CHARTERED PROFESSIONAL ACCOUNTANTS

Financial Survival for Entrepreneurs

An Educational Session sponsored by the Chartered Professional Accountants of Canada (CPA Canada)

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Agenda

- Introduction
- Managing growth and expansion
- The key numbers to understand and monitor
- Statement of Cash Flows
- Doing the math: the ratios that make or break you
- Group session: Scarves of the North case study
- Effective tax strategies
- Financing: The big league
- Tools and Resources
- Closing Q&A

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Introduction

As defined by Industry Canada:

- Small business has one 1 to 99 employees
- Medium businesses have 100 to 499 employees
- Large businesses have 500 employees or more

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The key numbers to understand and monitor

The VITAL KEY is good, accurate monthly bookkeeping.

Remember the key figures need to be compared to:

- The prior period (if applicable)
- Budget for this year
- Competitors

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Revenue (Sales) Gross Profit

- **Sales** is the amount invoiced to customers or clients excluding sales taxes, such as GST/HST or provincial sales tax
- **Gross profit**
  Sales – cost of sales (materials and wages) = gross profit

Profit and Loss Statement

Sales Activities	
Revenue	$100,000
Cost of Goods Sold	$36,000
Gross Profit	$64,000

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Expenses

- Operating
- Administration
- Selling
- Marketing
- Depreciation

Profit and Loss Statement

Sales Activities	
Revenue	$115,000
Cost of Goods Sold	$36,000
Gross Profit	$79,000
Expenses	
Operating	$15,000
Administration	$4,000
Selling	$20,000
Marketing	$15,000
Depreciation	$5,000
Total Expenses	$59,000
Operating Profit	$20,000

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Operating Profit & EBITDA

Operating Profit

The profit earned from regular business operations, excluding interest and taxes

EBITDA

Earnings before interest, taxes, depreciation and amortization

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Net income before tax

This is the "bottom line," what is left after all expenses have been deducted from revenues.

Profit and Loss Statement

Sales Activities	
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Cost of Goods Sold	$36,000
Gross Profit	$79,000
Expenses	
Operating	$15,000
Administration	$4,000
Selling	$20,000
Marketing	$15,000
Depreciation	$5,000
Total Expenses	$59,000
Operating Profit	$20,000
Interest	$4,000
Other	$0
Net income before tax	$16,000

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Statement of Cash Flows

- Cash flow differs from net income
- Understand the timing of how cash in and out can affect your requirement for a bank loan
- Inflows minus outflows

Cash at Beginning of Period	$17,000
Cash Received	
Operating Activity	
Cash Sales	$5,000
Credit/Debit Card Collections	$10,000
Customer Payments	$75,000
Total Operating Activity	$90,000
Financing/Asset Activity	
Loan Proceeds	$32,000
Owners' Investment	$13,000
Asset Sales	$0
Total Financing/Asset Activity	$45,000
Total Cash Received	$135,000

Cash Paid	
Operating Activity	
Inventory Purchases	$26,000
Operating Expenses	$39,000
Interest	$4,000
Income taxes	$6,000
Total Operating Activity	$75,000
Financing/Asset Activity	
Loan Payments	$2,000
Dividend/Owner Payments	$0
Asset Purchases	$50,000
Total Financing/Asset Activity	$52,000
Total Cash Paid	$127,000
Cash at End of Period	$25,000

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Statement of financial position

Accounts receivable aging

A listing of the total amount each customer owes (including taxes like GST and HST) by how old the invoices are

Accounts payable aging

A listing of how much you owe each of your suppliers

- avoid late payment charges/take advantage of early payment discounts
- can mean the difference between a profit and a loss

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Doing the math:
The key ratios that make or break you

Gross profit margin –
Equals gross profit (sales less cost of sales) divided by revenue or sales

Profit Margin ***(after paying for goods sold)***	
Monthly Gross Sales (Revenue)	$20,000
Minus Cost of Goods Sold	– $9,000
Gross Profit	$11,000
Gross Margin ($11,000/$20,000)	**55%**

Operating profit margin –
Equals profit excluding interest and taxes divide by revenue or sales

Profit Margin ***(after paying for goods sold & operating expenses)***	
Monthly Gross Sales	$20,000
Minus Cost of Goods Sold	– $9,000
Minus Operating Expenses	– $5,000
Operating Profit	$6,000
Operating Margin ($6,000/$20,000)	**30%**

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Current ratio

Equals total current assets divide by total current liabilities.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\frac{\$60{,}000}{\$35{,}000} = 1.7$$

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Quick ratio (acid-test or liquidity)

Equals current assets less inventory and prepaid expenses divided by total current liabilities

$$\text{Quick Ratio} = \frac{\text{Current Assets} - (\text{Inventory} + \text{Prepaids})}{\text{Current Liabilities}}$$

$$\frac{\$40,000}{\$35,000} = 1.1$$

A healthy business has a quick ratio of at least 1.0.

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Accounts receivable turnover

Equals net credit sales divided by average accounts receivable (average of your last two years accounts receivable balance)

$$\text{Accounts Receivable Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

$$\frac{\$200,000}{\$20,000} = 10$$

365 / 10 = Age of 36.5 days

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Debt-to-equity ratio

Equals total liabilities divided by equity (or shareholders' equity if incorporated)

$$\text{Debt to Equity} = \frac{\text{Total Liabilities}}{\text{Owners' Equity}}$$

$$\frac{\$60{,}000}{\$100{,}000} = 0.6$$

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Case Study: *Scarves of the North*

- Split up into groups
- Review the case, analyze the numbers
- Answer the questions on the handout
- Remember to think "beyond the numbers" as to why the company is where it is
- We will then take up the case

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Case Study: *Scarves of the North* (Analysis)

- **Revenue has grown but by lower amounts and percentages as follows:**
  - Year 2: $5,600 (160%)
  - Year 3: $5,350 (59%)
  - Year 4: $5,100 (35%)
- **Gross profit margins are declining each year**
  - Year 1: 83%
  - Year 2: 75%
  - Year 3: 69%
  - Year 4: 65%

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Case Study: *Scarves of the North* (Analysis)

- **Expenses have increased significantly over the 4 years**
  - Admin from $300 to $6,000
  - Salaries from $0 to $7,000
  - How much longer can Fred afford losses?
- **Non-financial analysis**
  - Increased competition from “knock-offs” from overseas
  - Should the company expand from just scarves?
  - Is this a viable business?

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Effective Tax Strategies

- Corporate income tax rates
- The salary/dividend decision – Integration/CPP/RRSP
- Be wary of management fees
- Income splitting – salary
- Deferring taxes with a bonus

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Managing growth and expansion

Are you ready? Ask yourself these 4 key questions:

1. Is there increasing demand for my product or service?
2. Does my company have the right skill sets and resources?
3. What additional costs will be involved?
4. Will the expansion increase the bottom line?

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Financing: the Big League

- What major lenders/investors look for
  - The proposal
  - Numbers they want to see
- Sources of investment
  - Banks
  - Private lenders
  - Crowd funding

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Tools & Resources

- Innovation, Science and Economic Development Canada: Business and industry
  canada.ca/en/services/business.html
- Tips on growing your small business entrepreneur.com/grow
- 5 essential principles for growing your small business
  fastcompany.com/3004395/5-essential-principles-growing-your-small-business
- Information on business development programs
  innovation.ised-isde.canada.ca/s/?language=en_CA
- Canada Revenue Agency (registration, tax, GST/HST etc.)
  canada.ca/en/revenue-agency/services/tax/businesses/small-businesses-self-employed-income.html

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Tools & Resources

- Federal Scientific Research and Experimental Development Tax Incentive program
  canada.ca/en/revenue-agency/services/scientific-research-experimental-development-tax-incentive-program.html
- The Canada Venture Capital and Private Equity Association cvca.ca
- Video: 5 ways to achieve sustained growth
  (Business Development Bank of Canada)
  cpacanada.ca/flbdc
- 9 ways to avoid being crushed by your rapid business growth (Business Development Bank of Canada)
  cpacanada.ca/flbdc

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Questions?

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