Business Sense: How to read your financial statements -- the Income Statement

Colleen M. R. Trask/For the Times-Standard

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At least once a year, we should take a few minutes from working in our businesses to work ON our businesses, financially speaking. Tax time can be a good time for this because financial statements are -- or can be -- put together by our CPA or tax preparer when they prepare that stack of (scary-looking) documents for the IRS. Somewhere in that stack is a set of financial statements that can be useful for us as we run and grow our businesses.

Have you ever taken the time to read those financial statements? Do you have any idea how (or how much) they can help you? If you have never looked at your financial statements in this analytical way, you may know that you don't seem to have cash in your business bank account any more, but you are not likely to really know why.

There are three basic statements: Income Statement, Balance Sheet and Cash Flow Statement, and they all contain useful decision-supporting information. Don't let the sheer volume of numbers overwhelm you. Real, useful information can be extracted by the simple process of comparing two numbers to each other. We will look at the Income Statement this time, and tackle the Balance Sheet and Cash Flow Statements later.

The income statement is the one almost everyone knows how to read already. It is also sometimes called the Profit & Loss (or P&L), which I have always found to be odd and technically impossible -- you can't have both a profit and a loss at the same time, right? Wouldn't it make more sense to call it the Profit or Loss? Either way, the statement tells you if your business has made money for a particular period of time, say, last month or last year.

How do you know? By comparing the number showing your business income (up near the top) to the number showing your total expenses (down near the bottom). When your income is greater than your total expenses, your business is “profitable” and the bottom line will show a positive number. That's where the phrase “the bottom line” comes from. An old accounting convention is to write the positive number in black ink. If the number at the bottom was negative, it was written in red ink -- hence the phrases “in the black” or “in the red,” meaning the business made a profit or loss.

The really revealing information in income and expense numbers happens when you have several months' or years' worth of Income Statements. The accounting techno-speak official name for this is “horizontal analysis.” Was your business income from 2009 radically different from 2008? What about 2008 income compared to 2007? The question is “why.” What events and situations were different between those two periods? For most of us on the North Coast, the economic downturn that hit late in 2008 was the biggest single event impacting our sales, but other situations can also have an impact: a marketing strategy that fell short of expectations, a personal or family illness that left us less time to network with our customers, or an unexpected opportunity that we were able to turn into extraordinary sales.

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Expenses can also be compared between years. Has our liability insurance gone up? Our phone bill or Internet service? The payroll expenses or benefits that we pay for our employees? If our sales numbers are also rising, a jump in expenses may not have a big impact on our bottom line. However, if our sales are flat or falling, and our year-to-year comparison shows a big jump in a particular expense, we need to take a deep breath and consider some new strategies for controlling our expenses. This doesn't have to be depressing: We can view this as an opportunity to be creative and think about how to do our business differently.

Even within a single year, comparing your income from last April with the income from last November (for instance) will show you if your business has seasonal fluctuations in income. You probably have a feel for this already, knowing what times every year are busiest, but there may also be surprises. A retailer knows that the winter holiday season is the time of greatest sales, but may also find spikes in sales at other times. If those spikes occur at the same time two or three years in a row, you can create a strategy to take advantage of that. See? Useful, decision-supporting information!

Another useful comparison is to look at the percentage of each expense compared to income. The technical accounting term for this is “vertical analysis.” Most accounting software, including QuickBooks, will do this for you when you print the report. There are two categories of expenses: cost of goods sold expense (what it costs to make or buy the stuff you sell) and fixed or overhead expenses (all the other expenses). Your income will be 100 percent, net of returns or discounts. Now, compare your cost of goods sold expense to your income. Is it 40 percent? 50 percent? 60 percent? Let's say 40 percent for an example. This percentage tells you that, for every dollar of goods you sell, you spend 40 cents to acquire the items you sold and you will have 60 cents (60 percent) to cover your other expenses (payroll, rent, phone, etc.) That 60 percent is called your contribution margin percentage because it contributes to paying your other expenses. If you divide your fixed expenses by this percentage, you will have the amount of sales you need to cover all your expenses -- your “breakeven” sales. Are you selling enough to break even? If not, you have some important decisions to make about your marketing plan! More useful, decision-supporting information!

If the numbers are still too overwhelming, ask someone for a little help: your CPA or tax preparer, an accounting professor at College of the Redwoods or Humboldt State University, or a friendly business advisor at the North Coast SBDC. We aren't born knowing how to read financial statements, after all. If you want to look at your financial information more than once a year at tax time, (and you really should!) you will also need to have a good bookkeeping system: a place (and possibly a person) to collect your business transactions and turn them into useful, decision-supporting information. Financial analysis won't make your business decisions for you, but it will give you a place to start asking the right questions.

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