ASDP National Conference

Financial Literacy

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I Didn’t Get Into Business for This!

Why do I need to know and keep track of financials – I have an accountant that does my taxes after all.
Numbers Tell a Story

• And, a very important story too!
• You might be missing critical information about the health of your business
• They provide information and insight that you cannot find elsewhere
  – How is your business performing?
  – Can operations be improved?
  – How is the cash flow?
Statistics

• Federal statistics show consistent areas that causes businesses to end:
  – Poor management
  – Lack of financial resources
• Owners of creative businesses pay attention the least to business finance
"The good news is, profits are up 74%, the bad news is, we don't know why."
Common Terms: Debt

• Borrowed funds
  – Requires repayment of principal plus interest
  – Can be either short-term or long-term
• Short-term
  – Credit cards (be cautious!)
  – Lines of credit
  – Loan from owner
• Long-term (> 1 year)
  – Bank notes
  – Leases
  – Mortgages
Common Terms: Equity

- Stake of ownership in the company
- The company’s net worth
- Equity financing
  - Personal savings
  - Friends and family
  - Angels
  - Venture capitalists
  - Partners
  - Retained earnings
Common Terms: Expenses

• Fixed
  – Regular expenses that don’t change with volume of sales
  – Examples include rent, insurance, office supplies, office wages, etc.

• Variable
  – Directly related to volume
  – Examples include inventory used, direct labor, electricity, gas, shipping, etc.
Common Terms: Accounts Receivable

- **Source of credit**: *you* are “the bank”
- Income usually resulting from sales but not received as cash at time of sale
- Generally these sales are credit accounts
- Some accounts will not be collected due to various reasons
- Be sure customers have good credit scores before extending them credit
- Customers may not pay on time
Common Terms: Accounts Payable

- Source of credit: supplier is “the bank”
- Liability or something that is paid to someone else
- Short-term obligations to suppliers
- Try to maximize any discounts to increase your cash
  - Early payments
  - Cash versus credit discounts
Common Terms: Contribution Margin

- **Gross Margin**
  - Sales minus COGS
  - Based on fixed and variable product costs but excludes all of the selling and administrative expenses

- **Contribution Margin**
  - Net Sales minus the variable costs

- **How much is left of a sale to contribute to fixed cost coverage**
  - sale – variable cost

- **Stated as a percent**
Common Terms: Projections

- **Pro forma**
  - Projections for future periods based on forecasts
  - Typically projected for 2 to 3 years
  - Ideally based on historical financial information
  - “blue sky” the further you go out
Common Terms: Cash Flow

- How money flows in and out of a business
  - “In” refers to money coming into an organization
  - “Out” refers to expenses or money being paid out

- Concentrated on three main activities:
  - Operating
  - Investing
  - Financing
The “Big Three” of cash management are:

- Accounts receivable
- Accounts payable
- Inventory

A firm should always try to accelerate its receivables and stretch out its payables.
Why do I need them?
- Outside investors
- Helps you see the financial “big picture”
- Score card to track how you are doing

Historical
- Shows how the company has performed

Projected (pro forma)
- Basis for diagnosing:
  - problems
  - financing opportunities
  - process improvement
- Must be as realistic as possible
Income Statement

• Also known as a Profit & Loss statement
• Shows a company’s sales and costs
• Simple formula: revenues – expenses = P or L
• Goal is to have revenues exceed all operating costs to show a profit
Balance Sheet

• Often an overlooked statement
• Shows what you have and how you paid for it
• Snapshot in time
• Has to balance:
  – Company’s total assets always equals or balances the liabilities plus stockholder’s equity
• assets = liabilities + owner’s equity
Cash Flow

- Cash is King!
- Very important to analyze a company’s cash flow
- Many businesses fail due to poor cash flow
- Even if your company is profitable, it can suffer from insufficient cash flow
- If more money is routinely going out then is coming in, you have a problem
Statement of Cash Flow

- Another often overlooked statement
- Shows how a business is moving in “real time”
- Revenue and expense structure
- When does the event occur?
- Statement of liquidity
- What do these things tell you?
Inventory & Cash Flow

• How does inventory affect cash flow?
  – It’s expensive!
  – Can affect your profitability
  – Additional costs involved in excess inventory

• What can I do to improve cash flow?
  – Keep inventory to a minimum
  – Monitor current customer trends
  – Make sure you are receiving payments from customers as quick as possible
  – Make sure you are paying your bills as late as possible
Inventory

- Is a cash hoarder!
- Be cautious how much inventory you carry
- Looses its value quickly
  - Outdated
  - Damaged
- It is an asset, but do not think of it that way
Break-Even Analysis

• Tool used to see at what volume you will become profitable

• Break-even formula: \( BE = \frac{FC}{\text{contribution margin}} = \frac{VC}{I} \)
Break-Even Analysis

• Does have limitations
  – Ignores the importance of cash flow
  – Accuracy of information is crucial
  – Calculation assumes:
    • Fixed expenses remain constant for all levels of sales volume
    • Variable costs and sales changes are consistent with one another
    • The unit price will remain the same despite an increase in the volume of sales
  – Key is to know the denominator when figuring out the formula!
Pricing and Promotion

- Determining products that are:
  - Loss leaders
  - Cash cows
- Determining where product falls in product life cycle to help decide how to promote it
Product Life Cycle

- **Intro**
- **Growth**
- **Maturity**
- **Decline**

Primary Stages

Sales Volume
Pricing: Why is it important?

- Overhead costs need to be covered
- Needs to be in alignment with the marketplace
- Needs to be “acceptable” to the consumer
- Cannot be repeatedly altered
  - Should remain consistent for six months to one year
Value

- Perceived value
  - What the product or service is “worth” in the eyes of the consumer
  - Status
  - Can be different than true value

- True value
  - The realistic value of a product
  - Standard amount
Consumer Segments

- Determine consumer segments by:
  - **Top Tier:** those who will purchase items at full price
  - **Middle Tier:** those who will wait for initial mark-downs
  - **Bottom Tier:** those who will only purchase end-of-the-season bargains
- The most profitable consumers are the top tier
- The least profitable consumers are the bottom tier
Playing with Pricing

- Stores often play with pricing options
  - Buy two items for the price of one
  - Discounts for multiple purchases
  - Coupons
  - Odd pricing
    - Pricing ends in odd numbers
  - Promotional pricing
    - “specials” normally are short run
  - Time-sensitive pricing
    - Price is only good for a specific period of time
Pricing Models

- **Value-based pricing**
  - Determining the amount a consumer will pay for a product and lowering that amount a bit
  - Need to know what the perceived value of the product is

- **Cost-based pricing**
  - Adding a mark-up percentage to the products costs
  - Might be a standard percentage as determined by the industry
  - Can be a particular percentage the business owner picks
The “Right” Price

- Adds to the overall value of the product or service
  - Price too low can appear lower quality
  - Price too high could lead to lost sales
  - Keep in mind if there will be a “status” associated with the product and/or service
  - Needs to be aligned with the identity of the brand
Overhead Costs

• Pricing needs to cover costs
• Do not think you can make profit up in volume
• You need to determine the percentage of each dollar that goes to overhead
  – Allows you to properly allocate costs when setting prices and determining budgets
To Figure Overhead Costs

• To calculate the proportion of overhead costs compared to sales:
• Divide your monthly overhead cost by monthly sales
• Multiply that by 100
• Which gives you the percentage of overhead cost.

• Example, a business with monthly sales of $900,000 and overhead costs totaling $225,000 has ($225,000/$900,000) * 100 = 25 percent overhead
Commodities & Their Effect

• How many of you monitor the price of cotton or other commodities?
• How will you know whether or not your costs are going to be increasing?
• How will you know whether or not you have to raise the price to your customer?
How to Budget

• One of the keys for budgeting is categorizing the priorities.
• First step: calculate what you have coming in
• Second step: Determine what your needs are (operational costs)
• Subtract needs from income
• Experts suggest you save a percentage of your income, subtract that amount
• What’s left over is discretionary spending
Hmmm . . .
If I saved $2 per day
Develop Financial Best Practices

• Financial statements
  – Cash Flow
  – Income Statement (Profit & Loss)
  – Balance Sheet

• Projections

• Budgets

• Pricing strategies using break-even analysis

• Calculating financial needs to support business growth
Financing Basics

• The more money owners have invested in their business, the easier it is to attract financing.

• Sources for debt financing:
  – Banks/Savings and loans
  – Micro-finance companies
  – Commercial finance companies
  – Small Business Administration
Outside Financing

• Bank loans
  – 2-3 years historical financials
  – 1-2 years pro forma (projections)
External Debt Financing

• Banks
  – Various types of loans
• Micro loans
• Factoring
• Angels
• Online platforms
  – Kick starter
What You Need for Financing

• Be able to discuss your business
• Does financing make sense?
  – What are your objectives and plans?
  – Why do you need external money?
    • Growth
    • Finance equipment purchase
  – Are the plans reasonable and realistic?
    • What is the demand for your products and services?
    • Who is your customer?
    • Where is the business heading?
    • What is your competition doing?
  – What makes you unique?
What You Need for Financing

• Industry and economic conditions
  – How do economic cycles impact your business?
  – How does it affect your ability to grow?
• Competitive strengths and weaknesses
  – What sets you apart from your competition?
  – What makes you unique?
  – What niche do you fill?
  – How do you seek and build more customers?
    • Is it transactional or relationship based?
Financial Statements

• Are your financial statements timely and following GAAP principles?
  – Filed on time
  – Internal accounting system used with external support

• Be able to explain the financial objectives of the business
  – Have they been met?
  – Stability and the quality of earnings

• Is there positive equity (net worth) in the business?
Before You Approach a Bank

- Understand your capacity to repay
  - Frame out the request
  - Have the request be “right size”
- 5 C’s of Credit
  - Most important ones are character, capacity and capital
- How do your financials compare to similar companies?
- Have realistic financial projections been prepared?
  - Are the numbers justifiable?
Before You Approach a Bank

- Develop projections with best and worst case scenarios
- Watch out for high growth scenario
  - Can run out of cash
  - GAP analysis
- Develop benchmarking targets to determine operating performance
Personal Credit and Its Impact

- Your personal credit history will impact your business’ attempt to borrow
- You are the business
  - How you pay is how the business will pay
  - Be upfront and honest about any problems in the past
- Banks will require a personal guarantee
  - Owner is a secondary source of repayment
  - Indicates an owner’s commitment to the business
  - Indicates their confidence in abilities
Debt or Equity Financing

• Which do you need?
• Debt should not be used to fund losses!
• Loans should be used to finance:
  – Short term working capital needs
  – Longer term fixed asset purchases
  – Line of credit versus term loan financing
• Be careful what you requesting and what you want to use it for
Financial Statements

- You should be looking at them and comparing them:
  - Day to day
  - Month to month
  - Quarter to quarter
  - Year to year

- Even if you don’t have a background in accounting or finance, leverage your knowledge to understand what is happening in YOUR business
Conclusion

- All business owners need to become financially literate and should develop a strategy
- Has a huge impact on the overall health of the business
- Can help predict problems before you encounter them
- Things will go wrong in business, just as in life. Always have a back-up!
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