Erasmus+

Creativity + Innovation & Technology

LESSON CONTENT TEMPLATE

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1. Lesson Document

Topic 2: Measuring Performance in the Short Term
Lesson 1

Financial Statements

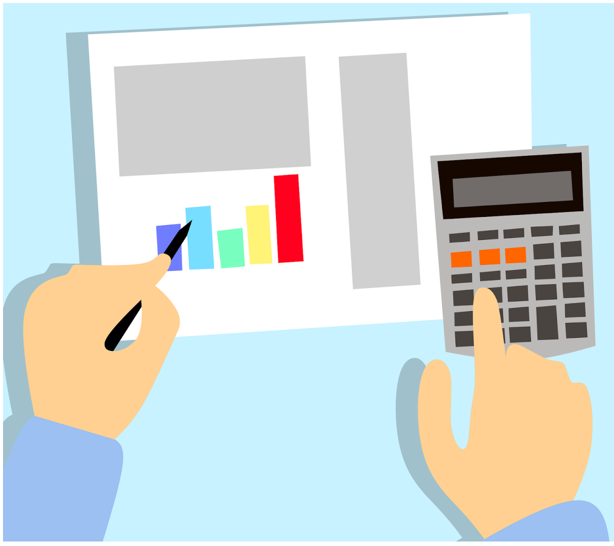
Introduction

Financial statements are types of documents that provide information about the financial health of a business. In this lesson we will learn more about these four financial statements (*Book Entrepreneurial Finance Concepts and Cases*, 2020):

1. Balance Sheet
2. Income Statement
3. Statement of Cash Flow
4. Statement of Owners' Equity

Balance Sheet

The balance sheet is organized into three broad categories: assets, liabilities, and capital.



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Total assets = Total liabilities + Total Equity

For a better understanding of the formula, let's talk about **assets.** (*The Art of Startup Finance*, 2014)
Your assets, begin at the top with your cash, probably is the most important asset you've got. But in addition to your cash, assets include your short-term assets or your current assets. And that can include receivables, money that is expected of your customers. In some cases, you will have inventory, which is a product that you have not sold yet. So these are your current assets. You also have long-term assets. You may even own some property, and that is the property of your company.

Now we will talk about **liabilities** and **equity**. Your liabilities can include things such as debt. Liabilities are money you owe to other people and your accumulated liabilities. Accumulated liabilities are mostly money that you owe to people such as the salary of your employees. Therefore, your liabilities and accumulated liabilities are considered your short-term liabilities. And that's very important because you want to know what you need to pay as soon as possible. Things that you have to pay later are your long-term debt, like the money you borrowed. Those are your responsibilities. The remaining amount is the equity of your shareholder.

What bankers can see from your balance sheet?

The first thing they will look at is your cash. They will try to find out if you have enough money to continue your business. The banker will also look at your working capital.

But what is working capital?

Your working capital includes everything you can turn into cash in a relatively short period of time. The next step that the banker takes is that he uses that number of working capital and then deducts your short-term liabilities and your accounts payable.

Working capital

-

Short term liabilities

=

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Net working capital

This is your net working capital.
The banker will also take a look at the ratio of your debt to your capital. The banker wants to know that you have a lot of equity in your company. He wants to be sure that your capital is bigger than your debt.

Income Statement

So in this part of the lesson, we will talk about the financial processes of your business. The income statement is also called the Profit and Loss Statement, and Income and Expenditure Statement. Records income and expenses for the company over a period of time, usually monthly, quarterly, and annually.

Let's start with revenue.
What is revenue?
Revenue or sales are generated by the sale of products and services by the job. Include both cash and credit sales. The term Net Revenue or Net Sales refers to an amount of income with all deducted allowances and reserves. That's a job estimates its actual income based on previous experience.

Net revenues = Gross revenues - Allowance for doubtful accounts - Reserves for returns

Expenses include all costs associated with generating revenue during the same time period when the sale was recorded. The income statement allocates costs according to the degree that can be directly attributed to sales. COGS is the first item of expenditure in the income statement. The part of that financial processes is the income statement and the cash flow statement. We have already learned that the balance sheet is a static snapshot of your company's health at any time. The income statement and cash flow statement are here to show your financial processes. Let's find out the structure of the income statement:

Revenue (Or Sales)

-

Costs of good sold (Material/Labor)

=

Gross profit

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At the top of your income statement are sales or revenues. Underneath you've got the costs of goods that you sold. You need to deduct the cost of sales from revenue and this gives you gross profit. Your gross profit is the profit you make.

But what is the gross profit margin?

Gross profit margin = Gross profit/Revenue*100%

That is the percentage of that profit measured against the sales number.

Now we will talk about the operating expenses
What is included in the operating expenses?

Operating expenses are the general costs that are fixed and do not differ depending on sales. The costs that are usually in this category are(*Finance and Business Strategies for the Serious Entrepreneur*, 2008):

- Sales,
- General and
- Administrative.

Selling expenses may include advertising, special promotional events, or sales materials.
General and administrative expenses may include rent, utilities, office supplies, and salaries for managers. These costs are necessary for the smooth operation of the company.
Research and development (R&D) costs are also included in operating costs. Also, we need to mention **CAPEX**. What is **CAPEX?**
Capital expenditures are money that an organization spends on the purchase, maintenance, or improvements of its fixed assets, such as buildings, vehicles, equipment, or land. They are in contrast to operating costs, which are running costs that are inherent in the operation of an asset.

What is the operating profit?

Gross profit
-
Operating expenses

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=

Operating profit

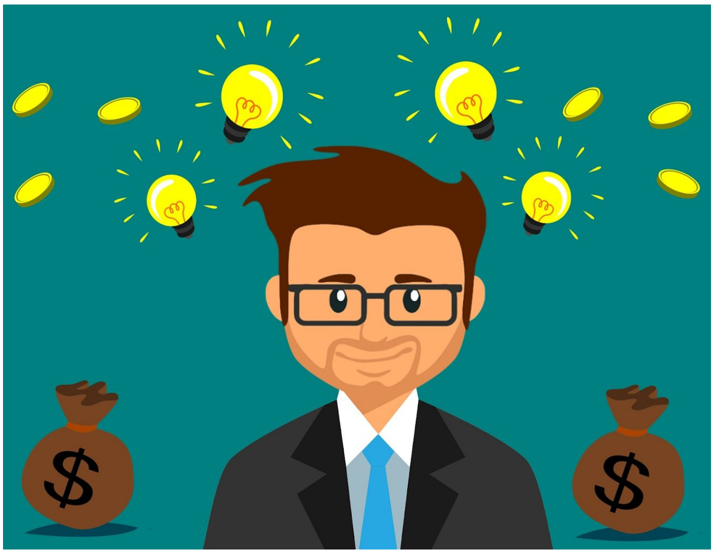
Your operating profit shows the profitability of your company's business.
EBITDA is another important metric because it shows whether the business is generating enough revenues to cover overheads.

EBITDA = Gross profits - Selling, General and Administrative expenses - Research and development expenses

Depreciation and amortization costs fall into the category of "non-cash" costs. These costs will be recorded when the supplier provides the services and the company uses them to post events, capital expenditures such as the purchase of equipment and buildings are depreciated over their useful lives resources.

How do investors look at your income statement?

First of all, they would like to know everything about the gross profit margin, then about operating margin and about net margin. What does that mean? That's mean that you need to concentrate especially on your gross margin but also on the net margin.



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Investors will look at these numbers as indicators of how profitable you are and how efficiently you run your business. They will look for what we call operational efficiency. And that means how efficient are you in running these processes compared to our other companies.

Statement of Owners' Equity

How did you raise the money and who owns the company. So that's part of your share capital in the balance sheet. This includes the income statement and cash statement which are at the top of the balance sheet, at the top of your company's financial base.

Conclusions

The financial statements provide a brief overview of the financial condition of the corporation, providing insight into its performance, operations, and cash flow. Financial statements are essential because they provide information about the company's income, expenses, profitability, and debt.

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