

# Understanding Financial Statements

## ***Studying and Understanding Financial Statements For Your Business Are Just As Revealing To You As Well As Your Accountant***

### **BALANCE SHEET**

The **balance sheet** is a snapshot of the company's financial standing at an instant in time. The balance sheet shows the company's financial position, what it owns (assets) and what it owes (liabilities and net worth). The "bottom line" of a balance sheet must always balance (i.e. assets = liabilities + net worth). The individual elements of a balance sheet change from day to day and reflect the activities of the company. Analyzing how the balance sheet changes over time will reveal important information about the company's business trends. In this lesson we'll discover how you can monitor your ability to collect revenues, how well you manage your inventory, and even assess your ability to satisfy creditors and stockholders.

**Liabilities** and **net worth** on the balance sheet represent the company's sources of funds. Liabilities and net worth are composed of creditors and investors who have provided cash or its equivalent to the company in the past. As a source of funds, they enable the company to continue in business or expand operations. If creditors and investors are unhappy and distrustful, the company's chances of survival are limited. Assets, on the other hand, represent the company's use of funds. The company uses cash or other funds provided by the creditor/investor to acquire assets. Assets include all the things of value that are owned or due to the business. Liabilities represent a company's obligations to creditors while net worth represents the owner's investment in the company. In reality, both creditors and owners are "investors" in the company with the only difference being the degree of nervousness and the time frame in which they expect repayment.

### **Assets**

As noted previously, anything of value that is owned or due to the business is included under the Asset section of the Balance Sheet. Assets are shown at net book or net realizable value (more on this later), but appreciated values are not generally considered Current Assets Current assets are those which mature in less than one year.

They are the sum of the following categories:

- Cash
- Accounts Receivable (A/R)
- Inventory (Inv)
- Notes Receivable (N/R)
- Prepaid Expenses
- Other Current Assets

Cash is the only game in town. Cash pays bills and obligations. Inventory, receivables, land, building, machinery and equipment do not pay obligations even though they can be sold for cash and then used to pay bills. If cash is inadequate or improperly managed the company may become insolvent and be forced into bankruptcy. Include all checking, money market and short term savings accounts under Cash. Accounts Receivable (A/R) Accounts receivable are dollars due from customers. They arise as a result of the process of selling inventory or services on terms that allow delivery prior to the collection of cash. Inventory is sold and shipped, an invoice is sent to the customer, and later cash is collected. The receivable exists for the time period between the selling of the inventory and the receipt of cash Receivables are proportional to sales. As sales rise, the investment you must make in receivables also rises. Inventory consists of the goods and materials a company purchases to re-sell at a profit. In the process, sales and receivables are generated. The company purchases raw material inventory that is processed (aka work-in- process inventory) to be sold as finished goods inventory. For a company that sells a product, inventory is often the first use of cash. Purchasing inventory to be sold at a profit is the first step in the profit making cycle (operating cycle) as illustrated previously. Selling inventory does not bring cash back into the company -- it creates a receivable. Only after a time lag equal to the receivables collection period will cash return to the company. Thus, it is very important that the level of inventory be well managed so that the

business does not keep too much cash tied up in inventory as this will reduce profits. At the same time, a company must keep sufficient inventory on hand to prevent stock outs (having nothing to sell) because this too will erode profits and may result in the loss of customers. Notes Receivable (N/R) N/R is a receivable due the company, in the form of a promissory note, arising because the company made a loan. Making loans is the business of banks, not of operating business, and particularly not the business of a small company with limited financial resources. Notes receivable is probably a note due from one of three sources: Customers, Employee, or Officers of the company. Customer notes receivable is when the customer who borrowed from the company probably borrowed because he could not meet the accounts receivable terms. When the customer failed to pay the invoice according to the agreed upon payment terms. The customer's obligation may have been converted to a promissory note. Employee notes receivable may be for legitimate reasons, such as a down payment on a home, but the company is neither a charity nor a bank. If the company wants to help the employee, it can co-sign on the loan advanced by a bank. An officer or owner borrowing from the company is the worst form of note receivable. If an officer takes money from the company, it should be declared as a dividend or withdrawal and reflected as a reduction in net worth. Treating it in any other way leads to possible manipulation of the company's stated net worth, and banks and other lending institutions frown greatly upon it. Other Current Assets Other Current Assets consist of prepaid expenses and other miscellaneous and current assets.

### ***Fixed Assets***

Fixed assets represent the use of cash to purchase physical assets whose life exceeds one year. They include assets such as:

- Land
- Building
- Machinery and Equipment
- Furniture and Fixtures

### ***Leasehold Improvements***

### ***Intangibles***

Intangibles represent the use of cash to purchase assets with an undetermined life and they may never mature into cash. For most analysis purposes, intangibles are ignored as assets and are deducted from net worth because their value is difficult to determine.

Intangibles consist of assets such as:

- Research and Development
- Patents
- Market Research
- Goodwill
- Organizational Expense

In several respects, intangibles are similar to prepaid expenses; the use of cash to purchase a benefit which will be expensed at a future date. Intangibles are recouped, like fixed assets, through incremental annual charges (amortization) against income. Standard accounting procedures require most intangibles to be expensed as purchased and never capitalized (put on the balance sheet). An exception to this is purchased patents that may be amortized over the life of the patent. Other assets consist of miscellaneous accounts such as deposits and long-term notes receivable from third parties. They are turned into cash when the asset is sold or when the note is repaid. Total Assets represent the sum of all the assets owned by or due to the business.

## ***LIABILITIES and NET WORTH***

Liabilities and Net Worth are sources of cash listed in descending order from the most nervous creditors and soonest to mature obligations (current liabilities), to the least nervous and never due obligations (net worth). There are two sources of funds: lender-investor and owner-investor. Lender-investor consist of trade suppliers, employees, tax authorities and financial institutions. Owner-investor consists of stockholders and principals who loan cash to the business. Both lender-investor and owner investors have invested cash or its equivalent into the company. The only difference between the investors is the maturity date of their obligations and the degree of their nervousness.

### ***Current Liabilities***

Current liabilities are those obligations that will mature and must be paid within 12 months. These are liabilities that can create a company's insolvency if cash is inadequate. A happy and

satisfied set of current creditors is a healthy and important source of credit for short term uses of cash (inventory and receivables). An unhappy and dissatisfied set of current creditors can threaten the survival of the company. The best way to keep these creditors happy is to keep their obligations current.

Current liabilities consist of the following obligation accounts:

- Accounts Payable -- Trade (A/P)
- Accrued Expenses
- Notes Payable -- Bank (N/P Bank)
- Notes Payable -- Other (N/P Other)

***Current Portion of Long term Debt Proper matching of sources and uses of funds requires that short term (current) liabilities must be used only to purchase short term assets (inventory and receivables).***

## **Notes Payable**

Notes payable are obligations in the form of promissory notes with short term maturity dates of less than 12 months. Often, they are demand notes (payable upon demand). Other times they have specific maturity dates (30, 60, 90, 180, 270, 360 days maturities are typical). The notes payable always include only the principal amount of the debt. Any interest owed is listed under accruals. The proceeds of notes payable should be used to finance current assets (inventory and receivables). The use of funds must be short term so that the asset matures into cash prior to the obligation's maturation. Proper matching would indicate borrowing for seasonal swings in sales which cause swings in inventory and receivables, or to repay accounts payable when attractive discount terms are offered for early payment.

## **Accounts Payable**

Accounts Payable are obligation due to trade suppliers who have provided inventory or goods and services used in operating the business. Suppliers generally offer terms (just like you do for your customers), since the supplier's competition offers payment term. Whenever possible you should take advantage of payment terms as this will help keep your costs down. If the company is paying its suppliers in a timely fashion, days payable will not exceed the terms of payment. Accrued Expenses are obligations owed but not billed such as wages and payroll taxes, or obligations accruing, but not yet due, such as interest on a loan. Accruals consist chiefly of wages, payroll taxes, interest payable and employee benefits accruals such as pension funds. As a labor related category, it should vary in accordance with payroll policy (i.e., if wages are paid weekly, the accrual category should seldom exceed one week's payroll and payroll taxes).

## **Non-current Liabilities**

Non-current liabilities are those obligations that will not become due and payable in the coming year. There are three types of non-current liabilities, only two of which are listed on the balance sheet:

- Non-current Portion of Long Term Debt (LTD)
- Subordinated Officer Loans (Sub-Off)
- Contingent Liabilities

Non current portion of long term debt is the principal portion of a term loan not payable in the coming year. Subordinated officer loans are treated as an item that lies between debt and equity. Contingent liabilities listed in the footnotes are potential liabilities, which hopefully never become due. Non-Current Portion of Long Term Debt (LTD) is the portion of a term loan that is not due within the next 12 months. It is listed below the current liability section to demonstrate that the loan does not have to be fully liquidated in the coming year. Long-term debt (LTD) provides cash to be used for a long-term asset purchase, either permanent working capital or fixed assets. Shareholder/Owner Loans (Subordinated). Notes payable to officers, shareholders or owners represent cash which the shareholders or owners have put into the business. For tax reasons, owners may increase their equity investment, beyond the initial company capitalization, by making loans to the business rather than by purchasing additional stock. Any return on investment to the owners can therefore be paid as tax deductible interest expense rather than as non-tax deductible dividends. When a business borrows from a financial institution, it is common for the officer loans to be subordinated or put on standby. The subordination agreement prohibits the officer from collecting his or her loan prior to the repayment of the institution's loan. When on standby, the loan will be considered as equity by the financial institution. Notice than notes receivable -- officer are considered a bad sign to lenders, while notes payable -- officer are considered to be reassuring. Contingent Liabilities are potential liabilities that are not listed on the balance sheet. They are listed in the footnotes because they may never become due and payable.

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Contingent liabilities include:

- Lawsuits
- Warranties

Cross Guarantees

If the company has been sued, but the litigation has not been initiated, there is no way of knowing whether or not the suit will result in a liability to the company. It will be listed in the footnotes because while not a real liability, it does represent a potential liability which may impair the ability of the company to meet future obligations. Alternatively, if the company guarantees a loan made by a third party to an affiliate, the liability is contingent because it will never become due as long as the affiliate remains healthy and meets its obligations. Total Liabilities Total liabilities represent the sum of all monetary obligations of a business and all claims creditors have on its assets

## ***EQUITY***

Equity is represented by total assets minus total liabilities. Equity or Net Worth is the most patient and last to mature source of funds. It represents the owners' share in the financing of all the assets.

## ***INCOME STATEMENT***

Known also as the profit and loss statement, the income statement shows all income and expense accounts over a period of time. That is, it shows how profitable the business is. This financial statement shows what how much money the company will make after all expenses are accounted for. Remember that an income statement does not reveal hidden problems like insufficient cash flow problems. Income statements are read from top to bottom and represent earnings and expenses over a period of time.