

Reading your financial statement

What does your financial statement tell its readers? It tells them of the financial condition of your business. You may not be able to extract all that an experienced banker or CPA could, but you can learn much from reading your self-prepared financial statements.

First, review your income statement. The income statement informs you how your operations are performing. If you sell goods, look first at your cost of good sold percentage. You should have a reasonable idea of how much your profit margin is. If your profit margin is lower, investigate. Did you have a sale? Did you have to scrap items? Are you not charging enough?

Your cost of goods sold may give you information on your operations. If your material costs are up, why are they up? Is material usage up? Do you have an inexperienced employee who is wasting material? Has the quality of your materials declined so that you need more to produce your normal output?

Compare regular expenses across months as many expenses are basically unchanging. For instance, you rent your office for \$2,000 a month. If the rent expense is more (or less) than that, investigate. The rent may have been paid twice (or not at all). Expenses similar to rent would be utilities and office supplies.

Other expenses may vary, but those variances can give you useful information. Are your auto repairs up? You may have a vehicle that needs to be replaced. Are your equipment repairs up? That may mean you need to replace equipment or add equipment (because your sales are increasing and you are overworking present equipment).

Some expenses are prone to abuse. Miscellaneous expenses are needed for a catch all – but large amounts in miscellaneous expense indicate misreporting or potential abuse. A spike in telephone expense may mean personal long distance or cell phones charged to the business.

Some expenses exist in more or less standard proportion to other expenses. The most common example is payroll tax expense compared to your W-2 payroll. Typically, payroll tax expense is about 8-12% of the payroll. If higher, you may be overpaying your unemployment tax. If lower, the payroll tax deposits may not be getting made (major problem!) or you may have contract labor misposted to salaries.

You review your income statement to see how you are controlling your spending. Samuel Johnson wisely said, ‘Whatever you make, spend less.’ Uncontrolled spending is the downfall of many businesses.

Second, review your balance sheet. Your balance sheet tells the reader how soon your cash will run out, and balance sheet review consists of the comparison of key asset accounts to key liability accounts.

First, look at the payroll tax and sales tax liabilities. I emphasize these liabilities because the government (state or federal) by law can collect these accounts from the owner if the business does not pay. Be sure that these amounts are current.

Second, add your cash, accounts receivable, prepaid expenses and inventory and then subtract the 'current liabilities' (accounts payable, customer deposits, payroll liabilities, and short term loans). The total result is called 'working capital'. Most businesses have positive working capital. Typically, if the business has negative working capital, most lenders are skittish about lending or advancing credit.

Third, add your cash and accounts receivable then divide by the current liabilities. This is the 'acid test' and a ratio of 1 or more is typical. Less than 1 leads to questions about whether the business can pay its bills in a timely manner.

Fourth, add beginning accounts receivable for the month to ending accounts receivable balance. Divide that by two times the current month sales then multiply by 30. This number is the days of outstanding sales in your accounts receivable and it tells how quickly you are collecting your receivables. Under 30 days is great, between 30 to 45 days is typical, over 45 days you need to start calling customers. Compare this to your end of the month 'accounts receivable aging' report.

With time you will become better skilled and accustom to not just generating reports from your accounting software but actually interpreting the reports and analyzing how they can make your business better.

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