

FINANCIAL STATEMENTS DEMYSTIFIED

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The Demystified Series of electronic courseware is designed for the busy entrepreneur. It's intentionally brief and intense because we believe you don't have time to read 300 pages of text to discover the data on the five to ten pages you will use. One spark of enlightenment from our series of small business reports and eBooks will return your investment many times over. Enjoy!

Your instructor for this course is Daniel Horne. Mr. Horne holds a Bachelor of Arts Degree in Business with an Accounting Major and an Economics Minor. He also holds a Master of Science Degree in Finance with post-graduate work in benefits & insurance planning. He has worked in high technology for the past 33 years, most recently as a Chief Financial Officer for seven years at a defense contractor.

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There are all sorts of documents, journals, schedules and reports in the world of accounting, but there are only 4 financial statements.

The Balance Sheet, Income Statement, Statement of Cash Flows and the lesser known Statement of Retained Earnings are the four. The Income Statement is often referred to as the Profit and Loss Statement, or P&L, but while popular this term isn't true accounting terminology per se.

The master document in Accounting's financial statements is the Balance Sheet.

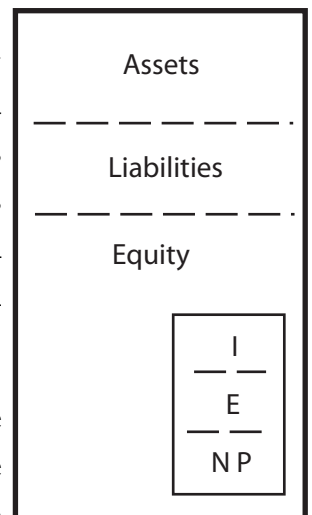
The other three statements support the Balance Sheet to represent a full rendering of a company's financial condition. A balance sheet also has a large number of notes that describe more fully than the numbers what the numbers mean.

Notes can contain the equivalent of dynamite in ascertaining a company's financial condition so it is important to pay close attention to them.

The Balance Sheet summarizes the financial condition of a business at a given point in time. If you notice the date on a Balance Sheet, it is dated as of a specific date (such as December 31, 2008) and the financial condition it describes is "the way it was" on that date.

Balance Sheet notes can pick up hidden contingencies that might be the harbinger of bad news (or good news for that matter). The Balance Sheet summarizes the Accounting Equation in its presentation. Assets equal Liabilities plus Equity. For a more full explanation of this equation, please read *Accounting Demystified* in this series.

The Income Statement is subordinate to the Balance Sheet. The result of this statement reports into the Equity Section of the Balance Sheet and is needed to

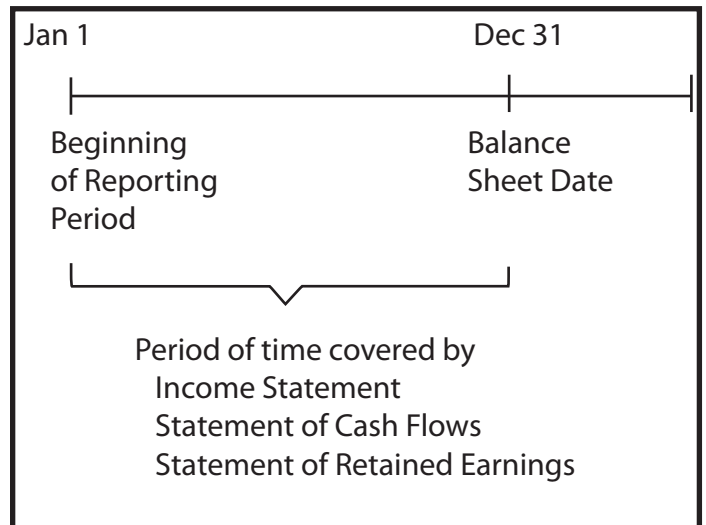


make the Balance Sheet balance. The Income Statement expands upon the Balance Sheet's presentation by showing the activities of the business from the beginning of the fiscal year (usually, but not always, January

The Income Statement reflects a summary of operations from day one of the current year through the reporting date. (Normally you will see a heading like "For the period ending December 31, 2008" at the top of an Income Statement.)

All of the Sales, costs related to those sales, and the expenses associated with running the business are reported on the Income Statement.

One not so trivial caveat is Cost of Goods (or Services) Sold, commonly referred to as COGS.



COGS are not considered an expense to the business, but rather a return of capital to be re-used in generating more sales. If you've ever invested in the stock market, or bought a home, you'll know that the money used for the purchase isn't considered an expense. When you sell something, the money you receive is divided into a return of the money you invested, your basis in accounting terms, and the money you've earned or lost on it between the purchase date and the sales date.

Watching COGS over time (multiple financial statements) is an excellent way to predict if a business has good management.

Sales minus COGS is the Gross Profit of a business, also known as the Operating Profit.

Gross Profit is the amount of money that sales have provided, less return of invested capital, to run the business.

If owners run the business well, that is control its expenses, then they

will have a net profit remaining. If the expenses are more than the gross profit, then they will have a net loss.

Financial statements are used by those interested for a number of reasons. Chief among them are the fabulous five:

To Make Predictions about a business

To assess the financial risk of doing business, or investing.

To evaluate the profitability of a business

To evaluate the solvency of a business

To evaluate the performance of the business' management team

A couple of financial statement terms that have come into vogue recently are EBIT and EBITDA (pronounced E-bit and E-bit-dah).

EBIT is Earnings Before Interest and Taxes. This is considered a slightly better measurement of overall business performance because some businesses are highly leveraged (they have a lot of debt) and the interest they pay consumes much of the profit. If one only looks at the bottom line, the business (for some readers of financial statement tea leaves) can look like it's operating more poorly than it truly is.

Debt isn't always a bad thing (although I personally distain debt), as some businesses are initially financed by other people and over time are purchased from the creditors by the shareholders.

From the idea of EBIT, analyzing a business without being affected by bank loans and government tax rates to get a better indication of its true worth comes EBITDA.

In like manner EBITDA is EBIT before Depreciation and Amortization. The DA in a business can be skewed by accounting wizardry it is believed

and should therefore be eliminated from analysis. This is fanciful for the most part in the financial industry when creating a stock price's Fair Value to look for buying opportunities or to sell before word hits the street that the business is not doing as well as the current stock price suggests.

There is merit to these ideas, but for a small business EBIT and EBITDA are only useful when pricing a business for buying or selling. If you read the notes to the Balance Sheet such wizardry should be discreetly disclosed for all to see, so in the end does little to fool any except casual observers.

The Statement of Cash Flows is probably the most misunderstood and mis-used of the financial statements. In my opinion, it is also the most important of the four.

Many of the small business accounting software applications will not even print a Statement of Cash Flows because the complexity requires at least some human intervention to get it right. Check yours and see if it has one. Better yet, see if you agree with it.

The Statement of Cash Flows is just what it says it is, a rendering of the inflows and outflows of cash from the business.

Like the Income Statement, the Statement of Cash Flows is from the beginning of the fiscal year through the date it is prepared.



The Statement of Cash Flows is organized to begin from the cash ending balance at the end of the last Statement of Cash Flows.

It has three sections for measuring cash in/out for Operating Activities, Financing Activities, and Investing Activities. Then it ends with the cash ending balance for the period.

Which, if your bank statements are synchronized, is be the same balance as the bank statement for that period giving you an excellent picture of your business' cash activity pegged to the bank.

Don't be surprised if you ask your accountant for a Statement of Cash Flows and you see a bead of perspiration on their forehead. I've been doing them for a decade and I still refer back to my textbook from time to time.

It's amazing how many accountants I've had work for me that can't put together a SofCF no matter what they're given. In small business there isn't often a request for one.

Come to love this document. It's important enough that I've even given it its own mini-course, *How to Construct a Statement of Cash Flows*.

Last of the financial statements is the lowly Statement of Retained Earnings. I call it lowly because few small business people ever see one and those that do push it aside to make room for the Income Statement.

Generally, such a disregard for the Statement of Retained Earnings is fine. It isn't something I suspect anyone would ever ask you to provide unless you are a public company reporting to the Securities and Exchange Commission.

This financial statement shows the beginning balance of the Retained Earnings account, adds (or subtracts) the current period's net profit and provides an ending balance for the account. It get more use from those who analyze public companies because it shows the pure accounting per share price of each share of common stock. For public companies dividends and changes in the per share value of stock so tabulated determine the distance between the literal worth of a share of stock and its Fair Market Value (it selling price on the stock exchange).

That's it for this mini-course. Hopefully, you're curiosity has risen to make the Statement of Cash Flows a higher priority on your list.

It quite possible to be making a nice profit and go out of business because cash wasn't being monitored as much as Net Profit on the Income Statement, but this should illustrate for you why I'm not overly impressed by profit alone.

Believe it or not, I run into any number of business owners so focused on sales that they've completely forgotten about cash. It was a total shock when

their bookkeeper walked in and said, “I can’t pay this bill.”

Stay ahead of the curve by knowing how to read financial statements and calculate the financial ratios they provide. That will give you a robust look at your business financials to provide insight into your planning, looking forward as you travel into the future with keener eyesight.

The mini-course *Financial Ratios Demystified* should be the next stop. That is assuming you have already completed the *Accounting Demystified* course. If not, then complete that course first.