Title:
Reading Your Financial Statements: What Every Entrepreneur Must Know

Word Count:
765

Summary:
As you consider which legal entity or entities--corporation, limited liability company, or limited partnership--you want to use for your business structure, the decisions you make will depend heavily on your current financial situation, both personal and professional. But do you know how to read a financial statement on your own? Do you know how to read your own personal and business financial statements? Knowing this is an essential skill for every entrepreneur.

Keywords:
income statements,financial statements,balance sheet,small business,home based business,irs,taxes,limited liability company,corporation,incorporate

Article Body:
As you consider which legal entity or entities--corporation, limited liability company, or limited partnership--you want to use for your business structure, the decisions you make will depend heavily on your current financial situation, both personal and professional. But do you know how to read a financial statement on your own? Do you know how to read your own personal and business financial statements?

Knowing how to do this is an essential skill not just for entrepreneurs but for everyone. However, for the entrepreneur having this skill can mean the difference between having a thriving business that continues to thrive and winding up in bankruptcy. The annals of the bankruptcy courts are strewn with cases of entrepreneurs who entrusted their accounting to others and, not knowing how to read the financial statements of their own businesses, were surprised when they found that the business was ultimately unsustainable. The purpose of this article is to help prevent this from happening to you--and to arm you with the skills you need to structure your business to your benefit from the outset.

Your Two Major Financial Statements

There are two major financial statements that every entrepreneur should know how to read and (ideally) prepare or have prepared in their financial software (we recommend QuickBooks):

The Income Statement
The Income Statement (also known as the P&L or Profit and Loss Statement) offers a dynamic picture of the ebb and flow of your finances. Briefly, income statement shows first: A. Your various sources of income Then subtracts from that, B. Your expenses To give you the net result: Net Profit or Loss Typically, it is the result shown on this statement that is the basis for your taxation by state and federal authorities at the end of the year. The net income or loss (revenue outgo) is carried over onto your second major financial statement: The Balance Sheet.

The Balance Sheet
Offers you a snapshot of cumulative results of your financial activities. It is made up of two columns:
On the left side you have your Assets

On the right are listed your Liabilities and Owners/Shareholders Equity (or ownership in the business). The two columns must be in balance, which is why this is called a Balance Sheet.

Assets=Liabilities + Equity

It's really quite logical how the Income Statement and Balance Sheet relate to one another.

If you have to use current or long-term assets to pay ongoing expenses during the current year, at the end of the year, the amount of your assets will be reduced by the amount of net loss. On the right hand side, your Equity has gone down too. If you borrowed, say $10,000 to pay current operating expenses, at year end, your assets remain the same, but your liabilities have increased by $10,000, lowering your net Equity or ownership in the company by that same $10,000.

It doesn't take a rocket scientist to figure out that if you continue on this path, you will quickly be in a very painful situation, because Liabilities carry their own cost. The cost of borrowing money is Interest, and if you are fortunate enough to borrow at only 10% interest (on unsecured debt) today, a year from now, you will have to pay $11,000 to pay off the original $10,000 debt. This reduces your equity still further--unless you have used the borrowed funds to create more assets that increase in value at the same rate as the interest on your debt or, better yet--at a higher rate.

More to the point for deciding which business entities to use is that you need to work out both your personal financial statements and those of your business(es). If you find, for example, that that you have significant salary or wage income in your personal financial statements that is causing you to pay out high taxes (as reflected in your balance sheet), and you expect that your business will generate some significant losses for the first several years, it would be advantageous to you to use a business entity that is a flow-through entity. Losses incurred by your S-Corporation (or, if you prefer, your Limited Partnership or your Limited Liability Company) will flow onto your personal balance sheet to offset the salary or wage income and thus reduce your tax liability.

Moreover, in general, if you want to draw up a roadmap to getting where you want to go, you need to know your point of departure. Thus, preparing and understanding your personal and business financial statements is an indispensable first step for your business planning.