SMALL BUSINESS CENTRE

Introduction to Financial Statements

Composing Financial Statements

A Business Plan has many different components. Addressing financial statements is a complex topic, which we will attempt to simplify for the small business start up. The only way to accurately determine the feasibility of your company is to see if it is profitable through analysis of the financial forecasts. There are 4 main parts to the financial section of the Business Plan for a business start-up. They are ***Start-up Costs***, ***Cash Flow Statement***, ***Income Statement*** and ***Balance Sheet.***

Start-Up Costs – These are all of the expenses incurred in order to get the business to a point where it can physically open the doors and start selling its product or service to the customer. This section allows the entrepreneur to examine all costs associated with getting the business up and running, which in turn will give the amount of funds needed from a bank or other source. Common things to include are cost of fixed assets, such as buildings, leasehold improvements, and equipment. Current expenses include insurance, licenses, inventory, wages, business registration, and professional fees.

The general rule for startup costs is to include all expenditures that are one time costs as well as the expenses for the initial month. For example the initial cost of getting a phone line installed may be $100 and the ongoing every month cost would be an additional $50. Therefore the startup cost is $150.

Cash Flow Projections Statement - Composing this statement will enable you to predict cash needs to service debt payments, purchase new inventory, pay for utilities and reconcile accounts with suppliers. Not only will it provide you with a view of your companies cash needs, it will also be presentable to banks and prospective investors, who could be necessary in obtaining financing.

You must do research in regards to how you will run your business and then extrapolate a projection of what your mandatory cash needs will be. Start with looking at expenses and sales, or any other activity that uses cash. You only include items that produce or use cash in that statement's period of time. Be realistic when composing this statement in order to get a true view. To get the best forecast, find past financials or industry averages for companies that are similar to yours, (size, employees, market potential, product being sold) and use numbers close to theirs. For assistance and guidance in completing market analysis, please book a consultation by calling 519-659-2882.

It is important to factor in all of the information you gathered, both on industry and customer trends. If the industry norm is to allow for payments from customers over 30 and 60 days, then factor that into the forecast as accounts receivable. Ideally you would want cash for every purchase when the items or service exchanged hands but realistically it is not always possible to accomplish this. Take all of this information and put it into a yearly forecast, broken into monthly components.

Income Statement – This statement shows the profitability of a company. The *Net Income* is the most important figure. It is usually drawn up once a year, but in the case of a start-up company, it is beneficial to address the composition of this statement in a monthly format. The major difference between the income and cash flow statements is that the cash flow records expenses or sales at the time when cash leaves or comes into the company. With an income statement, only the portion of expenses relative to that earning period are recorded. Note that just the interest portion of any loan is recorded on an income statement as an expense related to borrowed money. The principle is being repaid, so it is not an expense.

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For example let's say you get an insurance policy for your business. The insurance premiums must be paid for once every 6 months. This would translate into a cash expense when you got the policy, followed by a second expense 6 months later. On an income statement, you would take the total amount and divide it by 12 months, thus attributing a portion of expense in each month you were operating. This is done because the benefit of having insurance is for the entire year not just the two months that a payment is made. In this example we are matching expenses with earnings, and it allows us to determine if we are profitable.

There are a few financial terms on the Income Statement that should be defined.

- ***Depreciation*** is costing out an asset (equipment, car, machine) over the useful life of that item.
- ***Amortization*** is attributing the initial purchase price on a piece of property over the time you want to pay it off. Each period has a certain amount of the cost associated with the earnings in that period.
- ***Gross Margin*** is total sales minus the cost of goods sold. Sometimes seen as a percentage (cost of sales divided by sales). Comparing this percentage to industry averages will reveal whether your company is operating within a successful or failing profile.
- ***Revenues*** are all sources of income to the business
- ***Net Income/Sales (%)*** net income divided by sales is a percentage that reflects what the relationship of total sales to expenses are.

Balance Sheet – The balance sheet takes a snapshot of the company's assets, liabilities and equity at any one particular instance in time. Balance sheets are usually produced every year, but it is beneficial to do monthly balance sheets during the start-up period when financial values are changing so rapidly.

Assets are any items that the business owns that has value. Common assets include cash, accounts receivable, land, buildings, and inventory.

Liabilities are payments that the business still owes. Common liabilities include accounts payable, taxes and bank loans.

Equity is how much the company is actually worth at a moment in time. Equity is calculated by subtracting total liabilities from total assets. For example, if the business has $1000 in assets and $500 in liabilities, the remaining equity is $500.

Congratulations! You are now on you're way to understanding the financial side of your business.

If you would like to learn more about business and business planning, please talk to the staff members at the Small Business Centre. The SBC offers information sessions, business planning workshops, consultations with business advisors, information about grants and financing, targeted information seminars, and many other resources for small businesses. The Small Business Centre can be reached at 519-659-2882, or online at www.sbcentre.ca.

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