
# Financial Statements for the Beginner SME
Marc Gayle

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# Financial Statements for the more Advanced SME
Paul Cole

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# Financial Statements for the Beginner SME

*How To Create & Read Financial Statements*
*by Marc Gayle, TCP Tings Financial Analyst*

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# How To Create & Read Financial Statements

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**Disclaimer:**

- This course is NOT a comprehensive accounting course. There are many nuances of accounting that will be ignored and left out for brevity purposes, and also quite frankly you don't need a detailed knowledge of every aspect of accounting to be able to make informed financial decisions.
- The goal is to increase your financial knowledge, and give you a working knowledge of financial statements, not make you a CPA or a CFA.

**What are Financial Statements?**

The blueprint that describe the financial affairs of the company.

They describe how money flows into and out of the business and who owns that money.

The 3 statements are:

- Income Statement
- Balance Sheet
- Statement of Cash Flows

**Ultimately, they tell the story about whether the company can continue functioning.**

# How To Create & Read Financial Statements

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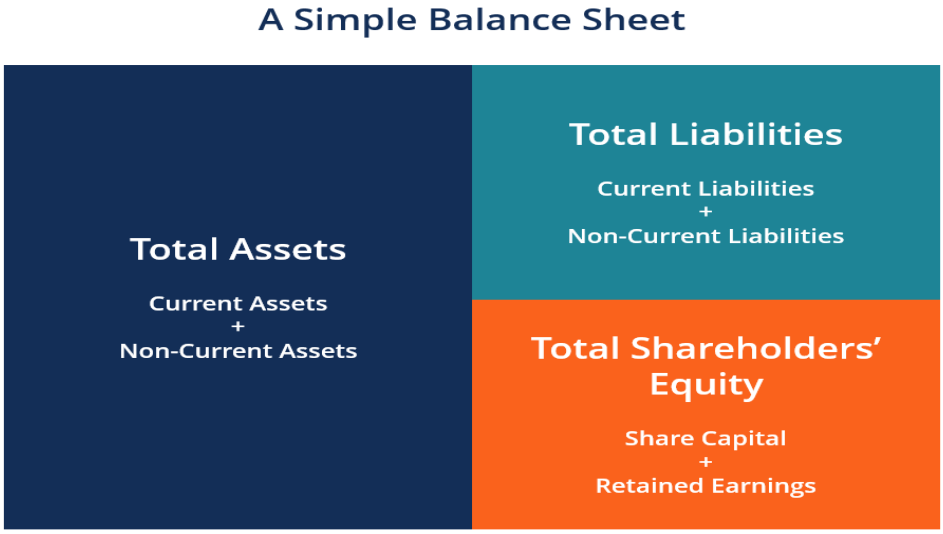
**Income Statement**

- How the company makes money (Revenue)
- How the company spends money (Expenses)
- The Difference = Profit/Loss


**Balance Sheet**

- What does the company own? (Assets)
- What does the company owe? (Liabilities)
- Who owes/owns the difference? (Shareholders Equity)



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**Statement of Cash Flows**

- How does cash flow INTO the company?
- How does cash flow OUT of the company?

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## Personal Financial Summary - Budget

| **Income** | |
|---|---|
| Monthly Salary | $150,000 |
| Coconut Jelly Income | $25,000 |
| ***Total Income*** | ***$175,000*** |
| **Expenses** | |
| Rent | $40,000 |
| Utilities | $20,000 |
| Groceries | $30,000 |
| Coconuts, Etc. | $10,000 |
| Transportation | $30,000 |
| Savings | $20,000 |
| ***Total Expenses*** | ***$150,000*** |
| **Surplus/Deficit** | **$25,000** |

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## Personal Financial Position

| Assets | |
|---|---|
| Car | $1,500,000 |
| Coconut Jelly Cart | $250,000 |
| ***Total Assets*** | ***$1,750,000*** |
| **Liabilities** | |
| Car Loan | $1,000,000 |
| ***Total Liabilities*** | ***$1,000,000*** |
| **Net Worth** | **$750,000** |

## Personal Bank Statement

| Item | Inflow | Outflow | Balance |
|---|---|---|---|
| Opening Balance | - | - | $50,000 |
| Salary | $150,000 | - | $200,000 |
| Transfer to Landlord | - | $40,000 | $160,000 |
| JPS | - | $15,000 | $145,000 |
| NWC | - | $5,000 | $140,000 |
| Supermarket & Coconuts | - | $40,000 | $100,000 |
| Car Payments | - | $30,000 | $70,000 |
| Jelly Sales Deposit | $25,000 | - | $95,000 |
| Savings Transfer | - | $20,000 | $75,000 |
| Closing Balance | - | - | $75,000 |

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**Additional Context & Thoughts**

- The Personal Financial Statements were simplified.
- Other Assets & Liabilities an individual may have include (but are not limited to):
  - House (Asset) & Mortgage (Liability)
  - Insurance (Asset) & Premium Outstanding (Liability)
  - Electronics (Assets) & Credit Card Debt (Liability)
- An Asset (Jelly Cart) can produce Income (Coconut Jelly Revenue) & generate expenses (Coconuts, Straws, Plastic Bags, etc.)
- Your Bank Statement doesn't show you the value of your Jelly Cart, nor the outstanding balance of your car loan.

**Company vs Personal**

**Similarities**

- Both capture the complete financial position
- Once you understand each statement for one, you can understand the other easily.

**Differences**

- Company is much more complex.
- Revenue isn't "Cash based" like Personal tends to be.

**Financial Ratios - Why?**

1. Track company performance with itself over time (e.g. an decreasing gross margin ratio overtime may signal that the company has lost control of the cost of its inputs.)
2. Compare company valuation with peers to see if it is currently undervalued or overvalued relative to the market or its peers.

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**Some Financial Ratios - Profitability Ratios**

Profitability ratios measure how well a company can generate income relative to revenue, balance sheet assets, operating costs & equity.

A Common Example includes, but is not limited to:

- Gross Margin Ratio (Gross Profit Margin Ratio)
  - This tells us the % of each $1 that a company has to cover all other expenses after paying for the raw material (or inputs) of each $1 earned.
  - Scenario:
    - Product Sale Price: $20
    - Raw Material + Labour to make Product: $4
    - Gross Profit: $20 - $4 = $16
    - Gross Profit Margin: $16 / $20 = 80%
  - Lower doesn't necessarily mean worse, unless you are comparing against a peer. E.g. a service business (like a law firm) with high gross margins shouldn't be compared to a car manufacturer that has high production costs and lower gross margins. Manufacturing companies tend to have low Gross Margins (30% - 50%).
  - This ratio can be improved by buying inventory cheaper or raising prices.

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**Relative Valuation Methods**

Some ratios can be used as a relative valuation method.

- Price-to-Earnings Ratio
  - Formula: Stock Price / Earnings Per Share
  - Expressed as a multiple (8X, 10X, 20X, etc.).
  - What it means is if you were to buy the stock at the current price, it would take roughly Y years to make back your money assuming you got paid all the earnings.
  - So an 8X multiple means it will take 8 years (assuming earnings remain constant) to recoup the investment.
  - This is just a rule of thumb to help compare how companies are valued.
  - For example, if all the peers in an industry have a P/E of ~25X, and Company B has a P/E of 15X, then it seems as if Company B is undervalued relative to the industry.
  - Investigate the causes of the undervaluation to determine if it is a good investment.


# Financial Statements for the more Advanced SME

*An Overview of Understanding Financial Statements by Paul Cole, Principal: PCA Chartered Accountants & Business Advisors*

# An Overview of Understanding Financial Statements

**Objective of document**

This document sets out the contents of a presentation entitled "an overview of understanding financial statements". This presentation will make reference to and utilise the financial statements of the following companies:

i. Paramount Trading (Jamaica) Limited – year ended 31 May 2018; and
ii. 138 Student Living Jamaica Limited – year ended 30 September 2018.

*These financial statements can be accessed from the Jamaica Stock Exchange website: https://www.jamstockex.com/*

**Contents of document**

The topics covered in this document are listed below:

- Financial Statements;
- Some Financial Distress Signals; and
- An Illustrative Question on Analysis of Financial Statements.

**Financial statements**

Financial statements are the end product of the accounting process. They are prepared following the consistent accounting concepts, principles, procedures and also the legal environment in which the business operates. These statements are the outcome of the summarizing process of accounting and therefore, are the sources of information on which conclusions are drawn about the profitability and financial position of the company.

**Generally Accepted Accounting Principles (GAAP) requires the preparation of financial statements should include five (5) different components:**

1. Income statement/profit and loss account
2. Statement of financial position/balance sheet
3. Statement of changes in equity
4. Statement of Cash Flows
5. Notes to the financial statements and other explanatory information

# An Overview of Understanding Financial Statements

**1. Income statement/profit and loss account**

- An Income Statement (also called a Statement of Earnings, Statement of Operations, or a Profit and Loss Statement) is a report that shows the flow of revenues (amounts earned from business activity) and expenses (amounts paid in the course of operations) over a given period of time, typically a quarter or year.

**2. Statement of financial position/balance sheet**

- A statement of financial position also called a balance sheet is a status report that shows information about the company's assets, liabilities and owner's/shareholders' equity (net worth) at a given time. In other words it is a snapshot of the company's financial position at a single point in time.

**3. Statement of changes in equity**

- The statement of changes in equity shows the change in an owner's or shareholders' equity throughout an accounting period. Also called the statement of retained earnings, or statement of owner's/shareholders' equity, it details the movement of capital and reserves that make up the shareholder's equity. The statement of changes in equity is important because it offers key information about equity reserves that cannot be found anywhere else in the financial statements.

**4. Statement of Cash Flows**

- A statement of cash flows (also called a cash flow statement) shows how much cash is generated and used during a given time period. The purpose of the statement of cash flow is to highlight the major activities that directly and indirectly impact cash flows and hence affect the overall cash balance. The main categories found in a cash flow statement are the operating activities, investing activities and financing activities of a company and are organized respectively. The total cash provided from or used by each of the three activities is summed to arrive at the total change in cash for the period, which is then added to the opening cash balance to arrive at the cash flow statement's bottom line, the closing cash balance.

**5. Notes to the financial statements and other explanatory information**

- The notes to the financial statements are a required, integral part of a company's external financial statements. They amplify the information given in the statement of financial position, statement of comprehensive income and statement of changes in equity. To some extent, the level of detail shown in the financial statements will determine the contents of the notes. The notes are also referred to as **footnote disclosures.** Each external financial statement should also include a reference to the notes, such as: **The accompanying notes are an integral part of the financial statement.**

**Footnotes**

Generally speaking there are two types of footnotes:

1. **Accounting Methods** - This type of footnote identifies and explains the major accounting policies of the business. This portion of the footnotes will tell you the nature of the company's business, when its fiscal year starts and ends, how inventory costs are determined, and any other significant accounting policies that the company feels that you should be aware of. This is especially important if a An Overview of Understanding Financial Statements PCA Chartered Accountants & Business Advisors 23 July 2020 3 company has changed accounting policies. It may be that a firm is practicing "cookie jar accounting" and is changing policies only to take advantage of current conditions to hide poor performance.

2. **Disclosure** - The second type of footnote provides additional disclosure that simply could not be put in the financial statements. The financial statements in an annual report are supposed to be clean and easy to follow. To maintain this cleanliness, other calculations are left for the footnotes. For example, details of long-term debt such as maturity dates and the interest rates at which debt was issued, can give you a better idea of how borrowing costs are laid out. Other areas of disclosure include everything from pension plan liabilities for existing employees to details about ominous legal proceedings the company is involved in.

## Some financial distress signals include:

**1. Inadequate working capital**

There are two types of capital need: **'fixed capital'** to invest in things such as buildings, plant and equipment; and **'working capital'** principally to pay for stock/inventory and to cover the amount of credit extended to customers.

Fixed capital, as the name implies, tends not to vary in the short term but to move up (or down) when major investment decisions are made (or assets sold). Working capital, on the other hand, is much more fluid and fluctuates with the level of business activities.

Working capital comprises short-term net assets: stock, debtors, and cash, less creditors. Working capital management is to do with management of all aspects of both current assets and current liabilities, so as to minimize the risk of insolvency while maximizing return on assets.

The primary objective of working capital management is to ensure that sufficient cash is available to:

- meet day-to-day cash flow needs;
- pay wages and salaries when they fall due;
- pay creditors to ensure continued supplies of goods and services;
- pay government taxation and providers of capital – dividends; and
- ensure the long-term survival of the business entity.

***Poor working capital management***

Poor working capital management can lead to:

- over-capitalisation (and therefore waste through under utilisation of resources and hence poor returns); and
- overtrading (trying to maintain a level of sales which is higher than working capital can sustain – for businesses which extend credit terms, more sales means more debtors and higher working capital demands).

Characteristics of over-capitalisation are excessive stocks, debtors, and cash, low return on investment with long term funds tied up in non-earning short term assets. Overtrading leads to escalating debtors and creditors, and if unchecked, ultimately to cash starvation.

**2. Key financial ratios**

- **Profitability ratios** are the financial statement ratios, which focus on how well a business is performing in terms of profit.

a) Gross profit margin:

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

The ***gross profit margin ratio*** shows how much gross profit the company makes for each dollar of sales. The ratio also provides clues to the company's pricing, cost structure and production efficiency. A low ***gross profit margin ratio*** indicates that a low amount of earnings, required to pay fixed costs and profits, is generated from revenues.

b) Net profit margin:

$$\text{Net Profit Margin} = \frac{\text{EBIT}}{\text{Sales}} \times 100$$

***Earnings before interest and tax (EBIT) to Total Sales*** evaluates the operational efficiency of the business. It also shows how much operating profit is generated for each dollar of sales. A low or declining ratio indicates that the business is near its breakeven point.

c) Return on capital employed (ROCE)

$$\text{ROCE} = \frac{\text{EBIT}}{\text{Capital Employed}} \times 100$$

The return on capital employed ratio shows how efficiently a company is using the resources invested in it. This ratio can be used by shareholders to assess whether they would be better off by putting the money they invested in the bank

**2. Key financial ratios**

- The **liquidity ratios** are the basic bank financial ratios. These ratios measure the ability of a business to meet its short-term financial obligations on time and, as such, are usually used by potential creditors.

***Liquidity ratios*** are also referred to as ***solvency ratios***.

d) Current ratio:

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

The ***current ratio*** is used to evaluate the liquidity, or ability of the company to meet short-term debts. The generally accepted ***current ratio*** is 2:1. The ratio measures the company's ability to meet its short-term liabilities as they fall due. A ratio in excess of 1 is desirable but the expected ratio varies between the types of industry.

A decrease in the ratio year on year or a figure that is below the industry average could indicate that the company has liquidity problems. The company should take steps to improve liquidity, e.g. by paying creditors as they fall due or by better management of receivables in order to reduce the level of bad debts.

e) Quick ratio (Acid test ratio):

$$\text{Quick Ratio} = \frac{\text{CA - Inventory}}{\text{Current Liabilities}}$$

The ***quick/acid test ratio*** measures the immediate amount of cash immediately available to satisfy short-term debt. A quick ratio of 1:1 is considered satisfactory, unless the majority of "quick assets" are in accounts receivable and the company has a pattern of collecting accounts receivable slower than paying accounts payable.

## 2. Key financial ratios

- ***Efficiency ratios*** are the financial statement ratios that measure how effectively a business uses and controls its assets.

a) Stock/turnover:

$$\text{Stock Turnover} = \frac{\text{Stock}}{\text{Cost of Sales}} \times 365$$

The ***stock turnover*** ratio shows the number of days that inventory is held prior to being sold. An increasing ***stock turnover ratio*** indicates a risk in the company's inability to sell its products. Individual inventory items should be examined for obsolete or overstocked items.

b) Debtors (Receivables) days:

$$\text{Debtor Days} = \frac{\text{Debtors}}{\text{Sales}} \times 365$$

This ratio shows the average period it takes to collect accounts receivable amount from customers. A high ***collection period*** shows a high cost in extending credit to customers and potential for bad debts.

f) Creditors days - (Creditors/Purchases)×365

$$\text{Creditor Days} = \frac{\text{Creditors}}{\text{Cost of Sales}} \times 365$$

The payment period indicates the average period for paying debts related to inventory purchase. This is the average period it takes for a company to pay for its purchases.

An increase in the company's payables period could indicate that the company is struggling to pay its debts as they fall due. However, it could simply indicate that the company is taking better advantage of any credit period offered to them.

A decrease in the company's payables period could indicate that the company's ability to pay for its purchases on time is improving. However, the company should not pay for its purchases too early since supplier credit is a useful source of finance.

**2. Key financial ratios**

- ***Gearing ratios*** are the financial statement ratios, which show the degree to which the business is leveraging itself through its use of borrowed money. The capital structure ratio shows the percentage of long term financing represented by long-term debt. A high ratio is unfavourable because it indicates possible difficulty in meeting long term debt obligations.

a) Interest cover:

$$\text{Interest Cover} = \frac{\text{EBIT}}{\text{Interest cost}}$$

The ***interest coverage ratio*** indicates the extent of which earnings are available to meet interest payments. A lower ***interest coverage ratio*** means less earnings are available to meet interest payments and that the business is more vulnerable to increases in interest rates.

b) Gearing – Long term debt/(Long term debt + Shareholders' equity)

This is the long-term debt as a percentage of equity.

$$\text{Gearing} = \frac{\text{Debt}}{\text{Equity}} \times 100$$

Or

$$\text{Gearing} = \frac{\text{Debt}}{\text{Debt + Equity}} \times 100$$

This ratio shows the percent of long term financing represented by long-term debt. A high level of gearing indicates that the company relies heavily on debt to finance its long-term (and even its short-term) needs. This increases the level of risk for the business since interest and capital repayments must be made on debt, whereas there is no obligation to make payments to equity.

## Illustrative question on analysis of financial statements

Audacious Ltd and Bold Ltd are both computer component manufacturers in the United Kingdom. You are provided with the following summarized information in relation to both companies.

**Balance Sheets as at 31 March 2019**

| | Audacious Ltd | | Bold Ltd | |
|---|---|---|---|---|
| | £000 | £000 | £000 | £000 |
| **Fixed Assets** | | | | |
| Machinery at cost | 4,000 | | 4,830 | |
| Less Depreciation | 1,000 | 3,000 | 3,500 | 1,330 |
| Buildings at cost | 3,000 | | 2,200 | |
| Less Depreciation | 1,140 | 1,860 | 600 | 1,600 |
| Motor vehicles at cost | 800 | | 600 | |
| Less Depreciation | 350 | 450 | 550 | 50 |
| | | 5,310 | | 2,980 |
| **Current Assets** | | | | |
| Stock | 150 | | 330 | |
| Trade debtors | 160 | | 370 | |
| Bank | 240 | 550 | - | 700 |
| | | **5,860** | | **3,680** |
| **Equity and Liabilities** | | | | |
| Issued equity shares | | 3,000 | | 2.000 |
| Retained earnings | | 1,600 | | 550 |
| | | 4,600 | | 2,550 |
| **Non-current liabilities** | | | | |
| 10% Debentures | | 1,000 | | 500 |
| **Current liabilities** | | | | |
| Dividends | 70 | | 100 | |
| Bank overdraft | 50 | | 220 | |
| Trade payables | 140 | 260 | 310 | 630 |
| | | **5,860** | | **3,680** |

## Illustrative question on analysis of financial statements

**Income Statements for the year ended 31 March 2019**

| | Audacious Ltd £000 | Bold Ltd £000 |
|---|---|---|
| Sales | 1,500 | 2,000 |
| Cost of sales | 1,000 | 1,600 |
| Gross profit | 500 | 400 |
| Operating expenses | 150 | 200 |
| Net profit before interest & tax | 350 | 200 |
| Interest on debentures | 100 | 50 |
| Net profit before tax | 250 | 150 |
| Tax | 50 | 30 |
| Profit after tax | 200 | 120 |
| Dividends | 70 | 100 |
| **Retained profits** | **130** | **20** |

Required:

a) Calculate the following ratios
   1) Gross profit margin
   2) Net profit margin (profit = operating profit)
   3) Return on capital employed - ROCE (capital employed = equity and loans)
   4) Current ratio
   5) Acid test ratio
   6) Average stock turnover period (days)
   7) Average settlement period for debtors (days)
   8) Average settlement period for creditors (days)
   9) Interest cover
   10) Gearing ratio

b) Comment on the performance of both companies in terms of profitability, liquidity and gearing, using the ratios you calculated and any other relevant information in the question.

***To obtain a suggested solution to the above question, please send your request to pcole@pcaja.com***

# REFERENCES

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- Paul Cole, Principal – PCA Charted Accountant and Business Advisors
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**Helpful Videos, Courses, Etc.**

- Reading Financial Statements FREE Course by Corporate Finance Institute - https://www.youtube.com/playlist?list=PLl3-0Xe_motTmt8KU8PQdt2URdOzBFRuX

- Understanding Financial Statements by Westpac Banking (Australia) - https://www.youtube.com/watch?v=f-N2hVWvzaM

- How to Read Financial Statements by Catching Clouds Academy - https://www.youtube.com/watch?v=rK5JMKdfJcU

- Understanding Financial Statements Workshop by Jamaica Institute of Financial Services - https://www.jifsjm.org/training-and-seminars/understanding-financial-statements

- 12 Things You Need to Know About Financial Statements by Investopedia - https://www.investopedia.com/articles/basics/06/financialreporting.asp

- The Beginner's Guide to Reading & Understanding Financial Statements by Harvard Business School Online - https://online.hbs.edu/blog/post/how-to-read-financial-statements