Financial Reports –
Getting started

Financial Reports are the monetary scorecard of a business. Financial reports are required to enable business operators and investors to understand how the business is performing from a financial perspective.

These reports tell the story of the operations of the business over a period of time, usually a financial year. The time period can be as short as a day or week or cover many years depending on what the preparer is trying to show.

There are three basic financial reports that are used.

- "The Balance Sheet", or
  "Statement of Financial Position"

- "The Profit and Loss Statement", or
  "Statement of Financial Performance"

- "The Cashflow Statement", or
  "Statement of Cashflows".

These reports are prepared by accountants and may be audited by another specialised accountant known as an auditor. It is the auditors' job to review the presented accounts and gather sufficient evidence to satisfy themselves that the accounts are free of material misstatement and have been properly prepared in accordance with recognised and statutory accounting standards. It's not their job to seek out and discover fraud but this does sometimes happen as a result of their testing.

The Balance Sheet

The Balance Sheet consists of three parts.

- Assets (items owned),
- Liabilities (money owed), and
- Equity (the owners share).

The Balance Sheet equation is generally stated as either –

- Assets – Liabilities = Equity

or

- Assets = Liabilities + Equity

This report tells the reader what the financial state of the business is at a particular point in time. It is like freezing time and taking a "snapshot" of the affairs of the business.

It is from this document that you can tell the financial stability of the business and there are some basic ratios that can help users gain a better understanding of the information provided. Examples are the Current ratio for understanding liquidity or the Debt Ratio to better understand funding of the business.

It is also important to understand the term "current" when looking at the Balance Sheet. Current means within twelve months of the balance date.

A Current Asset will be used up or rolled over within a year. Cash, Inventories, Accounts Receivable are good examples of current assets.

Current liabilities are amounts owing to others that will be paid within a year. Examples are Accounts Payable, the Bank Overdraft and Taxes.

<u>Balance Sheet</u>

Assets
    + Current Assets
    + Non Current Assets
        = *Total Assets* $ YYY
+ Liabilities
    + Current Liabilities
    +Non Current Liabilities
        Total Liabilities
+ Equity   =
    + Capital
    + Reserves
    + Retained earnings
        =Total Equity
=   *Total Liabilities and Equity* $ YYY

The above format shows total assets being equal to the Liabilities plus the Equity.

"Working Capital" is calculated by subtracting the Current Liabilities from the Current Assets. This figure should be a positive figure. It it's not positive then it is an indication the business may be insolvent and unable to pay its debts when they are due. The Working Capital Ratio, calculated by dividing Current Assets by Current Liabilities should be no worse than 1:1. If less than 1:1 it is an indicator of liquidity problems.

The Profit and Loss Statement

This statement tells the reader how the business performed over the period. The basic format is shown below.

In a trading or manufacturing business there may be a section known as the "Trading Statement". This statement is used to calculate the "Gross Profit" of the business.

Trading Statement

+	Sales	
-	Less: Cost of Sales	
		+Opening Stock
		+ Purchases
		+Other Direct costs
		- Closing Stock
		= Cost of Good Sold
=	Gross Profit	

Profit and Loss Statement

+	Trading income (Gross Profit)
-	Less: Expenses
=	Net profit before tax
-	Tax
=	Net profit after tax
+	Retained earnings carried forward
=	Retained Earnings

As a reader you can quickly see whether or not the business was profitable or made a loss.

You may however be more interested in how management achieved the result and again you can use ratio analysis for some clues.

Ratios give some guidance but, to be useful, must be compared to previous year's results, budgets and industry figures (when available). Inventory turnover can indicate if stocks are being well managed. The Gross Profit percentage (Gross Profit / Sales x 100 / 1) is an indicator of ability to cover overhead expenses and should be compared to budget, prior years and industry averages. Various expenses can be calculated as a percentage of Sales and when compared to prior years can indicate "trouble spots" or indicate good management.

The Statement of Cashflows

This statement is regrettably not usually prepared for smaller businesses. It is designed to enable the reader to see how cash was generated and used by the business over the accounting period.

The format breaks the cashflows into different areas and includes all inflows and outflows of cash in the business for the period. The end result should reconcile back to the cash balance shown in the Balance Sheet.

Statement of Cashflows
- Cashflows from operations
  - (e.g. general operating activities)
- Cashflows from Investing
  - (e.g. Changes in investments / new plant and equipment and sales of plant and equipment)
- Cashflows from Financing
  - (e.g. Capital raising / borrowings drawn and repaid / dividends)

Review

This article is intended to introduce you to the three reports you may receive from your accountant for your business or from a business you have invested in.

I highly recommend that you find more detailed literature on this subject and expand your knowledge as it will enable you to far better manage both you business and your investment portfolio.

Learn about ratio analysis and apply the techniques to analyse reports presented to you. Understand that this analysis doesn't give answers but are one toll in the process of understanding the reports. (Contact us for further information on this topic).

Try to determine if there is an agenda behind the reports. Do the directors want to portray high or low profits, a strong or weak Balance Sheet? What is the purpose of preparing the report? Is it for tax, borrowing or for the sale of the business and why would these possibly generate different results?

Contact us for a way to use this information in your business.

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