



Financial Statements

Have you ever wished you could know exactly how profitable your company was last month or if your cash flow is adequate to pay off a loan more quickly? Gone is the guesswork of yesterday with accounting software such as QuickBooks which allows you to access your company's financial statements whenever you wish. Financial statements should be reviewed by management minimally on a monthly basis in order for timely decisions to be made regarding the business. Quarterly or year-end statements do not allow management to correct the course quickly enough during the year. **We believe that timely accurate financial information is a foundation for business management.**

There are four fundamental financial statements which every company should utilize: 1) Income Statement, 2) Balance Sheet, 3) Cash Flow Statement, and 4) Owner's Equity Statement. As this memo is directed at private companies, it will not focus on the Owner's Equity Statement which shows changes in shareholders' interests over time.

Cash or Accrual Statements

Many private companies use the cash basis for developing financial statements. With the cash basis, income is recognized when the cash is received and expense is recognized when it is paid. Cash basis is easy since it relates to the check book. Yet, cash basis has serious weaknesses. The key weakness is failure to incorporate accounts receivable or accounts payable into the financial statements, as is done in the accrual method of accounting. Too often the checking account looks good only because the bills have not been paid. For this reason we strongly encourage accrual accounting for business financial statements.

Income Statement

The Income Statement, also known as the Profit and Loss Statement (P&L), shows the profit or loss a company earned over a specific operating period (see attachment for example). This period is typically monthly, quarterly, or annually. The P&L begins by showing total Revenue or sales less any sales discounts given. Cost of Goods Sold is then deducted from revenues to reach the Gross Profit Margins. Gross margins should be monitored carefully as they indicate how well a company is pricing their products as well as the costs to create those products. Many service firms do not use Cost of Goods Sold if their sole input for the product is labor.

Operating Expenses consist of fixed and variable expenses including sales, general, and administrative, and depreciation and amortization. Since operating expenses support operations and are not linked directly to a product, they are not included in the Cost of Goods Sold. As operating expenses do not necessarily increase the overall revenues but rather take away from the company's profits, they should be monitored closely. Operating Expenses are deducted from the Gross Margins and the difference is Net Income (or Loss) before taxes. When taxes are removed, we arrive at our Net Income or Loss, also known as the "bottom line."

Balance Sheet

Unlike the Income Statement, the Balance Sheet (see attachment for example) provides an overall view of the financial position of a company for a specific point in time. The Balance Sheet is often referred to as the “snap shot” of the business financial condition. The Balance Sheet includes Assets, Liabilities, and Owners Equity.

1. Assets are listed in order of liquidity –first the Current Assets (cash and equivalents that can be converted into cash within twelve months) and then Long-Term Assets (Plant & Equipment, Land & Buildings, Intangible Assets, etc.).
2. Liabilities are listed in the same order by commitments due. Current liabilities include those that need to be repaid within twelve months such as Accounts Payable, short-term loans, and accrued liabilities. Long-term liabilities include mortgages or other long-term loans.
3. Equity in most small companies consists of individuals or partners. Profits are either paid as dividends to the owners or accumulated as Retained Earnings to be reinvested in the company.
4. Total Liabilities plus Owner’s Equity must equal Total Assets in order for this financial statement to be in balance.

The information provided on the Balance Sheet allows management to ensure the proper cash levels are maintained and excess cash is invested in short-term investments. Accounts Receivable should also be monitored so that the cash flow of the business continues in a regular manner. Inventory levels need to be watched so that additional carrying costs are not incurred from a surplus. Accounts Payable should be observed so that bills are paid within the terms and that enough liquidity is maintained in the company to permit this.

Cash Flow Statement

While the use of accrual accounting allows a company to accurately view income and expenses in the same period on the Income Statement, it does not show the flow of cash entering and exiting the company. This is the role of the Cash Flow Statement for a given period of time. It also shows the sources of cash.

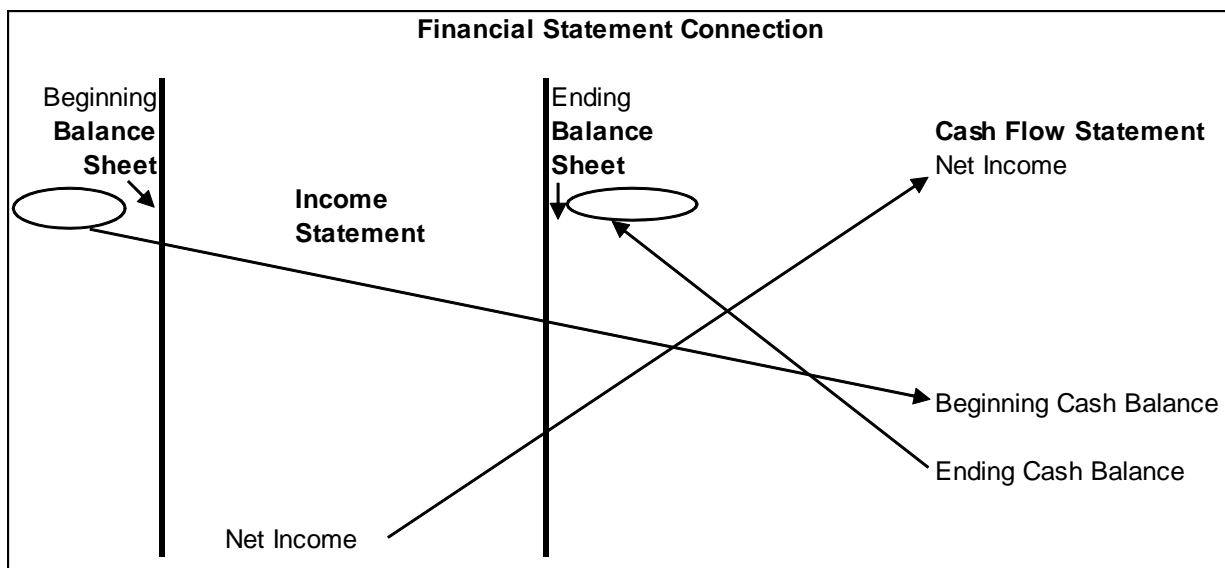
Cash Flow Statements (see attachment for example) are divided into three parts: Cash from Operating Activities, Cash from Investing Activities, and Cash from Financing Activities.

1. The Cash Flow Statement begins with the Net Income or Loss of the company and then adds or deducts non-cash operating activities. For example, depreciation is added back since no cash is utilized to pay depreciation expenses. Adjustments are also made to reflect changes in inventory, Accounts Receivable, and Accounts Payable.
2. Cash from Investing Activities usually includes capital expenditure activity such as a merger with another company or the purchase of long-term assets such as equipment. The sale of equipment or a portion of the investment portfolio would also be reflected here.
3. Cash from Financing Activities includes the sale and purchase of stock in public companies, but also the payment of dividends and the incurrence and payment of debt. In companies that are starting up or in growth phases, there will often be activity in this section related to the generation of more capital.

Connecting the Statements

The Income Statement, Balance Sheet, and Cash Flow Statement connect in several distinct ways and provide check points along the way. At Cathedral we encourage the use of a Quick Test as the starting point to verify the validity of the statements. This Quick Test includes the following check points:

- 1) Does the balance sheet balance? Total Assets should equal Total Liabilities & Owner's Equity.
- 2) Does the Net Income from the Income Statement start and match the Net Income on the Cash Flow Statement?
- 3) Does Cash from the Beginning Balance Sheet match the Beginning Cash Balance on the Cash Flow Statement?
- 4) Does Cash from the Ending Balance Sheet match the Ending Cash Balance on the Cash Flow Statement?



Comparative Financial Statements

Comparative financial statements enable management to better evaluate the business results for the period. Comparative financial statement will have the current period's actual results compared to the budgeted for the period, showing differences from budget. The current period's actual results will also be compared to the prior year's results for the same period. Generally, there will also be a year to date for the current period compared to the year to date for the prior year. Such comparisons create a real sense of the direction of the business. The budget is the expectation for the period and the prior year is a benchmark. To the extent there are unexpected variations, the business has early warnings and an opportunity to adjust for both positive and negative trends.

Basic Financial Analysis

Three years of financial data are typically reviewed in order to uncover trends and seasonality issues. Monthly review should include a comparison to budget as well as year on year examination. While the current monthly review might reveal that the company did not meet the projected budget for revenues or profits, a year on year comparison could still show positive growth. This simply shows that the stretch in budget was not reached and a management could have a conversation around alternative ways to increase revenues or profits. It is important that year on year financial statements reveal continued, steady growth in the company.

The discipline of regular review of the financial statements will encourage consistent company growth. This review also enables management to make adjustments as needed and compare the business relative to company goals and industry benchmarks.

Basic Ratios

While there are many ratios that a company can consider in analyzing the financial statements, one of the most critical is current liquidity. Working capital shows the amount of money a company will have to operate with if it pays down its current debts.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

If working capital is negative this means that the company's debt obligations exceed the amount of cash available to repay. However, if the Current Ratio is too high this also indicates that assets are not being invested well. Comparing this ratio with prior periods will reveal the trend in cash turn.

In order to ensure that Accounts Receivable is converted to cash in a timely way, the Accounts Receivable days outstanding should be calculated. Total Accounts Receivable is found under Current Assets on the Balance Sheet while Total Sales are found on the Income Statement.

$$\text{Average Days to Collect} = (\text{Total Accounts Receivable} / \text{Total Sales}) * 365$$

Tutorials & Articles for Further Reading

- This video-based tutorial from Baruch College provides an excellent overview of financial statements in under an hour. If you are at all confused about the statements, this is the place to start. <http://www.baruch.cuny.edu/tutorials/statements/>
- "Financial Statements." This article provides more in-depth explanations of the Income Statement and Balance Sheet and their uses to management. http://www.toolkit.com/small_business_guide/sbg.aspx?nid=P06_7001
- "Beginners Guide to Financial Statements." This article walks through the basics of financial statements and ratios. Unlike many sites, this article includes a good overview of the Cash Flow Statement. <http://www.sec.gov/investor/pubs/begfinstmtguide.htm>
- "Basic Financial Statements." The University of Arizona provides an overview and good basic descriptions of the Income Statement and Balance Sheet. <http://www.studyfinance.com/lessons/finstmt/index.mv>
- Epstein, Lita. *Reading Financial Reports for Dummies*. Indiana: Wiley Publishing, Inc., 2005.

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