Understanding Financial Statements: What do they say about your business?

This workbook is not designed to be your only guide to understanding financial statements. A much wider range of resources is available to you, and we strongly recommend you make use of them--everything from books and other publications to professional organizations and associations to workshops and training sessions.

The Washington Small Business Development Center, administered by the Washington State University and various Community Colleges, EDC's and Chamber of Commerce's, does not--and cannot--assure that your business will be successful as a result of implementing the steps outlined in this workbook.

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Introduction

- Do you want to be in financial control of your business?
- Do you want to know how your "books" work?
- Do you want to understand what your accountant tells you?
- Do you want to know where to find answers in your financial statements?

If your answers are yes, you will find helpful information in this booklet.

Owning a small business is the dream of many people in our country. These people have their own ideas for a product or service to provide to the public or to other businesses. And many of these business people do a very good job of providing their product or service, but they do not do a good job of controlling the financial part of their business. It is simply too easy to devote all of your mental and physical energies to your customers and then do nothing for yourself.

You must understand that there is no "mystery" to understanding your business's financial make-up. The same common sense and logic that you apply to your daily operations will carry you through the steps you need to grasp the financial information. All that is necessary is for you to learn a few simple concepts. Master them, and you will no longer be uncomfortable with your business financial statements.

There are four levels in your business accounting system. They are:

- The foundation - source documents and a filing system.

- The input list - transaction journals.
- The category list - general ledger.
- The management report - financial statements.

The purpose of this book is to help you understand that these four levels of information contain everything you need to comprehend the financial condition of your business. Let's consider these four areas one at a time.

Level One
The Foundation - Source Documents and a Filing System

In order to work with your accounting information, you must know what type of documents create your accounting information and where you can find those documents in your office. Examples of accounting documents are:

- Sales invoices or tickets.
- Deposit tickets.
- Paid bills.
- Bank statements.
- Canceled checks.
- Employee earnings records.
- Monthly, quarterly and annual payroll reports.
- Monthly sales tax reports (if applicable).
- Detailed accounts receivable and accounts payable lists.

These documents are the raw materials from which your books and financial statements are constructed, and they give rise to the first axiom of financial understanding.

Axiom 1
To be able to validate your financial statements, you must be able to verify any items on them from the applicable source documents.

You or your bookkeeper should have an organized system of filing these documents. Some are filed numerically, some chronologically, some alphabetically, but all must be filed promptly and consistently. The worst enemy in your office is your inability to find something when you need it. Although the daily responsibility may be a bookkeeper's or a clerk's, as the owner, you must know where everything is and what it means. Give up that responsibility and you are inviting a short business career.

Special Discussion - Bank Reconciliation

Bank reconciliation is done monthly after receiving a bank statement and canceled checks. Reconciling your bank balance verifies the accuracy of your checkbook, but you must also ensure that the bank balance in your books agrees with the reconciled checkbook balance. This ensures that your books and your financial statements include all of your deposits, checks and other charges to your account such as automatic payments.

If you do not personally do the bank reconciliation, you should physically review it each month and spot check the reconciliation to the bank statement itself. Always open the statement and check the ending bank balance with the "balance per bank" amount on the reconciliation. Also, review the list of outstanding checks, and if any are on the list for two months or more, find out to whom they were written. Do not make it easy for a bookkeeper to be dishonest by not checking for yourself. If you have an outside bookkeeper or accountant reconcile your bank statement, you add another level of security to your system.

Axiom 2
It is your responsibility to ensure that your bank balance is reconciled each month and that the bank balance in your books and financial statements agree with the reconciled balance.

Level Two
The Input List - Transaction Journals

The transaction journal is the entry point into your accounting system. Whether your system is manual or computerized, your sales, checks, deposits, adjustments, etc. are first listed in a sequential list showing the transaction date, number, amount, description and the account name or number to which the transaction has been assigned. Deposits are usually listed in date sequence, and sales invoices, checks, vouchers, etc. are listed numerically. Transaction journals are monthly reports, so if you know the date or number of the transaction, you can find the point at which it entered your accounting system and where it went.

Your accounting system, whether it is your own internal system or that of a service bureau or bookkeeping or accounting service, should always include one or more transaction journals. Some accounting systems group all transactions together into a single journal, and some have separate journals for each type of transaction, such as sales, disbursements, etc. The style is not of primary importance; that its available to you in a regular, consistent format is.

Axiom 3
To discover where a specific transaction such as a check or a deposit will show in your books and financial statements, go to the appropriate transaction journal and find the entry in the sequential list of transactions.

Level Three
The Category List - General Ledger

The general ledger is a cumulative (year-to-date) book (for a manual system) or report (for a computerized system) that shows the balances in each of your accounts. Your accounting system is built around a list of account names called a chart of accounts, organized under the following categories:

- Assets.

- Liabilities.
- Capital (Owner's Equity).
- Income.
- Cost of Sales (for a business that sells a product).
- Operating Expenses.
- Other Income (Expenses).

It is important to understand these categories. You must know what to find in each category and understand what order they are listed in to be able to find them in your general ledger (and later in your financial statements). Consider the following informal definitions:

Assets - The physical items that your business owns including money, receivables, investments, buildings, equipment, etc.

Liabilities -Those amounts that your business owes to third parties. They include payables, notes, mortgages, taxes, owner loans (not owner investments), etc.

Capital - The investments of the owners and the accumulation of profits or losses for the business since it began.

Income - The sources from which the business earns its money. Income is measured for a period of time.

Cost of Sales - The cost of the product sold by a business and the related costs of having the product available to sell. In some instances service-technician labor is included in cost of sales along with the product sold. Cost of sales is measured for a period of time.

Operating Expenses - The daily expenses incurred in running your business. They are the rent, advertising, insurance, etc. Operating expenses are measured for a period of time.

Other Income (Expense) - These are a part of doing business, but are not daily necessities or a required part of operations. Examples include bad debts recovered, interest income and expense, discounts earned, insurance on corporate officers, etc. Consult with your accountant for more information. Other income and expenses are measured for a period of time.

Your general ledger will have the categories grouped in the order listed above. If your accounting system is computerized, you should have a "detailed general ledger" in which every transaction for each category is listed. This is ideal for tracing transactions through your books. If you do not have a detailed general ledger, or if you have a manual set of books, there should be an entry in each general ledger account that refers back to one or more transaction journals. These entries allow you to locate specific transactions that were classified into the various general ledger accounts. The general ledger is an output-oriented report. In other words, you analyze the general ledger from the end product (the category or account name) back to the source transaction. This leads to Axiom 4.

Axiom 4
To analyze your business by questioning what is in a specific account, begin with the general ledger and trace backwards through the transaction journal until you get to the source documents.

The general ledger, then, contrasts with the transaction journal, which is an input-oriented report. To get into the journals you must identify the source transaction. Your question relates to where in your books the transaction was posted. The output-oriented general ledger, on the other hand, begins with an account balance, and your question relates to what items have been posted to a specific account.

Your general ledger and transactions journals are the building blocks upon which your financial statements are constructed. Many of the answers you seek when you analyze your financial statements will be found in the journals and ledger. It is crucial that you understand their role in your accounting system.

Level Four
The Management Report - Financial Statements

We have now arrived at the point that you've been waiting for - how to understand your financial statements. It is important, however, that you study and understand the material you have already read, because understanding your financial statements depends on being able to move comfortably from your source documents through your journals and ledgers.

Every time you have statements prepared, whether monthly, quarterly or annually, you should receive the following two primary financial statements:

Income Statement

The income statement will tell you if you made a profit or a loss for a specific accounting period (month, quarter, year, etc.)

The income statement is the one you always look at first. Its purpose is to show you if you made a profit or a loss. The income statement is designed to give you information about the accounts in your accounting system that fall in the categories of income, cost of sales, operating expenses and other income (expense). The income statement measures results for a period of time.

Balance Sheet

The balance sheet will tell you how you have managed the assets and liabilities of your business. It will show if you are a good steward with your money.

The balance sheet is the statement you seldom look at because you may not understand what it is telling you. The purpose of the balance sheet is to show you what the business owns, what it owes, and what the difference - or its capital - is. It is designed to give you information about the accounts in your accounting system that fall in the categories of assets, liabilities and capital (owner's equity). The balance sheet describes a specific date in time.

You will find examples of balance sheets and income statements in Appendix A. Turn now to A2 - A5 and look at them. We will talk next about where to look to find answers to your specific questions. Later we will review some specific techniques to emphasize relationships within the two statements.

The Secret of Understanding Financial Statements

When reading your financial statements is new to you, most of what you see is strange. If you are unable to find something that makes sense quickly, you are likely to lose interest and turn to something that you like or understand better. But the positive financial impact that a thorough review of your statements will have on your business is crucial. This leads to Axiom 5.

Axiom 5
When looking at financial statements, ask questions that will eliminate 50 percent of your alternatives first, thus, reducing your confusion and reducing the time it takes to address your concerns.

The first thing you must do when you are unfamiliar with analyzing financial statements is to ask the following question:

Q: Is the item I am asking about part of the profit or loss of my business, or is it part of what it owns and what it owes?

A: If your question is about profit or loss like income, cost of sales, operating expenses or other income (expense), you want the income statement.

OR A: If your question is about assets, liabilities, or capital (owners' equity), you want the balance sheet. Now that you have eliminated 50 percent of your financial statement alternatives, let's look at the composition of each statement so that we can further limit our alternatives.

Income Statements

Income statements will be organized like this:

- Income.
    - Cost of Sales.
    - Gross Profit (a total of income less cost of sales)
- Operating Expenses.
    - Net Operating Income (a total of gross profit less operating expenses)
- Other Income (Expense).
    - Net Income (a total of net operating income plus or minus other income)

Look at the categories that have the dots beside them. They are from your general ledger. By classifying your question under one of those four areas, you can effectively eliminate 75 percent of the income statement. Now you can set about finding the answer to your question.

Example

Say you had a question about an advertising expense, what would you do? Your thought process would be something like this:

1. My question is about advertising. Is that part of profit and loss or part of what I own and what I owe (assets and liabilities)?

Advertising is about profit and loss. Set the balance sheet aside.

2. Is advertising part of income, cost of sales, operating expenses or other income and expense?

It is not income. It is not cost of my product sold. It is not other income (expense), because it is a normal part of operations. Therefore I can ignore the other three parts of the income statement and concentrate on operating expenses.

With two simple questions you can narrow your search down to a single part of a financial statement. Now, if you wanted to know what was in advertising expense, using what you learned earlier in this booklet, you would go to the general ledger and through the transaction journal and possibly all the way back to your filed source documents to find a paid bill for a specific advertising expense.

The first part of analyzing your own financial statements is being able to decide quickly where to look, and then to be able to work backwards through the general ledger to identify any income or expense item about which you have a question.

Now look again at the income statement in Appendix A and review the individual account names. Compare them against your own financial statements. If necessary, visit with your own accountant and learn how each account is used and what you can expect to find in it. Your responsibility is to become familiar with your own income statement and learn what to expect as you read and study it.

Balance Sheets

Balance sheets are usually organized from the top of a page down and usually look like this:

- Assets.
  - Current Assets.
  - Fixed Assets (Property, Plant and Equipment).
  - Other Assets.
- Liabilities.
  - Current Liabilities.
  - Long-term Liabilities.
- Capital (Owner's Equity).

The major categories above are from the categories of accounts that are in your general ledger. Each of these categories has specific characteristics, and by narrowing your question to one of these areas, you can limit the amount of work you must do to answer your question. Here are some simple definitions:

Current Assets - Assets that either are cash now or will become cash within the next 12 months. Examples are bank accounts, accounts receivable, inventories, etc.

Fixed Assets - The things you own for the purpose of producing income. Examples are buildings, vehicles, equipment, furniture, computers, etc.

Other Assets - The things you own that do not fit in the above two categories. Examples are patents, copyrights, utility deposits, etc.

Current Liabilities - Amounts you owe that must be paid within the next twelve months. Examples are trade accounts payable, sales and payroll taxes, income taxes and the next 12 payments for your notes and mortgages.

Long-term Liabilities - Amounts you owe that will be paid after the next 12 months. These are usually confined to all payments on your notes and mortgages due after the next 12 months.

Capital (Owner's Equity) - The investment made by the owner, less any capital withdrawals, plus all accumulated earnings of the company since inception.

Look again at the balance sheet in Appendix A and become familiar with the captions and the descriptions that go under each one.

Example

Suppose your question concerns amounts you owe your customers for trade accounts payable.

1. I owe my customers for trade accounts payable. Is that part of profit or loss or what I own and what I owe (assets and liabilities)?

Accounts payable are part of what you owe, which are shown on the balance sheet.

2. Are accounts payable assets or liabilities?

Trade accounts payable are liabilities and are due within the next 12 months. Look in the current liabilities section of the Balance Sheet.

With these two questions you have narrowed your search first to the balance sheet, and then to the specific section of the balance sheet. Now you can trace through the general ledger, the transaction journal, the subsidiary list or report of accounts payable, and, if necessary, the paid bills files to answer your question.

Let's consider the balance sheet a little further. We have already established that it represents a report that shows what your business owes and what it owns. In more formal terms it discloses your assets, liabilities and capital. All of these are real-world numbers. This leads us to Axiom 6.

Axiom 6
Every number on your balance sheet represents some specific thing your business owns or owes. This means that you should be able to verify every number on your balance sheet from a source document in your office.

Chances are you seldom, if ever, look at your balance sheet with the goal of understanding where the numbers come from. You should take up the project of tracing every number on your balance sheet to its origin. This is the only way that you can be sure that your statement is accurate. If you have done your own homework and learned how your office is organized and where your source documents are filed, you should be able to do this. Insist that any errors you find be corrected and explained to you. Do not let someone convince you that this is not important! You are working very hard to run your business and make a profit. You are entitled to accurate financial statements. Go for it!

Conclusion

At this level of understanding your financial statements, you should be able to determine quickly which statement to look at to answer whatever your question is. Once you identify the statement, and more specifically the part of the statement you want, then you will also want to identify the transactions that were posted to the account or accounts in question. By understanding the role and relationship of your general ledger (the category list), the transaction journals (the input list) and your original source documents and their physical location in your office, you will be able to answer any question you have about what is in your books and where it is reported. If you do not understand why something is posted where it is, then it is your duty and responsibility to ask your bookkeeper or your accountant. The books are yours, and you must have final approval.

Advanced Financial Statement Analysis

The next step in your journey through your financial statements is to learn how to draw management information from them to evaluate your company's strength and your effectiveness as a manager. The concept we will use for this is called ratio analysis. Ratio analysis is the process of identifying certain numbers from your financial statements, making a mathematical calculation with them and then evaluating the results. In the previous section you were identifying specific numbers on your statements and learning how to verify them to be sure that your statements were totally accurate. Now you will draw management conclusions from your statements. We will look at ratios in the following three categories:

Liquidity Ratios
Profitability Ratios
Efficiency Ratios

As we work our way through several financial ratios, you will see how they take certain numbers from the financial statements and calculate a number that can be used as a management tool. However, calculating a ratio is not an end in itself and is of no value to you. Here comes another axiom!

Axiom 7
A ratio by itself is meaningless until it is compared to a standard. The standard may be your own prior period ratios, industry averages or your own projections and goals.

The benefit of ratio analysis is that it provides a benchmark to measure performance, target future goals and help identify patterns and problem areas. First let's consider sources of comparative data. The best are outside sources such as the following:

Industry publications
Banking and finance industry publications
General financial reference books

You can contact several sources to search for comparative financial ratios. The first is your local, state or national trade association. The second is the loan officer at your bank. The third is a library. The larger public libraries will have reference materials and will also have indexes of magazine articles that contain financial information. You can also look to college and university libraries for similar information. Finally, you can contact the advisor at the Washington Small Business Development Center for leads on comparative financial ratio information for your type of business. You will usually be able to find information organized by type of business, size of business and geographic location.

Once you find a source for comparative ratios, or if one is unavailable and you decide to use your own historical ratios, you will need to decide on a way to organize and present your information. Some small business owners make a fill-in-the-blank form they use each month to calculate their ratios and compare them against standards or prior periods. Others plot them on graph paper. Ratios lend themselves well to computerized spreadsheets such as Excel and many others. If you like spreadsheets, you can enter your data and have both a report and a series of graphs or charts printed. The choice is yours. The important thing is that you regularly calculate your ratios and review them.

Let's look at three types of ratios. Sample calculations of all the following ratios appear in Appendix B.

Liquidity Ratios

A liquidity ratio measures some aspect of your company's proportion of cash and other liquid assets and short-term liabilities. Because his ratio considers only assets and liabilities, all of the numbers will come from your balance sheet. Since all cash and near cash assets will become cash within the next 12 months, and since all of the liabilities considered are due within the next 12 months, all of these items are further isolated within current assets and current liabilities.

Four important liquidity measurements are:

1. Working Capital = Total Current Assets - Total Current Liabilities

The number that represents working capital should be a positive number, that represents short-term unencumbered capital. It is important for any business to have unencumbered cash balances. This is the short-term capital a business uses for day-to-day operations, for taking advantage of purchase discounts, for making payrolls, etc.

Look for a positive working capital difference, the larger the better. Look for consistency and growth over time.

2. Current Ratio =

This ratio represents the number of times your current assets will pay your current liabilities. Therefore, you want the ratio to be at least one. A ratio of less than one indicates more current liabilities than current assets, which is not good. A ratio of two indicates twice as many current assets as current liabilities. That is good.

Look for a positive dividend, the larger the better. Look for consistency and growth over time.

3. Acid Test Ratio (Quick Ratio) =

This ratio carries the same logic as the current ratio, but it is a more conservative ratio. With only cash and accounts receivable as the numerator, essentially fewer liquid assets are available to pay current liabilities. The resulting ratio will be lower than the current ratio.

Look for a positive dividend, the larger the better. Look for consistency and growth over time.

4. Inventory to Working Capital Ratio =

This ratio indicates the percentage of working capital made up of inventory. It will be expressed as a percentage, since it will be less than one. Inventory is a current asset, but it is not as liquid as cash or accounts receivable.

Look for a low percentage, the smaller the better. Look for consistently lower percentages over time.

Take a moment now to look at the balance sheet in Appendix A, specifically at the current assets and current liabilities. Become familiar with the items shown there. Then look at these four ratios, and think about what they mean logically, not the formulas. Logically they are telling you that to be successful you must have unencumbered liquid assets and that you must have more liquid assets than short-term liabilities. Become familiar with the concept of working capital, because you simply cannot run a successful business without positive working capital.

These four ratios highlight the use of common sense and good judgment to be sure you have enough money to pay your bills. By analyzing the change in these ratios over time you can track your progress toward financial stability and measure your business against industry standards.

Profitability Ratios

Profitability ratios measure various aspects of your company's ability to generate good profits. They consider only income, cost and expense accounts; accordingly, only the income statement is used for these ratios. Look again at the income statement in the Appendix A and become familiar with the various classifications and accounts displayed under each classification. Profitability ratios will be expressed as percentages. All these ratios will be displayed on an income statement.

1. Gross Profit Percentage =

The gross profit percentage represents the proportion of your sales dollar that is left over after the cost of your product is deducted to pay operating expenses and result in a profit.

Work to make this percentage increase over time. A higher percentage is better.

Axiom 8
The single most important percentage on your income statement is the gross profit percentage. The battle for success in your income statement is won or lost there You should know the percentage by memory and understand why it is what it is and what causes it to change.

2. Operating Expense Percentage =

This ratio can be calculated for total operating expenses or for each operating expense individually. It is used to control operating expenses.

Look at the percentages and work to decrease them. Work consistently to get your expenses to become a lower proportion of your revenues.

3. Net Income before Tax Percentage =

This ratio shows the proportion of your sales dollar that remains for profit after all expenses except income taxes.

Work to increase this percentage.

Efficiency Ratios

Efficiency ratios measure your effectiveness in managing two of the most important areas of your small business - accounts receivable and inventory. Any business can tie up a lot of money in receivables and inventory. Unless these two areas are monitored with objective standards such as these ratios, the amount of money invested can get out of hand quickly.

1. Accounts Receivable Turnover =

This ratio indicates the number of times your accounts receivable turns over into cash during the year. It measures the effectiveness of your credit terms and collection procedures.

Work to increase the turnover number.

2. Accounts Receivable Collection Period =

This ratio shows the average length of time in days from sale to collection of your accounts receivable.

Work to reduce the number of days in your collection period.

3. Inventory Turnover =

This ratio indicates the number of times your inventory turns over during the year. It helps to measure the effectiveness of your purchasing and inventory control procedures.

Work to increase the turnover number.

4. Days Inventory on Hand =

This ratio indicates the average number of days it takes to sell your inventory.

Work to lower the days-on-hand number.

5. Operating Cycle =

This number, expressed as a number of days, represents the amount of time from the purchase of inventory to the collection of cash from your sales.

Work for a lower number. A higher number requires more working capital.

These ratios are not intended to be all inclusive, but they are a good "starter set" for you. When you have the opportunity to review ratios available from your trade association, your banker, your accountant or other sources, by all means use them.

Action Steps

Now that you have completed this booklet, you have one more set of tasks before you can properly use your newly acquired knowledge about your accounting system and financial statements.

1. Make a three-ring binder with monthly tab dividers to file your monthly financial statements.

2. Ensure that you are provided a balance sheet, income statement, a detailed general ledger and transaction journals with your financial statements.

3. Set up a monthly time to review your business financial statements and to review your goals and plans.

4. Learn and understand the purpose of the balance sheet and the income statement and learn to use each for evaluating your business.

5. Learn how all of the numbers on your financial statements can be traced and verified.

6. Set up a worksheet to track your percentages and ratios each month.

7. Obtain comparative financial information from a trade association, your banker, the Washington Small Business Development Center, your CPA or some other source to use with your own financial information and ratios.

Appendix A - Sample Financial Statements

ABC Company, Inc.
Balance Sheet
December 31, 2008

Assets	
Current Assets	
Cash	$5,368
Marketable Securities	3,090
Accounts Receivable	235,382
Inventory	262,582
Prepaid Expenses	2,870
Total Current Assets	$509,292
Property, Plant & Equipment	
Land	$4,520
Building	78,540
Less: Accumulated Depreciation	(30,696)
Equipment	18,907
Less: Accumulated Depreciation	(7,980)
Total Property, Plant and Equipment	$ 63,291
Total Assets	$572,583
Liabilities and Stockholders' Equity	
Current Liabilities	
Accounts Payable	$224,235
Accrued Expenses	9,758
Income Tax Payable	2,040
Current Portion L/T Debt	3,000
Total Current Liabilities	$239,033
Long-Term Liabilities	
Mortgage Payable	$25,000
Bank Note Payable	5,000

Total Long Term Liabilities	$30,000
Total Liabilities	$269,033
Stockholder's Equity	
Common Stock ($1 Par)	$ 10,500
Retained Earnings	293,050
Total Equity	$303,550
Total Liabilities and Equity	$572,583

ABC Company, Inc.
Comparative Balance Sheets
As of December 31, 2008

	2007	2006
Assets		
Current Assets		
Cash	$5,368	$ 6,574
Marketable Securities	3,090	1,570
Accounts Receivable	235,382	232,936
Inventory	262,582	210,434
Prepaid Expenses	2,870	2,590
Total Current Assets	$509,292	$494,104
Property, Plant & Equipment		
Land	$4,520	$4,300
Building	78,540	78,540
Less: Accumulated Depreciation	(30,696)	(29,196)
Equipment	18,907	16,717
Less: Accumulated Depreciation	(7,980)	(7,840)
Total Property, Plant and Equipment	$63,291	$62,521
Total Assets	$572,583	$556,625
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts Payable	$224,235	$230,353
Accrued Expenses	9,758	6,137
Income Tax Payable	2,040	1,425
Current Portion L/T Debt	3,000	3,000
Total Current Liabilities	$239,033	$240,915
Long-Term Liabilities		
Mortgage Payable	$ 25,000	$ 28,000
Bank Note Payable	5,000	

Total Long Term Liabilities	$30,000	$ 28,000
Total Liabilities	$269,033	$268,915
Stockholder's Equity		
Common Stock ($1 Par)	$ 10,500	$ 10,000
Retained Earnings	293,050	277,710
Total Equity	$303,550	$287,710
Total Liabilities & Equity	$572,583	$556,625

XYZ Company, Inc.
Income Statement for the year ended December 31, 2008

Income	
Sales	$2,102,358
Cost of Sales	
Beginning Inventory	$ 331,764
Purchases	1,469,825
Other Costs	136,003
Goods Available for Sale	$1,937,592
Less: Ending Inventory	(501,575)
Cost of Sales	$1,436,017
Gross Profit	$ 666,341
Operating Expenses	
Advertising	$ 4,341
Auto & Truck	8,264
Bad Debts	807
Bank Charges	110
Casual Labor	3,586
Commissions	41,298
Contributions	1,194
Depreciation	16,658
Dues & Subscriptions	1,925
Entertainment	10,181
Equipment Rent	6,601
Fuel	13,133
Insurance	50,788
Janitorial Service	4,299
Leasing	11,688
Legal & Accounting	1,911
Miscellaneous	41,124
Office Supplies	12,711
Rent	19,246

Repairs & Maintenance	4,533
Salaries	238,674
Shop Supplies	10,097
Taxes - General	3,643
Taxes - Payroll	19,269
Telephone	14,119
Travel	8,981
Utilities	8,165
Total Operating Expenses	$557,356
Net Operating Income	$108,985
Other Income (Expense)	
Discounts Earned	$2,915
Discounts Allowed	(3,385)
Interest Expense	(43,759)
Total Other Income (Expense)	$44,529
Net Income	$64,456

XYZ Company, Inc.
Comparative Income Statements
For The Years Ended Dec. 31, 1992 and Dec. 31,2008

Income	2007		2006	
Sales	$2,102,358	100.0%	$2,006,888	100.0%
Cost of Sales				
Beginning Inventory	331,764	15.8	146,078	7.3
Purchases	1,469,825	69.9	1,569,161	78.2
Other Costs	136,003	6.5	67,771	3.4
Goods Available for Sale	$1,937,592	92.2	$1,783,010	88.9
Less: Ending Inventory	501,575	23.9	331,764	16.5
Cost of Sales	$1,436,017	68.3	$1,451,246	72.4
Gross Profit	$666,341	31.7	$555,642	27.6
Operating Expenses				
Advertising	$4,341	.2	$7,444	.4
Auto & Truck	8,264	.2	3,990	.2
Bad Debts	807		385	
Bank Charges	110		66	
Casual Labor	3,586	.2	11,149	.6
Commissions	41,298	2.0	37,987	1.8
Contributions	1,194	.1	420	
Depreciation	16,658	.8	13,636	.7
Dues & Subscriptions	1,925	.1	1,480	.1
Entertainment	10,181	.5	2,287	.1
Equipment Rent	6,601	.3		
Fuel	13,133	.6	10,119	.5
Insurance	50,788	2.4	38,346	1.8
Janitorial Service	4,299	.2	1,540	.1
Leasing	11,688	.6	19,115	1.0
Legal & Accounting	1,911	.1	7,934	.4
Miscellaneous	41,124	2.0	2,821	.1
Office Supplies	12,711	.6	8,759	.4

Rent	19,246	.9	13,683	.7
Repairs & Maintenance	4,533	.2	11,270	.6
Salaries	238,674	11.2	228,444	11.4
Shop Supplies	10,097	.5	6,098	.3
Taxes - General	3,643	.2	3,704	.2
Taxes - Payroll	19,269	.9	23,242	1.2
Telephone	14,119	.7	12,066	.6
Travel	8,981	.4	12,838	.6
Utilities	8,165	.4	7,885	.4
Total Operating Expenses	$557,356	26.5%	$486,708	24.2%
Net Operating Income	$108,985	5.2%	$68,934	3.4%
Other Income (Expense)				
Discounts Earned	$2,915	.1%	$1,695	.1%
Discounts Allowed	(3,385)	(.2)	(7,804)	(.4)
Interest Expense	(43,759)	(2.0)	(22,835)	(1.2)
Total Other Income (Expense)	$44,529	(2.1)	$28,944	(1.5)
Net Income	$64,456	3.1%	$39,990	2.0%

Appendix B - Sample Ratio Calculations

Liquidity Ratios

Working Capital
Total Current Assets - Total Current Liabilities
$ 509,292 - $ 239,033 = $ 270,259
Working capital is $ 270,259. Current Ratio
Current Ratio = 2.1
Acid Test Ratio
Acid Test Ratio = 1.04
Inventory to Working Capital
Inventory to Working Capital = .98

Profitability Ratios
Gross Profit Percentage
Gross Profit / Net Revenue = $ 666,341 / $2,102,358
Gross Profit Percentage = 31.7%
Note that this percentage is already calculated on the income statement shown on page A-5. An income statement that shows these percentages is an excellent management tool and is standard on most computer software packages used for bookkeeping.
The operating expense percentages and net income before tax percentages are also shown on the statement on page A-5. For that reason they are not calculated individually here.

Efficiency Ratios
Accounts Receivable Turnover
(Assume all sales are credit sales)
Credit Sales / Average Accounts Receivable
Accounts Receivable Turnover is 8.98.
Accounts Receivable Collection Period
Accounts Receivable Collection Period is 40.65 days.