

# How Is My Business Doing?

Your business's past, present and future will, to a large extent, be judged by its financial performance. The numbers in your financial statements hold the secrets to finding out how your business is doing. This worksheet will concentrate on the two most common financial statements: the **Balance Sheet** and the **Income Statement**. Using numbers taken from both statements, you will be worked through the process of analyzing how your business is doing.

Financial statements are prepared for a number of reasons with the two most important being to provide you with a means of understanding how your business is doing and to satisfy taxation requirements. Statements are produced yearly on December 31st for proprietorships but may be done at different times in the year for limited partnerships and incorporated companies, depending on the end of the particular company's fiscal year.

Here is how a typical balance sheet would be set up: (See "Balance Sheet" hand out for further explanation)

Company Name	
Balance Sheet	
Date	
<u>Assets</u>	<u>Liabilities</u>
CURRENT ASSETS	CURRENT LIABILITIES
FIXED ASSETS	LONG-TERM LIABILITIES
TOTAL ASSETS .....\$ _____	TOTAL LIABILITIES..... \$ _____
	<u>Owner's Equity</u>
	Balance at beginning of year
	Income for the year
	Less owner's drawings
	Total Owner's Equity
	TOTAL LIABILITIES & OWNER'S EQUITY..... \$ _____

# How Is My Business Doing?

## Assets

### Current Assets

These are owned items that could be converted into cash in the normal course of business within a short period of time. Examples are cash, accounts receivable, inventory, prepaid expenses, etc. These should all be itemized separately on the balance sheet.

### Fixed or Capital Assets

These are owned items that have an expected life measured in years. They cannot be liquidated as quickly as a current asset and most of them are depreciated at set rates over the estimated life of the asset. Examples of fixed assets include building, furniture, automobiles, land, etc.

## Liabilities

### Current Liabilities

These are debt items that you must have cash for to pay within a short period of time. Examples of current liabilities include accounts payable (supplier credit for inventory), short term loans (operating line of credit, overdraft), taxes and employees' wages.

### Long-term Liabilities

These are debt items that you are committed to paying for over a period that exceeds usually one year. Examples of long term liabilities include equipment purchase loans, vehicle purchase, and mortgage.

## Owners Equity

(This represents the personal investment of the owner and/or shareholders)

**Balance at the beginning of year.** This is the amount of cash and/or retained profit that has been invested in the company by the owner(s) at the start of the period. For an incorporated company this would be called *Retained Earnings*. For a proprietorship, this would be call *Owner's or Proprietor's Equity*.

### Income for the Year

The income or (loss) for the period is identified from the income statement. This may also be identified as current earnings or (current loss) from the income statement.

### Less Owner's Drawings (money taken out of the business by the owner)

Drawings come directly out of the equity of the business. *They are not treated as wages on the business income statement.* This is the amount reported by the business owner on his personal income tax filings for the year.

# How Is My Business Doing?

## The Balance Sheet

We will look at three formulas to illustrate what can be learned from looking deeper into the balance sheet. These are referred to as *RATIOS*, which is a process of simply showing how one number on the balance sheet relates (compares) to another number on the balance sheet.

- **Current Ratio**
- **Debt/Worth Ratio**
- **Net Worth**

## Current Ratio

THE *CURRENT RATIO* IS A MEASURE OF *LIQUIDITY* (HOW EASILY A BUSINESS CAN MEET ITS CURRENT DEBTS) BY COMPARING (DIVIDING) THE CURRENT ASSETS BY THE CURRENT LIABILITIES. If a business has current assets of \$20 and current liabilities of \$10, the current ratio would be \$2 of current assets to every \$1 current liability (\$20 divided by \$10). This can also be shown as 2:1. Here is the formula to compute the current ratio:

$$\text{Current Ratio} = \text{Current Assets divided by Current Liabilities}$$

Different situations can occur but a rule-of-thumb puts a strong current ratio at 2:1 and anything less is considered a poor current ratio. The current ratio, calculated from the example balance sheet, would be (\$65,000 divided by \$40,000) 1.63:1, or expressed as: for every \$1.63 of current assets we have \$1 of current liabilities. A current ratio can be improved by either increasing current assets or decreasing current liabilities. This can be done by:

- Acquiring a term loan (payable over more than 1 year's time) to pay off short term debts.
- Selling a fixed asset to acquire cash for operating funds or pay down debt.
- Putting profits back into the business rather than the owner taking them out.

However, a high current ratio may mean that cash is not being utilized in an optimal way. That is, the cash might better be invested in equipment, paying off long-term debt or in a term deposit at your financial institution, which will at least yield you some interest until the money is needed.

## Debt/Worth Ratio

THE *DEBT TO WORTH (EQUITY) RATIO* IS AN INDICATOR OF A BUSINESS' *SOLVENCY* (ABILITY TO PAY OFF ITS LONG-TERM DEBTS) BY COMPARING (DIVIDING) THE TOTAL LIABILITIES BY THE OWNER'S EQUITY. If a business has total liabilities of \$200 and owner's equity of \$10, the debt/worth ratio would be (\$200 divided by \$10 equals) \$20 debt for every \$1 of owner equity, which is shown as a 20:1 ratio.

A debt/worth ratio is computed as follows:

$$\text{Debt / Worth Ratio} = \text{Total Liabilities divided by Owner's Equity}$$

It is a measure of how dependent a company is on borrowings as compared to owner's equity. It also shows how much of a business is owned by the owner and how much is owed to bankers. Lenders, particularly banks, place a high priority on this ratio. From our balance sheet example this would be (\$140,000 divided by \$40,000) 3.5:1, or expressed as; for every \$3.50 of total liabilities (debt), we have \$1 of owner's equity. Lenders consider 2:1 and under to be acceptable. Our example business debt/equity ratio would not be looked upon favourably at 3.5:1.

## Net Worth

THIS IS CALCULATED BY SUBTRACTING TOTAL LIABILITIES FROM TOTAL ASSETS. Net Worth must be positive. If it's not, that means that if you sold ALL your business assets to pay off all your business debts, you would STILL need to come up with more money. DO NOT LET YOUR BUSINESS GET TO THIS POINT!!!. If this is the case, you are out of business for all intensive purposes.

The formula for calculating net worth is:

$$\text{Net Worth} = \text{Total Assets} - \text{Total Liabilities.}$$

From our example balance sheet the net worth would be \$180,000 - \$140,000 = \$40,000

## The Income Statement

The income statement is a report of operating results for a company over a specified period of time, usually one year. Income statements must be prepared annually for Revenue Canada purposes but again preparing them more frequently will provide you with current information about how your business is performing; ie: quarterly.

In practice, there are many variations to the amount of detail recorded in an income statement dependent upon the type of business you are operating. The basic format lists all revenues and subtracts all expenses. The difference between revenue and expenses is known as net income or (net loss).

**Here is how a typical income statement would be set up:**

<b>Company Name</b>	
<b>Income Statement</b>	
<b>For the Month or Year Ending ....</b>	
<b>SALES (Revenue)</b>	<b>\$200,000 (A)</b>
Less Cost of Goods Sold	<u>\$130,000 (B)</u>
<b>Gross Profit</b>	<b>\$ 70,000 (C)</b>
<b>OPERATING EXPENSES</b>	
-selling	
-general	
-administrative	
<b>TOTAL OPERATING EXPENSES</b>	<b><u>\$ 36,000 (D)</u></b>
<b>NET INCOME (LOSS)</b>	<b>\$ 34,000 (E)</b>
<b>BEFORE TAXES</b>	

The following highlights the information contained in an Income Statement for the specific time frame you are shown.

#### **Sales (Revenue) (A)**

Include in this section, the total of all sales for all services/products, both cash sales and on account. Keep in mind that SALES DO NOT MEAN PROFITS. You have to use some of the money to replace the inventory sold in the transaction Profits do not occur until all costs have been paid. In other words, YOU GET PAID LAST.

#### **Cost Of Goods Sold (Variable costs) (B)**

This is the amount that it cost to obtain your inventory or supplies to in turn sell your product or service to your clients.

## **Gross Profit (C)**

This is the difference between your sales and the cost of goods sold. It is the amount of money that is available to pay your operating expenses.

## **Operating Expenses (Fixed costs) (D)**

These are the costs that will be incurred as a result of being in business. They are not a direct cost of producing your product. In other words, whether or not you make a sale, you still have these costs.

## **Net Income Before Taxes (Loss) (E)**

It is the difference between the Gross Profit and Total Operating Expenses. It puts a dollar figure to your business performance for a specified period. If the number is negative, your business lost money and the dollar figure should be shown in brackets.

## **Taking a Closer Look**

We will look at two formulas to illustrate what can be learned from looking deeper into the income statement:

- **Gross Profit**
- **Gross Profit Margin**

## **Gross Profit**

This is calculated by subtracting the cost of goods sold from your sales (revenue).

$$\text{Sales (A)} - \text{Cost of Goods Sold (B)} = \text{Gross Profit (C)}$$

From our income statement, the gross profit would be  $\$200,000 - \$130,000 = \$70,000$

## **Gross Profit Margin**

THIS IS A KEY MEASURE THAT IS USED TO DETERMINE THE HEALTH OF A BUSINESS. IT INDICATES A BUSINESS'S MARKUP. In general, your gross profit margin ratio should be stable and there should be little fluctuation from period to period unless your industry is undergoing changes that influence your pricing policies or cost of goods sold. A falling gross profit margin from one year to the next could indicate the business is not increasing its prices in relation to its costs and/or the owner is reducing his prices for his goods to compete. There is no hard and fast rule for what margin is acceptable but it does have to be sufficient to be able to cover replacement inventory, operating expenses AND pay you a wage.

The formula is:

**Gross Profit (C) divided by Sales (A) x 100 = Gross Profit Margin (expressed as a %)**

Our example would be \$70,000 divided by \$200,000 = .35 X 100 = 35%.

35% is the Gross Margin this business uses to set its pricing of its products. This means that for every \$100 of inventory purchased the selling price is \$135. To keep the business operating, \$100 goes back to buying more inventory to sell

and \$35 is used to cover operating expenses and, hopefully, pay you at the end of the day.

There are four additional indicators that can be used to understand how your business is doing:

- **Age of Receivables**
- **Age of Payables**
- **Age of Inventory**
- **Break-even Analysis**

**Note:** To simplify matters, some of the individual accounts mentioned in the following calculations were not itemized in the example balance sheet and income statement. Dollar figures have been inserted to work through the samples. Your financial statements should show these items individually.

## Age of Receivables

THIS INDICATOR SHOWS HOW LONG IT IS TAKING FOR YOU TO COLLECT YOUR ACCOUNTS RECEIVABLE (IF YOU HAVE ANY). There is no generally accepted standard but historical comparisons should be done to ensure that you are keeping on top of your receivables. For example, if this number came out to 75 days and your payment terms were 30 days, then you have not been keeping a tight enough control on your receivables. Try offering a discount for prompt payments or a penalty for slow payments to get receivables in faster. The formula is:

***(Accounts Receivable divided by Sales) x 365 = Number of days***

Using an example: (\$25,000 divided by \$200,000) x 365 days = 46 days. In this case your accounts receivable are taking 46 days to collect. *Rule of thumb:* this should be no more than 30 days in today's business world. Any longer and it is taking you too long to get your money for the sales you are making.

## Age of Inventory

THIS INDICATOR SHOWS THE SPEED WITH WHICH MERCHANDISE MOVES THROUGH YOUR BUSINESS (INVENTORY TURNOVER). This may vary, depending on the type of business/industry but look for trends and this can be done either by comparing this figure to other reporting periods, or by asking your banker if he has any resources to refer you to. Sharp increases in the days the inventory “turns” can mean that you are not carrying the right merchandise.

The formula is:

$$\text{(Inventory divided by Cost of Goods Sold)} \times 365 = \text{Number of days}$$

Using an example: (\$20,000 divided by \$130,000) x 365 days = 56 days

This means it takes 56 days for your inventory to “turn” (sell) one time. There is no rule of thumb for this but the more times your inventory “turns” the more times you are selling it and this is what being in business is all about – selling as many times as you can. If you are selling many different kinds of inventory, try and track each and see which “turns” the most and which does not “turn” at all. If stock is not “turning”, get rid of it – discount the price, give away as a promotion, maybe the supplier will buy it back (likely at a discount), whatever works for you. This is inventory taking up space and costing you money just to sit there – you don’t want this.

## Age of Payables (Suppliers)

THIS INDICATOR SHOWS HOW LONG A BUSINESS IS TAKING TO PAY SUPPLIERS. Like the accounts receivable aging, you should be looking to see if your number is where it should be. If you are supposed to be paying in 30 days and you are taking 60 days, you may run into problems with your suppliers not wanting to deal with you on credit and you may be put on C.O.D. only. If you are paying in 10 days, you may not be using your money as efficiently as possible.

The formula is:

$$\text{(Payables divided by Purchases)} \times 365 = \text{Number of days}$$

Using an example: (\$20,000 divided by \$150,000) x 365 days = 49 days. This means you are taking 49 days to pay your suppliers on average. DO NOT ABUSE YOUR SUPPLIERS!! They are not banks and don’t generally finance business purchases. That’s what banks and other lenders are for; ie: Lines of Credit, Operating loans, etc. If your supplier’s terms are 30 days then don’t take any longer than that to pay them. If you are selling your products you want to get paid right away – right – so do your suppliers.

## Break-even Analysis

Another important tool to evaluate your business's performance is to calculate the level of sales needed for your business to *break even*. THE BREAK-EVEN POINT IS WHERE YOUR *TOTAL COSTS* AND *TOTAL REVENUES* ARE EQUAL. Only after you reach the break-even point will your business start turning a profit. You must have certain information available, or assumptions made in the case of a new business start-up, in this calculation. We have used annually for this calculation but you can do it semi-annually, quarterly or even monthly, by simply dividing your amounts by the period you want to use; ie: monthly = 12.

- Know what your operating (fixed) expenses are, or will be; ie: \$36,000 annually
- Know what your owner drawings from the business are, or will be; ie: \$24,000 annually
- Know what your loan payments are, or will be; ie: \$3,600 annually
- Know what your Gross Margin is, or going to be; ie: 35%.

Following is the formula for calculating your break-even:

- 1) What do you need for a Gross Profit, in dollars, to be at a break even using the above information?

***(Operating Expenses + Drawings + Loan Payments) divided by Gross Margin Percentage***

$$(\$36,000 + \$24,000 + \$3600) = \$63,600 \text{ divided by } .35 \text{ Gross Margin} = \$181,715$$

You now know, that in order to break even, you would have to generate sales of \$181,715 to cover operating expenses, owner drawings and debt payments to break even annually.

Working through the calculations presented in this worksheet should allow you to gain a better insight into how your business is doing. A good idea is to compare these ratios with prior years', prior quarters', or even prior months' numbers and see what trends are happening in your business either in the short term or long term. The following are questions you may want to consider addressing in your business.

- **Is the Gross Margin percentage going up or down?**
- ***Up is good, down is not so good.***
- **Is the business Net Worth increasing?**
- ***Increasing Net Worth is always good.***
- **Is the Net Profit/Income increasing or declining?**
- ***Should be increasing or at least stable.***
- **Is the total Sales increasing but your Profits are not keeping pace?**
- ***What's happening?***
- **Are your operating (fixed) costs increasing but Sales are not? *Why?***

- **Why am I using my bank Line of Credit more than ever and yet my Sales are higher than ever?**
- **Why are my Sales decreasing?    *Less customers?    Inventory nobody wants to buy?***
- **Is my inventory level increasing or decreasing?    Do I have seasonal inventory that is causing problems?    *Dead inventory?    More diversified inventory?***

These are not the only calculations that can be done. Community Futures has the resources to assist you in completing a more detailed analysis including providing you with comparisons to how other companies in your industry are doing.

The following tables are an example of ways of doing a “snapshot” of key areas of your business to identify trends:

<b>ITEM DESCRIPTION</b>	<b>CURRENT YEAR \$</b>	<b>LAST YEAR \$</b>	<b>2 YEARS AGO \$</b>	<b>3 YEARS AGO \$</b>
<b>Balance Sheet</b>				
Current assets				
Total assets				
Current Liabs.				
Total Liabs.				
Owner Equity				
Tot. Liab & OE				
<b>Income Statement</b>				
Sales/Revenue				
Less: COGS				
Gross Profit				
Operating Exp.				
Net Income (Loss) Bef. Tax				