Understand Your Financial Statements

A Financial Management Guide for Entrepreneurs

Summary

1

Balance sheet

Your balance sheet gives you a summary of your company's financial position at a point in time. It provides you with a clear picture of what you own and what you owe. You can use it to track your company's progress over time. Banks and investors will also look at it to understand your company's financial health before investing or lending you money.

2

Income statement

The income statement (also called the statement of earnings or profit and loss statement) tells you if your company has been profitable over a given period of time. The income statement is an essential tool to track your company's performance over weeks, months and your financial year.

3

Statement of retained earnings and cash flow statement

The statement of retained earnings shows the relationship between a company's income statement and balance sheet from one reporting period to the next. Specifically, it shows how much of the company's earnings after tax have been moved to the company's retained earnings.

Meanwhile, the cash flow statement provides a high-level view of how cash moved through your business during the year.

Why should I use a balance sheet?

Balance sheets are used in a number of ways by both internal users, such as you and your management group, and by external users, such as bankers and investors.

As an entrepreneur, you will want to review your balance sheet monthly to keep a handle on your company's assets, liabilities and shareholders' equity.

Internal users

They will use balance sheets to:

- know what a company owns and what it owes at a particular point in time
- track a company's performance over a period of time

External users

They will use balance sheets to:

- assess the health of a business
- evaluate your liquidity position
- make lending and investing decisions which can directly impact a business' growth and future success

What information can I find on my balance sheet?

ABC Co. Balance Sheet	Year 1	Year 2
Assets		
Current assets		
Cash	5,000	3,000
Accounts receivable	55,000	51,600
Inventory	50,000	53,500
Prepaid expenses	10,000	8,750
	120,000	116,850
Fixed assets (net)		
Land	75,000	75,000
Vehicles	15,000	-
Equipment	50,000	51,837
Building	40,000	40,612
	180,000	167,449
Total assets	300,000	284,299
Liabilities and shareholders' equity		
Current liabilities		
Bank overdraft	25,000	15,000
Accounts payable	23,049	37,695
Accrued expenses	15,000	14,500
Taxes payable	3,201	3,204
Current portion of the long-term debt	3,750	3,750
	70,000	74,149
Long-term liabilities (long-term portion of bank debt)	130,000	132,000
Shareholders' equity		
Common shares	100	100
Retained earnings	99,900	78,050
	100,000	78,150

1. **Current assets**
   Cash and other assets you expect to turn into cash within the next 12 months. For example: accounts receivable and inventory.

2. **Fixed assets**
   Property, plant or equipment the company owns and uses in its operations to generate income.

   Fixed assets are purchased for long-term use (longer than one year) and therefore decrease in value over time. This change is recorded as depreciation.

3. **Current liabilities**
   Debts and other obligations due to creditors within the next 12 months. For example: accounts payable, credit card bills, sales taxes, payroll liabilities and loan payments.

4. **Long-term liabilities**
   Debts and other obligations due to creditors, but not in the next 12 months. For example: loans and mortgages.

5. **Shareholders' equity**
   Profits you and other shareholders have kept in the business. Equity includes retained earnings, which are an accumulation of company profits, that have not been distributed to shareholders.

Click to enlarge table.

Total assets must always equal total liabilities, plus the shareholders' equity.

Total assets = **Total liabilities** + **Shareholders' equity**

How do bankers read my balance sheet?

Bankers and investors will want to look at your company's balance sheet to calculate ratios and decide whether to loan you money or invest in your business.

Current ratio

The current ratio measures your company's ability to pay its current liabilities with its current assets.

The current ratio is calculated as follows.

Current assets ÷ Current liabilities

For example, ABC Co.'s balance sheet shows that the company's current assets total **$120,000**, while its current liabilities total **$70,000**. This makes for a current ratio of 1.71, meaning that the company has $1.71 available to pay every dollar of debt.

As a general rule, higher current ratios indicate a lower risk the business will run out of cash. If your current ratio is well above 1, you can be reassured your company can meet its financial obligations. If your current ratio falls toward 1, you may want to pay a closer attention to ensure you can pay your bills.

Calculate your current ratio.

Debt-to-equity ratio

The debt-to-equity ratio evaluates the percentage of financing that comes from creditors and investors, compared to the amount invested by shareholders.

It is calculated as follows.

Debt ÷ Equity

For example, ABC Co.'s balance sheet shows that the company has **$130,000** of long-term debt and $3,750 in short-term debt, and **$100,000** invested in its equity. This makes for a **debt-to-equity ratio of 1.34**.

Many companies have a ratio that is considerably higher than 1, meaning they have more debt than equity. Generally speaking, capital intensive industries have a higher debt-to-equity ratio. An example of this would be a trucking company.

Calculate your debt-to-equity ratio.

Why should I use an income statement?

The income statement shows three main types of information about a company:

1. **Revenue** that is earned once you sell a product or provide a service.
2. **Expenses** incurred to generate the revenue and manage the business that has been recognized.
3. **Net income** or the profit that remains after you have deducted your expenses.

As an entrepreneur, a regularly updated income statement will allow you to track the performance of your business over time.

Internal users

They will use income statements to:

- measure the revenue recorded for a period of time, as well as the expenses incurred and the net income generated
- check that sales generated enough profit to ensure the long-term viability of your business

External users

They will use income statements to:

- asses annual tax fillings
- understand the growth and profitability of the business

What information can I find on my income statement?

ABC Co. Income Statement	Year 1	Year 2
Revenue		
Lamps	165,000	145,000
Fixtures	40,000	30,000
	205,000	175,000
Cost of goods sold		
Direct labour	15,000	11,000
Material	54,000	44,000
	69,000	55,000
Gross profit	136,000	120,000
Operating expenses		
Advertising	15,000	12,000
Auto and travel	7,500	5,000
Insurance	4,000	2,500
Legal and accounting	10,000	8,000
Utilities	4,000	4,000
Rent	24,000	24,000
Salaries and benefits	35,000	15,000
	99,500	70,500
Earnings before interests, taxes, depreciation and amortization (EBITDA)	36,500	49,500
Depreciation	2,500	3,150
Interests	6,500	6,000
Income before taxes	27,500	40,350
Income taxes	3,200	3,200
Net income	24,300	37,150

1. **Revenue**
   By analyzing the revenue trends of your products or services, you can learn which ones are performing well.

2. **Cost of goods sold (COGS)**
   Costs that go into creating the products or services you sell, and the costs of acquiring the goods to sell.

3. **Gross profit**
   Revenues minus cost of goods sold. Gross profit must be sufficient to cover a business's operating expenses, taxes and financing costs. You will use your gross profit numbers to monitor the financial progress of your company over time.

4. **Operating expenses**
   Operating expenses—also called selling, general and administrative expenses (SG&A)—are the costs of running a business. They do not fluctuate directly with manufacturing or purchase volumes so they are typically described as fixed or semi-variable in nature.

5. **Income before taxes (or Earnings before tax (EBT)**
   Because companies pay tax at different rates, income before tax is a more meaningful reflection of profitability than net income.

6. **Net income**
   Amount of profit left over after deducting all expenses and income taxes from the revenue generated during a period of time.

Click to enlarge table.

Why should I use the statement of retained earnings and a cash flow statement?

The statement of retained earnings is the staging point between the income statement and the balance sheet. It shows any deductions from net income (such as dividends paid to shareholders) to determine the amount left to the company as retained earnings. The statement also shows the changes in the retained earnings account between the opening and closing periods identified on each balance sheet.

The numbers in the retained earnings statement do not represent surplus cash, but rather are a measure of the cumulative earnings after dividends and distributions to shareholders.

The cash flow statement

The cash flow statement provides a high-level view of how your cash has moved through your business during the year.

It breaks down the cash that you generated or used into three types of activities:

1. **Operating activities**
2. **Financing activities**
3. **Investing activities**

Most accounting software will create a cash flow statement for you. It is an important statement to monitor on a monthly basis and it explains how cash was earned and disbursed in your business.

What information can I find on my statement of retained earnings?

ABC Co. Statement of Retained Earnings	Year 1	Year 2
Retained earnings, beginning	78,050	40,910
Net income	24,350	37,140
Dividends	(2,500)	-
Retained earnings, closing	99,900	78,050

1. **Retained earnings, beginning**
   The starting balance is the same as the ending balance from the previous period.
2. **Net income**
   The income that was generated during the period.
3. **Dividends**
   This is the amount distributed or paid to shareholders and is deducted from retained earnings.
4. **Retained earnings, closing**
   This shows the remaining retained earnings after net income has been added and dividends have been subtracted. This amount is also disclosed in the shareholders' equity section of the balance sheet.

Click to enlarge table.

What information can I find on my statement of cash flow?

ABC Co. Statement of Cash Flow	Year 1	Year 2
Cash flow from operating activities		
Net income	24,350	37,140
Items to reconcile net earnings to net cash used in operating activities	–	–
Depreciation	2,449	3,156
	26,799	40,296
Changes in non-cash working capital		
Decrease (increase) in accounts receivable	(3,400)	2,050
Decrease (increase) in inventory	3,500	680
Decrease (increase) in prepaid expenses	(1,250)	420
Increase (decrease) in accounts payable and accrued expenses	(14,146)	750
Increase (decrease) in taxes payable	(3)	200
	11,500	44,396
Cash flow from investing activities		
Acquisition of equipment	–	(27,346)
Acquisition of vehicles	(15,000)	–
	(15,000)	(27,346)
Cash flow from financing activities		
Common share dividends paid	(2,500)	–
Increase (decrease) in debt	(2,000)	(2,050)
	(4,500)	(2,050)
Increase (decrease) in cash and cash equivalents	(8,000)	15,000
Cash and cash equivalents, beginning of year	(12,000)	(27,000)
Cash and cash equivalents, end of year	(20,000)	(12,000)

1. **Operating expenses**
   These are cash flows you find in your company's income statement. They are your company's regular business activities, in other words, what your business gets paid to do and how it pays its bills. They include the products or services you sell, the materials you use, the services you pay for, utilities, wages and taxes.

2. **Investing activities**
   These are cash outflows (or inflows) that occur when buying (or selling) long-term assets such as machinery, tools, a building or a new vehicle.

3. **Financing activities**
   These are cash inflows from borrowing funds from banks or receiving funds from investors. Cash outflows in this section include loan repayments and dividends distributed to shareholders. They also include additional contributions by shareholders to the business.

Click to enlarge table.

How do the financial statements relate to each other?

Let's say you decide to buy a new fridge.

At the end of the financial year, your accountant records a depreciation expense that represents the reduction in the value of the fridge resulting from wear and tear during year in the income statement 1. The cash flow statement takes your net income and adds back the depreciation because it is not a cash expense 2. These changes in turn affect ending cash balance, which will be shown on the balance sheet 3. The balance sheet will show the purchase of the fridge as an addition to fixed assets at a reduced value because of depreciation 4.

Income statement
Sales • Less: Cost of goods sold
Gross profit
Operating expenses • General and administration • Research and development • Sales and marketing
Operating Income
Earnings before interests, taxes, depreciation and amortization (EBITDA) • Depreciation 1 • Interest
Earnings before taxes (EBT) • Taxes
Net income

Statement of cash flow
Beginning cash balance
Net cash from operations • Net income • Plus: Depreciation 2 • Changes in non-cash working capital
Net cash from investments • Equipment purchase • Buildings
Net cash from financing • Equipment loan • Common shares dividends paid
Net changes in cash
Ending cash balance 3

Statement of retained earnings
Retained earnings: Beginning
Plus: Net income
Less: Dividends
Retained earnings: Ending

Balance sheet
Assets
Current assets • Cash • Accounts receivable
Fixed assets 4
Liabilities • Current liabilities • Long-term liabilities
Shareholders' equity • Common shares
Retained earnings

Click to enlarge table.

How do the financial statements relate to each other?

Let's say you generate positive net income one year.

That's first recorded in the income statement 1. The net income is added to the statement of retained earnings and the statement of cash flow 2. After subtracting dividends, retained earnings are stated in the final line of the statement of retained earnings and reflected in the balance sheet under shareholders' equity 3.

This all goes to show that financial decisions have an impact on the numbers in your financial statements, which show the health and stability of your company.

Click to enlarge table.

Income statement
Sales • Less: Cost of goods sold
Gross profit
Operating expenses • General and administration • Research and development • Sales and marketing
Operating Income
Earnings before interests, taxes, depreciation and amortization (EBITDA) • Depreciation • Interest
Earnings before taxes (EBT) • Taxes
Net income 1

Statement of cash flow
Beginning cash balance
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Net changes in cash
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Statement of retained earnings
Retained earnings: Beginning
Plus: Net income 2
Less: Dividends
Retained earnings: Ending 3

Balance sheet
Assets
Current assets • Cash • Accounts receivable
Fixed assets
Liabilities • Current liabilities • Long-term liabilities
Shareholders' equity • Common shares
Retained earnings 3

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