1. Understanding the financial statements

Understanding financial statements is an integral part in finance literature. The financial statements mainly include income statement, statement of financial position, statement of cash flow.

1.1 Income statement

In Public Limited Company (PLC), this is referred to as Statement of Comprehensive Income (SOCI). Income statement was earlier being identified as, Trading, Profit and Loss statement. As the name implies this is prepared to identify profit or loss of the organization for a particular time period. When preparing this statement, "Accrual Concept" is followed. Revenue is recognized when earned and not when actual cash is received. Similarly, expenses too are recognized when they are incurred irrespective of actual cash payment. Income statement can be prepared either in vertical format or horizontal format. The income statement comprises of two components;

- Trading Account
- Profit and Loss Account

1.1.1 Trading account

Trading account is prepared in order to find out the gross profit or gross loss of the business.

Gross profit = Sales – Cost of Sales

1.1.2 Profit and loss account

This part of the income statement captures the overall profit or loss of the organization identified as net profit or net loss.

Net profit = Gross profit + Other income - Expenses

Expenses will be divided into 3 categories;

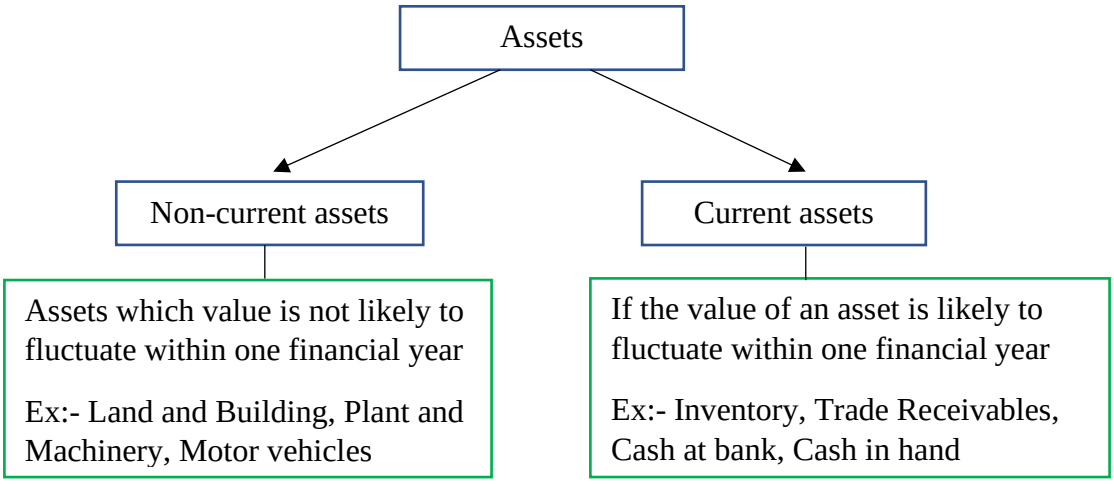
- Administration expenses
- Sales and distribution expenses
- Financial charges

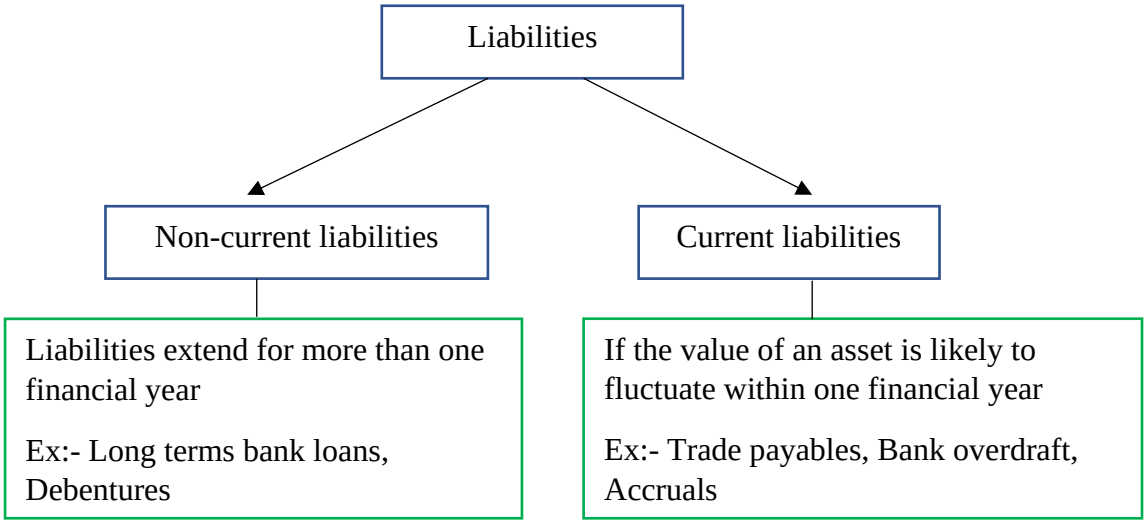
1.2 Statement of Financial Position (SOFP)

This is also referred to as the Balance Sheet and prepared to identify what the organization owns and owes at a certain date. This satisfies the basic accounting equation.

Assets = Equity + Labilities

Therefore, SOFP includes, assets, liabilities and equity. This too can be prepared in 2 formats, vertical and horizontal.





Equity includes stated capital and reserves. Reserves are 2 types namely, capital reserves and revenue reserves. Capital reserves can only be utilized for the purpose for which those reserves were created. For example, asset replacement reserves, share premium, revaluation reserves.

Revenue reserves can be used for any purpose including dividend distribution of subsequent year. For instance, general reserves, retained profits, dividend equalization reserves.

1.3 Information revealed by the financial statements

- The financial position or financial health of the organization
- Liquidity position of the organization

  Liquidity can be two-fold namely, liquidity of the organization and liquidity of an asset. Liquidity of an organization refers to the ability or ease with which an organization can meet its short-term dues as and when they fall due. Liquidity of an asset can be identified as, the ability or ease with which an asset can be converted into cash conveniently and quickly incurring a minimum loss.

- Gearing situation

  This is also known as leverage. Gearing is the relationship between debt capital and equity capital in the total capital employed. If the proportion of debt is great than equity, such organization has high geared capital structure whereas, if the equity is greater than debt, the organization is said to have low geared capital structure

- Useful in terms of identifying the Net Worth of an organization

  This is also referred to as, Net Assets and is the true value of an organization

Net Worth = (Non-current assets + Current assets) – (Non-current liabilities + Current liabilities

- Capital adequacy
- Over trading

  When and organization sells on credit but doesn't collect past dues at the same rate. In other words, the rate at which the organization is selling on credit and the rate at which the organization is collecting such credit doesn't correspond

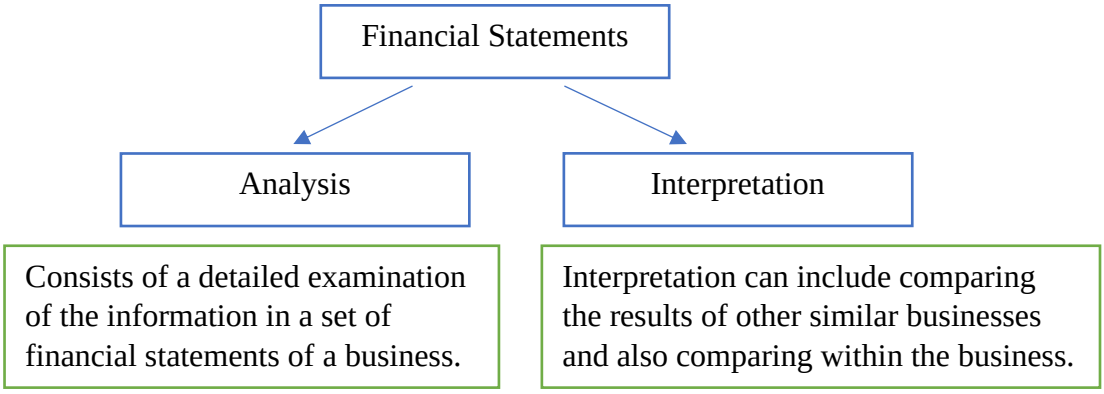
- Provides an indication for the need to upgrade the fixed assets

  When assets are old, the Net Book Value (NBV), will be low, indicating the need for replacement

- Provides information when excessive costs are being incurred

2. Analysis and Interpretation of Financial Statements

It is necessary to analyze and interpret the financial statements of a business in order to assess its performance and progress.



2.1 Ratio analysis

Ratio analysis enables the comparison to be carried out in a meaningful way. There are five types of rations in terms of,

- Profitability ratios
- Liquidity ratios
- Asset management/Efficiency ratios
- Debt management/Gearing ratios
- Market/Investor/Investment ratios

2.1.1 Profitability Ratios

Measure the firm's ability to generate profits

- Gross Profit (GP) Margin

$$GP\ Margin = \frac{Gross\ profit}{Turnover\ (Sales)}\ X\ 100\%$$

This represents the gross profit as a percentage of turnover.

- Gross Profit Markup

$$GP\ Markup = \frac{Gross\ profit}{Cost\ of\ Sales}\ X\ 100\%$$

Represents the gross profit as a percentage of cost of sales.

- Net profit margin

$$Net\ profit\ margin = \frac{NPBT}{Turnover}\ X\ 100\%$$

Represents the net profit as a percentage of turnover

- Return on Capital Employed (ROCE)

Debt – Non current liability

Equity – Stated capital + reserves

} Capital employed

Return - Operating profit

$$ROCE = \frac{Operating\ profits}{Capital\ employed}\ X\ 100\%$$

Measures the return generated on the capital employed (in terms of both debt and equity) in the business

- Return on Total Assets (ROTA) or Return on Assets (ROA)

Total assets = non current assets + current assets

$$ROTA = \frac{NPAT}{Total\ Assets}\ X\ 100\%$$

Measures the return generated on the investment in total assets

- Return on Net Assets (RONA)

Net Assets = (non current assets + current assets) – (non current liabilities + current liabilities)

$$RONA = \frac{NPAT}{Net\ Assets}\ X\ 100\%$$

This measures the return generated on the investment in Net Assets or net investment in Net Assets.

- Return on Equity (ROE)

$$ROE = \frac{Divisible\ Profits}{Equity}\ X\ 100\%$$

When computing this ratio, return is considered as the profits attributable to ordinary shareholders. Also known as divisible profits. This shows the return generated for the ordinary shareholders of the organization. This figure is derived after deducting preference dividend as well

2.1.2. Liquidity Ratios

These ratios enable to identify the ability of the firm to meet its short-term dues as and when they fall due.

- Current Ratio

$$Current\ Ratio = \frac{Current\ Assets}{Current\ Liabilities}\ X\ 100\%$$

Shows for every Rupee of current liability, how much of Rupees in current assets are available. For this ratio, generally accepted standard is 2:1. Having said that, it should also be noted that the standard may vary in certain industries. Current assets are also referred to as "idle assets". Short term investments are the only asset that generate revenue. Whereas, other current assets do not generate revenue as such, thus referred to as idle assets. On contrary, non-current assets generate revenue. Therefore, holding excessive current assets will not be advisable.

- Quick Ratio (Acid Test Ratio)

$$Quick\ Ratio = \frac{Current\ Assets - Inventory}{Current\ Liabilities}\ X\ 100\%$$

Generally accepted ratio is 1:1. But as with the current ratio, size and type of the business should be considered. This shows for every Rupee of current liability; how many Rupees are available in the form of more liquid assets. This excludes inventory, because inventory is not regarded as liquid asset. Inventory can be two stages away from being money. The goods have to be sold and then the money has to be collected from debtors if it is credit sales.

2.1.3 Asset Management/Efficiency Ratios

These ratios measure how productively the firm is using its assets

- Inventory Turnover Ratio

$$Inventory\ Turnover\ Ratio = \frac{Average\ Inventory}{Cost\ of\ Sales}\ X\ 365\ days$$

The lesser this ratio would be better. But at the same time, if it is too low, it might indicate another issue which is over-trading.

- Debtors Turnover Ratio

$$Debtors\ Turnover\ Ratio = \frac{Average\ trade\ receivables\ (Debtors)}{credit\ sales}\ X\ 365\ days$$

This measures on average how soon the debtors settle their accounts.

- Creditors Turnover Ratio

$$Creditors\ Turnover\ Ratio = \frac{Average\ trade\ payables\ (Creditors)}{credit\ purchases}\ X\ 365\ days$$

- Fixed Asset Turnover Ratio

$$Fixed\ Assets\ Turover\ Ratio = \frac{Turnover}{Fixed\ Assets\ (Non-current\ assets)}$$

Compared with investments in fixed assets, what multiple is generated in the form of turnover.

- Total Asset Turnover Ratio

$$Total\ asset\ turnover\ ratio = \frac{Turnover}{Total\ Assets}$$

Compared with investments in total assets what multiple is generated in the form of turnover.

2.1.4 Debt Management Ratios (Gearing Ratios)

- Debt – Equity Ratio

$$Debt - Equity\ Ratio = \frac{Debt}{Equity}\ X\ 100$$

This shows the relative use of debt and equity of the capital employed of the organization. If this is greater than 100%, the company is highly geared. If this less than 100%, company is lowly geared.

- Debt Ratio

$$Debt\ Ratio = \frac{Debt}{Total\ Assets}\ X\ 100$$

How much of total assets is required to settle long term loans.

- Times interest earned / Interest Cover

$$Interest\ Cover = \frac{Operating\ profit\ (EBIT)}{Interest}$$

Interests paid on loans is tax allowable while the dividends paid on equity is not tax allowable. Thus, taking a loan as opposed to issuing equity when funds are required can help to reduce the tax liability of the organization.

2.1.5. Market /Investor Ratios

These ratios measure how the firm is valued by the investors

- Earnings per Share (EPS)

$$EPS = \frac{Divisible\ Profits}{Number\ of\ Ordinary\ Shares}$$

This shows the organization's earning for an Ordinary Share

- Price Earnings Ratio

$$Price\ Earnings\ Ratio\ = \frac{MPS}{EPS}$$

This shows how long it takes for a potential investor to recover their investment

- Dividend Yield

$$Dividend\ Yield\ = \frac{DPS}{MPS} X100$$

This ratio shows the return, a potential investor can earn in the form of dividends.