



Reading Financial Statements

Understanding your organization’s financial statements is essential to making confident, informed decisions. This guide gives an overview of the three core financial statements (Income Statement, Balance Sheet, and Cash Flow Statement) so that any employment social enterprise (ESE) team member can understand what the numbers really mean. This guide will help you to:

- Understand the purpose and structure of each core financial statement, and how they relate to one another
- Interpret key numbers and trends to support planning, budgeting, and operational decisions
- Ask informed questions about your ESE’s financial health, even if you’re not a finance expert

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Introduction

Financial statements are documents or reports that give a particular view into the financial health of an employment social enterprise (ESE). Financial statements serve several useful purposes including:

- Providing input to internal management discussions and decisions such as budgeting, determining if or how to access external financing, assessing readiness to scale, or identifying root causes of organizational challenges
- Allowing for a standard form of reporting to key stakeholders such as board members or funders
- Complying with legal requirements such as reporting financials to the IRS

Most often when you hear the term “financial statements,” someone is referring to one or more of the following three standard financial statements. Note that nonprofits often use different names for these three standard financial statements (which are also listed below). As we go through each standard financial statement in this guide, we’ll highlight some of the other main differences in the nonprofit version of each of these statements.

Financial Statement ¹	In Nonprofits, this statement is often called...	Description
Balance Sheet (BS or B/S)	Statements of Financial Position (SOFPP)	Snapshot of an organization’s financial health at a specific point in time . It shows what the organization owns (assets), what it owes (liabilities), and what’s left over (equity or net assets).
Income Statement (IS, I/S) or Profit & Loss Statement (P&L)	Statements of Activities (SOA)	Shows an organization’s financial performance over a specific period (e.g., monthly, quarterly, annually). It details revenues, expenses and costs, and net income/loss or net assets (for nonprofits) to determine whether the organization earned or lost money during the given period.
Cash Flow Statement (CFS)	Cash Flow Statement² (CFS)	Shows how cash moves in and out of an organization over a specific period . It helps track actual cash availability, which is critical for ensuring an organization has enough available cash to cover expenses such as payroll. Note that unlike the Income Statement, which includes non-cash items (such as depreciation), the Cash Flow Statement focuses only on actual cash transactions.

¹ Importantly, these names are the most commonly used to refer to these statements. So – even if you’re a nonprofit, a lender may ask for your “Balance Sheet” even if they’re really referring to your “Statement of Financial Position” since that’s the most common shorthand.

² In both for-profit and nonprofit accounting, the term Cash Flow Statement is most often used. Occasionally in nonprofit accounting you may see this referred to as Statements of Cash Activity, Cash Flow Report, or Sources & Uses of Cash.



A Few Words on Generally Accepted Accounting Principles (GAAP)

Before we dive into each financial statement, it's important to understand Generally Accepted Accounting Principles (GAAP). These are a set of accounting rules, standards, and procedures issued and maintained by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). These standards ensure consistency, accuracy, and transparency for financial reporting across organizations. In a few words, GAAP helps to make sure everyone's doing accounting using the same principles. In this way, funders, lenders, donors, boards, and the general public can more readily rely on the information in financial reports and meaningfully compare those reports for different organizations. While your bookkeeper, accountant, or auditor will be the ones applying the technical details, having a basic awareness of these principles will help you interpret your financials with greater confidence.

When Your ESE Should Use GAAP

In general, it's best to implement GAAP as soon as is feasible within your ESE. GAAP standards in reporting and financial statements are required for nonprofits that receive a certain amount of funding from the federal government, and GAAP may also be required for nonprofits by certain states. Additionally, funders and lenders usually expect reports and financial statements to follow GAAP standards (so, for-profit ESEs will also likely find themselves needing to implement GAAP at some point in their growth).

As you can see, there are several reasons why GAAP is worth implementing as early as possible within your ESE. It's important to note, however, that some smaller or early-stage ESEs may elect to delay implementing GAAP because it often requires more detailed accounting (as you'll see below in the summary of important GAAP standards). ESEs that are in the very early stages of maturity usually find cash accounting methods (versus accrual accounting which is required by GAAP) easier to implement and manage. This may be OK for a brief period, but if your ESE waits too long to switch to GAAP standards, it may increase the complexity of the change. It's important that you work with a CPA to evaluate if and how to follow GAAP standards for accounting at your ESE.

Some Important GAAP Standards

While GAAP includes hundreds of detailed accounting rules, most ESE team members don't need to know them all. There are, however, a handful of important standards that directly affect how an ESE's financial statements are prepared. Understanding these standards will help you to interpret what the financial statements say. The guidelines below shape how revenue, expenses, and assets are recorded. Reviewing these can help you spot red flags, ask better questions, and feel more confident in financial discussions. Keep in mind that this is only a selection of GAAP standards that may be relevant to your ESE – be sure to consult with a CPA in order to understand all of the GAAP standards that apply to your situation.

- **Accrual accounting is the GAAP standard**

This is one of the most important standards in GAAP. In accrual accounting, revenues and expenses are recorded when they are earned or incurred, not when cash is received or paid. (This is why you'll see items like Accounts Receivable or Prepaid Expenses on the Balance Sheet.) In contrast, cash accounting allows you to recognize revenue or expenses immediately when cash is exchanged. The accrual principle of GAAP is the foundation of many of its rules and standards (to include some of those listed below).



- **Prepaid expenses must be spread over the period that the benefit is received**

If your ESE pays upfront for things like insurance, rent, or subscriptions, you must recognize that as a “Prepaid Expense” asset on the Balance Sheet, gradually drawing down on that asset as the expense is incurred (and the benefit received). As a practical example, your ESE may pay upfront for its entire year of mobile phone services on the first month of the year, but that full amount will not appear as an expense on the Income Statement. Rather, a portion of that amount will appear each month of the year, totaling the amount that was paid up front.

- **Revenue recognition must match service delivery**

GAAP requires that you only recognize revenue when the service or product has been delivered, not when the cash hits your ESE’s bank account. This may have a significant impact on an ESE’s statements as it applies to grants, government contracts, prepaid customer deposits, or situations where payment is collected after a product/service is delivered.

- **Depreciation spreads out cost of fixed assets**

If your ESE buys equipment, vehicles, or furniture, GAAP requires you to depreciate those assets. This means that you spread the expense of these assets over the years you expect to use them instead of recording the entire expense when it was acquired.

- **Tracking restricted grants**

If a grant is restricted for a certain program or time period, it must be treated as temporarily restricted net assets and recognized as revenue only when the restriction is met.

- **In-kind contributions must be valued and recorded**

GAAP requires ESEs to assign a reasonable dollar value to donated goods or services (like pro bono legal help or donated equipment) and include that value in both revenue and expenses.

Balance Sheet or Statements of Financial Position

The Balance Sheet (B/S) or Statements of Financial Position (SOFP) is a snapshot of your ESE’s financial position at a single point in time. Think of it as a photo of everything the organization owns, owes, and has left over. The B/S or SOFP is divided into three parts: assets (what you own), liabilities (what you owe), and equity or net assets (what’s left after subtracting liabilities from assets). This statement helps you understand whether your ESE is financially stable, whether it has the resources needed to meet its obligations and invest in the future, how much flexibility it has to borrow or take on new investment.

Key Questions that the B/S or SOFP Can Help You Answer

Question to Ask	What the answer will tell you (along with any relevant Core ESE Metrics) See the “Financial Health Metrics and Indicators for Your ESE” guide for more on Core Metrics
How much cash do we have on hand, and is it enough?	A strong cash position indicates short-term financial stability. Too little may indicate risk of shortfalls when covering financial obligations. Use the guidance on the “Days Cash on Hand” core metric to determine if your ESE is facing any cash risks.



Question to Ask	What the answer will tell you (along with any relevant Core ESE Metrics) See the "Financial Health Metrics and Indicators for Your ESE" guide for more on Core Metrics
Are we financially positioned to cover short-term obligations?	Compare your ESE's Current Assets to Current Liabilities. ³ If liabilities are higher, your ESE may struggle to pay bills. This is one relatively easy way to get a picture of solvency but be sure to refer to the Liquidity Metrics in the Financial Health Metrics guide for more relevant metrics.
How much of our total assets are restricted or not easily accessible?	If most assets are tied up in inventory or restricted funds, your real flexibility and ability to respond to unexpected events may be limited. Review the Days of Liquid Unrestricted Net Assets (LUNA) core metric to assess usable resources.
Are we carrying significant debt or financial risk?	A high debt load compared to net assets or equity could signal risk and could make it difficult for your ESE to acquire additional funding from lenders or investors. Check the Debt-to-Equity Ratio core metric guidance to assess leverage.
Are our net assets (or equity) growing over time?	This requires you to compare balance sheets from two different periods in order to identify any change. A growth in net assets means that the ESE is building financial strength and is either deepening its reserves and/or is able to invest in growth. A shrinking balance may signal losses or funding gaps. If a negative trend continues, this could be a major risk to flag.

How a B/S or SOFP is Organized

Below is what you will typically find in a balance sheet (typical of a for-profit) or statements of financial position (typical for a nonprofit) that follows an accrual method of accounting. Note the important distinctions to keep in mind.

	Balance Sheet (B/S)	Statements of Financial Position (SOFP)
How it's organized	Assets: What the ESE owns. This may include unique for-profit assets such as deferred tax assets. Liabilities: What the ESE owes. This may include unique for-profit liabilities such as income taxes payable. Equity: Remaining assets (retained as equity) after all debts or obligations are paid.	Assets: What the ESE owns. This may include unique nonprofit assets such as pledges and grants receivable. Liabilities: What the ESE owes. This may include unique nonprofit liabilities such as advanced funding received for a program before the services have been delivered. Net Assets: Remaining assets after all debts or obligations are paid. Often organized into sub-categories of "Without donor restrictions" and "With donor restrictions."

³ This is commonly referred to as a "Current Ratio." It's a rapid and relatively easy way to get a picture of solvency, but has some flaws. You can read more here: <https://www.investopedia.com/terms/c/currentratio.asp>



	Balance Sheet (B/S)	Statements of Financial Position (SOPF)
Other important distinctions to keep in mind	In for-profit ESEs (and any for-profit organization), what is left over after subtracting liabilities from assets is the equity retained by the organization's owners (or shareholders). In contrast, in nonprofits there are no shareholders. As such, what is left over is referred to as net assets.	

Income Statement, Profit & Loss, or Statements of Activities

The Income Statement (IS), Profit & Loss (P&L), or Statements of Activities (SOA) shows how your ESE is performing financially over a specific period (usually a month, quarter, or year). It reports revenue earned, expenses incurred, and the resulting net income or loss (or change in net assets). This statement is key to understanding your ESE's operational health. Particularly for ESEs, the Income Statement helps you see what portion of your total expenses are covered by earned revenue, what your ESE's funding profile looks like, and what opportunities exist for improving financial performance over time.

Key Questions that the IS, P&L, or SOA Can Help You Answer

Question to Ask	What the answer will tell you (along with any relevant Core ESE Metrics) See the "Financial Health Metrics and Indicators for Your ESE" guide for more on Core Metrics
Are we bringing in more than we're spending?	If revenue exceeds expenses, you have a surplus that can contribute to reserves and/or be invested in growth. If the opposite is true, you're operating at net loss. A net loss isn't uncommon for a very limited period of time (especially in very early stages of an ESE's maturity, or when the ESE is undergoing a significant change), but a long period of net losses could signal a major issue that needs to be addressed. The Net Margin core metric guidance will help you to assess this.
What portion of our operating costs are covered by earned revenue?	It's not uncommon for an ESE to only have a portion of their operating costs covered by earned revenue. Understanding this helps to clarify what must be covered by contributed revenue in order to achieve sustainability, and/or whether costs and expenses may need to be reduced. Use the guidance on the Earned Revenue Cost Coverage core metric.
Are expenses growing faster than revenue?	This requires comparing income statements from two different periods (use the core metric guidance on % Change in Unrestricted Operating Revenue and % Change in Expenses). ESEs may see brief periods where expenses grow more rapidly than revenue (for example, if the ESE is investing in growth). But, if the trend continues of expense growth exceeding revenue growth, it could be a signal that there is an issue to address.
What's driving most of our costs and expenses?	Understanding your largest expense categories (like payroll, inventory, or supplies) can inform budgeting and resource planning.



How an IS, P&L, or SOA is Organized

Most of the differences between how for-profits and nonprofits report their financial statements are found here. Below you will find a summary of how an IS or P&L (typical of a for-profit) might look versus an SOA (typical of a nonprofit). And – while not comprehensive – a few important distinctions to keep in mind are noted as well.

	Income Statement (IS) or Profit & Loss Statement (P&L)	Statements of Activities (SOA)
How it's organized	Revenue: The ESE's income from core operating activities. This includes sales revenue or service revenue. Grants received to support operations may appear here, depending on the terms, but are more commonly listed under Other Income (see below). Cost of Goods Sold (COGS): Direct costs tied to producing goods or services. This includes wages, materials & supplies, and shipping. Gross Profit: This is calculated by subtracting COGS from Revenue. Operating Expenses: Ongoing business expenses not directly tied to sales. This includes salaries for admin staff and supervisors, marketing, and rent. Operating Income: This is calculated by subtracting Operating Expenses from Gross Profit. Other Income / Expenses: Other income and expenses that are not tied to core operating activities. These may include loan interest or gains/losses on sales of assets. Net Income: The resulting total after summing Operating Income and Other Income / Expenses.	Revenues: All of the ESE's income sources. This will include all donations and contributions as well as earned revenue. In nonprofits you may also see a row called "Net assets released from restrictions" which is revenue that can be recognized because the conditions have been met. Expenses: Most often broken into two categories – "Program Services" (expenses related to delivering on the mission) and "Supporting Services" (expenses that are essential to running the organization such as Admin and Fundraising).
Other important distinctions to keep in mind	A key distinction is how for-profits and nonprofits are required to track and report their expenses. For-profits are given more flexibility and can use what's called <i>natural classification</i> – this reflects what the expense actually was (e.g., salaries, utilities, rent, etc.). Nonprofits that follow GAAP standards must use both <i>natural</i> and <i>functional classification</i> – this refers to what the expense supported (e.g., program services, fundraising, etc.). You'll see this reflected in an additional report that nonprofits often have to produce called "Statements of Functional Expenses," where each of the natural classifications (e.g., salaries, utilities, rent, etc.) is broken out to show which function each expense supported (e.g., program services, fundraising, etc.). The "Statements of Functional Expenses" is where ESEs may report the social enterprise-related expenses as a sub-category of "Program Services."	



Cash Flow Statement

The Cash Flow Statement (CFS) shows how cash actually moves through the organization over a specific period of time. It helps you understand if the ESE has enough cash on hand to pay bills, make payroll, and invest in operations. Unlike the Income Statement, which tracks profitability, this statement focuses purely on liquidity. For ESEs with tight margins or timing gaps between grants, sales, and payroll, understanding cash flow is essential to staying stable and strategic.

Key Questions that the CFS Can Help You Answer

Question to Ask	What the answer will tell you (along with any relevant Core ESE Metrics) See the "Financial Health Metrics and Indicators for Your ESE" guide for more on Core Metrics
How much does my net income or change in net assets differ from my net cash from operating activities?	The CFS adjusts your net income (or change in net assets for nonprofits) to account for non-cash items on the Income Statement or Statement of Activities. This is an important aspect of accrual accounting – the IS or SOA will record many non-cash income or expenses that must then be accounted for in the CFS. Comparing these totals can help to highlight how much items like Accounts Receivable (for example) might be contributing to income but not reflected in cash on hand.
Do we have enough cash to make payroll and pay vendors this month?	If your ESE doesn't have enough cash on hand to meet short-term obligations, it may need to employ tactics to address this. The Days of Cash on Hand core metric guides you on calculating this. Additionally, the "Managing Liquidity & Cash Flow" guide can assist with developing strategies to address cash shortfalls.
What are the primary sources of cash inflows and how stable are they?	Reviewing and comparing sources of net cash inflows will help you to see how much the ESE is relying on sales, contributions, or loans (for example), and how much cash inflows vary from period to period. A stable cash inflow indicates a stronger financial position.
Are we borrowing or repaying loans?	Look at the financing activities section of the CFS to track loan proceeds, repayments, or capital infusions. This will help you to understand how financing is contributing to your cash position.

How a CFS is Organized

The Cash Flow Statement (CFS) is organized into three main sections: Operating Activities, Investing Activities, and Financing Activities. This structure is largely the same whether you're looking at the CFS for a for-profit or nonprofit ESE (although some of the content will likely be distinct). Given the similarity in the structure below is a summary of what you might find in each section of the CFS regardless of ESE type.



Cash Flow Statement (CFS)	
How it's organized	Operating Activities: This section shows net cash that was provided by the ESE's operating activities over a given period of time. Note that the first line in this section will <i>a/ways</i> be either net income (for-profit ESEs) or change in net assets (nonprofit ESEs). This is because the bulk of the "Operating Activities" section of the CFS includes adjustments to this number in order to account for non-cash items in the IS or SOA. Investing Activities: Reflects the net cash resulting from the purchase or sale of long-term assets (like equipment, vehicles, or buildings). For both for-profit and nonprofit ESEs, this section shows how cash is being used to invest in future capacity or that is being generated by selling off assets. Financing Activities: Shows the cash inflows and outflows related to how the organization funds itself. This includes loans, equity investments (for for-profits), grants for capital projects (for nonprofits), and repayments of debt. This section helps explain where the money came from to fuel operations or growth, beyond regular income.