

Understanding your Financial Statements

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1.0 Course objectives

By the end of this workshop, you will understand:

- The contents of the Income Statement (Profit and Loss Account)
- The contents of the Balance Sheet (Statement of Financial Position)
- The contents of the Cash Flow Statement
- The jargon and terms used by finance people
- How the above financial information and terms are used to assess financial performance.

2.0 The Financial Statements

Introduction

UK companies are required to publish three financial statements:

- a) **Profit & Loss Account** -now called the **Income Statement**
- b) **Balance Sheet** – now called the **Statement of Financial Position**
- c) **Cash Flow Statement**

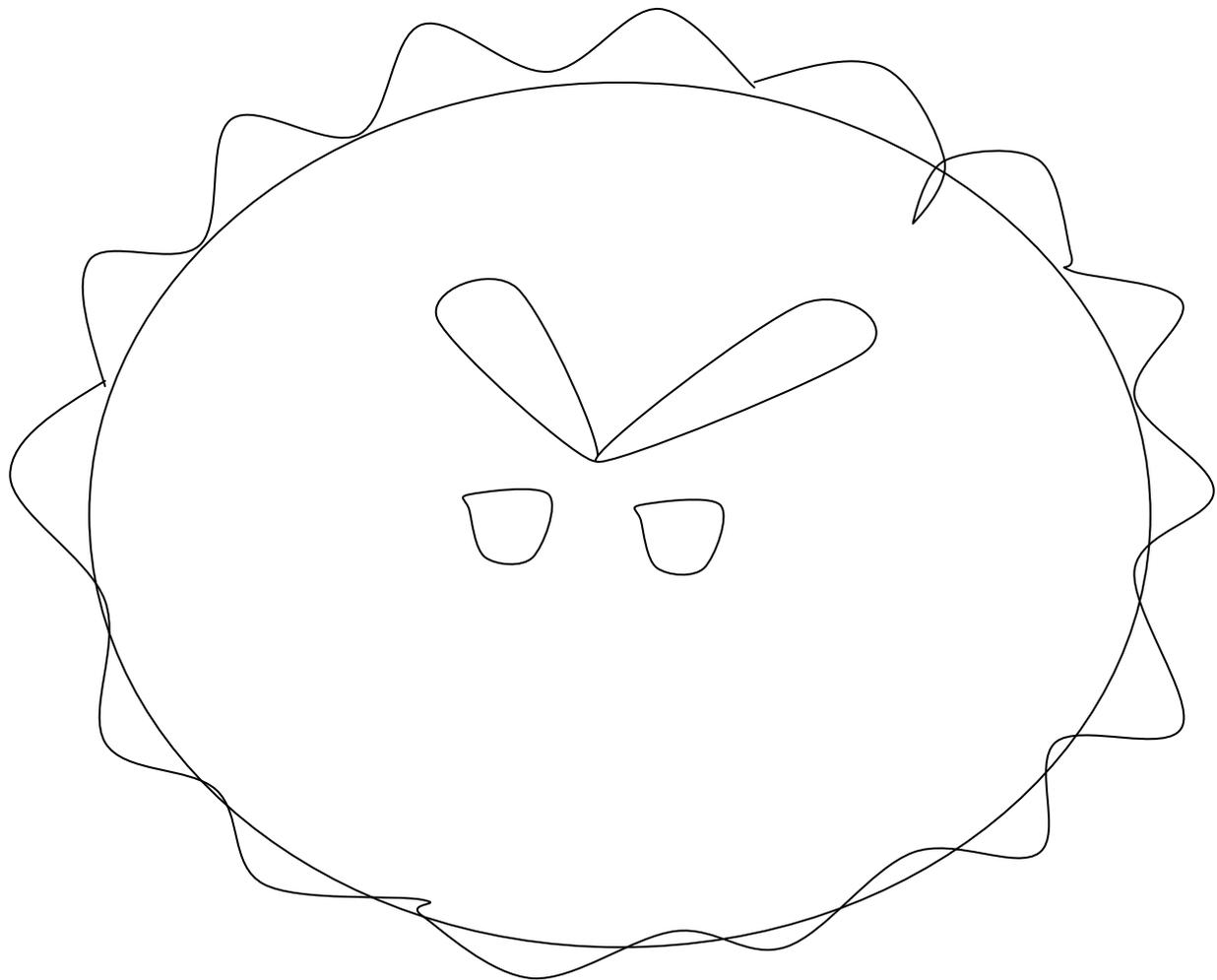
These documents are supported by notes giving further explanations.

3.1 Profit And Loss Account (Income Statement)

A Profit and Loss account records income and expenses that relate to a given period of time - typically one year. It shows all the *revenue and expenditure* that the company has incurred, rather than the *cash* it has received or spent.

The amount of expenditure charged against the profits for a period is the amount incurred for the period irrespective of whether cash has been paid or not. Similarly, all sales made during the period under review will be included in the profit and loss account even though all the cash may not have been received.

It can be compared to an 'apple pie':



There is a recognised format for the Profit and Loss account.

**PROFIT AND LOSS ACCOUNT for the year ended
30th June 2018**

| | £000 |
|--|-----------------|
| Turnover | 15,000 |
| Cost of sales | (9,000) |
| | <hr/> |
| Gross profit (or loss) | 6,000 |
| Distribution costs | (1,500) |
| Administrative expenses | (3,500) |
| | <hr/> |
| Operating profit / Profit on ordinary activities | 1,000 |
| Interest payable | (200) |
| | <hr/> |
| Profit (or loss) on ordinary activities before taxation | 800 |
| Tax on profit on ordinary activities | (210) |
| | <hr/> |
| Profit (or loss) on ordinary activities after taxation | 590 |
| Dividends | (250) |
| | <hr/> |
| Retained profit for the financial year / Net Profit | 340 |
| | <hr/> <hr/> |

Jargon Buster:

Turnover –

Cost of Sales –

Gross Profit –

Operating Profit –

Earnings –

3.2 How can we analyse what these numbers mean?

Ratio analysis – performance measures:

Profit ratios:

Gross Profit Margin = Gross Profit / Sales Turnover x 100%

Operating Profit Margin = Operating Profit / Sales Turnover x 100%

Exercise 1:

Look at the Profit and Loss Accounts of Tesco and Sainsbury.

(See handouts)

What do the numbers tell us?

| | Tesco | Sainsbury |
|--|-------|-----------|
| Gross Profit Margin | | |
| = $\frac{\text{Gross Profit}}{\text{Sales Turnover}} \times 100\%$ | | |
| Operating Profit Margin | | |
| = $\frac{\text{Operating Profit}}{\text{Sales Turnover}} \times 100\%$ | | |

4.0 Balance Sheet (Statement of Financial Position)

A balance sheet is a 'snapshot' of the company's wealth taken at one moment in time. In a set of accounts this will be at the company's **year end**.

It highlights what the **company owns** (its assets) and what it **owes** (its liabilities) on the date shown at the end of the year.



You could prepare your own **personal Balance Sheet**

Assets

| | |
|--------------------------------|-------|
| | £ |
| House | x |
| Car(s) | x |
| Shares / Premium Bonds | x |
| Bank account | x |
| Others (property in Mallorca?) | x |
| | _____ |
| Total assets | x |
| | _____ |

Hopefully this is a big number!

Liabilities

| | |
|--|---------------|
| | £ |
| Mortgage | x |
| Car loan(s) | x |
| Credit card balance (do you know what it is?!) | x |
| Other loans | x |
| Others | x |
| Total liabilities | <hr/> x <hr/> |

This is the not so welcome number!!

The net of these two values, the **Net Assets** value, is the important value.

So are you winning or losing?

There is a car sticker that says “he who has the most toys at the end of his life is the winner”. Perhaps it should read “he who has the highest net asset value is the winner”.

Doesn't have the same effect somehow does it?

4.0 Balance Sheet For A Company

Again there is a recognised format that companies use:

BALANCE SHEET as at 30th June 2018

| | £000 | £000 |
|--|---------------|---------------|
| Fixed assets | | |
| Intangible assets | | 4,000 |
| Tangible assets | | 12,000 |
| | | <u>16,000</u> |
| Current assets | | |
| Inventory | 4,000 | |
| Receivables | 6,000 | |
| Cash at bank and in hand | 1,500 | |
| | <u>11,500</u> | |
| Creditors: amounts falling due within one year | (3,500) | |
| | <u>8,000</u> | |
| Net current assets (liabilities) | | <u>8,000</u> |
| Total assets less current liabilities | | 24,000 |
| Creditors: amounts falling due after more than one year | | (6,000) |
| | | <u>18,000</u> |
| Capital and reserves / Shareholders funds | | |
| Called up share capital | | 10,000 |
| Profit and loss account | | 8,000 |
| | | <u>18,000</u> |

Jargon Buster:

Non-current Assets –

Intangible Assets –

Tangible Assets –

Depreciation –

Amortisation –

Current Assets –

Inventory –

Receivables –

Liabilities/Creditors (less than one year) –

Liabilities/Creditors (more than one year) –

Capex –

Opex –

Shareholders Funds/Equity –

5.0 Cash Flow Statement

A cash flow statement is similar to a profit and loss account in so far as both consider what has happened in the company from one balance sheet date to the next.

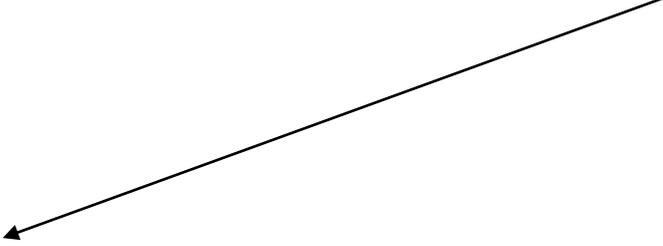
However, whereas a **profit and loss account** for the year ended 30 June 2008 shows the revenue, costs and hopefully profit generated for the year, the **cash flow statement** shows how much cash has been **received into** the company and how much cash has been **paid out** of the company during the year.

The **net cash received or paid** (difference between cash paid out and cash received in) should be the same as the change in the cash balance from last year's balance sheet to this year's balance sheet.

Once again there is a recognised format.

CASH FLOW STATEMENT for the year ended 30th June 2018

| | £000 |
|---|-------------|
| Net cash inflow from operating activities | 5,000 |
| Returns on investments and servicing of finance | (200) |
| Taxation | (205) |
| Capital expenditure | (1,500) |
| Equity dividends paid | (170) |
| Financing | 1,000 |
| | <hr/> |
| Increase / (decrease in cash) | 3,925 |
| | <hr/> <hr/> |


 Net cash paid out or received in during the year. This is a good indicator of solvency of the company especially if there has been a huge cash outflow!

Exercise 2:

Look at the Cash Flow Statement of Tesco.

(See handouts)

What do the numbers tell us?

6.0 A Jargon Buster

Profit and Loss Account Jargon Buster:

Profit and Loss Account

- The Profit and Loss Account (also called the Income Statement) records the sales revenue earned less the costs incurred in running the business for an accounting period which will usually be one year (hence the term accounting year end).

Turnover

- The sales achieved is called Sales Revenue or Turnover.

Cost of Sales

- The Cost of Sales is the cost (sometimes called the direct cost) of making the product or supplying the service to customers.

Gross Profit

- Gross Profit is calculated as Turnover less Cost of Sales and can be used to assess the efficiency of the business in making the product or supplying the service to customers using the Gross Profit Margin.

Operating Profit

- The Operating Profit is the level of profit achieved after deducting all operating costs rather than just the direct costs. The operating performance of the business can be assessed using the Operating Profit Margin.

Earnings

- The Earnings generated by the business is the profit that has been “earned” for the shareholders (hence the term “Earnings”). It is the Operating Profit less Interest paid and Tax paid. Any dividend paid to the shareholders is paid out of these earnings.

Balance Sheet Jargon Buster:

Balance Sheet

- The Balance Sheet (also called the Statement of Financial Position) shows what the business owns (assets) less what it owes (liabilities) on the last day of the accounting period (the Balance Sheet Date).

Non-current Assets

- These used to be called Fixed Assets and represent the assets that the business uses over a long term period. They include land and buildings, motor vehicles, computer equipment, brands, patents and copyrights.

Intangible Assets

- Examples of intangible assets are brands, patents and copyrights.

Tangible Assets

- Examples of tangible assets are land and buildings, motor vehicles and computer equipment.

Depreciation

- The decrease in value of Tangible Assets is known as Depreciation.

Amortisation

- The decrease in the value of Intangible Assets is known as Amortisation.

Current Assets

- Current Assets are the cash held by the business together with other assets which can be turned into cash quickly i.e. receivables and inventory (see below).

Inventory

- Inventory used to be called Stock and represents the products held by the business ready for sale to customers.

Receivables

- Where goods or services have been sold to and invoiced to customers who take a period of credit, the Receivables balance represents the amount owed by customers which is realistically expected to be received from those customers.

Liabilities/Creditors (less than one year)

- This represents any amounts that the business is liable (hence "liabilities") to pay during the forthcoming year. Many of these amounts will be paid out more quickly than in 12 months time and would typically include amounts due to suppliers (called Trade Payables), Dividends declared based on the profit achieved and Tax payable on the profit achieved.

Liabilities/Creditors (more than one year)

- This represents any amounts that the business will have to pay in more than 12 months time and would include any bank loans that the business has taken out and has to repay in more than 12 months time.

Shareholders Funds/Equity

- Shareholders are also called Equity holders. The Shareholders Funds or Equity represents the amount of money that shareholders provided to the business when shares were issued to raise funds together with the amount of profit that has been generated over the life of the business to date that has not been paid out to the shareholders in the form of dividends.

Cash Flow Statement Jargon Buster:

Cash Flow Statement

- The Cash Flow Statement records the amount of cash received into the business less the amount of cash paid out of the business during the accounting period (usually one year).