

# UNDERSTANDING BASIC FINANCIAL STATEMENTS

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Perhaps the best way to illustrate the importance of basic, commonly used financial statements is to offer an over-simplified comparison of business financing to home financing (which is more familiar to most these days).

Most people know that you would not call a bank to refinance your current home loan without at least knowing how much money you make, how much you owe on the current mortgage and an approximate value of the home being refinanced to determine your equity position (assuming that your credit and other common criteria are adequate). The same principles apply when financing your business. The income statement and balance sheet essentially provide this basic information.

Let's start with the income statement. Simply put, this is similar to showing your pay stub for a personal loan. It illustrates the gross and net income that is generated by your business during a particular period of time. Although it provides more detail than a pay stub, it serves as a starting point when attempting to determine how much the business can afford to borrow as a stand-alone entity.

The financial statement that often provides more confusion is the balance sheet. The balance sheet is actually a very simple statement to understand once you understand its purpose. The balance sheet provides a snapshot of the overall condition of the business at a particular period in time. Using the same example as above, this is similar to stating the current value of a home, and then breaking down how much is financed through debt and how much is left in the form of equity. If you went to apply for a personal loan, you would need to know the breakdown of all of these items. The same principle applies with your business, and a balance sheet will provide this information in an organized format.

It helps to think of the balance sheet as an equation. On one side of the equation are the assets (current value) and on the other side are the liabilities (debt) and equity (retained earnings, owner contributions, etc.) used to acquire, maintain and generate a return on the assets of the business. Both sides must balance, hence the name.

Therefore, the balance sheet in equation form is:  $\text{Assets} = \text{Liabilities} + \text{Equity}$

To calculate your business assets, you would account for subcategories like cash, accounts receivable, inventory, property and equipment (net depreciation) and prepaid expenses.

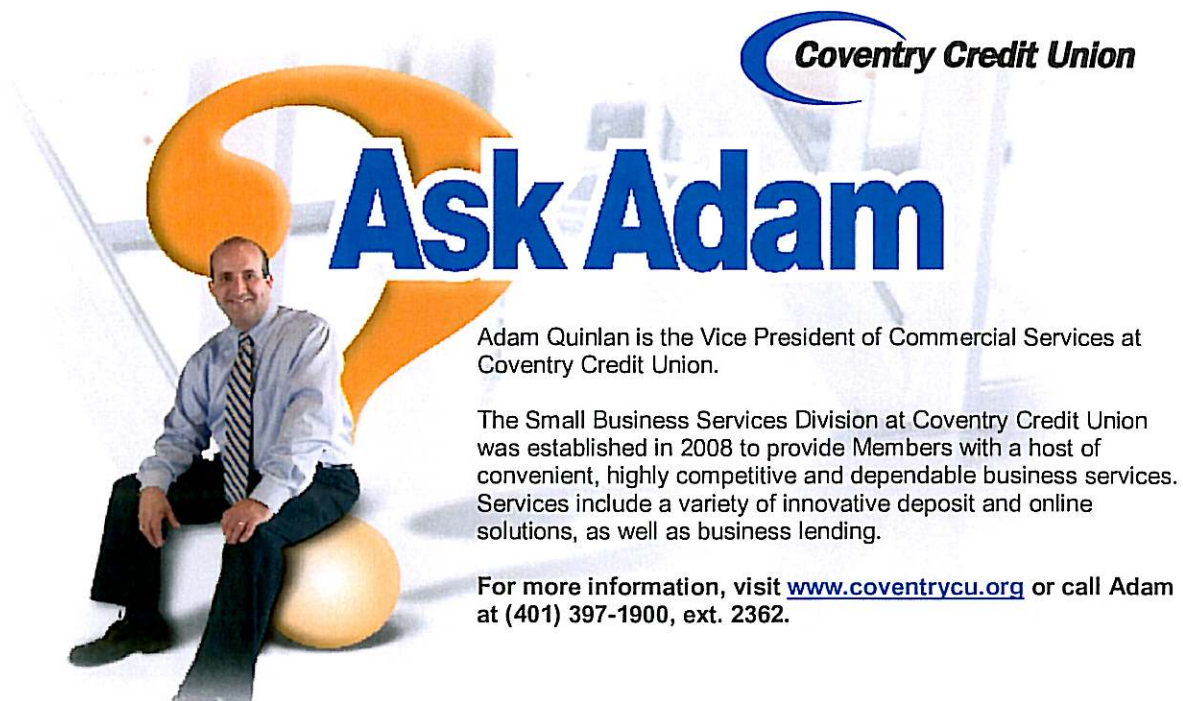
Liabilities can include short-term liabilities (liabilities due within the next year or operating cycle, such as accounts payable or short-term loans), and long-term liabilities which include any obligations exceeding one year.

Equity (also referred to as "net worth"), includes items such as retained earnings (money that the business has earned and was reinvested back into the business) and other equity accumulated by common and preferred shareholders.

If business financing is being sought, your business banker will review your income statement and balance sheet with you to determine the actual cash flows passed through the business. Many people have the misconception that the net income on the income statement is the same as the actual *free cash flow* realized by a business. This is actually not true, and a review of the income statement and balance sheet over consecutive periods is necessary to accurately determine free cash flows generated by a business during the periods under review. This is due to changes in items such as accounts receivable, accounts payable, prepaid and deferred items, inventory levels and other factors related to actual cash flows. It is important for you, as the business owner, to take part in that review and understand the mechanics and intricacies related to the cash flows of your business.

In order to effectively manage your business and strategically plan for upcoming periods (especially during turbulent times), you, as a business owner, **MUST** have a clear understanding of these fundamental pieces. Whether you are looking to survive, expand, or explore exit strategies, this information is vital.

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# Ask Adam

Adam Quinlan is the Vice President of Commercial Services at Coventry Credit Union.

The Small Business Services Division at Coventry Credit Union was established in 2008 to provide Members with a host of convenient, highly competitive and dependable business services. Services include a variety of innovative deposit and online solutions, as well as business lending.

For more information, visit [www.coventrycu.org](http://www.coventrycu.org) or call Adam at (401) 397-1900, ext. 2362.