Financial Statements That Make Sense

Monitoring the vital signs of your business

"...when business is healthy, all of society is healthy."

– Harry Jack Gray, Chairman, United Technologies Corp.

Overview

Financial statements are the financial quantification of your business. Financial statements are more than an accounting exercise; they are an accurate, objective picture of your business. Everything in your financial statements is a reflection of something real in your business.

The two most important financial statements are your balance sheet and your income statement.

Your balance sheet is a snapshot, as of a specific point in time, of your assets (what your business owns), your liabilities (what your business owes to others), and owners' equity (what is left for the owner and investors after liabilities have been covered). It describes the financial health and value of your business.

Your income statement shows your business' revenues and related expenses during a specified period of time, usually a month, a quarter, or a year. It describes the financial performance of your business.

The financial trends of your business are the changes over time of the various components on your balance sheet and income statement. Ratio analysis combines various line items of your financial statements in the form of ratios, fractions, or percentages. Ratio analysis adds depth to your understanding of your financial dynamics.

Typical Income Statement Layout

<table>
<thead>
<tr>
<th>Financial Indicator</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$</td>
</tr>
<tr>
<td>Net revenues</td>
<td>$</td>
</tr>
<tr>
<td>Variable costs</td>
<td>%</td>
</tr>
<tr>
<td>Contribution</td>
<td>%</td>
</tr>
<tr>
<td>Fixed expenses</td>
<td>%</td>
</tr>
<tr>
<td>Total fixed expenses</td>
<td>%</td>
</tr>
<tr>
<td>Operating profit</td>
<td>%</td>
</tr>
<tr>
<td>Other income and expenses</td>
<td>%</td>
</tr>
<tr>
<td>Net profit before taxes</td>
<td>%</td>
</tr>
<tr>
<td>Taxes</td>
<td>%</td>
</tr>
<tr>
<td>Net profit (or loss)</td>
<td>%</td>
</tr>
</tbody>
</table>
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Do You Really Know Your Business?

If you don’t have financial statements, you don’t know your business.

If you do have financial statements but don’t understand them, you still don’t know your business.

And if you can read them, but don’t know what to do about what they tell you, you can’t manage your business effectively.

Your financial statements are the single most revealing picture of your business, how it’s performing, and its general state of health. That’s why bankers, investors, and other outsiders want to see your “financials.” They can learn more about your business in the shortest amount of time from your financial statements than from any other single source.

And so can you.

Your financial statements are also the most accurate indicator of what’s happening in your business and where to direct your management attention to detect and solve problems.

Financial statements are all these things. If you construct them properly. If you know how to read them. If you pay attention to them. If you act on what they tell you.

Your Balance Sheet and Your Income Statement – Understand Them and the Rest Is Easy

When you understand your balance sheet and your income statement, you understand the basics of all the other financial tools and reports you will be developing and using. Cash flow analysis, budgeting, financial forecasting – they are all variations on the basic idea of financial statements.

Keep one essential fact in mind, and all the mystery of financial statements disappears. Financial statements – no matter how detailed, no matter how full of accounting jargon, no matter how technical or mathematical they seem – are nothing more than a picture of your business. Everything in your financial statements – everything – is a reflection of something you do in your business.
And that's the true value of financial statements. They're useful to outsiders, to be sure, but they're indispensable management tools for you. They tell you what's going right and what's going wrong in your business, and they tell you how seriously right or wrong.

You don't have to be an accountant to understand financial statements. Some would even say it's better if you're not an accountant. That way, the businessperson's point of view shapes the way you read and interpret your statements; and that's what you are, a businessperson with ownership and management concerns, not accounting concerns. That's no insult to accountants. They're highly trained, intelligent advisors, and essential allies of every business owner.

If you already know the value of your financial statements, this reminder doesn't hurt. If you don't really believe it yet, you will by the end of this process.

Two Views of Reality

Your income statement describes your company's overall performance, and your balance sheet tells you about the value and general health of your business. Remember:

**Income Statement = Business Performance**

**Balance Sheet = Business Health & Value**

The income statement (it's also called the “profit and loss” statement or “P&L”) tells how much money you're making in your business and how you're making it. It measures **revenues** received and **costs** incurred over a period of time. The time period could be a week, a month, a quarter, a year—monthly is most common, but any period can be used. The point is that the income statement shows the cumulative **profits or losses** incurred by your business between some starting date and some ending date. It tells you if you're making money or not, and how much you're making or losing.

The balance sheet, on the other hand, tells what you own and what you owe. It identifies **assets**, which are the resources your business controls (cash, equipment, material, buildings, furniture, savings accounts, money owed to you), **liabilities**, which are debts and other obligations you owe to others (accounts payable, taxes, payroll, loans), and **equity**, also called net worth, which is what's left for the owners and investors after liabilities are subtracted from assets. The balance sheet tells you about the financial “health” and “value” of your business; in fact, some call it the “statement of condition.”
A balance sheet measures your financial health and value as of a specific point in time. Rather than covering a range of time like the income statement, the balance sheet states the balance between your assets and liabilities at one point in time.

The difference between what an income statement shows and what the balance sheet shows can be compared to the difference between a video camera and a 35mm still camera photographing a horse race. The video camera will catch all the movements of the horses from the starting gate to the finish line: the pounding of their hooves, the bobbing of their heads, the muscles in their legs – all of the activity between the start and the finish of the race will be filmed by the video camera. Likewise, all of the money coming in and all of the money going out of the business during a specified period of time will be shown in an income statement.

The still camera will capture the horses in an instant of time – it will not show movement; it won’t show what happened ten seconds before. It simply shows the features of the horse at the moment the picture was taken. Similarly, a balance sheet does not show changes in the financial picture over a period of time. It identifies the condition of the business at a specified instant in time, by showing what resources the business had at its disposal and what amounts the business was obligated to pay to others at that stated moment.

So let’s look in more detail at each of these management tools – the income statement and the balance sheet – to see what information each provides and how it can be used.

**Your Income Statement: Are You Making a Profit?**

Your income statement tells you if your business earned money or lost it during a specific period of time. Every income statement is no more than an expanded version of this simple equation:

\[
Revenues - Costs = Earnings
\]

Your income statement measures the profitability of your business by subtracting all the costs of doing business in a specific period of time from the revenues generated during that same period. If your revenues exceed your costs, it’s a profit; if not, it’s a loss. The time period is usually a month, although it could be any time period.

If you’ve ever looked at financial statements in annual reports or elsewhere, you’ve probably noticed that no two seem to be put
Financial Statements That Make Sense

The E-Myth Mastery Program
Module 3: E-Myth Money Fundamentals
Business Development Process: FN-0020

together in the same way. That’s the beauty of income statements. They adapt to the needs of the companies using them. While they may seem as different as the companies they measure, they all conform to certain underlying principles. Once you understand the principles, and a little accounting jargon, they all make perfect sense.

There are two general approaches to income statements, the “contribution” and the “functional” methods. They both start with revenues and they both arrive at the same bottom line, but they organize operating costs differently and are useful in different ways for different audiences.

For external communication and reporting, the functional method is preferred. It breaks costs into categories that relate to the major functions of your business – production, marketing and sales, and general and administrative. Outsiders, who don’t know your business as well as you do, get a clearer picture from the functional categorization of costs. Take a look at the inset on the next page for a little more information about functional method income statements.

For internal business management purposes, the contribution method is recommended because it lends itself to a clearer understanding of the financial dynamics of your business. It helps you understand the profitability of your products and services and make intelligent pricing decisions. It’s also simpler to construct and use. It’s the better method for “getting your house in order,” and it’s the method used throughout this module.

The Vital Components of Your Income Statement

It’s not our intention, nor is it likely to be yours, to turn you into accounting experts. But it is important to know your way around a financial statement and how to use one to manage your business. Here’s a quick overview of the most important elements of your income statement:

\[
\text{Revenues} - \text{Variable Costs} = \text{Contribution} - \text{Fixed Expenses} = \text{Operating Profit} \pm \text{Non-operating Income & Expenses} = \text{Net Profit}
\]
The Income Statement Using the “Functional Method”

All income statements cover the same information and follow the same basic formula: Revenues – Costs = Profit. The difference between the contribution method and the functional method is in the presentation of costs. The contribution method groups “variable” and “fixed” costs, and calculates the “contribution.” The functional method groups costs by business function, with: a “cost of goods sold” category to show the cost of producing or obtaining the products to be sold; and an “operating expenses” category to show the operating costs of running the business, which is often divided into “marketing & selling expenses” and “general & administrative expenses.” A “gross profit” number is also calculated. The functional income statement has the following general presentation:

\[
\text{Revenues} - \text{Cost of Goods Sold} = \text{Gross Profit} - \text{Operating Expenses} = \text{Operating Profit} + \text{Non-operating Income & Expenses} = \text{Net Profit}
\]

The functional income statement contains all the variable and fixed expenses, but they are intermixed into the functional expense categories. If you prefer to use the functional method, you can still (and you should) total your variable and fixed costs and calculate your contribution in order to understand the financial dynamics of your business, get a clearer picture of the riskiness of your business (through “break-even analysis”), and make intelligent pricing decisions.

You can see how these components are typically presented in the income statement example to follow.

It’s especially important to understand the concepts of variable costs, fixed expenses, and contribution. They are the keys to understanding the financial dynamics of your business, making sound pricing decisions, quantifying the financial consequences of marketing and sales activities, and keeping a watchful eye on the riskiness of your operation. You’ll hear a lot more about them in the Financial Strategies process of this module.

Revenues (also, sales). In addition to actual cash transactions, the revenue figure reflects amounts due from customers on credit or other delayed payment arrangements (such as layaway plans or grace periods), as well as the equivalent monetary value of merchandise or other tangible items received as payment. Service businesses derive revenues from fees; retailers and manufacturers derive revenues from sales.

You’ll usually see three line items that, together, comprise revenues:

- **Gross revenues** include all income flowing into your business for services rendered or goods sold.
- **Less returns and allowances** is the recognition that some sales are returned (customer dissatisfaction, faulty merchandise, unsatisfactory service), and some businesses offer discounts for timely payment, which, in effect, reduces the amount of the original sale.
- **Net revenues** is the amount your business received and kept—the actual amount of the sale when returns and allowances are subtracted from gross revenues.

Variable costs (sometimes called “direct” costs). These are all costs of doing business that are directly proportional to your revenues—they “vary” with revenues. If revenues double, variable costs double. If revenues drop by 10%, variable costs drop by about 10% as well. Variable costs usually include things like sales commissions, the costs of materials and components used to manufacture your product, the cost of labor directly involved in making your products, and freight charges for delivering products to customers.

Contribution (also called “contribution margin” or “marginal income”). The amount of money available to cover fixed expenses and generate profits. The idea is that each unit of product or service sold provides a certain amount, or “contribution...
tion,” that goes toward the covering of fixed expenses. This is an important number, as you will see later.

If you think of variable costs as those that are “automatically” covered by your sales (not quite accurate, but a useful way to think of it), then fixed expenses are the additional costs of running your business that also have to be covered by your sales. Or another way to look at it: your products and services have to generate revenues to pay for their own production and delivery. What’s left after that is available to “contribute” to all the other costs of running your business, plus the profit you want to earn. Either way you look at it, contribution margin tells you how well you’re doing it.

You may be familiar with the term “gross profit,” which is what you get when you subtract costs associated with manufacturing a product from revenues. It’s an important number when you use the functional type of income statement. There are some similarities, but it’s not the same as contribution, and you shouldn’t get the two terms confused.

**Fixed expenses.** These are costs that do not vary with revenues. They don’t change much, if at all, when revenues change, although they might change a little. If revenues go up 25%, fixed costs won’t change at all, or they might change 2% or 5%, but not in a direct relationship with revenues. The cost of your bookkeeping staff’s salaries, for instance, is the same if your sales double or drop by half. The same is true for your rent, your heating and electricity bills, your insurance, the cost of your bank loans, salaries of your support staff, and a host of other expenses. As your company grows, fixed expenses may increase significantly, or they might rise due to inflation, but they don’t change in close correlation with your sales.

**Operating profit.** This is the pretax profit earned by your business during the month. It is the net of revenues, variable costs, and fixed expenses:

\[
\text{Revenues} - \frac{\text{Variable Costs}}{} - \frac{\text{Fixed Expenses}}{} = \frac{\text{Operating Profit}}{}
\]

**Other income and expenses.** Income and expenses that are not generated by the usual operations of your business are shown separately. They can be important contributors to your “bottom line,” but they aren’t your main line of business. Typically, items in this category include financial revenue (such as interest from company investments), financial expense (such as interest on borrowed capital), and extraordinary items like settlements.
from lawsuits, sale of a major asset not in the normal course of your business, or costs incurred as a result of a disaster such as a flood or an earthquake.

**Net profit before taxes** (also pretax income, pretax profit). Add other revenues and subtract other expenses from net operating income and you have pretax income.

**Net income** (also, net profit or net loss). This is the well-known “bottom line.” It’s what’s left after all the expenses incurred by your business are subtracted from your revenues.

### Formatting Your Income Statement

The inset box shows the layout and general contents of a typical income statement. There are any number of variations on this basic theme, and your accountant will help you decide what format will work best for you.

Here are some important general points to keep in mind:

- For each “line item,” show both the dollar amount and its percentage of net revenues. From period to period, you’re going to want to know changes in dollar amounts, as well as any shifts in the mix of your variable and fixed costs. Unusual or unexpected changes in either dollar amounts or percentages are signals that should command your attention and motivate you to determine the causes.

- It’s a good idea to show two columns of results, typically one for the most recent month and one for the year to date. That way you can track your progress as the year progresses from month to month.

- It’s important to track your basic business and to separate out the financial effects of anything not related to the business operation. That’s why there are separate categories for “other income and expenses.” They might not occur in your business very often, but when they do, separating them from your operating results will prevent distortions and preserve consistency from period to period.
# Income Statement Example

## XYZ WIDGET WORKS

For the Month and Year to Date Ending March 31, 199X

<table>
<thead>
<tr>
<th></th>
<th>Current Month</th>
<th>Year to Date</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>REVENUES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross sales</td>
<td>$202,780</td>
<td>$597,770</td>
</tr>
<tr>
<td>Less returns and allowances</td>
<td>6,340</td>
<td>19,520</td>
</tr>
<tr>
<td>Net Revenues</td>
<td>$196,440 100.0%</td>
<td>$578,250 100.0%</td>
</tr>
<tr>
<td><strong>VARIABLE COSTS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise purchased for resale</td>
<td>$51,500 26.2%</td>
<td>$152,960 26.5%</td>
</tr>
<tr>
<td>Product packaging materials</td>
<td>4,850 2.5%</td>
<td>15,030 2.6%</td>
</tr>
<tr>
<td>Product postage and delivery charges</td>
<td>1,370 0.7%</td>
<td>4,030 0.7%</td>
</tr>
<tr>
<td>Direct mail marketing expenses</td>
<td>10,500 5.3%</td>
<td>31,120 5.4%</td>
</tr>
<tr>
<td>Sales commissions</td>
<td>3,250 1.7%</td>
<td>9,330 1.6%</td>
</tr>
<tr>
<td>Telephone (telemarketing)</td>
<td>1,820 0.9%</td>
<td>5,310 0.9%</td>
</tr>
<tr>
<td>Travel and entertainment (sales)</td>
<td>1,420 0.7%</td>
<td>3,560 0.6%</td>
</tr>
<tr>
<td>Supplies (brochures, mailers)</td>
<td>1,230 0.6%</td>
<td>3,580 0.6%</td>
</tr>
<tr>
<td>Other marketing/selling expenses</td>
<td>2,300 1.2%</td>
<td>6,870 1.2%</td>
</tr>
<tr>
<td><strong>CONTRIBUTION</strong></td>
<td>$78,240 39.8%</td>
<td>$231,790 40.1%</td>
</tr>
<tr>
<td><strong>FIXED EXPENSES</strong></td>
<td>$118,200 60.2%</td>
<td>$346,460 59.9%</td>
</tr>
<tr>
<td>Salaries, wages and benefits</td>
<td>$65,650 33.4%</td>
<td>$193,330 33.4%</td>
</tr>
<tr>
<td>Occupancy expense</td>
<td>7,860 4.0%</td>
<td>23,580 4.1%</td>
</tr>
<tr>
<td>Telephone and office communications</td>
<td>2,640 1.3%</td>
<td>8,050 1.4%</td>
</tr>
<tr>
<td>Travel and entertainment</td>
<td>2,660 1.4%</td>
<td>5,780 1.0%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>4,080 2.1%</td>
<td>12,240 2.1%</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,830 0.9%</td>
<td>5,110 0.9%</td>
</tr>
<tr>
<td>Other general &amp; administrative expenses</td>
<td>3,400 1.7%</td>
<td>9,990 1.7%</td>
</tr>
<tr>
<td><strong>TOTAL FIXED EXPENSES</strong></td>
<td>$88,120 44.9%</td>
<td>$258,080 44.6%</td>
</tr>
<tr>
<td><strong>OPERATING PROFIT</strong></td>
<td>$30,080 15.3%</td>
<td>$88,380 15.3%</td>
</tr>
<tr>
<td><strong>OTHER REVENUES and EXPENSES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lawsuit settlement received</td>
<td>$12,000 6.1%</td>
<td>$12,000 2.1%</td>
</tr>
<tr>
<td><strong>NET PROFIT BEFORE TAXES</strong></td>
<td>$42,080 21.4%</td>
<td>$100,380 17.4%</td>
</tr>
<tr>
<td><strong>TAXES INCURRED</strong></td>
<td>$18,150 9.2%</td>
<td>$52,120 9.0%</td>
</tr>
<tr>
<td><strong>NET PROFIT</strong></td>
<td>$23,930 12.2%</td>
<td>$48,260 8.3%</td>
</tr>
</tbody>
</table>
Time Out for a Reality Check

We’re going to look at your balance sheet in a moment, but let’s pause a bit to think about what’s going on here. We’ve talked about categorizing your revenues and costs, doing some simple arithmetic, and arranging your income statement. It’s a lot of accounting talk. But what are you really doing?

You’re thinking about your business – about various parts of it and how they work together to achieve a financial result. Revenues focus your attention on your lead generation and sales activities. Your operating costs, both variable and fixed, tell you what it costs to run your business, and each line item of cost tells you about specific areas of your business. Operating profit (you’ll see later how important it is to maximize your operating profit) tells you how much money your basic business is generating. And the famous (or infamous) “bottom line”—net profit—tells you how much profit you generated over the time period. Each of those “line items,” and each of the many more you will establish for yourself, relate to a specific part of your business that you can track and manage for the best financial result.

If we seem to be dwelling on this point to excess, we are, and we’re doing it on purpose. We don’t want you to lose sight of the fact that financial statements are as much about management as they are about money.

Your Balance Sheet: How Healthy Is Your Business?

Your balance sheet provides a snapshot picture of your business’ health and value as of a specified point in time. It does not show movement – it does not cover a range of time – it is the financial “health” of your business at a given moment. Balance sheets are prepared at the close of a particular day (usually at the end of an accounting period such as month-end, quarter-end, or year-end).
The balance sheet summarizes resources your business controls (its assets), obligations it owes to others (its liabilities), and what is owned by you and any others who have invested in your business (your equity or net worth).

There is a standard format for balance sheets, regardless of the size of the company or the nature of the business or industry you’re in. That is, a balance sheet for a large corporation will have the same general arrangement as a balance sheet for a sole proprietorship. The diagram on the previous page and the example on the next page show the typical balance sheet layout. Occasionally you’ll see a balance sheet in a single column, starting with assets, followed by liabilities, and ending with owners’ equity.

If the income statement indicates a business’ profitability — how its operating expenses compare to its operating revenues — the balance sheet provides a picture of the business’ general financial condition — its financial health and vitality. In fact, the balance sheet is sometimes called a “statement of financial condition” — perhaps a more descriptive name for the information it provides.

Your balance sheet is a summary of your company’s assets, liabilities, and owners’ equity. The key to understanding a balance sheet is a simple formula. Balance sheets always follow the formula:

\[
\text{Assets} = \text{Liabilities} + \text{Owners' Equity}
\]

As with an income statement, the balance sheet starts with the company’s name at the top of the page, followed by the date of the financial records. Remember, this isn’t a period of time but a specific date, so the balance sheet heading says something like: “As of March 31, 1996.” Usually, the specified date is the last day of the accounting period which you have established for your accounting system.
### Balance Sheet Example

**XYZ Widget Works Balance Sheet**  
*As of December 31, 1995*

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES &amp; OWNERS' EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CURRENT ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>Cash on Hand</td>
<td>$ 850</td>
</tr>
<tr>
<td>Cash Deposits in Bank</td>
<td>5,200</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>21,600</td>
</tr>
<tr>
<td>Merchandise Inventory</td>
<td>45,530</td>
</tr>
<tr>
<td>Prepaid Expenses - Rent</td>
<td>1,200</td>
</tr>
<tr>
<td><strong>TOTAL CURRENT ASSETS</strong></td>
<td>$ 74,380</td>
</tr>
<tr>
<td><strong>FIXED ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>Equipment and Fixtures</td>
<td>$ 143,700</td>
</tr>
<tr>
<td>(Less Depreciation)</td>
<td>(82,500)</td>
</tr>
<tr>
<td>Real Estate Owned</td>
<td>455,000</td>
</tr>
<tr>
<td><strong>TOTAL FIXED ASSETS</strong></td>
<td>$ 516,200</td>
</tr>
<tr>
<td><strong>OTHER ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>Patent Rights Purchased</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Product License Purchased</td>
<td>45,500</td>
</tr>
<tr>
<td><strong>TOTAL OTHER ASSETS</strong></td>
<td>$ 95,500</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td>$ 686,080</td>
</tr>
</tbody>
</table>

### The Vital Components of Your Balance Sheet

The accounting rules for balance sheets are every bit as technical as for income statements. Remember, the point is not to try to become an accounting expert, but to understand how to read and use the balance sheet to make financial decisions. Here's a quick overview of the most important elements of your balance sheet – some of the elements are oversimplified from an accountant's point of view, but that's deliberate. You need to grasp the idea of the balance sheet and the essence of its parts, not the accounting details. Your accountant will attend to the technicalities.

**Assets** are anything of value that is owned or legally due to the business. Assets are usually real, tangible things like money, equipment, inventory, investment securities, real estate, office
supplies, and contracts, but they can also be intangible things like patents and licenses.

**Current assets** are cash and other resources that can be converted into cash within 12 months of the date of the balance sheet. Besides currency and cash in deposit accounts, current assets include the following (listed in order of their “liquidity”– the ease with which the items can be converted into cash):

- **Accounts receivable**: The amounts due but not yet paid from customers in payment for merchandise or services.
- **Inventory**: Raw materials on hand, work in process, and all finished goods either manufactured or purchased for resale.
- **Temporary investments**: Also called marketable securities or short-term investments, they are interest-bearing or dividend-yielding holdings expected to be converted into cash within a year. This includes the current portion of longer term holdings. They include stocks and bonds, certificates of deposit, and time deposit savings accounts. They are listed on the balance sheet at either their original cost or their current market value, whichever is less.
- **Prepaid expenses**: Goods, services, and benefits you buy or rent in advance of their actual use, such as office supplies, insurance protection, and office space.

**Long-term investments** (also, long-term assets) are holdings that you intend to keep for a year or more. They typically yield interest or dividends and include stock, bonds, and special purpose savings accounts.

**Fixed assets** (also called “plant and equipment”) are the resources your business owns for use in operations and does not intend for resale. Except for land, fixed assets are listed at their purchase cost less depreciation. Depreciation is how the balance sheet recognizes that things get used up, wear out, or otherwise lose value over time. Regardless of current market value, land is listed at its original purchase cost and does not depreciate.

**Other assets** are things that don’t fit into any of the above categories. They can include tangibles, such as outdated equipment salable for scrap, and intangibles, such as trademarks.

**Liabilities** are all monetary obligations of your business and all claims creditors have against your assets.

**Current liabilities** are debts and obligations payable within 12 months. The main kinds of current liabilities are:
- **Accounts payable**: Amounts owed to suppliers for goods and services purchased on credit in connection with business operations.

- **Short-term notes**: The balance of principal due to pay off short-term debts.

- **Current portion of long-term debt**: The current amount due on the total balance of notes whose terms exceed 12 months.

- **Interest payable**: Any accrued fees due for use of both short-term and long-term borrowed capital and credit extended to the business.

- **Taxes payable**: Taxes due but not yet paid.

- **Accrued payroll**: Salaries and wages currently owed.

**Long-term liabilities** are notes, contract payments, or mortgage payments due over a period exceeding 12 months. They are listed as outstanding balances less the current portion.

**Owners' equity** (also, net worth) is the claim of the owners on the assets of the business. Owners' equity has two general classifications:

- **Invested capital**: Funds invested in the company by the owner or other investors for the purpose of building the business and earning a return on their investment. Invested capital shows up in the owners' equity portion of the balance sheet in a variety of forms, such as "paid-in capital" and "capital stock."

- **Retained earnings**: The portion of net income that is retained in the business rather than paid out to owners and investors. Retained earnings are an important source of funds for growing the business and for building the market value of the business. Owners continually face the question, "Do I leave the profits in the company to help it grow, or do I use them to pay myself a higher personal income?"

### You Need Both Statements to Make Sense of Your Financial Situation

So, you have two financial management tools at your disposal: an income statement and a balance sheet. So what? Why do you need both? Isn't profitability enough? Why do you care about liquidity if you're profitable? What information will two statements provide together that you can't get from one of them alone? And how will they help you make better decisions?
As you’ve already seen, the income statement measures the profitability of your operations. It compares the revenue you’ve received during a period with the expenses incurred during that same period and lets you know if you’re making any money. Later, we’ll look at ways to analyze the income statement to get better management information from it, but for now let’s just focus on the fact that it measures the profitability of your business operation.

The balance sheet measures liquidity – your overall ability to pay what you owe out of the resources at your disposal – the financial “health” of your business. By analyzing your balance sheet in more detail (we’ll cover that later), you can get a whole range of useful insights about your business.

Together, these two financial statements provide a complete financial model of the vitality of your business. They give you indication of the prospects for your business over the long term. They provide an important first step in getting your financial house in order. They offer guidance for what you can do to improve your business’ long-term success.

The importance of using both a balance sheet and an income statement to fully describe and understand the financial strengths and weaknesses of your business can be demonstrated by considering the financial situations of two different companies. Both businesses earn the same amount of revenue and both have exactly the same expenses. They have the same number of employees, they spend exactly the same amount on gasoline, they have identical telephone bills, and regularly pay off their credit card balances each month. In other words, their income statements are identical.

But one business owns the building in which it operates (an asset on its balance sheet), whereas the other business rents. Their balance sheets are different – one has a fixed asset that the other doesn’t have. Can you see that the business with the equity in the building is a bit stronger financially? The financial picture of each business is much clearer with both statements providing information.

The Numbers Are Just Numbers, Unless You Can Interpret Them

Financial literacy is critical to getting your house in order.

Much of what you learn from your financial statements is the result of your knowing your business. Sales, accounts receivable...
telephone expense – every line item on both statements tells you something about your business and does so in an exact way that personal observation can’t match. The numbers don’t mean much without your intimate knowledge of your business. But your knowledge is woefully incomplete without the numbers. To be sure, there’s nothing like personal observation and the first-hand “feel” it gives you about what’s going on. But without “the numbers,” you lack objectivity and precision. You lack that comprehensive grasp of everything your business does and the integrated nature of your business. The numbers give you the whole view, while personal observation is limited only to what catches your eye or what you have time for.

If your financial statements seem academic or theoretical to you – like mathematics in school probably did – then you haven’t yet learned to see them for what they really are, a special way to look at your business, a combination window and microscope into what’s really happening.

You probably don’t remember your earliest days of learning to read, but we all went through the same process, each in our own way. First you had to learn the alphabet. Then you learned rudimentary spelling. C – A – T, cat. D – O – G, dog. Then you learned to sound out words and, later, to string them together into sentences. Finally, you could read and write, not too well at first, but better and better with practice. Now you read easily and the meanings of the individual words are irrelevant because you read whole thoughts, fully-felt emotions, and mental pictures with no conscious effort. C – A – T is irrelevant because your mind grasps ideas directly without being mired down in paying attention to the alphabet and sounding out the words.

It’s the same with your financial statements. In fact, it’s the same for any kind of quantification of your business. As you become familiar with financial statements and how to read and analyze them, you develop an intuitive understanding of what they are telling you. Before long, you can simply glance at them and their underlying messages are clear to you.

Getting Inside the Numbers – Ratio Analysis

The figures listed in each line item of a financial statement are important in themselves as gauges of business health. However, they become even more valuable measurements when they are compared with one another. These comparisons are called “ratio analysis.”
Some of these ratios appear in the percentage column of your income statement. Ratio analysis provides answers to questions such as:

- How much am I making on every sale?
- How much sales do we need to cover all our expenses?
- Are operating expenses excessive?
- Do we have a “cushion” to cover any unexpected expenses?
- Does the business have too much debt?

The comparison is commonly shown as a ratio, but percentages and fractions are also common. For instance, if current assets are $100,000 and current liabilities are $50,000, it means that for every two dollars of current assets you have a dollar of current liabilities – a two-to-one ratio. The comparison can be shown as 2:1 (a ratio), 200% (a percentage), or \( \frac{2}{1} \) (a fraction).

There are a few key income statement and balance sheet items that, when compared with each other, provide insights into the profitability, efficiency, and solvency of your business. Here is a brief overview of a few of the most basic financial ratios:

**Return on revenues** (also, return on sales, net profit ratio). This ratio shows how much net income is derived from every dollar of net revenues. It’s a key indicator of the profit dynamics of the business.

\[
\text{Return on Revenues} = \frac{\text{Net Profit}}{\text{Net Revenues}}
\]

Although many people would like a very high number here, most businesses earn a net profit of under 10% of net revenues and are quite successful. The number varies considerably by the type of industry you’re in. An important consideration of your return on revenues is its trend over time. How much has your profitability changed in the past few years… and in what direction? You should increase your return on revenues as you improve the efficiency of your business operations.

**Contribution margin ratio.** This ratio, a percentage of net revenues, tells you how well you are generating funds to cover fixed expenses and make a profit.

\[
\text{Contribution Margin Ratio} = \frac{\text{Contribution Margin}}{\text{Revenues}}
\]

**Break-even revenues.** This important indicator tells you at what point your business “breaks even.” It is the dollar amount of revenues that exactly covers all your variable costs and all your fixed costs, with nothing left over for profit. It’s an important indicator of risk because it shows you how close your business is...
to the "no profit" line. For instance, if your business is currently producing revenues at the level of $100,000 per month, and your break-even point is $60,000 per month, you are comfortably above your no profit line.

\[
\text{Break-even} = \frac{\text{Fixed Expenses}}{\text{Revenues}} + \frac{\text{Contribution Margin Ratio}}{\text{Operating Expense Ratio}}
\]

**Operating expense ratios.** By dividing operating expenses by net revenues, you can measure the percent of each revenue dollar being spent on the operations of your business. This should be built into your income statement (as was shown in the example earlier). You should cultivate the habit of watching each line item of operating expense from period to period to spot problems and reinforce favorable trends at the earliest opportunity.

\[
\text{Operating Expense Ratio} = \frac{\text{Operating Expense Line Item}}{\text{Net Revenues}}
\]

**Working capital.** It represents the short-term resources you have available to maintain normal business operations. The more working capital you have, the more reliable your operation is and the more it can withstand stresses such as high growth or unexpected circumstances.

\[
\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}
\]

**Debt-to-equity.** This is the well-known "leverage" ratio. It indicates how much the owners' equity is leveraged — in other words, how much the owners have at stake in the company compared with how much creditors have at stake. The general idea is that the more the owners have at stake in the company, the more they are motivated to manage the company well. For instance, a company that has total liabilities of $1,000,000 and owners' equity of $200,000 is highly leveraged at 5:1. On the other hand, a company having total liabilities of $200,000 and owners' equity of $500,000 is hardly leveraged at all with debt-to-equity of 2:5.

A high ratio is considered a sign of a "risky" company, the business may be extending its obligations beyond its ability to pay. A low ratio is a sign of a "conservative" business, and a very low ratio may indicate that the company is not realizing its potential.

\[
\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Owners’ Equity}}
\]
Watching Your Progress – Trends

Trends are the general pattern of month-to-month changes over an extended period of time. There’s no mystery here. You want your sales and profit trends to be upward and your expense item trends to be downward. You should compare each line item of your income statement with the previous month’s line item, and you should also look at the longer-term trend over the past months and years. And you should do the same for your key ratios. Trends are no more complicated than that. Important, but not complicated.

It’s Worth the Time and Effort

You’re a business owner, not a financial analyst or a banker. So why do you have to worry about all these financial statements, ratios, and trends?

The short answer is: to understand your business.

It bears repeating: Everything you see on a financial statement, every trend, and every ratio, reflect something real going on in your business. Financial statements and analysis are merely a way to more objectively and more precisely see your business as an integrated whole.

Naturally, if you are new to all this, or if you tend to be uncertain about financial management, it may seem intimidating. It takes time and attention before it will all become second nature to you.

But it will. And when it does, you’ll wonder how you ever got along without it.