

HOW TO READ FINANCIAL STATEMENTS

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INTRODUCTION

Financial statements such as a profit and loss account and a balance sheet can cause considerable confusion to business people who do not have a proper understanding of how such reports are generated. Often a business owner is presented with a set of year end financial statements and not given a detailed explanation of the contents. This report endeavours to demystify financial statements and assist a business owner acquire a basic set of tools that can be used to analyse a set of accounts in order to facilitate a better understanding of their business.

THE PROFIT AND LOSS ACCOUNT

The profit and loss account is a primary financial statement, it details all the income generated in period and all the expenditure incurred during a period. The first issue that needs to be highlighted is that all the figures shown in the profit and loss account are shown excluding VAT. A sample profit and loss account is detailed below:

Note: The profit & loss account can also be referred to as an income & expenditure statement.



Figure 1

PROFIT & LOSS ACCOUNT

	€	€
	Amt	Amt
	'000	'000
TURNOVER		100
OPENING STOCK	20	
PURCHASES	60	
CLOSING STOCK	10	
		<hr/>
COST OF SALES		70
		<hr/>
		<hr/>
GROSS PROFIT		30
		<hr/>
		<hr/>
OVERHEAD		
Rent	6	
Insurance	1	
Payroll	12	
Light & Heat	2	
Advertising	3	
		<hr/>
TOTAL OVERHEAD		24
		<hr/>
NET PROFIT		<u>6</u>



Turnover represents all sales made during the period excluding VAT of 100k.

Purchases represent all costs directly relating to sales excluding VAT of 60k.

Therefore this 60k ex VAT worth of stock was purchased during the financial period.

The opening stock of 20k excluding VAT is the amount of stock that was held by the business at the beginning of the financial period. The closing stock of €10k is the value of stock held by the business at the end of the year. The stock figures are obtained by conducting a stock take i.e. physically counting all the stock in the warehouse and placing a value on the products.

Cost of sales is obtained by adding opening stock to purchases and deducting closing stock. This is the value of purchases made that relate to the €100k ex VAT worth of sales generated during the period.

The gross profit is calculated by deducting the cost of sales of 70k from turnover of 100k i.e. gross profit = €30k.

The overhead represents the indirect costs of the business. The overhead of €24k ex VAT is deducted from the gross profit of €30k to give a net profit of €6k.

The main difficulty that the profit and loss account creates is that the figures shown are not actual cash income received and actual cash expenditure paid out.

Turnover/sales identified in the profit and loss account show the value of all invoices issued during the period, usually twelve months. An example of this would be a business issues €100k ex VAT worth of invoices during the year and at the end of the

year €20k ex VAT worth of these invoices are not paid by customers. The figure shown in the profit and loss account is still €100k even though only €80k worth of these sales have been paid by customers. The business will pay tax on the profits generated from the €100k ex VAT of turnover/sales. The principle holds when dealing with the costs of the business. If the business had noted in the profit and loss account cost of sales of €70k ex VAT at the end of the year and included in this cost of sales figure are purchases of €60k ex VAT. At the end of the year €30k worth of these €60k purchase invoices are not paid to creditors. The business is still allowed to deduct the full €60k as a cost even though the business has not even paid its creditors for the all the goods yet.

The reason that income that has not been received by a business and costs that have not been paid for being recorded in full in the profit and loss account is due to the fact the profit and loss account is produced on a matching concept basis. The matching concept simply means that all income generated needs to be matched by costs incurred, whether the income is received or the cost paid is not relevant. It is only by understanding this fundamental concept can the profit and loss be fully understood.



SUMMARY – PROFIT & LOSS ACCOUNT

The profit and loss account does NOT represent all payments received in by a business from its customers less all payments made by a business during its financial period. A profit and loss account identifies all sales invoices issued during a period whether paid by customers or not and also identifies all costs incurred by a business whether not these are paid by the business to its creditors. All the figures in the profit and loss accounts are shown excluding VAT.



THE BALANCE SHEET

A balance sheet is simply a list of assets and liabilities of a business at given date.

Therefore to understand a balance sheet it is necessary to define assets and liabilities.

DEFINITION: An asset is anything that a business owns or is owed.

Examples of assets would be as follows:

- Motor vehicles
- Machinery
- Computer hardware
- Office furniture
- Stock
- Debtors
- Cash held at bank

DEFINITION: A liability is anything that a business owes to a third party.

Examples of liabilities are as follows:

- Trade creditors
- Bank overdraft
- Mortgages
- Leases
- Term loans
- Credit card bills
- Unpaid taxes PAYE/PRSI/VAT

To reiterate, a balance is a list of assets and liabilities at a given date, therefore it is necessary to establish what assets a business has and what liabilities a business has in order to generate a balance sheet. Figure 2 below shows an example of the categories assets and liabilities are placed in a balance sheet.

FIGURE 2

BALANCE SHEET AS AT 31 DEC 2009

FIXED ASSETS		
Motor Vehicles		150
Plant and machinery		250
Computer hardware		100
		<hr/>
		500
CURRENT ASSETS		
Stock	10	
Debtors	150	
Cash in bank	15	
	<hr/>	175
CREDITORS (< 1 YEAR)		
Trade creditors	115	
Bank overdraft	40	
Taxes	10	
	<hr/>	165
Working capital = CA less Creditors		10
CREDITORS(> 1 YEAR)		
Term loan		65
		<hr/>
Total assets less total liabilities		<u>445</u>
CAPITAL & RESERVES		
Share capital	55	
Profit & Loss reserve	390	
		<hr/>
		445
		<hr/>



Assets are separated into fixed assets and current assets. Fixed assets are those assets that held in the business not for resale with a useful economic life greater than one year. Current assets are those assets that are held in the business for less than twelve months.

Liabilities are separated into creditors held for less than a year and creditors held for more than one year.

The capital and reserve section of the balance identifies the amount of monies invested in the business by the owners/shareholders and also the amount of accumulated profits that have not yet been distributed to the owners/shareholders of the business.

The balance sheet shown in Figure 2 identifies that the business has a positive balance sheet i.e. the assets of the business are in excess of the liabilities of the business to the amount of €445k.

HOW TO INTERPRET FINANCIAL STATEMENTS

Once the basics of the profit and loss account and the balance sheet are understood it is then possible to use the information presented in financial statements to evaluate the finances and performance of a business.

The first aspect to consider is the performance of the organisation over a period of time. How has the business progressed from one year to the next. The accounts will identify some information and further questioning will reveal a greater insight.

Profit & Loss Account

- Are sales increasing or decreasing?
- What is the product mix of sales?
- Is the business dependent on a narrow range of products?
- Has the gross profit improved or deteriorated as a percentage of sales?
- Are overheads/indirect expenditure roughly the same as the previous period?
- If overheads/indirect expenditure has increased, is there an explanation for this?

Balance Sheet

- Do the current assets exceed the value of creditors less than one year?
- Is the figure for total net assets less total liabilities positive or negative?
- If the figure for total net assets less total liabilities is negative how has this occurred and what can be done to rectify?