

MAKING YOUR NUMBERS TALK

How to **interpret and use** your financial statements

WALSH



Contents



What are your financial statements telling you?	04	Case study	14
The building blocks	04	ACME Industries profit & loss statement	14
The balance sheet	05	ACME Industries balance sheet	15
The profit & loss statement	06	So what do the financial statement tell us about ACME Industries' liquidity?	16
The cash flow statement	07	What do the financial statement tell us about ACME Industries' asset management?	17
Ratios	08	What do the financial statement tell us about ACME Industries' debt management?	18
Using ratios to help your business	08	What do the financial statement tell us about ACME Industries' profitability?	19
Liquidity ratios	09	How can Walsh Accountants help you?	21
Asset management ratios	10	Contact us	23
Debt management ratios	11		
Profitability ratios	12		



When you have your accountant prepare your financial figures, **do you just glance over the detail and head straight to the profit figure** because you think this is the best indication of the success of your business?

Or perhaps **you get too confused and overwhelmed with all the financial details** so the profit figure is the only one you understand?

By taking some time to learn how to interpret and use your financial statements, you can make your numbers talk and use them to better understand and manage your business.



What are your financial statements telling you?



While you might always look at the profit figure of a financial report, it may not always be a clear indication of how the business is performing.

Example:

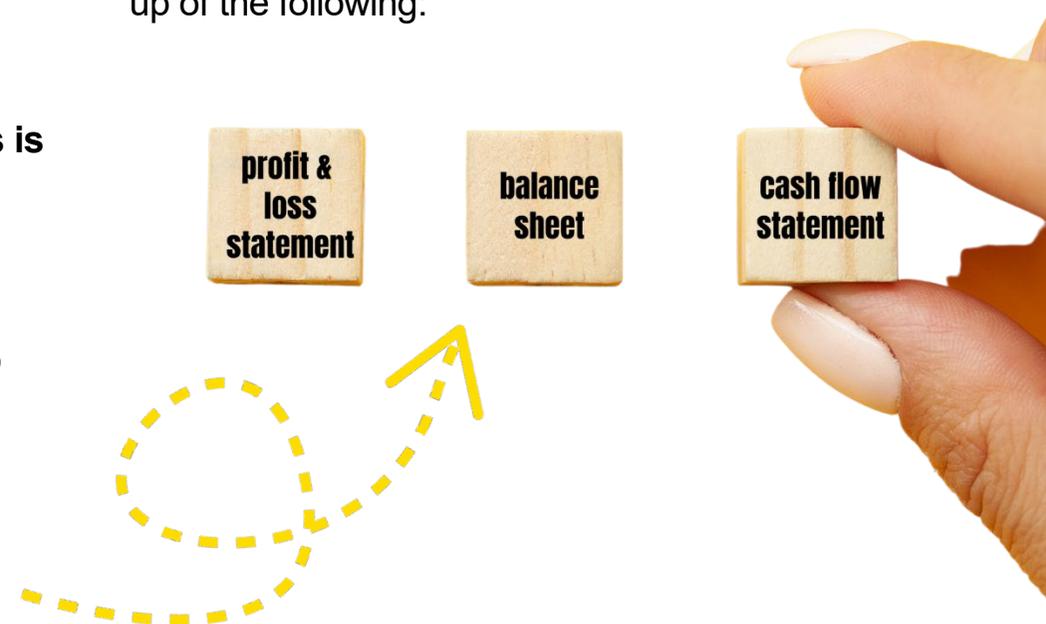
If sales are increasing, you would think the business is growing. What if your debtors were growing even faster than sales?

It would likely mean that the profit is increasing but cashflow isn't, so there may not be enough cash to keep the business running.

By understanding some basics, you will be able to spot these any many other problems and quickly fix things up before they get out of hand!

The building blocks

A set of financial statements will typically be made up of the following:





The balance sheet

ASSETS				
Tangible assets	105,000	93,167	81,333	69,500
Intangible assets	3,750	3,750	3,750	3,750
Financial assets	0	0	0	0
Total fixed assets	108,750	96,917	85,083	73,250
Inventory	586	586	1,435	1,680
Account receivables	0	0	0	0
Advances paid	0	0	0	0
Deferred costs	0	0	0	0
Cash	8,130	0	0	0
Total short-term assets	8,716	586	1,435	1,680
Other assets	0	0	0	0
TOTAL ASSETS	117,466	97,503	86,518	74,930
LIABILITIES & EQUITY				
Account payables	0	0	0	0
Advances received	0	0	0	0
Deferred revenues	0	0	0	0
Fiscal and social debts	(23,645)	1,716	1,926	2,248
Financial debt	75,000	50,622	25,627	0
Overdraft	0	2,319	26,589	26,687
Accrued interests	0	0	0	0
Total debts	51,355	54,657	54,142	28,935
Capital	20,000	20,000	20,000	20,000
Shareholders' loan	55,000	55,000	55,000	55,000
Reserves	0	0	0	0
Investment grants	0	0	0	0
Retained earnings	(8,889)	(32,155)	(42,624)	(29,005)
Other equity	0	0	0	0
Total Equity	66,111	42,845	32,376	45,995
Provisions	0	0	0	0

What is it?

Tells you what assets you own and what you owe

What does it show you?

Overall financial position of your business

How much of your debt is long-term and short-term

Cash you received from your sales

The amount of stock you still have on hand

Your unpaid expenses

What it won't show you

Current or market value of assets

The income and expenses you have made during the year



When you subtract **liabilities** from **assets**, this is what the business is worth. This is also called **equity**.



The profit & loss statement

Profit & Loss Statement		
For the year ended 30 June 2011		
REVENUE	\$	\$
Sales		250,000
Cost of Goods Sold		
Opening inventories (as at 1 July 2010)	40,000	
Add purchases	100,000	
Add freight-in and customs duty	10,000	
Less closing inventory (as at 30 June 2011)	60,000	
Less Cost of Goods Sold		90,000
Gross Profit		160,000
Add other operating revenue		
Rent received	3,000	
Commission received	2,000	
Total Revenue		165,000
LESS OTHER OPERATING EXPENSES		
Selling & Distribution expense		
Advertising	5,000	
Public Relations	2,000	
Website marketing	7,500	
General and Administrative expenses		
Depreciation	10,000	
Electricity	1,500	
Insurance	1,000	
Rent expense	30,000	
Wages & salaries	46,500	
Financial expenses		
Bad debts	1,500	
Total expenses		105,000
NET PROFIT (EBIT)		60,000

What is it?

Tells you what your income and expenses are for the year

What does it show you?

How much profit you made for the year

Your gross profit for the year

How much your sales have increased and decreased compared to last financial year

Shows which expenses have increased and decreased compared to last financial year

How much money is left to grow the business or pay the owners

What it won't show you

Whether your business is worth more than last year

What you owe other people

How much cash came in

How much cash went out



The cash flow statement

	2016-17 Revised Budget \$'000	2017-18 Forw ard estimate \$'000	2018-19 Forw ard estimate \$'000	2019-20 Forw ard estimate \$'000	2020-21 Forw ard estimate \$'000
OPERATING ACTIVITIES					
Cash received					
Appropriations	1,410,820	1,359,553	1,383,635	1,261,634	1,280,404
Sale of goods and rendering of services	133,653	136,694	138,272	140,318	137,566
Other	133,556	135,203	77,713	150,891	137,625
Total cash received	1,678,029	1,631,450	1,579,620	1,552,843	1,535,595
Cash used					
Employees	760,846	743,847	741,296	727,254	732,188
Suppliers	742,034	691,089	698,216	612,950	607,105
Other	41,593	276,469	55,195	61,748	58,677
Total cash used	1,544,473	1,711,405	1,494,707	1,401,952	1,397,970
Net cash from/(used by) operating activities	133,556	(79,955)	84,913	150,891	137,625
INVESTING ACTIVITIES					
Cash received					
Proceeds from sales of land, buildings, property, plant and equipment	-	215,158	-	-	-
Total cash received	-	215,158	-	-	-
Cash used					
Purchase and development of land, buildings, property, plant, equipment and intangibles	346,587	266,001	172,299	228,265	213,751
Total cash used	346,587	266,001	172,299	228,265	213,751
Net cash from/(used by) investing activities	(346,587)	(50,843)	(172,299)	(228,265)	(213,751)
FINANCING ACTIVITIES					
Cash received					
Contributed equity	213,031	130,798	94,586	77,374	76,126
Total cash received	213,031	130,798	94,586	77,374	76,126
Cash used					
Returns of equity	-	-	7,200	-	-
Total cash used	-	-	7,200	-	-
Net cash used by financing activities	213,031	130,798	87,386	77,374	76,126
Net increase/decrease in cash held	-	-	-	-	-
Cash and cash equivalents at the beginning of the reporting period					
	57,295	57,295	57,295	57,295	57,295
Effect of exchange rate movements on cash and cash equivalents at the beginning of the reporting period					
	-	-	-	-	-
Cash and cash equivalents at the end of the reporting period					
	57,295	57,295	57,295	57,295	57,295

What is it?

Tells you whether you ended up with more or less cash in the business during the year

What does it show you?

Where cash has come from – sales, investment, loans or equity

Where cash has gone – expenses, assets, debt or dividends

Whether the business has enough money to pay debts or cover daily running costs

What it won't show you

What assets you own

What debts you owe

Your overall financial position



“Ok...got it!
So how do I use these numbers?”

Ratios



Using ratios to help your business

Using a ratio sounds a bit complicated but these simple maths equations can help you understand and manage your business operation.

Not surprisingly, when the bank or an investor is looking at your business, they will use these ratios to determine how you are going.





Liquidity ratios

These ratios tell you how your business is at turning sales into cash

<p>Working capital ratio</p> <p><i>This tells you if the business has enough cash to pay its bills</i></p> <p> If the answer is positive then you have enough to pay your bills. If it is negative you may have an issue with cash flow</p>	<p style="text-align: center;">EQUATION</p> <p style="text-align: center;">current assets = current liabilities</p>
<p>Current ratio</p> <p><i>This ratio tests your ability to pay short-term debt</i></p> <p> The higher the number the better, but should be at least 1</p> <p><small>* Very important ratio for the building and construction industry in particular relating to QBCC reporting requirements.</small></p>	<p style="text-align: center;">EQUATION</p> <p style="text-align: center;">current assets / current liabilities =</p>
<p>Quick ratio</p> <p><i>This ratio focuses on cash assets and your ability to pay by taking inventory out of the equation (this is because inventory might be obsolete or have less value than cost)</i></p> <p> A good answer is 1 or higher. Too low means trouble, but too high might mean you have too much cash on hand</p>	<p style="text-align: center;">EQUATION</p> <p style="text-align: center;">current assets - inventory / current liabilities =</p>



Asset management ratios

These ratios tell you how effectively you are managing your assets

Accounts receivable turnover ratio

This tells you how many days it takes to collect money owed to you

EQUATION

$$\text{accounts receivable} \times 365 / \text{net sales figure} =$$

Inventory turnover ratio

This ratio tells you how many days it takes to sell your inventory

EQUATION

$$\text{inventory} \times 365 / \text{cost of goods sold (COGS)} =$$



Debt management ratios

These ratios tell you who has given the company the most money – the owners or the bankers!

<p>Leverage ratio <i>This determines the level of debt to equity in a company</i></p>	<p>EQUATION</p> <p>total liabilities / total equity =</p>
<p>Accounts payable turnover ratio <i>This tells you how quickly the business pays its suppliers</i></p> <p> The lower the number the better, however a low number might mean you pay!</p>	<p>EQUATION</p> <p>accounts payable X 365 / purchases =</p>



Profitability ratios

These ratios tell you what the business's ability is to make a profit

Profit margin on sales ratio

This tells you the net profit % for each dollar of sales



The higher the number the better, but if the margin is too low then either your prices are too low, the cost of goods is too high, or the expenses are too high

EQUATION

$$\text{net profit} / \text{net sales} =$$

Cash flow to debt service ratio

This tells you the ability the company has to pay long term debts after dividends



An answer of 2 or more is good

EQUATION

$$\text{net profit} + \text{depreciation expense} / \text{current portion of long term debt (payable in 12 months)} =$$



Let's try this
stuff out,
huh!



Case study



ACME Industries profit & loss statement

Gross Sales	1,000,000
Less: Cost of Goods Sold	
Opening Stock	200,000
Purchases	407,000
Closing Stock	(210,000)
	397,000
Gross Profit	603,000
Operating Expenses	
Bank Fees	2,000
Depreciation	10,000
Electricity	6,000
Insurance	5,000
Interest	10,000

Motor Vehicles	20,000
Printing & Stationery	4,000
Repairs & Maintenance	10,000
Salary & Wages	450,000
Superannuation	28,500
Total Expenses	545,500
Net Profit	57,500



ACME Industries balance sheet

Assets	
Current Assets	
Cash at Bank	15,000
Accounts Receivable	80,000
Stock on Hand	210,000
Total Current Assets	305,000
Non-Current Assets	
Plant & Equipment	140,000
Less: Accumulated Depreciation	(25,000)
Total Non-Current Assets	115,000
Total Assets	420,000
Liabilities	
Current Liabilities	
Accounts Payable	100,000
GST Payable	2,000

Income Tax Payable	4,000
Current Portion of Bank Loan	14,500
Total Current Liabilities	120,500
Non-Current Liabilities	
Bank Loan	85,500
Total Non-Current Liabilities	85,500
Total Liabilities	206,000
Net Assets	214,000
Equity	
Share Capital	10,000
Retained Earnings	204,000
Total Equity	214,000





So what do the financial statements tell us about ACME Industries' liquidity?

Working capital ratio

This figure shows the excess amount of assets after paying the bills.

Looking good!

EQUATION

$$\$305,000 - \$120,500 = \$184,500$$

Current ratio

This figure supports the above showing the current assets are 2.5 x current liabilities

EQUATION

$$\$305,000 / \$120,500 = 2.53$$

Quick ratio



Yellow flag – score below 1!

Although there are plenty of current assets, most of it is inventory. This not necessarily a bad thing, but it's something to watch. Any drop in the value of inventory may leave you short of cash for bills. You can't pay your bills with inventory so you need to turn it into cash.

EQUATION

$$\$305,000 - \$210,000 / 120,500 = .788$$



The financial statements are telling us that things are generally going well with cash, but you need to be careful that your stock values are maintaining their original cost. This will need to be monitored.



What do the financial statements tell us about ACME Industries' asset management?

Accounts receivable turnover ratio

Each sale takes 29.2 days to get the cash collected

EQUATION

$$80,000 \times 365 / 1,000,000 = 29.2$$

Inventory turnover ratio



Red flag

This shows that inventory is turning over less than twice per year.

Why does it matter?

The longer you hold inventory the greater the risk it will decrease in value.

As inventory is already highlighted as a risk in the **quick ratio**, this needs to be addressed before it gets out of hand and becomes a cash flow issue.

Ideally inventory should turn over 5-6 times per year - so we need to decrease that number!

EQUATION

$$210,000 \times 365 / 397,000 = 193 \text{ days}$$



The financial statements are telling us that inventory is not moving quickly enough.



What do the financial statements tell us about ACME Industries' debt management?

Leverage ratio



This tells us that the business is not overly reliant on debt.

A figure of 3 or lower is good!

EQUATION

$$206,000 / 214,000 = 0.96$$

Accounts payable turnover ratio



Yellow flag – almost 90 days to pay

This tells us that the business is taking 89.68 days to pay its suppliers.

This may simply be a case of having good credit terms.

However, given that inventory turnover has already been highlighted as a problem this may be a related issue of tying up capital in inventory which can't be sold before suppliers are due to be paid.

EQUATION

$$100,000 \times 365 / 407,000 = 89.68 \text{ days}$$



The financial statements tell us that the inventory problem may be spreading to other areas. Now we have identified the problem we can get things back on track!



What do the financial statements tell us about ACME Industries' profitability?

Profit margin on sales ratio

This tells us that the business has a 5.75% net profit margin or in other words makes 5.75 cents profit for each dollar of sales.

This is a reasonable percentage for a business of this size.

EQUATION

$$57,500 / 1,000,000 = .0575$$

Cash flow to debt service ratio



Looking good!

This shows that for every \$1 of loan payments there is \$4 to pay it with.

An answer of 2 or higher is good.

EQUATION

$$57,500 + 10,000 / 14,500 = 4.6$$



The financial statements tell us that profitability of the business is good. Now once we get that inventory issue sorted we should be in good shape!



See!

We told you that
financial statements
can help a lot!



How can Walsh Accountants help you?



When it comes to your business growth and improvement, **we share your drive, persistence and passion.**

Our specialised [team](#) understand the significant commitment made by business owners and entrepreneurs because we are in the business of business.



our team is here to help you
unleash your potential



*Let us share our experience
and passion with you!*

ENQUIRE NOW

WALSH

Contact us



ADDRESS

Unit 10, The Pegasus Centre, 42 Bundall Road, Bundall 4217



EMAIL

info@walshaccountants.com



PHONE

07 5592 3644



WEBSITE

walshaccountants.com



DISCLAIMER

This guide is only intended to be general in nature and the appropriateness will be dependent on each individual's circumstances.

This information is provided as an information service only and, therefore, does not constitute financial product advice and should not be relied upon as financial product advice. None of the information provided takes into account your personal objectives, financial situation or needs. You must determine whether the information is appropriate in terms of your particular circumstances. For financial product advice that takes account of your particular objectives, financial situation or needs, you should consider seeking financial advice from an Australian Financial Services licensee before making a financial decision.

The advice provided is not 'financial product advice' as defined by the Corporations Act. We are not licensed to provide financial product advice and taxation is only one of the matters that you need to consider when making a decision on a financial product. You should consider seeking advice from an Australian Financial Services licensee before making any decisions in relation to a financial product.

