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Interpretation of Financial Statements

Financial Advice NEW ZEALAND

Presentation by

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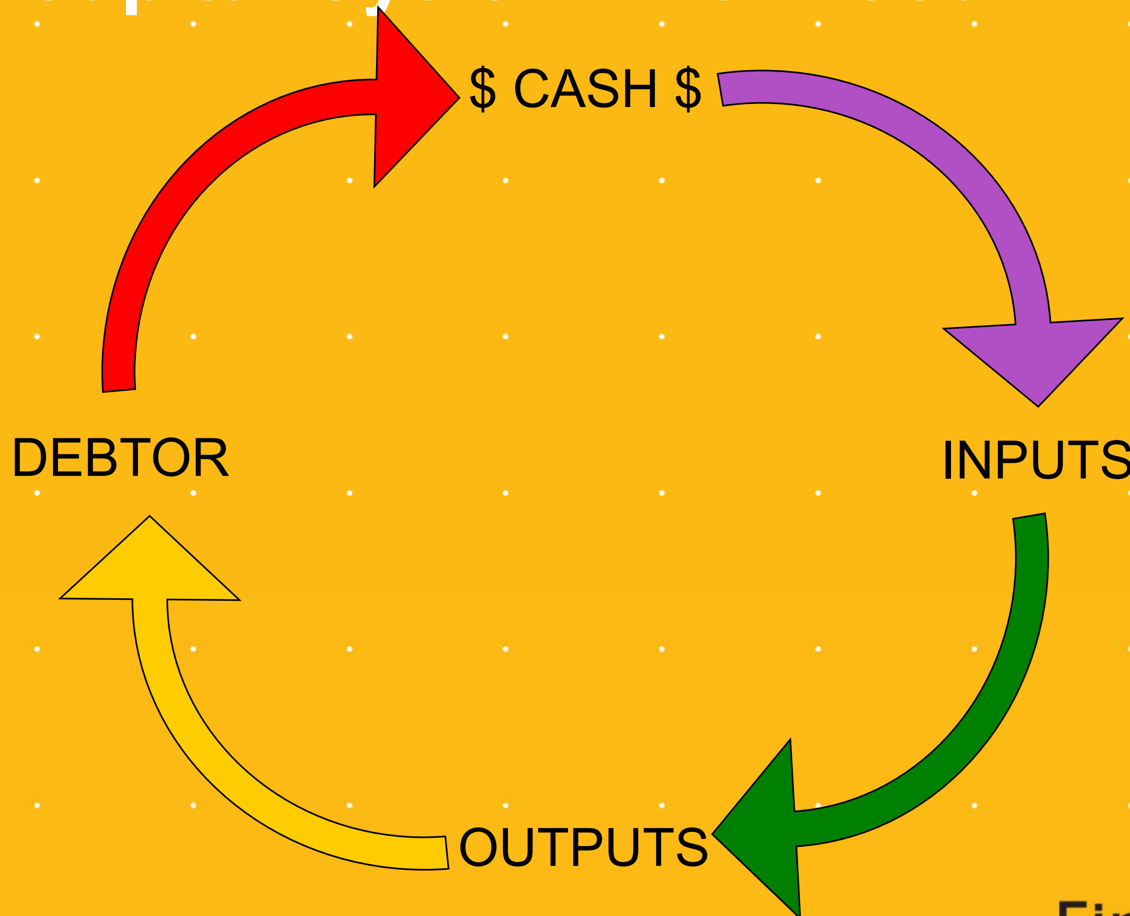
Working Capital Cycle – Life Blood



Financial Operating Cycle – Balance Sheet

$$A = L + E$$

Financial Operating Cycle – Income & Expenses

A = L + E

↓

I

-

E

S

Financial Operating Cycle - Full

A = L + E

(Assets) (Liabilities) (Equity)

Invest

Repay

Distribution

I (Income)

- (Minus)

E (Expenses) =

S (Net Surplus)

Statement of Financial Performance

Previously known as the Profit and Loss Account or P & L for short

This statement is divided into 2 parts, income and expenditure.

- **Income** - this is where it draws its revenue streams from.
  How reliant is it on these sources ?
  How reliable is this source ?

- **Expenditure** - these are the costs incurred in the business, most reflect actual cash payments made. The exception is depreciation, which is the progressive write down in value of a fixed asset over its economic life.

- The result, of income minus expenditure is either a **surplus** (profit) or a **deficit** (loss). - This indicates if the organisation is able to cover its costs from its income ? If not, why not ?

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Statement of Financial Performance

- **Timing** - it is important that income and expenditure is recognised in a timely manner to match costs/revenues as the events (they relate to) occur. **Accruals** are used to assist this process.

- **Budgets** - the results for a given period are compared with the budget to see if the business is performing better or worse than expected. As the year progresses a **forecast** of the year end outturn should be prepared, and updated, to give a more accurate view (than the original budget) of what the likely year end result will be.

- **Activities** - A second view of the statement of financial performance can prepared showing the expenditure from an Activity viewpoint. An **output** view, which is typically used for **PBE** public benefit entities for external reporting.

Statement of Financial Position

Previously known as the Balance Sheet

This statement is also divided into 2 parts, **assets and liabilities**.

- **Assets** - this is further divided into 2 parts; current assets and non-current assets.

  Current assets are those items that are realisable (able/expected to be turned into cash in the next 12 months). It typically includes the bank account, debtors (or Accounts Receivable), stock (or inventory), prepayments (for an item paid, which has value over a term longer than a month, such as an insurance premium) and short-term investments.

  Non-current assets are those items that have a longer term value to the business, the major category being fixed assets. This includes equipment, computers, buildings, vehicles etc. at book value. Book value is the cost less accumulated depreciation to date on those assets.

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Statement of Financial Position

- **Liabilities** - this covers things the business "owes" to other parties, including its owners. It is subdivided into 3 parts; current liabilities, term liabilities and shareholder loans.

  Current Liabilities include all liabilities that need to be met/able to be met (paid) within the next 12 months. It typically includes, Creditors (or Accounts Payable), Accruals, staff leave provisions, and short term loans (those payable in the next 12 months).

  Term Liabilities includes all liabilities that are not due in the next 12 months, usually long term loans.

  Equity represents the Owner's interest in the business. For a PBE, this is the Taxpayers' or Members' Funds; for a limited liability company, it is Shareholders' Funds, for a partnership or limited partnership, it is Partners' Funds .

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Statement of Cash Flows

This statement is also divided into 3 parts, operating, investing and financing activities.

- **Operating activities** - this covers the day to day aspects of a business. If there is not a surplus here, it indicates that the business is unable to fund its day to day activities from the cash flows involved. This means it has to either borrow or dig into its reserves to do this – not a good sign for long term survival.

- **Financing activities** - this covers funding from lenders and shareholders in setting up the equity and debt capital structure of the business.

- **Investing activities** - this covers the acqusition, holding and disposal of fixed assets, capital items and other investments.

Depreciation – What is it?

- Non cash expense
- Systematic recording of diminution in value of fixed assets
- Allocation of the cost of fixed asset over its useful life
- Records usage of the fixed asset over its useful life

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Depreciation – What it is not

- It is not a cash expense
- It is not repairs and maintenance of fixed assets
- It does not involve a movement of funds
- It does not provide for the replacement of fixed assets
- It is not the setting aside of cash to purchase new assets

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Cost to be Depreciated

- Cost to be depreciated is the purchase price plus commissioning costs less expected resale value at end of economic life.

	$
Purchase price	= 9,000
Installation & freight	= 2,000
Expected resale value	= (1,000)
Cost to be depreciated	= 10,000

- [Depreciable Base]

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Depreciation Methods

Straight Line	Depreciable base / economic life - gives same expense each year
Diminishing Value	Depreciable base less Accumulated depreciation * fixed % - expense decreases each year

Accrual Accounting

- A business is required to produce monthly financial statements on an accruals basis
- It is a means for matching revenue with the associated costs/expenses incurred in that same period
- It is important that all costs/expenses incurred during a month are recorded in the correct month
- Otherwise cost of outputs produced in a particular month will be understated.
- That would not only indicate poor financial management, but also make budgeting expenditure flows for the rest of the year very difficult

Accrual Accounting

- Where the work is done, or goods received, and paid for in the same calendar month there is no problem in matching revenue and expenditure:
- Where the work is done, or goods are received, and invoiced (i.e. a supplier invoice is received) in the same calendar month, the invoice can be entered into the accounts payable system.

  This means that, although they will not be paid until the following month, the expenses have been recognised by the accounting system as work related to work done/revenue received in the previous month:

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Accrual Accounting

- Here the work is done/produced and delivered, but:
  - An invoice is not received that month
  - The work is ongoing, and the provider/supplier will only be paid at the end of the job, or it is a payment made by instalments;
  - The exact cost is not known and may be influenced by other variables, e.g. an overseas purchase where it is not certain what exchange rate will apply until the invoice arrives, or an invoice is in dispute;

Then an **accrual** should be made using an estimate based on the best information available at the time of making that accrual.

Ratio Analysis

- Liquidity and Working Capital
- Managerial Efficiency
- Capital Structure
- Profitability

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Liquidity and Working Capital Ratios

- Ability of entity to pay bills as they become due
- How liquid is the entity?
- Current ratio:
  - Current Assets divided by Current Liabilities
- Liquid Ratio:
  - Current Assets less Stock, divided by, Current Liabilities less Bank Overdraft
  - Also known as the “quick ratio”, or “acid test”

Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Measures current assets available to meet current commitments.

It shows for every $ of current liabilities, how many $ of current assets the business has?

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Liquidity Ratio

<u>Current Assets – Inventory</u>
Current Liabilities - Bank Overdraft

Also known as the “Quick Ratio” or “Acid Test”

Managerial Efficiency Ratios

- These ratios are normally expressed in turnover or total assets
- Measures how well the business manages its scarce resources
- Measures operating efficiency
  - Sales Divided by Net Assets,
  - Return on Total Assets,
  - Accounts Receivable Days,
  - Accounts Payable Days and
  - Age of Inventory

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Sales to Net Assets

$$\frac{\text{Sales}}{\text{Net Assets}}$$

Measures how well the business manages its scarce resources

Asset Turnover

$$\frac{\text{Sales}}{\text{Total Assets}}$$

- Similar to previous ratio
- Measures how well the business manages its scarce resources
- Identifies material idle assets

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Accounts Receivable Days

$$\frac{\text{Average Accounts Receivable}}{\text{Credit Sales/360}}$$

Measures the average collection period for receivables as a basis for assessing operational performance against trade terms.

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Accounts Payable Days

Average Accounts Payable

Cost of Sales/360

Measures how quickly payables are settled as a basis for assessing ability to pay trade terms.

May also serve as an operational performance indicator highlighting overzealous or overworked accounts payable staff

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Inventory Days

$$\frac{\text{Average Inventory}}{\text{Cost of Sales/360}}$$

A financial and operational performance indicator which measures how frequently stock is turned over to provide indication of stock levels

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Return on Total Assets

Profit Before Interest & Tax

Average Tangible Assets

Measures operating efficiency and hence management performance in utilising assets available to it

Capital Structure Ratios

- Measures relative proportions of debt and equity funds of a business
  - Debt to Equity
  - Gearing Ratio
- Other capital structure measures
  - Sustainable Growth
  - Working Capital per $1 of Sales
  - Net Tangible Asset %
  - Current Liabilities & Debt

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Debt to Equity Ratio

$$\frac{\text{Debt}}{\text{Equity}}$$

Measures amount of debt per $1 of equity

Gearing Ratio

$$\frac{\text{Debt}}{\text{Debt + Equity}}$$

Measures level of gearing of business

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Sustainable Growth

$$\frac{\text{Retained Income}}{\text{Opening Equity}}$$

Definition: The maximum amount by which the business can increase its sales and investment in total assets, without changing the way business operates, and without changing debt to equity ratio.

2 ways to grow at a sustainable level:

- By increasing sales without increasing expenses
- By increasing sales without employing more working capital

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Working Capital Per $1 of Sales

$$\frac{\text{Working Capital}}{\text{Sales}}$$

Measures amount of working capital to generate $1 of sales

Net Tangible Asset %

$$\frac{\text{NTA}}{\text{TTA}}$$

NTA = Net Tangible Assets

TTA = Total Tangible Assets

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Current Liabilities & Debt

<u>Net IBD</u>

NTA

Net Borrowings (IBD) = Current liabilities + Financial Debt + Inter-Group Debt - Cash at Bank

NTA = Net Tangible Assets

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Profitability Ratios

- Lastly, but most important of all ratios which measure profitability
- These ratios include <u>return</u> on assets, on equity funds, on sales and many possible variations
- While all of these ratios are acceptable, it is important to supplement them with the ratio which removes influence of existing financial structure on profitability: EBITDA as return on total assets

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EBITDA Return as % of Total Assets

$$\frac{\text{Profit before interest, tax, depreciation and amortisation}}{\text{Average Tangible Assets}}$$

- EBITDA = Profit before interest, tax, depreciation and amortisation
- Excludes intangibles

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Questions

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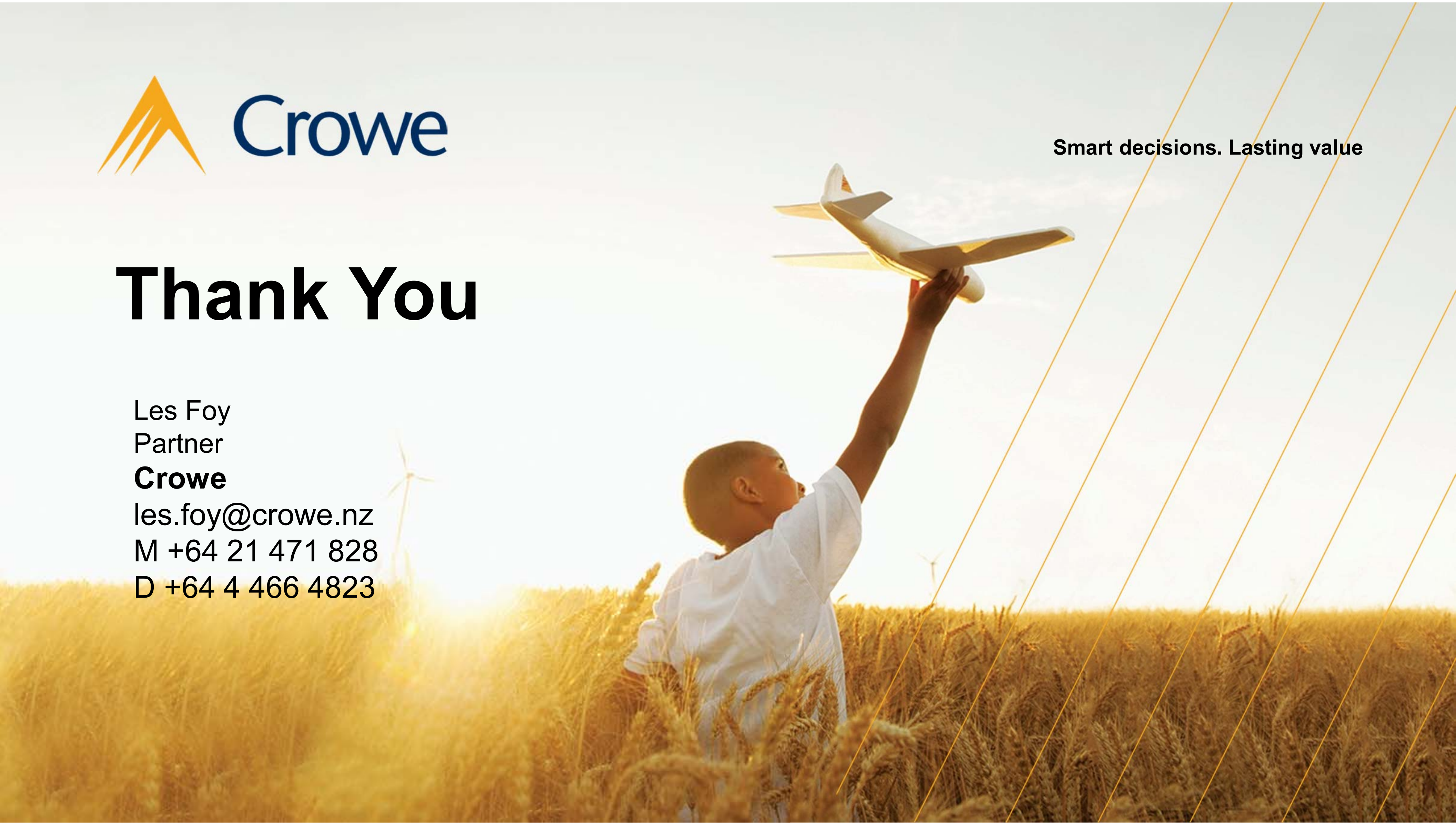

Thank You

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