



# Financial analysis:

## About business numbers

Chapter: 9

# Introduction

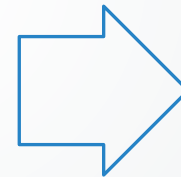




# Introduction



1. It enables you to make sound business decisions about what financial resources your company actually needs, and about what financial moves your company needs to make, to be successful.



2. It helps you plan for and obtain the necessary financing to establish your business, continue its operation, and help it grow.



# What is financial plan?

## Definition ([investopedia.com](https://www.investopedia.com))

- A financial plan is a comprehensive evaluation of an investor's current and future financial state by using currently known variables to predict future cash flows, asset values and withdrawal plans.



# What is financial plan?

Financial plan should include:

- Start-up costs, if you are starting a new business
- Cash flow forecasting
- Projected (pro forma) balance sheets and income statements
- Balance sheets and income statements for at least the previous year (if your business is already in operation)
- A break-even analysis
- A ratio analysis (if your business is already in operation)

# What is financial plan?

- ▶ Financial statements are based on the actual numbers
- ▶ Financial projections look into the future and estimate
- ▶ It is advisable to use best, worst, and most likely scenarios



# Start-up Costs

## Included:

- Equipment
- Supplies and materials
- Inventory
- Permits
- Incorporation fees
- Accountant's fees
- Legal fees
- Registration charges
- Advertising
- Promotional activities
- Employee training.





# Cash Flow forecasting

## Importance:

- Estimates the amount of money necessary to finance month-to-month business operations
- Enables you to plan for the times when revenue will not be sufficient to cover expenses
- Demonstrates to potential lenders that you expect to have sufficient revenue to repay loans on a regularly-scheduled basis
- Can be used to compare estimated and actual cash flows on a monthly basis

# Preparing a cash flow forecasting

To estimate how much revenue you expect to generate from sales on a monthly basis:

- Consider sales from previous years
- Consider best and worst case projections, but use the most likely scenario for your business

What other cash are you expecting to bring into your business?

Detail your expenses and other cash outlays

Take a look at your accounts payable from the previous period



# Income statements

- Income includes all revenue streams generated by the business.
- Cost of goods includes all the costs related to the sale of products in inventory.
- Gross profit margin is the difference between revenue and cost of goods.
- Operating expenses include all overhead and labor expenses associated with the operations of the business.
- Total expenses are the sum of cost of goods and operating expenses.
- Net profit is the difference between gross profit margin and total expenses.
- Depreciation reflects the decrease in value of capital assets used to generate income.
- Earnings before interest and taxes shows the capacity of a business to repay its obligations.
- Interest includes all interest payable for debts, both short-term and long-term.
- Taxes includes all taxes on the business.



# Balance sheets

## Lists

- The assets
- Liabilities
- Equity

The formula behind the balance sheet is:

- $\text{Assets} = \text{Liabilities} + \text{Equity}$

It is used to gain insight into a company and its financial operations



# Break-even analysis

It allows you to calculate the amount of sales your business needs to not lose money

Based on three main factors:

- Selling price
- Fixed costs
- Variable costs

# Business ratio analysis

These financial measurements will provide you with information about your company as you compare the current accounting period to previous ones

Useful ratios:

- Current Ratio
- Quick Ratio
- Debt to Equity Ratio
- Profit Margin Ratio



# Business ratio analysis: Current ratio

## Formula

- $\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$

## Examples of current assets:

- Cash
- Marketable securities
- Accounts receivables / debtors
- Inventories / stock
- Prepaid expenses

## Examples of current liabilities:

- Accounts payable / creditors
- Accrued payable
- Short term bonds payable

## Example:

- On December 31, 2016, the balance sheet of Marshal company shows the total current assets of \$1,100,000 and the total current liabilities of \$400,000. You are required to compute current ratio of the company.

## Solution

- $\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$1,100,000}{\$400,000} = 2.75$  times

# Business ratio analysis: Quick Ratio

Example:

## Current assets:

- Cash: \$2,400
- Accounts receivable: \$12,000
- Inventory: \$16,000
- Prepaid expenses: \$600

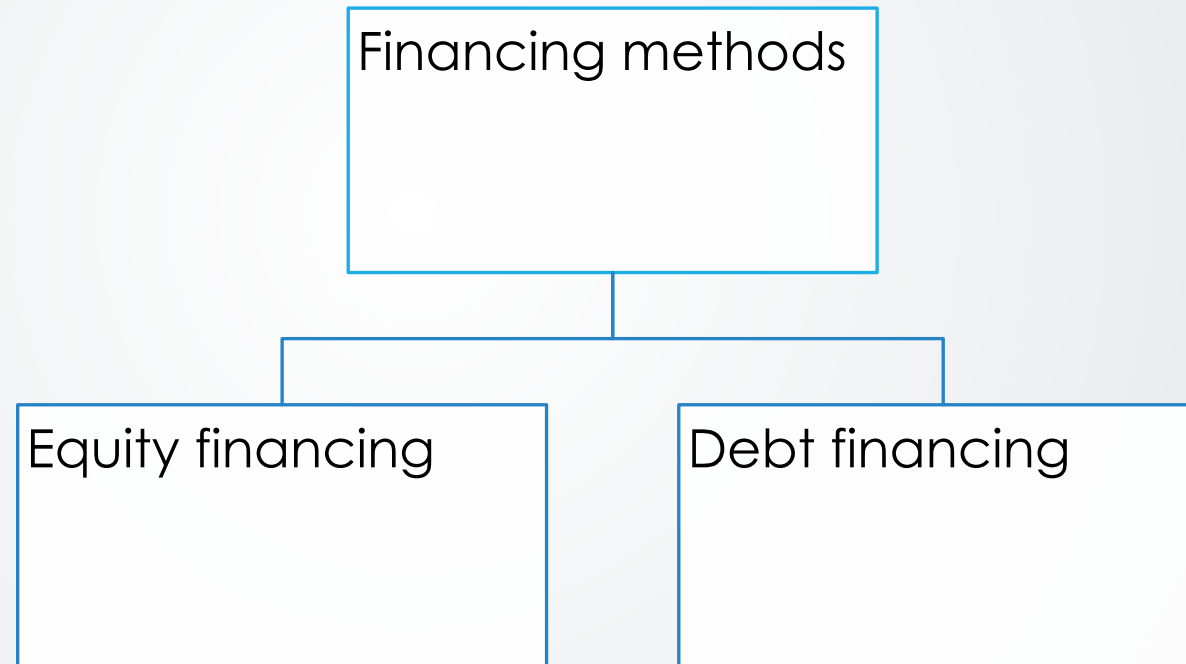
## Current liabilities:

- Accounts payable: \$11,600
- Accrued parables: \$1,800
- Notes payable: \$600

Solution:

- $= 14,400^*/14,000^{**} = 1.03$
- **\*Liquid assets:** = (Total current assets) – (Inventories + Prepaid expenses) =  $\$31,000 - (\$16,000 + \$600) = \$31,000 - \$16,600 = \$14,400$
- **\*\*Current liabilities:**  $\$11,600 + \$1,800 + \$600 = \$14,000$
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# Methods of financing your business

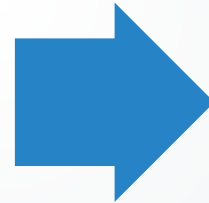




# Equity vs. Debt financing

## Advantages of equity financing:

- Equity financing is not a loan and doesn't have to be quickly repaid (with interest)
- You can increase your business' debt financing ability by increasing its equity
- Increased equity may improve your business' credit rating with suppliers
- It provides greater flexibility if the business experiences difficult times



## Advantages of debt financing:

- If your business succeeds, you won't have to share the profits with partners or investors
- You will maintain independence and control over how your business is run



# Internal sources of finance

## Retained Earnings

- They are liquid assets
- They are the portion of net income

## Current Assets

- Current assets consist of cash that can easily be converted into cash

## Fixed Assets

- Not easily converted to cash
- Include equipment, property and factories

Personal Savings



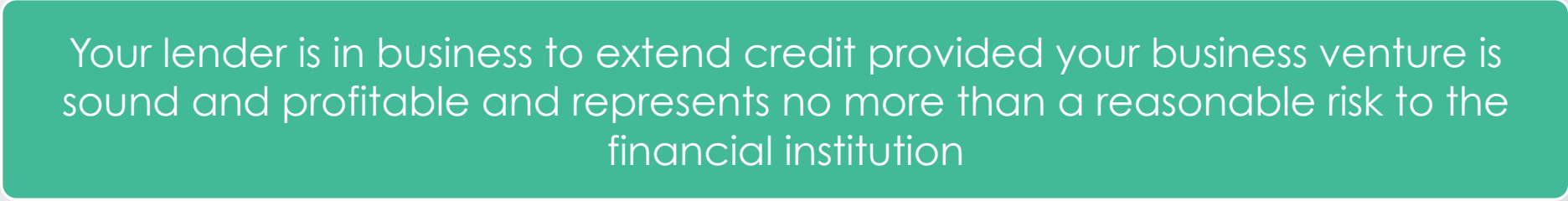
# How to approach lenders?



In order to make money, the lender needs your business



It is in the lender's interest to see your business succeed and grow

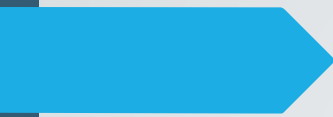


Your lender is in business to extend credit provided your business venture is sound and profitable and represents no more than a reasonable risk to the financial institution

# Questions before you borrow?

- ▶ Does your business really need to borrow money?
- ▶ How much does your business need to borrow?
- ▶ How fast should you repay your loans?





# Understanding the loan approval process

## Step-1: The interview

- How much money you need and how you plan to spend it
- How the money will help your business grow and prosper
- How much money you can afford to pay back on a regular basis
- What you plan to use as collateral, including personal guarantees you are willing to make
- How you are prepared for a worst case scenario

## Step-2: Assessment and decision

## Step-3: The paperwork



# What lenders are looking for?

- ▶ Your current assets, such as inventory and receivables, for security for short-term loans
- ▶ Your fixed assets for security for long-term loans
- ▶ How much money you have invested in the business
- ▶ The business' overall debt to equity ratio
- ▶ Your ability to repay your loan based on cash flow projections
- ▶ Your business' past financial performance and current reputation
- ▶ The long-term prospects for the industry you are in
- ▶ You and your business' track record in repaying loans



# If your application is rejected

- Your business plan was incomplete
- Your presentation was unprofessional
- There is not enough equity in your business
- Your cash flow is insufficient to ensure regular repayment of the loan
- Your business, or the industry your business is in, appears too risky or unpredictable
- Your management team lacks the necessary abilities
- You cannot supply enough security for the loan



Thanks for attention