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Financial Literacy Essential for Business Owners

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Business owners don't need a degree in accounting, but they do need to know how to read basic financial statements and when to ask the accountants who prepare them to explain what they don't understand.

No one wants to be like the business owner who believed she was making a profit because her checkbook had a positive balance. But even business owners who diligently record financial transactions using basic accounting software don't always comprehend the reports their CPA generates based on these records.

That means they're not using the expertise they pay for, and they're not using the numbers as tools to build their business.

The three financial reports every business owner should understand are the profit and loss statement, the balance sheet and the cash flow statement.

Profit and loss: The P&L, or income, statement shows how much profit a company makes — or doesn't make — over a given period. The statement reports revenues, expenses, gains and losses. If a positive balance remains once expenses and losses are subtracted from revenues and gains, the result is net income. If the balance is negative, the statement shows a net loss.

Understanding the profit and loss statement helps the owner understand why he's making or losing money and suggests where to trim expenses. Knowing the difference between fixed and variable expenses helps him make this decision. Variable expenses — such as raw materials and sales commissions — increase or decrease with changes in production. But fixed expenses — like rent, phone service and loan payments — are paid even if sales are flat.

Balance sheet: The balance sheet tallies a company's assets, liabilities and shareholder's or owner's equity at a specific moment, offering a summary of the company's financial strength.

Assets are what a company owns, and they include cash, accounts receivable, inventory, supplies, land, equipment and trademarks or other intellectual property. Liabilities represent a company's obligations, such as accounts and wages payable, unearned revenues and income taxes owed. Owner's equity in a sole proprietorship or shareholder's equity in a corporation shows a company's book value — its assets minus its liabilities.

Banks use the balance sheet to determine if a business has enough assets to qualify for a loan, and owners need it to assess their business's health.

Cash flow statement: An owner needs to know how much cash enters and exits a company over a given period by way of operating, investing, financing and other activities, and that's the purpose of the cash flow statement.

A company that's making a profit can still fail if it doesn't have the resources to pay its bills when they're due because of uneven or inconsistent cash flow. If a business doesn't have enough cash to survive the slow periods, the owner needs to review the cash flow statement and make adjustments. If the business has more cash than it needs, it should invest excess money in an interest-bearing account to create more wealth for the business.

Business owners can learn more about financial statements by attending workshops offered by the New Mexico Small Business Development Center Network. Since 1989, SBDC consultants have supported the growth of small businesses and startups through training and mentorship. Learn more at www.nmsbdc.org.

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