accurri.com

The numbers that count

The numbers that count

This publication is a complimentary resource provided by Accurri Pty Limited and its related entities and is intended to assist investors, stakeholders, auditors and accountants that want to analyse financial statements.

If you are reading a printed version of this publication, please visit accurri.com/resources to make certain that it is the most up-to-date version.

Contents

Disclaimer

No party should rely on the contents of this publication without first obtaining advice from a qualified professional person.

This publication is provided on the terms and understanding that i) the authors, consultants and editors are not responsible for the results of any actions taken on the basis of information in this publication, nor for any error in or omission from this publication; and ii) the publisher is not engaged in rendering legal, accounting, professional or other advice or services.

The publisher, and the authors, consultants and editors, expressly disclaim all and any liability and responsibility to any person, whether a purchaser or reader of this publication or not, in respect of anything, and of the consequences of anything, done or omitted to be done, by any such person in reliance, whether wholly or partially, upon the whole or any part of the contents of this publication.

Without limiting the generality of the above, no author, consultant or editor shall have any responsibility for any act or omission of any other author, consultant or editor.

Introduction

This booklet is part of a series of complimentary resources that we make available to professionals involved in the preparation, oversight or audit of statutory accounts production.

The resources fall into the following three broad categories:

- Example Financial Statements
- Explanatory booklets
- Editorial articles and social media commentary

Example Financial Statements

Accurri Example Financial Statements are an invaluable statutory accounts production resource. Available in PDF and Word formats, the Example Financial Statements are updated to reflect the International Financial Reporting Standards (IFRS) as at 31 December (all regions) each year.

These practical and clear examples are complimentary, cover a wide range of reporting scenarios and can be used with ease and confidence. You can subscribe to this resource using the following link https://accurri.com/examples.

Explanatory booklets

Whilst example financial statements are very helpful, they can be like a map that shows only the destination (or end result). What they don't show is 'how to get there' or 'how things have changed'.

Our explanatory booklets fill this gap. These booklets cover a range of issues such as 'Constructing of financial statements', 'The impact on disclosures when changing the basis of preparation' and 'The impact on disclosures arising from changes to the Accounting Standards'.

We don't create booklets for every circumstance, just those that a) we think are important and b) issues that people are finding challenging. Our explanatory booklets can be downloaded from https://accurri.com/resources.

Editorial articles and social media commentary

Accurri articles, posts and tips can be found in a range of accounting publications and social media sites.

We acknowledge that Accurri resources are prepared from our point of view, which is just one of many. However, after many years, and many hundreds of financial statements prepared, we know our process works and we are proud to share it.

If you would like to suggest a topic for us to consider or comment on, add to, or even challenge anything in this booklet, please email us at enquiries@accurri.com.

Accurri software

Many of the complimentary resources we provide are a by-product of our efforts to develop and deliver the world's best statutory accounts production software.

The example Financial Statements are produced as part of our testing and quality assurance processes, while the explanatory booklets can come from our research with preparers, auditors and regulators.

We build Accurri so that users don't need to worry about the complexities associated with changing the basis of preparation from one period to the next, or worrying about how disclosures are affected by changes to the Accounting Standards.

If you would like to know more about Accurri software please visit accurri.com.

The numbers that count

With 17 numbers, all of which can be found in the financial statements, it is quite easy to calculate the 11 key ratios that reveal the financial health of any company.

In this booklet we identify the 17 numbers, explain the ratio equations and use extracts from financial statements to offer some insight into how the ratios can help answer a range of questions, such as:

- What is the company's ability to pay its bills?
- How long, on average, does the company take to collect its receivables?
- How quickly, or otherwise, is inventory sold?
- What is the return on equity invested?
- What is the exposure to debt?
- Why does the profit and operating cash flows differ?

Whilst a company may appear financially strong, it is important to draw the link between profit, cash flows and the statement of financial position. In the example provided in this booklet, there are increased sales, an increased profit, steady cash flows and a strong statement of financial position, all positive indicators.

However, further analysis, using the aforementioned ratios, reveals that inventories have grown by 65%, and inventories turnover has increased from 30 days to 47 days, as the increase in inventory is far greater than the increase in sales this may be a cause for concern.

The risks rise even higher when taking into account the company in this example is a seller of fast moving consumer goods; and inventory obsolescence and discounting in the next period is a very real possibility.

By comparing ratios over time, against competitors or within industry sectors, it is possible to establish patterns, trends and benchmarks; all of which will aid the analysis of the financial statements.

Ratios afford the opportunity to scale and create points of comparison and measure like with like. However, they are but one tool in the box. Ratios must be analysed in context and, where possible, compared with peer or sector trends.

Ratios will change over time and the greater the period of analysis, the more variation can be expected. Other factors will also have an impact, things such as the Accounting Standards applied, climate of the economy, capital employed, management in charge, businesses held, business risks, etc.

The 17 numbers you need

As mentioned earlier, the 17 numbers you need will be in the financial statements, as follows:

1. Sales
2. Interest revenue
3. Share of profits of associates
4. Depreciation and amortisation expense
5. Finance costs
6. Profit before income tax
7. Profit after income tax
8. Trade receivables
9. Inventories
10. Total current assets
11. Total assets
12. Trade payables
13. Bank overdraft
14. Total current liabilities
15. Total liabilities
16. Total equity
17. Net cash from operating activities

While this booklet focuses on 11 key ratios, there is no 'hard and fast' rule that says it must be 11. We have chosen the ratios we believe to be most valuable, but in doing so we acknowledge that there are additional ratios that could be applied.

However, we are confident that regardless of whether you are an investor, stakeholder, auditor or an accountant; the following ratios will most likely be of interest.

1. Current ratio

Total current assets ÷ Total current liabilities

92,188 ÷ 54,850 = 1.68 times

Note: the values used throughout the explanation of ratios are taken out of the 'Extracts from the financial statements' beginning on page 6 and provided as examples.

The target for this ratio is greater than 1.00, which means the company can pay its immediate bills with its short-term assets (cash, receivables, inventories, etc).

A ratio of 1.68, achieved in the example, indicates a healthy buffer of current assets over current liabilities.

2. Quick ratio (the acid test)

(Total current assets - Inventories) ÷ (Total current liabilities - Bank overdraft)

(92,188 - 59,525) ÷ (54,850 - 2,651) = 0.63 times

For companies with inventory, this provides more meaningful information as it takes inventory out of the equation.

2. Quick ratio (the acid test) continued

Inventory is eliminated in the quick ratio equation on the basis that it is not liquid and therefore may not instantly be converted to cash. As with the current ratio, the objective is to have a quick ratio greater than 1.00.

In the example provided, inventory accounts for more than half of the current assets and once taken out, there are only 63 cents of current assets for every dollar of current liabilities. This is a decline on last year and flags potential short-term cash flow difficulties.

The analysis shows that inventories increased 65% over the prior period and this increase had a detrimental effect on cash. This could result in inventories being sold under a 'fire sale' condition and if this occurs it has the potential to adversely impact future profits.

3. Days trade receivables

(Trade receivables x 365) ÷ Sales

(14,344 x 365) ÷ 462,781 = 11 days

As the proportion of cash sales to credit sales increases, the number of days will decrease. If all sales are credit sales, then the number of days should be close to the average credit terms. If it is higher than that specified in the average credit terms, it may indicate slow collection rates and point to a higher risk of bad debts.

In our example we know that 60% of sales are cash sales. By applying this equation (14,344 x 365) ÷ (462,781 x 40%) we can establish the collection rate for credit sales is 28 days. This is in line with the average 30 days credit terms stated in the company's accounting policy.

4. Days inventories

(Inventories x 365) ÷ Sales

(59,525 x 365) ÷ 462,781 = 47 days

This shows how many days inventory is held before it is sold. It should be extremely low for perishable items, mid-range for fast moving consumer goods and higher for higher value items.

In our example, inventory turnover is 47 days, which is up from 30 days in the prior year. This is due to inventory increasing 65% (as mentioned earlier) and sales only increasing 7%.

As this is a fast moving consumer goods company and inventory becomes obsolete quickly, 47 days is a concern.

In addition to the risk of obsolescence, there are finance, storage and logistical costs involved. Unless there is a significant uplift in sales, inventory, and by extension the number of days inventories is held needs to be reduced to levels in line with the prior year.

5. Days trade payables

(Trade payables x 365) ÷ Sales

(18,070 x 365) ÷ 462,781 = 14 days

This ratio indicates how many days it would take for payables to be paid from sales. It is a hypothetical measure of what could be done, rather than an actual measure of what is done.

The target figure should be in line with the suppliers credit terms, which typically range from 14 to 90 days.

A ratio of 14 days, as in the example, indicates the company is in a strong position to pay its bills in a timely manner. It is however worth noting that this ratio has increased from the prior year.

6. Interest cover

(Profit before income tax - Interest revenue + Finance costs) ÷ Finance costs

(45,415 - 1,087 + 2,239) ÷ 2,239 = 21 times

This indicates how many times profit will cover the finance costs and, as such, how comfortable the company is in meeting its finance obligations (noting that there are also principal repayments to consider).

It is also an indicator of the company's ability to borrow and a minimum level of cover is considered to be 3 times.

In the example provided, the ratio is a very healthy 21 times and profit would have to reduce drastically for there to be an issue. It also indicates that the company has the capacity to borrow more (when or if required).

7. Profit margin

Profit before income tax ÷ Sales

45,415 ÷ 462,781 = 10%

Profit margin is the ratio that shows the percentage of sales that ends up as profit.

The target or goal for this ratio will vary from industry to industry. The 10% achieved by the example company is healthy and compares favourably with its peers.

8. Return on investment

Profit after income tax ÷ Total equity

32,550 ÷ 225,931 = 14%

This indicates the return on equity, so not just the invested capital but also the reserves and retained profits. This would have to be compared to the share price (and resulting market capitalisation, if publicly listed) and dividends paid (per the company's dividend policy).

The expectation is that returns should be higher where the risks, real or perceived, are higher.

In the example, a 14% return indicates a healthy return on investment. Compared to the example company's share price of 2.85, market capitalisation of 418,693 and dividends paid of 0.20 per share, it should be noted that the return is diminished to 8% of market value. However, this remains a good result relative to its peer group and the risks associated with the company.

9. Debt ratio

Total liabilities ÷ Total assets

91,636 ÷ 317,567 = 29%

The debt ratio clarifies the percentage of assets that are funded by liabilities.

Ideally this would not exceed 100% and is generally less than 60%, although this will vary depending on the industry in which a company operates.

At 29% our example company is not highly geared and this supports the earlier observation that the company has the capacity to borrow more (when or if required).

10. Debt to equity ratio

Total liabilities ÷ Total equity

91,636 ÷ 225,931 = 41%

The debt to equity ratio is a measure of the ratio of liabilities to equity and therefore an indicator of risk.

If the debt to equity ratio is greater than 100% it indicates that creditors and lenders have a greater risk than shareholders.

Acceptable debt to equity ratios will vary according to industry, however 150% is usually regarded as the upper limit, regardless of industry.

The example company's ratio of 41% is good and confirms earlier assessments related to its low gearing and favourable borrowing capacity.

11. Profit to operating cash flows

We acknowledge that 'Profit to operating cash flows' is a calculation rather than a ratio, however we regard it as an important measure, worthy of inclusion in this booklet.

Profit after income tax - Share of profits of associates + Depreciation and amortisation expense - Net cash from operating activities

32,550 - 3,211 + 19,101 - 39,119 = 9,321

The 'profit to operating cash flows' calculation indicates the difference between profit and net cash from operating activities. It can be used as a mechanism to better understand the relationship between profit and cash.

The relationship between cash and profit may not always be immediately clear, take the following scenarios for example:

- A highly profitable company can have poor operating cash flows. It may not be collecting receivables, it could be holding too much inventory or it could be paying its debts too quickly, all of which will adversely impact operating cash flows.
- Conversely, a company can have very good cash flows but have no profit. It could have a large depreciation and amortisation expense, it may be receiving income in advance or it may simply be very slow in paying its bills.

If the indirect method is used for the statement of cash flows, this will detail the movements in operating assets and liabilities and help provide greater clarity on the relationship between cash and profit of the company.

The result of the 'profit to operating cash flows' calculation for the example company is 9,321. This result is quite significant as it means that approximately 10,000 is being invested into net operating assets.

A closer look at the statement of financial position reveals that inventories have increased by 23,477, helped by an offset in an increase in both payables by 2,698 and provision for income tax by 4,350.

Significant profits were absorbed by the increase in inventory, having a detrimental effect on operating cash flows.

Sample Limited
Statement of profit or loss and other comprehensive income
For the year ended 31 December 2019

	Note		Consolidated 2019 £'000	2018 £'000
Revenue (see example Note 4 - shown on page 9 - for the details of sales A)	4	A	466,475	435,118
Share of profits of associates accounted for using the equity method	5	B	3,211	2,661
Other income	6	C	742	1,692
Interest revenue			1,087	543
Expenses				
Changes in inventories			23,477	9,218
Raw materials and consumables used			(164,078)	(141,118)
Employee benefits expense			(227,169)	(221,724)
Depreciation and amortisation expense	7	D	(19,101)	(20,363)
Impairment of goodwill	7		(500)	-
Net fair value loss on investment properties	7		(600)	-
Other expenses			(35,890)	(32,372)
Finance costs	7	E	(2,239)	(3,451)
Profit before income tax expense		F	45,415	30,204
Income tax expense	8		(12,865)	(8,355)
Profit after income tax expense for the year		G	32,550	21,849
Other comprehensive income				
Items that will not be reclassified subsequently to profit or loss				
Gain on the revaluation of land and buildings, net of tax			-	1,400
Items that may be reclassified subsequently to profit or loss				
Gain on the revaluation of financial assets at fair value through other comprehensive income, net of tax			35	-
Cash flow hedges transferred to profit or loss, net of tax			-	(2)
Cash flow hedges transferred to inventory in the statement of financial position, net of tax			(3)	(7)
Net change in the fair value of cash flow hedges taken to equity, net of tax			(7)	(18)
Foreign currency translation			(257)	(218)
Other comprehensive income for the year, net of tax			(232)	1,155
Total comprehensive income for the year			32,318	23,004
Profit for the year is attributable to:				
Non-controlling interest			142	229
Owners of Sample Limited	37		32,408	21,620
			32,550	21,849
Total comprehensive income for the year is attributable to:				
Non-controlling interest			142	369
Owners of Sample Limited			32,176	22,635
			32,318	23,004
			Cents	**Cents**
Basic earnings per share	57		22.06	15.34
Diluted earnings per share	57		22.06	15.34

The above statement of profit or loss and other comprehensive income should be read in conjunction with the accompanying notes

Sample Limited
Statement of financial position
As at 31 December 2019

	Note		Consolidated 2019 £'000	Consolidated 2018 £'000
Assets				
Current assets				
Cash and cash equivalents	9		8,787	14,165
Trade and other receivables (see example Note 10 - shown on page 9 - for details)	10	H	14,336	13,178
Inventories	11	I	59,525	36,048
Financial assets at fair value through profit or loss	12		360	-
Other	13		3,180	2,788
			86,188	66,179
Non-current assets classified as held for sale	14		6,000	-
Total current assets		J	92,188	66,179
Non-current assets				
Receivables	15		145	145
Investments accounted for using the equity method	16		34,192	30,981
Financial assets at fair value through other comprehensive income	17		170	-
Investment properties	18		46,900	47,500
Property, plant and equipment	19		121,253	134,014
Intangibles	20		12,170	11,616
Deferred tax	21		9,289	8,464
Other	22		1,260	1,445
Total non-current assets			225,379	234,165
Total assets		K	317,567	300,344
Liabilities				
Current liabilities				
Trade and other payables (see example Note 23 - shown on page 9 - for details)	23	L	20,004	17,306
Borrowings (see example Note 24 - shown on page 9 - for details)	24	M	8,765	6,251
Derivative financial instruments	25		122	107
Income tax	26		6,701	2,351
Employee benefits	27		8,352	8,143
Provisions	28		3,494	2,837
Other	29		3,412	3,062
			50,850	40,057
Liabilities directly associated with assets classified as held for sale	30		4,000	-
Total current liabilities		N	54,850	40,057
Non-current liabilities				
Borrowings	31		20,823	22,437
Deferred tax	32		3,339	3,205
Employee benefits	33		11,149	10,854
Provisions	34		1,475	1,070
Total non-current liabilities			36,786	37,566
Total liabilities		O	91,636	77,623
Net assets			225,931	222,721
Equity				
Issued capital	35		182,953	182,678
Reserves	36		3,276	3,508
Retained profits	37		22,339	19,314
Equity attributable to the owners of Sample Limited			208,568	205,500
Non-controlling interest	38		17,363	17,221
Total equity		P	225,931	222,721

The above statement of financial position should be read in conjunction with the accompanying notes

accurri
statutory financial reporting software

accurri.com

Sample Limited
Statement of cash flows
For the year ended 31 December 2019

	Note	Consolidated 2019 £'000	Consolidated 2018 £'000
Cash flows from operating activities			
Receipts from customers		508,040	474,832
Payments to suppliers and employees		(462,673)	(428,469)
		45,367	46,363
Interest received		1,084	540
Other revenue		3,964	3,358
Interest and other finance costs paid		(2,154)	(3,451)
Income taxes paid		(9,142)	(8,461)
Net cash from operating activities	54 Q	39,119	38,349
Cash flows from investing activities			
Payment for purchase of business, net of cash acquired	49	(8,072)	(155)
Payments for investments		(510)	-
Payments for property, plant and equipment		(6,215)	(3,048)
Proceeds from sale of investments		80	-
Proceeds from sale of property, plant and equipment		1,511	250
Proceeds from release of security deposits		155	-
Net cash used in investing activities		(13,051)	(2,953)
Cash flows from financing activities			
Proceeds from issue of shares		25	78,750
Proceeds from borrowings		5,000	-
Share issue transaction costs		-	(1,420)
Dividends paid	39	(29,383)	(17,616)
Repayment of borrowings		(6,837)	(88,601)
Net cash used in financing activities		(31,195)	(28,887)
Net increase/(decrease) in cash and cash equivalents		(5,127)	6,509
Cash and cash equivalents at the beginning of the financial year		11,251	4,734
Effects of exchange rate changes on cash and cash equivalents		12	8
Cash and cash equivalents at the end of the financial year	9	6,136	11,251

The above statement of cash flows should be read in conjunction with the accompanying notes

Sample Limited
Notes to the financial statements
31 December 2019

Note 4. Revenue

		Consolidated	
		2019	2018
		£000	£'000
Sales revenue			
Sale of goods		459,403	428,186
Rendering of services		3,378	3,574
	A	462,781	431,760
Other revenue			
Rent from investment properties		3,623	3,310
Other revenue		71	48
		3,694	3,358
Revenue		466,475	435,118

Note 10. Current assets - trade and other receivables

		Consolidated	
		2019	2018
		£'000	£'000
Trade receivables	H	14,344	13,181
Less: Allowance for expected credit losses		(75)	(50)
		14,269	13,131
Other receivables		60	43
Interest receivable		7	4
		14,336	13,178

Note 23. Current liabilities - trade and other payables

		Consolidated	
		2019	2018
		£'000	£'000
Trade payables	L	18,070	15,711
Other payables		1,934	1,595
		20,004	17,306

Note 24. Current liabilities - borrowings

		Consolidated	
		2019	2018
		£'000	£'000
Bank overdraft	M	2,651	2,914
Bank loans		4,500	2,000
Lease liability		1,614	1,337
		8,765	6,251

Sample Limited
Ratio report
31 December 2019

		2019 workings	The equations		Consolidated 2019	2018
Current ratio Current assets / Current liabilities	=	92,188 / 54,850	J ÷ N	=	1.68	1.65
Quick ratio (the acid test) Current assets - inventories / Current liabilities - bank overdraft	=	92,188 - 59,525 / 54,850 - 2,651	(J - I) ÷ (N - M)	=	0.63	0.81
Days trade receivables Trade receivables x 365 / Sales	=	14,344 x 365 / 462,781	(H x 365) ÷ A	=	11.31	11.14
Days inventories Inventories x 365 / Sales	=	59,525 x 365 / 462,781	(I x 365) ÷ A	=	46.95	30.47
Days trade payables Trade payables x 365 / Sales	=	18,070 x 365 / 462,781	(L x 365) ÷ A	=	14.25	13.28
Interest cover Profit before income tax - interest revenue + finance costs / Finance costs	=	45,415 - 1,087 + 2,239 / 2,239	(F - C + E) ÷ E	=	20.80	9.59
Profit margin Profit before income tax / Sales	=	45,415 / 462,781	F ÷ A	=	0.10	0.07
Return on investment Profit after income tax / Total equity	=	32,550 / 225,931	G ÷ P	=	0.14	0.10
Debt ratio Total liabilities / Total assets	=	91,636 / 317,567	O ÷ K	=	0.29	0.26
Debt to equity ratio Total liabilities / Total equity	=	91,636 / 225,931	O ÷ P	=	0.41	0.35
Profit to operating cash flows* Profit after income tax - share of profits of associates + depreciation and amortisation expense - net cash from operating activities	=	32,550 - 3,211 + 19,101 - 39,119	G - B + D - Q	=	9,321	1,202

Key

A = Sales	B = Share of profits of associates	C = Interest
D = Depreciation and amortisation expense	E = Finance costs	F = Profit before income tax
G = Profit after income tax	H = Trade receivables	I = Inventories
J = Total current assets	K = Total assets	L = Trade payables
M = Bank overdraft	N = Total current liabilities	O = Total liabilities
P = Total equity	Q = Net cash from operating activities	

*We acknowledge that 'Profit to operating cash flows' is a calculation rather than a ratio, however we regard it as an important measure, worthy of inclusion in this booklet.

Sample Limited
Ratio report
31 December 2019

		2019 workings		Consolidated 2019	Consolidated 2018
Current ratio					
Current assets / Current liabilities	=	92,188 / 54,850	=	1.68	1.65
Quick ratio (the acid test)					
Current assets - inventories / Current liabilities - bank overdraft	=	92,188 - 59,525 / 54,850 - 2,651	=	0.63	0.81
Days trade receivables					
Trade receivables x 365 / Sales	=	14,344 x 365 / 462,781	=	11.31	11.14
Days inventories					
Inventories x 365 / Sales	=	59,525 x 365 / 462,781	=	46.95	30.47
Days trade payables					
Trade payables x 365 / Sales	=	18,070 x 365 / 462,781	=	14.25	13.28
Interest cover					
Profit before income tax - interest revenue + finance costs / Finance costs	=	45,415 - 1,087 + 2,239 / 2,239	=	20.80	9.59
Profit margin					
Profit before income tax / Sales	=	45,415 / 462,781	=	0.10	0.07
Return on investment					
Profit after income tax / Total equity	=	32,550 / 225,931	=	0.14	0.10
Debt ratio					
Total liabilities / Total assets	=	91,636 / 317,567	=	0.29	0.26
Debt to equity ratio					
Total liabilities / Total equity	=	91,636 / 225,931	=	0.41	0.35

This is a sample of a typical Accurri ‘Ratio report’.

The numbers in this report (all of which can be found in the financial statements) can be used to gain an insight into the financial health of any company.

accurri
statutory financial reporting software

To find out more about Accurri you can:

- Visit our website:
  accurri.com

- View an online demonstration:
  accurri.com/demo

- Email:
  enquiries@accurri.com

- Pricing:
  available at accurri.com/software

Statutory financial reporting *made easier!*