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Understanding Financial Statements

A plain-English guide to the three reports ***every business produces.***

Why this matters

Financial statements are the language of business. Whether you run a company, work in one, or are thinking of investing in one, being able to read these three documents gives you a clearer picture of what is really going on than any headline figure or sales pitch. This guide walks you through each statement, what it tells you, and how they fit together.

The three statements at a glance

Statement	The question it answers	Time frame
Profit and loss account (P&L)	Did the business earn more than it spent?	A period (e.g. a year or quarter)
Balance sheet	What does the business own and owe right now?	A single point in time
Cash flow statement	Did cash actually arrive in the business?	A period (e.g. a year or quarter)

The profit and loss account

The profit and loss account (P&L) shows whether the business made a profit over a given period. It starts with turnover at the top, deducts the cost of sales to give gross profit, then subtracts operating expenses to reach operating profit. After interest is deducted you arrive at net profit and after tax is applied you reach profit after tax which is the bottom line.

Gross profit margin (gross profit divided by turnover) is one of the most useful numbers on this page. It tells you how much the business keeps from each pound of sales before it pays its overheads. A falling margin, even with rising turnover, is a warning worth investigating.

Worked example: profit and loss account (Dr / Cr format)

The traditional 'T-account' format taught in bookkeeping: debits (costs) on the left, credits (income) on the right. Both sides always total the same amount by definition — the gap between them is the profit, entered on the debit side as the balancing figure.

Dr. (expenses)	£	Cr. (income)	£
Cost of sales	100,000	Turnover	250,000
Operating expenses	95,000		
Interest	5,000		
Tax	10,000		
Profit after tax (balancing figure)	40,000		
Total	250,000	Total	250,000

The balance sheet

The balance sheet is a snapshot of what the business owns (assets) and what it owes (liabilities) at a single point in time. The difference between the two is equity: the owners' stake in the business. The golden rule is that Assets always equal Liabilities plus Equity. This is not a target or a coincidence. It is true by definition and if it does not hold, there is an error in the accounts.

Assets are split into current (cash, debtors, stock) and fixed assets (property, equipment, long-term investments). Liabilities follow the same split into current and long-term. The current ratio (current assets divided by current liabilities) gives a quick read on whether the business can meet its short-term obligations.

Worked example: balance sheet (Dr / Cr format)

Same fictional business, as at the year end, in the traditional horizontal format: liabilities and capital (credit balances) on the left, assets (debit balances) on the right. Current assets here is cash £35,000, debtors £40,000 and stock £20,000. Both sides total £215,000 — the golden rule holding true.

Liabilities (Cr.)	£	Assets (Dr.)	£
Current liabilities	40,000	Fixed assets	120,000
Long-term liabilities	60,000	Current assets	95,000
Capital & reserves (equity)	115,000		
Total	215,000	Total	215,000

The cash flow statement

The cash flow statement shows where cash came from and where it went during a period. It is divided into three sections: operating activities (the day-to-day business), investing activities (buying or selling fixed assets such as equipment or property) and financing activities (borrowing, repaying debt, or raising equity). The closing cash balance on this statement ties directly back to the cash line on the balance sheet.

Operating cash conversion (operating cash flow divided by operating profit) is a useful measure of how well the business turns its profits into real cash. A healthy, well-managed business will typically convert most of its operating profit into cash. A low or negative figure is worth understanding.

Worked example: sources and application of funds

Cash flow statements aren't kept as debit/credit ledger accounts in modern practice — the nearest genuine equivalent is this older 'sources and application of funds' layout: where the cash came from on the left, where it went on the right. The closing cash balance of £35,000 is the balancing figure, and it ties straight back to the cash figure inside current assets on the balance sheet above.

Sources (in)	£	Applications (out)	£
Opening cash balance	20,000	Investing activities	20,000
Operating activities	42,000	Financing activities	7,000
		Closing cash balance (balancing figure)	35,000
Total	62,000	Total	62,000

PROFIT IS NOT THE SAME AS CASH

A business can report a healthy profit and still run out of cash. This happens because accounting records revenue when it is earned, not when the money arrives. If customers are slow to pay, stock is building up or the business is investing heavily in growth, cash can fall even while profits look strong. The cash flow statement is the truth test. A profitable business with negative operating cash flow is a business worth looking at more closely.

How the three statements connect

- Profit after tax from the P&L flows into retained earnings on the balance sheet, increasing the owners' equity.
- Depreciation reduces profit on the P&L but does not use cash, so it is added back in the operating section of the cash flow statement.
- Capital expenditure (buying equipment or property) appears as a cash outflow on the cash flow statement and increases fixed assets on the balance sheet. Only the annual depreciation charge reaches the P&L, spread over the asset's useful life.
- New borrowing appears as a cash inflow on the cash flow statement and simultaneously increases both cash (an asset) and the loan liability on the balance sheet.

Common misconceptions

- Turnover is not cash received. Revenue is recognised when earned, which may be weeks or months before the customer pays.
- A profitable business is not necessarily solvent. Timing mismatches between income and cash can push even healthy businesses into difficulty.
- Assets are not cash. Stock, equipment, and amounts owed by customers (debtors) are all assets, but none of them pay next month's wages.
- The balance sheet always balances, by definition. If someone tells you otherwise, there is an error in the accounts.
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What to do next

- Find your most recent set of accounts and identify the three statements
- Check your gross profit margin and compare it to the previous year
- Look at your operating cash flow. Is it higher or lower than your operating profit, and do you know why?
- If you would like help reading your own numbers, get in touch. This is exactly what we do and what we love