Small Business Financial Fundamentals Guide:

Financial Statements 101

BUSINESSLINK

The Income Statement

The Income Statement is also called a Profit & Loss Statement. If you are wondering about the profitability of your company or "the bottom line" then look no further than the bottom line of your Income Statement.

This standard form shows **sales** first, then the **cost of sales** (or cost of goods or cost of goods sold (COGS), or **direct costs**, all of which are the same thing). Then it subtracts costs from sales to calculate **gross margin**, which is defined as sales less the cost of sales. Then it shows **operating expenses**, usually (but not always) subtracting operating expenses from **gross margin** to show **EBIT** (Earnings Before Interest and Taxes). Then it subtracts interest and taxes to show profit.

Sales - Cost of Sales = Gross Margin

Gross Margin - Expenses = Earnings Before Interest and Taxes

EBIT - Interest and Taxes = Net Profit

The Income Statement is about the flow of transactions over a designated period—such as a month, a quarter, a year, or several years.

Download our sample **Income Statement.**

The Balance Sheet

A Balance Sheet is straightforward. It shows your company's assets, liabilities, and owner's equity at a specific point in time. Put simply, a Balance Sheet shows what a company owns (**assets**), what it owes (**liabilities**), and how much owners and shareholders have invested (**equity/capital**). Think of this document as a snapshot of your company frozen in time. The details of your Balance Sheet will be different each time you take a new snapshot. It will always show assets on the left side or on the top, with liabilities and equity (capital) on the right side or the bottom.

Balance Sheets must always obey the following formula:

Assets = Liabilities + Equity

Unless this simple equation is true, the Balance Sheet doesn't balance, and the numbers are not right. You can use that to help make estimated guesses and pull things together for projected Cash Flow.

Download our sample **Balance Sheet**.

The Cash Flow Statement

The Cash Flow Statement is one of the three main financial statements (along with the Income Statement and Balance Sheet) that shows the financial position and health of a business.

It shows the actual cash inflows and outflows. The statement then compares cash received to cash spent to determine if a business is cash flow negative or cash flow positive. The Cash Flow Statement also shows how much cash a business has on hand at the end of the specified period.

A cash flow positive business is receiving more cash than it is spending. Likewise, a cash flow negative business is spending more cash than it is receiving.

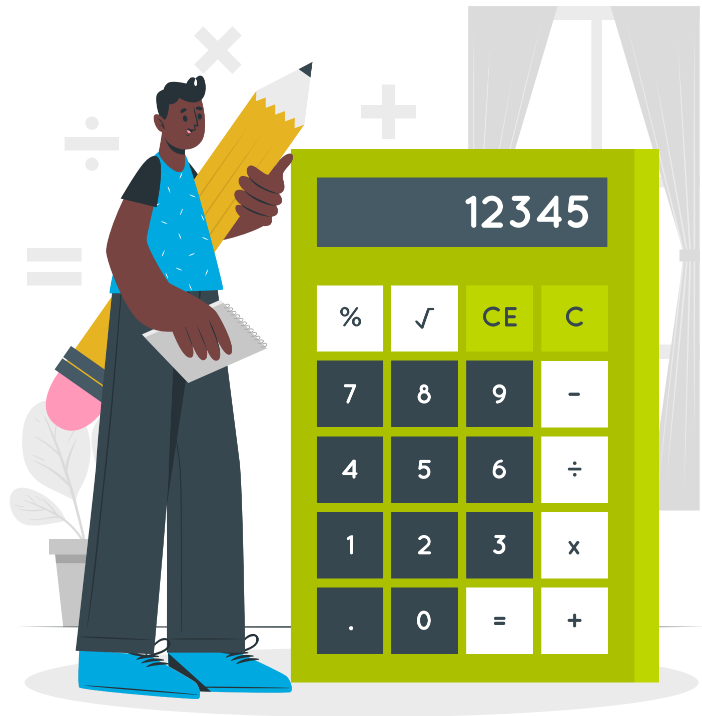
Download our **Cash Flow Template** to help you get started.

The Two Types of Cash Flow Statements

There are two different types of Cash Flow Statements that a business may produce: An Indirect Cash Flow Statement and a Direct Cash Flow Statement.

Indirect Cash Flow Statement

The indirect method starts with Net Income from the Income Statement and then makes additions and subtractions from that number to arrive at cash flow.
The Indirect Cash Flow Statement is more popular because it can be easily created from reports produced by accounting software. That said, it can be more difficult to use for cash flow forecasting.



Direct Cash Flow Statement

The direct method simply totals up cash received, and cash spent, and then compares the two numbers to arrive at a cash flow number.

Learn more about Cash Flow from **Investopedia**.

How to Use a Cash Flow Statement

The Cash Flow Statement shows if a business is bringing in cash or losing cash over time. With cash being the lifeblood of business, knowing if cash is moving into the business or out of the business is critical.

You can use the Cash Flow Statement to calculate cash runway - the amount of time that a business can stay in operation if it continues to lose money at its current pace. Cash Flow Statements are an important part of a business plan as lenders will look for positive cash flow as part of their overall lending criteria.

How Cash Flow Statements work with your Income Statement & Balance Sheets

Along with the Income Statement and Balance Sheet, the Cash Flow Statement is one of the three critical financial statements you can use to evaluate a business's performance. It is also the most important, and least intuitive, of the three. In both mathematical and financial detail, it reconciles the Income Statement with the Balance Sheet - but that detail can be hard to see and follow. What is most important is tracking the money. By cash we mean liquidity, as in the balance in chequing and related savings accounts, not strictly bills and coins. Tracking cash is the most important thing a Cash Flow Statement does. The underlying truth is:

Ending Cash = Starting Cash + Money Received - Money Spent

What's particularly important in planning is that neither the Income Statement nor the Balance Sheet alone is enough to plan and manage cash.

The Income Statement records booked sales and expenses and calculates profits. It is important to know if a business is profitable or not, but you then turn to the Cash Flow Statement to see how this activity impacts cash.

The Income Statement does not reflect cash received and spent. This is because customers often take time to pay after they receive an invoice and businesses also don't pay all their bills right away.

The Balance Sheet connects to the Cash Flow Statement in that it also records the amount of cash a business has on hand. In addition to this key metric, the Balance Sheet also lists a business's assets and its liabilities.