Growing Forward 2
A federal-provincial-territorial initiative

FINANCIAL PLANNING AND MANAGEMENT

BRITISH COLUMBIA

Canada

Session Outline

- Financial Statements
- Your Business Model
- Gross Margin
- Profit & Loss
- Cash Flow
- Working Capital
- Balance Sheet
- Ratios
- Debt & Debt Service
- Valuation
- Return On Investment

FINANCIAL STATEMENTS

Tell A Story

Financial statements tell a story.

Financial statements provide information of a business situation in a quantitative way.

With this information one can understand the state of their business at a given date or over a period of time on the basis of money; how it was obtained, where it was consumed, and how much is left over for current and future activities.

To many people, business financial statements can be intimidating.

These documents are critical to understand the business and for others to understand the state of the business, particularly those interested in investing or currently hold debt for your company, even if for a short term period.

Some business owners simply consider themselves “not good with numbers” while others are uncomfortable with terms they are unfamiliar with. The confusion is often intensified because of the abbreviations and the apparent “code” or ratios those who work with financial information use all the time.

It is a language you will greatly benefit learning!

WHAT ARE FINANCIAL STATEMENTS?

PROFIT = SALES - COSTS

As a means of demystifying the world of finance, we can boil everything down to the simple arithmetical equation:

Profit = Sales – Costs

This simple equation is a common sense notion to comprehend at any level. In order for the enterprise to be profitable (i.e. sustainable) all of its revenues must exceed its costs.

In practice then, keeping track of those revenues and costs becomes an important part of how an enterprise stays in existence.

Financial accounting and the accompanying Financial Statements tell the story of how the business is doing and has become a sophisticated and exacting art and science. Understanding the basics however can be fairly straight forward and are laid out in this Module.

You Manage What You Measure

"If you don't Measure,
You can't Manage …
You can't Control …
You can't Improve …
You Lose Money"

There is an important saying in business management, and that is:
"You Manage What You Measure"

The goal of this training module is to provide a sound introductory knowledge of the key principles of Financial Planning and Management so you may better manage your enterprise.

WHAT IS YOUR BUSINESS MODEL?

This is a good place to begin this explanation.

Your "Business Model" is nothing more than a quantitative way of describing how your business works. That is to say – how does it make a profit? Further described then as … How does your business generate its revenues? What are all of the associated costs with generating those revenues and ultimately, what is left as profit?

Your business model is then presented in the financial form of your Profit and Loss Statement. In planning and managing the financial story of your enterprise one must have a clear idea of its various revenue streams and direct costs associated with producing those revenues.

In the financial planning of your business, spending time on clearly understanding your present and potential revenue streams is a highly recommended exercise. You may think you are in one business – for example growing cherries and selling them wholesale - when you realize how much more return you can achieve when your cherries go into making your own Cherry Ice Cream product.

One such infamous example is that of the legendary rock group, **the Grateful Dead**. Though they had a few singles which made it to the top 10, they consistently had the highest earnings per band member for many years. They built their business model on live concert touring. The revenue stream in which the band keeps the maximum amount of its profits versus selling record albums where the record company, agents, and distributors take a large share of money.

So taking the time to clearly identify your revenue streams and create your Business Model so your efforts provide the maximum return on investment is a highly recommended step in the Financial Planning of your enterprise.

THE PROFIT & LOSS STORY

Revenues
- Cost of Goods Sold
= Gross Profit
- Wage Expenses
- Direct Operating Expenses
- Fixed Costs
= Profit Before Tax

ALWAYS STATED OVER A PERIOD OF TIME

For a business to be sustainable it would seem logical that the venture must earn more money than it expends. This common sense philosophy is expresses by the equation
Profit = Sales – Cost

In the financial planning world, the traditional Profit and Loss Statement is presented with the following key headings:
Revenues
Cost of Goods Sold*
Gross Profit
Wage Expenses
Direct Operating Expenses
Fixed Costs
Profit before Tax.

*Cost of Goods Sold includes the cost to make the products that are sold, such as the ingredients, packaging, labour, and freight in. There may be other costs that are specific to the manufacture of the specific products, such as regulatory supervision.

GROSS MARGIN

Gross Profit / Revenues = Gross Margin %

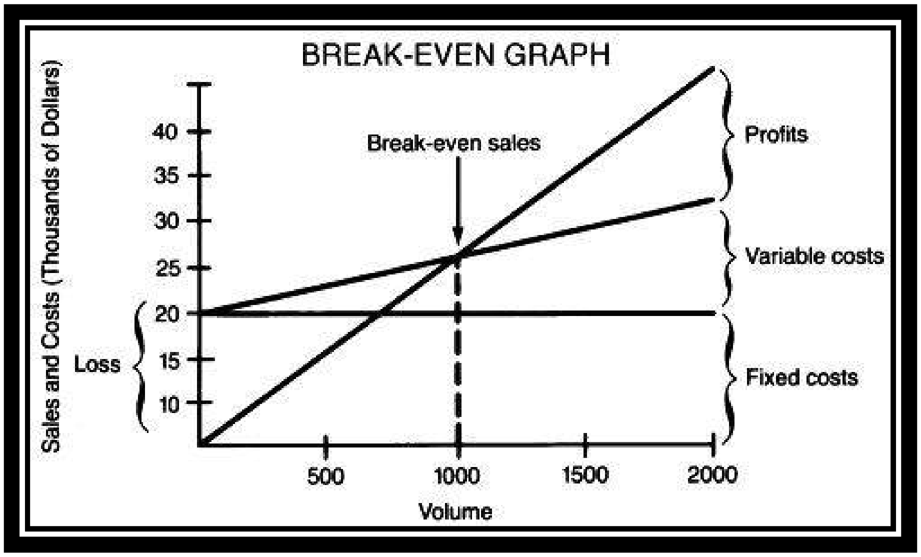
Gross Margin versus Gross Profit

Gross Margin is the business' gross profit, expressed as a percentage of total sales.

The Gross Profit is a required income statement entry that reflects **total revenue minus cost of goods sold (COGS)**.

Your Breakeven Point

Sales = Fixed Costs / (1 – Variable Cost %)



Knowing what the annual fixed costs are allows one to get a sense of what minimum business volumes must be achieved for the business to **Breakeven** – i.e. so that all its costs are covered.

From this example is illustrates that you have to sell 1000 units to cover the fixed and variable costs before you make any profit.

Also note that until you sell approximately 750 units or generate $20,000 in sales you are in a loss situation as you need that amount to cover your fixed or overhead costs – just to "open the doors".

YOUR PRE-TAX BOTTOM LINE

EBITDA

Earnings **B**efore **I**nterest, **T**ax, **D**epreciation and **A**mortization

Indicates your company's ability to pay off debt and interest. It is used to help place a Value on your business

Earnings Before Interest, Taxes, Debt & Amortization (EBITDA) is often used as the bottom line measurement for the performance of the business.

It is used because it points to an operating profit number which then can be used to service debt and its lending obligations which can often vary considerably depending on the nature of the financing for a project.

It is usually expressed as a % of total sales, for any given time period being considered.

A negative EBITDA indicates that a business has fundamental problems with profitability and cash flow. A positive EBITDA does not necessarily mean that the business generates cash because ***it ignores changes*** in Working Capital, capital expenditures, taxes and interest.

EBITDA is a useful measure for large companies with significant assets and/or for companies with a significant amount of debt financing. It is rarely a useful measure for evaluating a small company with no significant loans.

It is often called operational cash flow.

CASH FLOW

An estimate of when and where cash inflow and cash outflow will occur in the coming year.

Allows one to plan when cash is needed to meet obligations as they come due.

A cash flow projection is ***an estimate of when and where cash inflow and cash outflow will occur in the coming year***.

It goes beyond a profit and loss statement because it takes into account delays in receiving revenues such as when a buyer may take 30 days to pay for a product and when your own actual operating expenses come due.

Monitoring these differences accurately will reveal differences between the actual and the projected cash flow which allows you to consider what adjustments to the business must be made. This is crucial as it will point to when you may need to draw on cash reserves in some form (known as Working Capital – more on this to come) in order to meet your financial obligations as they come due; these include such expenses as Rent, Debt Payments, paying a key supplier on time. The consequences of missing such payments may make the continued operations of the business very difficult.

A cash flow projection may be set up for various time periods, usually monthly, quarterly or annually. Set up an annual projection as a starting point then modify it to a quarterly or monthly version as necessary. Lending institutions such as banks often demand the use of a working cash flow calculation in the management of the business.

In the Cash Flow calculation, only cash items are included in the inflows and outflows. Items that increase and decrease the cash position are taken into account. Below are some of the typical items taken into account to determine the actual cash position of the company.

CASH FLOW CALCULATION

After tax earnings

\+ Depreciation expense

\+ / - the Change in Accounts Receivable from period to the next

\+ / - the Change in Accounts Payable from one period to the next

\+ / - the Change in the amount of Inventory being held

\+ Expenditure in Capital Items during the time period

WORKING CAPITAL

Working Capital is required to meet Cash Flow needs.

Positive working capital is required to ensure that a firm is able to continue its operations and that it has sufficient funds to satisfy both maturing short-term debt and upcoming operational expenses.

WORKING CAPITAL

Most businesses fail because they are "under capitalized".

Many times, the need to fund for working capital needs is not properly addressed.

Working Capital essentially is represented by its Current Assets (especially cash) and its ability to meet its Current Liabilities as they come due on a regular basis. This obviously ties into the discussion of Cash Flow and in particular the Cash Flow Management of the business.

The business must ensure it has sufficient Working Capital to meet its obligations as they come due or it will be in a state of Insolvency. This is of particular importance where delays may exist in getting paid for sales made and also when the business must pay for its goods and services well ahead of normally receiving its revenues.

Working capital needs must be planned for by:
performing Profit and Loss projections,
performing its cash flow projections

Month to month shortfalls can be met by ensuring sufficient cash balances are held in its bank account through the arrangement of a revolving line of credit (over draft) financing from its bank or through appropriate credit arrangements through its major suppliers.

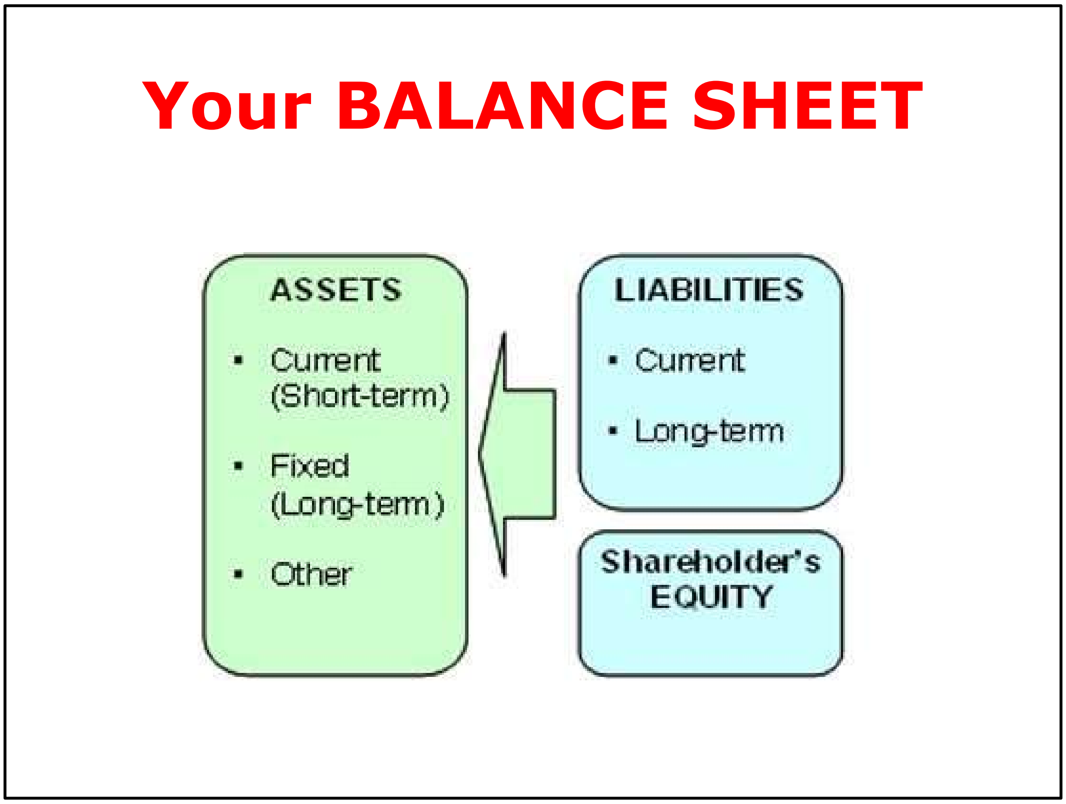
Both the bank lending and supplier credit arrangements are a function of the length of time in business and the strength of the credit worthiness in those relationships.

Newer businesses must make specific plans for its Working Capital needs in its initial financing and further access to funds from private investors, etc.

YOUR BALANCE SHEET

A SNAPSHOT

If the Profit and Loss Statements and Cash Flow Projections tell a financial story about the business *over a specified period of time* such as a week, a month or a year, the Balance Sheet always tells a financial story about the *business at a point in time* – like a snapshot picture.



The essential pieces of this picture are to describe in detail the nature of the **ASSETS** of the business and its corresponding **LIABILITIES**. The difference in value between the Asset Value of the business versus its Liabilities determines what the NET WORTH (equity) of the business is. The objective of the business of course, is to continue to increase its Net Worth over time.

DEBT TO EQUITY RATIO

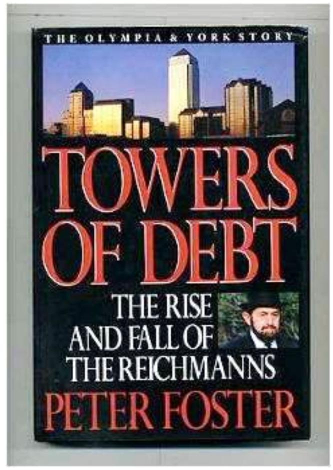
The amount of debt (loaned money) compared to the amount of private investor money that goes to finance a project is known as the

Debt to Equity Ratio

WHAT IS LEVERAGE ?

The amount of **debt**, *loaned money*, compared to the amount of private investor money that goes to finance a project, is known as the **Debt to Equity Ratio**. A project costing $100,000 for example, that utilizes a $50,000 bank loan and $50,000 raised from investors is considered to have a 50/50 Debt to Equity Ratio and is considered, in general, a **standard "bankable" financing deal**; the business is demonstrating that it is willing to wager at least as much money as the lender it is requesting the loan from. When one borrows more money than is actually being risked by the shareholders of the business, this is known as **"leverage"**. A business or project with a very good track record and/or very high probability of success is considered credit worth enough to leverage a financing project. Leverage works very much in the favour of the business when the project is a success, as it shares a minimum amount of its profit with others outside the business as its obligation is limited only to the amount of the principal it has borrowed plus whatever interest fee is applicable.

REMEMBERING OLYMPIA & YORK



Conversely however, if the business does not fare well in a highly leverage financial situation, the debt service burden/obligation may be so severe to the company's cash flow that it may actually become insolvent during a cash flow crunch and the business may be lost altogether to its creditors.

This famously became the case for Canadian property development giant, Olympia and York, who during the 1980s became the largest property development company in the world.

Their high flying successes of the 1980s made them very credit worthy with banks willing to lend them billions of dollars based on a phone call or hand shake.

Major recessions in London and New York hit their highly leveraged projects hard, eventually leading to their highly publicized bankruptcy in 1992.

RETURN ON INVESTMENT (ROI)

Money is sometimes referred to as a form of Energy. As such it has certain characteristics. One such characteristic is its need to gravitate to its **HIGHEST RATE OF RETURN** for any given amount of **RISK** involved. Every day, every minute of the day, money is moving around the globe in such a fashion.
Likewise, when an investment decision is being made, be it to invest private funds in an enterprise or to borrow the funds to do so, one must properly consider this notion of **Return on Investment** given a certain risk involved.

PLACING A VALUE ON YOUR BUSINESS

1. Comparative Value
2. What a purchaser is prepared to pay
3. A multiple of annual earnings
4. Discounted Cash Flow

In addition to business generating annual profits and a Rate of Return annually on given investment, the business is also appreciating in its overall Value as an asset itself.

Obviously, a business that is accumulating cash and demonstrates an ability to consistently generate such returns, will have a value that a potential purchaser, would pay to acquire this business asset (or a share of the asset itself).

To this extent then, an owner of well-managed, successful business can not only enjoy annual rates of return on the original investment but an appreciation of the original asset value of the business as well.

A business that is not yet in existence can even have a Value determined in attracting investors to the project. Such a Valuation is based on a sound set of future Cash Flow projections, usually in the 5 year time frame.

In such a case, one can apply a traditional financial formula known as the **Discounted Cash Flow calculation of future earnings** to establish a Value range of the business today.

Such a Valuation involves the use of a **Discount Rate** to effectively “discount” the projections based on the inherent uncertainty in any future event.

The actual discount rate utilized in the calculation always becomes a point of negotiation between business founder and potential investor; the business founder always argues for a lower discount rate while the investor always argues for a higher discount rate to determine a present Value for investment purposes.

An investor will always want their investment to be a higher percentage ownership of the business being invested in.

Working through examples of such calculations is the best way to understand this concept should you be starting an enterprise from scratch and looking to attract private equity funding.

YOUR FINANCIALS & INVESTOR Qs

- What Funding do you need and how did you arrive at that?
- 3 Year P&L Projections
- What are your Fixed Costs?
- What is your breakeven volume?
- How did you choose your revenue streams?
- What are your Cash Flow and Working Capital requirements?
- Who are your key people? Tell me your Implementation Plan?
- If I invest, what are my shares worth as % ownership?

By this point, a lot of ground has now been covered on the general topic of Financial Planning and Management.

The goal of this seminar to give you a solid introduction to all of the key principles of Financial Planning and Management and allow you to become conversant with investors and bankers when the time comes.

The following are financial items that investors and lenders pay particular attention to and will ask about. Having solid answers is imperative in dealing successfully with people in this industry, and staying in control of your business affairs, as you structure your ventures required capitalization.