Understanding Your Business's Financial Statements

David Oetken, MBA CPM

Being a successful entrepreneur takes a unique mix of skills and practices. You need to generate exciting ideas, deliver desirable products or services, maintain a winning attitude, set goals, undertake strategic planning and more, all while keeping an eye on the life's blood of your business -- its finances. To track your business's performance and plan effectively for future growth and opportunities, you must have a thorough understanding of how money flows through your business. You'll want to understand the important statements that reveal the company's financial position and how to measure the business's performance using accepted standards. This document offers you straightforward guidance to managing your company's financial information.

The Louisville Small Business Development Center is committed to providing educational resources that help entrepreneurs like you make the most of every busy, rewarding day. Small businesses are the heartbeat of this region's thriving economy, and we're here to help you succeed.

David Oetken, MBA CPM

Director, Louisville Small Business Development Center

AMERICA'S SBDC KENTUCKY

Published by LouPreneur© LLC; Printed By Louisville News Company, LLC

Understanding Your Business's Financial Statements

Please note: This information is not intended to help you prepare your financial statements. Rather, it will help you become familiar with these statements and how you can use them to benefit you and your business.

Business owners, potential lenders and investors need a way to gauge how a company is doing financially. In order to clearly communicate how your business is doing today, how it did in the past month, quarter or year, and how you believe it will do tomorrow, you can use three standard financial statements. The data in these statements illustrates how effective your stewardship of the business is and helps answer questions like these:

- Does your business have a positive cash flow?
- Can you pay your debts in a timely manner?
- Are you making good business decisions?
- Can you afford to take out a loan if you need one, and if so for how much?
- Is your company viable in the long run?

The Three Financial Statements

The following statements are used to record your business's financial information. If you don't prepare them yourself—perhaps you have an accountant who does that for you—you should still take the time to examine them on a regular basis so you always know where your business stands:

- Income Statement—Presents a summary of your businesses income and expenses over a defined period
- Balance Sheet—Lists what your business owns, what you owe and any equity at a point in time
- Statement of Cash Flows—Summarizes the ways in which money comes into and goes out of your business in a defined period

Choosing an Accounting Method

It's important to choose an accounting method and stick with it—this makes your statements consistent and easy to follow. Plus, the IRS requires it. So which method is best for your business, cash or accrual?

Cash accounting means you track all income and expenses when money comes in or goes out:

- You can accurately track your cash flow, because money collected and spent is recorded when those transactions happen.
- This approach does not accurately track long-term income and expenses: for example, if many of this year's sales aren't paid for until the New Year, your cash flow may appear to be negative even though you know the money will be paid.
- Less bookkeeping is involved, because transactions are straightforward and recorded when they happen. For this reason, small businesses often choose this accounting method.

continued on next page

Accrual accounting means you record income when you make a sale, even if the sale isn't paid for immediately. Similarly, you record expenses when you receive goods or services, not when you pay for them:

- This approach does not accurately track your cash flow: for example, you may have made and recorded many sales this year, but if they haven't been paid for yet, your cash flow will appear unrealistically high.
- You can accurately track long-term income and expenses. For the given period, you know your total sales and expenses.
- This approach requires more bookkeeping, because you must record both transaction dates and dates of payment. Businesses often switch to this method as they grow, in order to get a more accurate picture of their overall transactions.

All About Your Balance Sheet

Your business's **Balance Sheet** tells you where your business stands financially at a particular point in time. As of today, or the end of the quarter, or the end of the year, how much does your business own (assets), how much does the business owe (liabilities) and what is the business's equity or net worth (capital)? The Balance Sheet is sometimes called a Statement of Financial Condition.

Your balance sheet lists three things that together give you a picture of your business's financial health:

- **Assets** are property of value that your business owns. Assets can include cash, stock, buildings, land, machinery, equipment, patents and trademarks, accounts receivable (money that people or other companies owe to your business) and so on.

  Assets may be *current* or *non-current.* A current asset is liquid (can be turned into cash in less than a year); these assets include cash and inventory. Non-current assets are less liquid (they can't be converted to cash within a year) and include things like buildings and equipment.
- **Liabilities** are the debts your business owes to other individuals and businesses. Liabilities may be current (due within a year) or long-term.
- **Net Worth, Capital, or Owner's Equity**, is the amount of money the business's owners have invested, as well as profit that has been retained in the business.

Your business's assets are funded by liabilities and equity. Everything you buy must be paid for, and that money can come from outside lenders, business profits or cash from the owners:

This can also be written: {

Assets = Liabilities + Equity

Net Worth = Assets – Liabilities

In other words, your business's net worth equals everything it owns minus everything it owes.

Remember, the balance sheet is a financial picture of a point in time. So, it's useful for comparing how your business is doing now versus at the end of a comparable period (month, quarter, or year, for example). You can use the balance sheet to answer questions like these:

- How your cash is balance now compared to the end of last year?
- Are you carrying more or fewer accounts receivable than you were at the end of the previous quarter?
- Do you have more inventory on hand than you did last month?

- How does your business's net worth compare to what it was a year after you opened?
- How much does your business own in the way of buildings, machinery, and equipment?
- How much debt do you owe within the next 12 months? Over the long term?
- Do you have more retained profit in the business now than a year ago?

Widget World, Balance Sheet

Year End, as of Dec. 31

Assets (What You Own)

Current Assets (can be converted to cash in 12 months or less):

Cash	7,000		
Accounts Receivable	**95,000**		Money that is owed to the business from sales
Inventory (ending)	55,000		
Total Current Assets		157,000	

Non-Current Assets (take more than 12 months to convert to cash):

Fixed Assets (land, buildings, equipment)	**89,000**		The original cost of these assets
Less Accumulated Depreciation	**(16,000)**		The portion of the fixed assets' original cost that has been written off over time as the assets have lost value
Fixed Assets (net)	73,000		
Advances to Owners	4,000		Money that the business's owners take as a loan that must be repaid
Total Non-Current Assets		77,000	
Total Assets		234,000	

Liabilities (What You Owe)

Current Liabilities (debts due within 12 months):

Current Portion of Long-Term Debt	**3,000**		Total of loan payments over 12 months
Note Payable	64,000		
Accrued Taxes	2,000		
Accounts Payable	**73,000**		Money that your business owes for purchases of goods and services
Total Current Liabilities		142,000	
Long-Term Liabilities/Loan Payable (due in more than 12 months)	34,000		The balance remaining on a loan after the current portion (12 months' worth) has been paid
Total Liabilities		176,000	

Owner's Equity (or Net Worth or Capital)

Owner Investment	15,000		
Retained Earnings	43,000		Profits that are not paid to the owners; they are retained in the business and accumulate over time
Total Equity		**58,000**	
Total Liabilities and Equity		234,000	

All About Your Income Statement

Your business's Income Statement defines the company's income, expenses, profit or loss, and loan interest during a defined period of time. It may also be called a Statement of Profit and Loss (P&L), an Earnings Statement, an Operating Statement, or an Income and Expense Statement. The end product of these transactions is net income or loss:

Sales – COGS = Gross Profit – Expenses = Net Profit

All businesses have income and expenses to report, but only companies that sell products (goods) include an entry for Cost of Good Sold (COGS). The COGS calculation depends on the type of business:

- Retail and wholesale businesses factor in their starting inventory, purchases made during the period and their ending inventory.
- Manufacturing companies take into consideration their inventory of finished goods, raw materials, goods in process, labor and factory overhead.
- Service businesses make most of their income from the work of employees, so the COGS includes relatively small amounts for materials.

COGS = Beginning Inventory + Purchases – Closing Inventory

You (or your accountant) should prepare an income statement at regular intervals (usually monthly and at the end of the fiscal year) to see how the results compare to the previous period. This way, you can track whether your profit expectations are being met.

Remember, the income statement describes your business's financial transactions over a period of time. So, it's useful for answering questions like these:

- Is your business making a net profit? How much?
- How does net profit compare to the previous period?
- Are sales increasing or decreasing?
- Are expenses increasing or decreasing?
- Are labor costs increasing or decreasing?

Widget World, Income Statement

January 1- December 31

Sales			
Net Sales	**876,000**	**100%**	Total of sales after any returns or allowances
Cost of Goods Sold			
Beginning Inventory	43,000		
Purchases (to produce goods)	504,000		
Labor (to produce goods)	97,000		
Less: Ending Inventory	(55,000)		
Total Cost of Goods Sold	589,000	**67%**	
Gross Income (876 – 589)	287,000	**33%**	
Expenses			
Selling Expenses	**58,000**		Salaries and other expenses directly related to sales
General and Administrative	**108,000**		Any other expenses required to run the business
Total Expenses	166,000	**19%**	
Operating Income / Loss (287 – 166)	121,000	**14%**	Measure of the business's profitability before paying interest and taxes
Less: Interest Expense (on loans)	(12,000)	**1%**	
Net Income before Taxes	109,000	**12%**	
Less: All Income Taxes	(32,000)	**4%**	
Net Income	77,000	**9%**	

Why the Percentages?

Numbers can start running together after you look at them for a while, and it can be difficult to mentally compare them to each other. Percentages, however, provide a straightforward means of comparison. In the example, calculating each major line item as a percentage of net sales gives you an immediate, clear picture of how much of your sales are required to cover those expenses.

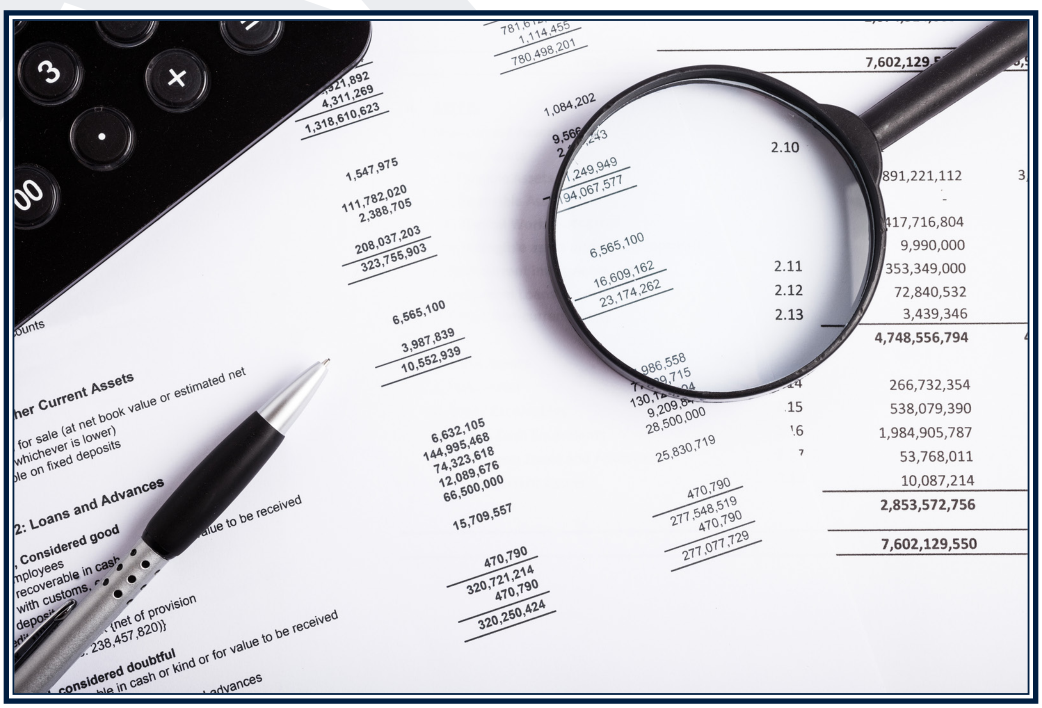
These calculations also let you quickly see how your gross and net profit during this period compare to previous periods. Are the profit percentages greater or less than they were last year? A list of numbers may not seem exciting, but seeing that your net profit increased from, say 4% last year to 9% this year will definitely catch your attention!

All About Your Statement of Cash Flows

Your business's **Statement of Cash Flows** is a summary of all the money that comes into and goes out of your business during a defined period of time. It's possible for a business to have a net profit but still have a negative cash flow; it all depends on when and how payments flow to and from your accounts. To be sure you always have cash on hand for expenses and to cover emergencies, it's vital that you keep track of your business's cash position. (Note that this statement shows historical data; you can create a similar statement that shows your forecast of your business's cash flows in the time ahead.)

Your cash flows include day-to-day operating activities (receipts and payments), investing activities (such as purchasing or selling assets) and financing activities (such as borrowing or repaying money). This statement can help you answer a number of important questions:

- Does your business have a positive cash flow?
- Are your cash receipts less than your cash payments? That is, are you running out of money?
- Is your net operating cash flow positive or negative?
- Are you spending more than you're earning or taking too much cash out of the business?
- Do you have enough money to cover your expenses and pay your debts?
- How large of a loan payment could your business afford to pay?
- Do you need to take out loans or put more equity into the business in order to break even from month to month?



Resova Inc., Statement of Cash Flows

January 1- December 31

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Cash on hand (beginning of month)	55,000	50,600	60,798	51,798	53,698	51,398	42,098	31,498	29,798	40,898	40,098	53,698
Cash on hand (end of month)	50,600	60,798	51,798	53,698	51,398	42,098	31,498	29,798	40,898	40,098	53,698	79,298
CASH RECEIPTS	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
Cash sales	240,000	260,000	240,000	260,000	248,000	250,000	240,000	255,000	260,000	250,000	270,000	275,000
Credit sales collections	5,000	4,000	4,000	5,000	3,000	4,000	4,000	2,000	4,000	5,000	4,000	5,000
Interest income	500	600	500	500	600	500	600	600	500	600	600	500
TOTAL CASH RECEIPTS	**245,500**	**264,600**	**244,500**	**265,500**	**251,600**	**254,500**	**244,600**	**257,600**	**264,500**	**255,600**	**274,600**	**280,500**
Total cash available	**300,500**	**315,200**	**305,298**	**317,298**	**305,298**	**305,898**	**286,698**	**289,098**	**294,298**	**296,498**	**314,698**	**334,198**
CASH PAID OUT	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
Advertising	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Professional services	600	700	1,200	1,500	500	400	500	600	500	500	300	700
Contract services	1,800	2,000	1,800	1,800	1,900	2,100	2,000	1,800	1,900	2,000	2,000	1,700
Interest expense	100	100	100	100	100	100	100	100	100	100	100	100
Meals, entertainment, car	1,500	1,200	1,400	1,300	1,800	2,000	1,200	1,100	900	1,400	1,300	1,200
Office expense	400	500	400	400	500	500	500	400	500	500	400	400
Purchases (merchandise)	116,000	119,000	118,000	124,000	118,000	122,000	114,000	123,000	117,000	120,000	119,000	116,000
Rent or lease	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600	3,600
Repairs and maintenance	300	200	100	300	100	200	200	300	100	400	200	100
Supplies	400	400	400	400	400	400	400	400	400	400	400	400
Taxes and licenses	500	500	500	500	500	500	500	500	500	500	500	500
Travel	1,200	500	0	1,500	1,000	300	200	0	0	0	700	500
Utilities	700	700	700	700	700	700	700	700	700	700	700	700
Gross payroll	102,000	101,000	103,000	105,000	103,000	104,000	107,000	105,000	103,000	104,000	110,000	108,000
Payroll expenses	8,000	9,000	9,000	10,000	9,000	9,000	11,000	9,000	8,000	9,000	9,000	8,000
Printing	1,500	1,700	2,000	1,200	1,500	1,700	2,000	1,500	1,700	2,000	1,500	1,700
SUBTOTAL	**240,100**	**242,600**	**243,700**	**253,800**	**244,100**	**249,000**	**245,400**	**249,500**	**240,400**	**246,600**	**251,200**	**245,100**
Loan principal payment	300	300	300	300	300	300	300	300	300	300	300	300
Capital purchases	0	2,000	0	0	0	5,000	0	0	3,200	0	0	0
To reserve and/or escrow	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500
Owners' withdrawal	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000
TOTAL CASH PAID OUT	**249,900**	**254,400**	**253,500**	**263,600**	**253,900**	**263,800**	**255,200**	**259,300**	**253,400**	**256,400**	**261,000**	**254,900**
Cash on hand (end of month)	**50,600**	**60,800**	**51,798**	**53,698**	**51,398**	**42,098**	**31,498**	**29,798**	**40,898**	**40,098**	**53,698**	**79,298**

This company has a positive cash flow, as shown on the bottom line for each month.

Glossary

Accrual Accounting: System of accounting that recognizes revenue when it's earned and expenses when they occur.

Advance to Owners: Money that a business's owners take as a loan that must be repaid.

Appraisal: Evaluation by a qualified person to determine an asset's current market value.

Asset: Anything a company owns that has a monetary value. Assets may be current or fixed.

Break-even: Point at which a company's income equals expenses.

Budget: Financial plan that estimates a business's income and expenses during a specified future period.

Capital: Cash invested in a business.

Capital Expenditures: Money a business spends to buy or upgrade assets.

Cash Accounting: System of accounting that records income when cash is received and expenses when cash is paid.

Cash Flow: Movement of cash into and out of a business.

Collateral: Asset pledged as security by a borrower for repayment of a loan.

Collection Agency: Company that works with delinquent customers to obtain full or partial payment of debts.

Cost of Goods Sold (COGS): Direct costs attributable to producing goods that a business sells (labor, materials, and direct production costs).

Creditor: Business or individual to whom a business owes money.

Credit Policy: Guidelines that detail a business's terms and conditions for selling on credit.

Credit Report: Document summarizing a business's or individual's credit history and financial position.

Current Assets: Assets that can be turned into cash in less than a year.

Current Liabilities: Debts that are due within a year.

Debtor: Business or individual who owes a business money.

Depreciation: Write-off of a fixed asset's original cost over time as the asset loses value.

Equity: Total assets minus total liabilities, giving a business's or the business owner(s)' net worth.

Expenses: Cost of doing business, in the form of money spent to operate and earn revenue.

Extended Payment Terms: Arrangement that lets a debtor pay back a loan over a period longer than the loan's original term.

Financial Ratio: Measures of a business's profitability and efficiency based on figures from the business's financial statements.

Financial Statements: Income statement, balance sheet, and statement of cash flows, which summarize a business's financial position and performance.

Fixed Assets: Assets expected to last and/or be used by a business for more than a year.

Fixed Costs: Costs that remain more or less the same regardless of production or sales (mortgage, salaries etc.).

Glossary (continued)

Forecasting: Using past and present financial data to predict a business's future performance.

Gross Profit: Sales minus cost of goods (or services) sold.

Intangible Assets: Assets with no physical form that provide legal or intellectual rights and value.

Interest: Money paid in return for using money loaned by another business or individual.

Inventory: Value of the goods a business has available to sell.

Liability: Anything a company owes. Liabilities may be current or long-term.

Liquid Assets: Assets that can be turned into cash quickly.

Long-Term Liabilities: Debts that are due more than a year from the current time.

Markup: Amount added to the cost of an item to yield a profit.

Maturity: Time at which a loan, insurance policy, etc., matures.

Net Profit: Sales minus all operating expenses.

Overhead: Indirect expenses that aren't associated directly with a business's products but rather are related to its overall operation.

Owners' Equity: Amount of money the business's owners have invested, as well as profit that has been retained in the business.

Payroll Service: Company that handles a business's payments to employees, including withholding and taxes.

Profit: Total income minus total expenses.

Purchase Order: Document provided by a buyer that details a purchase of goods or services.

Receivables: Money that individuals or other companies owe to a business.

Reserves: Retained earnings set aside for a specific use.

Retained Earnings: Profits that are not paid to the owners; they are retained in the business and accumulate over time.

Retained Profit: Profits of the current year that have not been distributed to a business's owner(s).

Retainer: Fee paid to a business or individual (such as an attorney) in advance, to secure their services as required.

Return on Investment: Profit made as a result of a business investment or decision.

Revenue: Income that comes from a business's operations.

Return: Proceeds from a sale, or yield from an investment.

Variable Costs: Costs that vary based on production or sales (materials, labor, etc.).

Working Capital: Current assets minus current liabilities.

Published by LouPreneur© LLC; Printed By Louisville News Company, LLC