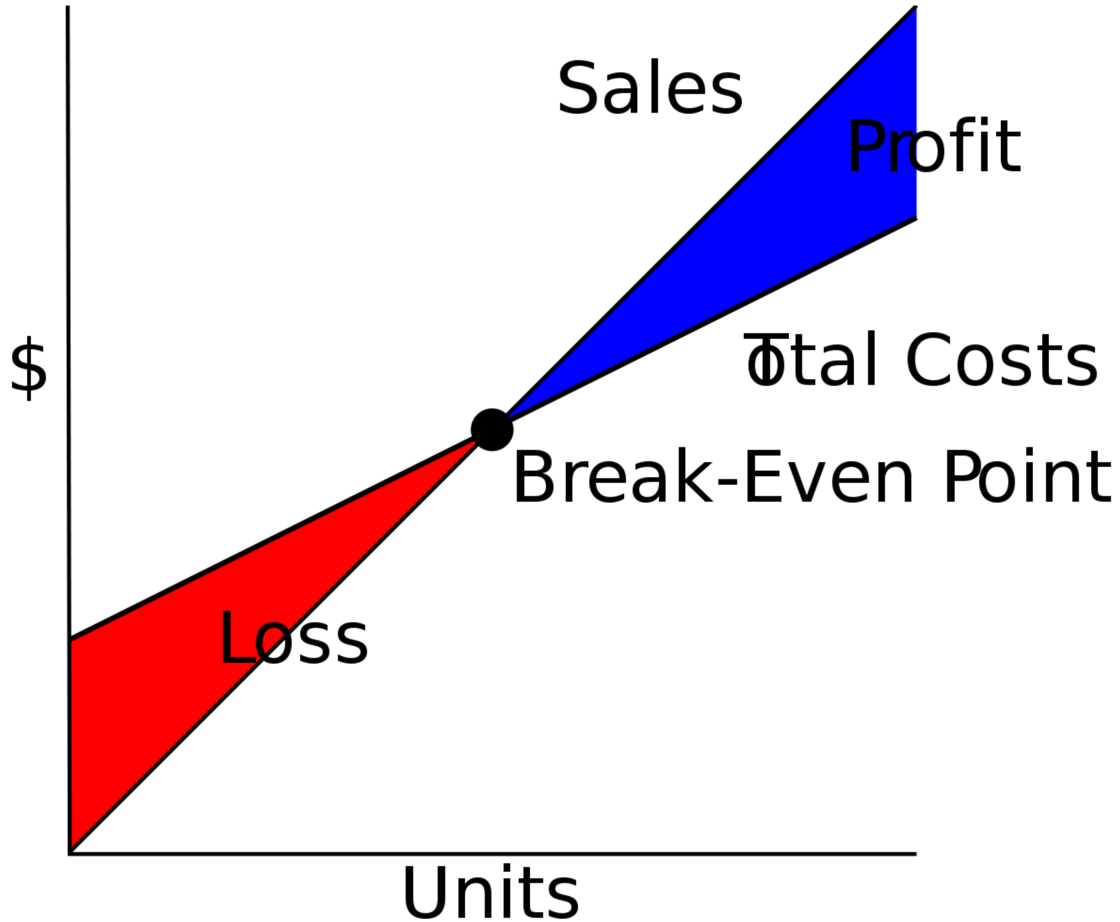
When to look at your numbers?

- Every quarter
- Every month
- Every week

Break Even Analysis

- A **breakeven analysis** is used to determine the volume of sales your business needs to start making a profit. The breakeven analysis is especially useful when you're developing a pricing strategy, either as part of a marketing plan or a business plan.

$$\text{Break Even} = \frac{\text{Fixed Costs}}{\text{Revenue per unit} - \text{Variable cost per unit}}$$


Sales
Profit
$
Total Costs
Break-Even Point
Loss
Units

What are financial statements?

The summarized results of your business financial transactions over a designated period of time.

They will show total income, expenses, cash balances, level of debt, and much more.

But where does this information come from?

Business Activities

All businesses are involved in three types of activity —

- financing,
- investing,
- and operating.

The accounting information system keeps track of the results of each of these business activities.

Business Activities

Financing Activities

Two primary sources of outside funds are:

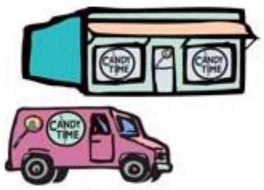
1. Borrowing money
   - Amounts owed are called liabilities.
   - Party to whom amounts are owed are creditors.
   - Notes payable and bonds payable are different type of liabilities.

2. Issuing shares of stock for cash.
   - Payments to stockholders are called dividends.

Business Activities

Investing Activities

Purchase of resources a company needs operate.

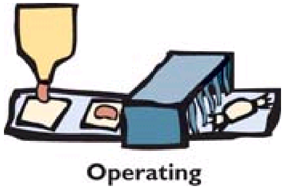


- Computers, delivery trucks, furniture, buildings, etc.
- Resources owned by a business are called assets.

Business Activities

Operating Activities

Once a business has the assets it needs, can begin its operations.



- Revenues - Amounts earned from the sale of products (sales revenue, service revenue, and interest revenue).
- Inventory - Goods available for sale to customers.
- Accounts receivable - Right to receive money from a customer,in the future, as the result of a sale.

Business Activities

Operating Activities

- Expenses - cost of assets consumed or services used. (cost of goods sold, selling, marketing, administrative, interest, and income taxes expense).
- Liabilities arising from expenses include accounts payable, interest payable, wages payable, sales taxes payable, and income taxes payable.
- Net income – when revenues exceed expenses.
- Net loss – when expenses exceed revenues.

Accounts

Accounts are the categories into which the effects of transactions are recorded, and from which financial reports are created.

5 major account categories:

Income	**Expenses**	**Assets**	**Liabilities**	**Equity**
Proceeds from sales	Costs of operation	What you own	What you owe	Net worth / level of investment

Operations

Financial Position

Chart of Accounts

Sample Income accounts	**Sample Expense accounts**
• Sales revenue • Other income	• Rent • Cost of Goods Sold (COGS) • Marketing • Office supplies • Payroll • Professional fees

Sample Asset accounts	**Sample Liability accounts**	**Sample Equity accounts**
Current assets • Cash • Inventory • Accounts receivable *Fixed assets* • Equipment • Property	• Accounts payable • Credit card payable • Loan payable	• Owner's equity • Retained earnings

Financial Statements

Income Statement*

Balance Sheet*

Statement of Cash Flow

* today’s class will focus on the income statement and balance sheet

Income Statement / Profit & Loss Statement (P&L)

- Shows the performance of your business over a period of time
- Resets at the beginning of each new accounting period
- Summarizes all revenue generated by the business
- Summarizes all expenses incurred by the business (by category)
- Calculates the net profit or loss, or "bottom line" = Income – Expenses
- Tells you how well your business is operated

My company Income Statement
For the month of August 2008

Income		
	Sales revenue	$2,000
Expenses		
	rent	$ 850
	utilities	75
	payroll	400
	insurance	25
	marketing	250
Total expenses		1,600
Profit/Loss		$400

Reviewing your income statement

- How is your revenue trending?
  - Month-to-month
  - Against same period last year (considers seasonality)
- How are your expenses trending?
- What are your highest categories of expenses?
- Which expenses are fixed vs. variable?
- What is your cost of goods sold?
- How do your expenses (as a % of sales) compare to others in your industry?

Reviewing your income statement will tell you…

- Are you profitable?
- What’s your profit margin?
  - Profit / Sales
- What’s your gross profit margin?
  - (Sales – COGS) / Sales

Accounting Equation

Assets = Liabilities + Owners' Equity

Resources | **Sources of Funding**

Resources to use to generate revenues = **Creditors' claims against resources** + **Owners' claims against resources**

Sample Balance Sheet

Assets		Liabilities	
Cash	$ 40	Accounts payable	$ 50
Accounts receivable	100	Notes payable	150
Land	200		$200
		Owners' Equity	
Total assets	$340	Capital stock	$100
		Retained earnings	40
			$140
		Total liabilities and owners' equity	$340

Must Equal

Balance sheet

- Shows a snapshot of your business at a point in time
- Accumulates over the lifetime of your business
- Shows the net worth of your business
- The balance sheet always balances ASSETS – LIABILITIES = EQUITY

My company Balance Sheet
As of August 31, 2011

<u>Assets:</u>		<u>Liabilities:</u>	
Cash	5,000	Accounts Payable	900
Accounts Receivable	600	Loan Payable	3,500
Inventory	900		
Equipment	1,000	**Total Liabilities**	**4,400**
		<u>Equity:</u>	
Total Assets	**7,500**	Owner's equity	2,700
		Retained earnings	400
		Total Equity	**3,100**

The Balance Sheet

Current Assets
- Cash & Securities
- Receivables
- Inventories

+

Fixed Assets
- Tangible Assets
- Intangible Assets

=

Current Liabilities
- Payables
- Short-term Debt

+

Long-term Liabilities

+

Shareholders’ Equity

Link between balance sheet and income statement

Profit or loss is taken from the bottom line of the income statement and recorded on the balance sheet in the Retained Earnings equity account. Retained earnings accumulate over the life of the business.

- When a business operates at a profit, it increases in equity (is worth more)
- When a business operates at a loss, it decreases in equity (is worth less)

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As of August 31, 2008

Assets:		Liabilities:	
Cash	5,000	Accounts Payable	900
Accounts Receivable	600	Loan Payable	3,500
Inventory	900		
Equipment	1,000	Total Liabilities	4,400
		Equity:	
Total Assets	7,500	Owner's equity	2,700
		Retained earnings	400
		Total Equity	3,100

Reviewing your balance sheet

- Liquidity: Can your company meet its payment obligations?
  - Cash balance
  - Working capital: Current assets – Current liabilities
  - Current ratio: Current assets / Current liabilities
- Cash flow management
  - How much inventory do you have? How fast are you selling it?

    Is your inventory on the shelf collecting dust and interest?

    Are you doing physical inventories monthly, annually, never?
    - Inventory turns: (COGS / Inventory balance)
  - How high is your accounts receivable balance?
    How quickly are you collecting it?
    - Days sales outstanding: (AR / Sales) * # of days in period

Reviewing your balance sheet

- Debt management
  - What are your total debt obligations?
  - What is your total equity in the business?
  - How leveraged is your company?
    - Debt-to-equity ratio: Total liabilities / Total equity

Statement of Cash Flows

- Reports the amount of cash collected and paid out by a company in operating, investing and financing activities for a period of time.
- How did the company receive cash?
- How did the company use its cash?
- Complementary to the income statement.
- Indicates ability of a company to generate income in the future.

Statement of Cash Flows

Cash inflows

- Sell goods or services
- Sell other assets or by borrowing
- Receive cash from investments by owners

Cash outflows

- Pay operating expenses
- Expand operations, repay loans
- Pay owners a return on investment

Double-entry accounting

Every business transaction will affect at least two accounts. If only one side of the entry is done, the accounting system will become out-of-balance.

Example: You write a check to the newspaper for $100 to place an advertisement.

- Your cash account is reduced by $100
- Your marketing expense account is increased by $100

Accounting methods

Cash-based accounting

- You record transactions when payment is made or received (cash exchanges hands), not when the business event occurs

Accrual-based accounting

- You record transactions when the business event occurs, regardless of whether payment has yet been made or received
- Accounts payable and accounts receivable accounts are used

Analyzing financial statements

To obtain optimal management information from the numbers on your financial statements, they should not just be looked at alone, but compared against other numbers.

To know if your numbers are "good," you must compare them to:

- Your expectations and needs (budget-to-actual)
- Your competitors and industry norms (benchmarking)
- Historical performance (trending)
- Each other (ratios)