BAS ASSOCIATES

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OUR GUIDE TO YOUR BALANCE SHEET REPORT

Introduction

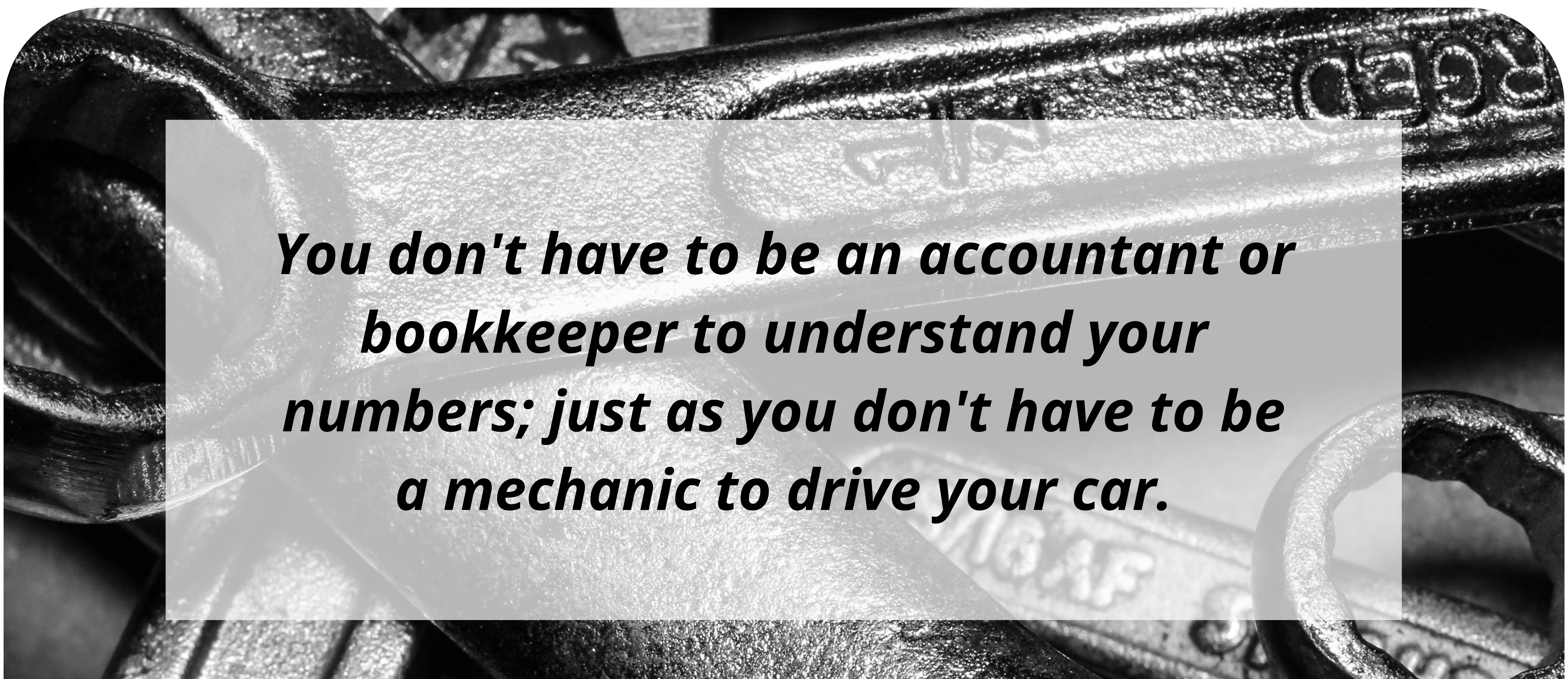
Your financial reports tell you the story of your business; allowing you to interpret the results of your business activity. The better you understand your financial reports, the better your decision-making and results will be.

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, this guide is no substitute for specific one on one advice. We are available to talk to you about your unique situation and how we can help you and your business.

The benefits of knowing your numbers:

- Understand if your business is growing or shrinking
- Identify and track trends
- Compare results to your expectations (as set in your budget)
- Compare results between years or different periods
- Identify areas of strengths and weakness
- Measure your business efficiency
- Measure the value of your business
- Identify symptoms of underlying problems
- Measure your cashflow
- Make better business decisons



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 your car.

Tips for beginners

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. Profit & Loss Statements measure income and 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.

Tips for beginners cont.

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 date required). 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. Not to mention reoccurring monthly expenses may not be included if using a mid-month date.

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 Balance sheet reports.

To ensure you have a rounded view and understanding of your business numbers, we recommend you also look at the following reports:

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

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 in the case of companies shareholders' equity (funds left in the business by owners 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.

Balance sheet

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.

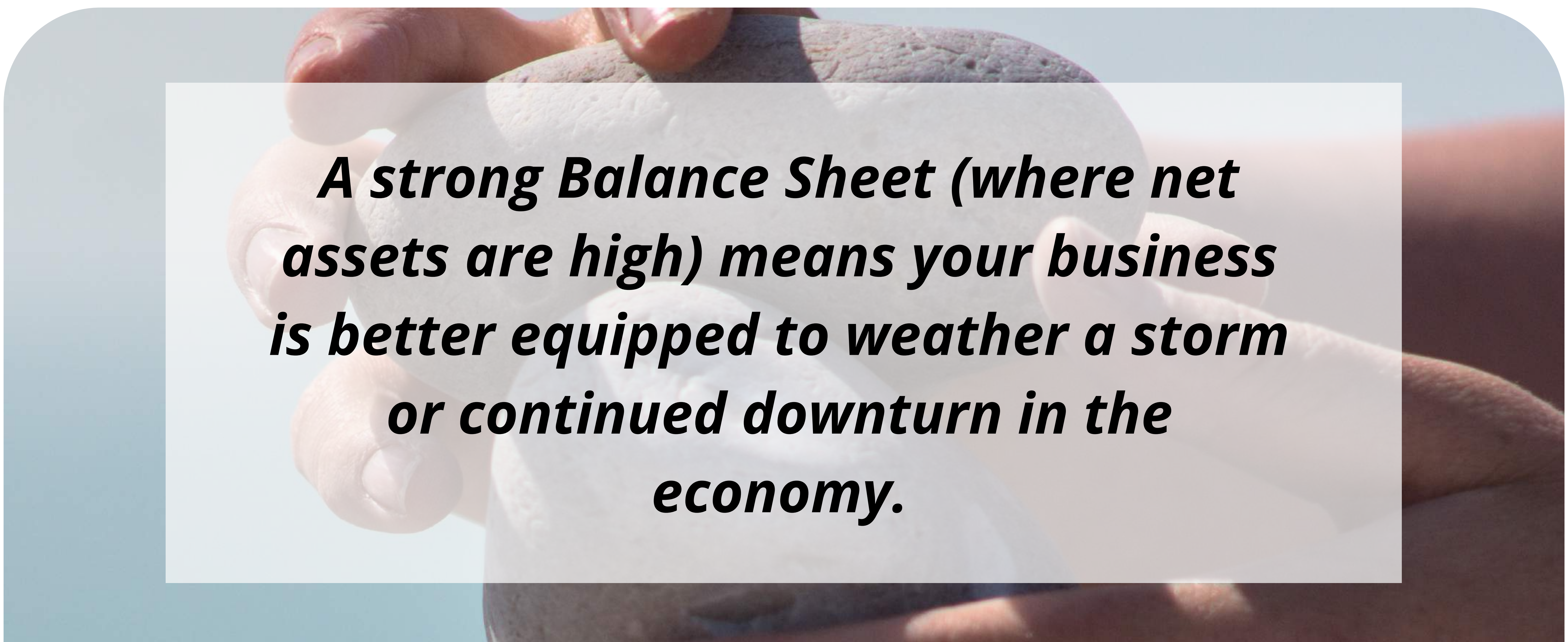
Breaking this format down further we have:

Total Assets = Current Assets + Non-current Assets

Descriptions
Current Assets: Cash, bank accounts, stock/inventory, tax refundable, debtors, work in progress... essentially, anything that can be converted into cash.
Non-current Assets: Investments, goodwill, loans made to other parties, fixed assets, those that take longer to turn into cash.

Total Liabilities = Current Liabilities + Non-current Liabilities

Descriptions
Current Liabilities: Creditors, overdraft, loans repayable within 1 year, tax payable
Non-current Liabilities: Term Loans, shareholder loans/advance accounts



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.

Balance sheet

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 80p 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.

Balance sheet

Key Ratios:

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.

Balance sheet

Key Ratios:
Inventory Days = (Inventories / Cost of Sales) * 365
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? You won't get a true valuation of the business by only looking at your Balance Sheet. Valuing a business is a complicated process with a multitude of different factors used to provide an estimate. Further to this, valuations vary by industry and sector. Finally, a bit like buying a house, a valuation is a guideline and a business is only really worth what someone is prepared to pay for it. A buyer looking to asset strip will make a very different offer to a buyer looking to maintain business as usual.

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"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."

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