

THEME: ANALYZING FINANCIAL STATEMENTS

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ACCOUNTING TERMS: Vertical & Horizontal Analysis

Vertical analysis means reviewing one year or less of data. A good example is the profit and loss statement. Horizontal analysis means arranging the data to be reviewed in a year-to-year, month-to-month, budget-to-actual, fashion.

FEATURE ARTICLE: Analyzing The P&L Statement

Some small business owners have an inherent dislike for numbers. They may be very good at selling their product or service, but when it comes to numbers, Yuk! I would even be willing to bet that if it were not a governmental requirement for business owners to report their earnings each year, some owners would never get around to preparing financial statements.

It is very common for the small business owner to pay good money to have his/her financial statements prepared, then, simply toss them into a drawer without a peek. This may be done for a variety of reasons. First, the owner or manager doesn't know how to read a financial statement; second, the attitude of the owner is, "why bother", as things seem to be running just fine; third, the statements are never completed in a timely manner so the information is old; fourth, the owner/manager is just too darned busy to get around to it.

Given this reality, I would suggest that ignoring your financial statements can be hazardous to the health of your business. It doesn't have to be this way. Analyzing your monthly or quarterly financial statement can take only a few minutes if you know what to look for. Let's take a look at a P&L statement and do what is called "Vertical Analysis". Here is an example that I use in my online course, "Accounting for Non-Accountants".

<u>Be Hair Now</u>		
Statement of Income & Expense		
For The Seven Periods Ended July 31, 20XX		
	Year-to-Date	
	Actual	Percent
REVENUE		
Taxable Sales	27,361.13	16.4
Services Rendered	139,614.60	83.5
Tanning Beds	115.00	.1

Refunds & Allowances	<u>(26.00)</u>	<u>0.0</u>
TOTAL REVENUE	167,064.73	100.0
COST OF SALES		
Direct Labor	55,076.29	33.0
Freight	6.93	.0
Purchases (Inv)	19,543.75	11.7
Supplies	<u>473.45</u>	<u>.3</u>
TOTAL COST OF SALES	<u>75,100.42</u>	<u>45.0</u>
GROSS PROFIT	91,964.31	55.0
OPERATING EXPENSES		
Accounting & Legal	330.00	.2
Advertising	2,400.00	1.4
Bank Charges	1,429.77	.9
Cleaning & Janitor	1,320.00	.8
Dues & Subscription	76.00	.0
Education	22.15	.0
Employer Payroll Tax	5,646.10	3.4
Ins. – Liability	261.44	.2
Ins. – Medical	2,222.00	1.3
Ins. - Wkrs. Comp.	1,556.36	.9
Meals & Ent.	58.54	.0
Miscellaneous	6.00	.0
Office Expense	350.31	.2
Office Wages	4,486.19	2.7
Outside Services	280.32	.2
Permits/Licenses	100.00	.1
Postage	50.48	.0
Property Taxes	600.00	.4
Rent	7,000.00	4.2
Repairs & Maintenance	26.72	.0
Small Tools	137.72	.1
Stationery & Printing	66.75	.0
Telephone	580.14	.3
Utilities	<u>1,464.00</u>	<u>.9</u>
TOTAL OPERATING EXPENSES	<u>30,470.99</u>	<u>18.2</u>

NET INCOME FROM OPERATIONS	61,493.32	36.8
OTHER INCOME & (EXPENSE)		
Interest Income	218.58	.1
Depreciation	(5,855.73)	(3.5)
Amortization	(937.23)	(.6)
Interest Expense	(1,638.22)	(1.0)
TOTAL OTHER INCOME & (EXPENSE)	(8,233.71)	(4.9)
NET INCOME (LOSS)	<u>53,259.61</u>	<u>31.9</u>
	=====	=====

Notice how there is a list of percentages on the right side of the numbers. Find Total Revenue of \$167,064.73 and its corresponding 100 percent. All the expenses located below Total Revenue are based on a percentage of Total Revenue. For instance, if you divided Direct Labor \$55,076.29 by Total Revenue \$167,064.73, the percent derived is 33.0. Find Net Income of \$53,259.61 and notice that it is 31.9 percent of Total Revenue.

The first thing I look for on a P&L statement is Total Revenue. I want to know how much sales I generated during the month or quarter. This gives me a sense of volume. If I am watching this figure closely, it will be apparent how the current period compares to the last period (horizontal analysis). If the figure has dropped dramatically, then the alarm bells will sound inside my head.

The next figure I like to examine is Net Income. I want to know if I made any money during the period. If it is low, then I want to know why. The first place I start looking for an answer is in Cost of Sales. If I have an idea of what my percentage normally runs for Cost of Sales, such as, in the example 45.0 percent (Scenario 1), and my new financial statement reflects a percent close to that (Scenario 2) then I'm not concerned. However, if Total Revenue has dropped significantly and the dollar amount of Cost of Sales has remained the same amount (\$75,100.42) then the Cost of Sales ratio would jump to 50% (Scenario 3). This would catch my eye and tell me further investigation was necessary. For example:

Scenario 1

Total Revenue	\$167,064.73	100%
Cost of Sales	\$ 75,100.42	45%

Scenario 2

Total Revenue	\$150,000.00	100%
Cost of Sales	\$ 67,500.00	45%

Scenario 3

Total Revenue	\$150,000.00	100%
Cost of Sales	\$ 75,100.42	50%

If I don't see anything that gets my attention in Cost of Sales, I then scan the Operating Expenses for key variables such as: Advertising, Office Wages, Repairs & Maintenance and, Telephone, or any accounts that I know can fluctuate with the volume of sales. I also keep my eye peeled for anything unusual. The only way I can notice things out of the ordinary is to review the financial statements on a regular basis. And how much time did I spend? Perhaps ten minutes at the most.

Is it worth it? All I can tell you is that I have had clients that were losing money for months and didn't have any idea how bad the situation was. They borrowed money to stay afloat but were doomed months before. Had they known the truth, they could have done a "Going out of Business" sale and walked away without owing the banks and credit card companies a ton of wasted money. These debts still have to be paid, but now with personal assets.

Another example. There was the drywall contractor client who decided to become an entrepreneur and hire others to do the "grunt work" while he cruised around and found the jobs. After a couple of years, he had a financial statement prepared and found that his workers made much more than he did. He had no idea of the overhead costs of running a small business. He went back to doing the drywall himself and made more money and had fewer headaches.

My point is, since the government requires that a financial statement be prepared at least once a year, then why not do it periodically throughout the year and get some mileage out of it? I think I have just shown you how simple it can be.

QUESTION: How To Do You Perform A Quick Analysis Of The Balance Sheet?

As you know, the Balance Sheet consists of Assets, Liabilities and Equity. When I analyze a Balance Sheet, I start from the top and work my way down. Cash is always at the top. It is crucial that Cash is accurate. The way to prove Cash is to reconcile it with a bank statement. Therefore, I look at the Bank Reconciliation to see if the "Book" cash balance is the same as the "Bank" cash balance. I then look at my Balance Sheet and make sure the Cash balance listed there is the same as on the Bank Reconciliation.

Next, I look at the Accounts Receivable balance, if there is one. It is important to not let the Accounts Receivable balance get too high because Accounts

Receivable represents potential cash, which is the lifeblood of the organization. I know that the longer those receivables remain uncollected the less likely they will be collected. So I'm doing two things with Accounts Receivable: 1) I want to know if the number I am looking at is accurate, so I want to verify that the monthly Accounts Receivable Ageing Report's ending balance is on the Balance Sheet; 2) I also want to know how old these receivables are. I can look on the Ageing Report to see how many receivables are outstanding for 30, 60, 90, 120 days and over. With this information in hand, I can determine how much energy to apply to collections.

It is a good idea to check on Employee Advances and the Payroll Clearing account to see if there are any outstanding balances. If so, I need to find out what they are.

If I have Inventory, I mentally check to see if the balance is unusually low or high.

Other assets such as Fixed Assets, Accumulated Depreciation, Deposits, etc., are not items I concern myself in a quick review.

Under Liabilities, I look closely at the Accounts Payable balance and review the Accounts Payable Ageing Report and compare the balances for accuracy. As with Accounts Receivable, I want to know how old the outstanding bills are because I don't want to lose a good credit standing with any of my vendors.

I scan the Payroll Tax liabilities that stay about the same from month to month or quarter to quarter. If that number starts building, then the payroll taxes are not being paid on time.

Other liabilities, such as Notes Payable, are not of immediate concern.

In the Equity Section of the Balance Sheet, I glance at the Owner's Draw just to see how much I have been taking out of the business. But, what I really look at is The Net Profit or Loss figure. I quickly make sure that that number is the same number found on the P&L Statement.

This whole process could take from five to twenty minutes. Regardless, it gives me a bird's eye view of what is going on with the financial aspects of my business.

TIP: Month End Ten Point Checklist

In Phase VI, "The Maintenance" of my online accounting course, I offer a "Balance Sheet Key Indicators Monthly Checklist", to help owners and managers of small businesses quickly review the financial statements they receive either from outside professionals or an inside accounting staff. If you are the person where "the buck stops" you cannot afford to trust that 100% of the accounting

information coming to you is accurate. It seems like you should be able to, but it is simply too risky.

So what do you do? First, you must have a basic understanding of accounting concepts. With this knowledge you can quickly review a set of financial statements and ask intelligent questions of those who prepared the statements. Next, use my mini ten-point checklist that is a summary of what was discussed in the articles above, plus a few other items:

- 1). Review the Profit & Loss statement (Statement of Income & Expense) as described above.
- 2) Review the Balance Sheet starting with Cash. Compare the bank balances with the bank reconciliation balances.
- 3) Compare the Accounts Receivable Ageing Report total to the Accounts Receivable control account. (The control account is the Balance Sheet Account.)
- 4) Review the Inventory balance. Is it high or low?
- 5) Did the Employee Advance and Payroll Clearing account clear?
- 6) Compare the Accounts Payable Ageing Report total to the Accounts Payable Balance Sheet total.
- 7) Measure the total debt to total equity. Equity should be two times higher than debt to indicate a healthy business.
- 8) Review the Working Capital ratio, that is, total Current Assets to total Current Liabilities. Current Liabilities should be no higher than the Current Assets (one-to-one). This is a measure of the company's "liquidity" or ability to pay current debts.
- 9) Verify that the Total Assets equal the Total Liabilities plus Total Equity. You want to make sure your Balance Sheet balances.
- 10) Check for anything unusual. If a bell goes off in your mind, don't ignore it. Following up on those mental alerts usually pays off.

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