Understanding financial statements

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Abstract

Financial statements are used to show the financial performance and status of businesses of all types. These statements can be used to analyze, manage and improve the performance of a business. It is important for a veterinary business owner or manager to understand what each of the business statements measures within their business. Further, it is important to learn how to use the information presented in the statements to help them manage both the daily business and assist in long term planning for the business. This presentation explains the financial statements and how to use them to make better business decisions in a veterinary practice and other businesses or organizations a veterinarian may be associated with.

Key words: accounting, financial, business, profitability, statements

Background

Businesses of all types have several reasons for tracking their financial transactions and performance. Some of these reasons include tax requirements, management of necessary daily business functions and business analysis for planning functions. Beyond taxes, there are also requirements for reporting of business financial performance from lenders, company shareholders and payroll reporting requirements.

As veterinarians, we are well-educated in many areas of science, data analysis, disease, animal husbandry and tracking of production parameters for the animals on the farms we serve. Advanced business and accounting training is not a requirement for acceptance into veterinary training programs and is difficult to incorporate into busy veterinary curriculums. In recent decades, there have been some increases in veterinary business clubs and attention to business management at individual veterinary programs. Many recent graduates, however, find they lack comfort levels in understanding financial statements, performance of business functions and determining how to make educated business decisions. This happens when they either find themselves in a management or ownership situation in a veterinary practice or when they strike out on their own to build a veterinary business for themselves.

Basic business financial statements

The three basic financial statements used widely across all businesses are the balance sheet, income statement and cash flow statement. A fourth statement, the retained earnings statement, is used by corporations as a way to reconcile activities over time to reflect the balance of capital of the owners. This statement will not be discussed in this limited format, as its importance for early career veterinarians is less than the other statements.

Balance sheet

A balance sheet shows the company's financial position at a point in time. The main components of a balance sheet are assets, liabilities and net worth. Assets are the values of the things the company has (owns). Liabilities are the values of what the company owes to others. Net worth is the difference between the assets and the liabilities. It shows the value of what the company truly owns after its debts are subtracted.

The overall equation at the base of accounting is: assets - liabilities = net worth. The balance sheet's name refers to the reworked equation which is at the base of the balance sheet. This equation is assets = liabilities + net worth. Double entry accounting is rooted in the concept that when any asset is added to a business, it must be balanced by something on the other side of the equation. For example, if a pharmaceutical order (asset - inventory) comes in to a veterinary practice, there may be a corresponding increase for an account payable (liability) on the other side of the equation. The equation can also stay balanced by shifting assets between different accounts. For example, a decrease in cash (asset) as a payment can be exchanged for a pharmaceutical order with an associated increase in inventory (asset). Luckily, modern accounting programs do all this behind the scenes once the chart of accounts for a business is properly set up.

It should be noted that a balance sheet for a business is very similar to a personal financial statement for an individual or family. They have a different name but essentially shows the same thing; what you own (assets), what you owe (liabilities) and how much of that value of what you own is really yours (net worth). You may be asked to fill out a personal financial statement when applying for loans, credit cards or other financial needs. Net worth is what is reflected when someone talks about a millionaire. It is what is left after all liabilities are subtracted from total assets. Sometimes people confuse the term with making a million dollars or having a million-dollar house. Some people with high incomes may never become a millionaire if they spend away most or all of the money they earn. Similarly, if they owe 80% of the value on their million-dollar house to the bank, unless they have enough other assets, they aren't a millionaire. The point to remember is that net worth is what is left after liabilities are subtracted from assets for a business or a person.

When creating or examining a balance sheet for a veterinary business, assets may include bank accounts, accounts receivable, inventories of products, vehicles, equipment and real estate. Common liabilities will include accounts payable, credit card balances, payroll due, trade credits, line of credit balances and loan balances for vehicles, equipment or real estate. Net worth equals the assets less the liabilities.

It is important to understand when analyzing a balance sheet what the basis for valuations are. Is it tax basis or market basis? A tax basis balance sheet has the assets valued at their value reflected on the taxes of the business. This means that depreciable assets, assets that decrease in value over time as they are "used up", are reflected as their purchase price less the accumulated depreciation. Things like buildings are depreciated over time on taxes also, even if they may be worth more than that if sold on the market. Land is valued at the tax-based purchase price of it, since it doesn't depreciate with time. There are also interesting tax-based values for goodwill of a business that has been purchased, tax treatment of leased equipment and accelerated depreciation for tax planning purposes. A market-based balance sheet reflects the value of assets at their value if sold in the free market. These values can vary widely from tax-based values, particularly for real estate. If you are considering purchasing a veterinary practice, make sure you get competent help from an advisor or accountant to understand the intricacies of the financial statements associated with the business.

Income statement

The income statement, also known as a profit & loss statement, is a summary of revenues and expenses incurred over a period of time. The basic equation for the income statement is revenues - expenses = income. Revenues are reduced to gross profit by subtracting the costs of goods sold from revenues. For analysis and planning, revenues should be broken down into various accounts reflecting different business activities. Expense categories should also be broken down into manageable accounts to be meaningful for the business. An income statement measures the true profitability of a business over a period of time, not just the cash flow of transactions. Depreciation is shown as an expense category, reflecting the portion of value for depreciable items during this period of time, not the amount of cash flow spent on these items. Similarly, principal payments are not on an income statement, as that is a financing and investing decision made by the business, not a true expense during the period examined in the statement. Depending on the business structure of the company, owner salaries may be included under payroll costs or taken as profits from the company.

An important concept to understand when creating or analyzing an income statement is that of accrual versus cash basis. A true income statement by accounting standards uses the accrual system, even though some companies do not enter their financial data in such a manner. Cash basis is just as it sounds. Items are entered into the system when cash moves. For example, when a payment to the company for a product or service is made to it, that item is entered into the system. When cash moves to pay for something or is transferred to someone it is entered in as an expense. This method is very simple but doesn't truly measure the profitability of the business over the period examined. Conversely, with the accrual system, the item enters the accounting system when the event or action took place. For example, when a veterinarian performs a service or sells a product, the transaction enters the accounting system when that occurs, not when the product or service is paid for by the client. Also, the cost of goods for the product sold is entered at that same time, not when the practice paid for the product to the distributor.

To clarify the difference between accrual vs. cash accounting, consider a $550 invoice for veterinary products and service performed on March 15. With an accrual system, the $300 service income along with the $250 product sale with a $200 cost of goods sold (COGS) are all entered as of March 15. Further the $200 expense for the associate veterinarian's payroll expense is also entered as occurring on March 15. All the activities associated with the service provided by the company is reflected at the time the action took place and the income statement would reflect this. This is all done by entering in the invoice as an account receivable, the COGS expensed when it moves from inventory into accounts receivable and the payroll is entered as a payroll payable.

In a cash system, the product may have been paid for by the clinic a month before, the associate may not get paid until the month after she performed the service on a commission basis and the client actually didn't send the check for the service until sometime in May. Ironically, in the cash system and this example, nothing from the event that occurred in March shows up anywhere during the month of March on the cash-based income statement.

If very minor monthly variation occurs in a business related to services provided, sales of products, inventory levels, accounts receivables, accounts payable or any other expenses categories, then the statements would be similar with each system. If that is not the case, analysis and conclusions made should be viewed with skepticism, as the statements may not truly reflect the profitability of the business during a period in time.

Cash flow statement

A cash flow statement reflects what can be loosely called checkbook accounting. The cash flow statement shows the movement of money in and out of a business. It does not equate with profit to the business. However, the cash flow statement and cash flow to any business is absolutely critical to understand. The source of cash inflows to a business can be customers paying for products and services, contributions from owners of the business, loan funds from banks for various things and a number of other things. Outflows can include regular business expenses, principal payments for loan obligations, distributions to owners and capital investments in equipment or real estate. As you can see, this statement shows the flow of money for many different potential things and doesn't necessarily represent the true profit of a business during this time period. It is vital to understand these cash flows, however to make sure the business stays liquid and can meet its obligations.

Cash flow statements are very useful to understand the movement of money in the past and spot various trends and seasonal intricacies in a business. From this information, realistic budgets can be made to project the future cash flow needs of a business and perform feasibility assessments of potential changes to the business in the future. Any anticipated deficits can be identified and proper lending or use of revolving lines of credit can be utilized. A new owner of a business should spend some time really understanding the cash flow of their business to avoid experiencing an unforeseen cash crisis in their business. There are times when a business can be technically profitable while finding itself in a cash flow crisis. Situations can include increased accounts receivable, inventory buildup, principal payments on loans being much higher than depreciation, purchasing capital expenses out of cash flow during peak periods and lack of cash reserves or access to a line of credit. If all 3 financial statements are understood and regularly reviewed and analyzed, these issues should be avoided.

Discussion

The 3 financial statements discussed here measure different aspects of a business. Taken together, they paint a very good picture of the status and success of the business over the periods examined. From this basis, "pro forma" statements can be created that make projections into the future about the performance of a business. Not only is this very useful for business owners in making decisions about changes they are considering in the future, but they may be required to provide these documents to lenders in order obtain necessary financing for future projects. Use of the information learned from financial statements can also help managers of a business make management decisions about their practice on a regular basis. Managerial accounting is the use of financial data to make better business decisions within a business.

As veterinarians practicing in rural and semi-rural North America, it is very useful to have a good understanding of the concepts associated with and the proper use of financial statements. There are many instances of using this with food animal clients along with production medicine concepts to offer more robust consulting services. From a personal finance perspective, it can help you understand and improve management of business "you". There are also many boards of director opportunities where this knowledge is very useful including school boards, municipal elected positions, church councils and for-profit and non-profit businesses.