Understanding Your Financial Statements

Hello and welcome to the SBDC introduction video on *Understanding Your Financial Statements*.

If you have not already done so you can download a document from the SBDC Web site that covers the material we will be discussing.

The most important financial statements are the balance sheet, the profit and loss or (income) statement, and the cash-flow statement. Each statement depicts a different aspect of the overall financial picture of a business.

To set the stage we need to make it clear that we understand that day-to-day operations take up most of your long days and energy as a business owner. We also know that for most of you tracking your financials is kind of like eating your vegetables: It may not be the tastiest part of running your business! But we also know that it is critical for you and your company—in the short term and long.

Start with general overview.

- Understanding this is crucial to the success of any business.
  - They tell you what has happened in the past
  - More importantly - what's going to happen in the future.
  - You must develop both a profit and loss forecast and a cash-flow forecast
  - This is essential to the very survival and growth of your business.

- So what do you get for doing all this work:
  - Typically show what has happened
  - Useful in making future decisions
  - Compares performance vs. your plans
  - Shows what's going right and wrong
  - Where there are opportunities
  - What changes are needed

Balance Sheet

A **balance sheet** is:

- A list of the accumulated assets and liabilities of the business on any given day
- The difference between the two represents the net worth or Equity of the business

ASSETS

Current Assets & Fixed Assets

Cash
Accounts Receivable
Supplies
Inventory
Prepaid Expenses
Land
Buildings
Equipment

Liabilities

Current Liabilities & Long Term Liabilities

Accounts Payable
Taxes Payable
Notes Payable

Equity

Owner's Capital Contribution and Retained earnings

The balance sheet has lot of numbers. In reality reviewing a few critical ratios can tell you a lot about:

- How your business is doing
- How well it is managed and
- How healthy it is.

The two most basic ratios are the Current Ratio and the Debt to Equity Ratios.

- Ideally, both should be two-to-one and
- You definitely can't afford either one to be negative.

Income Statement

The **profit and loss or income statement** answers the question

- How did we do or how are we going to do from a revenue, expense and profit perspective

You need to understand where your revenue comes from and when you'll get it and which expenses you must incur, which are fixed and which expenses differ depending on your production and sales activity, which are variable. Fixed expenses indicate your break-even point, a number that's crucial to know as you tweak your business.

If you've got a picture of your fixed expenses, you can know how much money you need to set aside for that rainy day.

REVENUE
  Sales of Books
  Sales of Coffee
TOTAL REVENUE

COST of GOODS SOLD
  Cost of Books
  Cost of Coffee
TOTAL COST of GOODS SOLD

GROSS PROFIT

OVERHEAD EXPENSES
Depreciation
Advertising
Bank Service Charge
Auto Expenses
Insurance
License & Permits
Supplies
Professional Fees
Rent Expense
Payroll
Payroll Taxes and Insurance
Travel Utilities
Misc.
TOTAL OVERHEAD EXPENSES

LOAN INTEREST EXPENSE

PROFIT BEFORE TAXES
TAX EXPENSE

NET PROFIT

Management by Percentages (example)

An effective way to manage your Income statement is by using percent not by dollar numbers. Using percentages allows for quick and easy identification of changes either up or down whereas just looking at the number may not show a trend that is developing or a change that has occurred.

As an example:

OVERHEAD EXPENSES		
Depreciation	$_____	_____%
Advertising	$_____	_____%
Auto Expenses	$_____	_____%
Insurance	$_____	_____%
License & Permits	$_____	_____%
Supplies	$_____	_____%
Professional Fees	$_____	_____%
Rent Expense	$_____	_____%
Payroll & Taxes	$_____	_____%
Utilities	$_____	_____%
Misc.	$_____	_____%
TOTAL OVERHEAD EXPENSES	$_____	_____%

If you've got a picture of your fixed expenses, you can know how much money you need to set aside for that rainy day.

Cash Flow Statement

The **cash-flow statement** answers the question

- Where does the cash come from (Sources of Cash) , how was it used (Uses of Cash) and how much cash is left over?"
- Changes in the cash flow indicate:
  - Ability to meet its debt obligations
  - Pay the owners
  - how much external financing the company is using and
  - its ability to generate cash flow in the future.

Bottom line: “Cash is king in business, so you need to know month-to-month that your cash flow is and will continue to be positive.”

You need to determine how much you need to sell or bill each month to keep you and your business going, and hit that number every time—whether it's by delaying expenses or pushing for payment of accounts receivable..

Beginning Cash
Current revenue
Receivables
Withdrawal from Line of Credit
Additional Equity (Cash)
Additional Debt (Cash)

TOTAL CASH AVAILABLE

General & Admin. Expenses (Less Depreciation)
Loan Payment(s)
Cost of Goods Sold
Payment on Line of Credit
B&O & other Taxes Due
Equipment
Owner's draw
TOTAL CASH WITHDRAWALS

TOTAL CASH AVAIL. or (SHORT)

The bottom line: Pouring over your financials isn't as fun as closing deals or developing new products. But it's a necessary discipline. And doing it right, using the information they contain, can give you an important lever on managing your business toward success and growth.

Return to the SBDC web site for access to information on resources, great tools and of course information on contacting your nearest SBDC Certified Business Advisor.