

Understanding Financial Statements

Financial Statements contain much information of value to running a business.

It is sad fact, however, that many clients of professional accountants simply ask "How much tax am I up for?" and ignore the Financial Statements. It is an even sadder fact that some accountants have ceased giving their clients any Financial Statements. Until 1987, tax-payers had to lodge their Financial Statements with the Tax Office. In addition, if they were trading as a company, they had to lodge their Financial Statements with their local Corporate Affairs Office. The Tax Office no longer requires Financial Statements to be lodged with a Tax Return. Instead, they require an assortment of unrelated figures to be included with the Return. Likewise, the Australian Securities Commission does not now require Financial Statements to be included with the Annual Return. An accountant desirous of "cutting corners" could obtain the required figures without going to the trouble of producing or typing a formal Balance Sheet or Income Statement. Some accountants now give no copies of documents to clients, not even a copy of the Tax Return. A client of such an accountant, who is content not to receive any documents, is flying blind. He is like a pilot who never looks at his instruments.

Let us assume that you are thinking of buying a retail store. You have inspected the store. It is well presented and situated in a busy shopping complex. Is it worth paying a \$100,000 for? You ask for copies of the Financial Statements for the past five years. You start by examining the latest Financial Statement. What should you look for?

Before we start, I should give a brief explanation of the difference between Cash Accounting and Accruals Accounting. Cash Accounting, as the name implies, only takes account of cash received and cash paid by the business. Accrual Accounting takes into account, in addition, amounts owing by the business and amounts owing to the business. For example, a business has received \$50,000 in cash sales during the year. It has spent \$40,000 in cash on expenses. It has debtors owing to it at 30th June of \$10,000. It owes suppliers \$7,000 for goods and services received. On a Cash Accounting basis, the net profit of the business would be \$10,000 (i.e. \$50,000 less \$40,000). On an Accruals Accounting basis, the net profit would be \$13,000 (i.e. \$50,000 + \$10,000 - \$40,000 - \$7,000). Individuals, professionals and some small businesses prepare their Financial Statements on a cash basis. Companies and large businesses always prepare their accounts on the Accruals basis. Until recently, all Governments prepared their accounts on a cash basis but many are now switching over to the Accruals basis. Accordingly, the first thing you must ask about the Financial Statement of your prospective business is "Are they based on Cash Accounting or Accrual Accounting?". Let us assume that the business you are thinking of buying is a company and thus Accrual Accounting based.

You now start by examining the Income Statement. It could also be called the Trading and Profit & Loss Statement. Below is an example.

Sales	300,000
less Cost of sales	160,000
GROSS PROFIT	140,000
LESS OVERHEAD EXPENSES	
Accounting	1,500
Advertising	500
Cleaning	200

Depreciation	8,000
Electricity	800
Insurances	1,600
Interest	12,000
Phone	3,000
Postage and stationery	1,000
Publications	100
Rent of shop	1,000
Travel and accommodation	3,000
Vehicle expenses	2,000
Wages	60,000
TOTAL OVERHEAD EXPENSES	103,700
NET PROFIT FOR YEAR \$	36,500

You should first of all ask "Do the Wages figure include any wages for the owner?". Three situations could exist viz no wages have been included for owner, the going rate or award rate for a manager has been included or the owner has drawn all of the profits as wages. In any case, you must decide what reasonable wages should be included for the owner. Normally, it should be in the region of a manager's wages, say, \$30,000 to \$35,000 pa. Assume the owner has included no wages for himself in this example.

You must now work out the gross profit percentage or Mark-up. The gross profit percentage is obtained by dividing \$140,000 Gross Profit by Sales \$300,000. It comes to 47%. The Mark-up on stock is 88% in this case. These are satisfactory ratios. Normally, there is a low gross profit percentage where the goods are fast-moving e.g. food or where there is cut-throat competition. There is a high gross profit percentage where the stock is slow-moving e.g. a jeweller's shop or where there is little competition.

You must now ask yourself "How do the overheads compare with industry standards?". You can obtain the industry standards from either a trade organisation or from a research institution which specialises in such figures e.g. the University of New England Small Business Centre.

Now you work out how often the stock turns over in a year. You obtain the stock figure from the Balance Sheet. Assume it is \$40,000. The total stock bought during the year was \$160,000. Therefore, there is enough stock on hand to last three months. (i.e. 4/16 of 12 months). Put another way, the stock turns over four times per year on average.

You now ask yourself "Is the profit adequate?" Assume that the total capital employed in the business is \$50,000.

Net profit, per Income statement	36,300
less manager's wages	30,000
TRUE NET PROFIT \$	6,300

Because of the high risks involved in any type of small business, an investor would expect a return of at least 20% on his investment. How does this investment compare? A 20% return on

capital of \$50,000 is \$10,000. In the above example, we are left with only \$6,300 so it does not look like the business is achieving an adequate return on capital.

What is the break-even point for this business? In other words, how much sales must it generate just to cover expenses. Total overhead expenses, including owner's wages, come to \$133,700. The gross profit percentage is 47%. Therefore, we need sales of \$284,468 before we break even. (Note: 47% of \$284,468 equals \$133,700).

Now, we must have a look at the Balance Sheet. The Balance Sheet is divided into Liabilities and Assets. The total of Liabilities always equals the total of the Assets. Liabilities are divided into a) Share Capital, b) Reserves, c) Long-term Liabilities and d) Short-term Liabilities, also known as Current Liabilities.

When buying a business, if the business is a limited company, you have the option of buying either the actual assets or buying the shares in the company. It is nearly always inadvisable to buy the shares in the company. The company could have liabilities that you are not aware of. In such a case, eventually the company would have to pay these liabilities. For example, if the company had underpaid its tax in previous years and the Tax Office were to later carry out an audit and increase the tax payable, the company would have to pay. This could be at a point of time when you had become the new owner, assuming that you bought the shares in the company.

Assume the Liabilities side of the Balance Sheet looked like this.

Share Capital		1,000
Reserves		-34,000
LONG TERM LIABILITIES		
Finance company loan	20,000	
Directors' loan	94,000	
		114,000
CURRENT LIABILITIES		
Creditors	20,000	
Bank overdraft	5,000	
		25,000
TOTAL LIABILITIES		106,000

Assume that the Assets side of the Balance looks like this.

NON-CURRENT ASSETS		
Fixtures and fittings	5,000	
Vehicle	5,000	
Goodwill	50,000	

		60,000
CURRENT ASSETS		
Stock	40,000	
Debtors	5,000	
Cash on hand	1,000	
		46,000
TOTAL ASSETS		106,000

The first thing to be observed is that there is a minus quantity on Reserves i.e. - \$34,000. This appears to indicate that the business made losses in past years. This would have to be looked into.

To get a clearer picture of the business, all assets and liabilities will have to be revalued at their market or realisable value. Non-current assets are usually stated at book value i.e cost less depreciation.

Have the Financial Statements been prepared on a true Accruals basis? If not, perhaps some creditors have been omitted. This would decrease the net profit. You may find the Fixtures and Fittings are worthless. You should obtain a vehicle valuation from a car dealer, if you intend buying the vehicle. Ignore the value placed on Goodwill. You will compute this value yourself later on when you have got all the figures to hand. Make sure that obsolescent stock is written down in the stock valuation. Make sure all the debtors are good and there are no bad debts.

Once you have revalued all assets and liabilities, you will be in a position to ascertain the capital employed in the business and work out whether an adequate return is being obtained on it.

What is the value of Goodwill in the above example? After charging owner's "wages" of \$30,000, there is hardly any profit left. In fact, it is not sufficient to pay 20% on capital employed. There would appear to be no Goodwill attached to this business. The value of \$50,000 placed on Goodwill by the proprietor should not be accepted.

Current Assets less Current Liabilities is an important ratio in any business. If a business is to be able to pay its debts as they fall due, the Current Assets must exceed the Current Liabilities. If they do not, the business is likely to experience a liquidity crisis. In the above example, Current Assets amount to \$46,000 while Current Liabilities amount to \$25,000. The business is in a good cash situation.

Another useful ratio is the ratio of Debtors to Sales. This ratio is only valid where all sales are on credit terms e.g. in a manufacturing company. Assumes sales were \$300,000 for year and debtors at end of year were \$50,000. The ratio is 1/6th. Putting it another way, debtors are taking, on average, two months to pay. (i.e. 1/6th of 12 months). This is a satisfactory situation. If the ratio were four months, this would indicate an unsatisfactory state with a probability of bad debts.

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