Understanding financial statements

Introduction

There are three basic financial statements which, between them, describe the activities and financial state of any business:

- The profit and loss (P&L) account shows how a business performed over a specific period, and shows total revenue and expenditure for that period.
- The balance sheet summarises the financial state of a business at a specific date. Balance sheets are linked by a P&L account, which covers the period between the two dates.
- The cash flow statement summarises cash receipts to and cash payments from the business for a specific period.

Understanding the uses of and differences between these financial statements, and how they are prepared and interact with each other, will enable you to review your performance with greater confidence.

Profit and loss account

The P&L account shows how a business performed over a specific period and reveals the total revenue and expenditure. All businesses prepare a P&L statement as part of their annual accounts. However, producing a P&L statement is also a valuable part of preparing monthly management accounts. A P&L account shows:

- The revenue for a specific period, usually a year for formal accounts but typically a month for management accounts;
- The expenditure for the period;
- The surplus for the period;
- Whether the surplus has been retained by the business or distributed.

A simplified profit and loss statement	
Income	
Revenue	40,000
less: direct costs	(12,000)
Gross profit	28,000
Expenditure	
Overheads	22,000
Net profit	6,000

Revenue

Revenue reflects all the income for the period whether from sales, donations, fees or subscriptions. It does not reflect the cash actually received, since some receipts may still be outstanding and some may have been received in advance.

Direct costs

The direct costs are the costs that can be directly attributed to the production of a product or delivery of a service.

Gross profit

This is the difference between revenue and direct costs. It is also known as the contribution, because it contributes towards the overhead costs and, when they are all paid, contributes towards the surplus.

- **Overheads**

Operating costs not directly linked to a product or service and which, generally speaking, are fixed (such as rent, utilities and insurance), are classed as overheads.

- **Net surplus**

The surplus (known as net profit in a for-profit business) is the gross profit less the overheads. The word 'net' is often dropped, so you simply have 'surplus' or 'profit'.

Using a P&L account

Use the P&L to keep an eye on how the organisation is performing. Ideally, you should prepare a budget P&L each year; each month compare the actual with the budget. Analysing the differences will help you see what has gone well, such as achieving higher revenue, or what hasn't gone so well, such as higher costs. You can then take corrective action as necessary.

Limitations of P&L accounts

The P&L account shows profitability but it does not show the cash position. You need to ensure you are making a surplus, but you also need to ensure you do not run out of cash, which is easy to do if revenue is doing badly or costs are rising.

Balance sheet

A balance sheet is a financial 'snapshot' that shows how a business is financed, how much capital is employed and how quickly assets can be turned into cash. All businesses have to prepare a balance sheet at the end of their financial year as part of their annual accounts. A balance sheet is a good indicator of whether a business is solvent. The starting point for understanding balance sheets is to think about sources and applications of funds. Sources show from where the money has come; applications show to where the money has gone.

Source of funds		**Application of funds**	
Liabilities		Assets	
Owner	10,000	Cash in bank	3,000
		Equipment	7,000
Total finance	10,000	Total assets	10,000

Imagine that the owner of a business provides start up capital of £10,000. That £10,000 is owed to the owner, but it is also used to finance the business. Initially it might be held as 'cash in bank', that is, an asset. If the business then spends £7,000 on equipment, it has fixed assets of £7,000 and cash in bank of £3,000, still totalling £10,000.

A simplified balance sheet	
Fixed assets	
Equipment	80,000
Current assets	
Stock	3,000
Debtors (trade)	-
Cash in bank	26,150
Current liabilities	
Loan	(80,000)
Creditors	(3,150)
Net current assets	(54,000)
Long-term liabilities	-
Net assets	26,000
Represented by	
Owner's capital	20,000
Retained profit	6,000
Net worth	26,000

This is the more common way to display a balance sheet. The fixed assets are shown first, then the current assets, and these together give the total assets. Current liabilities are then shown, and are deducted from the current assets to show the net current assets of the business. Net assets are calculated by adding fixed assets to net current assets and deducting any long-term liabilities. The value of net assets will always equal the net worth of the business.

- **Fixed assets**

Fixed assets are assets with a lifespan of more than one year. For BMOs, these will be tangible assets such as equipment and buildings. The cost of tangible assets is 'depreciated', over the expected life of the asset; it is quite common to see on a balance sheet the original cost together with the accumulated depreciation. The depreciation is charged to the P&L account and reduces the net profit.

- **Current assets**

Current assets include stock, work in progress, debtors, cash in bank and so on. Debtors (receivables) shows the amount of money owed by customers.

- **Current liabilities**

Current liabilities include creditors, overdrafts, loans due within one year, money owed under hire purchase agreements and so on. Creditors (payables) represent the amount of money owed by the business.

- **Loans**

Loans falling due in more than one year are usually shown separately from current liabilities as long term loans.

- **Net current assets**

Also known by accountants as 'working capital', this refers to the difference between current assets and current liabilities. This should be positive or the business may not be able to meet debts as they fall due. In this example, it is negative and is known as 'net current liabilities'.

- **Net assets**

This equates to the value of fixed assets added to net current assets and should always equal net worth.

- **Net worth**

The bottom 'half' of the balance sheet shows the capital and reserves: the net worth, also known as 'net finance' or 'equity'. This comprises the money introduced by the shareholders or owners (if any) and the retained earnings.

The term 'reserves' is often misunderstood: reserves show where the money came from, not how it has been used. They may exist as cash in the bank, but more likely they will have been used to buy more equipment or to add to working capital. To avoid misunderstanding, it is preferable to use the term 'retained earnings'.

Using a balance sheet

A balance sheet can be used to analyse business performance and consider ways to improve it. Specifically, the balance sheet shows:

- How much capital is employed in the business (how much is the business worth, where did the capital come from and how much of it is debt?).
- How quickly assets can be turned into cash (how liquid is the business?).
- How solvent the business is (what is the likelihood that the business might become insolvent?).

Limitations of balance sheets

A balance sheet can tell you a lot, but it cannot tell everything. That requires a P&L account and a cash flow statement as well. A balance sheet:

- Shows a different perspective from the P&L account of a financial position. For example, a business can be making good profits but have a weak balance sheet, and hence be financially vulnerable because of low net asset value. Conversely, a business can sustain a period of poor profitability when it has a strong balance sheet, shown by a high net asset value.
- Does not show profitability. This is shown on the P&L account.
- Does not reflect the true market value of the assets, which may be more or less than the figures given on the balance sheet.
- Does not show the market value of a business. This depends on profitability and the current values (as opposed to costs) of assets.

Cash flow statement

The cash flow statement summarises cash receipts to, and cash payments from, a business for a specific period. Cash flow statements for historical periods usually show what happened for a year they can be prepared for any period. The cash flow statement shows how money flowed into and out of the business during the period, and relates the P&L statement to the balance sheet. In particular, it shows by how much the working capital in the business increased or decreased and highlights the reasons for the changes.

A simplified cash flow statement	
Receipts	
Debtors	47,000
Loan	80,000
Original capital	20,000
Cash inflow	147,000
Payments	
Creditors	17,625
Overheads	23,225
Capital expenditure	80,000
Cash outflow	120,850
Opening cash balance	0
Cash inflow (outflow)	26,150
Closing cash balance	26,150

Receipts

All the money coming into the business from debtors, cash sales, grants loans, etc.

Payments

All the money leaving the business to cover all expenditure, loan repayments, and expenditure on capital items such as vehicles, computers, and equipment.

- **Balances**

The opening cash balance will be the closing cash balance from the previous period. The cash flow for the period is calculated by subtracting the total payments from the receipts and this is added to the opening balance. The closing cash balance should match the figure on the bank statement for the end of this period.

Using a cash flow statement

A cash flow comes into its own when it is used as a forecast. It provides an estimate of the cash required for the next period. There are two major reasons why you should prepare a cash flow forecast. The first is to estimate your working capital needs and, if necessary, seek additional funds. The second is to provide a management tool that can help you exercise proper financial control.

Limitations of cash flow forecasting

- The cash flow forecast is probably the most useful financial forecast, but remember that it is only as accurate as the accuracy of each figure.
- Even if the figures are estimated accurately, it is always possible that revenues might be lower than forecast or that costs may rise, so use the forecast to prepare 'what if' scenarios (usually referred to as a 'sensitivity analysis') to see what happens to the cash flow if income is, say, 20% higher or lower than forecast, or if energy costs rise by 60%.