

6

Financial Health

LEARNING OBJECTIVES

- Identify income and expenses and build an income statement
- Define business assets (value), liabilities (debt), and equity (ownership) and show each on a balance sheet
- Recognize how cash flows through a business via operations, investments, and financial sources and develop a statement of cash flows
- Interpret the information on the three financial statements to determine the financial health of a business

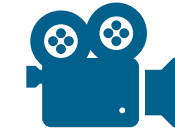
Case Study: How Is Cone Crazy Doing?



Willa has a POS system in place to help track revenue and expenses. As the owners of an LLC, she knows that understanding the financial profile of her company is important for understanding her tax liability.

She wonders how her business's valuation and health is doing overall. Now is the time to learn.

The Income Statement




[Video: "Income Statement"](#)

- Also called the profit and loss (P&L) report
- Identifies sources of revenue and expenses
- Four sections:
 - Gross Profit
 - Operating Profit/Loss (EBIT)
 - Profit/Loss (Earnings Before Taxes [EBT])
 - Net Income/Loss


Revenue:	Month 1	Month 2	Month 3
Cones	\$12,000	\$15,000	\$15,500
Quart Containers	\$2,000	\$2,000	\$2,100
Total Revenue (net sales)	\$14,000	\$17,000	\$17,600
Cost of Goods Sold (COGS):			
Ingredients	(\$300)	(\$400)	(\$400)
Labor	(\$600)	(\$600)	(\$600)
Total COGS	(\$900)	(\$1,000)	(\$1,000)
Gross Profit	\$13,100	\$16,000	\$16,600
Operating Expenses:			
Advertising	(\$750)	(\$750)	(\$750)
Repairs	(\$500)	(\$500)	(\$500)
Equipment Purchase	(\$4,000)	\$0	\$0
Rent	(\$2,000)	(\$2,000)	(\$2,000)
Insurance	(\$200)	(\$200)	(\$200)
Utilities	(\$250)	(\$250)	(\$250)
Connectivity (internet/cell service)	(\$300)	(\$300)	(\$300)
Cleaning	(\$75)	(\$75)	(\$75)
Other	(\$300)	(\$300)	(\$300)
Total Operating Expenses	(\$8,375)	(\$4,375)	(\$4,375)
Operating Profit/Loss (EBIT)	\$4,725	\$11,625	\$12,225
<i>Other income/loss from finances</i>			
Interest payment	(\$100)	(\$100)	(\$100)
Profit/Loss (EBT)	\$4,625	\$11,525	\$12,125
Tax Expense (20%)	(\$925)	(\$2,305)	(\$2,425)
Net Income/Loss	\$3,700	\$9,220	\$9,700

- 1




Gross Profit

Earnings after the costs attributed to the product are subtracted
- 2




Operating Profit (EBIT)

Earnings after the general operating expenses are subtracted
- 3



Earnings Before Taxes (EBT)

Earnings after the financing income or expenses are subtracted
- 4



Net Income

Final earnings after all expenses are subtracted

Cost of Goods Sold (COGS) and Gross Profit

- The direct costs (ingredients, labor) attributed to making the product that earns revenue
- Lower COGS = higher gross profit

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Operating Expenses and Operating Profit (EBIT)

- Expenses necessary for running the business:
 - Rent
 - Marketing
 - Utilities
 - Insurance
 - Etc.
- Gross profit – operating expenses = operating profit/loss (EBIT)

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Earnings Before Taxes (EBT)

- Many firms make investments with the net income of the business
- Can lead to further earnings or losses
- Add or subtract this number from operating profits to obtain the earnings before taxes (EBT).

<i>Other income/loss from finances</i>			
Interest payment	(\$100)	(\$100)	(\$100)
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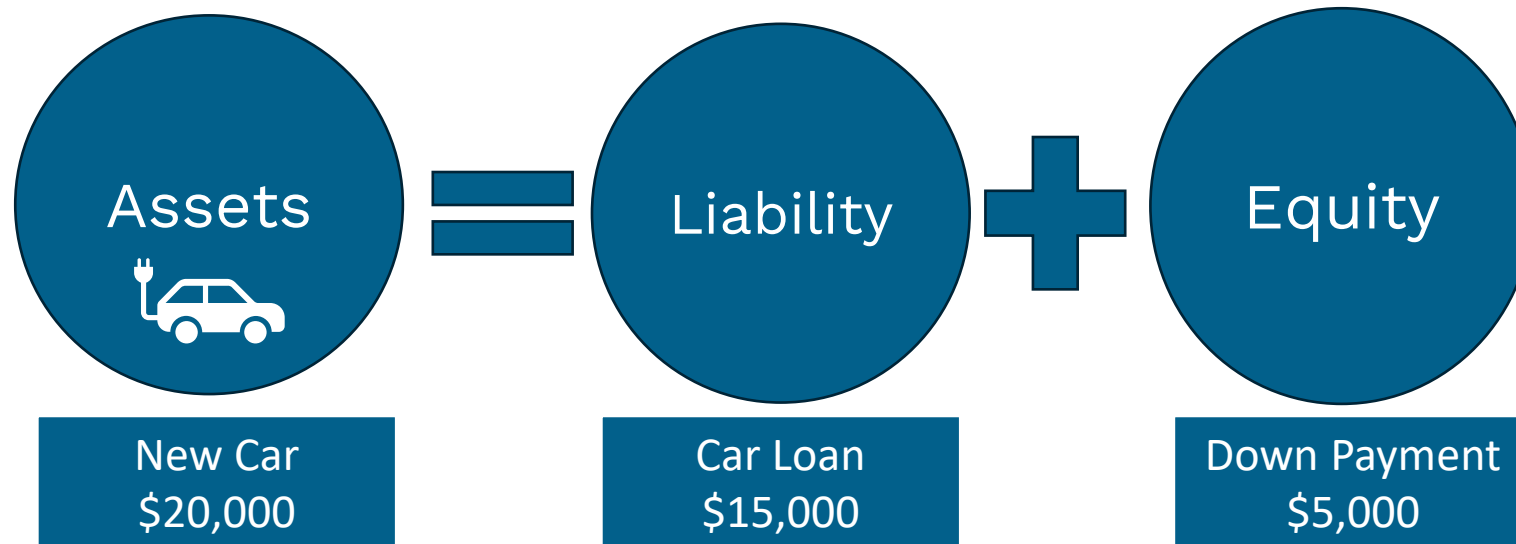
Tax Liability and Net Income

- All businesses pay taxes
- Tax obligation is based on final net income after all expenses/deductions have been made
- Tax obligation is also based on the final amount a business earns

Tax Expense (20%)	(\$925)	(\$2,305)	(\$2,425)
Net Income/Loss	\$3,700	\$9,220	\$9,700

The Balance Sheet

Indicates the value of the assets the business has (assets), how much it **OWES** (liability), and how much of those assets it **OWNS** (equity)



The Balance Sheet (cont.)

- Balance sheet must always balance
- Sections:
 - Current assets
 - Non-current assets (fixed assets)
 - Current liabilities
 - Non-current liabilities (long-term liabilities)
 - Owners'/shareholders' equity and retained earnings

Apple Inc.			
CONSOLIDATED BALANCE SHEETS			
(In millions, except number of shares which are reflected in thousands and par value)			
	September 25, 2021	September 26, 2020	
ASSETS:			
Current assets:			
Cash and cash equivalents	\$ 34,940	\$ 38,016	
Marketable securities	27,699	52,927	
Accounts receivable, net	26,278	16,120	
Inventories	6,580	4,061	
Vendor non-trade receivables	25,228	21,325	
Other current assets	14,111	11,264	
Total current assets	134,836	143,713	
Non-current assets:			
Marketable securities	127,877	100,887	
Property, plant and equipment, net	39,440	36,766	
Other non-current assets	48,849	42,522	
Total non-current assets	216,166	180,175	
Total assets	\$ 351,002	\$ 323,888	
LIABILITIES AND SHAREHOLDERS' EQUITY:			
Current liabilities:			
Accounts payable	\$ 54,763	\$ 42,296	
Other current liabilities	47,493	42,684	
Deferred revenue	7,612	6,643	
Commercial paper	6,000	4,996	
Term debt	9,613	8,773	
Total current liabilities	125,481	105,392	
Non-current liabilities:			
Term debt	109,106	98,667	
Other non-current liabilities	53,325	54,490	
Total non-current liabilities	162,431	153,157	
Total liabilities	287,912	258,549	
Commitments and contingencies			
Shareholders' equity:			
Common stock and additional paid-in capital, \$0.00001 par value: 50,400,000 shares authorized; 16,426,786 and 16,976,763 shares issued and outstanding, respectively	57,365	50,779	
Retained earnings	5,562	14,966	
Accumulated other comprehensive income/(loss)	163	(406)	
Total shareholders' equity	63,090	65,339	
Total liabilities and shareholders' equity	\$ 351,002	\$ 323,888	

EXAMPLES OF ASSETS

Current Assets



- Cash, bank accounts
- Accounts receivable (money owed to the business)
- Inventory
- Prepaid accounts (insurance policies, leases)

Fixed Assets



- Buildings
- Equipment
- Goodwill (the value of a brand name)

EXAMPLES OF LIABILITIES

Current Liabilities



- Accounts payable (bills owed within the next year, like supplies and inventory)
- Portion of long-term debt that is owed
- Wages
- Taxes

Long-Term Liabilities



- Long-term bonds
- Building mortgages
- Long-term loans

Equity (Ownership Paid to the Company)

- How much has been paid into the firm
 - Investments
 - For a corporation, this is via stock purchases
- How much the company has saved after expenses (retained earnings)



Statement of Cash Flows

- How cash moves through the company
- Cash is needed to pay
 - Wages
 - Bills
 - Other short-term needs
- Three areas
 - Operations
 - Investing activities
 - Financing activities

An Example Business, LLC Statement of Cash Flows For the Year Ended December 31, 2027	
Cash Flow from Operating Activities	\$ 250,000
Net Income	
Adjustments to reconcile net income to net cash from operating activities	
Depreciation and Amortization Expense	24,000
Increase in Accounts Receivable	(37,000)
Decrease in Accounts Payable	(18,000)
Loss on Sale of Vehicle	8,000
Net Cash Flow from Operating Activities	227,000
Cash Flow from Investing Activities	
Capital Expenditures	(48,000)
Proceeds from Sale of Vehicle	33,000
Net Cash Flow from Investing Activities	(15,000)
Cash Flow from Financing Activities	
Cash Dividends Paid	(13,000)
Proceeds from Business Loan	150,000
Payments to Current Debt	(52,000)
Net Cash Flow from Financing Activities	85,000
Total Cash Flow	297,000
Cash at Beginning of Year	118,000
Cash at End of Year	\$ 415,000

Statement of Cash Flows

Cash flow from OPERATING ACTIVITIES

Cash in: Sales

Cash out: Raw materials, depreciation, A/P

Cash flow from INVESTING ACTIVITIES

Cash in: Sale of land or equipment

Cash out: New equipment purchases

Cash flow from FINANCING ACTIVITIES

Cash in: Securing loans

Cash out: Loan repayment

The Financial Statements Linked: Key Business-Health Ratios

- Link financial statement data to assess the financial health of the company
- Ratios
 - Profitability: How much is left over compared to inputs (sales, assets, and equity)
 - Liquidity: Ability of the business to obtain cash
 - Asset usage: How well the business uses equipment, inventory, and property to create sales
 - Debt usage: How well the business leverages loans and credit to create sales

Profitability Ratios

- Profit Margin

$\text{NET INCOME} \div \text{SALES}$

- Return on Assets (ROA)

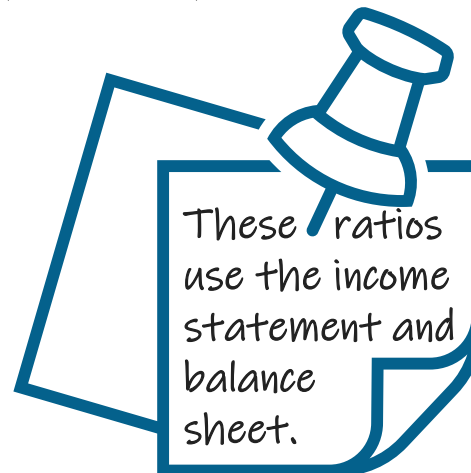
$\text{NET INCOME} \div \text{ASSETS}$

- Return on Equity (ROE)

$\text{NET INCOME} \div \text{EQUITY}$

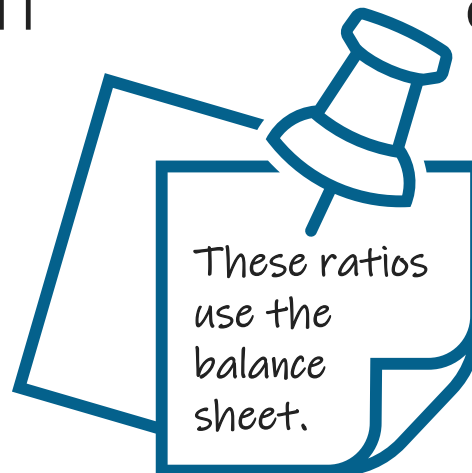
- Industry comparisons

- Grocery stores: low profit margins
- Service industries: high profit margins



Liquidity Ratios

- Current Ratio
 $\text{CURRENT ASSETS} \div \text{CURRENT LIABILITIES}$
- Quick Ratio
 $(\text{CURRENT ASSETS} - \text{INVENTORY}) \div \text{CURRENT LIABILITIES}$
- Best to have a ratio > 1
- Quick ratio is lower than current ratio
 - Better snapshot of industry, as inventory is difficult to liquidate quickly to help in cash acquisition



Asset and Debt Usage Ratios

- Asset Usage

- Inventory Turnover Ratio

$\text{COGS} \div \text{AVERAGE INVENTORY VALUE}$

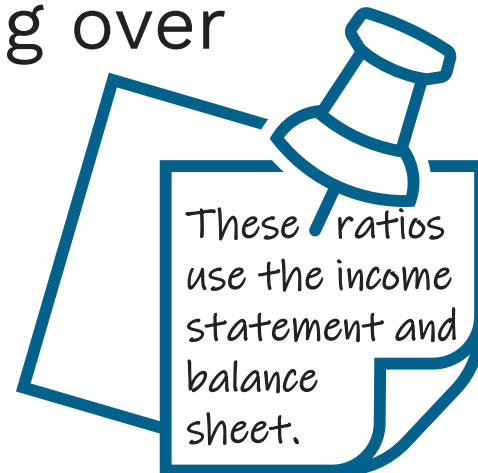
- High ratio means inventory is turning over

- Debt Usage

- Debt-to-Asset Ratio

$\text{TOTAL DEBT} \div \text{TOTAL ASSETS}$

- Ratio < 1 is good



CHAPTER SUMMARY

- The income statement shows balances for revenue and expenses accounts and net income/loss.
- The balance sheet summarizes the assets, liabilities, and equity of a business over a period.
- The statement of cash flows outlines the different ways cash moves through a business (operations, financing activities, and investments).
- Information from the three key financial statements can be used to ascertain the health of a business by calculating the profitability, liquidity, and asset/debt usage ratios.