

The Entrepreneur's Guide to Understanding Financial Statements and Accounting©

By

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and

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Preface

By Bethany Rhine

The overwhelming presence of financial illiteracy in today's society, ranging from high school and college students to business owners and entrepreneurs, demonstrates a need for a basic understanding of accounting and financial management principles. These principles are not grasped by most people due to the complication of most accounting texts or the mere lack of exposure to accounting principles. Planning a budget, balancing a checkbook, or reconciling a bank statement, do not guarantee financial literacy or an understanding of the necessary principles. The following pages focus on providing the necessary knowledge to enable business owners and entrepreneurs to use financial statements effectively and profitably. This knowledge will be an effective tool for the management and operation of your business, and the key to necessary communication between you and your accountants and advisors. Basic terminology will be presented through simple definitions and analogies. If you are a financial professional, this presentation is probably not for you. It is simplistic, but effective.

At the age of eight, when I wanted to open a lemonade stand, my Dad taught me, in his words, "The only accounting equation you will likely ever need to know is: *Assets = Liabilities + Equity*." It is simple, but requires explanation. This equation, and its explanation, began my understanding of financial concepts. Hopefully this information will serve as a starting point for your financial literacy and provide for better management and decision making in your business.

Introduction

By Timothy L. Rhine

“Know The Score”

If you had never been previously exposed to baseball, then attended a Major League game for the first time, would you be able to understand the scoreboard? I think you would agree that it would be confusing. The terminology would be foreign to you, the numbers in the different boxes may not make sense and you may draw the wrong conclusions. With some explanation, the scoreboard becomes relatively simple to understand and you know what is going on in the game and, most important, who is winning. Accounting and your business are analogous to baseball and the scoreboard. Your financial statements are your scoreboard. With basic understanding of accounting, and the ability to read your scoreboard (financial statements) you will know what has happened over time, you will know what is happening now, you will know if you are winning and you will be better able to plan future actions and make decisions.

You would not attend a Major League Baseball game and not look at the scoreboard, yet a surprising number of business owners and entrepreneurs fail to look at, or understand, their scoreboard. You cannot tell who is winning, plan strategy or make decisions without “knowing the score.”

It is the goal of this brochure to enable you to “know the score.”

The information presented comes from my experience as an entrepreneur, business owner, business consultant and from a variety of text and academic sources. Out of necessity the information is in-

complete and at variance with some accepted accounting terminology and practices. It is my intention for you to grasp concepts and provide you with management tools. It is not intended to replace your accountant, but rather increase your communication and effective utilization of professional advice and service. But most importantly, this information is intended to increase your management capabilities and to provide the basic knowledge necessary for small business owners and entrepreneurs to grasp their financial situation.

Mission Statement

This guide provides the basic knowledge to enable entrepreneurs and business owners to read, interpret and utilize financial statements in the management and operation of their businesses. It introduces financial management through ratio analysis and industry benchmarks and provides the basic terminology necessary to communicate with professional advisors.

Objectives

To provide understanding of an income statement, cash flow statement and balance sheet; what information they provide; and how they are interrelated.

To provide understanding of basic accounting terminology and the “Accounting Equation” –

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

To provide the basis for generating integrated pro forma financial statements.

To provide understanding of the benefit of accrual based accounting.

To provide financial management tools through basic ratio analysis.

I have *italicized* common accounting terminology when first utilized to emphasize its use and your familiarity. Terminology can be referenced in the Glossary or other basic accounting sources.

Acknowledgements

Various sources of information were drawn upon, in part, for material for this presentation, as well as my own experience. I want to recognize in particular the following resources and would recommend readers to pursue further study.

The entire Barron's Business Library and Barron's Business Review Books; the Portable MBA series published by Wiley; the American Management Association's Financial Series; Business Ratios by Tyran; Fundamental Accounting Principles, Seventeenth Edition, Volume 1 and 2 - Kermit D. Larson (University of Texas at Austin), John J. Wild (University of Wisconsin at Madison), Barbara Chiappetta (Nassau Community College). Published by McGraw-Hill Irwin. Any omissions are entirely my responsibility and accidental.

I particularly want to thank my daughter, Bethany, a student in San Luis Obispo, California, for her valuable contribution throughout this presentation, including material suggestions, proof reading, written text and concepts, and for drafting the Preface and Glossary.

The Entrepreneur's Guide to Understanding Financial Statements and Accounting

I The Accounting Equation

There is only one equation you need to know in accounting. It is:

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

It comes from the *Balance Sheet* and it tells you what you own (*assets*); what you owe (*liabilities*) and what would be left over for you (your *equity*) if you had to sell all your assets and pay off all your debts. Using fifth grade algebra: **Equity = Assets – Liabilities.**

Think of it in terms of who owns your business. If I asked you 'Who owns your business?' you would answer, 'I do.' I would reply 'Only if there is anything left over.' Assume for example you have to pay off all your debts. If you owe any taxes, those will be paid first. If you owe any wages, they will come next. If you owe any loans they will come next, and so on. If there is anything left over, it belongs to you and is your *equity*.

There can be many variations in format, entries and presentations in financial statements, but they are all premised upon the Balance Sheet equation: **Assets = Liabilities + Equity**

Now you understand the "Accounting Equation" and a basic balance sheet, one of the three essential financial statements. We will now look at how a balance sheet should be generated.

II Accrual and Cash Basis Accounting

There are two methods of accounting. One is convenient, easily understood and implemented, and often fatal to the business. It is known as *cash basis* of accounting. The other method is more complicated to grasp and implement, but is the only method that can accurately reflect your financial picture. It is known as *accrual basis*. (Remember the baseball scoreboard. Sometimes a wrong score is worse than not knowing one.) The cash basis accounts for, or recognizes income and expenses when the income is actually received and the expenses are actually paid. It is no different than keeping a check book balance. Just because you have cash in the bank does not mean you are in good shape financially. Case (1) If your only asset was your checking account and you had \$1 million dollars in it, but owed \$20 million in past due bills, what is your equity? (What do you own?) Your equity is a negative -\$19 million, yet your cash basis set of accounting records would show a balance sheet equity of positive \$1 million.

What if, under Case (2), you had \$1 million in the bank, were owed \$40 million on sales you had not yet collected and had \$20 million in bills past due? Your cash basis set of records would show \$1 million in equity, but in reality, you have another \$40 million asset that is not reflected. Cash basis accounting distorts your financial picture and should not be relied upon.

Accrual basis accounting recognizes income and expenses when the income is earned and the expenses are incurred. In another example, Case (3) – You have \$1 million in the bank and owe \$20 million in invoices or “bills” (*accounts payable*), and have made \$40 million in sales but not yet collected the funds. Accrual basis accounting would reflect \$21 million in equity. (Assets: \$1 million

cash; \$40 million *accounts receivable*; total assets = \$41 million. Liabilities: \$20 million in *accounts payable*. Equity = \$21 million. Assets = Liabilities + Equity or Equity = Assets - Liabilities). There is only one real picture (one true, accurate scoreboard) of your financial situation and it is reflected by accrual basis financial statements. It is assumed throughout this presentation that accrual basis accounting is used.

III Financial Statements

Financial Statements are the scoreboard for your business. There are three essential statements to “knowing the score”, the *income statement*, *cash flow statement* and *balance sheet* and they are interrelated. They all influence each other and all are essential to “knowing the score.” Two statements tell you what activity has happened over a period of time (the *income statement* and the *cash flow statement*) – a moving picture, if you will, over a period of time, in arrears. The third statement is a “still photograph” or “snap-shot” of what your business looks like right now, at this point in time, or as of the date of the statement (the *balance sheet*). The income statement and cash flow tell you the activity and how you got here; the balance sheet tells you what your business looks like right now. (What you own - assets; what you owe - liabilities; and what is left over for you – equity.)

The income statement and cash flow can be for any period of time you desire. They can cover one day, one week, one month, one quarter year or one year or more. Pick periods that are meaningful to you and the management of your business. A friend of mine once generated income statements three times per day to cover each shift of the factory he owned and managed.

Briefly, the financial statements are interrelated as follows:

The income statement reflects what money you have earned (not necessarily collected and put in the bank or your mattress) and what expenses you have incurred (who has sent you a bill) or what you have obligated yourself for, not necessarily what bills you have paid. Remember accrual versus cash basis accounting? (Accrual is the only way to know the score.) The cash flow statement tells you what money you have collected and what money you have actually disbursed. The balance sheet tells you what you own (assets), what you owe (liabilities) and what is left over for you (equity).

Therefore:

If you earn some money, but have not yet been paid, it still is your money and will be reflected on the income statement (as *sales* or *revenues*) and on the balance sheet as an asset (*accounts receivable*), but not as cash, since you do not yet have it. See Example (1).

Example (1) - Income Statement

	Week ending June 15
Sales	
Widget#1	\$500,000
Widget#2	\$250,000
Total Sales	\$750,000
Expenses	\$0 (for example)
Net Income	\$750,000

Example (1) - Cash Flow Statement

	Week ending June 15
Cash In	\$0
Cash Out	\$0
Ending Cash Balance	\$0

Example (1) - Balance Sheet

	As of June 15 th
Assets	
Cash	\$0
Accounts Receivable	\$750,000
Liabilities	\$0
Equity	\$750,000

Now let's assume you collected your money in the same week as you made the sales. It will show up on the cash flow statement and will show up as cash on the balance sheet instead of accounts receivable because you have collected it and put it in the bank. See Example (2)

Example (2) - Income Statement

	Week ending June 15
Sales	
Widget #1	\$500,000
Widget #2	\$250,000
Total Sales	\$750,000
Expenses	\$0
Net Income	\$750,000

Example (2) - Cash Flow Statement

	Week ending June 15
Cash In	\$750,000
Cash Out	\$0
Ending Cash Balance	\$750,000

Example (2) - Balance Sheet

	As of June 15 th
Assets	
Cash	\$750,000
Accounts Receivable	\$0
Liabilities	\$0
Equity	\$750,000

For review: **Assets = Liabilities + Equity** (it always has to BALANCE; i.e. "Balance Sheet")

With a few more examples you can see how each financial statement influences the others and how they are interrelated.

In Example (3) assume you made the same sales, \$750,000 total; accrued (obligated for) \$200,000 in expenses, paid \$50,000 of those expenses and collected all \$750,000. Can you tell me what your balance sheet would look like and what your equity is at this point? See Example (3).

Example (3) - Income Statement

	Week ending June 15
Sales	
Widget #1	\$500,000
Widget #2	\$250,000
Total Sales	\$750,000
Expenses	\$200,000
Net Income	\$550,000

Example (3) - Cash Flow Statement

	Week ending June 15
Cash In	\$750,000
Cash Out	
Expenses	\$50,000
Ending Cash Balance	\$700,000

Example (3) - Balance Sheet

	As of June 15 th
Assets	
Cash	\$700,000
Accounts Receivable	\$0
Liabilities	
Accounts Payable	\$150,000
Equity	\$550,000

Accounts payable, under liabilities, represents the balance of expenses that you owe and have not yet paid. The difference in eq-

uity between Example (2) and (3) came from the fact that we spent \$200,000 in expenses to make the \$750,000 in sales in Example (3).

In Example (4) let’s assume during the period you make \$750,000 in sales, collect \$500,000, obtain a \$100,000 loan, purchase \$500,000 in machinery financed with \$100,000 down, the balance carried by the seller, and accrue and payoff your accounts payable of \$200,000. Your financial statements would look as follows:

Example (4) - Income Statement

	Week ending June 15
Sales	
Widget #1	\$500,000
Widget #2	\$250,000
Total Sales	\$750,000
Expenses	\$200,000
Net Income	\$550,000

Example (4) - Cash Flow Statement

	Week ending June 15
Cash In	
Sales	\$500,000
Loan Proceeds	\$100,000
Total Cash In	\$600,000
Cash Out	
Expenses	\$200,000
Machinery Down payment	\$100,000
Total Cash Out	\$300,000
Ending Cash Balance	\$300,000

Example (4) - Balance Sheet

	As of June 15 th
Assets	
Cash	\$300,000
Accounts Receivable	\$250,000
Machinery	\$500,000
Total Assets	\$1,050,000
Liabilities	
Accounts Payable	\$0
Equipment Loan	\$400,000
Bank Loan	\$100,000
Equity	\$550,000

The above examples ignore *depreciation, inventory* and *Cost of Goods Sold (COGS)* and assume your purchased equipment is worth what you paid for it. Note that there are numerous accounting and tax rules that require certain items be treated in particular ways when making accounting entries, but examples (1) – (4) illustrate the workings and interrelationships of the financial statements. *Depreciation* is a non-cash charge allowed as an expense by the IRS to recover the cost of purchased equipment. It is an expense on the income statement, but leaves the cash in your pocket. *Inventory* is goods and materials you have purchased and have on hand in order to generate sales. *Costs of Goods* is the cost of the inventory used to generate sales during the same period. It is best explained as what has “disappeared” during a period of production and is connected with the sales of that period. It leads you to the ***Gross Profit Margin*** on the income statement – a key component in managing your business.

Example (5) illustrates a more complete, typical business financial statement. (When I say “financial statement”, again, I always refer to all three essential financial statements that make up the “scoreboard”: the income statement, cash flow and balance sheet.) I have made notes of clarification throughout the statements.

Example (5) - Income Statement

Item	Period	%	Comments
	12 Months Ending December 31, 2004		<p>* Denotes key measures by which to manage your business; should be reviewed on a regular basis as frequently as necessary; should be measured and compared against your previous performance; <i>industry benchmarks</i> and data for “like” firms. Also set and do “ratio analysis” or percentage of each category of net sales. Note “%” column.</p> <p>You want to organize and set up (or have your accountant set up) your expense categories to help you more easily manage your business. Make your <i>chart of accounts</i></p>

			(categories on your financial statements) meaningful to you, not convenient for your accountant.
Gross Sales	1,000,000		* Sales or Revenues – money generated from operations.
Returns & Allowances	10,000		Allowances for returned sales; refunds to customers.
Net Sales	990,000	100%	Sales minus Returns = Net Sales
Cost of Goods Sold (COGS)	600,000	60.6%	The raw material cost (or inventory) for items used in production to produce sales. (If I have to buy sheet metal to make an air duct it is part of the COGS.) It is the inventory that “disappeared.”
Gross Profit	390,000	39.4%	Net Sales minus COGS Your GP tells you what you have left over to pay payroll and other operating expenses.
*Gross Profit Margin (GPM)	39.4%		* Gross Profit / Net Sales Your GPM is one of the key numbers on your scoreboard.
Expenses			Expenses are what you pay

			<p>for items and services used in the production of sales during the same time period, excluding items classified under COGS. What goes into COGS is subject to debate. The more you can identify something specifically used to produce a specific item, the more it should be classified as COGS, not expenses. If you cannot specifically identify an item with a product produced or sold, the more it should be classified as an expense. i.e. electricity; insurance; etc.</p> <p>* Each expense category should be measured and compared against past performance and industry benchmarks to see where you may superior or where you may need to improve. Ask questions, for example, as to “Why are my utilities 15% of sales, when my competition is running only 6%?”</p>
Interest	10,000	1%	
Utilities	35,000	3.5%	

Insurance	15,000	1.5%	
Labor	240,000	24.2%	Specific labor associated with specific products could fall under COGS.
Rent	50,000	5.1%	In some industries rent is separated out and entered in a separate category after expenses are totaled.
Maintenance	25,000	2.5%	
Depreciation	150,000	15.2%	In some cases depreciation is entered in a category separate from expenses. Depreciation is a “non-cash” cost or charge allowed by the IRS to recover the cost of machinery and equipment used in the production of income. Since it is a “non-cash” cost, you do not write a check for it, but it appears as an expense on the income statement. It will be added back in on the cash flow statement.
Total Expenses	425,000	42.9%	
Net Income / (Loss)	(135,000)	(13.6%)	* GP minus Total Expenses

Example (5) shows a \$135,000 loss for the year ended December 31, 2004. You should be asking yourself, ‘How can this business

continue to exist when it is losing money?' Let's look at the cash flow statement for the answer.

The cash flow statement reconciles your income statement's sales, expenses and net income to your bank balance. That is: if you have \$1,000,000 in the bank, where did it come from? If you began the year with a \$1,000,000, but now have nothing, where did it go? Also, the balance sheet will come into play to reconcile both the income statement and the cash flow statement.

Example (5) - Cash Flow Statement

	12 Months Ending December 31, 2004	Comments
Cash In		
Collected Sales	\$990,000	All sales collected in year
Loan Proceeds	\$100,000	Liability to appear on the balance sheet. Will not appear on the income statement because it has nothing to do with earnings & expenses.
Total Cash In	\$1,090,000	
Cash Out		
COGS	\$600,000	See income statement. Assumes you paid for and replaced inventory used in producing the \$1,000,000 gross sales that generated \$990,000 in net sales after returns.

Expenses Expenses minus depreciation (since depreciation is a non-cash cost, it is an expense that you did not payout in cash.)	\$275,000	See income statement. Total expenses of \$425,000 minus depreciation of \$150,000. Cash flow statements and the other financial statements can be set up in different formats. Depreciation may be added back in as a line item in other formats.
Investing Machinery Down payment on \$500,000 purchase	\$100,000	\$500,000 asset and \$400,000 liability to appear on the balance sheet. Will not appear on the income statement.
Debt Service Principal Repayment	\$20,000	Interest payments will appear on your income statement as an expense, but principal payments do not. You have to have a cash flow statement to show accurate debt service.
Total Cash Out	\$995,000	
Ending Cash Balance	\$95,000	Asset to appear on the balance sheet

The answer as to how the company stays in business while losing money shows up in the depreciation (non-cash cost) of \$150,000 and a \$100,000 bank loan. As long as cash keeps coming in from whatever source, the company can stay operational.

Example (5) - Balance Sheet

	December 31, 2004	Comments
Assets		
Cash	\$95,000	From the cash flow statement (ending balance)
Accounts Receivable	\$0	From cash flow statement and income statement – the difference between net sales and collected sales
Machinery	\$500,000	Referenced from the investing section of cash flow statement; contracts; or appraisal
Inventory	\$0	Inventory and changes in inventory will give you your COGS which is key to your profitability. Accounting for inventory is difficult, costly and time consuming, but essential to knowing the score. A detailed discussion of inventory is beyond the scope of this text, but suffice it to say, an accurate inventory, on a timely basis is required for an accurate financial statement. See formula for calculating COGS and gross profit margin in section “Financial and Business Management Through Ratio Analysis and Industry Benchmarks - page 24
Total Assets	\$595,000	
Liabilities		
Accounts Payable	\$0	
Equipment		

Loan	\$400,000	
Bank Loan	\$100,000	
Total Liabilities	\$500,00	
Equity	\$95,000	

Assets = Liabilities + Equity

In Summary:

The Income Statement (a moving picture, over time, in arrears) tells you what your sales (revenues) were; what your costs of goods were; your gross profit margin; your expenses; and your net profit.

The Cash Flow Statement (a moving picture, over time, in arrears) tells you where your cash came from and where it went (how you spent it).

The Balance Sheet (a still snapshot at this point in time) tells you what you own (assets); what you owe (liabilities) and what is left over for you (equity).

You cannot tell what you sold, what it cost you, where you money came from or where it went and what you actually own, owe and have without all three statements.

IV Integrated Pro Forma Financial Statements in Business Planning

The two biggest and most frequently made errors I see in small business are: (1) failure to know actual costs (both COGS and ex-

penses) and (2) failure to have the complete financial picture when planning.

In order to see the complete financial picture when planning, you must have integrated pro forma financial statements. For example, if you do not include a cash flow statement, where do you account for principal payments on debt service, or determine how large a bank loan you need, and more importantly, how do you prove to your banker you will be able to pay back the loan? If you do not include a balance sheet, how do you see the result of your decisions and the result on equity? Without an income statement, how do you adequately play the “what if” games to explore options? With today's personal computers and spreadsheets a truly sophisticated planning tool can be utilized by anyone in business. It is too time consuming to do each scenario by calculator and without financial statements, the complete picture is lost and you very likely will not know your true costs. I have not found an off the shelf software package that meets my needs in business planning for myself and my clients, so I usually construct a custom application in each case. If you are skilled in spreadsheet usage, you can build your own integrated pro forma financial statements and in doing so will learn more about your business than any of your advisors will ever know. Also, with the numerous accounting packages available today, you can have accurate records kept to accurately measure and analyze your results. However, your advisors should play a vital role in your business planning and analysis by bringing outside advice, expertise, experience and perspective to your business. Most entrepreneurs and business owners are too close to their business to be objective, so it is vital to properly utilize outside advisors. They should act as your “Board of Directors and Advisors.”

V Financial and Business Management through Ratio Analysis and Industry Benchmarks

The purpose of generating financial statements is to “know the score.” To better understand the “score” let's look at some of what the financial statements tell us. The numbers on the financial statements tell you the results of your actions. To analyze the numbers I recommend ratio analysis and using industry benchmark comparisons.

Each category or item on your chart of accounts used to set up your accounting system should illustrate that number as a percentage of net sales on your income statement.

First, have your income statement set up so it shows your **gross profit margin as a percent of net sales**. (If your program will not do it, then calculate by hand and write it in the margin of your income statement.) For example, if you sold \$100,000 worth of goods, products or services and you had a gross profit margin of 40%, you would have \$40,000 left to pay your expenses, meet other debt service, make investments in your business and generate a profit.

Next, set up the expense section of your income statement so it illustrates **each expense category as a percentage of net sales**. It makes it easy to monitor each expense item, tells you quickly where major expenses are and allows you to concentrate on the ones that can be improved. For example, if your expenses total 38% of net sales, you instantly know you have only 2% of net sales left to meet debt service, make investments, etc. **Remember, this has nothing to do with cash flow**. It is a separate issue as to when the money comes in and goes out. (Cash flow statement.) If labor is 20% of net sales, it likely is your biggest expense item. You as

the manager will know if there is any room for efficiency improvement or not.

Your net profit expressed as a percentage of net sales is known as “the bottom line.” It is your “final score.”

To analyze your business compare each category on your income statement, both in real numbers and as a percentage of net sales, to published industry benchmarks. Information on like size firms is available from trade groups, universities, surveys and magazines allowing you to compare your “score” with your peers and competitors. It will give you insight into how you are doing by industry standards and where you might improve your operation.

Finally, analyze the financial health of your business through some company financial ratios. These ratios can be monitored monthly and compared to industry standards and provide a good picture of your financial situation. There are many more ratios available and not all of these will be applicable to every business. Pick and choose the most meaningful and pick appropriate timeframes, but **DO IT!** Financial statements and analysis give you the “score” so now make yourself accountable. Pick a knowledgeable and impartial advisor or group to review your business and financial statement with you, to ask questions and to provide insight, but be sure to **DO IT ON A REGULARLY SCHEDULED BASIS** and without interested parties. It will do wonders for your “bottom line.”

Suggested company ratios and formulas to use in financial and business analysis:

Profitability Measurements

- Gross Profit Margin % - Gross Profit divided by Net Sales
- Profit Margin % (Net Profit) - Net Income divided by Net Sales
- Return on Equity % - Net Income divided by Paid In Capital plus Retained Earnings (Equity)

Liquidity Measurements

- Working Capital - Current Assets minus Current Liabilities
- Current Ratio - Current Assets divided by Current Liabilities
- Quick Ratio - Cash plus Accounts Receivable plus Marketable Securities divided by Current Liabilities

Solvency

- Debt Ratio - Total Liabilities divided by Total Assets
- Debt to Equity Ratio - Total Liabilities divided by Stockholder's Equity
- Times Interest Earned - Income before interest, taxes, depreciation & amortization divided by Interest Expense

Asset Utilization

- Total Asset Turnover - Net Sales divided by Average Total Assets

Your banker, accountant, advisor or published industry benchmarks can give you acceptable ranges of value for the above meas-

ures, however, here are some guidelines (and note, some of these ratios appear to be reversed, due to accounting convention, so beware – just use common sense i.e. “Am I more comfortable with twice as much debt as I have assets, or twice as much assets as debt?” Which do you think your banker would prefer?):

1. Current Ratio - 2:1 minimum
2. Quick Ratio - No less than 1
3. Debt to Equity - Indicates the amount of leverage, borrowed capital and overall debt, the company is carrying in relation to what it “owns.” It is an indication of risk. (Same for Times Interest Earned.) A higher coverage ratio means the company has its debt “covered” to a better degree with what it owns.
4. Total Debt to Total Assets Ratio - a ratio greater than 50% would indicate trouble.
5. Gross Profit Margin – look to industry standards
6. Net Profit Margin – look to industry standards
7. Return on Equity - anything less than your cost of capital, you are in trouble.

Note

Calculate Cost of Goods Sold (COGS) and Gross Profit Margin for a Department or Division the same as for the Company:

Take company (department) *beginning inventory*; add *purchases*; subtract *ending inventory*, the difference equals *what was used during the period in production of sales* (Cost of Goods (COGS)).

Calculate Gross Profit Margin for the Company or Department or Division:

Take the sales for the Company, Department or Division, subtract **COGS**, equals **Gross Profit**. Divide **Gross Profit** by **Sales**, equals **Gross Profit Margin %**.

The above is useful in managing specific projects, departments or measuring results from enterprises.

Best of luck in all your endeavors and we hope you found this guide useful. Contact us with any questions or suggestions and see the last page for permission to reprint and educational purposes.

Timothy L. Rhine

Selected Glossary

- Accounting Equation – (Assets = Liabilities + Equity)
- Asset Utilization – measurement of the use of assets in a business showing the return you are getting on what you own.
- Assets – resources a business owns or controls that are expected to provide current and future benefits to the business.
- Balance sheet – a financial statement that lists types and dollar amounts of assets, liabilities, and equity at a specific date.
- Cash flow statement – a financial statement that lists cash inflows (receipts) and outflows (payments) during a period; arranged by operating, investing, and financing.
- Cost of Goods – cost of inventory sold to customers during a period
- EBITDA – a measure of profitability standing for: earnings before interest, taxes, depreciation, and amortization.
- Equity – owner's claim on the assets of a business
- Expenses – outflows or using up of assets as part of operations of a business to generate sales.
- Financial statement(s) – includes the balance sheet, income statement, statement of owner's (or stockholder's) equity, and statement of cash flows.
- Gross Profit (Margin) – net sales minus cost of goods sold
- Income statement – a financial statement that subtracts expenses from revenues to yield a net income or loss over a specified period of time; includes any gains or losses.
- Industry Benchmarks – published information available through universities, trade groups, and other surveys, which display an industry's financial and operational data, includ-

ing revenues, expenses, financial ratios and other information, allowing a basis for comparison with your own business.

- Liabilities – creditors' claims on an organization's assets; involves a probable future payment of assets, products, or services that a company is obligated to make due to past transactions or events.
- Liquidity – the availability of resources to meet short term cash requirements.
- Market Value – the price at which stock is bought and sold.
- Net Profit – amount earned after subtracting all expenses necessary for and matched with sales for a period.
- Profitability – a company's ability to generate an adequate return on invested capital.
- Ratio Analysis (Percentage Analysis) – the determination of key relations between financial statement items in numerical measurements.
- Solvency – a company's long-run financial viability and its ability to cover long-term obligations.

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