

# Demystifying Financial Foundations: Income, Assets & Cash Flow

SCORE Kansas City

For the Life of Your Business

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# AGENDA

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- Introduction to SCORE
- Financial Management – What is it
- Financial Management Partners for small businesses
- Financial Managements Terms – The language of business
- Financial Management Tools
  - Balance Sheet
  - Income Statement
  - Cash Flow Statement
  - Cash Forecasting
- Cost/Volume/profit Tool
- Summary

# What is Financial Management / The role of a CFO?

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## Financial Management includes:

- Planning                      Hiring? Expanding? Borrowing?
- Directing                      Investing? Spending?
- Monitoring                    Making money? Growing sales?
- Organizing                    Expenses? Sales?
- Controlling                    Cash flow? Inventory?

of the monetary resources of an organization.

# What are the Benefits of Financial Management?

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## **Financial management** helps you:

- know if you are making a profit.
- decide on capital purchases and investments.
- set your prices and manage your vendors.
- plan for overall business growth.
- decide which products, services, and markets are profitable.
- plan for financing.

# When you measure your results, you can ask, analyze and answer many relevant questions

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- Are you making a profit?
- Is there enough cash to run the business?
- Is the business building wealth or destroying it?
- Can we adjust pricing, lower cost.

# Key Partners at start of business and throughout

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**Accountant – CPA / Bookkeeping**

**Lawyer (Legal and Tax)**

**Banker**

**Part time CFO**

**WHY:**

- **What form of legal structure to manage personal liability / optimize tax strategy**
- **How you file your tax return (avoid, never evade taxes)**
- **How you fund the business (your money or someone else's – borrow)**
- **CFO – With all the data you track, how do you analyze it to identify areas of improvement**

# Accounting and Finance Partners

## CPA

- Expert in accounting policy, tools, taxes
- Required in set up/taxes

## Bookkeeper

- Track all income and expenses
- Set up bank account to aid in tracking
- Tool to use in tracking (QuickBooks, etc.)
- Chart of Account –
  - How do you want to track/manage your business
- You cannot manage what you do not measure

## CFO

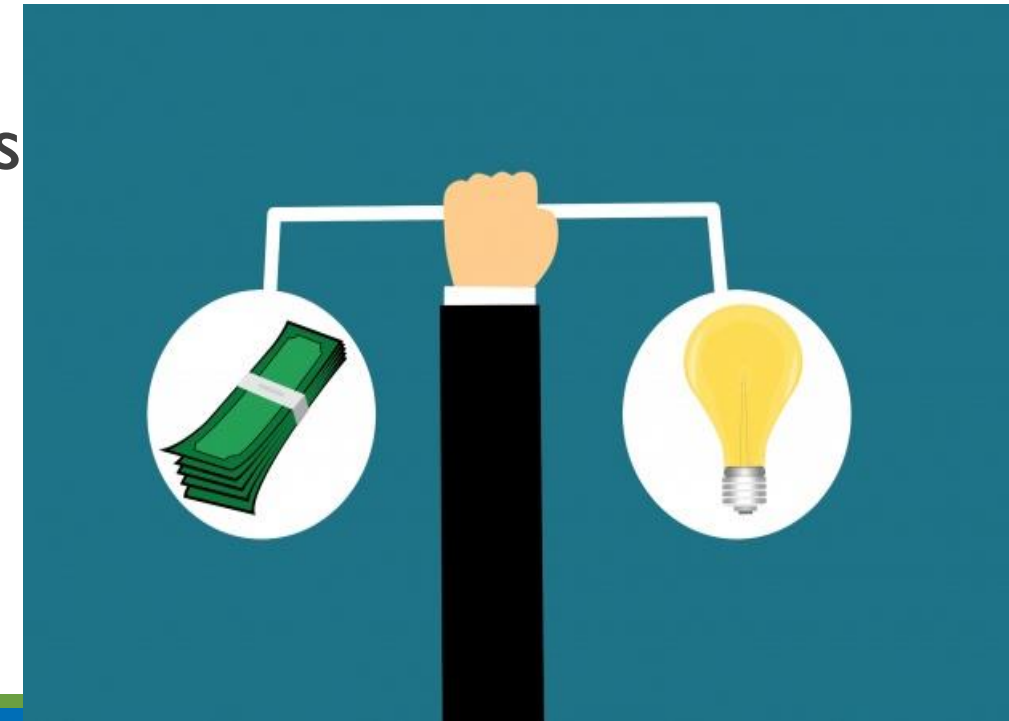
- Key partner with CEO (owner) who analyzes all the accounting data/cash, and provides input on how to improve the business. CEO decides if adjustment gets executed or not.



# Bookkeeper and CFO

## Bookkeeping and Forecasting/budgeting

- Track all your sources of income
- Track all your business expenses
- Plan for the future
- Analyze your business to improve results
- Analyze business to determine if on plan
- Plan for expansion
- History/tracking helps with budgeting
  - History is generally a good predictor of the future



# Financial Management Practices

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## Bookkeeping Steps

- Do bookwork daily
- Hire a bookkeeper or accountant
  - CPA at the beginning, but lower cost later with bookkeeper
- Obtain business accounting software
- Open a separate business checking account
- Reconcile your checking account
- Track and deposit all sales
- Write business checks for all **Business Expenses**
- Obtain a separate business credit card
- Pay business expenses first
- Run a **Profit and Loss (P&L) Statement**
- Pay yourself

# Hire Help – Would you rather?

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- Would you rather spend your time doing the Financial Management functions (CFO) or spend time with Marketing/Sales/Strategy to grow the business?
- CPA/Tax Attorney/Legal attorney – You can set up right and pay expensive CPA/Attorney fees, or not set up wrong and really pay for it in the long run
- Banker – always good to build a relationship because you never know when you will need cash to get through a rough period or grow
- We all work for someone who sold something, which is the reason you are in business . It's your idea, your connections that are the genesis of the business.
- You determine where to spend your time that you are good at to have the “high class problem” of too many customers

# Financial Statement Terms

Assets: cash, accounts receivable, inventory, office furniture, equipment, vehicles, .....

Liabilities: accounts payable, notes payable, long-term debt

Capital/Net Worth : earnings, retained earnings, paid-in capital

Revenue: sales, income,

Variable costs / Cost of Goods Sold: costs to make the product or service (Variable Costs)

Fixed cost : costs to run the business that don't vary with sales volumes

Earnings before taxes :  $\text{Revenue} - \text{Variable costs} = \text{Gross Margin} - \text{Fixed Cost} = \text{Net income}$

Income taxes: State and Local income taxes

Net Income: Earnings before taxes – taxes

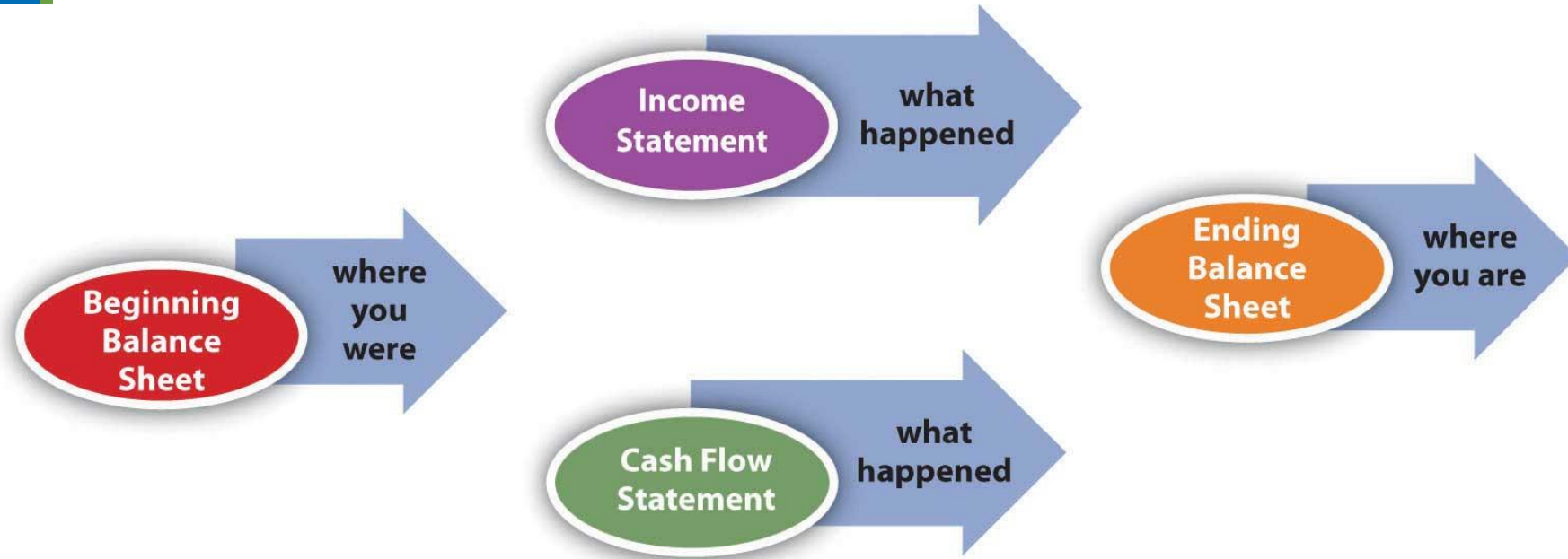
EBITDA: Earnings before taxes and depreciation – cash generated by the business

Free Cash flow: EBITDA less required capital expenditures, you can do whatever you want with it

# Financial Management Practices

## Financial Statements

- Balance Sheet
- Income Statement (Profit and Loss)
- Cash flow statement
- Cash Forecast



- A balance sheet is always at a point in time
- An income statement is for a “period” of time.
- Cash flow statement, primarily required by large Corporations (SEC requirement), is a reconciliation of your checkbook
- **A cash forecast is separate but critical for a small business.**
- All are interlinked

# Example of a Personal Balance sheet

## Personal Assets (Cash and things you can turn into cash) . What you OWN

Checking account	\$	10,000
Investments	\$	20,000
Car	\$	15,000
Contents	\$	5,000
Misc	\$	5,000
Home	\$	200,000
<b>Total Assets</b>	<b>\$</b>	<b>255,000</b>

## Personal Liabilities - What you OWE

Credit cards	\$	3,000
Future taxes	\$	4,000
Car Loan	\$	15,000
Student Loan	\$	10,000
Home Loan	\$	170,000
<b>Total Liabilities</b>	<b>\$</b>	<b>202,000</b>

## Net Worth - Diffence between what you OWN and what you OWE

<b>Net Worth</b>	<b>\$</b>	<b>53,000</b>
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- Your business idea should drive increase in net worth over time, but usually not at the start.
- Always good to track periodically to look at trends and if you are improving or not,
- Can be measured at any point in time. Trends help tell the story
- Having this information helps you think through how you will fund your business (my money from your net worth, or someone else's money via a loan).
- If net worth is negative, may be a hard sell to get a loan; important to have a relationship with your banker.
- You can choose how you track (chart of accounts), that makes sense to you.
- **You can only manage what you measure!**

# Example of a Balance Sheet for Business

Assets		Liabilities and Capital	
Current Assets		Current Liabilities	
Cash	\$1,000	Accounts Payable	\$500
Accounts Receivable	\$2,000	Notes Payable	\$1,000
Inventory	\$1,500	Other	\$500
Other	\$700	Subtotal	\$2,000
<b>Subtotal</b>	<b>\$5,200</b>	Long-term Liabilities	\$1,000
Long-term Assets		<b>Total Liabilities</b>	<b>\$3,000</b>
Office furniture	\$1,000	<b>Capital</b>	
Vehicles	\$3,000	Earnings	\$300
<b>Subtotal</b>	<b>\$4,000</b>	Retained earnings	\$900
Less Accumulated Depreciation	\$1,000	Paid-in Capital	\$4,000
<b>Subtotal</b>	<b>\$3,000</b>	<b>Total Capital</b>	<b>\$5,200</b>
<b>Total Assets</b>	<b>\$8,200</b>	<b>Total Liabilities &amp; Capital</b>	<b>\$8,200</b>

- Your business idea should drive increase in net worth over time, but usually not at the start.
- Always good to track periodically to look at trends and if you are improving or not,
- Can be measured at any point in time. Trends help tell the story. Required for tax returns
- Having this information helps you think through how you will fund your business. For loans it usually requires a 2 year forward looking view.
- Net Worth often is negative in the beginning given the income statement impact (more expenses than revenue
- You can choose how you track (chart of accounts), that makes sense to you.
- Working capital can be a source of funding.
- **You can only manage what you measure!**

# Income Statement – Example for Personal

## Cash In (Revenue)

Pay check net of taxess	\$	3,000
Your business draw/wage net of taxes	\$	10,000
Interest/dividends	\$	200
Misc (gifts)	\$	300
<b>Total cash in</b>	<b>\$</b>	<b>13,500</b>

## Cash out (Expenses)

Credit cards	\$	6,000
Debit cards	\$	1,000
Venmo/zelle/cash	\$	1,000
Checks	\$	500
Home loan	\$	1,500
Car loan	\$	400
SH	\$	300
<b>Total cash out</b>	<b>\$</b>	<b>10,700</b>

## Net Income - Difference between revenue and expenses

Net income	<u>\$</u>	<u>2,800</u>
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Free Cash flow - The excess of what you make v. what you spend on required items to apply to discretionary items

- At a minimum track your expenditures by method of payment and track over time
- Evolve it to track how you want (Needs v. wants v. discretionary line items)
- Analyze it to think of ways to improve it
- You are never financial free if you spend more than you make on a repeatable basis (ok periodically on a month basis)
- If seeking loans, banker will seek this type of information and tax returns
- You can choose how you track (chart of accounts), that makes sense to you.
- You can only manage what you measure!

# Income Statement – Example for Business

## Income statement example

TEDDY FAB INC. STATEMENT OF INCOME Year Ended December 31, 2100	
Revenues	\$ 1,000,000
<u>Cost of goods sold</u>	<u>200,000</u>
Gross profit	<u>800,000</u>
<b>Operating expenses</b>	
Selling, general, and administrative expense	357,700
Interest expense	20,000
<u>Depreciation and amortization expense</u>	<u>5,200</u>
Operating income	<u>417,100</u>
Interest income	20,000
<b>Net earnings before taxes</b>	<u><u>437,100</u></u>
Income tax expense	<u>240,000</u>
<b>Net income</b>	<u><u>\$ 197,100</u></u>

- Track your revenue and expenses in way that makes sense to you
- Evolve it to track to help you improve results
- Analyze it to think of ways to improve it
- You are never financial free if you spend more than you make on a repeatable basis (ok periodically on a month basis)
- If seeking loans, banker will seek this type of information and tax returns .
- As a business owner, with net income you can
  1. Pay yourself
  2. Pay your employees/contractors
  3. Pay down debt
  4. Invest in growing your business
  5. Give it to charity
- You cannot manage what you do not measure

# Example of Cash Flow Statement – Publicly Held Companies

<b>Cash Flow from Operating Activities</b>	
Net income	\$23,000
Add: depreciation expense	4,000
Increase in accounts receivable	(6,000)
Decrease in inventory	9,000
Decrease in accounts payable	<u>(5,000)</u>
Cash provided (used) in operating activities	<u>25,000</u>
<b>Cash Flow from Investing Activities</b>	
Capital expenditures	(28,000)
Proceeds from sale of property	<u>7,000</u>
Cash provided (used) by investing activities	<u>(21,000)</u>
<b>Cash Flow from Financing Activities</b>	
Borrowings of long-term debt	10,000
Cash dividends	(5,000)
Purchase of treasury stock	<u>(8,000)</u>
Cash provided (used) by financing activities	<u>(3,000)</u>
Net increase in cash	1,000
Cash at the beginning of the year	1,200
Cash at the end of the year	<u>\$ 2,200</u>

- This statement is only for Publicly held companies (SEC). Nothing more than a bank account reconciliation.
- Required because Public companies must do “accrual accounting” while most small businesses apply “cash basis accounting”. This helps investors/traders in Company stocks understand better what large companies are doing with their cash.
- Accrual accounting requires adjustments to the income statement and balance sheet to match revenue to expenses as earned; adjust for timing of receiving revenue and paying for your expenses.
  - Accrual accounting “limits” publicly traded companies from “cooking the books”
  - Small business owners have no incentive to “cook the books”.
- Cash basis accounting is as the name implies you account for transactions as cash is spent and cash comes in from products/services
- Useful concepts for small business owners
  1. You can generate cash by how you manage your assets (collect receivables and turn your inventory), yet defer payments
  2. However, always look if it makes sense to defer payments as some vendors give you great discounts to pay early
  3. Think about how you want to grow your business (investing activities)
  4. And how you might fund it (loans, your funds)

# Cash Forecasting

Day of Month	August	Sept	October
Beginning Balance	10000 Beginning balance	8000 Beginning Balance	2000 Beginning Balance
1	0	0	0
2	0	0	0
3	0	0	0
4	2000 Cash in	2000 Cash in	2000 Cash in
5	0	0	0
6	-3000 Expense 1	-5000 Expense 1	-5000 Expense 1
7	0	0	0
8	0	0	0
9	0	0	0
10	0	0	0
11	2000 Cash in	2000 Cash in	2000 Cash in
12	0	0	0
13	0	0	0
14	-1000 Expense 2	-1000 Expense 2	-1000 Expense 2
15	0	0	0
16	0	-2000 Quarterly payment	0
17	0	0	0
18	2000 cash in	2000 cash in	2000 cash in
19	0	0	0
20	0	0	0
21	-2000 Expense 3	-2000 Expense 3	-2000 Expense 3
22	0	0	0
23	0	0	0
24	0	0	0
25	2000 cash in	2000 cash in	2000 cash in
26	0	0	0
27	0	0	0
28	-3000 Expense 4	-3000 Expense 4	-3000 Expense 4
29	0	0	0
30	0	0	0
31	-1000 Safety/stuff happens	-1000 Safety/stuff happens	-1000 Safety/stuff happens
Balance End of Month	<b>8000</b>	<b>2000</b>	<b>-2000</b>

- No less than 3 month rolling forecast
- Always contingencies (stuff happens) safety net estimate
- Use your history to aid in forecasting
- Update regularly with cash balance
- Think through how to fund deficits
- If “too much”, how do you invest to grow the business, pay down debt, pay yourself more, pay employees/contractors more
- Don't forget to forecast your tax liabilities

# After you track, you are in a better position to forecast/budget

- Forecasting is helpful in being proactive v. reactive
- Every forecast is wrong, just by what degree. However, the lack of forecasting limits your ability to make good decisions and get ahead of issues before they happen.
- A forecast is a very useful tool to determine if you are achieving your goals (how much do you want to pay yourself)
- You generally forecast your sales forecast first as it will tell you where you need to invest to grow to meet your goals (hire, buy more equipment, increase inventory, etc.)
- If you track information at the level you want, it becomes much easier to do a forecast.
- Forecast are always built on assumptions, because no one knows what the future will be. It is key to validate your thought process behind each assumption.

# Cost/Volume/Profit Tool

- A useful tool to help you think through how much you have to sell to achieve your profit goals (what you pay yourself).
- Useful for deciding what “lever” to pull to aid in improving the business results (sell more, increase/decrease price, lower unit cost, lower fixed costs, etc.)
- Requires cost to be split between those that vary with sales and those that are fixed (do not vary with sales).

# Cost/Volume/Profit Tool

## Fixed or Variable Expenses?

Rent

Utilities

Direct labor

Insurance

Employees or Contractors

Raw material

Inventory Purchases

Permits and Licenses

Dues, memberships, subscriptions

Income Taxes

Travel

Owner's Draw

Interest

Packaging

Legal and Accounting

Postage

# Financial Management Practices

## Types of Expenses

### Variable Expenses

Expenses change directly with sales.

The cost to deliver one unit of product or service.

Direct labor (hourly), raw materials, packaging, unit transport, payroll taxes and costs per employee.

Variable costs are not optional

### Fixed Expenses

Expenses you pay independent of sales.

Remain the same over a given period of time.

Rent, brick and mortar location, salaries (not hourly), advertising, insurance, write-off of equipment

# The Accounting Game

Darrell Mullis and Judith Orloff



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# Income Statement

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## Sales

\$25.00

- Beginning inventory \$0.00
- Purchases
  - Sugar \$2.00
  - Lemons \$10.00
- Total available for sale \$12.00
- Ending inventory \$2.00
- COST OF GOODS SOLD \$10.00



- GROSS Margin

\$15.00

# Income Statement

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GROSS PROFIT \$15.00

## Expenses (fixed costs)

- Glass Rental \$2.00
- Advertising \$1.00
- Rent \$2.00

TOTAL EXPENSES \$5.00

NET PROFIT (pay yourself) \$10.00

You can think of net profit as a “fixed cost” in what you want to pay yourself

## Income Statement (Profit and Loss)

+Sales

- Cost of Goods Sold

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= Gross Profit

- Fixed expense

---

= Net Profit

## Income Statement (Profit and Loss)

+Sales



- Cost of Goods Sold

---

= Gross Profit


- Fixed Expenses

---

= Net Profit

- Income from your products
- Income from your services
- Prices you charge for shipping and handling
- Does NOT include taxes charges.

## Income Statement (Profit and Loss)

$$\begin{array}{r} +\text{Sales} \\ - \text{Cost of Goods Sold} \\ \hline = \text{Gross Profit} \\ - \text{Fixed Expenses} \\ \hline = \text{Net Profit} \end{array}$$


- Direct material – including freight and other charges
- Direct labor to produce product – outside or contract
- Packaging and cost to ship product

## Income Statement (Profit and Loss)

$$\begin{array}{r} +\text{Sales} \\ - \text{Cost of Goods Sold} \\ \hline = \text{Gross Profit} \\ - \text{Fixed expenses} \\ \hline = \text{Net Profit} \end{array}$$



- Rental space
- Cart lease payments
- Transportation and utilities
- Insurance
- Salaries
- Marketing
- Permits and Licensing

## Income Statement (Profit and Loss)

+Sales

- Cost of Goods Sold

---

= Gross Profit

- Fixed expenses

---

= Net Profit



\$

# Financial Management Practices – Income Statement

## COFFEE Cup SALES

Price	\$ 2.00
Sales Volume - Month	3,200
<b>Total Sales</b>	<b>\$ 6,400</b>

## VARIABLE COSTS (Cost of Goods Sold)

Coffee costs	\$ 0.50
Cup	\$ 0.05
Other supplies	\$ 0.10
Variable cost per unit	\$ 0.65
<b>Total Variable Cost</b>	<b>\$ 2,080</b>

Sales

**- Cost of Goods Sold**

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= Gross Profit

**- Overhead/Fixed cost**

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= Net Profit



# Financial Management Practices – Income Statement

## COFFEE Cup SALES

Price	\$ 2.00	
Sales Volume - Month	3,200	
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## VARIABLE COSTS (Cost of Goods Sold)

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Cup	\$ 0.05	
Other supplies	\$ 0.10	
Variable cost per unit	\$ 0.65	
<b>Total Variable Cost</b>		<b>\$ 2,080</b>
Per Cup Margin	\$ 1.35	
<b>Gross Profit</b>		<b>\$ 4,320</b>

+Sales

- Cost of Goods Sold

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**= Gross Profit**

- Overhead/Fixed cost

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**= Net Profit**



# Financial Management Practices – Income Statement

## Kansas Coffee

### COFFEE Cup SALES

Price	\$ 2.00	
Sales Volume - Month	3,200	
<b>Total Sales</b>		<b>\$ 6,400</b>

### VARIABLE COSTS (Cost of Goods Sold)

Coffee costs	\$ 0.50	
Cup	\$ 0.05	
Other supplies	\$ 0.10	
Variable cost per unit	\$ 0.65	
<b>Total Variable Cost</b>		<b>\$ 2,080</b>
Per Cup Margin	\$ 1.35	
<b>Gross Profit</b>		<b>\$ 4,320</b>

### FIXED COSTS EACH MONTH

Rental Space	\$ 1,200	
Cart Lease Payment	\$ 750	
Transportation and Utilities	\$ 625	
Insurance	\$ 450	
Salaries	\$ 1,295	
<b>Total Fixed Costs per Period</b>		<b>\$ 4,320</b>

+Sales

- Cost of Goods Sold

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= Gross Profit

- Overhead

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= Net Profit



# Financial Management Practices – Income Statement

Kansas Coffee

## COFFEE Cup SALES

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<b>Total Sales</b>	<b>\$ 6,400</b>

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**Net Profit** \$ -

+Sales

- Cost of Goods Sold

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= Gross Profit

- Fixed Expenses

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= **Net Profit**



# Financial Management Practices – Income Statement

Kansas Coffee

## COFFEE Cup SALES

Price	\$ 2.00	\$ 2.00
Sales Volume - Month	3,200	4,000
<b>Total Sales</b>	<b>\$ 6,400</b>	<b>\$ 8,000</b>

Increase Sales

## VARIABLE COSTS (Cost of Goods Sold)

Coffee costs	\$ 0.50	\$ 0.50
Cup	\$ 0.05	\$ 0.05
Other supplies	\$ 0.10	\$ 0.10
Variable cost per unit	\$ 0.65	\$ 0.65
<b>Total Variable Cost</b>	<b>\$ 2,080</b>	<b>\$ 2,600</b>
Per Cup Margin	\$ 1.35	\$ 1.35
<b>Gross Profit</b>	<b>\$ 4,320</b>	<b>\$ 5,400</b>

Increase COGS

Increase Margin

## FIXED EXPENSES EACH MONTH

Rental Space	\$ 1,200	\$ 1,200
Cart Lease Payment	\$ 750	\$ 750
Transportation and Utilities	\$ 625	\$ 625
Insurance	\$ 450	\$ 450
Salaries	\$ 1,295	\$ 1,295
<b>Total Fixed Costs per Period</b>	<b>\$ 4,320</b>	<b>\$ 4,320</b>

Constant Fixed

Increase Profits

<b>Net Profit</b>	<b>\$ -</b>	<b>\$ 1,080</b>
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# Financial Management Practices – Income Statement

## Kansas Coffee

### COFFEE Cup SALES

Price	\$ 2.00	\$ 2.00	\$ 2.25
Sales Volume - Month	3,200	4,000	4,000
<b>Total Sales</b>	<b>\$ 6,400</b>	<b>\$ 8,000</b>	<b>\$ 9,000</b>

### VARIABLE COSTS (Cost of Goods Sold)

Coffee costs	\$ 0.50	\$ 0.50	\$ 0.48
Cup	\$ 0.05	\$ 0.05	\$ 0.04
Other supplies	\$ 0.10	\$ 0.10	\$ 0.08
Variable cost per unit	\$ 0.65	\$ 0.65	\$ 0.60
<b>Total Variable Cost</b>	<b>\$ 2,080</b>	<b>\$ 2,600</b>	<b>\$ 2,400</b>
Per Cup Margin	\$ 1.35	\$ 1.35	\$ 1.65
<b>Gross Profit</b>	<b>\$ 4,320</b>	<b>\$ 5,400</b>	<b>\$ 6,600</b>

### FIXED COSTS EACH MONTH

Rental Space	\$ 1,200	\$ 1,200	\$ 1,200
Cart Lease Payment	\$ 750	\$ 750	\$ 750
Transportation and Utilities	\$ 625	\$ 625	\$ 625
Insurance	\$ 450	\$ 450	\$ 450
Salaries	\$ 1,295	\$ 1,295	\$ 1,295
<b>Total Fixed Costs per Period</b>	<b>\$ 4,320</b>	<b>\$ 4,320</b>	<b>\$ 4,320</b>

<b>Net Profit</b>	<b>\$ -</b>	<b>\$ 1,080</b>	<b>\$ 2,280</b>
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# Decisions Decisions

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- Do you raise or lower price
- What will price due to volume
- What will change in price do relative to competition's reaction
- Can you lower your unit costs for the variable items
- Do you find different vendors to lower cost, but will it impact the quality of the product.
- Sure, fixed costs are constant over time, but they can change also. Can you lower those costs?
- Recommend this type of analyze upfront, to see if your business meets the “reasonableness test” and with all of the assumptions you applied to predict the future, you can reasonably achieve your financial goals

# Financial Management Practices – Summary

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- Benefits of Financial Management
- Financial Partners and others (CPA, Bookkeeper, CFO, Banker and Lawyer – Tax/Business)
- Financial Management tools
  - Balance sheet
  - Income statement
  - Cash Flow Statement
  - Cash Forecast
- Cost/Volume/Profit Tool
- Test your business idea to determine if the assumptions used about the future will achieve your financial goals

Thank **you**