



# Understanding Financial Statements

## (A Free Guide)

### What your financial statements are really telling you (and how to use them)

Most business owners don't need "more reports." They need clear signals they can trust to make better decisions—pricing, hiring, spending, taxes, and growth.

Your three core financial statements work together like a dashboard:

- **Profit & Loss (P&L)** = performance over time (did you make money?)
- **Balance Sheet** = financial position at a point in time (what do you own/owe?)
- **Cash Flow Statement** = cash movement (where did the cash go and why?)

When they're accurate and reviewed consistently, they answer the questions that matter most:

- Is my business profitable—or just busy?
- Can I afford to hire, buy equipment, or expand?
- Why is cash tight if sales are up?
- Am I building a healthy business or accumulating risk?

### 1) Profit & Loss Statement (Income Statement)

#### What it tells you

Your P&L shows whether your business is generating profit over a period of time (month, quarter, year). It's the clearest view of operating performance.

#### What to look for (the "decision" metrics)

1. **Revenue trends** Are sales growing, flat, or declining? Are you overly dependent on one customer, product, or season? **Decisions it supports:** marketing spend, sales focus, product/service mix.



## 2. **Gross profit (and gross margin)**

$$\text{Gross Profit} = \text{Revenue} - \text{Direct Costs (COGS / Job Costs)}$$

Are you pricing correctly? Are your direct costs rising faster than revenue?

**Decisions it supports:** pricing changes, vendor negotiations, which services to stop offering.

3. **Operating expenses (overhead)** These are costs that keep the business running—software, admin, rent, insurance, etc. Are overhead costs creeping up “quietly”? Are you paying for tools/subscriptions you don’t use? **Decisions it supports:** cost cutting, budgeting, when to hire admin help.

4. **Net profit (and net margin)** Net profit is what’s left after all expenses. Is the business producing enough profit to pay you and still grow? Are you profitable on paper but still struggling (cash flow issue)? **Decisions it supports:** owner pay, reinvestment, expansion timing.

5. **Owner reality-check items** Small business P&Ls often get distorted by:

- Owner draws vs payroll
- Personal expenses mixed into business
- One-time expenses (equipment, legal, catch-up work) **Decisions it supports:** clean reporting, tax planning, lender-ready financials.

## Common P&L mistakes that lead to bad decisions

- Categorizing transactions inconsistently month to month
- Missing expenses (especially autopay subscriptions, reimbursements, loan interest)
- Treating transfers as income
- Not tracking COGS/job costs separately from overhead

## 2) Balance Sheet

### What it tells you

Your balance sheet is a snapshot of your business’s financial strength at a specific moment.

It answers: **“If we stopped today, what do we own and what do we owe?”**

Balance sheet equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

## What to look for (the “health” metrics)

1. **Cash** Do you have enough cash to handle payroll, taxes, and surprises? Is cash dropping even though profit looks okay? (That’s a cash flow timing issue.)  
**Decisions it supports:** spending limits, timing purchases, building reserves.
2. **Accounts Receivable (A/R)** This is money customers owe you. Is A/R growing faster than sales? Are invoices sitting unpaid for 30/60/90+ days? **Decisions it supports:** tightening payment terms, collections process, requiring deposits.
3. **Accounts Payable (A/P)** This is what you owe vendors. Are you paying bills late to survive? Are you stacking up payables without a plan? **Decisions it supports:** vendor negotiations, cash planning, avoiding late fees.
4. **Loans and credit cards** Is debt increasing month to month? Are you using credit cards to cover operating losses? **Decisions it supports:** restructuring debt, reducing overhead, adjusting pricing.
5. **Equity** Equity reflects what’s left for the owner after liabilities. Is equity growing over time (healthy)? Or shrinking (risk increasing)? **Decisions it supports:** long-term sustainability, readiness for financing, owner compensation strategy.

## Common balance sheet issues

- Old A/R that should be written off (makes the business look stronger than it is)
- Unreconciled bank/credit card accounts (numbers aren’t trustworthy)
- Loans not recorded properly (principal vs interest)
- Inventory/asset values not updated

## 3) Cash Flow Statement

### What it tells you

Cash flow explains why cash changed during a period—even when profit looks good.

This is the statement that answers:

- “Where did the money go?”
- “Why am I profitable but broke?”
- “Can I afford to grow?”

### How cash flow is typically broken into

#### *A) Cash Flow from Operations*

Cash generated by your core business activity.



**Look for:** Is your business producing cash from normal operations? Or are you constantly relying on loans/credit to stay afloat? **Decisions it supports:** fixing collections, adjusting expenses, improving profitability.

### *B) Cash Flow from Investing*

Cash used for equipment, vehicles, long-term assets.

**Look for:** Are you buying assets at the right time? Are you investing while operations are weak? **Decisions it supports:** timing purchases, leasing vs buying.

### *C) Cash Flow from Financing*

Loans, owner contributions, owner distributions.

**Look for:** Are you taking cash out while the business is under pressure? Are you relying on debt to cover operating shortfalls? **Decisions it supports:** owner draw planning, debt strategy, building reserves.

## Common cash flow misunderstandings

- **Profit is not cash** (because invoices, loan payments, inventory, and timing exist)
- **Growth can consume cash** (more sales often means more payroll, materials, and A/R)

## How the statements work together (simple examples)

Example 1: “Sales are up, but cash is down.”

### **Usually means:**

- A/R is increasing (customers paying slower)
- Inventory/materials purchased ahead of sales
- Debt payments increased

**What to do:** review A/R aging, tighten payment terms, improve invoicing/collections cadence.

Example 2: “Cash is okay, but profit is low.”

### **Usually means:**

- Pricing is too low
- Direct costs are too high
- Overhead is creeping up



**What to do:** review gross margin, raise prices, renegotiate vendors, cut nonessential overhead.

Example 3: “Profit is high, but the balance sheet looks risky.”

**Usually means:**

- Too much debt
- Too much A/P
- Not enough cash reserves

**What to do:** build a cash buffer, pay down high-interest debt, create a plan for payables.

## A simple monthly review checklist (15–20 minutes)

If you want better decisions, consistency beats complexity. Each month:

### P&L

- Compare this month vs last month vs same month last year
- Check gross margin and net margin
- Identify top 3 expense changes

### Balance Sheet

- Reconcile bank and credit cards (trust the numbers first)
- Review A/R and A/P totals
- Confirm loans/credit balances make sense

### Cash Flow

- Confirm operations are generating cash
- Identify the #1 reason cash changed this month

## When to get help (and what to ask for)

If you’re not confident your statements are accurate, the best next step is not “more analysis”—it’s clean bookkeeping and consistent reporting.

Ask for:

- Monthly reconciliations (bank + credit cards)
- Clean chart of accounts (simple, consistent categories)
- A/R tracking and collections process
- Monthly financial review with action items
- Tax-ready books (so filing is easier and deductions are captured)



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