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BALANCE SHEETS AND INCOME STATEMENTS

As a business owner or manager, you wear different hats and juggle several "management balls" at once. But the one hat you can never shed is that of financial manager and planner.

When you finally have an accounting system that produces timely and accurate financial statements, your primary ownership responsibility of understanding and interpreting exactly what you have begins.

The process of analysing your statements is not a glamorous task, and the best way to start is to roll up your sleeves and dig in.

Three steps are required: -

1. understand how your statements are formulated;
2. use your data to produce a series of financial ratios; and
3. interpret using the ratios to analyse the causes and effects of financial events in your business.

MAKING A STATEMENT

All financial analysis begins and ends with financial statements. The two basic statements are the **Balance Sheet** and the **Income Statement (or Profit & Loss Statement)**.

The balance sheet functions as a historical record of activity since day one of your business.

Functionally it's like taking a snapshot of the business at a point in time – usually the end of an accounting period. It reveals three things: - assets, liabilities and net worth. This fundamental relationship is summarised in the following formula: -

Assets equals Liabilities plus Net Worth or Assets minus Liabilities equals Net Worth

There are several issues worth noting in relation to your balance sheet. First, the assets are broken down into three basic sections based on the time frame in converting them to cash: - current assets, fixed assets and intangibles.

Since assets are things the business owns, they have to be bought. Liabilities reflect funds in the form of loans, and net worth reflects funds in the form of capital investment and retained earnings.

THREE CLASSES OF ASSETS

Let's discuss briefly the three classes of assets. **Current Assets** are those that are normally converted to cash within one year. – such as cash at bank, accounts receivable and inventory. These three types of assets interact to create the ***working capital cycle***. : - cash to inventory to accounts receivable and back to cash. If you're a retailer with no accounts receivable, you still have inventory to manage in the cycle.

In current assets, you also typically find a category called prepaid expenses such as rent and insurance that you "use up" over the course of the year.

Fixed Assets represent those tangibles upon which the activity of the business turns – such as land, buildings and plant and equipment. With the exception of land, fixed assets are depreciated - or written off – over the "useful life" of the items.

Intangibles are the third asset category and are represented by such items as goodwill and franchise rights.

Most of your assets are placed on your books at cost or fair market value – whichever is less.

LIABILITIES AND NET WORTH

Liabilities are also classified into short-term and long-term, depending again on whether they are paid within one year.

Current Liabilities (short-term), such as accounts payable, overdraft and accruals are paid within one year. Accruals are simply a way of saying, "I know I owe it, but I haven't written the cheque yet".

Long Term Liabilities (Non-Current Liabilities) such as mortgages or equipment loans, are those that will be repaid over a period exceeding one year.

The last section of the balance sheet is labelled **– Net Worth**. There are two components: - owner's contributions (share capital) and retained earnings. Retained earnings are those after-tax earnings kept (retained) in the business to finance the acquisition of new assets.

There are two important things to remember about retained earnings: - first, they are not cumulative; and second, they are not usually cash. Many owners make the mistake they represent cash. Not so. They represent funds available to purchase new assets, and in many case, they have been spent before you get them.

BALANCE SHEETS AND INCOME STATEMENTS

To sum up the balance sheet: it's a record from day one and measures what a company owns and owes at a point in time. The key financial issues relating to the balance sheet are liquidity/solvency, financial risk and asset management.

And why does the balance sheet balance? A system of double entry bookkeeping means each entry is checked by a balancing entry.

Now let's talk about the **income statement (or Profit & Loss Statement)**. It's simply the results of the operations over a given period, normally a year.

The primary benchmarks are ***gross profit*** and ***net profit***. Gross profit measures what remains when the cost of goods sold (variable expenses) is subtracted from sales and, naturally net profit measures what remains when operating (fixed) expenses are subtracted from gross margin. The key financial issues relating to the income statement are pricing, margin maintenance and expense control.

At the end of each year, your bookkeeper closes all of the income and expense accounts to produce "net profit after tax" (your income statement). This amount goes directly into retained earnings (your balance sheet) and then you start all over again in income/expense. Thus, the income statement represents only one year at a time while a balance sheet is forever.

Now let's wrap it all up. This information can be used to see where you've been and where you're going. The goal? Planning and control.