How to Make Sense of Your Small Business Financial Statements

How does your business assess its financial strength? No doubt you refer to your income statement and your bank account for the basics, but the truth is most businesses ignore the most powerful financial tools in the accounting arsenal: the balance sheet and the cash flow statement.

Combined with the income statement, these statements provide the most comprehensive financial view of any business. That's why they're considered essential components of a business plan. But what role does each of these financial statements play and how do you interpret the data they produce?

Here's an overview of the three key financial statements and how they can help you keep your finger on the pulse of your business's fiscal position.

The Income Statement

Think of the income statement as your business's report card.

The business income statement, also referred to as a profit and loss (P&L) statement, is a useful tool for providing an overview of how your business is doing over time and breaks down the revenue generated by your business and the expenses incurred.

A well-maintained income statement will show how profitable your business is and inform any steps that can be taken to increase profitability (i.e., whether you should focus on more profitable product lines or curb unnecessary expenses). It also shows you how much cash is left over to grow the business, pay your salary as owner, and cover any debt. When investors look at your business plan, they will use your income statement to assess the level of risk involved in extending credit or venture capital your way.

What your income statement won't tell you is whether your overall financial condition is weak or strong (refer to your Balance Sheet for this), the money you owe or that's owed to you (refer to your Cash Flow Statement), or list any assets you own or liabilities you owe (again, see your Balance Sheet).

An income statement is usually prepared monthly, quarterly or annually.

The Balance Sheet

Think of the balance sheet as a window into your business's financial strength.

Although investors may pay attention to your income statement, the balance sheet is actually their preferred starting point for building a picture of your business's fiscal health. Why? Because at its simplest level, the balance sheet summarizes key financial information on a given date (as opposed to the income statement, which shows profitability over a period of time) and is a good indicator of company stability and liquidity (both important factors in determining your business's ability to fund its own growth without requiring outside financing).

The balance sheet is usually put together at the end of a particular time period—usually a month or quarter—and lists the following:

- **Business assets** – "*What do we have?*" Not just what your business owns, but what it controls or what is in its possession, such as a financed vehicle.
- **Liabilities** – "*What do we owe?"* Your debts, including loans, outstanding credit card payments, etc.
- **Owner's equity** – "*What is left over for the owner(s)?"* How much of the business's assets do you still own once you've paid off all your liabilities?

This information in your balance sheet can provide a view into the following:

- The net value of your small business (should you ever want to incorporate or sell your business).
- Current and long term debt.
- Asset management (how effectively you're managing your assets) and liquidity ratios (your ability to turn an asset into cash).
- Comparative data so that you can see changes in cash, accounts payable/receivable, equity, inventory, and retained earnings.

A balance sheet can seem a little overwhelming and the format can differ wildly depending on your business type, so it's a good idea to have an accountant help you set up and interpret your first one. Even if creating a balance sheet is intimidating, don't shy away from it—it's an essential part of your business plan and an extremely helpful tool for running your business.

The Cash Flow Statement

Does your business have the cash to stay afloat?

More businesses fail because of cash flow issues than for any other reason. That's because cash doesn't always flow into your business at the same rate that it exits it! In fact, your business can be profitable yet still have cash flow problems. While your income statement can tell you whether you made a profit, it doesn't take into account delinquent or missing payments or help you determine whether you actually generated enough cash to stay afloat.

In order to understand and manage the flow of cash in and out of your business you'll need to maintain a cash flow statement. Updated on a daily, weekly, or monthly basis, the statement can be a simple one-page spreadsheet or a more dynamic report created with accounting software like QuickBooks or FreshBooks.

Whichever template you use, you'll rely on the following formula to calculate your end balance: **Operational Costs + Asset Investments + Financing = Cash Balance**. Let's dig a little deeper:

- **Operational Costs** – This includes your net income and losses, minus your regular expenses, and is the one number that you'll want to see growth in because it provides an accurate picture of the cash you are generating before any costs associated with financing or investments are taken into consideration.
- **Asset Investments** – This section reports both inflows and outflows from purchases and sales of long-term business investments such as property, assets, equipment, and securities.
- **Financing** – This is the cash you've received as a result of a business loan, line of credit, the sale of stock, or other capital infusions.

In addition to helping you gauge whether your business has enough money to cover its day-to-day activities, pay its bills on time, and maintain a positive cash flow, your cash flow statement also informs a number of other financial decisions, such as whether you need additional capital to fund seasonal fluctuations or purchase inventory to support a growth in sales.

For lending purposes, you'll include the cash flow statement in your business plan to provide evidence to your bank that you can manage cash and have a plan for dealing with cash flow gaps when they arise.

The Bottom Line

While the cash flow statement is often considered the most important financial statement for a small business, the three main financial statements are interrelated. Viewing them holistically can help you make smart financial, investment, and management decisions for your business.