Janmar Consultants Inc.

Ensure Reporting is Timely and Meaningful and Focus on the Most Important Key Performance Indicators ("KPI's")

Financial Reporting

Financial reporting provides a standard methodology to look at the historical results of your business and to assess those results. It is based on facts and is free from bias, judgement, and will allow you to make decisions and give direction.

Many business owners look at financial reporting as a necessary evil and something they do not pay much attention to. However, when used properly financial reporting can provide valuable insights into your business and if produced in a timely fashion provides you with the information you need to help manage your business.

Executive Summary

Ensure reporting is timely and meaningful and focus on the most important Key Performance Indicators ('KPI's")

Financial reporting can put many people to sleep, at the best of times. However, you as a business owner need regular reporting that provides you insight into your business – the sooner the better. You also need a means of keeping your finger on the pulse of your business. This will allow you to know:

- **What is working**
- **What problems are there, as soon as possible**
- **Are there any opportunities**

Financial reporting provides a standard methodology to look at the historical results of your business and to assess those results. It is based on facts and is free from bias, judgement, and will allow you to make decisions and give direction.

In this Issue

- **What are the financial statements you need?**
- **How do you read the financial statements?**
- **What financial ratios are right for your business?**
- **How a Janmar Consultants part-time CFO can assist with and improve your financial reporting**

Introduction

Many business owners look at financial reporting as a necessary evil and something they do not pay much attention to. However, when used properly financial reporting can provide valuable insights into your business and if produced in a timely fashion provides you with the information you need to help manage your business.

It will also allow you to:

- Forecast better as it will provide insight into the future
- Give you actual historical results that you can then use to help predict the future and make changes in the future as required

The financial statements you need:

- **Balance sheet**
- **Income statement**
- **Cash flow statement**

What are the Financial Statements You Need?

The minimum financial reports you need are as follows:

- **Balance Sheet**
- **Income Statement**
- **Cash Flow Statement**

From these three reports you get important information:

- How much cash do you have or what is your bank loan?
- Who owes you money?
- Who you owe money?
- What are your sales?
- How much money did you make?
- How much money did you make from operations?

Balance Sheet

The balance sheet is divided into three sections:

- **Assets – what do you own – separated between current assets and long-term assets?**
- **Liabilities – what you owe or who you owe money to – separated between current liabilities and long-term liabilities?**
- **Equity – what do you have invested in the business?**

By looking at various ratios and calculations related to the balance sheet it shows the overall health of your company. For example, your current ratio (current assets/current liabilities) tells you your ability to pay your debts as they come due.

Lenders and investors will also use the balance sheet to determine your credit worthiness. If you have too much debt, you will be a riskier client and accordingly, they may ask you for personal guarantees if additional loans are required. The reality is too much debt will impact your ability to support growth in your company.

Balance sheet:

- **Assets**
- **Liabilities**
- **Equity**

Income Statement

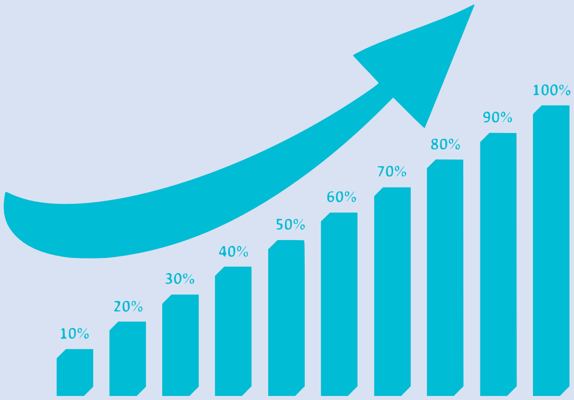
The income statement tells how much money your business made. It shows your sales, expenses and earnings over a period of time.

The income statement will also tell you where to focus your efforts to increase profit – higher sales, lower direct costs, or lower operating expenses.

Lenders and investors will use the income statement to assess your ability to make money. If you are losing money, they will be hesitant to lend you additional money or invest in your business.

It will also show your gross margin and net profit, which if looked at over time, will give you insight into what changes you need to make in your business.

You can also use the income statement to compare/benchmark your results to other competitors in your industry.



Cash Flow Statement

The cash flow statement tells you whether or not your business is generating cash from three different areas. It is divided into three areas and tells you whether you are using cash or generating cash from these:

- **Operating activities**
- **Financing activities**
- **Investing activities**

Operating activities are the business operations, so this tells you if you are generating cash from the actual business. A rule of thumb is you always want to generate cash from operations.

Financing activities tells you whether you are taking on more debt or paying debt off.

Investing activities tells you where you are investing your money in the business – equipment, intangible assets, etc.

A rule of thumb is you always want to generate cash from operations.

How do you Read the Financial Statements?

Reading the numbers on your financial statements is quite often confusing and accordingly, there are ratios that can be calculated to make the interpretation of these financial statements easier.

Rather than just looking at numbers they look at percentages and ratios. Then, by looking at these percentages and ratios over time it gives you the ability to understand what they mean and give insights into where to focus your business improvement efforts.

It will also give you the ability to compare these ratios to your competitors. Additionally, your lender or investors will use these ratios to compare you to other clients they lend to or businesses they are invested in.

Questions these ratios can answer are the following, to name a few:

- Are you carrying too much debt?
- Are your interest costs too high?
- Are you paying your suppliers to quickly?
- Are your receivables too high?
- Are your gross margins too low?

Typical ratios looked at are as follows:

- **Liquidity ratios – analyze the ability of a company to pay off both its current and long-term liabilities as they come due**
- **Profitability ratios – financial metrics used to measure and evaluate your company's ability to generate income/profit relative to revenue and balance sheet assets**
- **Leverage ratios - ratios used to measure your company's susceptibility to risk and what a businesses debt load is**
- **Efficiency ratios - ratios used to measure how well a business manages its assets and liabilities**

For ratios to be meaningful they need to be looked at over time and with reference to your industry

Liquidity Ratios

The ability of a company to pay its debts as they come due. Examples of these ratios are:

- Current Ratio (or Working Capital Ratio) – current assets divided by current liabilities. This is a measure of a company's ability to pay its debts as they come due. This is an important measure of liquidity as current liabilities are due within one year. If it is less than one it means you may run out of cash within the next year. A healthy current ratio is 2:1 or higher.
- Quick Ratio (or Acid Test Ratio) – quick assets (cash, cash equivalents, short-term investments/marketable securities, and accounts receivable) divided by current liabilities. This is the measure of a company's ability to pay its debts as they come due with only quick assets. This tells how well a company can quickly convert its assets into cash to pay its current liabilities. This calculation excludes inventory.
- Defensive Interval Ratio – quick assets (cash, cash equivalents, short-term investments/marketable securities, and accounts receivable) divided by daily operating expenses [(annual operating expenses – non-cash charges)/365]. This measures how many days a business can operate without accessing additional cash. A healthy company has this between 30 – 90 days depending on the industry.

Liquidity ratios:

- **Current ratio**
- **Quick ratio**
- **Defensive interval ratio**

Questions Answered Related to Liquidity Ratios

- Is my working capital increasing or decreasing?
- What are the trends related to my liquidity ratios? Are they getting better or worse?
- Are our customers paying us faster or slower?
- Are we paying our suppliers on time?
- Are we carrying the right amount of inventory?
- How am I doing related to my competitors?
- Is the mix between short-term and long-term debt correct?

Profitability Ratios

To measure if your company is as profitable as it should be or as profitable as you think it is, here are some profitability ratios to use:

- Gross Profit – sales less cost of goods or services sold. Amount of money left over from sales after deducting cost of goods sold – also known as direct production costs. This excludes selling and marketing, research and development, administration and financial costs. If you take this amount and divide it by sales, you get gross margin percent or gross margin ratio.

- EBIT ("Earnings Before Interest and Taxes") or Operating Profit - the profit from business operations (gross profit less operating expenses, amortization and depreciation), before deducting interest and taxes. It is the measure of how efficiently you produce and sell your product or service. Put another way how much profit is left after covering fixed costs. One downside to using operating profit is it ignores the debt load of the company. If gross margins are increasing and EBIT is decreasing it may indicate your indirect costs are out of control. If you take this amount and divide it by sales, you get operating profit percent.
- Net Profit also called Return on Sales – sales less all expenses. This is how much money your company generates after paying all expenses. This tells you how well a business has managed all expenses. Generally, analysts and investors want to see increasing net profit over time. If this is divided by sales, you get Net Profit Percent or Ratio.
- Return on Assets – net income divided by total assets. A financial ratio that shows how effectively a company employs its assets. A very capital-intensive business will show lower return on asset ratios. You also need to be careful whether total assets include a lot of intangible assets as this could increase total assets, but the business may not have a lot of physical assets. To also put this in perspective it should be compared to other competitors in your industry.
- Return on Net Worth - net income divided by total equity. This is the rate of return on invested capital. Put another way this shows how well the company is using the money invested by the shareholders. To put this in perspective it should be compared to other competitors in the industry. For a shortcut this can be compared to the return on equity near the long-term average of the S&P 500 group of companies. Higher risk investments or companies should have higher returns on net worth.

Profitability ratios:

- **Gross profit**
- **EBIT**
- **Net profit**
- **Return on assets**
- **Return on net worth**

Questions Answered Related to Profitability Ratios

- Is our gross profit high enough?
- Are we making enough money to cover our expenses?
- What are the trends over time? Getting better? Getting worse?
- Am I making enough money for what I have invested in the business?

Leverage Ratios (also known as Capitalization ratios)

These are ratios used to measure your company's susceptibility to risk and what a businesses debt load is. Higher leveraged companies are more risky investments. A financial leverage ratio of more than 2:1 indicates financial weakness. Leverage ratios are as follows:

- Debt to Equity Ratio – total debt divided by total equity. This quantifies the relationship between debt and equity in a business. It measures the level of risk in a business due to the amount of debt it is carrying. The higher the ratio the higher the risk to current and future lenders. A lower ratio means the company is more financially stable and there is lower risk for current and future lenders. Too low of a ratio may mean you are inhibiting the ability of the company to grow by not borrowing money.
- Debt Ratio – total debt divided by total assets. Measures what portion of assets purchased are being funded by debt. A high ratio means most assets purchases are being funded with debt. Again, a low ratio may indicate you are hindering the growth of the company by not utilizing or accessing debt to fund additional equipment or other assets needed for expansion.
- Times Interest Earned Ratio (or Interest Coverage Ratio) – EBIT divided by Interest Expense. It is the measure of a company's ability to meet its debt obligations. It measures how many times a company's earnings cover its interest charges. If a company cannot make these payments it may be forced into bankruptcy. The higher the ratio the more capacity a company has to take on more debt.

Leverage ratios:

- **Debt to equity ratio**
- **Debt ratio**
- **Times interest earned**

Questions Answered Related to Leverage Ratios

- Are our lender's covenants to restrictive?
- Should we be looking for other sources of debt to replace our current lenders?
- Do we have too much debt in the business?
- How much debt should we have in our business and how much am I comfortable having?

Efficiency Ratios

Ratios used to measure how well a business manages its assets and liabilities. It also measures how efficiently a company uses its assets to generate sales. Efficiency ratios are as follows:

- Accounts Receivable Collection Period (also Days Sales Outstanding) – accounts receivable divided by average sales per day. Tells how many days on average it takes to collect accounts receivable. Generally speaking, the lower the days, the better. However, be careful, you don't want low collection days driven by strict credit terms driving customers to competitors.
- Accounts Payables Payment Period – accounts payable divided by average cost of goods/services sold. Tells how many days on average it takes a company to pay its suppliers. This should be compared to the accounts receivable collection period to see if you are collecting your money from your customers before you need to pay your suppliers. You need to monitor this to make sure you are paying your suppliers soon enough that they do not penalize you on price or quality in exchange for taking too long to pay.
- Inventory Turnover – cost of goods/services sold for a period divided by average inventory. Tells how often you turn your inventory in a certain period. The higher the better as it shows you have good inventory controls in place and your product or service is in demand. Conversely, a low turnover would indicate you have too much inventory or poor demand for your product/service.
- Inventory Turnover in Days – average inventory divided by average cost of goods sold in a period. Measures on average how many days it takes to turn over inventory. The lower the days, the quicker you turn your stock. The quicker it turns, the better as with inventory turnover.
- Sales to Net Worth – sales divided by equity. Tells the ratio of how many sales are generated for each dollar invested. The higher the ratio the better.
- Sales to Total Assets – sales divided by total assets. Tells the ratio of a company's sales relative to its assets. This indicates how efficiently a company uses its assets to generate sales. Again, the higher the ratio the more efficiently the company uses its assets.
- Debt Coverage Ratio – net operating profit (EBIT) divided by total debt service (interest expense plus debt payments). Is a measure of the cash flow available to pay current debt obligations. Also indicates a company's ability to take on additional debt without impairing its survival.

Important efficiency ratios:

- **A/R collection period**
- **A/P payment period**
- **Inventory turnover**
- **Inventory turnover days**
- **Debt coverage ratio**

Questions Answered Related to Efficiency Ratios

- Are we collecting our receivables quick enough?
- Are we paying our suppliers in a timely manner?
- Do we have the right amount of inventory for our level of sales?
- What are the trends related to these ratios? Are they getting better/worse?

What Financial Ratios Are Right for Your Business?

The reality is there are no specific financial ratios that are the correct ones to look at and monitor in all situations. Some are more applicable for certain industries and businesses, so unfortunately as with shoes, one size does not fit all. For example, inventory turnover is not applicable for a service business.

However, what is key is to select 5-10 ratios that are pertinent to your business and then track them as part of your monthly reporting. This will allow you to identify trends, both good and bad, when they occur, and this reporting also needs to be timely. Monthly reporting should not be done 45 days after month end, we would suggest within 15 days or less.

Failing to plan is planning to fail

Why Businesses Don't Use Timely Reporting

We have seen it time and time again. Businesses without timely reporting or no reporting at all. Why is this? Some of the reasons for lack of reporting or reporting that is not timely:

- People feel they don't have time for reporting
- No people in house or access to a person who can prepare the reporting
- Don't know what reporting to focus on or someone to help them determine what they should be reporting or analyzing
- No systems in place to capture the information needed for reporting

Having the proper reports on a timely basis can help identify:

- Is your business making money?
- Is your business generating positive cash flow?
- Who are our most profitable customers?
- What are your most profitable products/services?
- What is your breakeven?
- Do you have the right mix between short-term and long-term debt?

The reality is analyzing the history of your company through reporting allows you to understand what is working in your business and what is not working in your business. This in turn allows you to plan and make changes in the future to make your business profitable. Afterall as they say, failing to plan is planning to fail, so take the steps with respect to reporting that will allow you to plan for business success.

How a Janmar Consultants Part-Time CFO Can Assist with and Improve Your Financial Reporting

Reporting is taking all of the various data within your business and turning it into information. All businesses have some sort of reporting, but in a lot of cases it is too late to be meaningful for planning, or insufficient for the proper analysis to be done to assist with improved future profits.

A Janmar Consultants part-time CFO can provide you with a seasoned, experienced, common sense CFO, to help you determine what reporting is right for your business and when it should be prepared, at a fraction of the cost of a full-time junior accountant.

With their assistance you will be able to establish a reporting structure in a fraction of the time it would take without their help. You will also have access to their expertise when you want it.

Specifically, with respect to reporting they will:

- Identify the Key Performance Indicators ("KPIs") for your business
- Prepare monthly financial statements – balance sheet, income statement and cash flow
- Calculate the key ratios that are important to your business and draw to your attention ones that require action
- Analyze the trends of key ratios and let you know what these trends mean
- Assist with digging in to determine if ratios are deteriorating and why
- Create systems and procedures to facilitate timely reporting
- Identify fixed and variable costs, and show you how to control them
- Educate your team about KPIs and why they are important
- Implement procedures for monitoring and controlling costs
- Introduce departmental budgets, targets, and assign responsibilities to manage these budgets to departmental managers

Conclusion

All businesses need timely, accurate financial reporting. From this information you can ascertain what your business has done well and what your business has not done well. This will than allow you to make modifications or changes as your business moves forward. It will also allow you to determine what threats there are to your business and what opportunities exist that you can capitalize on. You have built a successful business and when presented with the correct facts you can make quick decisions to make your business even more successful. Why not start today?

A part-time CFO from Janmar Consultants will help your business provide you with the information you need to drive it to the next level of success. Reach out we are here to help.

Janmar Consultants Inc.
1-519-830-3103
www.janmarconsultantsinc.com