Understanding Financial Statements

For Your Business

Disclaimer

- **The information provided is for informational purposes only, does not constitute legal advice or create an attorney-client relationship, and may not apply to all circumstances. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.**

Topics

- Balance Sheet
- Income Statement
- Cash Flow Analysis
- Ratios

Financial statements - written records to diagnose financial strengths and weaknesses of business.

Usually prepared annually - income statement developed on monthly or quarterly basis.

- Balance Sheet
- Income Statement
- Cash Flow Statement

Why Needed?

The business owner needs to understand financial statements to:

- determine if business is making a profit or losing money;
- calculate current and future financial needs;
- ensure positive cash flow for short-term needs.

For lending and operating purposes, statements determine:

- if business can afford to pay a loan;
- loan amount;
- loan term (number of years);
- assets to buy vs. assets to finance;
- collateral available to secure a loan.

Balance Sheet

What a business owns (assets).

What it owes (liabilities).

What is left over (net value or equity in business).

Picture of your business, frozen for second in time.

Changes when business receives money or gives credit to a customer or pays a bill.

Income Statement
Cash Flow Statement
Ratios

Income Statement

Business' sales and expenses plus its profit (or loss).

Cash Flow Statement

Sources, uses, and balance of cash, shown by month.

Ratios

Numbers used from financial statements to analyze a business' financial condition. Ratios can be compared to other businesses in same industry.

Accounting Principles

- GAAP: Generally Accepted Accounting Principles
- FASB: Financial Accounting Standards Board

Choose Accounting Method

Cash Method

- Records sale when money collected.
- Records expense when paid.

Accrual Method

- Sales are made on credit. Amount customers owe is called Accounts Receivable. Record when sale made, not payment received.
- Incur business expenses on credit. Amount owed is called Accounts Payable. Record amount due when incurred, not when paid.

Depreciation Methods

- Straight Line: Original cost minus estimated salvage value of asset written off in equal amounts during asset's life.
- Double Declining Balance: Records large depreciation expense in early years of asset's life and reduced depreciation expense in later years of asset's life. Designed to reduce taxable income and tax payments so that extra cash can be reinvested.
- MACRS (Modified Accelerated Cost Recovery System): Assets are classified according to prescribed IRS life or recovery period.

Balance Sheet

WHAT DOES A BALANCE SHEET TELL YOU?

What you own (assets), what you owe (liabilities), and what's left over (net value or equity in the business). See handout.

Liabilities + Net Worth = Assets

- **Assets**

  Assets divided into two categories: **current and non-current**. Current assets can quickly be turned into cash, such as cash and inventory.

  Non-current assets are furniture, fixtures, property and equipment.

- **Liabilities**

  Liabilities (debts you owe) are divided into two categories: **current and non-current** (or long-term).

- **Capital or Net Worth**

  Business' equity: money owners have invested **and** income kept in business from profits.

Balance Sheet

WHAT IT SHOWS YOU

- Net value of business.
- How much of loan debt is current or long-term.

Balance Sheet

WHAT IT WON'T SHOW YOU

- Income or expenses over time.
- Market value of assets – it **will** show original purchase costs and accumulated depreciation.
- Quality of assets.

Terms from Balance Sheet

- *Accounts Receivable*: Sales made but money still owed to business.
- *Depreciation*: Assets lose value. Deductions made according to tax rules. Accumulated depreciation is total amount of depreciation.
- *Advances to Owners*: Money owners take, in form of a loan, to be repaid.
- *Accounts Payable*: Purchases not paid for.
- *Current Portion of Long-Term Debt*: One year’s worth of loan payments.
- *Loan Payable*: Loan balance after one year’s worth of principal payments.
- *Owner’s Investment*: Money owner invests in business.
- *Retained Earnings*: Money left in business from profits, accumulated over life of business.

Income Statement

WHAT DOES AN

INCOME STATEMENT TELL YOU?

Income Statement is report card for business.

Developed monthly, quarterly and annually.

See handout.

Income Statement

WHAT IT SHOWS YOU

- If sales are going up or down.
- Gross profit —money left after deducting costs to produce product.
- Expenses for time period covered.
- Increases and decreases in net income.
- How much money is left to grow business.
- How much money is left for owner.
- How much money is left to pay debt (principal only).

Income Statement

WHAT IT WON'T SHOW YOU

- Whether financial condition is weak or strong (see Balance Sheet).
- What's tied up in Accounts Receivable (money owed to you) and Accounts Payable (money you owe).
- What you own (assets) and what you owe (liabilities).

OTHER NAMES FOR INCOME STATEMENT

- Operating Statement,
- Earnings Statement,
- Profit & Loss Statement (P&L)

Terms from Income Statement

- *Amortization*: Distribution of a single lump-sum into smaller cash flow installments, determined by an amortization schedule. Loan repayment over time.
- *Net Sales*: Revenue or income. Gross sales is *before* returns and allowances. Net sales is *after* returns and allowances.
- *Gross Profit*: Profit margin.
- *Selling Expenses*: Salaries and expenses related to sales only.
- *General & Administrative*: All other business expenses.
- *Operating Income (or Loss)*: How business performed.
- *Net Profit:* Profit left after all expenses have been paid.

Typical Expenses

- Advertising
- Amortization
- Bad Debts
- Bank Charges
- Charitable Contributions
- Commissions
- Contract Labor
- Depreciation
- Dues and Subscriptions
- Employee Benefit Programs
- Insurance
- Internet Access
- Legal and Professional Fees
- Licenses and Fees
- Materials and Supplies
- Meals and Entertainment
- Miscellaneous
- Office Expenses
- Payroll Taxes
- Postage
- Rent or Lease
- Repairs and Maintenance
- Supplies
- Telephone
- Travel
- Utilities
- Vehicle and Equipment Expenses (rent or lease)
- Wages
- Website Fees and Expenses

Cash Flow Statement

WHAT DOES CASH FLOW STATEMENT TELL YOU?

What money comes in, what goes out and what stays. See handout.

What It Shows You

- If business has enough money to:
  - cover day-to-day activities
  - pay debts on time
  - maintain and grow business without a negative cash flow
- Need for additional working capital (cash).
- Maximum loan payment business can afford.
- Breakdown of principal and interest on loan payments.
- Weaknesses (inability to keep and generate cash). For lending purposes, explain how weaknesses will be managed (via increased sales, cost reductions, or owner’s investments).

What It Won’t Show You

- Accounts Receivable and Accounts Payable
- Balances in assets, liabilities and net worth.
- Depreciation of equipment.

For New Companies:

Losses common in first year of start-up. Lenders want to see business break-even. To produce positive balances, cover months that show losses with loans, increased revenue, additional owner's investments or by reducing expenses.

Ratio Analysis

Ratios can be compared to other companies in your industry. Companies are grouped by "NAICS" code (North American Industry Classification System).

Asset Management Ratios: How effectively you are managing assets.

<u>Accounts Receivable Turnover</u>

Number Source: Balance Sheet & Income Statement

- **<u>Formula</u>: (Accounts Receivable multiplied by 365 days) divided by Net Sales.**
- **<u>How to Interpret</u>: Answer shows how long it takes to collect bills. Lower number is better.**
- **<u>Accounts Receivable = 3000</u>**

  <u>Net Sales = 10,000</u>

  <u>3000 x 365 = 1,095,000</u>

  <u>1,095,000/10,000 = 109.5 days</u>

- **It is important to speed up collection of monies due business.**

Liquidity Ratios: Shows how "cash rich" business is.

<u>Working Capital</u>

- Number Source: Balance Sheet
- **<u>Formula</u>: Subtract current assets from current liabilities.**
- **<u>Interpret</u>: Answer shows if business has enough money to pay its bills. Answer must be positive. Higher number is better.**
- **<u>Current assets</u>: 50,000**
- **<u>Current liabilities</u>: 20,000**

50,000 -20,000 = 30,000

- **Business has adequate cash to pay its bills.**

Quick or Acid Test Ratio (Fire Sale)

- Number Source: Balance Sheet
- **Formula: (Total Current Assets – Inventory) divided by Total Current Liabilities**
- **How to Interpret: Answer shows whether current assets will cover current liabilities. It excludes inventory.**
- **Current assets: 170,000**
- **Inventory: 85,000**
- **Current liabilities: 50,000**

  85,000/150,000 = .56
- **If answer is less than one, it reflects a dependency on inventory and other less current assets to liquidate short term debt.**

Current Ratio

Number Source: Balance Sheet

Formula: Total Current Assets divided by Total Current Liabilities

- **How to Interpret: Tests business's short-term debt paying ability. Higher number better. Answer should be 2 or more. Example shows for every One Dollar of Debt there is $1.13 in assets.**
- **Current assets: 170,000**
- **Current liabilities: 150,000**

170,000/150,000 = 1.13

Inventory Turnover

Number Source: Balance Sheet & Income Statement

- <u>Formula</u>: **Inventory Amount multiplied by 365 days with result divided by Cost of Goods Sold**
- <u>How to Interpret</u>: **Answer shows how many days it takes to turnover (sell) your inventory. Lower answer is better.**
- **<u>Inventory = 15,000</u>**
- **<u>Cost of Goods Sold = 60,000</u>**

  <u>15,000 x 365 = 5,475,000</u>

  <u>5,475,000/60,000 = 91.25 days</u>
- **It is important to increase sales efforts to decrease number of days it takes to sell inventory (e.g., offer incentives to bring in customers). May reflect overstocking or obsolescence.**

Debt Management Ratios: Shows how much money owners have invested in business versus lenders.

- **LEVERAGE (OR DEBT TO WORTH) RATIO**
- Number Source: Balance Sheet
- **Formula: Total Liabilities divided by Total Capital (Owner's Equity)**
- **How to Interpret: Determines if a business has enough equity. Lower answers are better. Answer of 3 or lower is preferred.**
- **Total Liabilities: 204,000**
- **Total Capital: 87,000**
- **204,000/87,000 = 2.34**
- For every $1 owners have invested, lenders and creditors have invested $2.34. This ratio affects business's flexibility to secure financing. Lenders want to have protection for amount loaned.

Accounts Payable Turnover

Number Source: Balance Sheet & Income Statement

- **<u>Formula</u>: Accounts Payable multiplied by 365 days with result divided by Purchases**
- **<u>How to Interpret</u>: Answer shows how many days it takes to make payments. Lower numbers (30 days or less) are better.**
- **<u>Accounts Payable</u>: 15,000**
- **<u>Purchases</u>: 40,000**

  15,000 x 365 = 5,475,000

  5,475,000/40,000 = <u>136.9 days</u>
- **It is important to speed up payment so as not to damage business's credit rating.**

Profitability Ratios: Shows business' ability to make profit.

- **PROFIT MARGIN ON SALES**
  Number Source: Income Statement
  NOTE: Shows the percentage of net profit for every dollar of sales. The higher the number, the better.
  If the profit margin is too low:
- the prices are too low or
- the cost of goods is too high or
- expenses are too high.

- **<u>Formula</u>: Net Profit divided by Net Sales**
- **<u>Net Profit</u> = 10,000**
- **<u>Net Sales</u> = 150,000**
- **10,000/150,000 = .066**

- **The profit margin is 6.6 cents per dollar.**

Cash Flow to Current Maturities (Debt Service) Ratio

Number Source: Balance Sheet & Income Statement

- **Formula: Net Profit plus depreciation divided by long term debt**
- **How to Interpret: Answer shows business's ability to pay term debts after owner's withdrawals. Answer of 2 or more is preferred.**
- **Net Profit: 53,000**
- **Depreciation: 13,000**
- **Current Portion of Long Term Debt: 6,000**

66,000/6,000 = 11

For every dollar of debt, $11 is available to pay it.

Thank You For Coming!!

- Please fill out evaluation form.

- Please let us know what other subjects you are interested in.