



Excerpted from  
FastTrac® GrowthVenture™

Taking Action

## A Closer Look @ Financial Statements

### The Language of Business

Accounting and financial concepts may be as alien to you as a foreign language. Still, the ability to understand and communicate financial information is critical to every entrepreneur. To succeed at business, you need to learn the language of business, which will enable you to understand the financial reports and information generated from your business and to communicate this information to others.

### The Accounting System

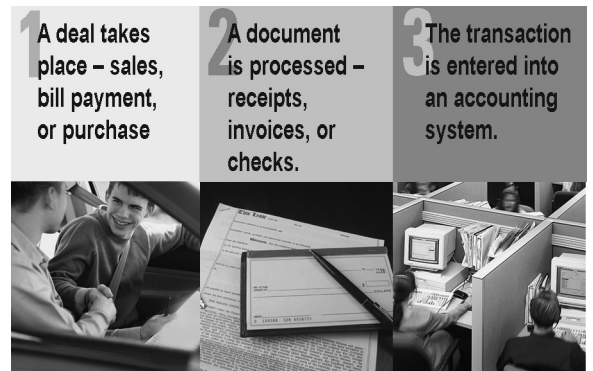
Financial transactions occur every day in business. Each time a bill is paid or a sale is made, a financial transaction takes place. These financial transactions can't be interpreted unless they are arranged into a useful format. The transactions must be recorded in a way that easily provides the information an entrepreneur needs to make good financial decisions. The accounting system provides this organization.

The accounting system takes business transactions and categorizes them into accounts, such as Utility Expense, Consulting Revenue, and Bank Loans. Accounts are grouped into categories and then arranged into several reports, mainly the Income Statement, Balance Sheet, and Cash Flow Report or Cash Flow Statement.

### Accounting Language

When beginning to learn a new language, it is always helpful to learn a few basic rules—pronunciation, grammar, and syntax, for example. This information provides a basis of understanding about language. Accounting systems are built on rules as well. You need to understand the two basic methods of accounting that businesses use, since specific rules are associated with each. They are the *accrual basis* and *cash basis* methods of accounting. Based on the accounting method you choose, your financial reports will communicate a different message.

**Accrual Basis Accounting** – Most businesses use the accrual basis accounting method, which reports income at the time it is earned and expenses when they are incurred, without regard to when the cash changes hands. This method presents a very accurate financial position. For example, if insurance is paid every six months, it is recorded as a prepaid asset on the Balance Sheet at the time it is paid. Each month, a portion of the insurance will be recorded on the Income Statement to represent the portion of insurance associated with that specific month.



Accounting System Categories	
<b>Balance Sheet</b>	<b>Income Statement</b>
Assets	Revenue
Liabilities	Expenses
Equity	



**Cash Basis Accounting** – Some businesses use the cash basis accounting method, which records revenue when cash is received and expenses when bills are paid. This method is very simple to use, but doesn't provide the most accurate financial picture, because income may not be appropriately matched with related expenses. Looking at the insurance example, every six months a payment to the insurance company is reported in the month it is paid, but it represents half the yearly insurance due. This allocation may be true from a cash perspective, but does not show an accurate account of expenses as they relate to monthly revenue.

**Reporting Cash vs. Profits** – Although the Income Statement reports the profitability of the business, Net Income doesn't always indicate positive cash flows for the following reasons:

- When using the accrual basis accounting method, the Income Statement reflects income earned and expenses incurred, without regard to whether the cash changed hands.
- Non-cash expenses such as depreciation and amortization are included in the Income Statement.
- Cash outflows for debt repayments, purchases of inventory, and payments to the owners of the business (dividends or draws) and cash inflows from borrowings from banks and other lenders do not show up on your Income Statement.

These discrepancies between what is shown on the Income Statement and what is actually flowing into and out of your business make it critical for you to understand all three financial statements—Income Statement, Balance Sheet, and Cash Flow Report.

## Income Statement

The Income Statement shows the net income or loss that the business has experienced over a period of time. It is your company's financial grade card. The time period could be a day, week, month, quarter, or year. This report helps you determine if your business is making or losing profits. The Income Statement displays the revenue (sales) earned by your company and the expenses it incurred to generate those revenues. Then it reports Net Income based on those revenues and expenses for the intended period of time.

### Income Statement Categories

**Revenue** – Revenue (or Sales) can be described as money earned from conducting the business's activities. It is sometimes called Net Sales on the Income Statement.

**Expenses** – Expenses are costs associated with supporting the business's activities. The expenses that appear on the Income Statement are generally the same expenses that the Internal Revenue Service allows as deductions for income tax purposes. In addition, the Income Statement may include some non-cash expenses such as depreciation or amortization.

**Net Income** – The ultimate goal of any business is to produce a positive net income or profit over the long haul.

Income Statement	Sample %
Revenue (Sales)	100%
- Cost of Goods Sold	75%
= Gross Margin	25%
- Operating Expenses	15%
= Operating Income	10%
- Non-Operating Expenses	7%
= Net Income	3%



The Cedar Solutions Income Statement demonstrates the format used by the Financial Template. Use this sample to review the headings, sub-headings, and accounts below that appear on a detailed Income Statement.

### Line Item Descriptions

**Net Sales** includes all sales reduced by any discounts or returns.

**Cost of Goods Sold** includes all the costs of inventory sold, including production labor, materials, and overhead. This amount is subtracted from the Inventory account on the Balance Sheet.

**Gross Margin**, or Gross Profit, is the first cut. Can the company's sales price cover all of the costs to manufacture the items being sold?

**Operating Expenses** lists the total of expenses incurred to operate the business. Non-operating expenses, such as interest expenses, are excluded.

**Advertising** includes any costs directly related to advertising products/services to potential customers.

**Bad Debt Expense** is used to write off invoices to customers who are not expected to pay.

**Bank Charges** includes any cost of banking for a checking account, merchant account, or other fees.

**Depreciation & Amortization** is used to allocate the expense of fixed and intangible assets over a certain number of years.

**Dues & Subscriptions** includes costs of trade magazines or periodicals and membership dues to organizations.

**Insurance** includes the cost of purchasing general liability or other insurance.

The Net Income reports the company's profit or loss. Profits represent an increase in the value of the business to the owner(s). Therefore, this amount will show up as Retained Earnings in the equity section of the Balance Sheet.

### Cedar Solutions Year-End Income Statement (Projected)

	2005	%
Net Sales (less returns & allowances)	\$775,175	100.0%
Cost of Goods Sold	542,623	70.0%
<b>Gross Margin</b>	<b>232,552</b>	<b>30.0%</b>
<b>Operating Expenses</b>		
Advertising	-	-
Bad Debt Expense	-	-
Bank Charges	-	-
Depreciation & Amortization	14,095	1.8%
Dues & Subscriptions	220	0.0%
Insurance	2,700	0.3%
Licenses & Fees	215	0.0%
Marketing & Promotion	11,300	1.5%
Meals & Entertainment	1,000	0.1%
Miscellaneous	1,200	0.2%
Office Expense	1,800	0.2%
Office Supplies	-	-
Outside Services	1,640	0.2%
<b>Payroll Expenses</b>		
Salaries & Wages	44,000	5.7%
Payroll Taxes	3,600	0.5%
Benefits	12,000	1.5%
Professional Fees	4,000	0.5%
Property Taxes	-	-
Rent	50,400	6.5%
Repairs & Maintenance	720	0.1%
Shipping & Delivery	-	-
Telephone	3,840	0.5%
Training & Development	-	-
Travel	5,000	0.6%
Utilities	7,400	1.0%
Vehicle (includes mileage)	1,440	0.2%
Leased Equipment	4,800	0.6%
Other	-	-
Other	-	-
<b>Total Operating Expenses</b>	<b>171,370</b>	<b>22.1%</b>
<b>Operating Income</b>	<b>61,182</b>	<b>7.9%</b>
Interest Expense	3,477	0.4%
Other Income (interest, royalties)	-	-
<b>Income Before Taxes</b>	<b>57,705</b>	<b>7.4%</b>
Income Taxes (if C Corp)	-	-
<b>Net Income</b>	<b>\$ 57,705</b>	<b>7.4%</b>



**Licenses & Fees** includes any costs incurred for occupational licenses, fees, or other licensing registrations.

**Marketing & Promotion** includes any costs related to marketing to customers or helping establish the business's image.

**Meals & Entertainment** includes the costs incurred for networking meals and other meetings with potential customers and advisers.

**Miscellaneous** includes expenses that do not fit into any other category.

**Office Expense** includes the expenses to run the office, including postage but not office supplies.

**Office Supplies** includes the supplies you purchase for office needs, not including products that will be resold to customers.

**Outside Services** includes money paid for outside consultants, sub-contractors, and other vendors.

**Payroll – Salaries, Taxes, & Benefits** includes the entrepreneur's salary, benefits, and company-paid taxes and the salary, benefits, and taxes of all employees. Sole proprietors record their "salary" as an owner's draw.

**Professional Fees** includes costs to hire a professional to help with different areas of a business, such as management consultants, lawyers, accountants, and other professionals.

**Property Taxes** includes taxes paid on the property owned by the business. It does not include income taxes. Income taxes are not an operating expense of the business.

**Rent** includes the specific costs of renting the business facility including common area maintenance costs.

**Repairs & Maintenance** includes all costs to maintain computers, equipment, and other capital purchases.

**Shipping & Delivery** includes costs associated with shipping or delivering products/services.

**Telephone** includes costs associated with local service, long distance, and mobile phone service, if applicable.

**Training & Development** includes costs for employee training and development.

**Travel** includes costs for traveling for business purposes to training sessions, out-of-town association meetings, or other business-related events.

**Utilities** includes costs of utilities, such as electricity, water, and gas.

**Vehicle** includes actual costs incurred for company-owned vehicles or mileage reimbursement if the vehicle is not company-owned.

**Leased Equipment** includes lease payments for equipment. The management of Cedar Solutions added this title by replacing one of the Other categories in the Financial Template.



Three **Other** categories are included on the Financial Template so users can add additional account categories. This company has used one of these for Leased Equipment.

**Operating Income**, also known as Earnings Before Interest and Taxes (EBIT), is the income generated from conducting business. (Gross Margin less Total Operating Expenses.)

**Interest Expense** is the interest portion of the loan payments made during the year.

**Other Income** is income received from activities other than the normal business operations, such as non-operating rent income.

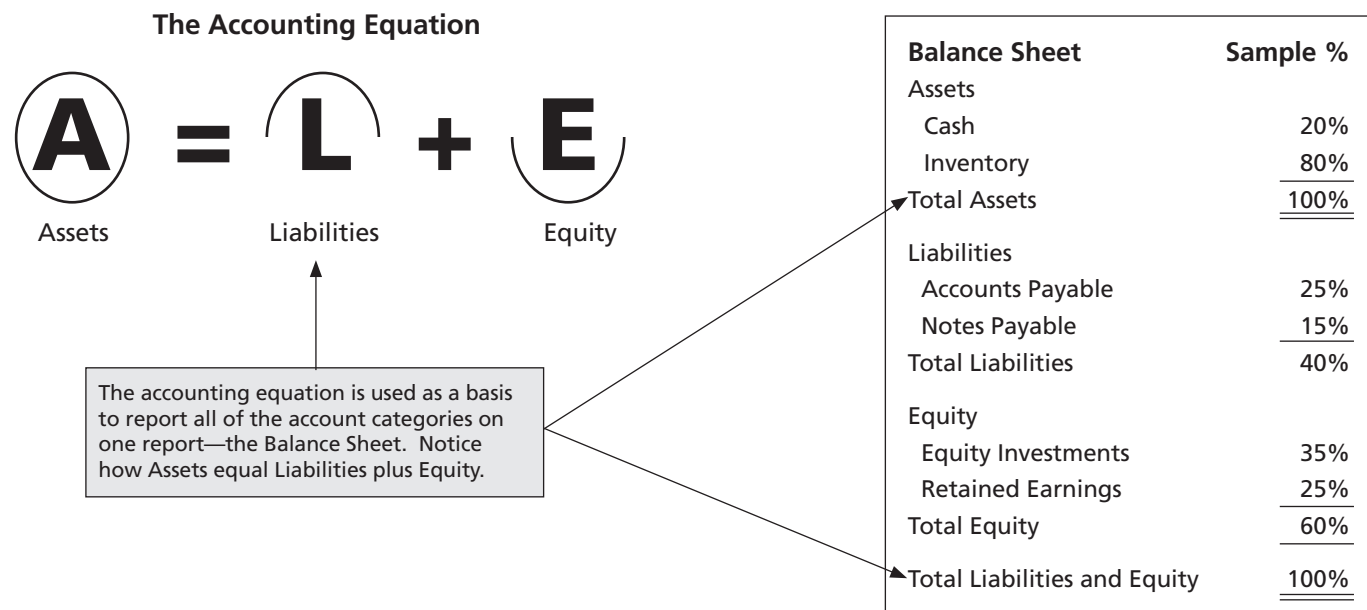
**Income Before Taxes** is a Net Profit calculation that is often used to compare one company against another since this figure has not been reduced by income taxes paid.

**Income Taxes (if C Corp)** is calculated on this report to help identify the real bottom line. With sole proprietorships, partnerships, S corporations, and LLCs, the income taxes are passed through to the owners, so they would not be included here.

**Net Income**, also known as Net Profit, is the earnings after taxes are paid—the “bottom line.” When measured as a percentage, this item is referred to as Net Margin, Net Income Margin, or Net Profit Margin.

### Balance Sheet

The accounting equation is an accounting rule that provides the foundation for the Balance Sheet. It states that the value of a company’s assets must equal the value of the rights of the creditors (liabilities) plus the rights of the owners (equity). Therefore, even though they are considered company assets, both owners and outsiders may have rights to those assets.





At any point in time, a Balance Sheet can be produced to report the value in the following account categories:

**Assets** – Assets can be described as things in your business with value, such as cash, equipment, inventory, and investments. In the same way you might own your car or house, these items are owned by the business. The business may not have the sole rights to these assets, however, just as you may share the rights to your car or house with the bank that lent you money.

On the Balance Sheet, assets are divided into Current Assets and Non-Current Assets. Current Assets include cash or assets that can or will be turned into cash within one year. Examples include Cash, Accounts Receivable, and Inventory. All assets that are not expected to be converted into cash within one year are considered Non-Current Assets. These accounts include Fixed Assets, such as Land, Facilities, Equipment, and Vehicles. Other Non-Current Assets include Long-Term Notes Receivable and Intangible Assets such as Goodwill, Patents, and Copyrights.

**Liabilities** – Liabilities describe others' rights to the value in the business, such as banks that have loaned the business money and vendors who have allowed the business extended payments. This amount can be compared to the amount of money you still owe on your house or car, which are personal liabilities. You will see Liabilities divided into Current Liabilities and Non-Current Liabilities. Current Liabilities include those liabilities you expect to pay within the next year, such as Accounts Payable. Since lines of credit typically have a renewal provision included in the loan agreement, they are also usually classified as current. Long-Term Liabilities include Notes Payable, such as loans from banks or other financial institutions with payment terms over several years.

**Equity** – Owner's Equity is the difference between Assets and Liabilities. It shows the owner's rights to the value of the company. Depending on the structure of the company, this number could reflect what you as the sole proprietor own in the company or what you and the other stockholders or shareholders own if your company has multiple owners.

One equity account that seems to stump many business owners is called Retained Earnings. This account represents the amount of cumulative earnings or Net Income that has not been paid out to owners in dividends or owner's draw. The amount in Retained Earnings, however, may not always be equal to the amount of cash the business has on hand. This discrepancy occurs because you may re-invest the earnings of the business in new equipment or even a new building. You may also make a strategic decision to increase the operations of the business and, therefore, need to purchase more inventory. The Retained Earnings account may also show a negative number if the business has not been profitable or the business owners have taken out more money than the business has generated in income.

The Balance Sheet on p. 7 reflects the format of the FastTrac® Financial Template. Use this example to review the accounts on a detailed Balance Sheet.



### Account Descriptions

**Cash & Equivalents** is the amount of cash the company has in the bank at this time.

**Accounts Receivable** is the amount of money owed to the company from its customers.

**Inventory** is the amount of merchandise or finished goods the company has on hand ready to sell to customers.

**Security Deposits** includes money paid as a deposit for services, such as utilities and rent. These payments are considered assets because they have value.

**Other Current Assets** is a category to accumulate any other assets that could be turned into cash within a year and do not fit into any other category.

**Property, Plant, & Equipment** includes all tangible assets in the business that have ongoing value.

**Accumulated Depreciation** includes the total of each year's allocation of the purchase price of an asset.

**Other Non-Current Assets** is a category to accumulate any other assets that will not be turned into cash within a year and do not fit into any other category.

**Accounts Payable** includes the money the company owes for expenses incurred on credit, generally due in 30 to 60 days.

**Line of Credit** is for short-term financing, usually granted by a bank up to a predetermined limit.

**Other Current Liabilities** is a category to accumulate any other liabilities that will be paid within the year and do not fit into any other category.

**Loans** includes the amount of money the company has borrowed and owes to banks or others.

**Mortgages** includes amounts owed on loans for real property, usually reserved for real estate loans.

**Other Non-Current Liabilities** is a category to accumulate any other liabilities that will not be paid within a year and do not fit into any other category.

### Cedar Solutions Year-End Balance Sheet (Projected)

	2005
<b>Assets</b>	
Current Assets	
Cash & Equivalents	\$110,320
Net Accounts Receivable	15,291
Inventory	5,352
Security Deposits	-
Other Current Assets	-
<b>Total Current Assets</b>	<b>130,963</b>
Fixed Assets	
Property, Plant, & Equipment	72,000
Less: Accumulated Depreciation	(14,095)
Other Non-Current Assets	-
<b>Total Non-Current Assets</b>	<b>57,905</b>
<b>Total Assets</b>	<b>\$188,868</b>
<b>Liabilities</b>	
Current Liabilities	
Accounts Payable	\$ -
Line of Credit	-
Other Current Liabilities	8,428
<b>Total Current Liabilities</b>	<b>8,428</b>
Long-Term Liabilities	
Loans	37,735
Mortgages	-
Other Non-Current Liabilities	-
<b>Total Non-Current Liabilities</b>	<b>37,735</b>
<b>Total Liabilities</b>	<b>46,163</b>
<b>Equity</b>	
Equity Investments	85,000
Retained Earnings	57,705
Less: Owner's & Investor's Draws	-
<b>Total Equity</b>	<b>142,705</b>
<b>Total Liabilities and Equity</b>	<b>\$188,868</b>

Because this company is only one year old, the Retained Earnings account reflects the same amount as the company's first year's Net Income.



**Equity Investments** is the amount of capital the owners have invested into the business.

**Retained Earnings** reflects the owner's stake in the company. It is the Net Profit that is re-invested or kept in the company.

**Owner's & Investor's Draws** includes amounts withdrawn by owners or investors in a sole proprietorship.

## Cash Flow Report and Cash Flow Statement

Entrepreneurs usually use one of two cash flow tools to assist them in financial decision making: the Cash Flow Report or the traditional Cash Flow Statement. Both can be used to report historical figures or budget future cash flow. The difference between the two documents is the way in which this information is prepared and reported.

Both of these reports include the cash flows received and paid out for loans and owner investments, as well as the purchases of fixed assets. But the primary difference is that the Cash Flow Report records cash activity as it relates to the individual revenue and expense categories such as you would find on an Income Statement. The traditional Cash Flow Statement reports cash activity as it relates to the operating, investing, and financing activities of the business.

**Cash Flow Report** – The monthly Cash Flow Report is one of the most important planning and reporting tools you can use in your business.

Compare the Cash Flow Report to your personal checkbook register. Every time you deposit money into your account or write checks out of the account you record the transaction and keep a running total. In the same way, the Cash Flow Report records every cash entry into your business and cash payment out of the business on a monthly basis. These inflows and outflows are grouped by categories that will affect the other financial statements, such as Equity Contributions, Inventory Purchases, or Operating Expenses.

<b>Cedar Solutions Cash Flow Report (Projected)</b>		
<b>2005</b>	<b>JAN</b>	<b>FEB</b>
<b>Cash In</b>		
Cash Sales	\$ -	\$ -
Collections from Accounts Receivables	15,504	13,798
Equity Received	-	-
Loans Received	20,000	-
Other Cash In (receipts from other assets)	-	-
Other Cash In (interest, royalties)	-	-
<b>Total Cash In</b>	<b>35,504</b>	<b>13,798</b>
<b>Total Cash Available</b>	<b>45,504</b>	<b>27,000</b>
<b>Cash Out</b>		
Inventory Expenditures		
Inventory/Raw Material (cash)	8,363	8,363
Inventory/Raw Material (paid on account)	-	-
Production Expenses	2,256	2,256
Operating Expenses		
Advertising	-	-
Bank Charges	-	-
Dues & Subscriptions	-	-
Insurance	225	225
Licenses & Fees	215	-
Marketing & Promotion	3,500	200
Meals & Entertainment	1,000	-
Miscellaneous	100	100
Office Expense	150	150
Office Supplies	-	-
Outside Services	70	70
Payroll Expenses		
Salaries & Wages	2,000	2,000
Payroll Taxes	300	300
Benefits	1,000	1,000
Professional Fees	1,200	200
Property Taxes	-	-
Rent	4,200	4,200
Repairs & Maintenance	-	-
Shipping & Delivery	-	-
Telephone	300	350
Training & Development	-	-
Travel	5,000	-
Utilities	500	500
Vehicle	120	120
Leased Equipment	400	400
Other	-	-
Other	-	-
Paid on Account	-	-
Non-Operating Costs		
Capital Purchases	-	-
Estimated Income Tax Payments	-	-
Interest Payments	309	306
Loan Principal Payments	594	598
Owner's Draw	500	500
Other Cash Out	-	-
<b>Total Cash Out</b>	<b>32,302</b>	<b>21,838</b>
<b>Monthly Cash Flow (Cash In – Cash Out)</b>	<b>3,202</b>	<b>(8,040)</b>
<b>Beginning Cash Balance</b>	<b>10,000</b>	<b>13,202</b>
<b>Ending Cash Balance</b>	<b>\$13,202</b>	<b>\$ 5,162</b>



The advantage of the Cash Flow Report over your regular checkbook register is the way it displays monthly financial activity over time, making it easy for you to analyze past fluctuations in cash flow in the year and predict future ones for next year.

The Cash Flow Report can help you with day-to-day cash budgeting. You need cash flow analysis because a delay usually occurs between the time you pay out cash to generate sales (for example, purchasing inventory or paying employees' salaries) and the time you actually receive cash from those sales—also called the cash cycle. Since typical sales transactions have a cash cycle of days, weeks, or even months, you will need to locate additional funds to keep the business running while waiting for the cycle to be completed.

Fortunately, cash flow planning is simple in concept, although coming up with the numbers can involve considerable work. Cash flow is exactly what its name implies: the anticipation of cash as it flows into and out of the company. Only cash transactions are included in this analysis. You can ignore non-cash accounting entries such as Depreciation and Amortization which do not appear on the Cash Flow Report.

The Cash Flow Report lists the sources of cash expected to be received into the business on a monthly basis. This list includes cash sales, collections from accounts receivables, equity contributions from owners, and loans from either owners or outside sources. The cash you expect to receive is added to the cash balance remaining from the prior month to total the cash available for that month. You deduct all items paid for with cash from the total cash available to identify the cash balance at the end of the month. This amount must always be above zero. In fact, you should try to maintain a healthy cushion to cover unexpected differences between budgeted cash flow and actual cash transactions.

**Cash Flow Statement** – The traditional Cash Flow Statement prepared by accountants reconciles the changes that occur within the Balance Sheet accounts with the cash provided from the operations of the business. The cash flows from investing and financing activities are also reported. Although these statements can be used to budget future cash flows, they are more effective at reporting actual cash activity than at budgeting predicted activity.

<b>Cedar Solutions</b> <b>Statement of Cash Flows for the Year Ending 2005</b> <b>(Projected)</b>	
<b>Cash Flows from Operating Activities</b>	
Net Income	\$ 57,705
Adjustments to reconcile Net Income to Net Cash provided by operating activities:	
Depreciation & Amortization Expense	14,095
Decrease in Accounts Receivable	2,650
Decrease in Inventories	5,730
Decrease in Accounts Payable	<u>(6,834)</u>
Net Cash Provided by Operating Activities	73,346
<b>Cash Flows from Investing Activities</b>	
Purchase of Property, Plant, & Equipment	<u>(25,000)</u>
Net Cash Used by Investing Activities	(25,000)
<b>Cash Flows from Financing Activities</b>	
Proceeds from Loans	40,000
Principal Payment on Loans	(7,026)
Payment of Owner's Draws	(6,000)
Proceeds from Issuance of Stock	<u>25,000</u>
Net Cash Provided by Financing Activities	51,974
Net Increase in Cash	100,320
Cash at Beginning of Year	<u>10,000</u>
Cash at End of Year	<u><u>\$110,320</u></u>