ACCOUNTING BASICS FOR SMALL BUSINESS OWNERS: FINANCIAL STATEMENTS AND RATIOS

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MIND WHAT MATTERS

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You probably weren't thinking about financial statements and financial ratios when you started your business. Your mind was on your mission, the reason you decided to build a company in the first place. But the more you understand about accounting basics, the better prepared you'll be to make informed, forward-looking decisions.

Financial statements and **financial ratios** are two of the most powerful tools you can use to gauge your company's financial health. They provide valuable insight to you as a manager, but you can also present them when, for example, you're applying for a loan or trying to attract investors.

COMPLICATED OUTPUT

You may already be creating basic reports (especially if you're using an accounting software) that help you in your daily work. You can see who's behind in paying you and who you must pay. If you have product inventory, reports can tell you what's selling and what's not, and when to reorder.

Financial statements are much more complex reports that you don't need to create as frequently as you do others. In fact, some small business owners look at them only monthly or quarterly. Many do so with the help of an accounting professional who can analyze them and suggest changes that might improve them.

Financial ratios are even more difficult to decipher. Here, too, a financial professional can help you both calculate them and interpret what they mean.

Here's a closer look at both.

FINANCIAL STATEMENTS

What Are They?

Financial statements are windows into your company's performance and health. You've probably heard their names before and may even have seen one filled with live data. They are a combination of:

- Balance Sheet,
- Income Statement (also known as Profit and Loss Statement, or Statement of Operations),
- Statement of Stockholders' Equity,
- Statement of Cash Flows, and,
- Footnotes to the Financial Statements.

BALANCE SHEET

The balance sheet is a record of a company's assets, liabilities, and equity at a specific point in time. Why the name? A company's financial structure balances like this:

ASSETS = LIABILITIES + EQUITY

Sample Company, LLC
Balance Sheet
As of December 31, 2016 and 2015

	31-Dec-16	31-Dec-15
CURRENT ASSETS:		
Cash	$ 25,000	$ 20,000
Accounts Receivable	120,000	175,000
Inventory	20,000	25,000
Prepaid Expenses	40,000	50,000
Total Current Assets	205,000	270,000
PROPERTY AND EQUIPMENT:		
Machinery and Equipment	125,000	60,000
Less: Accumulated Depreciation	25,000	10,000
Net Property and Equipment	100,000	50,000
TOTAL ASSETS	$ 305,000	$ 320,000
CURRENT LIABILITIES:		
Current Portion of Long-Term Debt	$ 7,000	$ 8,000
Accounts Payable	6,830	8,000
Credit Cards Payable	14,007	15,000
Total Current Liabilities	27,837	31,000
LONG-TERM LIABILITIES	70,000	90,000
TOTAL LIABILITIES	97,837	121,000
MEMBER'S EQUITY	207,163	199,000
TOTAL LIABILITIES AND MEMBER'S EQUITY	$ 305,000	$ 320,000

Assets are the resources that the business owns or controls at a given point in time. This includes items like cash, inventory, machinery, equipment, buildings, and investments.

The other side of the equation represents the total value of the financing the company has used to *acquire* those assets. **Liabilities** signify debt, while **Equity** is the total value of money that the owners have contributed to the business. The latter comprises retained earnings, which is the profit made in previous years.

INCOME STATEMENT

The income statement measures a company's performance over a specific time period. It presents information about the revenues, expenses, and profit or loss that were generated by the business' operations for that period.

Sample Company, LLC
Income Statement
For the Years Ended December 31, 2016 and 2015

	31-Dec-16	31-Dec-15
SALES	$ 3,315,938	$ 2,652,750
COST OF SALES	2,675,286	2,140,229
GROSS PROFIT	640,652	512,522
OPERATING EXPENSES:		
Advertising	5,264	4,211
Auto and Truck Expenses	3,686	2,949
Bank Service Charges	3,158	7,160
Credit Card Fees	16,621	13,297
Depreciation	8,436	6,749
Insurance	24,511	19,609
Legal and Accounting	15,943	12,754
Miscellaneous	10,963	8,770
Payroll Taxes	29,931	23,945
Rent	36,000	28,800
Repairs and Maintenance	34,370	27,496
Supplies	35,748	28,598
Travel	7,071	5,657
Utilities	28,338	22,670
Wages	199,537	159,630
Total Operating Expenses	459,577	372,295
OPERATING INCOME (LOSS)	181,075	140,226
INTEREST EXPENSE	6,237	5,613
NET INCOME BEFORE TAXES	174,838	134,613
INCOME TAXES:		
Current	43,710	33,653
NET INCOME	$ 131,129	$ 100,960

Components of the Income Statement include:

- Sales (how much the company earned),
- Cost of Sales (costs incurred to generate sales),
- Operating Expenses (costs associated with primary operating activities),
- Other Income and Expense (income and expenses not related to primary operating activities), and,
- Net Income (the company's profits).

STATEMENT OF CASH FLOWS

By capturing the current operating results and the accompanying changes in the balance sheet accounts, the cash flow statement shows a true picture of the changes in cash from one period to the next.

ABC Company, LLC
Statement of Cash Flow
For the Year Ended December 31, 2016

		31-Dec-16
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	$	131,129
Adjustments to Reconcile Net Income to Net Cash Flows From Operating Activities:		
Depreciation		15,000
Decrease (Increase) in Operating Assets:		
Trade Accounts Receivable		55,000
Inventory		5,000
Prepaid Income Taxes		10,000
Increase (Decrease) in Operating Liabilities:		
Accounts Payable		(1,170)
Credit Cards Payable		(993)
Total Adjustments		82,837
Net Cash Flows From Operating Activities		213,966
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of Property and Equipment		(65,000)
Net Cash Flows From Investing Activities		(65,000)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of Debt		(21,000)
Member's Withdrawals		(122,967)
Net Cash Flows From Financing Activities		(143,967)
NET INCREASE (DECREASE) IN CASH		5,000
CASH - BEGINNING		20,000
CASH - ENDING	$	25,000

Components include:

- Operating Activities (the amount of cash a company generates from the revenues it brings in),
- Investing Activities (purchasing and disposing of assets necessary for business operations), and,
- Financing Activities (obtaining funds to start and operate the business).

STATEMENT OF STOCKHOLDERS' EQUITY

The Statement of Stockholders' Equity shows the changes in each type of stockholders' equity over a specific period. The components of stockholders' equity include Common Stock (the par value of stock) and Additional Paid-in Capital, which is money contributed above the par value of stock. The Statement also consists of Retained Earnings (earnings retained in business) and Distributions, the amounts paid out to owners.

Sample Company, LLC
Statements of Member's Equity
For the Years Ended December 31, 2016 and 2015

	31-Dec-16	31-Dec-15
MEMBER'S EQUITY - BEGINNING	$ 199,000	$ 185,989
Net Income	131,129	100,960
Member's Withdrawals	(122,967)	(87,949)
MEMBER'S EQUITY - ENDING	$ 207,161	$ 199,000

Total equity should be rolled forward from year to year.

FOOTNOTES TO THE FINANCIAL STATEMENTS

These footnotes help readers learn about the nature of an organization's work. They summarize significant accounting policies and provide explanations of the amounts shown on the face of the financial statements. They also discuss commitments and contingencies, as well as related-party transactions. These footnotes can sometime be omitted for a simpler presentation of the financial statements.

NO ONE STATEMENT TELLS THE COMPLETE STORY

All four statements we have discussed here are related. The changes in assets and liabilities on the Balance Sheet are also reflected in the revenues and expenses that you see on the Income Statement, which may result in the company's gains or losses. The Statement of Cash Flows provides more information regarding changes in Balance Sheet accounts.
The Footnotes to the Financial Statements give the reader more information, like terms of debt and significant transactions.

WHY EVALUATE FINANCIAL STATEMENTS?

There are internal uses that can benefit stockholders, partners, members, and management. Financial statements can also assist with performance evaluation (compensation and comparison between divisions, cash flow analysis, etc.) And they can help management plan for the future, guiding them as they estimate future cash flows and the strategic direction of the company.

Financial statements can also be of value to external parties, like

- Creditors (banks, leasing companies, etc.),
- Suppliers,
- Customers, and,
- Regulators.

THE CPA'S ROLE

AUDIT	THE CPA PERFORMS DETAIL TESTING OF ALL AREAS OF THE FINANCIAL STATEMENTS AND PROVIDES THE HIGHEST LEVEL OF ASSURANCE THAT FINANCIAL STATEMENTS ARE MATERIALLY CORRECT IN ACCORDANCE WITH GENERALLY-ACCEPTED ACCOUNTING PRINCIPLES (GAAP).
REVIEW	THE CPA ESSENTIALLY PERFORMS ANALYTICAL PROCEDURES OF ALL AREAS OF THE FINANCIAL STATEMENTS. THIS PROVIDES "LIMITED ASSURANCE" THAT THE FINANCIAL STATEMENTS ARE MATERIALLY CORRECT IN ACCORDANCE WITH GAAP.
COMPILATION	NO TESTING IS PERFORMED. THE CPA ASSISTS MANAGEMENT IN PREPARING A FINANCIAL STATEMENT IN THE PROPER FORMAT USING THE COMPANY'S ACCOUNTS. NO ASSURANCE IS PROVIDED.

CASH VS ACCRUAL-BASED ACCOUNTING

Which accounting method should you use to produce the most accurate financial statements?

The difference between cash and accrual basis has to do with timing. When are revenue and expenses recognized? In cash-based accounting, this occurs when money is actually received and paid out. If your accounts are accrual-based, you record revenue as you earn it and expenses as they are incurred, even if no money has changed hands.

GAAP (Generally Accepted Accounting Principles) requires the accrual method. This method allows the current cash inflows and outflows to be combined with future expected cash inflows and outflows, which will provide a more accurate picture of a company's current financial condition.

Cash basis, on the other hand, is not GAAP-compliant, and can produce misleading financial statements.

FINANCIAL RATIOS

Financial ratios use the values found in all the elements of the financial statements to express a company's overall fiscal condition. They can pinpoint strengths and weaknesses – information that is of great interest to two groups of individuals: management and investors.

Management can determine how well the company is performing and highlight areas of needed improvement. Investors can evaluate whether a company is a good investment by comparing ratios between companies and industries.
The three most common types of ratios are used to analyze a company's abilities in very specific areas. They are:

- **Liquidity Ratios:** Can the company pay off its short-term debt obligations?
- **Profitability Ratios:** How well can the company generate earnings compared to its expenses?
- **Leverage Ratios:** What about its debt vs. capital structure?

LIQUIDITY RATIOS

The Current Ratio is primarily used to evaluate the company's ability to pay back its short-term liabilities with its short-term assets. The higher the current ratio, the more capable the company is of fulfilling its obligations.

A ratio of less than 1.00 suggests that the company would be unable to pay off its obligations if they came due at that point. While this indicates that the company may not be in good financial health, it does not necessarily mean that it will go bankrupt, thanks to financing options.

CURRENT RATIO	$\frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$

PROFITABILITY RATIOS

There are three of these:

Gross Profit % is a financial metric that assesses the company's financial health by calculating what's left over from sales after accounting for the cost of sales. Additional expenses and future savings come out of the gross profit margin.

$$\frac{\text{GROSS PROFIT}}{\text{SALES}}$$

Operating Expenses % is a measurement of management efficiency. Management usually has greater control over operating expenses than it does over revenues, thus the ratio. When viewed over time, the operating expense ratio can tell you if management can expand operations without dramatically increasing expenses. For example, if sales were to expand from year to year and the operating expense ratio goes down, it would be a very positive situation from a net earnings perspective.

$$\frac{\text{OPERATING EXPENSES}}{\text{SALES}}$$

Rate of Return on Sales is a ratio of profitability. For every dollar of sales, how much actually drops to the bottom line? It may indicate whether the business is generating enough sales to cover the fixed cost and operating expenses and still leave an acceptable profit.

$$\frac{\text{OPERATING INCOME}}{\text{SALES}}$$

LEVERAGE RATIOS

Debt to Equity. Total debt to equity indicates what proportion of debt and equity the company is using to finance its assets. A high debt to equity ratio generally means that the company has been aggressively financing its growth with debt. This can result in volatile earnings because of the additional interest expense. Generally, a ratio of less than 1.00 is preferred.

$$\frac{\text{TOTAL LIABILITIES}}{\text{TOTAL EQUITY}}$$

Debt Service Coverage Ratio. This measures the amount of cash flow available to meet annual debt service requirements.

EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION & AMORTIZATION (EBITDA) / ANNUAL DEBT SERVICE (CURRENT PORTION OF LONG-TERM DEBT + INTEREST)

OR

$$\frac{\text{(EBITDA)}}{\text{PRINCIPAL + INTEREST PAYMENTS}}$$

QUICK QUALIFIERS

What ratios do lenders look at, and what do they want to see? Here are some examples.

Current Ratio – a healthy business is 1.5% or greater

Debt to Tangible Net Worth – the lower the ratio the healthier the business

Debt Service Coverage Ratio – most lenders require 1.25 or higher

Ratio	Formula
CURRENT RATIO	CURRENT ASSETS / CURRENT LIABILITIES
DEBT TO TANGIBLE NET WORTH	TOTAL DEBT / TOTAL ASSETS - TOTAL LIABILITIES - INTANGIBLE ASSETS
RETURN ON ASSETS	INCOME BEFORE TAXES / TOTAL ASSETS
RETURN ON INVESTMENT	INCOME BEFORE TAXES / NET WORTH
DEBT SERVICE COVERAGE RATIO	EBITDA / CURRENT PORTION LT DEBT + INTEREST

Even if you aren't looking for financing or outside investors, understanding your financial statements and financial ratios can be beneficial to you as a manager. Remember these ratios reflect the conditions at a point in time and they can and will change over time.

With the help of an accounting professional, you'll gain far more insight into your company's overall fiscal health than you do from your everyday reports. The more knowledge you have, the better you'll be able to plot a course for a successful future.