It is important that you understand how a bank views your business's financial statements. The next section is devoted to helping you assess your business's financial statements through the eyes of a banker.

Income Statements and Balance Sheets

The balance sheet and income statement are the two basic financial documents that lenders require to assess the condition of your company. Your financial statements are seen as report cards for your business and measure a specific period (e.g., January through December). Balance sheets typically measure a business's solvency and income statements usually measure profitability. In combination, these two statements measure cash flow. Let's examine each type of statement and how a bank will assess them.

Income Statements

There are only two types of expenses on an income statement — variable and fixed.

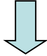
- *Variable costs* are the expenses a business pays to produce services or products (e.g., materials, labor, depreciation, fuel, etc.)

- *Fixed costs* are the expenses paid regardless of whether a business generates revenue (e.g., rent, utilities, insurance, accounting and legal expenses, office wages, and taxes)

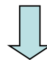
Once variable costs are paid, the money left over is the gross profit. Gross profit is the measurement that bankers use to determine how well you are managing your materials and labor costs. You pay your overhead expenses with your gross profits and the amount remaining is your profit. The diagram on the following page illustrates the concept of how money flows through an income statement. Also note that the income statement shows money flowing through a firm. It segregates costs into variable and overhead. Interest expense and depreciation may be added back to profit in order to determine profits to service debt payments.

Break-Even

Sales dollars pour into your company



First Stop for Revenue:
Variable Cost cup to
cover production costs



Second Stop for Revenue:
Fixed Cost cup to cover
overhead

Income Statement	2002	% of Sales	2003	% of Sales
Sales	**$4,656,082**		**$4,267,975**	
Cost of Goods Sold	$4,333,313	93%	$3,843,722	90%
Gross Profit	**$322,769**	**7%**	**$424,253**	**10%**
Expenses				
Overhead	$273,266	6%	$366,674	9%
Depreciation	$12,500	0%	$12,365	0%
Interest Expense	$12,298	0%	$10,970	0%
Total Expenses	**$298,064**	**6%**	**$390,009**	**9%**
Operating Profit	$24,705	1%	$34,244	1%
Other Income	8119		0	
EBIDTA	$49,503		$57,579	
Taxes	$8,500		$10,000	
Net Profit	**$24,324**	**1%**	**$24,244**	**1%**

A business owner should regularly review the financial results indicated on the income statement and assess the business's financial condition based on the information. Business owners who can successfully answer the following banker's questions about the income statement will consistently have credibility as a borrower.

- Did the increase in sales exceed the increase in the business's costs? (If "yes," why? If not, why not?)
- What is driving the business's sales increase or decrease?
- Why is the gross profit increasing or decreasing? Will it be consistent?
- Why is the business's overhead increasing?

Balance Sheets

The balance sheet measures the solvency of a business and tells a banker how much debt a business is supporting and how much cash is in the business. Bankers use standard financial ratios to measure leverage (the amount of debt a business has) and liquidity (the ability to quickly convert assets into cash):

- *Current ratio* measures the amount of current assets a business owns (e.g., cash, accounts receivables, inventory, and other short-term assets) in proportion to its current liabilities (e.g., accounts payables, short-term notes due, and other short-term liabilities). For example, if a business owns $150,000 in current assets and owes $115,000 in current liabilities, its current ratio is 1.30 ($150,000 ÷ $115,000). This means the business has $1.30 for every dollar it owes in current liabilities. This ratio should be as large as possible because it is an indication that the business is collecting receivables and managing liabilities efficiently. (Note*:* Receivables that are beyond 90 days old and/or are pledged to someone else must be discounted.)

- *Quick ratio* measures the amount of cash a business has to pay off its current liabilities if they became due. For example, if a business has $25,000 in cash and $75,000 in accounts receivables, it has a quick ratio of $.87 in cash in proportion to every dollar in current debt/liabilities ($100,000 ÷ $115,000). This ratio should be as large as possible because it is an indication that the business is efficiently managing its cash.

- *Debt-to-worth ratio* measures how much a business owes *all* of its creditors in proportion to the amount of cash in the business obtained from profits, personally invested by the owner, or obtained through the sale of assets. For example, if a business has total liabilities of $275,000 in proportion to total retained earnings and loans from shareholders in the amount of $100,000, the business's debt-to-worth ratio would be 2.75. This means that the business has $2.75 in debt for

every dollar in owner’s equity. This number should be as low as a business can afford.