

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 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.**

The **Balance Sheet** is the last topic but will not be looked at in this paper.

First we will address reading and writing of financial statements. The correct way to list any items in the asset and liability area is from most liquid (the items closest to cash) to least liquid (items which are hardest to get cash for even though they are worth actual dollar amounts). An example would be a five-dollar bill in your pocket. It is worth 5 dollars and can be used to pay debts or make purchases as is. Your home, even though it's worth \$100,000, cannot be used to purchase anything else until converted to cash. The longer it takes to convert items such as a house into cash the less liquid the asset is. When reading financials it is important to acknowledge the date and time the statements were composed. This will give us an idea of which statements relate to one another. Also comparing the information on the statements from different time periods allows for accurate analysis of what the company is doing year over year.

Start-Up Costs – These are all 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 building, leasehold improvements, 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 not just the onetime installation expense. Use Table 1.0 on the back of this page as a guideline for startup expenses. Add your business' specific needs under the space for other.

Start-up Costs
Table 1.0

Items		Estimated Cash Required (\$)
Business registration		
Licenses or Permits		
Signage		
Inventory Purchase		
Legal Fees (contracts, advice)		
Banking Fees (accounts & visa)		
Office Furniture & Equipment		
Office Supplies		
Down Payment on Building		
or Security Deposit for Rent		
Leasehold Improvements		
Telephone & Utilities Installation		
Machinery & Equipment		
Tools and Supplies		
Pre-opening Advertising		
Cash Reserve (operating line)		
Other		
Other		
Total Start Up Requirements:		

After getting an estimate of start-up needs compose a summary of where you predict each portion of the amount needed will come from. If you need \$50,000 then show that 20% or \$10,000 will be supplied by yourself, another 25% or \$12,500 will be supplied by a private investor and the remaining 45% will be supplied by a bank loan. Show it in a chart format like the following:

Proposed Sources of Financing:

Source	Dollar Amount Contributed	Percent of total
Owners Equity	\$10,000.00	20.00%
Private Investor	\$12,500.00	25.00%
Bank Loans	\$27,500.00	55.00%
Gov't Grants	\$0.00	0.00%
Venture Capital	\$0.00	0.00%
Totals-	\$50,000.00	100.00%

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 possible investors or just the bank, in order to obtain 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 things 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. A good spot for information regarding industry averages is at Industry Canada's Strategis website:

http://strategis.ic.gc.ca/cqi-bin/sc_mangb/contact/sbp/sbp.cgi

Factor in all the information you gathered. 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 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 important figure. It is usually drawn up once a year but in the case of a start-up company we are going 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 it's not an expense.

For example lets 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 then another one in 6 months. 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.

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

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