



The numbers that count

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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 financial reporting.

The resources fall into the following three broad categories:

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

Illustrative Financial Statements

Accurri Illustrative Financial Statements are an invaluable statutory financial reporting resource. Available in PDF and Word formats, the Illustrative Financial Statements are updated to reflect the International Financial Reporting Standards (IFRS) as at 30 June and 31 December each year.

These practical and clear examples 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/ifs>.

Explanatory booklets

Whilst illustrative 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 financial reporting software.

The Illustrative 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

$\text{Total current assets} \div \text{Total current liabilities}$

$92,188 \div 54,850 = 1.68 \text{ times}$

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)

$(\text{Total current assets} - \text{Inventories}) \div (\text{Total current liabilities} - \text{Bank overdraft})$

$(92,188 - 59,525) \div (54,850 - 2,651) = 0.63 \text{ times}$

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

$$(\text{Trade receivables} \times 365) \div \text{Sales}$$

$$(14,344 \times 365) \div 462,781 = 11 \text{ days}$$

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 $(14,344 \times 365) \div (462,781 \times 40\%)$ 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

$$(\text{Inventories} \times 365) \div \text{Sales}$$

$$(59,525 \times 365) \div 462,781 = 47 \text{ days}$$

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

$$(\text{Trade payables} \times 365) \div \text{Sales}$$

$$(18,070 \times 365) \div 462,781 = 14 \text{ days}$$

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

$$(\text{Profit before income tax} - \text{Interest revenue} + \text{Finance costs}) \div \text{Finance costs}$$

$$(45,415 - 1,087 + 2,239) \div 2,239 = 21 \text{ times}$$

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

$$\text{Profit before income tax} \div \text{Sales}$$

$$45,415 \div 462,781 = 10\%$$

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

$$32,550 \div 225,931 = 14\%$$

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

$$91,636 \div 317,567 = 29\%$$

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

$$91,636 \div 225,931 = 41\%$$

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			
<i>Items that will not be reclassified subsequently to profit or loss</i>			
Gain on the revaluation of land and buildings, net of tax		-	1,400
<i>Items that may be reclassified subsequently to profit or loss</i>			
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	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

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

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

Note 10. Current assets - trade and other receivables

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

Note 23. Current liabilities - trade and other payables

	Consolidated	
	2019	2018
	\$'000	\$'000
<i>Trade payables</i>		
Other payables	L 18,070	15,711
	1,934	1,595
	<u>20,004</u>	<u>17,306</u>

Note 24. Current liabilities - borrowings

	Consolidated	
	2019	2018
	\$'000	\$'000
<i>Bank overdraft</i>		
Bank loans	M 2,651	2,914
Lease liability	4,500	2,000
	1,614	1,337
	<u>8,765</u>	<u>6,251</u>

Sample Limited
Ratio report
31 December 2019

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

To find out more about Accurri you can:



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