Financial Planning

by Sophia

WHAT'S COVERED

How do you know where you are financially? Back in the day, people used checkbooks to track how much money they had, and how much money was going in and out. What are the tools that a business can use to make sure that they are where they need to be financially? This tutorial will cover the topic of financial planning. Our discussion breaks down as follows:

1. Having a Plan

Now, having a financial plan is something that financial managers spend a lot of their time doing. They look at current financials, or what is happening right now, as compared to the organization's goals. They will use this information to anticipate requirements for finances or cash, as well as evaluate possible risks that they may be exposed to along the way.

DID YOU KNOW

Not having a realistic financial plan is one of the key reasons that small businesses fail.

The following are three different types of reports, called financial statements, that are created during a financial planning process:

- Balance sheet
- Income statement
- Statement of cash flows

Together they help a business see their finances from different angles.

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2. Balance Sheet

A **balance sheet** is a ledger that compiles the holdings, liabilities, and funds, detailing the income and expenditures of an organization during a specific point in time. Basically, it reflects a snapshot of a business at a single point in time.

Now, being a snapshot of a company's financial condition, a balance sheet is useful because it gives current and short term information. Some of the details included on a balance sheet are a company's assets, liabilities, and owner's equity.

Balance Sheet Details	Description
Assets	Items that are solid, such as a building, or abstract, like a brand, that can produce value and/or add monetary value to a business. There are three types of assets: **Current*: Cash, or anything that could be converted quickly into cash within a year. This is known as liquidity, or having a liquid asset. **Fixed*: Things with long term value—like land or building equipment—that can decrease, because they wear out (also known as depreciation). **Intangible*: Future expected monetary value of assets, coming from assets such as patents, copyright, goodwill, or brand recognition, or the abstract idea of a brand mentioned above.
Liabilities	Items that are a present burden. There are two types of liabilities: **Current:* Debts that are payable within a year, such as your phone bill, rent, or employee salaries for a company. **Long term:* Debts that are payable in longer than a year, such as mortgage loans.
Owner's equity	A mathematical formula indicating the owner's contributions to the organization, minus the liabilities of the organization. This concept is represented by the **accounting equation**, which states that assets is equal to liabilities and owner's equity; (A = L + OE)

Let's take a look at a typical balance sheet that reflects the total for one year, ending December 31, 2018.

Balance Sheet			
31-Dec-18			
Assets		Liabilities	
Current Assets		**Current Liabilities**	
Cash	$40,000	Accounts Payable	$20,000
Accounts Receivable	$20,000	Short Term Notes	
(less doubtful accounts)		Current Portion of Long Term Notes	$10,000
Inventory	$100,000	Internal Payable	$100,000
Temporary Investment		Taxes Payable	$40,000
Prepaid Expenses	$10,000	Accrued Payroll	$100,000
Total Current Assets	**$170,000**	**Total Current Liabilities**	**$270,000**
Fixed Assets		**Long Term Liabilities**	
Long Term Investments	$20,000	Mortgage	$20,000
Land	$100,000	Other Long Term Liabilities	
Buildings	$50,000	**Total Long Term Liabilities**	**$20,000**
(less accumulated depreciation)			
Plant and Equipment	$40,000		

(less accumulated depreciation)			Shareholders' Equity	
Furniture and Fixtures	$10,000		Capital Stock	
(less accumulated depreciation)			Retained Earnings	$100,000
Total Net Fixed Assets	**$220,000**		**Total Shareholders' Equity**	**$100,000**
Total Assets	**$390,000**		**Total Liabilities and Equity**	**$390,000**

As you can see below, the balance sheet has assets on one side and liabilities and owner's equity on the other. Notice how the assets are listed as both current assets (short term concerns like cash and accounts receivable) and fixed assets (long term, permanent things). At the bottom, you can see the total assets for that column.

On the other side, you can see liabilities, both current (such as accounts payable or short term notes) and long term (like the mortgage). Everything else is owner's equity.

BIG IDEA

Notice that assets are equal to liabilities plus the owner's (in this case, shareholder's) equity, which is the definition of the accounting equation. You can see this in practice on the balance sheet.

TERMS TO KNOW

Balance Sheet
A ledger that compiles the holdings, liabilities and funds; laying out the income and expenditures, of an organization during a specific point in time.

Assets
Items that are solid (such as a building) or abstract (such as a brand) that can produce value and/or adds monetary value.

Liability
An item that is a present burden.

Owner's Equity
This is a mathematical formula indicating the owner’s contributions to the organization minus the liabilities of the organization.

Accounting Equation
Assets is equal to the liabilities and owner’s equity; (A = L + OE).

3. Income Statement

An **income statement** is a little different. This is a report reflecting the income (R, or revenue), minus the expenses (E) for a set period of time—say, a year or a quarter, for instance. Sometimes it's referred to as R minus E equals P or L, which stands for revenue minus expenses equals profit or loss.

An income statement includes items like **revenue**, which is the money acquired by an organization during a specific period of time. It also includes the cost of goods sold, or COGS, which encompasses all the costs that are associated with getting a good to market. Lastly, it includes the operating expenses, or OE, which are additional costs, besides the production of an actual item, that a company incurs.

Essentially, an income statement is the profit and loss statement that shows the bottom line for that particular period of time. It allows you to see how you're doing today, as well as how you're performing compared to last year or last quarter. Are you performing better or worse?

Here is an example of an income statement for the years ending December 31, 2018, and December 31, 2017.

Income Statement		
Your Company, Inc. For the Years Ending Dec. 31, 2018 and Dec. 31, 2017		
	2018	**2017**
Revenue		
Sales Revenue	$220,000	$195,000
(Less Sales Returns and Allowances)	($67,000)	($130,000)
Service Revenue	$80,000	$60,000
Interest Revenue	$20,000	$15,000
Other Revenue	$10,000	$2,000
Total Revenue	**$263,000**	**$142,000**
Expenses		
Advertising	$1,000	($1,000)
Bad Debt	$4,000	($2,000)
Commissions	$2,000	($1,000)
Cost of Goods Sold	$65,000	($63,000)
Depreciation	$0	0
Employee Benefits	$3,000	$4,000
Furniture and Equipment	$2,000	$8,000
Insurance	$200	$300
Interest Expense	$4,200	$5,200
Maintenance and Repairs	$4,000	$3,000
Office Supplies	$200	$300
Payroll Taxes	$5,000	$400
Rent	$3,000	$5,000
Research and Development	$6,000	$4,000
Salaries and Wages	$65,000	$55,000
Software	$4,000	$3,000

Travel	$1,000	$4,000
Utilities	$2,000	$2,000
Web Hosting and Domains	$300	$100
Other	$17,460	$16,500
Total Expenses	**$189,360**	**$43,800**
Net Income Before Taxes	**$73,640**	**$98,200**
Income Tax Expense	($14,936)	($9,920)
Income from Continuing Operations	**$58,704**	**$88,280**

You can see at the top, the company has a lot of different kinds of revenue—sales revenue, service revenue, interest revenue, etc. They also have a lot of expenses. One is the cost of the goods, which is everything it takes to get the goods to market directly. Other expenses include operating expenses, like salaries and commissions for sales, administrative expenses, payroll taxes, rent, etc.

When you subtract the expenses from the revenue, then you get the net income before taxes. If you subtract the income tax expense, you get the final net income.

TERMS TO KNOW

Income Statement

A report reflecting the income (R/ revenue) minus the expenses (E) for a set period of time; (R - E = P or L).

Revenue

The money acquired by an organization during a specific period of time.

4. Statement of Cash Flows

The **statement of cash flows** reflects how much cash you have on hand at any given time. Net income or loss can be very different than the amount of cash that you have. A statement of cash flows is a report reflecting the amount of revenue created and spent during a specified period of time. Investors want to see this to ascertain the health of the company. It is required by the Securities and Exchange Commission for any company that has its stock publicly traded.

Negative cash flow is referred to as being "in the red," and this is a cause for concern. This means that the business may be failing or perhaps reflecting a seasonal fluctuation, if you have a seasonal item like Christmas trees, for instance. Basically, negative cash flow means that you are laying out more cash than you're bringing in, and your bank account is getting smaller and smaller.

Positive cash flow, on the other hand, is called being "in the black." This is generally considered good, but may not always indicate a company making or exceeding its financial goals. For instance, you might be making money, but are you doing it at the same rate that you want to, according to your plan?

The statement of cash flows reflects cash from three different areas:

- *Operations:* This is money used to buy and sell goods and services.
- *Investing:* This is money used to buy and sell the long term assets such as equipment, building, or stocks or bonds that the company benefits from.
- *Financing:* This is money from borrowing and issuing one's own stock, paying dividends, or perhaps repurchasing shares of stock within the company.

Let's take a look at a statement of cash flows that reflects the time period of January 1 through December 31 of 2018.

Statement of Cash Flow	
Happy Company, Inc.	
For the Year Ending	12/31/18
Cash at Beginning of Year	**$16,700**
Operations	
Cash Receipts from Customers	$690,000
Cash Paid for:	
Inventory Purchases	($254,000)
General Operating and Administrative Expenses	($111,000)
Wage Expenses	($133,000)
Interest	($15,500)
Income Tax	($42,800)
Net Cash Flow From Operations	**$133,700**
Investing Activities	
Cash Receipts from Customers:	
Sale of Property and Equipment	$37,600
Collection of Principal on Loans	$6,800
Sale of Investment Securities	$10,000
Cash Paid for:	
Purchase of Property and Equipment	($75,000)
Making Loans to Other Entities	($14,000)
Purchase of Investment Securities	($12,000)
Net Cash Flow From Investing Activities	**($46,600)**
Financing Activities	
Cash Receipts from Customers:	
Issuance of Stock	$5,500

Borrowing	$6,000
Cash Paid for:	
Repurchase of Stock (Treasury Stock)	$0
Repayment of Loans	($34,000)
Dividends	($53,000)
Net Cash Flow From Financing Activities	**($75,500)**
Net Increase in Cash	**$11,600**
Cash at End of Year	**$28,300**

Notice the cash flow from operating expenses, investment activities, and financing activities—things like cash received from customers or issuing stock, or cash paid for capital assets.

For this particular company, you can see that the cash balance at the end of the period was positive. They started off with $16,700 and at the end of the period, they had $28,400—they almost doubled their cash during this period.

TERM TO KNOW

Statement of Cash Flows

A report reflecting the amount of revenue created and spent during a specified period of time.

SUMMARY

Today we learned about planning for a business's financial future, and the importance of **having a plan**. We also learned about **common reports**—the **balance sheet**, the **income statement**, and the **statement of cash flows**—that are vital for a business to understand where they stand financially.

Good luck!

Source: adapted from sophia instructor james howard

TERMS TO KNOW

Accounting Equation

Assets is equal to the Liabilities plus Owner's Equity; (A = L + OE)

Assets

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Balance Sheet

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