

ARE YOU REALLY MAKING A PROFIT?

2009

THE PREMIER
BUSINESS
MANAGEMENT FIRM
FOR EMERGING AND
GROWTH COMPANIES

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How much do you really know about what your business's financial statements are telling you?

How often do you read and ask questions about the financial statements from your bookkeeper, accountant, or accounting firm?

Your success depends on accurate timely information!

FINANCIAL STATEMENTS 101

Many companies fail not because of a lack of sales, not because their product or service is not needed, not because of the general economy, but because management doesn't really know if it is making a profit or not! Management cannot make sound decisions if the basis of those decisions were made using inaccurate or stale financial information!

Most new business owners and managers have very little experience reading and understanding financial statements. Too often the financial statements they get are old and contain multiple inaccuracies. Statements that are too old may contain critical information that if known sooner would allow management to make changes to increase profitability. Statements that are inaccurate, or not understood, make it very difficult if not impossible for management to make critical decisions to avoid losses or financial disaster.

In our practice we often see new businesses with little or no financial statements; or the only statement is the yearend tax return. Many times our Group finds gross errors in how a company compiles its financial statements resulting in management making decisions based on distorted facts or the lack of detailed information on the financial components. We seldom find outright deception but rather a gross misunderstanding of the importance and affect that financial statements can have on a business.

Our goal is not to make you a financial expert nor an accountant, but to provide you with some basic information that you can use to improve your financial statements and understand their critical importance to your success. We like to say "Financial statements tell a story...do you know what story yours tell?"

WE HELP WITH FINANCING & LENDERS

- Call for a free consultation to see how Strategic Business Group can help you improve your business performance and enhance profitability.
- Need help getting a loan or are you having problems with your lender? Our Group has helped many businesses obtain loans or negotiate new terms with lenders and vendors.



Is your business really profitable?
How do you know—because there is cash in the bank? Cash in the bank does not always equal profits!

Most small business owners have a limited understanding of what their business financial statements are showing. Some rely upon their bookkeeper who may not be able to interpret a problem or the potential causes of the problem.

Measurements:

Quick ratio: Current assets should be about 2X current liabilities. This measures the business's ability to pay current obligations.

Accounts Receivable: Over 90-days - their value is very much in doubt.

Inventory: Is it really valuable, when did you last check?

Payroll tax: Did you know that if your company doesn't remit payroll tax to the IRS the President, CEO & anyone who can sign a check are personally liable?

If the company cannot pay it's accounts payable or bank note in full before its due, call and attempt to negotiate a payment plan! Not doing this is a HUGE mistake!

THE BASICS OF FINANCIAL STATEMENTS

BALANCE SHEET

The balance sheet is a summary of the business assets and liabilities for a single day in time. A good balance sheet is divided into various sub sections for both assets, liabilities and equity:

ASSETS

- **Current Assets:** Are those assets that are cash or that can be converted to cash in a short time period. Generally they are; cash, deposits, accountants receivable (net of any accounts over 90-days past due), finished goods inventory, and inventory [provided both are either salable or can be used in current products {components for current products} or are part of sales e.g. drink cups, napkins, etc. for a food operation].
- **Fixed Assets:** Those assets that can not be converted to cash but are necessary for the business to function. Examples include; building, tenant improvements, equipment, machinery, and office furniture & fixtures. The total of these items must be shown less any depreciation. Depreciation is a non-cash expense and represents the 'wasting away of an asset by it's use'. The depreciation amount is determined by the tax laws.
- **Other Assets:** Represent assets that may not be tangible (something physical that you can touch or feel), examples include; patents, franchise cost, and goodwill [if the business purchased another business and paid more than the depreciated value of that business the difference is 'goodwill']. Intangible assets are shown less any amortization which is the 'wasting away' of a non-physical asset and the amount is determined by tax laws.
- **TOTAL ASSETS:** The total of Current, Fixed, and Other Assets.

LIABILITIES & EQUITY

- **Current Liabilities:** Are those liabilities that must be paid in 30-days or less. Examples include vendor accounts payable, payroll, payroll taxes, and the current amount of any long term loan payments (if the business has a loan that requires monthly payments of \$1,000, then \$12,000 would be considered 'current' and the amount in excess of that is long-term).
- **Long-Term Liabilities:** The most common long term liability is a loan amount that is greater than one year in duration. The current year's loan payments are shown as a 'current liability' and the remainder as long-term.
Often in a small business we see where the owner has 'invested' their equity money in the business and classifies that investment as a "note due to shareholders". This often causes a problem and is addressed below the green line at the end of this section.
- **Equity:** This is the cash the business owners have invested to start the business. Added to the initial investment are any profits the business has created, and subtracted from this are any business losses. Owner's equity is the "cash reported" value of the business.
- **TOTAL LIABILITIES & EQUITY:** The basic formula is Assets less Liabilities = Equity. If equity is shown in brackets (\$1.00) that means there is no equity!

We often see a problem for business owners who have shown their investment in the business as a "note due to shareholder". The problem this creates is it understates the business' actual equity and overstates its liabilities. Lenders are quick to see this and will make the owners sign a subordination agreement that requires the owners to not pay interest or principal payments on their shareholder note until the lender's loan is paid off (maybe years). Vendors of large companies who may require the company to provide a copy of its balance sheet before they agree to provide goods/services or enter into a large contract with the company, are very skeptical when they see this. It sends a message the owner may not have intended.

You may have a great future tax reason to report the "note due to shareholder's" but that is most likely a distant future event and your goal must be to present the best, most accurate statement now to gain the confidence of lenders, vendors, and major customers.



Be like an eagle— review your financial statements. Ask questions if in doubt so you remain in control of your business' financial future!

Sales: If you don't have accurate information then you cannot make an informed decision and may be losing cash!

Research & Development: Large companies often look to acquire a small company because it has created a new product/service and gained "market traction/sales". A large company may believe that with its regional/national/global resources it can generate more sales and profits.

Want to avoid failure? Then prepare a budget, compare your actual performance to that budget and do that by the 10th day of each month!

Visit your accountant more than once a year, have her/him review your statements for errors made by your staff/yourself. Have them interpret your statement in candid terms - where has the business been, where is it going and what can you do to improve it?

STATEMENT OF OPERATIONS— PROFIT & LOSS STATEMENT— ETC (are all the same)

The above titles are all for the same thing - the reporting of income, expenses, interest, taxes, and profit or (loss). The profit & loss statement is sub-divided into various sub-sections to help the reader 'visualize' the information. Often a percent figure is shown and that amount is always a percent of Total Revenue or Sales. This is a very helpful calculation because it shows the components that contribute the most revenue and those items that consume that revenue impacting company profitability.

- **Income/Sales/Revenues:** Most businesses sell more than one product or service. The major income categories should be itemized and smaller elements consolidated into "other".
- **Cost of Goods:** All manufacturing and retailers have a cost of goods; components, finished goods or subassemblies, food and related items, freight-in and out, direct labor costs, and in larger companies a pro rata share of the fixed overhead costs such as building costs, utilities, insurance, and equipment repair and maintenance.
- **GROSS PROFIT:** Is computed by subtracting the Cost of Goods from Income. This is a critical measure of business success! The higher the gross profit amount the more cash the business has for expenses and hopefully for profits.
- **Research & Development:** Businesses that are creating a new product or service may want to consolidate those costs so that they can 'visualize' the cost and compare the potential value of the final product to the perceived market.
- **Sales & Marketing:** Collects all of the direct and related costs to sell your product/service. Sales salaries, incentives, travel, entertainment, advertising & advertising creation, trade shows, product discounts, and promotional items. Critical cost factor to watch!
- **General & Administrative:** Basically all "fixed" costs that are not shown above but are required to operate the business, such as rent. Interest expense should NOT be shown here.
- **NET OPERATING PROFIT (LOSS):** *A critical key amount.* This represents the cash profit of the business from its operations. If this amount is negative you have a problem, with the exception of a startup business in which case there may be a loss for up to 1-year.
- **Other Income Expenses:** This is where interest expense should be reported because it represents a 'cost of capital'. Competitors may have no debt or more or less than your business. If it were shown above Net Operating Profit it would distort your ability to benchmark! You want to compare your business to that of your competitors to see opportunities to improve. *Lenders will compare your business before they make a loan and during the loan term!*

WE CAN HELP IMPROVE YOUR BUSINESS

LOOK at the last page to see an example of a small business profit and loss plan. We've kept it simple to read but with real world examples and side-bar information to explain the key elements and how they interact.

If you need new financing, or need to renew your current financing you may discover a nasty surprise—your 'friendly' banker isn't as friendly. Why? Because most bankers relied on the small business owner's home equity to help support the loan (secondary repayment source). With lower home values there is less or even no additional support. Thus your business will have to demonstrate that it can repay its loans. Plan now to shore up your financials before the renewal date! If you take action in time often you can avoid draconian actions by your lender!

In this example you will note that Product 1 was **(\$5,800)** less than expected. Product 2 and Service 1 exceed plan resulting in net total revenues being only **(\$700)** shy of budget.

Note that Gross Profit is down—why? It's important to discover why; higher costs, quality, rework, etc. This is your 1st key profit factor.

Marketing is 12% of total revenues. This is in-line with many businesses — 6 –12% is a good benchmark for an established business.

We decided not to show amortization/depreciation as those are non-cash expenses. Total 'fixed' overhead is 21.7% of total revenues.

Net Operating Income (Loss) is 5.1%. You need to know what your competitors margins are so that you can benchmark your business to their business. Trade journals and business publications might provide you with this information.

Net Operating Income (Loss) is your 2nd key profit factor and is affected by all other components!

Interest expense is 1.6% and that leaves 3.6% Net Income Before Taxes.

Note that Net Income is **(\$3,984)** below plan –Why?

**NEED HELP?
CALL US
BEFORE IT'S
TOO LATE!**

Revenue	ACTUAL	PERCENT	BUDGET	VARIANCE
Product 1	89,200	57.8%	95,000	(5,800)
Product 2	45,600	29.6%	42,000	3,600
Service 1	19,500	12.6%	18,000	1,500
TOTAL	154,300	100.0%	155,000	(700)
Cost of Sales	94,123	61.0%	91,450	2,673
Gross Profit	60,177	39.0%	63,550	(3,373)
Sales & Marketing				
Salaries	14,583	9.5%	13,500	1,083
Advertising	2,500	1.6%	3,000	(500)
Travel & Entertainment	500	0.3%	600	(100)
Trade Shows	1,200	0.8%	1,400	(200)
TOTAL	18,783	12.2%	18,500	283
General & Administrative				
Officer Salaries	12,500	8.1%	12,500	0
Salaries Other	7,917	5.1%	7,917	0
Payroll Burden	5,250	3.4%	5,088	163
Bank Fees	150	0.1%	125	25
Dues & Memberships	50	0.0%	50	0
Insurance Business Liability	250	0.2%	250	0
Janitorial & Maintenance	150	0.1%	150	0
Legal & Professional Services	500	0.3%	300	200
Licenses	50	0.0%	50	0
Meals & Entertainment	200	0.1%	225	(25)
Rent Including CAD & CAM	4,900	3.2%	4,900	0
Supplies	500	0.3%	600	(100)
Telephone & Internet	410	0.3%	385	25
Travel	150	0.1%	175	(25)
Utilities	490	0.3%	450	40
Other	0	0.0%	0	0
Amortization & Depreciation	0	0.0%	0	0
TOTAL GENERAL/ADMIN.	33,467	21.7%	33,164	303
NET OPERATING INCOME (LOSS)	7,927	5.1%	11,886	(3,959)
Other Income Expense				
Interest Income	50	0.0%	75	(25)
Interest Expense	2,445	1.6%	2,445	0
TOTAL	2,395	1.6%	2,370	25
NET INCOME BEFORE TAXES	5,532	3.6%	9,516	(3,984)



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