

BUSINESS SENSE

Next Level Tools for Entrepreneurs & Small Business Owners

FINANCIAL LITERACY SERIES

Importance of Financial Statements

Why is this important?

Financial statements are critical as they accurately reflect the business' performance and financial position. The knowledge the financial statements provide offers past and current performance benchmarks that inform decision-making. Financial statements help a business' owner(s) and management to make minor adjustments and/or determine the business' future direction to include expansion, financing, and even marketing by providing data indicating which aspects of company operations deliver the simplest return on investment. By publishing financial statements, management can also communicate with interested outside parties, like stakeholders, investors, journalists and industry analysts about its business accomplishments.



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Financial Statements

Finance and Accounting are seldom topics that excite entrepreneurs, yet they are crucial to the success of any enterprise whether start-up or well-established business. If you think of financial activities as inconsequential or mundane, you are missing the opportunity to fully understand your business and to make informed decisions to overcome your business challenges. You may also impede future growth of your business through the support of bankers and/or investors who will rely not only on your confidence but your thorough understanding of how your business works.

Three major financial statements essentially make up the "language of business." These statements provide a clear and efficient way for you to communicate to bankers, potential investors, vendors and employees - and to also tell you how your business is performing. The three financial statements are (1) the Balance Sheet, (2) the Income Statement (also referred to as the P&L or Profit and Loss Statement) and (3) the Cash Flow Statement.

In the cash basis method of Accounting, Income and Expenses are posted when money is received or paid, just like household accounting. Most businesses use this simple cash basis method when first starting up because it is easy to understand. This accounting method can continue to be useful if the business collects money immediately when the product or service is delivered, and if vendors are paid the same week that bills are received. However, the cash basis method does not accurately match revenue and its associated costs in the same time period if credit terms are offered, if there is a delay in paying bills, or for expenses that are paid in a lump sum but pertain to a whole year - like insurance premiums or subscriptions.

Most businesses eventually move to the accrual method of accounting which recognizes income when earned and expenses when incurred rather than when cash is received or paid. The accrual method provides a much more accurate picture of profitability in a time period which is essential for a growing business to understand.



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In both cash and accrual basis accounting all three statements are interrelated. However, it is the elegance of this inter-relationship in accrual accounting that enables the Entrepreneur to know if sales are increasing, whether cash is on hand and will be sufficient to meet obligations and whether the overall condition of the business is improving or deteriorating. The remainder of this article refers to accrual accounting.

Balance Sheet

The Balance Sheet is a statement of a company's financial position at a moment in time, or a snapshot that illustrates what your company is worth. The Balance Sheet has three major categories of entries: Assets, Liabilities and Shareholder's Equity. The Balance Sheet can tell you what is owed to you and not yet received, what you owe others and have not yet paid, cash you have in the bank, equipment you own outright, and equipment on which you may still owe money, and inventory (both raw materials and finished goods), furniture and leasehold improvements. The Balance Sheet also considers debt as well as investments.

Income Statement

An Income Statement (or Profit & Loss) is a statement of the revenue, expenses, and profits (or losses) the business has experienced over time. Generally, time is measured in months and cumulates over a calendar year. Importantly, the date for the Income Statement and the Balance Sheet must be the same so that profit or loss on the Income Statement and Net Income on the Balance Sheet align, meaning they are the same number.

Cash Flow Statement

A Cash Flow Statement, also referred to as Sources and Uses of Cash, is included by CPA's in audited financial statements. However, that statement is a static snapshot of the history of sources and

uses of cash up to a specific period end that is being reported.

Managers of a small business need another type of cash flow that reports a few weeks or months of history and also projects cash flow in the future. This cash flow is built in a spreadsheet. It is highly recommended for businesses to look at cash flows over a period of 13 consecutive rolling weeks, or effectively a quarter of the year. A 13-Week Cash Flow Template is available in this Series for your reference to enable you to examine your business' cash flow.

Loan officers and investors may want to see a cash flow of months or years so that they can make an informed decision about the future viability of your business. Cash flow as a managerial financial statement may be the most important of all because in an entrepreneurial business "Cash is King." Though your Income Statement may demonstrate you are making a profit, if your cash is tied up in inventory, or your receivables are late, you will be unable to meet payroll and pay your suppliers. Bottom line - if you run out of cash, you are out of business.



Business Sense is a no-fluff source of information that gets right to the heart of what small business owners need: essential tools and informational resources to help their businesses grow. Written by our team of business coaches, this series shares their decades of experience in areas such as financials, operations, sales and marketing, human resources, leadership, and governance. Business Sense is designed to provide entrepreneurs and small business owners in various sectors, including agriculture, forestry, waste management, renewable energy, and environmental technology, with recommendations and practical advice to help their businesses not only survive but thrive.

Our business management coaching and training series, and Business Sense are designed to accelerate the growth of the enterprises we work with and expand the leadership capacity of the entrepreneurs who own and manage these businesses.

Let Us Help You and Your Business

The Vermont Sustainable Jobs Fund provides tailored business management coaching, entrepreneurial support, and training to position Vermont-based entrepreneurs and small business owners in our designated market sectors for growth and long-term success. We partner with state government, private sector businesses and nonprofit organizations to build a thriving economic, social and ecological future for Vermont. Learn more at [VSJF.org](https://vsjf.org)



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Accelerating Sustainable Economic Development

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