

Financial Trend Analysis

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Analyzing the financial trends in a business is an exercise that can be very rewarding not only from a dollar and cents perspective but it also can be very helpful in the planning process and the development of growth strategies.

Almost all business owners can tell you what their Company's annual sales and net profits have been for the last three years, but very few can actually drill down to specific line item trends on the balance sheet and income statement.

Business financial statements are typically viewed as a single point in time, end of the month, end of each quarter or end of the fiscal year. The focus is generally on how much cash is available, how sales are doing and if the business is generating a profit.

Financial trend analysis should begin by looking at comparative periods (e.g. current month vs. last month vs. same month from prior year and then add vs. budget). This analysis can and should also be done on a quarterly basis as well as annually. To be meaningful, any financial analysis should include not only the balance sheet (assets, liabilities and equity) but also the income statement (revenues, expenses and net profits). Illustration # 1 below shows an example of a balance sheet financial trend spread out over three fiscal year ends. As you will note, there are several line items that when analyzed prompt some very specific concerns. If you owned this Company, write down how many questions you would ask your internal Chief Financial Officer.

Did you ask what happened to the accounts receivable at 12/31/13? What about the movement in the Loan to Related Company? The fixed asset increase at 12/31/13 probably should not be a big surprise, based simply on the size of the increase it would likely indicate something significant was purchased in 2013. What happened to accounts payable at 12/31/13? Did you spot the pay down and pays off of the Debt To Related Company over the three year period? I bet your Banker did! You really need to be concerned about the profitability in 2013. If you wrote down more than these questions, you are beginning to see the reason why this analysis is so important to your business.

Illustration #1 (a)

	12/31/11	12/31/12	12/31/13
Assets			
Cash	\$220,332	\$295,289	\$351,417
Account Receivables	<u>\$547,921</u>	<u>\$689,356</u>	<u>\$595,327</u>
Total Current Assets	\$768,253	\$984,645	\$946,744
Loan to Related Company	\$149,147	\$364,596	\$134,431
Fixed Assets Net of Dep.	<u>\$914,061</u>	<u>\$886,985</u>	<u>\$1,686,379</u>
Total Assets	\$1,831,461	\$2,236,226	\$2,767,554
Liabilities			
Current Portion LTD	\$51,000	\$51,600	\$152,200
Accounts Payable	\$123,005	\$119,772	\$767,501
Debt to Related Company	\$265,921	\$165,718	\$0
Other Current Liabilities	<u>\$21,957</u>	<u>\$52,396</u>	<u>\$76,409</u>
Total Current Liabilities	\$461,883	\$389,486	\$996,110

Long Term Debt	<u>\$967,343</u>	<u>\$915,743</u>	<u>\$1,463,543</u>
Total Liabilities	\$1,429,226	\$1,305,229	\$2,459,653
Equity			
Common Stock	\$1,000	\$1,000	\$1,000
Member's Equity	\$167,323	\$198,721	\$126,793
Net Income	<u>\$233,912</u>	<u>\$731,276</u>	<u>\$180,108</u>
Total Equity	\$402,235	\$930,997	\$307,901
Total Liab. & Equity	\$1,831,461	\$2,236,226	\$2,767,554

Now let's take a look at the income statement spread out over the same three year reporting period. Illustration #2 below is that spread. Do the same thing here and write down all the things that you would ask your Chief Financial Officer.

Were you concerned about the dip in revenue in the service category in the 12/31/13 reporting period from the 12/31/12 fiscal year end? How about the fact that service labor costs did not drop at the same level the service revenues slipped? Did you spot the decrease in the gross profit margin in product sales? There are numerous questions that need to be asked related to total expense, as every line item increased over the prior reporting period. In fact, total expenses increased over 50% in 2013 over the 2012 fiscal year, while total revenues increased by only 7.4% in the same reporting period. This would indicate signs of an out of control environment. The balance sheet in illustration #1 did show an increase in fixed assets of nearly \$800,000, which would likely represent a new building or facility expansion probably accounting for some of the increases in the various expense line items.

Illustration #2 (a)

	12/31/11	12/31/12	12/31/13
Revenues			
Product Sales	\$1,707,499	\$2,245,233	\$2,896,921
Service	\$1,179,397	\$1,369,402	\$986,437
Total Revenues	\$2,886,896	\$3,614,635	\$3,883,358
Cost of Goods Sold			
Products	\$853,750	\$1,109,271	\$1,578,038
Service - Parts	\$176,909	\$221,712	\$156,327
Service - Labor	\$530,729	\$602,303	\$537,921
Total Cost of Goods Sold	\$1,561,388	\$1,933,286	\$2,272,286
Gross Profit	\$1,325,508	\$1,681,349	\$1,611,072
Expenses			
Consulting	\$51,000	\$45,000	\$63,250
Depreciation	\$25,988	\$25,988	\$81,975
Insurance	\$23,469	\$23,571	\$37,817
Interest	\$44,645	\$43,732	\$82,964
Repairs & Maintenance	\$83,529	\$45,142	\$57,985

Office Wages	\$175,000	\$185,000	\$230,000
Labor	\$170,072	\$175,921	\$227,844
Office Expense	\$25,474	\$20,273	\$35,911
Professional Fees	\$21,368	\$20,975	\$76,775
Contract Labor	\$171,521	\$102,957	\$151,917
Equipment Rental	\$95,330	\$85,211	\$113,969
Taxes & Licenses	\$31,563	\$31,867	\$35,987
Travel	\$51,289	\$32,987	\$76,565
Utilities	\$20,898	\$21,965	\$43,571
Warehouse	\$84,282	\$73,876	\$92,897
All other	\$16,168	\$15,608	\$21,537
Total Expenses	\$1,091,596	\$950,073	\$1,430,964
Net Income	\$233,912	\$731,276	\$180,108

Another additional benefit of doing this type of financial analysis internally is that it can be used to set the stage for a proactive meeting with your Banker. Had these financial statements been given to your Banker as part of a reporting covenant in a loan agreement, your Banker's follow-up with you might well have started with some of the questions you had wrote down as part of this exercise. If you did not have good answers, your financial relationship with your Bank might likely take a different turn that could be very strained at best. ♦

- (a) It should be noted that the numbers in the two illustrations above were not taken from a real company's financial statement but were fictional in nature.

