Quick Guide to Understanding your Financial Statements

How to decode your own business numbers

Leslie Menard
BENCHMARK BUSINESS SERVICES LLC | www.benchmark-business-services.com

First of all, if you are reading or downloading this I'm giving you a standing ovation. It's just me, so it's not all that dramatic, but my point is that I am applauding you.

As a small business owner you need to have some understanding of your financial statements and this quickie guide will orient you to the basics. Good for you for being will to learn!

Let's start by decoding the term "financial statements". This usually refers to two basic documents: a Balance Sheet and a Profit & Loss Statement. There are more reports that you can rely on for business information, but we're just going to go over these two. Both of these together give you a complete picture of your business health and status. The dates need to match between each report so that the data on both is apples/apples and not apples/kumquats… Make sense? I've got a sample of each report at the end of this guide, and I've stuck a few notes on each one. Flip back to them as you work through the info below, okay?

The Balance Sheet is a snapshot view of what your business *owns*, what it *owes*, and *the net difference between the two*. This is a short picture of the typical heading and what the first part looks like:

Anycity Construction
Balance Sheet
As of June 30, 2022

ASSETS	
Current Assets	
Checking/Savings	
Checking	53,930.04
Petty Cash	500.00
Total Checking/Savings	54,430.04
Accounts Receivable	
Accounts Receivable	50,126.45
Total Accounts Receivable	50,126.45
Other Current Assets	
Inventory Asset	23,865.14
Pre-paid Insurance	2,571.31
Undeposited Funds	1,752.08
Total Other Current Assets	28,188.53
Total Current Assets	132,745.02
Fixed Assets	
Accumulated Depreciation	-110,344.60

The Balance Sheet date is <u>not</u> a range because it reflects current account balances at a point in time, rather than a range of activity. And I strongly recommend using a month *end* date when you review it – use the last month in which all the bank and loan statements were reconciled. That will assure you of reconciled, valid data.

Now as for the Profit & Loss statement, it does cover a date range. It gives you the effect of business activities (buying, selling, paying employees, etc.) over a period of time. Generally you will pick a single month, a quarter, or a fiscal year (and that's a *fiscal* year, not a *physical* year – I hear that all the time. Fiscal year means financial year. Weird word, simple meaning!)

The Profit & Loss looks like this in a shortened view:

Anycity Construction
Profit Loss
As of June 30, 2022

Ordinary Income/Expense	
Income	
Design Income	20,472.49
Labor Income	97,396.94
Materials Income	30,339.31
Permit Reimbursement Income	311.75
Subcontracted Labor Income	9,160.70
Total Income	157,681.19
Total Income	157,681.19
Cost of Goods Sold	
Cost of Goods Sold	7,740.34
Job Expenses	
Job Materials	28,243.71
Subcontractors	4,724.95

It might give the date range or just a single date – it depends on what you've asked for. The P&L will list all your income as recorded in that date range, and it will list all the expenses and the net income at the bottom.

This is the financial statement that most business owners rely on, but I'm here to ~~nag~~ suggest you also always include the Balance Sheet so that you have a full picture of what's going on with your wonderful business.

Let's get to the number crunching bit, okay?

One happy, Monday morning you walk into your office with your coffee/tea or morning drink of choice, and then you go find your bookkeeper and say, "Hey there you wonderful, number-crunching, piece of human awesomeness, would you please print me a P&L and Balance Sheet for last month? And also run me a year-to-date P&L too, okay?"

And then you go back to your office and wait for your reports like someone who knows exactly what they have asked for!

(Look at you go…)

And then - PLOP – financial statements have landed on your desk - tell your awesome bookkeeper thank you – even if it's your spouse. (*Especially* if it's your spouse…)

Let's start by reviewing your Balance Sheet.

Check the date – it should match the date on the P&L.

Scan down the column of account balances. There should be NO negative balances. If there are, then there may be some problems. There might be an overpayment of a liability, customer account credits, or something else, but any kind of negative balance on your Balance Sheet means something needs your attention.

One big exception to negative balances is Accumulated Depreciation. This is an account that tracks all the depreciation to date on fixed assets and it will always be a negative balance to offset the value of the assets.

For now, let's just notice that there are sections – if you look at the sample Balance Sheet I've attached to this guide, you'll see sections called Current Assets, Fixed Assets, Current Liabilities, Long Term Liabilities, and Equity. They may be grouped under headings or yours may be simpler. Either way, you should see two totals with double underscores – Total Assets and Total Liabilities and Equity.

Don't freak out here, but you have just found the Accounting Equation. Yup, math. Stay with me, there's no test and you do not need to understand this. Just accept and breathe through any anxiety or flashbacks to math classes.

Breathe...

The accounting equation is simply what bookkeepers and accountants use to record transactions according to Generally Accepted Accounting Principles, or GAAP. GAAP, pronounced 'gap' just like the clothing store but far less fun, is a collection of standards and guidelines set by a bunch of policy boards that you simply do not want to know anything about.

I'm talking in United States structures here, and the EU and other countries have varying standards. However, there is a lot of similarity and to maintain some simplicity for this guide, we can use the same elements.

The accounting equation is:

Assets = Liabilities + Equity.

That's it. That means that all the transactions that end up in asset accounts must equal the transactions that end up in the liability accounts *and* the equity accounts together. And thanks to modern software systems for small business, most of the time everything adds up just fine without you having to do anything to make it work.

But the point here is that the accounting equation IS the Balance Sheet and that's why it's called the Balance Sheet.

Bob Cratchit had to hunch over all those numbers in bad lighting and make it work by hand – you have software! Shoot out a silent thank you to QuickBooks, FreshBooks, Xero, or whoever built your software.

Now let's look at the numbers:

Assets are what you own – that includes bank accounts, cash on hand or in tills, amounts due to you from customers/clients (called Accounts Receivable), pre-paid balances for something you've paid ahead on like insurance, funds you have received but not deposited yet, buildings, furniture, equipment, and vehicles. All of these will vary depending on the nature of your business and how you conduct business.

Current assets are something that you expect will be converted to cash within a year. So while your inventory balance might not change a lot, it will change behind the scenes as you buy more, sell more, and write off some to waste or loss.

Long term assets are something that you will hold onto for more than a year – it might be vehicles, equipment, or something else that you record depreciation on (also called Fixed Assets), or it could be a long term loan that the business made to someone. You will likely have Fixed Assets listed on your Balance Sheet, rather than Long Term Assets.

Liabilities are what you owe to other business or people and might include Accounts Payable, Payroll Liabilities, Sales Tax Payable, loans, mortgages, etc.

Current liabilities are those that will be cleared in a year and long-term liabilities will hang around past a year. See a pattern there??

Equity is the value in your business. This is not necessarily what you could sell it for or what you could borrow against, but it shows you how conducting business has contributed to the value.

If you have added personal funds to the business then you have added to the equity. If you have withdrawn funds from the business then you have decreased the equity. Your contributions and withdrawals will show up on the Balance Sheet in the equity section as either Shareholder Contributions or Member Contributions and Shareholder Draws or Member Draws depending on your business structure.

The Equity accounts, for a corporation, will also include Retained Earnings (which just means the accumulated net loss or profit from each prior year), and Net Income which is the current year. There might also be stock accounts, and for an LLC there will be Member Equity accounts.

Now let's look at your Profit & Loss – it is simpler and the one that most people are familiar with.

It is basically the summary of your gross (unadjusted sales) sales minus what it cost you to make the sales (Cost of Goods Sold), and then another subtraction of what it cost to operate your business (Operating Expenses). Ideally, the net number is positive, which is Net Income. Sometimes though, life happens, and it's a negative which is Net Loss.

Income can be busted out into several categories depending on the kind of business you have and what you want to track. It is also called Gross Revenue or Sales.

Cost of Goods Sold is a collection of the direct cost of sales. So if you buy widgets and then sell widgets, you record the cost of the widget at the same time you sell the widget. You might also include credit card processing fees here, or some other materials. If you are service business this might be a small part of your business expenses.

Gross Profit is the calculation that comes right after the Cost of Goods Sold – it is the difference between what you sold and what it cost you to make those sales. This is where your profit margin is located. Ideal profit margins vary with industries, so I'm not going to go into that here. Just know that your gross profit needs to be high enough to cover all your other business expenses so that you have a happy number at the very bottom of this report.

Expenses make up the next section – it includes any costs required to operate your business – insurance, advertising, employee wages, payroll taxes, utilities, interest on loan payments, legal or accounting fees, and ever so much more. There are way too many variable to list here.

Other Income and **Other Expenses** are usually the last section of a P&L before the bottom line. They both are not a part of conducting business (interest on a savings account, the sale of some kind of scrap or equipment no longer needed, or some kind of expense that is not a part of business operations) so they go down to the bottom of the report.

Net Income or **Net Loss** is the bottom line number. This tells you what the final outcome of your business operations was for the date range you requested.

Seriously, it's that simple. The big key to getting valid financial statements is good bookkeeping – and that means all business transactions are recorded accurately. And reviewing the financial statements on a regular basis will ensure that no mistakes are made (yes, even really good bookkeepers like Yours Truly can make a mistake!), and then you have a solid, reportable financial history on which you can make good business decisions.

So, go run some financial statements and plan your business future!

Anycity Construction
Balance Sheet
As of June 30, 2022

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Total Other Current Assets	28,188.53
Total Current Assets	132,745.02
Fixed Assets	
Accumulated Depreciation	-110,344.60
Buildings and Improvements	325,000.00
Construction Equipment	17,020.00
Furniture and Equipment	34,326.00
Land	90,000.00
Vehicles	56,295.91
Total Fixed Assets	412,297.31
TOTAL ASSETS	**545,042.33**
LIABILITIES & EQUITY	
Liabilities	
Current Liabilities	
Accounts Payable	19,782.49
Credit Cards	4,674.89
Other Current Liabilities	
Payroll Liabilities	1,478.73
Sales Tax Payable	527.25
Total Other Current Liabilities	527.25
Total Current Liabilities	24,984.63
Long Term Liabilities	
Loan - Construction Equipment	35,343.11
Loan - Vehicles (Utility Truck)	19,936.91
Mortgage - Office Building	296,283.00
Note Payable - Bank of Anycity	29,344.32
Total Long Term Liabilities	380,907.34
Total Liabilities	405,891.97
Equity	
Capital Stock	500.00
Retained Earnings	100,530.51
Net Income	38,119.85
Total Equity	139,150.36
TOTAL LIABILITIES & EQUITY	**545,042.33**

Owed to your business by customers/clients.

Current assets can or will be converted to cash within a year.

Totally legit negative balance!

Fixed Assets total includes the negative amount for Accumulated Depreciation so you have a more valid net number.

These will take longer than a year to pay off.

Total Assets should always be equal to the combined total of Liabilities and Equity.

The difference between what your business is worth (assets) minus what you owe on it

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Profit Loss
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Cost of Goods Sold	
Cost of Goods Sold	7,740.34
Job Expenses	
Job Materials	28,243.71
Subcontractors	4,724.95
Total Job Expenses	32,968.66
Total COGS	40,709.00
Gross Profit	116,972.19
Expense	
Automobile	
Fuel	875.00
Insurance	1,425.12
Repairs and Maintenance	1,360.00
Total Automobile	3,660.12
Bank Service Charges	75.00
Insurance	
Disability Insurance	300.00
Liability Insurance	2,992.98
Work Comp	6,871.98
Total Insurance	10,164.96
Interest Expense	1,336.50
Payroll Expenses	
FUTA Expense	168.00
Gross Wages	54,510.05
Payroll Taxes	4,170.03
SUTA Expense	1,123.50
Total Payroll Expenses	59,971.58
Repairs	900.00
Tools and Machinery	1,660.68
Utilities	1,243.46
Total Expense	79,012.30
Net Ordinary Income	37,959.89
Other Income/Expense	
Other Income	
Interest Income	159.96
Total Other Income	159.96
Net Other Income	159.96
Net Income	38,119.85

Total income, gross income - all the same thing: the total sales for the period.

Cost of Goods Sold is simply matched costs and sales - what it cost you to make the sale.

Expenses are a part of conducting business, and the operating expenses are any costs that were not directly associated with a sale.

Net Income is what is left after COGS and operating expenses are deducted.

This sample P&L doesn't include Other Expenses, but it would be in this section too. This is income and expense that are not a part of business operations.

Net income or net loss - otherwise known as the "bottom line"!