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HOW TO READ

YOUR FINANCIAL STATEMENTS

Financial statements are crucial for visibility into the financial health of every business. They can be used to track and capitalize on trends, set goals for business performance, and guide decision-making.

Business growth is rooted in the understanding of the financial statements. We have created this guide to walk you through the Profit & Loss Statement, Balance Sheet, and Cash Flow Statement, and how they relate to each other, along with the actionable insight that can be gained from them.

1. The Profit & Loss Statement

Also known as the Income Statement or P&L, the Profit & Loss Statement provides insight into a company's financial performance over a period of time. The final result is the calculation of Net Income or loss during that time period.

The Profit & Loss Statement also shows

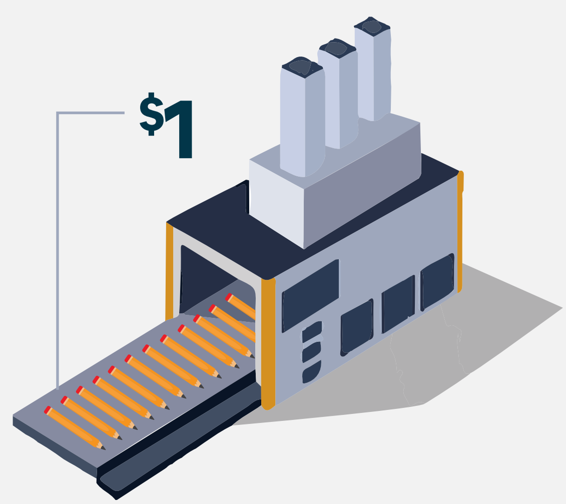
- **Sales:** the monetary amount that was sold.
- **Cost of Goods Sold (COGS):** the costs associated with providing the service or purchasing the product.
- **Gross Profit:** the difference between Sales and COGS.

- **Operating Expenses:** expenses paid to keep the business operational - rent, payroll, janitorial duties, marketing, and more.
- **Net Income:** Gross Profit minus Operating Expenses. This shows the Net Income after from sales, costs, and operation of your business.

The Profit & Loss Statement also provides insight as to how profitable the sales of products are in relation to direct costs.

To illustrate, here is an example:

You sell pencils for $2, and it costs you $1 to produce them.



Above the line:

- Last month, you sold **1,000 pencils.**
- You made **$2,000 in sales** ($2 * 1,000 pencils), and your **COGS was $1,000** ($1 * 1,000 pencils).
- Your Gross Profit came to $1,000, meaning your Gross Profit Margin was 50% (calculated by $1,000/$2,000).

1,000	=	$2,000	-	$1,000	=	**$1,000**
		Sales		Cost of Goods Gold		Gross Profit

Below the line:

- Below your Gross Profit are all the costs associated with running your business, also called operating expenses. Payroll, rent, utilities, internet, advertising and marketing, and contractors, are a few examples.
- By subtracting all of your operating expenses from your Gross Profit, you can calculate your Net Income.

Net Income could be a net loss, if operating expenses exceed Gross Profit. Whether you have Net Income or loss, the amount will flow to the Balance Sheet as Retained Earnings and also appears at the top of the Cash Flow Statement. This is one way that the financial statements connect.

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INCOME STATEMENT

INCOME STATEMENT	2020	2021
Revenue	**1,331**	**1,464**
Costs of Goods Sold	799	878
Gross Profit	**532**	**586**
Operating Expenses (SG&A)	200	220
Operating Income (EBIT)	**333**	**366**
Interest Income	43	38
Pretax Income	**290**	**329**
Income Tax Expense	102	115
Net Income	**189**	**214**

BALANCE SHEET

BALANCE SHEET	2020	2021
Cash	478	627
Accounts Receivable	109	120
Inventory	131	144
Total Current Assets	**718**	**892**
Property Plant & Equipment (PP&E)	840	837
TOTAL ASSETS	**1,559**	**1,729**
Accounts Payable	66	72
Current Portion on Long Term Debt	50	50
Total Current Liabilities	**116**	**122**
Long Term Debt	400	350
TOTAL LIABILITIES	**516**	**472**
Common Stock	100	100
Retained Earnings	943	1,157
TOTAL EQUITY	**1,043**	**1,257**
TOTAL LIABILITIES & EQUITY	**1,559**	**1,729**
Check	0.0	0.0

CASH FLOW STATEMENT

CASH FLOW STATEMENT	2020	2021
CASH FLOW FROM OPERATING ACTIVITIES		
Net Income	**214**	**241**
Add Back Non-Cash Items		
Depreciation	73	81
Amortization	0	0
Changes in Working Capital		
Accounts Receivable	(11)	(12)
Inventory	(13)	(14)
Accounts Payable	7	144
Net Cash Provided by Operating Activities	**269**	**302**
CASH FLOW FROM INVESTING ACTIVITIES		
Capital Expenditures - Purchase of PP&E	(70)	(70)
Net Cash Used in Investing Activities	**(70)**	**(70)**
CASH FLOW FROM FINANCING ACTIVITIES		
Revolving Credit Facility	(50)	(50)
Long Term Debt (Current Portion)	(50)	(50)
Net Cash Provided by (Used in) Fnce Activities	**(50)**	**(50)**
Net Cash Flow	**149**	**182**

Increasing Profitability with the Profit & Loss Statement

The Profit & Loss Statement is crucial to understanding how daily activities, sales, pricing, and operating expenses affect the income and profitability of your company. Because this report is produced monthly, it can be used to identify trends to see how sales are affected in direct correlation to pricing and purchasing decisions.

For example, if sales are increasing, but costs are remaining steady, your profit margin will grow larger over time. If costs are increasing along with sales, although you are selling more, the profit margin will not change or will decrease.

The Profit & Loss Statement can be used to understand where your company is today and make operational, pricing, and buying decisions to meet your goals tomorrow.

2. The Balance Sheet

Unlike the Profit & Loss Statement, the Balance Sheet does not illustrate performance over a period of time. Instead, it illustrates where you stand today, in terms of assets, liabilities, and equity. It paints a picture of overall financial health.

The Balance sheet relies on the accounting equation, which states that a company's assets must be equal to its liabilities and shareholders' equity. The two must be balanced, hence the name "Balance Sheet".

Assets = Liabilities + Equity

First, let's review each area of the Balance Sheet.

Assets

Assets are anything the company owns that has value. There are two types of assets: Current and Noncurrent. Fixed Assets, which are used to produce goods and services, fall under Non-current Assets. The categories Current vs Non-current are listed on the Balance Sheet according to how quickly they can be converted into cash, or liquidated.

CURRENT	NON-CURRENT	FIXED
Can be converted into cash within a year	Takes more that a year to convert into cash	Used to produce goods and services
Money in the bank, such as checking or savings accounts	Long-term investments	Property, plant, and equipment (PP&E): the land and machinery that is used to produce a product or service
Inventory	Intangible assets, such as brand recognition, patents, trademarks, and copyrights	Computer software
Accounts Receivable	Goodwill, such as positive customer and employees relations	Vehicles, such as delivery trucks

Liabilities

Liabilities are anything that the company is liable to pay out - think "debt". Examples include, but are not limited to:

- Accounts Payable - bills that are payable to a vendor
- Credit card and loan balances
- Payroll Taxes
- Taxes
- Rent

Equity

Equity, also known as capital (money invested into the company), includes what you own in the business and the amount of profits or loss retained by the company, also known as Retained Earnings. Retained Earnings shows cumulative profits and losses from previous periods - how much profit your business has made throughout its lifespan.

If your business is profitable, Retained Earnings will be shown as a positive number. If you are operating at a loss over time, Retained Earnings will be shown as a negative number. Retained Earnings passes through to the Balance Sheet from the Net Income (or Loss) reported on the Profit and Loss Statement.

Equity is one factor that helps banks to determine how solvent your business is, meaning your ability to pay back your financial obligations. Equity also shows how "invested" you are in your own company, and is a major factor in loan reviews. Investors and creditors want to know what you own (assets) and what you owe (liabilities).

Equity, Debt, Assets, and Inventory can all be used together to understand the financial standing of the company. Using the information on your Balance Sheet, investors will determine and examine your:

Debt to Equity Ratio: Do you have more debt than equity?

Calculated by: Total Liabilities / Total Shareholders' Equity

A good Debt to Equity Ratio is anything below 1.0. A ratio of 2.0 or more indicates that the business has more debt than it does equity, and is considered a risky investment to creditors.

Debt to Asset Ratio: Do you have more debt than assets?

Calculated by: Total Debt / Total Assets

A ratio greater than 1.0 (or 100%) indicates that the business has more debt than assets. A ratio less than 1.0 means that the business has more assets than debt.

Current Ratio: How much the business is bringing in versus paying out.

Calculated by: Current Assets / Current Liabilities

A Current Ratio that matches the industry average or slightly higher is generally considered ideal. On the other hand, a lower-than-average Current Ratio may indicate default, or the failure to repay debt.

Working Capital: Can you meet your financial obligations?

Calculated by: Current Assets - Current Liabilities

Positive Working Capital indicates that a company can successfully pay off its debt and continue to grow. If the company's liabilities are greater than its assets, it may have difficulty repaying debt and growing efficiently.

Tracking Performance with the Balance Sheet

The Balance Sheet measures the overall financial health of a business. It states how much profit has been generated, and how much debt has been taken on. It can be used to analyze current assets and liabilities to ensure upcoming payments can be made.

Many business owners compare current and previous Balance Sheets to see how far their businesses have come since their inception. By using the ratios above, business performance can be tracked, and hidden opportunities for growth can be discovered.

3. The Cash Flow Statement

The Cash Flow Statement shows the cash that was spent in a specific period of time. This statement gives true insight into how and when cash flows into and out of a business.

The bottom line is how much cash was "burned" that month, which will determine what cash remains. Using this data, you can see how much cash your business requires on average every month.

As you cycle through your money, it is imperative to know that you will have the cash you need, when needed. In the same way that gas needs to flow into your car to keep it running, cash needs to continually flow into your business.

The Cash Flow Statement is broken down into three sections: **cash flow from operating, investing, and financing activities**.

Cash Flow from Operating Activities.

This refers to the amount of money a business earns from ongoing business activities, such as selling products and services, and the cost of selling those goods and services, along with operating expenses.

Cash Flow from Investing Activities.

This includes money flowing into the business from equity or investors, as well as outflows, such as the purchase of long-term assets like buildings, land, and equipment.

- In some cases, investing activities can cause more cash to flow out than in. For example, if you are making major investments or loan or credit card payments, you may see consistently negative cash flow under investing activities. On the other hand, if you have just received a loan, you will see a positive cash flow under investing activities.

Cash Flow from Financing Activities.

This refers to the cash that is provided by or repaid to debt holders or equity holders. Examples of financing activities include (but are not limited to) the usage of a credit card or loan to fund the business (inflows), as well as credit card, loan, and dividend payments (outflows).

How to Use the Cash Flow Statement for Decision Making

The Cash Flow Statement illustrates how and when cash moves into and out of your business. With this information, you can determine that you have the cash you need to make crucial financial decisions and plan how to use your cash.

The Cash Flow Statement can be consulted to answer questions like:

- How will I fund the growth of my business this year?
- Can I afford to purchase new equipment in cash, or should I finance the purchase through a loan?
- Do I have the cash needed to put money toward paying my debt off faster?
- Are there areas of my business where I am overspending?
- How can I reduce costs while increasing revenue?

Understanding cash flow provides the visibility needed to identify cost and savings solutions and make informed decisions that will affect the future of your business.

Connecting the Dots Between Your Financial Statements

Throughout this guide, we have examined each financial statement separately. Each statement illustrates company performance from different points of view, but how do they connect to each other? The factors that link the financial statements are Net Income and financing activities.

Net Income

Net Income is represented on all three financial statements. It appears at or flows to:

- The bottom of the Profit & Loss Statement
- The top of the Cash Flow Statement
- The Balance Sheet via Retained Earnings

Net Income is also used to calculate cash flow from operating activities on the Cash Flow Statement.

Financing

The acquiring and repayment of debt affects each statement. Financing activities are listed on the Cash Flow Statement. Liabilities and assets, such as the amount of debt you owe and are owed, appear on the Balance Sheet. Interest expense is the interest payable on borrowed funds (such as loans or credit card payments). It appears on the Profit & Loss Statement and is used in the calculation of Net Income.

Other Connections

The Cash Flow Statement draws information from the Balance Sheet and the Profit & Loss Statement.

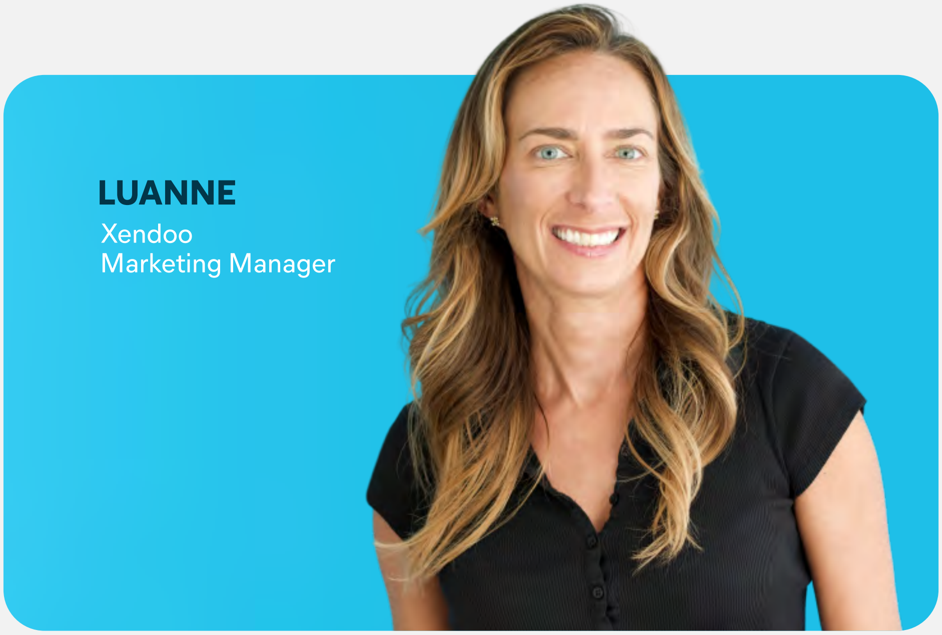
Transactions from the Balance Sheet appear on the Cash Flow Statement. For example, the purchase of new computer equipment would appear on the Balance Sheet under Fixed Assets, and on the Cash Flow Statement as a cash outflow. Sales and expenses from the Profit & Loss Statement will appear as cash inflows and outflows.

Each financial statement informs the other. The deeper your understanding of your statements, the more informed your decisions will be!

Your Financial Statements at a Glance

For a brief overview of your financial statements and what you can learn from them, take a look at the chart below:

FINANCIAL REPORT	PROFIT & LOSS STATEMENT	BALANCE SHEET	CASH FLOW STATEMENT
Key Insights	How daily activities, sales, pricing, and operating expenses are affecting income and profitability.	The overall financial health of your business. It can be used to compare current assets and liabilities to ensure upcoming payments can be made.	How cash moves into and out of your business, and how cash can be strategically used to keep your business operating.
Primary Categories	Revenue COGS Gross Profit Operating Expenses Operating Income Net Income	Assets Liabilities Equity	Cash Flow from: Operating Activities Investing Activities Financing Activities
Primary Metrics	Revenue (Top Line) Net Income (Bottom Line) Operating Income Gross Profit Margin	Debt to Asset Ratio Debt to Equity Ratio Retained Earnings Inventory Turnover Ratio	Total Cash Operating Cash Flow Cash "Burned", Cash Needs



Bookkeeping. You Hate It. We Love It. We Do It.

You deserve an **online bookkeeping** team that is dedicated to the success of your business. Xendoo matches you with a dedicated bookkeeper who understands your business and delivers timely financial reports, providing you with financial visibility and actionable insights to help you grow your business.

We are real **bookkeepers**, **accountants**, and **tax experts** who love small businesses. Let us handle the financial hassles while you put more money in your pocket and take your time back!

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