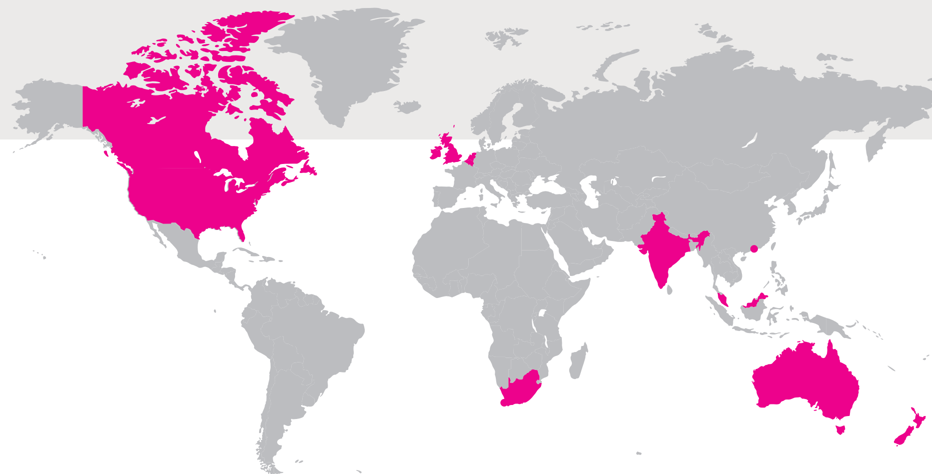
the fd centre

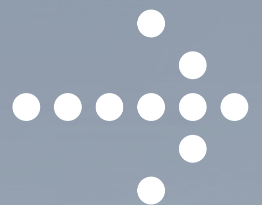
360° VISION – THROUGH GREAT FINANCIAL REPORTING



Financial reporting

"Our FD's analysis of the numbers (and subsequent advice) greatly influences the strategic direction of the business and is hugely valuable."

Liz Stockley The IDL Group



Executive summary

To be successful, you and your senior managers need regular access to accurate insights into your business. You need to be able to spot problems when they first emerge; see what's working; find opportunities, and recognise threats.

When you know the reality of how your business is actually performing, you have a platform to work from and can make decisions based on facts rather than speculation and anecdotal evidence.

Highlights

- The three key financial statements you need
- How to interpret your key financial statements using ratios
- Which financial ratios should you use
- The main reasons for poor business reporting
- How a part-time FD will improve your business reporting structure

Introduction

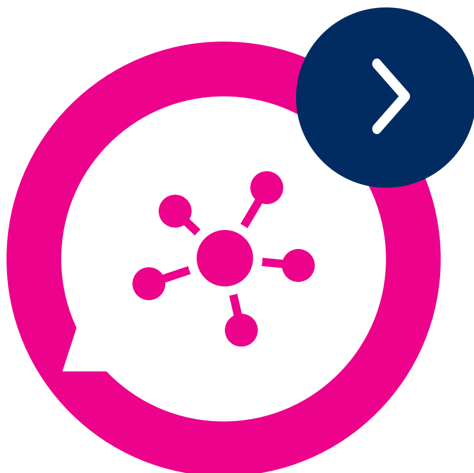
A lot of businesses wait too long to introduce a proper business financial reporting structure. But without the right information collected in the right way, effective analysis and precise planning is impossible.

The importance of business reporting is twofold:

1. To have retrospective visibility over past performance (that is, to analyse performance data and use it as a tool to course correct for the future).

2. To have visibility into the future (knowing what is likely to happen around the corner)

Well-constructed business reports are the secret weapon for CEOs and MDs of ambitious growth companies. They will reveal how your company is performing and how far you are from reaching your goals.



The three key financial statements

At the very least you need to have regular access to three key financial statements.

They are:
- The Balance Sheet
- The Cash Flow Statement
- The Profit and Loss Account (also known as the Income Statement, Statement of Earnings and Statement of Operations)

From these three statements, you'll get invaluable information that you can use to manage your company more effectively.

Essentially, they will show you:
- How much cash is in the bank
- Your sales income and business expenses
- What the business is owed and what the business owes.

1 Balance Sheet

Your Balance Sheet shows what your company owes and what it owes at a given time.

It reveals:
- The net value of your company (which is useful if you plan to sell your business)
- Current and long-term debt
- Asset management (how effectively you're managing your assets) and liquidity ratios (the ability to transform assets into cash)

It reveals the company's overall health in terms of its capacity to pay its current debts. By comparing the current assets to the current liabilities, you can see whether your company is in a position to meet its short-term financial obligations.

Lenders will use the information to determine your company's creditworthiness. Investors too will look closely at your Balance Sheet since it is a good indicator of your company's stability and liquidity (which are factors in determining your company's ability to fund growth without the need for external financing).

2 Profit and Loss Account (also known as an Income Statement)

This is the main tool businesses use to gauge their profitability. It shows how well (or not) your company performed over a particular period of time in terms of revenue, expenses and earnings.

The Profit and Loss Account reveals the steps you can take to increase profitability (for example, whether to focus on more profitable product lines or services or to cut unnecessary expenses).

Investors will use your Profit and Loss Account to assess the level of risk involved in extending credit or venture capital to your company.

It also allows you to look at your Gross Profit and Net Profit margins. These will show you trends that enable you to make business changes.

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You can use your Gross Profit and Net Profit margins as benchmarks to get a clearer picture of how your company is performing.

You can do that in two ways:

External benchmarking

- Compare your profit margins with those of similar companies within your industry. Find out where you're doing well as well as where you should set goals for improvement.

Internal benchmarking

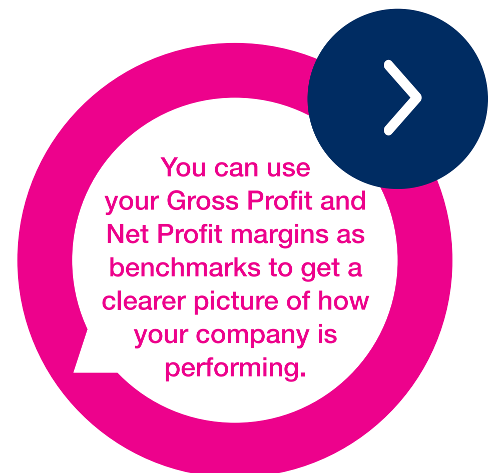
- Compare your profit margins to previous periods to see where costs are increasing or your selling prices are coming under pressure.

- Compare your profit margins on individual product lines or services to see which ones are the most profitable.

3 The Cash Flow Statement

This reveals how your company spends its money and where the money comes from (cash inflows) during a period of time. It is divided into three sections related to your company's business operations: cash flow from operations, financing, and investing transactions.

Essentially, the Cash Flow Statement reveals whether or not your company has the cash to cover its daily activities, pay bills on time and maintain a positive cash flow. It also helps you to determine whether you'll need additional capital to buy stock or to fund seasonal fluctuations.



How to interpret your key financial statements using ratios

To interpret and understand the numbers contained in your financial statements, you can use financial ratios. The numbers for ratios are taken from the Profit and Loss Account and the Balance Sheet, but not the Cash Flow Statement.

They measure performance in percentage terms rather than raw numbers. This means you can compare your company's performance with other businesses in your industry, with your previous results and with your projections.

They can help you to answer questions such as are your operating expenses too high, is the business carrying excess debt or inventory/stock, and are your customers paying according to terms?

Banks and other lenders will want to see your ratios to see how your business performs in comparison with other businesses they're lending to and with the standards they've set for lending.

Typically, owners, managers, and stakeholders look at four categories of ratios to analyse a company's performance:

- Liquidity ratios (which reveal your company's ability to meet its financial obligations including debt, payroll, taxes, payments to vendors/suppliers)
- Profitability ratios (which help you evaluate your company's ability to generate profits)
- Leverage ratios (which shows you how – and how extensively—your business is using debt)
- Efficiency ratios (which reveal how efficiently your company is managing certain key balance sheet assets and liabilities).

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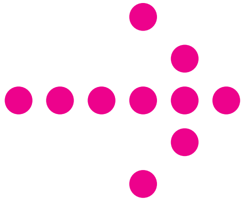

Liquidity ratios

These measure a company's capacity to pay its debts as they come due. They are:

- **Current Ratio:** This gauges how able a business is to pay current liabilities by using current assets only. A ratio of less than one means you could run short of cash within the next financial year unless you generate extra cash.
- **Quick Ratio (also known as the Acid Test Ratio):** This focuses on immediate liquidity (cash, accounts receivables, etc.) but doesn't include stock/ inventory.

  It indicates the extent to which your business could pay current liabilities without relying on the sale of inventory.
- **Defensive interval:** This is a measure of impending insolvency and shows the number of days your business can exist if no more cash flows into it. It should be between 30 and 90 days, although that depends on your industry.

When you've calculated your liquidity ratios, ask yourself the following questions:

- Did working capital increase or decrease?
- What factors caused any changes in our working capital?
- What are the trends in:
  - Current and quick ratios from year to year?
  - Working capital to annual sales, especially compared to receivables and inventories in relation to sales volume?
- How much working capital should we have for the type of business we are in?
- Are we carrying too much debt?
- Are our debt repayment terms too hard on cash flow?
- Is the company getting behind on its payments to suppliers?

Profitability ratios

The profitability ratios measure your company's ability to generate a return on its resources. They reveal whether your company is as profitable as it should be.

- **Gross Profit Margin:** This reveals the profit margin your company enjoys on the goods or services it sells after subtracting direct costs.

- **Operating Margin (Also known as Earnings Before Interest and Taxes (EBIT):** This shows the profit margin after deducting indirect costs from your gross profit margin. If gross profit margins are rising while operating margins are falling, you'll know that you need to take tighter control of your indirect costs.

- **Net Profit Margin (Also known as Return on Sales):** This shows how much net profit is derived from every pound of total sales. It indicates how well the business has managed its operating expenses. It can also show whether the business is making enough sales volume to cover minimum fixed costs and still leave an acceptable profit.

  Decreasing profit margins year over year may suggest changing market conditions, increasing competition, or rising costs. A very low profit margin could mean it is vulnerable to market conditions. A very high profit margin could mean that your company has an advantage that might not last.

- **Return on Assets:** This evaluates how effectively the company employs its assets to generate a return. It measures efficiency.

- **Return on Net Worth (Also called Return On Investment (ROI):** This determines the rate of return on the invested capital. It is used to compare investment in the company against other investment opportunities, such as stocks, real estate, savings, etc. There should be a direct relationship between ROI and risk (i.e., the greater the risk, the higher the return).

Once you've calculated your ratios, ask yourself:

- Are our expenses under control?
- Have our sales dropped? Why?
- Do we have excess cash in our account?

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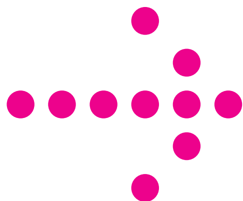

Leverage ratios (also known as capitalisation ratios)

These ratios reveal your company's vulnerability to risk. A financial leverage ratio higher than 2 to 1 indicates financial weakness. A highly leveraged company is considered more risky.

- **Debt to Worth Ratio (also known as the Debt to Net Worth Ratio):** This quantifies the relationship between the capital invested by the company's owners and investors and the funds provided by creditors.

  The higher the ratio, the greater the risk to a current or future creditor.

  A lower ratio means your company is more financially stable and is probably in a better position to borrow now and in the future.

  A very low ratio may indicate that you're being too conservative and may be inhibiting the company's growth.

- **Times Interest Earned Ratio:** This assesses your company's ability to meet interest payments. It also evaluates the capacity to take on more debt.

  The higher the ratio, the greater the company's ability to make its interest payments or perhaps take on more debt.

After calculating your ratios, ask the following questions:

- What is our long-range goal or target solvency position?
- How restrictive are our creditors' conditions?

A lower ratio means your company is more financially stable and is probably in a better position to borrow now and in the future.

Efficiency ratios

These evaluate how well your company manages its assets. Besides determining the value of the company's assets, you should also analyse how effectively the company uses its assets. You can use the following ratios to do that:

- **Accounts Receivable Turnover:** This shows the number of times accounts receivable are paid and re-established during the accounting period. The higher the turnover, the faster the business is collecting its receivables. That generally means your company has more cash on hand.
- **Accounts Receivable Collection Period**: This reveals how many days it takes to collect all your accounts receivable.
- **Accounts Payable Turnover:** This shows how many times in one accounting period your company turns over (repays) its accounts payable to creditors.

  The higher number indicates that either your company is holding onto its money longer or that it's having more difficulty paying your creditors.
- **Payable Period:** This reveals how many days it takes to pay accounts payable.
- **Inventory Turnover:** This shows how many times in one accounting period the company turns over (sells) its inventory/stock.

  It is useful for seeing problems such as overstocking, understocking, obsolescence, and the need for merchandising improvement.

  Faster turnovers are generally viewed as a positive trend; they increase cash flow and reduce warehousing and other related costs.
- **Inventory Turnover in Days:** This identifies the average length of time in days it takes the inventory to turn over. The fewer days, the more quickly your stock is being sold.
- **Sales to Net Worth:** This indicates how many sales pounds are generated with each pound of investment (net worth). This is a volume ratio.
- **Sales to Total Assets:** This reveals how efficiently the company generates sales on each pound of assets. A volume indicator, this ratio measures the ability of the company's assets to generate sales.
- **Debt Coverage Ratio:** This indicates your company's ability to satisfy its debt obligations, and its capacity to take on additional debt without impairing its survival.

Once you've calculated your ratios, ask the following questions:

- Are we buying too much stock?
- Are we collecting receivables on time? Can we do it more efficiently?
- Can we stretch out our payables without harming our relationships with our suppliers?

Which financial ratios should you track?

Some ratios will be more applicable to certain industries and businesses than others. If you provide a service rather than sell products, then ratios like return on assets and inventory turnover are unlikely to be relevant to your company whereas the receivables turnover is critical to your business operations.

It's best to choose the five most relevant ratios to your business and track those as part of your monthly management operating plan.

It's crucial to look at your ratios on a monthly basis so that you can spot trends as they develop.

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The main reasons for poor business reporting

There are various reasons why companies don’t use monthly financial management reports.

One is that they don’t have the services of an accountant so can’t interpret the data into something senior managers can understand. Another is they don’t have the time to compile the reports. And a third is the pain of implementing new systems to record the required data.

This, in turn, prevents business owners from making the decision to migrate to a new reporting platform. This is dangerous because it perpetuates confusion in the business and exacerbates the problem. Doing the hard work of getting a reporting infrastructure set up prevents all sorts of issues in the long run.

These reports can reveal such information as:

- How effective your team is at controlling costs
- Which of your products or services are the most profitable
- Your most profitable customers
- Where your break-even point is

Having all your business data at your fingertips means that you can spot gaps and weaknesses at a glance, have clear visibility over the future and course correct daily to ensure you are still en route to your destination.

How a part-time FD will improve your business reporting structure

'Reporting' is simply a case of recording all relevant data in your business and presenting that data in a range of different ways to allow for effective analysis.

Most businesses have some level of reporting in place but in most cases existing procedures are insufficient to allow for rapid growth.

The FD Centre will provide you with a highly experienced senior FD with 'big business experience' for a fraction of the cost of a full-time FD. This means you will have:

- One of the UK's leading FDs, working with you on a part-time basis
- A local support team of the highest calibre FDs
- A national and international collaborative team of the top FDs sharing best practice (the power of hundreds)
- Access to our national and international network of clients and partners

With all that support and expertise at your fingertips, you will achieve better results, faster. It means you'll have more confidence and clarity when it comes to decision-making. After all, you'll have access to expert help and advice whenever you need it.

When it comes to business reporting in particular, your part-time FD will:

- Identify your Key Performance Indicators (KPIs).
- Give you daily visibility of your KPIs, which will allow a much faster response time.
- Produce monthly management accounts/reports within 14 days of month end so the data is fresh and relevant.
- Establish reporting processes for sales and marketing so that there is clear visibility over what's working and what's not.
- Establish reporting processes for business operations so that activity can be monitored and improvements can be made periodically.
- Create back office systems and processes to make sure the right infrastructure is in place to operate the business efficiently.
- Implement processes for keeping costs to a minimum and visibility over expenditure so that managers can understand their own department figures and be held accountable for cost control.
- Introduce budgets and targets by department and allocate responsibilities to managers to free up your time to focus on growing the business.
- Educate managers about gross margin and profitability to help focus resource throughout the business to spend time on the things which lead to business growth.
- Identify your fixed and variable costs and show you how to control them.
- Analyse trends within the business and within the market and move to more predictable and considered forecasting to avoid panic and fighting last minute fires.

Conclusion

REAL IMPACT BETTER RESULTS FASTER MONEY CONFIDENCE

The benefits of having regular access to high-quality financial management reports are far-reaching. Good reports reveal the efficiency (or otherwise) of the constituent parts of the business and enable you to deal with potential threats and take advantage of opportunities to grow your business.

The compound effect of making regular, quick and high-quality decisions based on a strong set of data and reports cannot be overestimated.

Get access to high-quality business reports now

With the help of one of the FD Centre's part-time FDs, you too could be benefiting from having regular, high-quality business reports. To book a free one-to-one call with one of our part-time FDs:

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