

## How the Balance Sheet and Profit and Loss Interact

Two of your key responsibilities if you are a company director are to ensure that you act with care and diligence in performing your role, and to ensure you prevent the company from insolvent trading. As a business owner and director it is therefore critically important to be able to read the three main financial statements within a business. They are the Profit and Loss, the Balance Sheet, and the Cash Flow Statement.

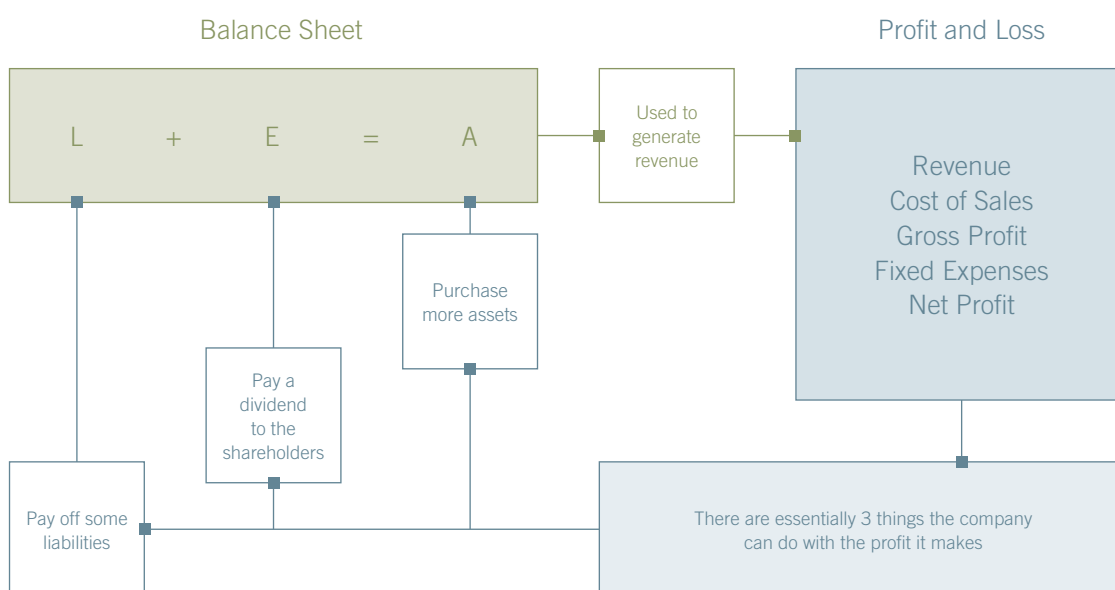
While most business owners are familiar with the Profit and Loss, the Balance Sheet tends to receive less attention. The two financial statements actually interact with each other, and should ideally be viewed, analysed and interpreted together.

### How the Balance Sheet and Profit and Loss Interact

The Profit and Loss is a summary of the income and expenses of a company for one specific period of time. It represents the operational results over that given time period. It establishes how much Income (revenue), Gross Profit and Net Profit were generated by the company in that time period.

The Balance Sheet is a snapshot of what the company owns (assets), and what it owes to creditors (liabilities) and share holders (equity). It is a record of the cumulative business activity since the company started.

The diagram below represents the Financial Operating Cycle; how the Profit and Loss and Balance Sheet interact.



Assets are purchased with money from creditors (liabilities) and/or owners (equity) and are used to generate revenue.

In generating the revenue the business will attempt to maximise the volume and price of its products and services, minimise variable and fixed expenses, and hence efficiently maximise the amount of net profit.

The net profit that the company makes can then be used to purchase more assets, pay off some liabilities, or pay a dividend to shareholders.

Reviewing the Profit and Loss and Balance Sheet together on a regular basis (at least monthly) will lead to a greater understanding of the financial position of the company.