A Guide to Financial Literacy by Rise

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Empowering people
Launching ideas

Contents

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Introduction

The Financial Literacy toolkit presents a list of definitions that may help you understand basic accounting concepts. The examples and case questions are presented to illustrate the concepts and provide practical explanations. Use the table of contents to navigate to the definitions and concepts you would like to read about. The points presented in bold font and marked by an arrow are the most important concepts to know.

List of definitions:

Sales forecast

Sales forecast, also called sales projection, is **a process of estimating what business sales are going to be in the future.**

- Timing: it can be done monthly, quarterly, semiannually, annually. (Note: for the Rise loan application, it has to be done monthly)
- **Purpose: provides a business owner with a solid idea of future sales to help manage inventory, cash flow, or their growth plan effectively and make appropriate business decisions.**
- Process: use the Rise cash flow template and follow the steps to create a sales forecast.

Cash flow (in & out)

Cash flow is the **money moving in and out of your business.**

- Cash in: money coming from sales to the clients and customers, loans, and owner's contributions to the business.
- Cash out: money paid for expenses (e.g. advertising, rent, equipment, etc.), and other cash outs such as loan payments and owner's draw.
- Process: use the Rise cash flow template and follow the steps to create cash flow projections.
- **Important: monitor cash flow regularly because cash is the most important thing for the business's survival.**

Income Statement

Income statement (also known as a profit and loss statement) is a financial statement. **It reports revenues earned less expenses (paid by a business), resulting in profit or loss for a period of time (usually month or year).**

An income statement shows us if the business is profitable. The careful analysis of revenues and expenses in the income statement helps a business owner make business decisions.

The income statement's main parts are revenue, income, cost of goods sold or direct costs, and operating expenses.

Revenue/Income/Loss

- Revenue = Sales. It is the total amount of money the business receives from the sales of goods/services. It is the top line of the income statement.
- **Net Income = Profit. It is the amount of money that remains after deducting all expenses from revenue. It is the bottom line of the income statement.**
- Loss happens when nothing remains after deducting expenses from sales, i.e. expenses are more than revenue.

Cost of goods sold (Direct costs)

- **Manufacturing/Producing business: the cost of goods sold (COGS) refers to the direct costs of producing the goods or providing the service (cost of labour, materials, and any expenses that are incurred to produce goods and supplies used in providing a service)**
- **Retail business: COGSrefers to the cost that a company of the product it sells.**
- Items **not included** in COGS:
  - Manufacturing overhead – business expenses not directly connected to creating a product/service (e.g. maintenance and equipment repairs).
  - Sales & marketing costs – costs necessary to secure customer orders and get finished product or service to a customer.
  - Administrative costs – costs that are spent on the general administration of the business (e.g. accounting or legal expenses).
- Inventory calculation for COGS = Beginning inventory + Purchases during the year – Ending inventory

Example:

ABC Inc. is in the retail business selling shoes. The company buys shoes in bulk from a supplier for $25. At the beginning of the year, the company had 30 pairs of shoes. During the year, ABC Inc. purchased 450 more pairs. At the end of the year, an inventory check showed 80 pairs of shoes on hand. What is the cost of goods sold?

Beginning inventory (30 pairs x $25)	$ 750
Add: Purchases during the year (450 pairs x $25)	11,250
Less: Ending inventory (80 pairs x $25)	2,000
Cost of goods sold	$ 10,000

Operating expenses

Operating expenses are **expenses a business incurs through its normal business operations.** They are costs the company will have to incur even if there are no sales.

- Examples: rent, advertising, equipment, interest, payroll, etc.

- Operating expenses are unavoidable but can be reduced to increase net income.
- **Important: analyze operating expenses regularly to maintain the balance.** Spending too much on costs may reduce your income and not necessarily increase sales. Spending too little may hinder the business performance.

Example of Income Statement

ABC Inc. Income Statement January 1 - December 31, 2020		
Sales		$ 30,000
Cost of Goods Sold		(10,000)
Gross Profit		20,000
Operating Expenses		
Rent	$ 5,000	
Utilities	450	
Advertising	150	
Salaries and Wages	4,000	
Total Operating Expenses		(9,600)
Net Income		$ 10,400

Balance Sheet Statement

Balance Sheet Statement (also called statement of financial position) is the financial statement that **reports the company's financial position at a point in time** (usually at the end of the month or year). It lists types and dollar amounts of assets, liabilities and equity.

Balance Sheet helps a business owner to analyze the health of the business by calculating various ratios.

The main parts of the Balance Sheet are Assets, Liabilities and Equity.

Business Assets

A business asset is an item of value owned by a company.

Business assets are presented on the balance sheet statement and are usually divided into current assets and capital assets.

Current assets (include all assets that are expected to be sold, collected or used within one year of the operating cycle):

- Cash - money received from sales in the form of real cash money or money on checking/saving account
- Accounts receivable - money the customers owe for goods/services they received but have not paid for yet

- Inventory - for a retail business: inventory is goods the company owns for sale to the customers. For manufacturing/producing business: inventory is raw materials used to produce goods for sale. It may be partly finished or finished goods the business produced for sale

Capital assets = Property, plant and equipment (include all assets that business owns and can use for more than one operating cycle to sell products/services):

- Equipment - computer, machinery, vehicles, printer, etc. bought for business use and used for several years

Capital assets wear out over time or become obsolete, as opposed to supplies, which get used up.

Liabilities (Accounts payable, financing)

Liabilities are debts or obligations of a business.

Liabilities are presented on the balance sheet statement and are usually divided into current and non-current liabilities.

Current liabilities (debts that are paid within one year of the operating cycle):

- Accounts payable – money the company owes suppliers for goods/services provided but not paid for yet
- HST collected and payroll deductions that must be remitted to the government
- Unearned revenue – money received from customers for goods/services that have not been provided yet. It may be in the form of a deposit the business charge a client

Non-current liabilities (debts/loans that are due longer than one year of operating cycle)

- Example: bank loan or Rise loan that has a loan term of more than a year.

Equity

Equity is represented on the balance sheet. **Equity is the value of the entire business.** In other words, what the business owner would get if all assets were sold and liabilities paid.

Calculation: Equity = Assets – Liabilities

Example:

Look at the balance sheet of ABC Inc. below.

Total Assets	$ 6,300
Less Total Liabilities	2,700
Equity	$ 3,600

Example of a Balance Sheet

ABC Inc. Balance Sheet 31-Dec-20		
Assets:		
Current Assets:		
Cash	$ 3,000	
Accounts Receivable	500	
Inventory	2,000	
Total current assests		$ 5,500
Proprety Plant and Equipment		
Computer	1,000	
Less: Accum. Depr'n - Computer	(200)	
Total Property, Plant and Equipment		800
Total Assets		$ 6,300
Liabilities and Shareholder's Equity		
Current Liabilities:		
Accounts payable	$ 1,500	
Unearned revenue	100	$ 1,600
Non-current Liabilities:		
Rise Loan		1,100
Total Liabilities		2,700
Equity		
Owner's capital		3,600
Total Liabilities and Shareholder's Equity		$ 6,300

As you can see, Assets are equal to Liabilities plus Equity. That's because assets can only be purchased in one of two ways: either through debt (liabilities) or with cash the business has (equity).

Cash Flow Statement

Cash flow statement is a financial statement that reports the sources and uses of cash for the reporting period and the amount of cash available at the beginning and the end of the reporting period.

The business must carefully manage cash to survive and prosper.

Calculation:	ABC Inc. example:
Cash In	2,850
- Cash Out	945
= Net Cash	1,905
+ Opening Balance	1,695
= Closing Balance	3,000

Example of Cash Flow Statement

ABC Inc. Statement of Cash Flows For the Month Ended 31-Dec-2020			
Cash flows from opertaing activities			
Cash received from clients	$ 2,850		
Cash paid for rent	(500)		
Cash paid for utilities	(45)		
Cash paid for salaries and wages	(400)		
Net cah provided by operating activities		$ 1,905	
Cash flows from investing activities			0
Cash flows from financing activities			
Withdrawal by owner		(600)	
Net increase in cash		1,305	
Cash balance, December 1		1,695	
Cash balance, December 31		$ 3,000	

Bookkeeping vs Accounting

Bookkeeping is the process of recording financial transactions either manually or using the software.

Accounting involves bookkeeping but also much more. Accounting includes providing reports on the company's activities, analyzing financial statements, consulting, planning and other financial services.

It is very important for a person starting their business to set up accounting books from the inception of the business and do bookkeeping regularly. It helps understand and maintain the company's financial health, expenses, invoices, etc. The new business owner needs not only to keep track and record financial transactions but also keep receipts and other documentation as it will be used in preparation for the income tax return filing.
Failure to set up the books and do regular bookkeeping may have different consequences: inability to assess the business's profitability, access financing (grants and loans), etc.

Payroll

Payroll is the process of recording and paying employees' salaries, wages and any corresponding taxes.

Payroll includes:

- Calculating employee earnings for the pay period
- Calculating EI and CPP employee deductions and employer contributions, WSIB, federal and provincial taxes
- Distributing employee paychecks
- Remitting the amount of collected taxes to the government
- Keeping all financial records of employees in order
- Issuing T4s to employees and a T4 Summary to CRA by the end of February each year

Sales Tax

In Canada, sales taxes include Provincial Sales Tax (PST), Goods and Services Tax (GST) and the Harmonized Sales Tax (HST). HST is a combination of PST and GST.

Some provinces adopted HST, while others charge GST, PST or both. The rates differ from province to province. **It is important to collect and pay correct sales tax when the business sells to and buys from various provinces.**

A business may voluntarily register for GST/HST if it has taxable sales and does not exceed the $30,000 revenue threshold over any consecutive 12 month period. **The registration is obligatory by the time if the company exceeds the $30,000 threshold in such a period.**

Income tax

Business owners have to provide information about their business income and expenses to determine the income tax payable. The calculation of tax owed, deadlines, and filling process is different for sole proprietorships and corporations.

- Sole proprietorship/partnership: business income and expenses are included in the owner's personal tax return (Form T2125). The filing deadline is June 15, but any tax owed is due April 30.
- Corporation: file 2 tax returns – one for the corporation, one for the business owner. The filing deadline for corporations is 6 months after fiscal year-end (tax year-end), but the balance of tax payable is due 2 or 3 months after fiscal year-end (tax year-end).

Analysis of financial data

Break-even analysis

The break-even point is the point when profit is zero or, in other words, when total sales equal total expenses. **This analysis can help business owners understand how many items of products/services should be produced to break even and start making a profit.**

Break-even point in units sold = Fixed expenses / (Price per Unit – Cost per Unit)

Example:
During the year, ABC Inc. incurred $9,600 in fixed expenses. The company buys shoes in bulk for $25 and sells for $75.
Break-even point in units sold = 9,600 / (75 – 25) = 192
It means that ABC Inc. need to sell 192 pair of shoes to cover all fixed expenses and start making a profit.

Profitability ratios

Ratios are usually used for the analysis of the financial performance of the company. They can be used to measure profit from sales, assets use, or how fast inventory or accounts receivable can be turned into cash. The main purpose of such analysis is to provide valuable information to the business owner and assist with decision-making.

Some of the ratios that might be useful are sales margin, return on asset, current ratio.

Profit margin

Profit margin is used to assess the company's pricing policies and cost control. It answers the question: **"Is the price charged for products/services enough to cover all the cost?"**

Profit margin = Net income / Sales.

The result represents the percentage of net income that comes from sales, i.e. how much is earned after all costs are paid.

Example:
ABC Inc.'s income statement shows $10,400 of net income and $30,000 of sales.
Profit margin = 10,400 / 30,000 = 35%.
This means that 35% of sales provide net income. The rest is paid for expenses and cost of products.

Gross profit margin

Gross profit margin is also sometimes called sales margin. This ratio helps identify a relationship between variable costs and sales. It answers the question: **"What percentage of the price is left after the product's variable costs are paid?"**

Sales margin = (Sales – Cost of goods sold) / Sales.

Example:
ABC Inc.'s income statement shows $10,000 of COGS and $30,000 of sales.
Sales margin = (30,000 – 10,000) / 30,000 = 67%.
This means that 67% of sales left after the costs of products are paid.

Return on asset

Return on asset ratio (ROA) helps us understand how efficiently assets of the company are used.

ROA = Net income / Total assets

The higher the percentage of ROA, the better business utilizes its resources.

Example:
ABC Inc.'s' income statement shows $10,400 of income, and the company's assets are $6,300 (from the balance sheet)
ROA = 10,400 / 6,300 = 165%
This means that the company is very efficient in utilizing its resources.

Financial Statement Audit

An audit is a review of financial statements by an independent auditor. As a result of the review, an auditor provides a report stating that information in financial statements is presented fairly and correctly.

Purpose: to add credibility to the information presented in financial statements. Banks, other lenders and some suppliers may require an audit of the company's financial statements before providing a loan or extending credit on supplies purchases.

Case studies and examples

Case 1

A business owner wants to purchase a new piece of equipment to increase their production and increase sales two times. What should they consider before doing it?

First, the business owner needs to estimate the price of new equipment and whether the company can afford to buy it or needs to seek financing (loan).

Then, the business owner can think about additional costs associated with this decision. For example,

- Will the company pay more utility bills to run the equipment?
- Is there training needed to run the equipment?
- Is there a demand for increased production?
- If not, what will the costs of the promotion activities be to increase demand and sales?
- If the loan is needed, what will be payments and interest?
- What will be the tax implications? (Note that the cost of the equipment is a capital expense and is not included in the tax return as a deduction. Besides, the increased sales would probably mean increased tax owed. It should be included in consideration and cash flow.)

Based on these answers, the new sales projections and cash flow need to be done to estimate how viable this investment is.

Example:

Tom Jones is a web and graphic designer. He recently learned about a new piece of computer equipment that can help him provide better and faster services to his clients, and Tom considers buying it. The equipment costs $2,000, and it will increase Tom's average monthly revenues by $500. This equipment uses different software from what Tom is using now, so he will need to spend some time learning to use it. Looking at his financial statements, Tom understands that he would need to apply for a loan. If he applies to Rise, his monthly payment for the loan will be $87.70 for the period of 2 years. Tom has enough clients now, but he anticipates that he will need to run a promotional campaign to attract new clients if he buys new equipment. Should he buy it?

Looking at the numbers, Tom should buy the equipment. It seems that the increase in sales is big enough to cover all the extra expenses. Note: this is assuming that advertising is working and attracts new customers. It is essential to analyze the results the new equipment had on financial statements after a month or a quarter after the purchase.

Cash in	Average sales increase	$ 500
Cash out	Training	(100)
	Loan payment	(87.70)
	Advertising and promotion	(200)
	Balance	$ 112.30

Case 2

It's the end of the fiscal year. The business owner examines whether or not the 1-year contract paid to a social media consultant was worth it. How should the owner determine whether or not to renew this opportunity?

The best way to see if the investment brought the desired return is to look at the financial statements and compare them with the last year's results. This is called trend analysis.

The main result of promotional activities is the increase in sales. Comparing this year's income statement with the last year will show how much the sales and advertising costs increased.

Comparison of the profit margin ratios will also help see how this contract impacted the net income. If the profit margin increased, it means that the company's revenue increased enough to cover increased costs to cover the consultant's fees and earn income.

Example:

Anne paid a social media consultant $5,000 for the year. At the year-end, Anne notices that her sales increased from $25,000 to $28,000, while her profit margin decreased from 30% to 28%.

From this information, it seems that the expense on consultant's services was higher than the increase in revenue. $5,000 was paid, but only $3,000 additional revenue was earned. The decrease in profit margin ratio also signals that this investment was not successful enough.

After considering these points, Anne decides not to renew the contract and instead look for other ways to increase revenue.

Case 3

A business currently relies on friends and family for labour help but wants to start hiring. Previously they paid out honoraria/cash as a thank you, but now they need to think about proper employment. Besides the payroll costs and other elements associated with hiring, what else should they consider when trying to decide whether or not to make this leap?

Hiring decisions are not the easy ones to make when running a business. A business owner needs to look at multiple factors to understand if it is worth it. From the financial perspective, the total costs of officially hiring employees can be pretty high. Some of the costs that increase employer's expenses are:

- CPP and EI expenses
- WSIB
- Vacation pay
- Additional Equipment
- Uniforms
- Training
- Increased bookkeeping/accounting costs

If friends and family are helping now from time to time, official employees would need their hours set regularly. The demand for products and services should be analyzed to understand if it is viable to have an employee on-site during their regular hours. For example, it is justified to have an employee on-site if a small retail shop is busy every day of the week. If the shop is busy only on weekends, there might be no need to keep an employee in-store during the weekdays.

Assuming that there is enough customer traffic to justify employee's regular working hours and the sales are enough to cover additional costs, official hiring is a great way to start growing your business.