

How to Analyze Financial Statements to Maximize Profitability & Minimize Risk



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Being able to interpret financial statements is particularly critical in a manufacturing business. The financial statements give valuable information regarding where a company has been and can help visualize a path for the next steps a company should take. Here are a few specific things to keep in mind when analyzing your financial statements:

The Basics:

What Are Your Financial Statements Telling You?

Many small companies find the income statement (P/L) to have the most valuable information, however, the balance sheet and the statement of cash flow can help fill the entire picture that is necessary to run your business and enable real decision making.

“A Snapshot”

Some describe the balance sheet as a “snapshot” of the company’s financial position at a point (a moment or an instant) in time. The balance sheet presents a company’s financial position at the end of a specified date.

Profitability

The income statement shows the profitability of a company during the time interval specified in its heading.

Cash Generated and Used

The cash flow statement reports the cash generated and used during the time interval specified in its heading.

3 Useful Ratios for Financial Analysis at a Small Manufacturing Company

1. Gross Profit Margin vs Contribution Margin

$$\text{Gross Profit Margin} = \frac{\text{(Revenue - Cost of Goods Sold)}}{\text{Revenue}}$$

Gross profit margin is a profitability ratio that measures how much of every dollar of revenues is left over after paying all cost of goods sold (COGS).

Contribution Margin = Product Revenue - Product Variable Cost / Product Revenue

Contribution margin is the product's price minus all associated variable costs, resulting in the incremental profit earned for each unit sold. The total contribution margin generated by an entity represents the total earnings available to pay for fixed expenses and to generate a profit.

2. Current Ratio

Current Ratio = Current Assets / Current Liabilities

Current ratio is a liquidity ratio that measures a company's ability to pay short-term and long-term obligations. The current ratio is mainly used to give an idea of the company's ability to pay back its liabilities (debt and accounts payable) with its assets (cash, marketable securities, inventory, accounts receivable).

3. Inventory Turnover Ratio

Inventory Turnover = $\frac{\text{Net Sales}}{\text{Average Inventory}}$

The inventory turnover ratio is a measure of the number of times inventory is sold or used in a time period such as a year. The inventory turnover ratio measures how fast a company is selling inventory and is generally compared against industry averages.

Minimize Risk Through Analysis

Key Areas Commonly Overlooked When Analyzing Financial Statements

Fully loaded payroll cost: This is base payroll cost plus employer payroll taxes, workers compensation insurance, and benefits.

Borrowing capacity: This is based on the balance sheet information. Most banks will use the balance sheet more the profit and loss.

Revenue diversification: Is your revenue diversified enough to lower risk? Is there a healthy mix of revenue sources? Try to avoid having all your revenue with one customer or channel.

3-month nut analysis: If you lose all your revenue for three months what are the costs you have to incur to keep your business running. These costs can include but not limited to- rent, payroll for certain production employees, insurance costs, etc.



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