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How to Read a P&L Statement for Those New to the Industry

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Agenda

- Discuss the major components that make up the financial statements
- Discuss components of the balance sheet
- Review important ratios and industry averages
- Discuss components of the income statement
- Talk about the difference between the income statement and the balance sheet
- Discuss the components of the cash flow statement

Why is it important for you to understand financial statements?

- The financial statements are the “health” gauge of your company
- Understand how to grow your company
- You will gain an advantage over competitors
- Understanding financial triggers will make you more empathetic to your client’s decision making process
- Your clients will be impressed by your level of professionalism

Components of a Financial Statement

- Balance Sheet – A balance sheet is a financial statement that reports a company's assets (what the company owns), liabilities (what the company owes) and owner's equity (what the shareholders have invested) at a specific point in time.
- Income Statement – An income statement reports a company's revenue and expenses for a specified period of time, usually 12 months
- Statement of Cash Flows – The statement of cash flows reports inflow and outflow of cash for operating, financing and investing activities and is presented for a specified period, usually 12 months.

Balance Sheet

“There are men who can write poetry, and there are men who can read balance sheets. The men who can read balance sheets cannot write.”

Henry R. Luce

Balance Sheet Principles

- $\text{Assets} = \text{Liabilities} + \text{Equity}$
- Presented “as of” a date
- We all have a personal balance sheet



Assets

Short Term (held for less than 1 year)

- Cash
- Accounts Receivable
- Inventory

Long Term (held for more than 1 year)

- Fixed Assets
- Deposits

Liabilities

Short Term

(Due within 1 year)

- Line of Credit
- Accounts Payable
- Credit Cards Payable
- Accrued Liabilities

Long Term

(Due after one year)

- Bank Debt
- Shareholder Loans

Equity

Consists of the following:

- Common stock
- Retained earnings
- Dividends/distributions
- Additional paid in capital



Balance Sheet – Key Ratios

Current Ratio – Used to assess liquidity and determine the company's ability to pay off short term debt with short term assets. You want this to always be above 1, higher is better.

- Current Ratio = Current Assets/Current Liabilities
- XYZ Co. Current Ratio - 1.25
- Promo Current Ratio – 1.66

Quick Ratio – The same as the current ratio but doesn't include inventory because inventory can sometimes be overvalued and is difficult to liquidate.

- Quick Ratio=(Current Assets – Inventory)/Current Liabilities
- XYZ Co. Quick Ratio - 0.39
- Promo Current Ratio – 1.02

XYZ COMPANY Balance Sheet 12/31/2017

ASSETS

Current Assets:

Cash	\$12,000
Accounts Receivable	35,000
Inventory	120,000
Prepaid Rent	8,000
Total Current Assets	\$175,000

Long-Term Assets

Land	\$126,000
Buildings & Improvements	300,000
Furniture & Fixtures	50,000
General Equipment	125,000
Total Fixed Assets	\$601,000

TOTAL ASSETS

\$776,000

LIABILITIES

Current Liabilities:

Accounts Payable	\$60,000
Taxes Payable	25,000
Salaries/Wages Payable	30,000
Interest Payable	25,000
Total Current Liabilities	\$140,000

Long Term Liabilities:

Loan 1	\$322,000
Total Long Term Liabilities	\$322,000

TOTAL LIABILITIES

\$462,000

OWNER'S EQUITY

Paid in Capital	\$64,000
Retained Earnings	250,000

TOTAL OWNER'S EQUITY

\$314,000

TOTAL LIABILITIES & OWNER'S EQUITY

\$776,000

Balance Sheet – Key Ratios

Days Sales Outstanding (DSO)
– Also known as the collection period of accounts receivable

- $DSO = (\text{Accounts Receivable} / \text{Revenue}) \times 365 \text{ days}$
- XYZ Co DSO- 88 days
- Promo DSO - 47 days
- Assume \$500,000 in sales

Days Inventory Outstanding (DIO)
- This ratio is used to measure the average number of days a company holds inventory before selling it.

- $DIO = (\text{Inventory} / \text{COGS}) \times 365 \text{ days}$
- XYZ Co. DIO – 135 days
- Promo DIO – 16 days
- Assume 35% gross margin

XYZ COMPANY Balance Sheet 12/31/2017

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Income Statement

You can have data without information, but you can't have information without data.

Daniel Keys Moran – American Fiction Writer

“The goal is to turn data into information and information into insight.” Carly Fiorina – Ex CEO of Hewlett-Packard

Income Statement – Key Components

Revenue – Sales of goods and/or services to customers.

Cost of Goods Sold (COGS) – Direct costs associated with the products sold.

Gross Profit – Profit after subtracting COGS from Revenue.

Operating Expenses/General & Administrative Expenses – Daily or administrative expenses incurred in the operation of a business



Income Statement – Core Principles

- Matching Revenue with Expenses – Each order's revenue should be recorded in the same period as the related invoice in COGS.
- Consistency – You want to try to stick with the same policies from year to year and categorize expenses in the same accounts from year to year to make the statements more valuable and comparative.
- Allocation – If the company does production it's important to make sure overhead is allocated accordingly. As mentioned previously these include rent, utilities, wages, etc.

Key Income Statement Analysis

Sales Trends

Gross Margin %

Commission %

Operating Profit %

Overhead Trends

ABC Company		
For the Years Ending		
	<u>12/31/2020</u>	<u>12/31/2019</u>
Revenue	1,000,000	1,200,000
COGS	<u>650,000</u>	<u>720,000</u>
Gross Margin	350,000	480,000
	35%	40%
Operating Expenses:		
Commission	140,000	192,000
Payroll Taxes	16,830	20,808
Advertising	5,000	6,000
Office Wages	80,000	80,000
Rent	36,000	36,000
Utilities	5,000	5,000
Telephone	3,600	3,200
Dues	1,000	1,100
Professional Fees	1,500	1,300
Insurance	12,000	10,000
Depreciation	<u>2,000</u>	<u>2,000</u>
Total Operating Expenses	302,930	357,408
Operating Profit	47,070	122,592
Other Income/(Expense):		
Other Income	1,200	1,000
Interest Expense	<u>(4,000)</u>	<u>(4,200)</u>
Total Other Income/(Expense)	(2,800)	(3,200)
Net Income	<u>44,270</u>	<u>119,392</u>

Sales Trends

- Gain a better understanding not just what is happening but why
- Look at order size
- Key customers
- Trends for the industry

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Gross Margin %

- Can't outsell bad margins

- Markup vs. Margins

(GM \$= Customer Price or Sales – Vendor Invoice or COGS)

Markup = GM\$/COGS – 53.8%

Margin = GM\$/Sales – 35%

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Commission %

- Don't overpay your salespeople
- 50/50 split with independent contractors only
- 40/60 is more standard for an employee model
- Salary model is appropriate for an agency

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Operating Profit

- Percentage of profit compared to sales
- Industry average is 5.24%
- Focusing on the percentage rather than the dollar amount is helpful when trying to grow
- Have a goal for this number just like you would gross margin%

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Overhead Trends

- Identify what operating profit goal is and back into a goal for overhead dollars spent
- Identify potential cost savings
- Brainstorm ways to make your overhead dollars work best for you

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Cash Flow Statement

“Revenue is vanity, profit is sanity, but cash is king.”
—*Unknown*

Cash Flow Statement

Operating Activity

- Net Income
- Decrease/(Increase) in AR
- (Decrease)/Increase in AP

Investing Activity

- Buying/selling equipment

Financing Activity

- Borrowings
- Dividends/Distributions

Bob's Donut Shoppe, Inc. Cashflow Statement As of the 31st January 2020

	\$	\$
Net Income	(6,050)	
Add back: depreciation expense	500	
		(5,550)

Changes in working capital

Increase in accounts receivable	(3,000)	
Increase in prepaid rent	(750)	
Increase in inventory	(18,800)	
Increase in accounts payable	19,000	
Increase in accrued expenses	700	
Increase in unearned income	9,000	

Net changes in working capital	6,150
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Total Cash from Operations	600
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Investing Cashflow

Renovations and improvements	(25,000)	
Cash from investing		(25,000)

Financing Cashflow

Issuance of common stock	50,000	
Issuance of long-term liability	24,500	
Dividends paid	(500)	
Cash from investing		74,000

Net Increase / decrease in cash flow	49,600
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Opening cash	-
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Closing cash	49,600
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