

Hipp Accounting Limited

Guide to Your Financial Reports

Your financial reports tell you the story of your business; allowing you to interpret the results of your business activity. The better you understand your financial reports, the better your decision-making and results will be.

We want to share the benefits of understanding your numbers, give you an overview of the standard reports and provide helpful tips on using them to improve your business. Where possible, we've avoided jargon and 'Accountanese', however, if you need further support or guidance from us, please do get in touch.

The benefits of knowing your numbers

Knowing your numbers will allow you to:

- Understand whether your business is growing or shrinking
- Track trends over time
- Compare results to your expectations (as set in your budget)
- Compare results between years or different periods
- Identify areas of strength and weakness
- Measure your business efficiency
- Measure the value of your business
- Identify symptoms of underlying problems
- Measure your cashflow
- Make better business decisions

"You don't have to be an accountant or bookkeeper to understand your numbers; just as you don't have to be a mechanic to drive a car."

Knowing your numbers puts you in a far stronger position to make informed decisions and measure the impact of those decisions on your results, enabling you to take corrective action.

This guide is designed to be general in nature and is no substitute for specific one on one advice. We strongly recommend you talk to us about your unique situation and how we can help you improve your business.

Tips for starters

No matter which report you're looking at, there are fundamentals to consider and understand:

- 1. Is the data 'clean'?** Most software packages allow you to export your own reports. While this gives you flexibility, the data can be unreliable if transactions haven't been coded correctly or bank statements haven't been reconciled. Likewise, if monthly invoicing hasn't been completed, sales reports could be understated. Contact us for information on the monthly procedures you should follow to keep your data 'clean'.
- 2. Inspect what you expect.** Your reports are a representation of what you planned for your business. For example, you may have set a sales or gross profit target in your Business Plan and Cashflow Forecast (what you *expected*). Your reports can then be used to *inspect* if you're on track to achieve those targets.
- 3. Know which reports to use.** Trading Accounts and Profit & Loss Statements measure income and

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expenses; the Balance Sheet measures assets, liabilities and net worth. There are different versions of each report, e.g. for the Profit & Loss you can measure this year vs last year, this period vs the same period last year, or this period vs the budget you set. Talk to us about the most appropriate reports for your business.

4. Go horizontal and vertical when analysing your financial reports. A horizontal analysis compares the results of previous periods, e.g. comparing your 2020 Gross Profit to your 2019 Gross Profit. This shows whether your results are improving over a specified period. A vertical analysis calculates each item in the statement as a percentage of a base item, e.g. calculating expenses as a percentage of sales in your Profit & Loss. Conducting both helps identify specific areas of potential improvement.

5. 'As at' or 'for the period ending'. An 'as at' report shows the balances at the end of a specific period, e.g. the Balance Sheet shows asset and liability balances at the end of the financial year. A 'for the period ending' report shows the results over a period of time, e.g. the Profit & Loss shows your Gross Profit or Net Profit over the specified period.

6. Choosing the date range. For a period ending report, ensure you correctly specify the start and end date for the period you want to measure. For example, reporting on the current month and the year to date (the period from the start of this current financial year to the month you are in now). It's best practice to choose a date that is a month end date, e.g. if you want to print a report on 15 July, set the date range to end on 30 June, as you should have all income and expenses coded and reconciled for the period ending 30 June, but may not have coded and reconciled them for July yet.

Your key financial reports

The rest of this guide provides an overview of your key financial reports, what each report tells you about your business, some key ratios to use to track your results, and some tips on how to make good use of the reports.

Key ratios:

By calculating key ratios, you can compare your results over a number of periods, compare the profitability of different product lines, divisions or locations, and compare your results to your industry benchmarks. All of this provides information which should be used in your decision-making. It's important to only compare your ratios with companies in the same industry; what may be viewed as a 'good' ratio for one industry, may be 'poor' in another.

Below is an overview of the following reports:

1. Your Trading Account.
2. Statement of Profit & Loss.
3. Balance Sheet.
4. Statement of Changes in Equity.
5. Shareholder Current Account.

1. Your Trading Account.

Your Trading Account can be prepared at any stage during the year and shows sales generated less any variable

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costs directly associated with those sales. It's used to calculate your Gross Profit (sometimes referred to as your Gross Margin) which is often also shown as a percentage.

The basic format for your Trading Account is: Sales - Cost of Sales = Gross Profit

If your business has multiple divisions, locations or product lines, a separate Trading Account should be used for each so you can monitor the performance and compare the profitability of each.

Cost of Sales

Cost of Sales is the total cost of producing the sales for the period being reported. In its simplest sense, if you sell ice cream, the cost of selling one ice cream is the cost of the ingredients plus other variable costs of producing that ice cream for sale, such as transport, packaging (the paper napkin or sleeve), and labour.

A more comprehensive way to measure Cost of Sales is:

Cost of Sales = Opening Stock + Purchases + Direct Labour Costs - Closing Stock

Opening Stock	Valued at cost price.
Purchases	All variable costs to produce the product, e.g. ice cream, cone, refrigeration, packaging, transport costs, etc.
Direct Labour Costs	Wages for staff selling the product but not business administration wages, e.g. ice cream sales staff.
Closing Stock	Valued at cost price.

Subtracting the Cost of Sales for any given period from the sales for that period gives you the Gross Profit.

Gross Profit

Your Gross Profit shows how much is left after costs directly relating to sales have been paid. Direct costs increase as your sales increase and include delivery expenses, direct wages, packing material, sales commission, etc.

Key Ratios:

Gross Profit Percentage = (Gross Profit / Sales) * 100

Your Gross Profit Percentage shows the contribution of each dollar of Sales towards your overhead costs and profit. For example, if Sales are \$1,000,000 and your Gross Profit is \$250,000, your Gross Profit Percentage is 25%. This means that for each \$1 of sales, 25c is available for overhead expenses and profit. To increase your Gross Profit Percentage, review cost of sales and direct costs to find potential savings. Increasing sales won't increase your Gross Profit Percentage as the costs will increase in line with the increase in sales.

Mark Up = ((Selling Price - Cost Price) / Cost Price) * 100

Mark Up is not the same as Gross Profit. The distinction between Gross Profit and Mark Up is very important.

Mark Up is the amount you add onto your variable costs to arrive at a selling price. It's expressed as a percentage, so you know how to convert your costs to a selling price. If we look at our ice cream example and determine that

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variable costs to produce one ice cream are \$2 and we sell that ice cream for \$4, our Mark Up is 100%: $((\$4 - \$2) / \$2) * 100$.

To calculate the Gross Profit Percentage for that single ice cream, divide the cost price by the selling price and multiply by 100. So the Gross Profit Percentage on that ice cream would be 50%: $(\$2 / \$4) * 100$.

Trading Account Tips:

A. Increasing sales is not the only way to grow your overall profit. However, growing sales should always be part of your strategy. There are five ways to grow sales:

1. Increase client retention - look after existing customers well so they keep coming back.
2. Generate more leads or enquiries - use your marketing effectively.
3. Convert more leads into customers - ensure you have an effective sales process and strong sales skills.
4. Increase transaction frequency - encourage people to buy from you more often.
5. Increase transaction value - encourage people to spend more each time they buy from you.

B. Lifting your Gross Profit Percentage by 1-2% can make a huge difference to your results. Calculate this impact by taking 1% of your total sales for the year; that is how much more will hit your overall profit if you lift your Gross Profit Percentage by 1%. We can help you employ strategies to increase your margin.

C. Compare your expected Gross Profit Percentage to your actual Gross Profit Percentage. You can do this by 'back costing' a job once you've finished it. Calculate all costs associated with a completed job, e.g. for a building job, the total material and labour costs for that job, then divide by the selling price to determine the Gross Profit for that job.

D. Ensure your pricing is up to date. If your Gross Profit is declining, review your costing to ensure you're using current costs when pricing a job, product or service. Many businesses use great pricing tools and standard Mark Up formulae but often have outdated costs in the model or calculation.

E. Consider all costs associated with creating a sale. Your margin could be slipping because there are costs hidden in overheads that should be measured as variable costs. For example, a mobile ice cream truck will have fuel as a variable cost, but the fuel costs might be lumped in as overhead costs with another business vehicle.

2. Statement of Profit & Loss.

Your Statement of Profit & Loss, or Income Statement, tracks the overall performance of your business. It begins with the Gross Profit from your Trading Account then lists all overhead expenses, giving you the Net Profit. Some software combines the Trading Account and the Profit & Loss into one report, so the items from the Trading Account appear at the top of the Profit & Loss.

The basic format for your Statement of Profit & Loss is:

Net Profit = Sales - Cost of Sales + Other Income - Expenses - Tax

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Sales	If Trading Account not reported separately.
Cost of Sales	If Trading Account not reported separately.
Other Income	Interest received, dividends received, rental income.
Expenses	Sometimes broken down into sections, e.g. Admin Expenses, Selling Expenses, Finance Expenses, etc.
Tax	Amount of tax payable on Net Profit Before Tax.

In the annual financial statements, depreciation is also included in the Statement of Profit & Loss.

Your Net Profit (or loss) is the amount left over after all expenses have been paid, including tax. Unlike the Trading Account, your Profit & Loss shows all fixed costs. These are the costs which remain the same no matter what your sales level is, e.g. electricity, office expenses, bad debts, accounting fees, vehicle expenses, depreciation, etc.

Key Ratios:

Net Profit Percentage = (Net Profit / Sales) * 100

This is the amount of Sales available as profit after all expenses, including tax, have been paid. For example, if Net Profit is \$100,000 and Sales are \$1,000,000, the Net Profit Percentage is 10%, so you make 10c profit for every \$1 of sales.

The higher the Net Profit Percentage, the better, as it shows how profitable your business is. To increase your Net Profit Percentage, review your fixed costs and find areas to save or increase your sales or margin.

Overhead Ratio(s) = (Overhead Cost / Sales) * 100

This shows the percentage of Sales spent on Overheads. The goal is to have a low Overhead Ratio; spending less on Overheads and retaining more as profit. For example, if total Overheads are \$150,000 and Sales are \$1,000,000, the Overhead Ratio is 15%, so for every \$1 of sales, 15c is spent on Overheads. If you're spending \$10,000 per year on advertising, check if 1% is in line with industry benchmarks for your business (or compared to the percentage in prior years or in your budget).

To reduce your Overhead Ratio, go through each overhead expense and determine whether it could be reduced or cut completely. For example, online meetings instead of in-person meetings will likely save a significant amount.

Be careful when cutting Overheads, as some may indirectly contribute to your profit. For example, before cutting advertising costs from 1% to 0.5%, establish the level of sales generated from current advertising. Spending 1% may still be the right decision, but the \$10,000 could be better directed at your most effective marketing channel.

Statement of Profit & Loss Tips:

A. Profit is a driver of business value. Most businesses are valued using a multiple of profit (usually Earnings Before Interest and Tax or EBIT) so, the higher the profit, the higher the business value.

B. Accounting / bookkeeping fees should be an investment, not a cost. If you view what you pay us as a cost,

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that cost ought to be cut; but if you see us as a strategic partner, helping you run a more successful business, then our fees are an investment in your business, not a cost to cut.

C. Fixing the Balance Sheet can fix the Statement of Profit & Loss too. Looking at the Profit & Loss in isolation won't reduce certain costs. For example, slow collection of debtors may mean a higher overdraft and more interest, increasing costs in your Profit & Loss. Likewise, you may be incurring bad debts or debt collection costs.

Having loans structured incorrectly could mean you pay more interest than necessary. For example, an overdraft carries a higher interest rate than a term loan, and banks usually charge less than finance companies.

D. Make sure you're accounting for a fair wage to working owners. Consider what you're being paid for the hours you work. You may be making a profit, but if you divide that by the total hours worked, you may be working for below minimum wage. Paying yourself a fair wage ensures the true cost of running the business is reported. There are tax implications to consider, so talk to us about the best way to record your effective wage cost.

E. Tax savings increase your profit and cashflow. Talk to us about strategies to legitimately minimise your tax.

3. Balance Sheet.

Your Balance Sheet, or Statement of Financial Position, measures the net worth of your business at a point in time and shows if your business is solvent (if assets are greater than liabilities).

It details assets, liabilities, and shareholders' equity (funds contributed by shareholders and accumulated profits not yet paid out as dividends). In many ways, the Balance Sheet is more important than your Profit & Loss as it shows:

1. The overall health of your business.
2. If your business is appropriately resourced from a financial perspective.
3. Areas of strength (and weakness).
4. How the business is financed - both from shareholders and financiers.
5. The cash reserves available.
6. The assets employed and investments made.
7. The level of debt outstanding to creditors, the tax department and financiers.
8. Amounts owed to shareholders.

The basic format for your Balance Sheet is:

Equity (retained profits and reserves) = Total Assets - Total Liabilities

It's called a Balance Sheet because the 'Net Assets' (Total Assets less Total Liabilities) should always balance with the Equity. If these don't, let us know as we love fixing problems like these.

Breaking this format down further we have:

Total Assets = Current Assets + Non-current Assets

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Current Assets	Cash, bank accounts, stock/inventory, tax refundable, debtors, work in progress.
Non-current Assets	Investments, goodwill, loans made to other parties, fixed assets.

Total Liabilities = Current Liabilities + Non-current Liabilities

Current Liabilities	Creditors, overdraft, loans repayable within a year, tax payable.
Non-current Liabilities	Term loans, shareholder loans/advance accounts.

If Total Liabilities are more than Total Assets, your Net Assets will be negative, and your business is insolvent. In this case, please contact us urgently so we can advise you on what needs to happen. There are serious consequences for you if your business is insolvent.

"A strong Balance Sheet (where net assets are high) means your business is better equipped to weather a storm or continued downturn in the economy."

Key Ratios:

Current Ratio = Current Assets / Current Liabilities

The Current Ratio, also known as your Working Capital Ratio, shows whether the company can meet its short-term obligations with its Current Assets if they all fell due at the same time. A ratio of 0.8 means that for every \$1 of Current Liabilities, there's 80c of Current Assets to cover them. A ratio of 2.5 means that for every \$1 of Current Liabilities, there's Current Assets of \$2.50, therefore there wouldn't be a problem paying short-term obligations.

However, a high Current Ratio could indicate the inefficient use of Current Assets or poor working capital management. The key is to compare the ratios across different periods or with companies in the same industry. To improve your Current Ratio, consider strategies such as better controls on expenditure, faster invoicing of work done or restructuring your overdraft into a long-term loan.

Debtor Days = (Debtors / Sales) * 365

This shows, on average, how many days it takes customers to pay you. The lower the number, the better, as your cash isn't tied up in your debtors and you've reduced the risk associated with bad debts / collection costs.

Calculate Debtor Days using Sales for the entire year and Debtors at month end. For example, if Debtors are \$80,000 and Sales are \$1,000,000, Debtor Days will be 29. How good this is depends on your payment terms; if they state payment within 7 days, 29 days is well above this and corrective action should be taken.

If your policy is payment on the 20th of the month following invoice, then you may consider 29 days to be fine. The reality is that 29 days is not fine. Using the above example, 10 days of debtors represents \$27,397 of cash you could have in your bank account (Sales / 365 x 10 days). If Debtor Days were reduced to 19 days, you'd have an extra \$27,000. Your terms should ensure you get paid as fast as possible. Payment within 7-14 days is standard.

Inventory Days = (Inventories / Cost of Sales) * 365

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This shows how long it takes you to sell your stock, in other words, the number of days that cash is tied up in inventory. The lower the number, the better. For example, if your Inventory is \$50,000 and your Cost of Sales is \$350,000, your Inventory Days will be 52. This means that, on average, inventory sits for 52 days before being sold.

To reduce your Inventory Days, review your inventory processes and identify slow-moving stock. Consider whether you should discontinue this, or only hold a display model in store and order stock on demand.

Debt to Equity Ratio = Total Liabilities / Shareholders' Equity

The Net Assets value in your Balance Sheet represents your Shareholders' Equity (Total Assets - Total Liabilities). The Debt to Equity Ratio shows how a company has financed its growth. A high ratio means it has mostly been funded by debt; a low ratio means it's funded more by shareholders and is more sustainable.

While debt is often necessary to help a company grow, high levels of debt put the company at a higher risk. Do the returns generated from the debt outweigh the cost of the debt? For example, if Total Liabilities are \$750,000 and Shareholders' Equity is \$200,000, the Debt to Equity Ratio is 3.75. This means that the company has \$3.50 of debt for every \$1 of equity. In most industries, this would be considered very high risk, however, it could also indicate expansion, leading to increased revenue in the future. On the other hand, a very low Debt to Equity Ratio may indicate a lack of growth.

Balance Sheet Tips:

A. Cash is king. Having large amounts of cash tied up in inventory, debtors, or work in progress can be a large drain on cash reserves. Worse still, it's likely you've already paid tax on these amounts. Talk to us about how to convert inventory, work in progress and debtors into cash faster and what it will mean for your business.

B. Shareholder loans can be your friend or foe. A shareholder loan, or Shareholder Current Account, is the amount owed to the shareholder by the company. These loans should show as a liability in the Balance Sheet as they form part of the financing of the business. If they're showing as assets, it means the shareholders owe that amount to the company. This is a high risk situation. If the company gets into financial difficulties, a receiver or liquidator can demand this money from the shareholder, who will no longer have the protection of limited liability.

C. Know your key ratios. These are different for each business and there may be some variation in how they're best calculated for your business. It's common to put the key ratios into your Business Plan to track your results over time. Talk to us about the best key ratios for your business.

D. What is the true net worth of your business? Unless you've correctly valued goodwill, you won't get a true valuation of the business by only looking at your Balance Sheet. Create a 'rule of thumb' valuation formula that you can adopt to assess your goodwill each year. This rule of thumb can then be used as a guide as to whether your business value is increasing or decreasing. Talk to us about an appropriate rule of thumb to track valuation movements over time.

4. Statement of Changes in Equity.

The Statement of Changes in Equity records what happens to any profits for the year; whether they are paid out as dividends or kept in the business as retained earnings. Generally speaking, the higher the equity, the better for the company. However, shareholder loans can also be treated as part of the equity. Therefore, it's possible that, while the company is technically insolvent (more liabilities than assets), if the shareholder loans are recorded as equity, the company is effectively relying on the shareholders to pay its debts as they fall due.

The basic format for your Statement of Changes in Equity is:

Total Equity = Opening Balance + Gain on Sale of Fixed Assets + Profit - Dividends Paid - Loss

Opening Balance	The equity position from the end of the last financial year.
Gain on Sale of Fixed Assets	Where assets have been sold for more than their cost.
Profit for the Period	Carried forward from your Statement of Profit & Loss.
Dividends Paid	Any dividends paid out to shareholders during the year.
Loss for the Period	Carried forward from your Statement of Profit & Loss.
Total Equity	The equity position at the end of the period.

If Total Equity is negative, the company is insolvent and cannot pay out any dividends. The directors must take action to increase the profitability of the company.

5. Shareholder Current Account.

This records all funds introduced to the business by shareholders, credited to shareholders as dividends or salary, or taken out of the business as drawings. The Shareholder Current Account is also called a Shareholder Loan as it's a debt owed by the company to the shareholder(s). Where a company has multiple shareholders, it ensures a record of different balances for each shareholder is maintained.

The basic format for your Shareholder Current Account is:

Closing Balance = Opening Balance + Funds Introduced - Drawings - Insurance

Opening Balance	Balance owed by the company to shareholders from the end of the last financial year.
Funds Introduced	Cash or assets invested into the company by shareholders.
Drawings	Cash withdrawals, assets taken from the company by shareholders, personal expenses paid by the company on behalf of the shareholders.
Insurance	Personal insurances paid by the company which aren't tax deductible by the company, e.g. life insurance.

The balance of each Shareholder's Current Account represents the amount the business owes that shareholder. If

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the balance is negative, the shareholder has taken out more than they've put in, and owes the company money. It's important to monitor your Shareholder Current Account and understand the potential tax implications of it being overdrawn.

To remedy an overdrawn Shareholder Current Account, a shareholder could repay the amount owed, declare a shareholder salary, or declare a dividend. The company must be solvent for a shareholder salary or dividend to be declared.

Shareholder Current Account Tips:

A. Consider security. As funds owed to shareholders are recorded as loans, consider having the company provide security for the debt. If the company gets into financial difficulty, the shareholders could potentially be paid back before unsecured creditors. Talk to us about whether this is possible for your situation.

B. Have a dividend and drawings policy. Instead of taking funds out of the business as drawings or dividends unchecked, establish a regular amount that you stick to. This amount can be worked out at the start of each year when you do your budget and forecast to ensure you don't strip the company of much-needed cash.

C. Keep shareholder loan balances in proportion to shareholding. If you have a 25% shareholder and a 75% shareholder, establish what the company can afford to pay out to shareholders each month, then distribute it 75:25 to shareholders. E.g. if monthly drawings total \$10,000, the 75% shareholder gets \$7,500 and the 25% shareholder gets \$2,500. This ensures no shareholder ends up funding more than their proportionate share of the company. Get in touch if you have multiple shareholders and need support ensuring your Shareholder Current Accounts stay in proportion to shareholding.

D. Pay working shareholders a wage. Paying a market wage to shareholders does two things: it allows the company to realistically measure profit (as the true wage cost is included in the expenses) and makes tax planning easier (as tax can be paid out each month as opposed to getting lumpy tax bills). Talk to us about the benefits of paying yourself a wage vs taking drawings from your company.

If you'd like to learn more about your financial reports, the key financial ratios you should be measuring, and how to improve your results, get in touch to find out how we can help.