FINANCIAL STATEMENTS GUIDE

Republic Bank

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Introduction

Understanding how to interpret financial statements is essential to knowing how well your business is performing.

However, many people who start a business (and quite a few seasoned entrepreneurs) do not take this aspect of business seriously enough – which can lead to costly mistakes, which could have been anticipated and avoided by preparing and reviewing their financial statements.

This guide will teach you how to read, interpret and prepare financial statements.

Financial statements provide owners and other stakeholders (e.g. banks, business partners, suppliers, potential investors etc.) with information to understand and evaluate a business' performance.

To put it simply, financial statements show how income earned has moved through the business, i.e. where the income earned came from, how it was used, and where it is now.

The three core financial statements are:

- Income Statement (also called Profit and Loss, or P&L)
- Balance Sheet
- Cash Flow Statement

The Income Statement shows how much revenue a business earned and spent over a period.

The Balance Sheet shows what a business owns (its assets) and how those assets were funded by equity and liabilities at a fixed point in time.

The Cash Flow Statement shows, quite literally, the flow of money between a business and the outside world over the same period as the Income Statement.

Together, these financial statements create a comprehensive picture of the overall financial health of a business.

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Income Statement Guide

Income Statement (also called a profit and loss statement) is one of business' core financial statements that shows their profit and loss over a period of time. [1]

Income Statement

Time: Over period of time

Shows: Profitability

Measures:

Revenues

Expenses

Profit or Loss

Purpose:

An income statement displays the amount of revenue generated by a business, together with the expenses incurred to generate those revenues.

Through this statement you would be able to understand how much the business earned and whether a profit, loss or break-even was made.

How constructed:

The income statement includes:

1) the business' revenue/ sales earned,

2) the cost of goods or services sold, (i.e. what it cost to specfically supply/manufacture those goods or services)

3) gross profit (a subtotal: revenue minus cost of sales),

4) operating expenses (other general expenses to run the business e.g. distribution costs, personnel salaries, administrative expenses such as telecommunication, rent, etc.

5) operating profit (another subtotal: gross profit minus operating expenses; also called "profit/earnings before interest and tax" (PBIT/EBIT)),

6) finance costs (interest on loans, overdraft and other credit facilities)

7) profit before tax (i.e. operating profit minus finance costs)

8) taxes (e.g. corporation tax, business levy, green fund etc)

9) net profit or loss after tax for the period (another subtotal profit before tax minus taxes) shown at the very end of the i ncome statement, hence its informal name: **"the bottom line"**).

N.B There might be some other lines and subtotals, but these are the most common for small and medium-sized businesses.

Revenue

Revenue is also called **"the top line" or sales**– it is the first and usually the largest line of the income statement. Revenue is the total amount of income earned from the sales of products or services (i.e. the value of invoices issued, which is **NOT** the same as cash received. E.g. when you raise an invoice for a job/ customer, this records that work has been done, but not that cash has been received. Note that not all sales will be paid for immediately.

Note: *Revenue – it is not cash, it is a record of income earned. Note that a business could be profitable (i.e. on paper revenue can be more than its expenses), but not have actual cash in the bank if not collecting what is owned from clients.*

Cost of Sales/ Cost of Goods Sold

The next line after revenue is the Costs of Sales. This represents the cost to produce /buy the goods or render the services sold.

This amount is the cost directly associated with manufacturing products (e.g. materials and contract labour, packaging etc) and/ or procuring services e.g. venue hire specifically for an event.

It can also be the cost of the goods you bought for resale.

Cost of sales is typically a variable cost, meaning that it will fluctuate based on the volume of sales. Increased sales lead to increased cost of sales, decrease in sales leads to a decrease in sales.

Operating Expenses

Operating costs are the expenses incurred to run the business e.g. office rent, salaries, advertising, warehousing, telephone etc. Unlike the cost of sales, operating expenses cannot be linked directly to the production of goods or rendering the services being sold.

Operating expenses also include depreciation. Depreciation reflects the wear and tear of assets (such as machinery, vehicles, office equipment, and furniture) over time. In essence, depreciation spreads the cost of such assets over the defined useful life (i.e. time they are used). E.g. a piece of equipment costs $20,000 and its useful life is 5 years.The depreciation would be $4,000 ($20,000 divided by 5 years) and this expense would be allocated to the income statement each year for 5 years, to account for the wear and tear of that asset). Work with your accountant for this area of your income statement.

Finance Costs

The main part of finance costs for most businesses is their intrest expense i.e. the amount of income they allocate towards the funds they borrow, usually from banks. (Businesses may also earn interest income e.g. from money deposited to a savings account).

Taxes

This includes corporation tax and other taxes (e.g. business levy, green fund etc.)

Net Profit After Tax

The resulting (net) profit or loss for the period is calculated by addng the revenue / income earned and deducting all the expenses incurred. It tells you how much income the business earned or lost during the period.

While gross profit is used to assess how profitable a business is in selling its products/services, operating profit tells us how efficient the management is in controlling both production and operating costs of the business.

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[1] Definition from Corporate Finance Institute: https://corporatefinanceinstitute.com/resources/knowledge/accounting/income-statement/

How to Read an Income Statement

INCOME STATEMENT
For the year ended 31 December 20XX

	Current Year **20XX**	Previous Year **20XX-1**
Reveneue	**150,772**	**142,341**
Cost of sales	57,310	53,254
Gross Profit	**93,462**	**89,087**
Operating Expenses		
Marketing expenses	25,245	23,002
General expenses	11,412	11,020
Depreciation & Amortization	16,080	16,544
Operating Profit	**40,725**	**38,522**
Finance costs	900	900
Profit Before Tax	**39,825**	**37,622**
Taxes	11,598	10,908
Net Profit After Tax	**28,227**	**26,713**

Revenue
Net revenue after returns and discounts.

Operating Profit (or Loss)
Shows how the business performed

Net Profit
Profit left after all expenses have been paid

Income Statements are usually shown against the previous year to show

- Revenue: If your sales are growing
- Gross Profit: Whether you made an increased profit or loss on producing and selling your products or services
- Expenses: How your expenses have changed from last year.
- Operating Profit – whether you are managing the business better
- Net Profit – If your net profit is increasing or decreasing

You cannot tell whether the financial performance is improving by only observing one year. Financial performance is more meaningful when you compare the current year with the previous year .

You can compare the year-on-year revenue growth rate. If the revenue grows slower than expenses (i.e. revenues falling and costs rising), it means profit would most likely slowdown or even shrink if no action is taken to address this.

PROFITABILITY

Profitability shows the business' ability to make a profit. The higher the number, the better.

If the profit is too low, it could be due to one (or the combination) of the following:

1) the selling prices are too low
2) the volumes sold are too low
3) the costs of production are too high
4) other expenses are too high

PROFITABILITY RATIOS CALCULATIONS

- ***Gross Profit Margin =*** gross profit divided by revenue.
- ***Operating Profit Margin*** = operating profit (Earnings Before Interest and Taxes) EBIT) divided by revenue.
- ***Net Profit Margin*** = net profit after tax divided by revenue. A business can have a high gross profit margin, high operating profit margin but make a net loss. This happens when a business borrows a lot and the net result is highly driven by debt.

Balance Sheet Guide

> **Balance Sheet**
>
> Time: A point of time (the end of the period, or "the balance sheet date")
>
> Shows: Financial position
>
> Measures:
>
> Assets
> Liabilities
> Equity

The balance sheet shown the net worth of a business.

The balance sheet displays the business' total assets (what it owns), and how these assets are financed, through either debt and/ or equity. [2]

Purpose:

A balance sheet provides a snapshot of a business' financial standing at the end of the reporting period. i.e. their assets, liabilities, and equity. Unlike the income statment and cash flow statement, it does not show the transactions and flows over a period of time.

The Balance Sheet only represents the position on the day the balances were noted.

A balance sheet can also be used to determine a business's liquidity (i.e. how easy it is to convert to cash) and evaluate its capital structure.

How constructed:

The following formula summarises how a balance sheet works:

Assets = Liabilities + Equity

At any point in time the business' assets must equal, or "balance," with the sum of its liabilities and equity.

The Balance Sheet is usually displayed with both the current and prior year. By looking at both years you can see changes in assets, liabilities, and shareholders' equity .

Assets

Assets are different kinds of resources that a business owns and that have business value. As assets have value, they can also be sold, exchanged, or used by the business to make products or render service, if the need arises.

Assets are:

- tangible (e.g. buildings, equipment, vehicles, inventory)
- intangible (i.e. things that cannot be touched, but still exist and have value, such as patents and trademarks),
- financial cash in the bank and accounts receivables (i.e. money owed to the business for goods and services sold)

In the balance sheet, assets are usually grouped based on their liquidity i.e. how quickly they will be converted into cash.

Non-current Assets are usually held for more than one year. Non-current assets include so-called "fixed" assets. Fixed assets are used to operate the business for more than one year (examples include delivery trucks, production lines, buildings, and office furniture). Non-current assets take longer to liquidate than current assets.

Current Assets are usually converted to cash within one year. A good example is accounts receivables (money that clients owe you, that have not yet been collected). Most businesses expect to get cash from their customers well within one year of the sale, preferably within 30 days . Current assets include cash, accounts receivables and inventory.

Liabilities

A liability is money that a business owes to another entity. Liabilities include different kinds of obligations, such as money owed to suppliers of raw materials, rent payable for use of an office building, salaries owed to its employees, bank loans, or taxes owed to the state. Liabilities can also include advance payments from customers for good and services not yet delivered.

In the balance sheet, liabilities are usually grouped:

- **Non-current liabilities** are obligations whose due dates are greater than one year.
- **Current liabilities** are obligations a business must settle within one year from the balance sheet date.

Equity

Equity = Share Capital plus Retained Earnings

Equity can also be calculated as Assets minus Liabilities (i.e. what you own minus your debts)

- **Share Capital** is the amount owners invested in the business
- **Retained Earnings** is the business' cumulative earnings or losses, less dividends paid (businesses can take earnings out of the business in the form of dividends, instead of retaining them)

Equity is also called "capital", "net worth", or "net as sets".

[1] Definition from Corporate Finance Institute:
https://corporatefinanceinstitute.com/resources/knowledge/accounting/income-statement/

How to Read a Balance Sheet

BALANCE SHEET		
As at 31 December 20XX	Current Year	Previous Year
	20XX	**20XX-1**
ASSSETS		
Non-current Assets		
Property, plant and equipment	37,521	38,602
Total Non-Current Assets	**37,521**	**38,602**
Current Assets		
Cash	239,550	211,069
Accounts Receivable	7,539	7,117
Inventory	11,342	10,531
Total Current Assets	**258,430**	**228,717**
Total Assets	**295,951**	**267,319**
LIABILITIES		
Non-current Liabilities		
Borrowings	30,000	30,000
Total Non-current Liabilities	**30,000**	**30,000**
Current liabilities		
Accounts Payable	5,671	5,265
Total Current Liabilities	**5,671**	**5,265**
Total Liabilities	**35,671**	**35,265**
EQUITY		
Share Capital	170,000	170,000
Retained Earnings	90,280	62,053
Total Equity	**260,280**	**232,053**
Total Equity and Liabilities	**295,951**	**267,319**

Non-Current Assets
Takes more than one year to turn into cash

Cash
Cash or assets can be converted into cash immediately. Include cash in bank accounts and marketable securities with maturity of less than 90 days.

Accounts Receivable
Sales made but cash not yet received

Non-current borrowings
Loan balance due more than one year away

Accounts Payable
Purchases not yet paid for

Retained Earnings
Amount of net income left in the business from the business's profits, accumulated over the life of the business. A business generates earnings that can be positive (profits) or negative (losses).

WHAT IT SHOWS YOU

- The net value of the business (note: businesses may be bought and sold for a multiple of their net value)
- Changes in key categories of assets, liabilities, and equity e.g. cash, accounts receivables and account payable, inventory, loans, and borrowings
- Liquidity position e.g. how much of your current loan/ debt and other current obligations can be covered by current assets

LIQUIDITY RATIOS

Liquidity ratios show a business' ability to settle its current obligations. The higher the number, the better.

- ***Current Ratio*** is simple: it is current assets divided by current liabilities. It shows if a business has enough assets to pay its bills and should be higher than 1. Extra money is needed to meet the obligations if the current ratio is less than 1.
- The current ratio can be modified to get the ***Quick Ratio*** (also called the "acid test"). To better measure the business' liquidity, inventory is excluded from the numerator (as they are usually the least liquid among the current assets). The Quick Ratio is current assets minus inventory divided by current liabilities.
- ***Cash Ratio*** is the most conservative liquidity metric. It is like testing the worst -case scenario. Cash ratio is evaluating whether the business would survive if it were to settle all the short-term liabilities the next day and is calculated as follows: cash divided by current liabilities.

ASSET MANAGEMENT RATIOS

Asset management ratios show how effective the business is in managing its assets.

- ***Inventory turnover*** (or "days cash is tied up in inventory") is calculated by inventory divided by cost of sales and then multiplied by the number of days in the period (e.g. 365 if you use the cost of sales for the year, 90 for the quarterly cost of sales). It estimates the average number of days it takes a business to convert and sell its inventory. Generally, the lower the better as that means the inventory is moving fast.
- ***Accounts receivables turnover*** is calculated by account receivables divided by revenue and then multiplied by the number of days in the period. It shows the number of days it takes a business to collect cash from its customers. Hence, the lower the number the better, as this means the business is collecting cash quickly.

DEBT MANAGEMENT RATIOS

Debt management ratios show how effective the business is in managing its debts and capital structure.

- ***Accounts payable turnover*** is calculated by accounts payable divided by the cost of sales and then multiplied by the number of days in the period. Generally, the higher this ratio the better, as this means the business delays cash outflows and effectively makes suppliers finance its operations (as long as it is still within the agreed credit term).
- The ***debt-to-equity ratio*** is calculated by total debt/liabilities divided by total equity. Total liabilities are equal to short-term liabilities + long-term liabilities. Debt-to-equity ratio shows which portion of the business is funded by debt. The higher the debt as compared to equity, the riskier it is for the business.

WORKING CAPITAL MANAGEMENT RATIOS

- ***Working capital*** is current assets minus current liabilities (i.e. it is a sum of cash, accounts receivables, and inventory, less accounts payables).
- ***Working capital cycle, or cash cycle*** is inventory turnover plus accounts receivables turnover minus accounts payable turnover. It shows the time it takes to convert current assets and current liabilities into cash. The rule of thumb in managing efficient working capital is to convert/sell inventory and to collect cash fast and pay others slowly.

Cash Flow Statement Guide

The Cash Flow Statement reports the cash generated and spent during a specific period of time (i.e. a month, quarter, or year). [3]

While an **income statement** shows you whether a business made a profit; a statement of cash flows shows whether the business generated cash.

Note: Issues with cash collection and cash flow gaps may turn a profitable business into a bankrupt one, unable to pay its debts.

Cash Flow Statement

Time: Period of time

Shows: Cash movements

Measures:

Increase and decrease in cash in:
Operating activities
Investing activities
Financing activities

Purpose:

A cash flow statement demonstrates a business' ability to generate positive cash flows and shows where the busines s uses its cash.

How constructed:

On your cash flow statement, you will find cash flows in the following order:

(1) operating activities

(2) investing activities and

(3) financing activities.

The total cash generated from or used in each of these thre e types of activities, will indicate the overall change in cash for the period. This is then added to the opening cash balance to arrive at the closing cash balance (which is usually at the bottom of your cash flow statement).

A cash flow statement shows c hanges over a given period. It uses and reorders the information from a business's balance sheet and income statement.

Key features:

- Shows the net change in the cash balance from start to end of the period
- Shows the increases and decreases in cash
- Splits cash flows into operating, investing, and financing activities
- Expressed over a period of time (i.e., a year, a quarter, year to date, etc.) the same period as the income statement.

Operating Activities

Operating activities are the day-to-day, routine business operations of a business e.g. paying employees and suppliers, collecting cash from customers and paying taxes, etc. It is an assessment of how much cash the business generated from its core business.

[3] Definition from Corporate Finance Institute: https://corporatefinanceinstitute.com/resources/knowledge/accounting/statement-of-cash-flows/

The cash flow statement starts with the net profit figure for the period. (Remember, this is the bottom-line figure from our income statement).

As mentioned previously, profit does not mean cash, so we need to "add-back" all the non-cash items from the income statement such as depreciation. This is because it does not represent a "real" cash flow, it is an accounting concept.

Then we add or deduct the changes in the working capital. For this, we need to calculate the change in the respective balance sheet numbers for inventory, accounts receivables, and accounts payables. (See FS Interaction worksheet for more detail - page 14)

Let's understand why we are doing this. If accounts receivable decreased from the prior year, it simply means that customers have paid outstanding invoices (i.e. you have received the cash). So that represents a cash inflow.

Similarly, if inventory decreased, it means the business has used some of its inventory to make products and then sold the items (hence cash inflow).

And if payables increased, it means that the business has delayed paying suppliers. Therefore, it represents an increase in cash.

Once you sum up all the line items mentioned above, you'll get the net amount of cash generated from operations.

Now you start seeing how the changes in the balance sheet flow directly to the cash flow statement. Just think about other balance sheet items, in a similar fashion and ask yourself whether its change represents a cash inflow or a cash outflow.

Investing Activities

Investing activities show cash used to buy (or, sometimes, sell) non-current assets such as property, plant and equipment, intangible assets, or investment securities. Over time, you want to see that your business generates enough cash from operations to cover the investment in non-current assets.

If a business buys a piece of equipment, the cash flow statement would show this activity as a cash outflow from investing activities (i.e. cash was used to buy a non-current asset). If the business decides to sell the shares an asset, the proceeds from such sale would be shown as a cash inflow from investing activities.

Financing Activities

Financing activities show cash received from or paid to lenders (not including normal trade credit) and owners. Payment of dividends is an example of cash outflow from financing activities, while receiving a bank loan is a classic example of financing cash inflow.

How to Read a Cash Flow Statement

For the year ended 31 December 20XX	Current Year	Previous Year
	20XX	**20XX-1**
Operating Cash Flow		
Net Profit	28,227	26,713
Plus: Depreciation & Amortization	16,080	16,544
Less: Changes in Working Capital	827	903
Net cash from operating activities	**43,480**	**42,354**
Investing Cash Flow		
Investments in Property & Equipment	(15,000)	(15,000)
Net cash used in investing activities	**(15,000)**	**(15,000)**
Financing Cash Flow		
Issuance (repayment) of debt	-	-
Net cash from/(used in) financing ac	**-**	**-**
Net Increase (decrease) in Cash	28,480	27,354
Opening Cash Balance	211,069	183,715
Closing Cash Balance	**239,550**	**211,069**

We need add back all the non-cash items in the income statement - as these are not really cash.

Investments in Property & Equipment
Amount of cash actually paid for Property & Equipment. Is not the same as the difference between the years in the Balance Sheet , as the Balance Sheet amounts include depreciaton and purchases of assets not yet paid for

This company has a positive cash flow. *Cash inflows during a period are higher than the cash outflows. Calculated as Net Cash from operating activities minus Net cash from/used in investing and financing activities*

Opening/Closing Cash Balance
This is the cash balance on the balance sheet

WHAT IT SHOWS YOU

- If the business generates enough cash to: a) cover day -to-day operations; b) pay debts; c) maintain and grow the business through investing in non-current assets
- The maximum loan payment (interest and principal) the business can afford
- The need for additional cash when the business expands (significant capital expenditure (Capex) i.e. purchase of non -current assets; or production and sales increase, when more working capital is needed)

CASH FLOW RATIOS

- ***Cash flow to net profit ratio*** is calculated by operating cash flow divided by net profit. A ratio of 1 means that the net profit the business earned is exactly the same as the amount of cash collected. Normally, the operating cash flow should be higher than the net profit (as you add back depreciation and need to cover debt payments). The higher the ratio the better the "quality" of the business' net profit as the business is converting its earnings into cash. A low ratio indicates that the "quality" of the net profit is poor, and most of that profit could be accounting ("paper") profit rather than cash earnings.

Interaction between the 3 Core Financial Statements

FINANCIAL STATEMENTS - How they are intricately linked to each other

INCOME STATEMENT
For the year ended 31 December 20XX

	20XX	20XX-1
Reveneue	**150,772**	**142,341**
Cost of sales	57,310	53,254
Gross Profit	**93,462**	**89,087**
Operating Expenses		
Marketing expenses	25,245	23,002
Administrative expenses	11,412	11,020
Depreciation & Amortization	16,080	16,544
Operating profit	**40,725**	**38,522**
Finance costs	900	900
Profit Before Tax	**39,825**	**37,622**
Taxes	11,598	10,908
Net Profit After Tax	**28,227**	**26,713**

STATEMENT OF FINANCIAL POSITION
As at 31 December 20XX

	20XX	20XX-1
ASSSETS		
Non-current assets		
Property, plant and equipment	37,521	38,602
Current assets		
Cash	239,550	211,069
Accounts Receivable	7,539	7,117
Inventory	11,342	10,531
Total Assets	**295,951**	**267,319**
LIABILITIES		
Non-current liabilities		
Borrowings	30,000	30,000
Current liabilities		
Accounts Payable	5,671	5,265
Total Liabilities	**35,671**	**35,265**
EQUITY		
Share Capital	170,000	170,000
Retained Earnings	90,280	62,053
Total Equity	**260,280**	**232,053**
Total Equity and Liabilities	**295,951**	**267,319**

Change in Working capital
827

Change in Retained Earnings
=
Net Profit for current period
28,227

Check:		
Assets = Liabilities + Equity	*0*	*0*

STATEMENT OF CASH FLOWS
For the year ended 31 December 20XX

	20XX	20XX-1
Operating Cash Flow		
Net Profit	28,227	26,713
Plus: Depreciation & Amortization	16,080	16,544
Less: Changes in Working Capital	827	903
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Investing Cash Flow		
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Issuance (repayment) of debt	-	-
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Net Increase (decrease) in Cash	28,480	27,354
Opening Cash Balance	211,069	183,715
Closing Cash Balance	**239,550**	**211,069**

Net profit after tax (the bottom line of the income statement) links to the balance sheet and cash flow statement. On the balance sheet, it represents the change in retained earnings. And it is the starting point for the "cash from operations" section on the cash flow statement.

The balance sheet gives you an overview of a business' financial position. The cash balances from the balance sheet feed into a final section of a cash flow statement. The cash flow statement explains how the cash at the beginning of the period has turned into cash at the end of the period.

Income statement explains the change in earnings over the year. The net profit of the business is either distributed to owners/investors by way of dividend or is retained within the business and increases its equity (equity = share capital + retained earnings).

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