<u>Reviewing Your Financial Statements</u>

You wouldn't play any game or sport without keeping score, and you shouldn't avoid keeping score of your most important game – your business – simply because you might not understand your financial statements.

Understanding your financial statements, and pairing that knowledge with an understanding of financial ratios (See "Reviewing Key Ratios" Worksheet), as well as tracking your Key Performance Indicators (See Tracking Your Key Performance Indicators worksheet) will give you the vital signs of the health and performance of your company.

The three main statements in your collection of financial statements are the

- Balance Sheet
- Income Statement
- Statement of Cash Flows

The Balance Sheet

Your Balance Sheet is a picture of your company *at a specific moment in time*. It lists everything you own (assets), everything you owe to others (liabilities), and your equity in the company (your investment - such as stock owned, and the accumulated earnings of the company since inception). The formula is ASSETS = LIABILITIES + EQUITY. After all, everything that the company owns (assets) came from somewhere – either you owe someone, you put the money in yourself, or the company made profits to pay for it (or all three scenarios!).

Assets
The order of this financial statement is based on a relatively simple concept… cash. All assets listings start with the asset that is most easily convertible to cash, and proceeds to the assets that are least easily convertible to cash. Therefore, all Balance Sheets list Cash as the first asset. You will usually see a few assets listed as *Current Assets*. Current Assets are assets that will most likely be converted into Cash within one year. Therefore, assets like Accounts Receivable and Inventory are typically listed under this sub-class of "Current Assets."

The next class of assets is generally *"fixed" assets* – namely machinery, furniture, buildings, land, etc. These are expenditures that were purchased for long-term use, and are therefore not Current Assets. Since they are purchased for long-term use, you would prorate the expenditure over the estimated period that they will be used. This is called *depreciation*. For example, if you bought a computer for $1000 and estimated that you will have it for five years, you can depreciate it $200 per year. *(Of course, there are many ways to depreciate assets, including allowable amounts by the IRS, but that is not the subject of this paper. See your accountant if you have detailed questions on*

depreciation.) Most Balance Sheets list the total expenditure on fixed assets with a separate line for *"Accumulated Depreciation"* (which is just a simple way of saying "all of the depreciation taken up to this point") that is subtracted from the total to give the reader an idea of the value of fixed assets remaining.

Finally, *Other Assets* can include many things such as patents, copyrights, deposits, long-term notes receivables and generally any other expenditure for a product or service that will be held for over one year and has a value to it.

Liabilities
Liabilities are what the company owes to other people or vendors. Like the assets, these are listed in the order that they will most likely use cash. Therefore, *Current Liabilities* (will be paid within one year) would include trade accounts payable, payroll taxes payable, accruals for payroll and other expenses (if you are on the accrual basis), short-term notes payable, and the current portion of your long-term debt that will be payable within a year.

The next category of liabilities are those that will be paid in a period longer than one year, such as notes to the bank, stockholders, or other lenders.

Equity
Equity includes the initial investment into the company in *stock*, as well as any other shares purchased by the company in way of *treasury stock*. Also included in equity is an account called Retained Earnings. This is the accumulated net profits of the company since its inception.

The Income Statement

The Income Statement is a recording over a period of time of the company's sales, cost of sales and other expenses that lead to the company's Net Profit.

The income statement begins with *sales*. Some income statements, particularly those used in-house, will list sales by product line or division so that the reader can see trends.

Immediately following sales, is the *Cost of Sales*, which is the raw materials as well as other expenses that are directly attributed to the product being sold. For example, if you manufacture pens, the cost of the plastic and other obvious ingredients of the final pen would obviously be included. Often, it starts with a *beginning inventory* or parts, adds all of the *purchases* made during the time period, and deducts the *ending inventory* to arrive at the actual cost of the product inventory that was used. Some companies go to great lengths to estimate other costs included in the Cost of Goods Sold, including depreciation attributable to the machines used in manufacturing, labor used, and even a percentage of the utilities used in the "shop", not to mention the many other costs that could be categorized as a cost of the final product. The better that you are able to attribute costs, the more accurately you can determine your true *Gross Profit* and percentages.

Sales less the *Cost of Goods Sold* gives you your *Gross Profit* – that is, your profit before selling, administrative and other expenses. The more accurate this number is, the more accurately you can predict the impact of increases or decreases in sales on your bottom line.

Selling expenses and *General and Administrative Expenses* follow your Gross profit. G&A expenses are commonly referred to as "Overhead." Your overhead is the amount that it would cost you each month (or whatever period that you are analyzing) regardless of the sales volume. Obviously, as you grow, you may need more office help, may spend more on marketing, etc, but these are generally *fixed costs*, such as rent, utilities, office payroll, professional fees, and other costs not directly associated with production.

Other income and expenses are generally those expenditures that are non-recurring on a regular basis.

Gross Profit less theses selling, administrative and other expenses gives you your Earning before Income Taxes, or EBIT if you are a C-corporation. Other types of entities do not pay their own taxes, and therefore, income tax is not recorded.

Your *Net Profit* is the Sales less all of the expenses.

Cash Flow Statement

The cash flow statement summarizes the activity of the company, reconciling it to the change in cash over a period of time. Many business owners have a hard time understanding this statement the most out of the three main statements. And for good reason!

The easiest way to understand it is this: since the Balance Sheet has to balance, if there is a change in cash of $1000, then the sum total of everything else on the Balance has to also change by $1000.

The statement begins with *Cash Provided (or Used) by Operating Activities* and begins with *Net Profits*, because the net profit affects the equity portion of the balance sheet (remember – net profits go to Retained Earnings.) You can also logically reason that cash would be increased by Net Profits. Depreciation is also recorded here (obviously it affects the account Accumulated Depreciation).

The next section under that Operating Activities section is called the *"adjustment to reconcile net income to net cash provided by operations.*" This is a fancy way of saying that the changes in the other assets and liabilities also affect the balance. For example, if Accounts receivable go up, you would subtract the increase in this section. Thinking logically for a moment, it is obvious that you book receivables when you sell something. This sale is recorded as income. Since it is recorded as income, and has been put on the Statement of Cash flows as an increase to cash, but, since it ISN'T cash yet, you would

adjust cash downward for the increase in sales. Looking at your statement of cash flows, you will see where an adjustment has been made to all of the other balance sheet items for their changes during the period – other than the financing and investing activities which are described later. You will see a sub-total for the Cash Provided or Used by Operating Activities.

The next major section of this statement is the *Net Cash Provided (or Used) from Investing Activities.* This section records all purchases of fixed assets (e.g. property, furniture and equipment) as a use of cash. Obviously when you might sell a fixed asset, the sale would provide cash. Again remember, the change in the balance sheet has to add up to the change in cash… You will see a sub-total for the *Cash Provided or Used by Investing Activities.*

The third section is the Net Cash Provided or Used by Financing Activities. This section records any sales or repurchase of stock as well as additional borrowing and payments of loans. Basically, it details the differences in the Equity accounts and the loan accounts.

Finally, the statement does a reconciliation of the beginning cash, the change, and the ending cash (which obviously would match the cash figure on your balance sheet).

Summary

Understanding these basic financial statements will take a bit of time and practice. Eventually, you will be able to glance at them in a matter of minutes and get a pretty good idea regarding the health of your company. We will give you a couple of quick pointers to sharpen your skills.

Balance Sheet – CASH. Cash is king. Look for increasing cash. Quickly look over accounts receivables and payables for any swings. Get a detail of A/R to see if any vendors are slow in paying you. Use the Ratio Analysis in another white paper for more quick tools.

Income Statement – First of all, look for increases in Sales. Secondly, ensure that your cost of sales (and relating Gross Profit) remains somewhat steady percentage-wise. Quickly scan you G&A expenses for wild fluctuations.

Statement of Cash Flows – Cash Provided or Used by Operating Activities is king. Be sure that it remains a positive number.

Pick a time once a month to bring in your financials to review with your coach, and soon you'll be able to do it within minutes!