

Take
Action
Series

Analyzing Financial Statements

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Overview

The objective of this manual is to provide a business owner with a complete understanding of what each financial statement attempts to communicate, and lay the foundation to be able to complete a financial analysis of his/her company. It will examine and explain in business owner terms the logic of financial statement construction, and examine the principles that dictate their creation.

FINANCIAL STATEMENTS are a communication tool that attempts to communicate the results of a business' operations, the status of its financial position, and the cash flow being generated or consumed as a result. A complete set of financial statements includes:

- Balance Sheet
- Income Statement
- Statement of Cash Flow

This trilogy of information has many purposes depending on the user's needs, how the user intends to utilize the financial statements, and to what level of detail the user requires to meet his/her needs. Each financial statement user will likely make economic decisions based on their unique perspective.

Prospective User; Who is the Reader	Purpose of Information; What Are They Looking at
Owners/Managers of Business	Evaluate/assess financial performance
Financial Institutions	Assess credit worthiness
Prospective Investors	Assess risk, viability and return potential
Suppliers	Assess credit worthiness for supply of goods
Customers	Assess sustainability of operation for future needs
Employees	Assess job security and future remuneration
Government Agencies, i.e. IRS	Assess tax responsibility
General Public	Assess impact on local economy, environment, etc.

The focus of this manual is from the business owner's/manager's perspective. Our Take Action Series book, "Analyzing Business Financial Performance", discusses the analytics of financial ratios. And the primary purpose for preparing/obtaining a set of financial statements. Our focus will be on developing a better understanding of their structure, and what each financial statement attempts to communicate.

Determination of Proper Debt Structure Worksheet

PART I:

Instruction: Obtain the latest 3-5 years of year-end balance sheets. Calculate the dollar difference for items in Step 1 thru 3 from years 1 to 3, or years 1 to 5, following the steps below:

STEP 1: CALCULATE THE DOLLAR CHANGE IN NET FIXED ASSETS \$ _____

STEP 2: CALCULATE THE DOLLAR CHANGE IN LONG TERM DEBT \$ _____

STEP 3: CALCULATE THE DOLLAR CHANGE IN EQUITY \$ _____

STEP 4: PERFORM TEST BELOW

Test: \$ _____ + \$ _____ = or > \$ _____
 [STEP 2] [STEP 3] [STEP 1]

Question: Does your company's long term funding sources [Step 2 + Step 3] equal or exceed its long term needs [Step 1]? If it does your company's balance sheet is properly funded and the company should have experienced an increase in its working capital. If it is not your company has a mis-financed balance sheet.

PART 2:

Instruction: Use the same balance sheets used in the above exercise

STEP 1: CALCULATE LATEST YEAR END DEBT TO EQUITY

$$\frac{\text{Total Liabilities}}{\text{Equity}} = \text{_____ Debt-to-Equity Ratio}$$

STEP 2: CALCULATE DOLLAR RATE OF CHANGE FOR LAST 3 OR 5 YEARS

$$\frac{\text{Dollar change in Total Liabilities}}{\text{Dollar change in Equity}} = \text{_____ Rate of Capital Formation}$$

Concern: If Step 1 is highly leveraged, and Step 2 is even higher, that's a concern

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