



INTERPRETING FINANCIAL STATEMENTS



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Introduction

This paper deals with understanding financial statements, being the Profit and Loss Statement, Cash flow Statement and Balance Sheet.

Presentation of Financial Statements

Australian Accounting Standards Board (“AASB”) 1 states that the purpose of financial statements is ‘*to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions*’ (paragraph 9).

A wide range of users includes those providing finance and/or credit to companies.

A complete set of financial statements as stated in paragraph 10 of AASB 101 contains: -

- a) A statement of financial position as at the end of the period;
- b) A statement of profit or loss and other comprehensive income for the period;
- c) A statement of changes in equity for the period;
- d) A statement of cash flows for the period;
- e) Notes, comprising a summary of significant accounting policies;
- f) A statement of financial position at the beginning of the required comparative period if applicable.

AASB 101 (paragraphs 15-46) outlines eight general features of a complete set of financial statements: -

1. Fair presentation and compliance with International Financial Reporting Standards.

This requires faithful representation of transactions, other events and conditions in accordance with definitions and recognition criteria for the elements of financial statements (assets, liabilities, income and expenses).

2. Going Concern

Financial statements for an entity are prepared on a going concern basis, unless management intends to liquidate the entity or cease trading, or has no realistic alternative but to do so.

3. Accrual basis for accounting

Financial statements are to be prepared using the accrual basis for accounting, except for cash flow information.

Accrual based accounting records revenues and expenses when they are earned and incurred, regardless of when cash is exchanged.

The term “accrual” refers to any individual entry of recording revenue or expense in the absence of a cash transaction.

It is a common misconception that profit equals cash. There is a timing difference with the profit coming into the hands of the Company and also there may be income (in the form of debtors) that are ultimately not received.

Accrual based accounting is an income statement that better measures the profitability of a company during a specific time period.

4. Materiality and aggregation

Each material class of similar items are to be presented separately. It would be meaningless to present users with details of every transaction, so the financial statements group together certain transactions.

Information is material if its non-disclosure could influence the decisions of financial statement users, this is also determined by the size and nature of the item.

5. Offsetting

Offsetting of assets and liabilities or income and expenses may result in the loss of relevant information for financial statement users and as such this is prohibited except where a particular standard requires or permits offsetting.

6. Frequency of reporting

AASB 101 paragraph 36 requires an entity to present a complete set of financial statements at least annually.

7. Comparative Information

An entity should report comparative financial information from the previous period for all items required to be reported in the current period's financial statements.

8. Consistency of presentation

Financial statements should be prepared on a consistent basis from one period to the next. Any significant change, i.e. change in accounting policy or a change required by a standard should be disclosed. Any change should only be made if the revised presentation provides information that is reliable and more relevant to users and is likely to continue.

Statement of Profit or loss and other comprehensive income

Profit or loss is the total of income less expenses, excluding the items of comprehensive income which include, changes in the value of property, plant & equipment, gains and losses in employee benefits, changes in foreign exchange rates and financial instruments.

Income is defined as *increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants* Conceptual Framework, para 4.25(a). Income encompasses revenue and gains.

- Revenue arises from the company's 'ordinary activities' and may include sales of goods, fees, interest, dividend and royalties. It represents gross inflows of economic benefits to a company, as such amounts collected on behalf of third parties like GST are not economic benefits flowing to a company.
- Gains arise from the disposal of an item of property, plant and equipment and are included when the gain occurred. It is not classified as revenue but recognised on a net basis (the difference between the net proceeds and the carrying amount of the asset as income).

Expenses is defined as *decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants* Conceptual Framework, para 4.25(b).

Expenses arise in the course of the company's 'ordinary activities' including cost of sales, wages and depreciation. Losses are described as expenses that may or may not arise in the course of ordinary activities of a company.

Other expense items include:

- The write-down of inventories to net realisable value or of property; plant and equipment to recoverable amount, and any reversal of such write-downs
- Restructuring of company operations and reversals of any provisions for restructuring costs
- Disposal of items of property, plant and equipment
- Disposal of investments
- Discontinued operations
- Litigation settlements
- Other reversals of provisions

Cash flow Statement

A cash flow statement, also known as *statement of cash flows*, is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.

The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses. The cash flow statement is a cash basis report on three types of financial activities: operating activities, investing activities, and financing activities. Non-cash activities are usually reported in footnotes.

The cash flow statement is intended to:

1. Provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances
2. Provide additional information for evaluating changes in assets, liabilities and equity
3. Improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
4. Indicate the amount, timing and probability of future cash flows

The cash flow statement has been adopted as a standard financial statement because it eliminates allocations, which might be derived from different accounting methods, such as various timeframes for depreciating fixed assets.

For example, consider a company that has a net income of \$100 this year, and its debtors increased by \$25 since the beginning of the year. If the balances of all other current assets, long term assets and current liabilities did not change over the year, the cash flows could be determined by the rules above as $\$100 - \$25 = \text{Cash Flows from Operating Activities} = \75 . The logic is that, if the company made \$100 that year (net income), and they are using the accrual accounting system (not cash based) then any income they generated that year which has not yet been paid for in cash should be subtracted from the net income figure in order to find cash flows from operating activities. And the increase in debtors meant that \$25 of sales occurred on credit and have not yet been paid for in cash.

Cash flow activities

The cash flow statement is divided into three segments, namely:

1. Cash flow resulting from operating activities;
2. Cash flow resulting from investing activities;
3. Cash flow resulting from financing activities.

The money coming into the business is called cash inflow, and money going out from the business is called cash outflow.

Operating activities

Operating activities include the production, sales and delivery of the company's product as well as collecting payment from its customers. This could include purchasing raw materials, building inventory, advertising, and shipping the product.

Operating cash flows include:

- Receipts for the sale of loans, debt or equity instruments in a trading portfolio
- Interest received on loans
- Payments to suppliers for goods and services
- Payments to employees or on behalf of employees
- Interest payments (alternatively, this can be reported under financing activities in IAS 7)
- buying Merchandise

Items which are added back to [or subtracted from, as appropriate] the net income figure (which is found on the Income Statement) to arrive at cash flows from operations generally include:

- Depreciation (loss of tangible asset value over time)
- Deferred tax
- Amortization (loss of intangible asset value over time)
- Any gains or losses associated with the sale of a non-current asset, because associated cash flows do not belong in the operating section (unrealized gains/losses are also added back from the income statement).
- Dividends received

Investing activities

Examples of Investing activities are:

- Purchase or Sale of an asset (assets can be land, building, equipment, marketable securities, etc.)
- Loans made to suppliers or received from customers
- Payments related to mergers and acquisition.

Financing activities

Financing activities include the inflow of cash from investors such as banks and shareholders, as well as the outflow of cash to shareholders as dividends as the company generates income. Other activities which impact the long-term liabilities and equity of the company are also listed in the financing activities section of the cash flow statement.

Examples of Financing activities include

- Payments of dividends
- Payments for repurchase of company shares
- For non-profit organizations, receipts of donor-restricted cash that is limited to long-term purposes

Disclosure of non-cash activities

Non-cash investing and financing activities are disclosed in footnotes to the financial statements. Non-cash activities may be disclosed in a footnote or within the cash flow statement itself. Non-cash financing activities may include:

- Leasing to purchase an asset
- Converting debt to equity
- Exchanging non-cash assets or liabilities for other non-cash assets or liabilities
- Issuing shares
- Payment of dividend taxes in exchange for assets

The following steps would occur to generate a Cash flow statement

- Decrease in non-cash current assets are added to net income
- Increase in non-cash current assets are subtracted from net income
- Increase in current liabilities are added to net income
- Decrease in current liabilities are subtracted from net income
- Expenses with no cash outflows are added back to net income (depreciation and/or amortization expense are only operating items that have no effect on cash flows in the period)
- Revenues with no cash inflows are subtracted from net income
- Non operating losses are added back to net income
- Non operating gains are subtracted from net income

Statement of Financial Position as at the end of the period

The statement of financial position is also referred to as the Balance Sheet. The Balance Sheet simply states an entities assets, liabilities and equity position.

The formula for the balance sheet is represented below: -

$$\text{ASSETS} - \text{LIABILITIES} = \text{EQUITY}$$

Naturally, an entity wants its assets to be greater than its liabilities so that the equity is greater than 1.

Elements of the Balance Sheet – Definitions and Recognition Criteria per the Conceptual Framework

Item	Definition	When Recognised
Asset	A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity (para. 4.4(a))	It is probable that the future economic benefits will flow to the entity, and that the asset has a cost or value that can be measured reliably (para. 4.44)
Liability	A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (para. 4.4(b))	It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation, and the amount at which the settlement will take place can be measured reliably (para. 4.46)

	Settlement of a liability may include, payment of cash, transfer of other assets, provision of services, replacement of the obligation with another obligation; and conversion of the obligation to equity.	
Equity	The residual interest in the assets of the entity after deducting all its liabilities (para. 4.4(c))	Because equity is the arithmetic difference between assets and liabilities, a separate recognition criterion for equity is not needed

AASB 101 paragraph 54 states that “*the statement of financial position shall include line items that present the following amounts:*”

- (a) *Property, plant and equipment;*
- (b) *Investment property;*
- (c) *Intangible assets;*
- (d) *Financial assets (excluding amounts shown under (e), (h) and (i));*
- (e) *Investments accounted for using the equity method*
- (f) *Biological assets within the scope of AASB 141 Agriculture;*
- (g) *Inventories;*
- (h) *Trade and other receivables;*
- (i) *Cash and cash equivalents;*
- (j) *The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with AASB 5 Non-current assets held for sale and discontinued operations;*
- (k) *Trade and other payables;*
- (l) *Provisions;*
- (m) *Financial liabilities (excluding amounts shown under (k) and (l));*
- (n) *Deferred tax liabilities and deferred tax assets, as defined in AASB 112;*
- (o) *Liabilities included in disposal groups classified as held for sale in accordance with AASB 5;*
- (p) *Non-controlling interests, presented within equity; and*
- (q) *Issued capital and reserves attributable to owners of the parent*

Paragraph 57 states that

- (a) *Line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity’s financial position; and*
- (b) *The description used and the ordering of the items or aggregation of similar items may be amended according to the nature of the entity’s financial position.*

An entity must make a judgement about whether to present additional items separately on the basis of an assessment of the following under AASB 101 paragraph 58

- (a) *The nature and liquidity of assets;*
- (b) *The function of assets within the entity; and*
- (c) *The amounts, nature and timing of liabilities.*

The traditional current/noncurrent categories can be used or, alternatively all the assets and liabilities can be presented in order of liquidity.

Current/non-current distinction

AASB 101 paragraph 60 states that “*an entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position in accordance with paragraphs 66–76 except when a presentation based on liquidity provides information that is*

reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity”.

Current Assets

Paragraph 66 defines a current asset as an asset which satisfies any of the following criteria

- (a) *It expects to realise the asset, or intends to sell or consume it in its normal operating cycle;*
- (b) *It holds the asset primarily for the purpose of trading;*
- (c) *It expects to realise the asset within twelve months after the reporting period; or*
- (d) *The asset is cash or a cash equivalent (as defined in AASB 107 Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period*

An entity shall classify all other assets as non-current

Non-current Assets

Non-current assets include tangible, intangible and long-term financial assets.

The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. The operating cycle can be longer than twelve months for some companies, including those in the construction industry.

Current Liabilities

Paragraph 69 defines a current liability as a liability which satisfies any of the following criteria

- (a) *it expects to settle the liability in its normal operating cycle;*
- (b) *it holds the liability primarily for the purpose of trading;*
- (c) *the liability is due to be settled within twelve months after the reporting period; or*
- (d) *it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73).*

Liabilities which do not satisfy the above criteria are classified as non-current liabilities.

Paragraph 77 requires an entity to disclose, either in the statement of financial position or in the notes, further subclassifications of the line items presented. The details provided in the subclassifications depend on the requirements of other standards and on the size, nature and function of the amounts involved.

The factors outlined in paragraph 58 indicated above are also used to decide the basis of subclassification. According to paragraph 78, additional disclosures may include: -

- Property, plant and equipment – for example land, land and buildings, machinery, ships, aircraft, motor vehicles, furniture and fittings, and office equipment;
- Receivables – separated into receivables from trade customers, related parties, prepayments and other amounts;
- Inventories – separated into classifications such as merchandise, production supplies, materials, work in progress and finished goods;
- Provisions – separated into provisions for employee benefits and other items;
- Contributed equity and reserves – separated into various classes of paid-up capital and reserves.

In addition paragraph 79(a) requires disclosure of certain items for each class of share capital: -

- (i) the number of shares authorised;
- (ii) the number of shares issued and fully paid, and issued but not fully paid;

- (iii) par value per share, or that the shares have no par value;
- (iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
- (v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
- (vi) shares in the entity held by the entity or by its subsidiaries or associates; and
- (vii) shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and (b) a description of the nature and purpose of each reserve within equity.

Measurement and recognition

An item that meets the definition of an element, being an asset, liability or equity should be recognised if

- (a) *it is probable that any future economic benefits associated with the item will flow to or from the entity; and*
- (b) *the cost or value of the item can be measured reliably.*
(conceptual framework, para 4.38)

Items that do not meet the probability criterion or the reliable measurement criterion (but otherwise meet the definition of the element) may warrant disclosure in the notes to the financial statements. This approach is reflected in the requirement for accounting for contingencies.

AASB 137 defines a contingent asset and liability as follows: -

Contingent Asset

“A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity”.

Contingent Liability

“A contingent liability is:

- (a) *a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*
- (b) *a present obligation that arises from past events but is not recognised because:*
 - i) *it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or*
 - ii) *the amount of the obligation cannot be measured with sufficient reliability.*

These items are not recognised as they do not satisfy the dual recognition criteria of a probable inflow or outflow of resources and sufficiently reliable measurement.

Once an item has met the recognition criteria the next decision is how to measure the item. The item is measured initially and then subsequently.

Relationship between Profit & Loss Statement and Balance Sheet

The Profit & Loss statement summarises a business’ trading transactions, income and expenses resulting in a profit or loss over a certain period of time. The Balance Sheet provides a financial snapshot at a particular point in time, it doesn’t show the day to day transactions or the current profitability of the business. However, the Balance Sheet figures are affected by the profit and/or loss on transactions.

Any profit recorded in the Profit & Loss not distributed is recorded in the equity section of the balance sheet as retained profits, thereby increasing the equity of the Company. Similarly any loss recorded in the Profit and Loss, reduces the equity of the Company.

Measurement bases

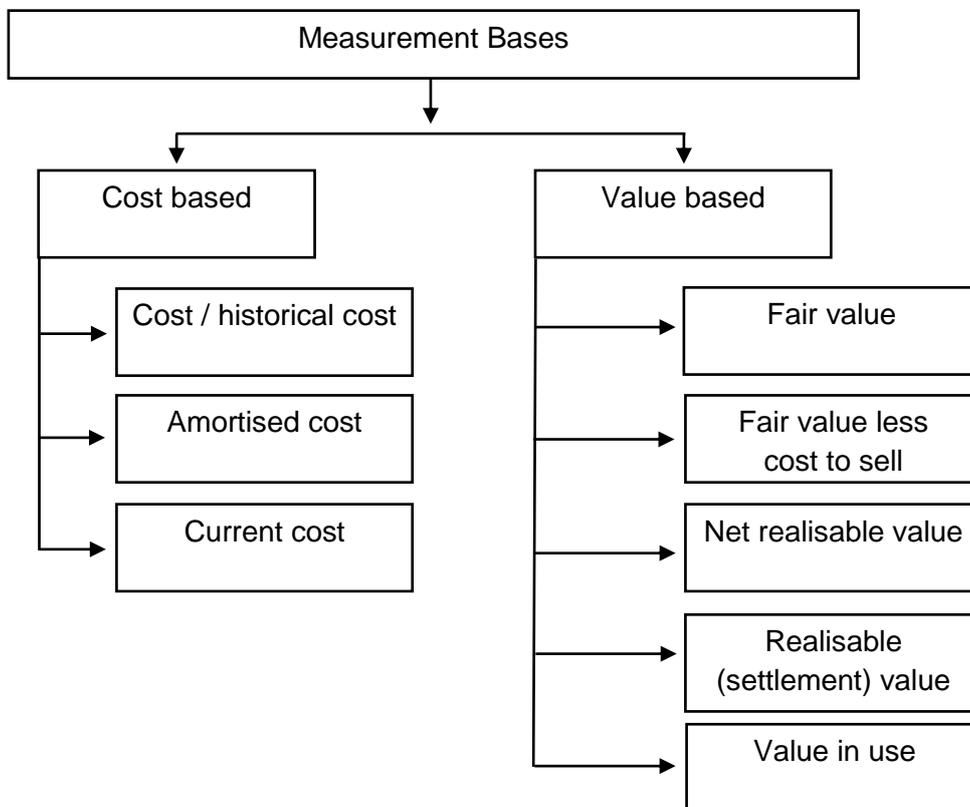
Cost-Based

Measurement of an asset on a cost basis includes the cost to acquire an asset, or an estimate of the cost that would be incurred in replacing an asset.

Measurement of a liability on a cost basis includes the proceeds received in exchange for the obligation, or the cash expected to be paid to satisfy the liability in the normal course of business.

Value-based

Value-based measures include those measurement attributes that require some form of valuation to be undertaken such, as fair value.



Cost/historical cost

This is the amount paid or the fair value consideration given to acquire the asset at the time of acquisition.

Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or the amount of cash expected to be paid to satisfy the liability in the normal course of business.

The advantages of using historical cost basis are as follows: -

- Well understood
- Relevant to decision making – as it is the fair value of the consideration given or received in exchange for an asset or liability
- Reliable – provides evidence for income based on actual transaction with external parties
- Less costly to implement – value is readily available due to occurrence of transaction

The disadvantages attributed to historical cost are as follows: -

- Limited relevance to decision making because: -
 - Not a forward looking measurement
 - Old costs being associated with current revenues
 - Profit can be affected by selective timing of the sale of assets
 - Needs to be supplemented by additional rules that check whether the amount is recoverable
 - Doesn't deal adequately with assets acquired for nil or nominal consideration
- Undermines the comparability of financial reports because: -
 - Costs incurred at various points in time are aggregated as though they are equivalent in economic terms
 - The costs incurred may depend on the efficiency of the entity, e.g. self – constructed assets
- Problems with reliability include: -
 - Can be difficulties in objectively determining the historical cost when calculating the fair value of the purchase consideration and other incidental costs;
 - Reflects at a minimum management expectations of recoverability to market expectations
 - Allocation may have been arbitrary and undermine its faithful representation

Amortised cost

This is defined as

“the amount at which the financial assets or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.”

Current Cost

The current cost of assets is the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. The current cost of a liability refers to the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Current cost has been criticised for the following: -

- Lack of relevancy to decision making, this includes
 - It is not a measurement of the value received but of the sacrifice amount that would be required to replace the asset and as such has no predictive value
 - Financial information is difficult to interpret where this measurement is used where an entity does not intend to replace the assets
 - Its applicability to non-renewable or irreplaceable assets is questionable
 - Not an independent measurement attribute it must be supplemented by other rules to ensure cost is recoverable
- Reliability problems
 - Need to identify equivalent items and their most current economic cost may reduce reliability
 - Uncertainty about reliability as replacement costs is an entity specific measure

- Comparability problems
 - Managements strategies and expectations with respect to the asset may change
 - There may be significant difference between entities in the determination of current cost

Fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in an arm's length transaction at the measurement date.

The assumptions of an orderly sale include: -

- There is exposure to the market for a period before the measurement date to allow for the marketing activities that would normally take place for the sale of such assets or liabilities; and
- It is not a forced sale.

Fair value has been criticised for the following: -

- Lack of relevance – in relation to assets that an entity does not intend to sell;
- Reliability problems – in relation to measuring the fair value of assets that are not traded in an active market

Fair value less costs

Fair value less costs to sell is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Net realisable value

Net realisable value measures the amount of economic benefits that an entity expects to derive from selling an asset in the ordinary course of business. It is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Realisable (settlement) value

Realisable (settlement) value is defined as follows: -

“assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business”.

The fair value of a liability is the amount that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. In contrast the settlement value refers to the amount that would be paid to settle the liability with the counterparty.

Value in use

Value in use is defined as the present value of future cash flows expected to be derived from an asset or cash-generating unit.

Value in use measurement is criticised for the following: -

- Reliability problems
 - Value in use is specific to each entity;
 - Subjective and not capable of being independently verified
 - The application to assets that do not generate contractual cash flows is problematic
 - An individual asset may work with other assets to generate cash flows, and such allocations across the assets may be arbitrary

- Understandability
 - Lack of clarity as to whether value in use should reflect management or market expectations.

Key Balance Sheet Items and Their Associated Measurement Criteria

Key Balance Sheet Item	Accounting Standard	Measurement at Recognition	Measurement After Initial Recognition
Property, Plant and Equipment	AASB 116	Where an asset can be recognised, AASB 116 para. 15 requires it to be initially measured at cost.	<p>Subsequent to initial recognition, an entity has the option of carrying assets under either the cost model or the revaluation model, as prescribed in AASB 116 para. 29.</p> <p>The selection of the cost model or the revaluation model is an accounting policy decision. The Standard prescribes that the policy must be applied to an entire class of PPE, rather than to individual assets (para. 36). An entity may elect to adopt the cost model of measurement for some classes of PPE and the revaluation model for other classes of PPE.</p>
Intangible Assets	AASB 138	An intangible asset is initially measured at cost (AASB 138 para. 24). Intangible assets may be acquired from other entities or may be internally generated.	<p>Subsequently, an entity will choose, on a class of asset basis, between the cost and the revaluation models (AASB 138 para. 72).</p> <p>Under the cost model, the intangible asset, after initial recognition, is carried in an entity's financial statements at its cost less accumulated amortisation and any accumulated impairment losses (AASB 138 para. 74).</p> <p>Under the revaluation model, the intangible asset, after initial recognition, is carried at a revalued amount, being its fair value at the date of revaluation less any subsequent accumulated amortisation and any accumulated impairment losses.</p>
Inventories	AASB 102	Inventories shall be measured at the lower of cost and net realisable value (AASB 102 para. 9)	When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs (AASB 102 para.34)

<p>Financial Instruments (includes cash at bank, trade receivables, fair value hedging derivatives, trade payables, borrowings)</p>	<p>AASB 9 AASB 139</p>	<p>AASB 9 para. 5.1.1 specifies that financial assets and financial liabilities shall be initially measured at fair value plus or minus transaction costs, unless they have been classified as a financial asset or financial liability at fair value through profit or loss (FVTPL), in which case, transaction costs are expensed.</p>	<p>Under AASB 9 the two bases under which financial assets and financial liabilities can be measured after initial recognition are fair value and amortised cost.</p> <p><u>Fair Value</u> The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.</p> <p>The change in fair value is recognised either in other comprehensive income or profit or loss depending on the classification of the instrument.</p> <p><u>Amortised Cost</u> Calculated as the initial amount recognised <u>less</u> any principal repayments <u>add or minus</u> cumulative amortisation (interest) using the Effective Interest Method (EIM) minus any write-downs for impairment or uncollectability.</p>
<p>Provisions, Contingent Liabilities and Contingent Assets</p>	<p>AASB 137</p>	<p>The amount recognised must be the best estimate of the expenditure required to settle present obligations at the reporting date, taking into account the risks and uncertainties that surround the events and circumstances affecting the provision. It should reflect the amount that an entity would rationally be required to pay to settle the obligation at the reporting date, or to transfer to a third party at that time (AASB 137 paras 36 and 37).</p> <p>If settlement is expected to occur after more than one year, and the effect of the time value of money is material, the amount should be discounted using a pre-tax rate specific to the liability.</p>	<p><u>Provisions</u> At each reporting date, the provision needs to be remeasured and adjusted to reflect the current best estimate. If the provision is measured using discounted cash flows, the carrying amount of the provision will increase each year to reflect the passage of time and, hence, the unwinding of the discount. This increase is recognised as a borrowing cost and treated as an expense (AASB 137 paras 59 and 60).</p> <p><u>Contingent Liabilities</u> A contingent liability is not recognised in the financial statements; however, disclosure is required, unless the possibility of an outflow of benefits is remote (AASB 137 paras 27–28).</p> <p><u>Contingent Asset</u> A contingent asset cannot be recognised as an asset in the statement of financial position. An example of a contingent asset that would require disclosure is a court case brought by an entity where the chance of a judgement in favour of the entity is uncertain but probable.</p>
<p>Employee Benefits</p>	<p>AASB 119</p>	<p>The main requirement of the Standard is that an employer must recognise a liability when employees have provided services for which benefits will be paid in the future. An expense is required to be recognised when the entity consumes the economic benefits</p>	<p><u>Short-Term Employee Benefits</u> As these benefits are due within 12 months of the reporting date, they are measured on an undiscounted (nominal) basis and recognised as both a liability (net of any amount already paid) and an expense (unless</p>

		<p>relating to the service provided by the employee.</p>	<p>permitted to be recognised in the cost of an asset) (AASB 119 para. 11).</p> <p><u>Short-term Paid Absences</u> The expected cost of an accumulating paid absence is recognised when the employee performs a service that increases their right to future paid absences. This rule applies regardless of whether the entitlement is vesting or non-vesting. However, a non-vesting entitlement is only included as a liability at reporting date if it is probable the entity will be required to pay the employee for the entitlement in the future.</p> <p>The expected cost of a non-accumulating paid absence is recognised when the absences occur (AASB119 para.13).</p> <p><u>Other Long-Term Employee Benefits</u> Generally, other long-term employee benefits should be recognised at the present value (PV) of the estimated future cash outflows to be made by the employer for services provided by employees up to the reporting date.</p> <p><u>Termination Benefits</u> The requirements for recognising and measuring a termination benefit liability are provided in AASB 119 paras 165–170. AASB 119 is used rather than AASB 137, which deals with other costs incurred in a restructure.</p> <p>Measurement of a termination benefit depends on when the termination will occur. If payment is expected to be less than 12 months from reporting date, then the liability is calculated based on the nominal value of benefits in the same way as other short-term benefits. If payment is expected to be more than 12 months from the reporting date, the liability is calculated by discounting the estimated cash flows in the same way as other long-term benefits.</p>
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The following tools are available for the purposes of financial statement analysis:

- Variances/Trends
- Ratio analysis

Variances/Trends

Variance analysis is the comparison of actual performance to an expectation or target. This could be a comparison to historical performance, budget, forecast, or the performance of competitors.

Key reasons for performing variance analysis include:

- To look for areas in which performance can be improved or where efficiency can be increased.
- To increase an organisation's learning and knowledge about its processes, as part of a continuous improvement process.
- To identify where standard costs are incorrect and need adjustment.
- To support the preparation of future budgets.

Favourable versus unfavourable variances

The terms 'favourable' and 'unfavourable' reflect the impact of variations between expectations and actual results. Variances are classified as either improving or reducing performance.

- How much of the variance is due to a difference in volumes, and how much to a difference in price?
- How much is a difference in volumes due to a change in the size of the total market, and how much is a reflection of a shift in market share?

The *standard cost variances* are the *direct* cost variances for materials, labour and overheads that are included in the total cost of the product or service. These can be driven by a combination of higher quantities or higher prices for the components that make up this total cost.

It is simply not enough to just calculate all the variances and identify them as favourable or unfavourable. The driver or cause of that variance – which will be specific to the circumstances needs to be identified so that appropriate action can be taken to address the issue.

Trend Analysis

Trend analysis is a tool that is used by management accountants to analyse an organisation's financial performance over a period of time.

A common comparison that is made to assess performance is between one year's results and those of the previous year. This comparison could be on an absolute dollar or percentage change basis. Often, both are required in order to reach a sensible conclusion.

By looking at comparisons that extend beyond a period of two years, it may be possible to identify trends in the performance of a business and see the effects of its strategic initiatives.

Trend analysis can also be used as a predictive tool. By understanding an organisation's performance over a period of time, its likely future performance can be assessed. For example, a decline in sales in a mature business could be extrapolated to forecast a likely decline in future periods.

Therefore it is important to consider the variances/trends appearing in each line item in the profit and loss statement. If there are any significant increases or decreases in these items further inquiry may need to be made especially if that variance is there to stay or that a trend is occurring that will negatively impact on the company's performance and its ability to generate revenue and pay its debts.

When a variance/trend occurs across each line item consider the following: -

- How large is the variance?
- What caused the variance?
- Did something extraordinary occur in that period and the variance is unlikely to occur again?

- Will the variance continue?
- What is the impact on the business if the variance continues?
- Is a trend occurring that will not be turned around/improved?

Ratio analysis

Ratio analysis is a quantitative analysis of information contained in a company's financial statements. Ratio analysis is used to evaluate various aspects of a company's operating and financial performance such as its efficiency, liquidity, profitability and solvency.

Rather than having to assess the many numbers in financial reports, ratios can provide a quick insight into an organisation's financial performance. There are a number of financial ratios that can be used in this form of analysis.

They are best used as indicators of areas in a business that needs to be investigated further.

Benefits of ratio analysis

There are a number of benefits to using financial ratios to analyse performance, including:

- Readily available data in financial statements or management reports.
- The ability to make comparisons across organisations or business units of a different size, or against industry averages or benchmarks.
- Using ratios to analyse trends to identify improvements or deteriorations in performance.

As with any analytical tool, there are potential limitations to its application:

- **Inconsistency in the ratio formulas used.** There is no mandated formula for calculating financial ratios. A consistent approach is key to successful analysis using ratios. Care needs to be taken when comparing financial ratios, as it is possible that different formulas have been used in calculating those ratios, or that the definition of one component in a formula is different to its definition in another (e.g. profit could be before or after tax). Either would mean the results of any comparison would be distorted.
- **Oversimplification of the analysis.** Looking at one ratio in isolation might provide a distorted view of an organisation's performance. For example, a business purchases an expensive, new state-of-the-art machine. The machine has a significant impact on productivity and, therefore, profitability. This would be reflected in the earnings before interest and tax (EBIT). However, when calculating asset turnover (sales + net operating assets), this indicator would drop due to the asset purchase. Analysing the two ratios provides a better view of the impact of the new machine.

Financial ratios can be categorised as profitability, activity, liquidity or financing ratios.

Profitability ratios

Profitability ratios measure an organisation's use of its resources to generate profit, including:

- Ratios that assess profitability.
- Ratios that assess an organisation's ability to generate income from its resources.

Ratios that assess profitability

The following ratios assess profitability:

Gross profit margin

$$\text{Gross margin} = \frac{\text{Sales} - \text{COGS}}{\text{Sales}}$$

This ratio is the percentage of sales dollars left after subtracting the cost of goods sold (cost of sales) from the net sales figure. It measures the percentage of sales dollars remaining (after meeting the cost of goods sold) to pay overhead expenses of the business. Comparison of the business ratios to those in your client base of similar businesses will reveal the relative strengths or weaknesses of the business you are looking at.

The gross profit margin is calculated as follows: -

$$\text{Gross profit margin} = \frac{\text{gross profit} \times 100}{\text{Sales}}$$

$$\begin{aligned} \text{Example} & \quad \frac{\$175,000 \times 100}{\$600,000} \\ & = 29.2\% \end{aligned}$$

This means that for every \$1.00 of sales generated, the business is making 29.2 cents gross profit to cover overhead expenses and provide for a profit.

Net profit ratio

$$\text{Operating expenses as a percentage of sales} = \frac{\text{Operating expenses}}{\text{Sales}}$$

The net operating profit ratio indicates how much money is left after deducting all direct and overhead expenses. This ratio is the percentage of sales dollars left after subtracting the cost of sales and all other expenses except tax.

The net profit rate is calculated as follows: -

$$\text{Net profit rate} = \frac{\text{net profit before tax} \times 100}{\text{Sales}}$$

$$\begin{aligned} \text{Example} & \quad \frac{\$50,000 \times 100}{\$600,000} \\ & = 8.33\% \end{aligned}$$

For every \$1.00 of sales, the business is making a net profit of 8.33 cents.

Material / Labour / Overhead Expense - Sales

$$\text{EBIT margin} = \frac{\text{EBIT}}{\text{Sales}}$$

As can be seen from each of the formulas above, these ratios are measured as a percentage of sales.

These ratios indicate how much of the sales dollar is consumed by the cost of direct materials, labour and overhead expenses.

Material sales is calculated as follows: -

$$\text{Material - Sales} = \frac{\text{direct materials} \times 100}{\text{Sales}}$$

$$\begin{aligned} \text{Example} & \quad \frac{\$269,000 \times 100}{\$600,000} \\ & = 44.8\% \end{aligned}$$

Labour – sales is calculated as follows: -

$$\text{Labour sales} = \frac{\text{Direct Labour} \times 100}{\text{Sales}}$$

$$\begin{aligned} \text{Example} & \quad \frac{\$130,000 \times 100}{\$600,000} \\ & = 21.6\% \end{aligned}$$

Overhead Expense – sales is calculated as follows: -

$$\text{Overhead expense sales} = \frac{\text{overhead expense} \times 100}{\text{Sales}}$$

$$\begin{aligned} \text{Example} & \quad \frac{\$125,000 \times 100}{\$600,000} \\ & = 20.8\% \end{aligned}$$

Ratios that assess an organisation's effectiveness in generating income from its resources

Profitability ratios that assess an organisation's effectiveness in generating income include:

$$\text{Return on assets (ROA)} = \frac{\text{EBIT}}{\text{Average total assets}}$$

Care needs to be taken when comparing ROA across different industries. A capital-intensive industry will have a lower ROA than a technology or service industry due to its higher investment in fixed assets.

$$\text{Dividend payout} = \frac{\text{Total dividends to ordinary shareholders}}{\text{Net profit after tax} - \text{Preference dividends}}$$

Dividend payout ratios vary widely across organisations. Large, blue-chip companies tend to issue larger dividend payments while growing organisations seek to retain their cash to fund future expansion.

Activity ratios

Activity ratios deal more with how effectively a business's income-producing assets are working. Commonly used ratios that assess the various types of assets include:

$$\begin{aligned}\text{Asset turnover} &= \frac{\text{Sales}}{\text{Average total assets}} \\ \text{Fixed asset turnover} &= \frac{\text{Sales}}{\text{Average fixed assets}} \\ \text{Working capital turnover} &= \frac{\text{Sales}}{\text{Average working capital}} \\ \text{Debtor days} &= \frac{\text{Average debtors} \times 365}{\text{Sales}} \\ \text{Inventory days} &= \frac{\text{Average inventory} \times 365}{\text{Cost of sales}} \\ \text{Trade creditor days} &= \frac{\text{Average trade creditors} \times 365}{\text{Purchases}}\end{aligned}$$

Note: Debtor and inventory days are often expressed as the number of times that debtors or inventory turnover each year.

Liquidity ratios

Liquidity ratios assess an organisation's ability to pay its short-term debt by comparing its most liquid assets to its short-term liabilities. Generally, the higher the level of coverage (i.e. the greater the difference between the level of short-term assets and liabilities) the better. This indicates that an organisation can pay debts as and when they fall due, and continue to fund ongoing operations.

The two most common liquidity ratios are the current and quick ratios.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

In general, the higher the current ratio is, the better; however, this can be misleading. The current ratio is based on all current assets being converted to cash to fund current liabilities and does not take into account the working capital required for an organisation to continue operating as a going concern (e.g. inventory is a current asset that is continually required for a retail store or wholesaling business to operate and a certain level needs to be maintained). It also does not take into account the amount of time it takes to convert assets, such as debtors or inventory, into cash.

While an acceptable current ratio is greater than 1, it is often the case that service-based organisations and organisations with a short cash cycle can have a lower current ratio and still be considered as having an appropriate liquidity position.

$$\text{Quick or acid test ratio} = \frac{\text{Cash assets (and equivalents)} + \text{Short-term investments} + \text{receivables}}{\text{Current liabilities}}$$

The quick ratio addresses the issue of inventory impacting on liquidity analysis. The numerator is often quickly calculated as current assets less inventory.

Conclusion

- Whilst financial statements are a useful tool for the assessment of a company's financial health it is important to acknowledge their shortcomings;
- A profit and loss statement is a snapshot at a historical point of time, which in and of itself is of limited usefulness.
- Further financial statements constitute a summary – it may be necessary to seek further information to identify the true cause of a negative trend.
- There is a not one 'size fits all' profit and loss statement – different businesses have different characteristics for instance the profit and loss of manufacturing business will look different to that of a labour hire business.
- Analysis of comparatives enables an assessment of the business performance over a period of time, the trend of that performance and to identify the key drivers of the business.
- The profit and loss is based on the accrual system – non cash items require adjustment to determine the cash position of the business. It is a truism that cash is king in business.
- Financial analysis enables identification of negative trends.

For instance high turnover is not always a good thing if the work that is completed results in a low margin.

Turnover based remuneration systems can encourage negative behaviours amongst sales staff as it could incentivise sales of low margin products.

Financial statements should be utilised as a tool to identify areas for further enquiry and not relied as a means to their own end.

ANNEXURE A

XYZ PTY LIMITED				
ABN 51 678 425 761				
Profit & Loss Statement				
	For the year ended 30 June 2013	For the Year ended 30 June 2014	For the year ended 30 June 2015	For the year ended 30 June 2016
	\$'000	\$'000	\$'000	\$'000
Revenue				
Sale of goods and services	108,471	104,885	108,074	107,310
Management charges	172	690	151	4,655
Gain from Sale of property, plant & equipment	16	17	3	
Foreign exchange gains (net)	136	59	36	31
Other	1,792	6	1	2
Revenue from ordinary activities	110,587	105,657	108,265	111,998
Expenses from ordinary activities, excluding borrowing costs expense				
Costs of sales of goods	85,670	80,134	83,526	81,086
Distribution expenses	4,991	4,224	4,639	7,256
Sales & marketing expenses	12,276	11,164	12,541	11,928
Administrative expenses	5,406	5,993	5,255	4,502
Other expenses from ordinary activities	2,843	5,753	1,246	3,686
Finance costs			641	643
	(111,186)	(107,268)	(107,848)	(109,101)
Borrowing costs expense	(442)	(526)		
Loss from ordinary activities before income tax expense	(1,041)	(2,137)	417	2,897
Income tax benefit		2,000	318	(352)
Net Profit (loss)	(1,041)	(137)	735	2,545
Increase in asset revaluation reserve	23,989			
Total changes in equity other than those resulting from transactions with owners as owners	22,948	(137)	735	2,545

XYZ PTY LIMITED
ABN 51 678 425 761
Profit & Loss Statement

	VARIANCES					
	2013 to 2014		2014 to 2015		2015 to 2016	
Revenue						
Sale of goods and services	(3,586)	-3%	3,189.00	3.04%	(764.00)	-0.71%
Management charges	518	301%	(539.00)	-78.12%	4,504.00	2982.78%
Gain from Sale of property, plant & equipment	1	6%	(14.00)	-82.35%	(3.00)	-100.00%
Foreign exchange gains (net)	(77)	-57%	(23.00)	-38.98%	(5.00)	-13.89%
Other	(1,786)	-100%	(5.00)	-83.33%	1.00	100.00%
Revenue from ordinary activities	(4,930)	-4%	2,608.00	2.47%	3,733.00	3.45%
Expenses from ordinary activities, excluding borrowing costs expense						
Costs of sales of goods	(5,536)	-6%	3,392.00	4.23%	(2,440.00)	-2.92%
Distribution expenses	(767)	-15%	415.00	9.82%	2,617.00	56.41%
Sales & marketing expenses	(1,112)	-9%	1,377.00	12.33%	(613.00)	-4.89%
Administrative expenses	587	11%	(738.00)	-12.31%	(753.00)	-14.33%
Other expenses from ordinary activities	2,910	102%	(4,507.00)	-78.34%	2,440.00	195.83%
Finance costs			641.00		2.00	0.31%
	3,918	-4%	(580.00)	0.54%	(1,253.00)	1.16%
Borrowing costs expense	(84)	19%	526.00	-100.00%	0.00	
Loss from ordinary activities before income tax expense	(1,096)	105%	2,554.00	-119.51%	2,480.00	594.72%
Income tax benefit	2,000		(1,682.00)	-84.10%	(670.00)	-210.69%
Net Profit (loss)	904	-87%	872.00	-636.50%	1,810.00	246.26%
Increase in asset revaluation reserve	(23,989)	-100%				
Total changes in equity other than those resulting from transactions with owners as owners	(23,085)	-101%	872.00	-636.50%	1,810.00	246.26%

XYZ PTY LIMITED				
ABN 51 678 425 761				
Statement of Cash flows				
	For the year ended 30 June 2013	For the Year ended 30 June 2014	For the year ended 30 June 2015	For the year ended 30 June 2016
	\$'000	\$'000	\$'000	\$'000
Cashflows from operating activities				
Receipts from trade and other debtors	122,641	108,911	116,463	116,597
Payments to suppliers and employees	(118,606)	(106,219)	(113,641)	(114,164)
Payments for restructuring	(4,418)	(3,328)	(353)	(636)
Interest paid	(442)	(560)	(641)	(643)
Net cash outflows from operating activities	(825)	(1,196)	1,828	1,154
Cash flows from investing activities				
Payments for fixed assets	(824)	(1,221)	(979)	(537)
Net cash used on disposal of controlled entity		(39)		
Procees from sale of fixed assets	16	17	419	531
Net cash outflows from investing activities	(808)	(1,243)	(560)	(6)
Cash flows from financing activities				
Loan to shareholder	(901)			
Repayment of borrowings	(2,415)			(1,925)
Net cash inflows (outflows) from financing activities	(3,316)			(1,925)
Net increase (decrease) in cash held	(4,949)	(2,439)	1,268	(777)
Cash at the beginning of the financial year	160	(4,789)	(7,228)	(5,960)
Cash at the end of the financial year	(4,789)	(7,228)	(5,960)	(6,737)
Reconciliation of cash				
Cash at bank	1,151	988	1,540	1,178
Less: Bank overdrafts	(5,940)	(8,216)	(7,500)	(7,915)
	(4,789)	(7,228)	(5,960)	(6,737)

XYZ PTY LIMITED				
ABN 51 678 425 761				
Balance Sheet				
	For the year ended 30 June 2013	For the Year ended 30 June 2014	For the year ended 30 June 2015	For the year ended 30 June 2016
	\$'000	\$'000	\$'000	\$'000
Current Assets				
Cash and cash equivalents	1,151	988	1,540	1,178
Receivables	15,435	14,857	14,680	16,243
Inventories	8,664	8,705	8,252	8,285
Prepayments	571	422		
Other current assets			557	116
Total current assets	25,821	24,972	25,029	25,822
Non-current assets				
Receivables	0	3,484	85	
Property, plant and equipment	27,851	27,011	25,941	25,927
Intangible assets			2,567	2,567
Deferred tax assets	0	2,000		
Total non-current assets	27,851	32,495	28,593	28,494
Total assets	53,672	57,467	53,622	54,316
Current Liabilities				
Payables	16,031	18,775	23,757	19,868
Interest bearing liabilities	5,940	8,216	7,500	7,915
Provisions	4,297	4,046		
Total current liabilities	26,268	31,037	31,257	27,783
Non-current liabilities				
Payables	4,000	3,000		
Long term borrowings			507	747
Deferred tax liabilities			1,919	2,121
Provisions	236	256	267	826
Total non-current liabilities	4,236	3,256	2,693	3,694
Total liabilities	30,504	34,293	33,950	31,477
Net assets	23,168	23,174	19,672	22,839
Equity				
Contributed equity	3,879	4,019	4,019	4,019
Reserves	32,424	32,424	25,132	25,764
Minority interest	(3)	0		
Retained profits (losses)	(13,132)	(13,269)	(9,479)	(6,944)
Total equity	23,168	23,174	19,672	22,839

XYZ PTY LIMITED
ABN 51 678 425 761
Balance Sheet

	VARIANCES					
	2013 to 2014		2014 to 2015		2015 to 2016	
Current Assets						
Cash and cash equivalents	(163)	-14.16%	552.00	55.87%	(362.00)	-23.51%
Receivables	(578)	-3.74%	(177.00)	-1.19%	1,563.00	10.65%
Inventories	41	0.47%	(453.00)	-5.20%	33.00	0.40%
Prepayments	(149)	-26.09%	(422.00)	-100.00%	0.00	
Other current assets	0		557.00		(441.00)	-79.17%
Total current assets	(849)	-3.29%	57.00	0.23%	793.00	3.17%
Non-current assets						
Receivables	3,484		(3,399.00)	-97.56%	(85.00)	-100.00%
Property, plant and equipment	(840)	-3.02%	(1,070.00)	-3.96%	(14.00)	-0.05%
Intangible assets	0		2,567.00		0.00	0.00%
Deferred tax assets	2,000		(2,000.00)	-100.00%	0.00	
Total non-current assets	4,644	16.67%	(3,902.00)	-12.01%	(99.00)	-0.35%
Total assets	3,795	7.07%	(3,845.00)	-6.69%	694.00	1.29%
Current Liabilities						
Payables	2,744	17.12%	4,982.00	26.54%	(3,889.00)	-16.37%
Interest bearing liabilities	2,276	38.32%	(716.00)	-8.71%	415.00	5.53%
Provisions	(251)	-5.84%	(4,046.00)	-100.00%	0.00	
Total current liabilities	4,769	18.16%	220.00	0.71%	(3,474.00)	-11.11%
Non-current liabilities						
Payables	(1,000)	-25.00%	(3,000.00)	-100.00%	0.00	
Long term borrowings	0		507.00		240.00	47.34%
Deferred tax liabilities	0		1,919.00		202.00	10.53%
Provisions	20	8.47%	11.00	4.30%	559.00	209.36%
Total non-current liabilities	(980)	-23.14%	(563.00)	-17.29%	1,001.00	37.17%
Total liabilities	3,789	12.42%	(343.00)	-1.00%	(2,473.00)	-7.28%
Net assets	6	0.03%	(3,502.00)	-15.11%	3,167.00	16.10%
Equity						
Contributed equity	140	3.61%	0.00	0.00%	0.00	0.00%
Reserves	0	0.00%	(7,292.00)	-22.49%	632.00	2.51%
Minority interest	3	-100.00%	0.00		0.00	
Retained profits (losses)	(137)	1.04%	3,790.00	-28.56%	2,535.00	-26.74%
Total equity	6	0.03%	(3,502.00)	-15.11%	3,167.00	16.10%

XYZ PTY LIMITED
ABN 51 678 425 761

Ratio	Formula	FY2014	FY2015	FY2016	Comment
Return on assets (ROA) =	$\frac{\text{Net Profit After Tax}}{\text{Average Total Assets}}$	-0.25%	1.32%	4.72%	ROA is a financial ratio that shows the percentage of profit a company earns in relation to its overall resources. ROA increased throughout the financial years indicating that the company had increased the efficiency of use of its overall resources to generate profit.
Asset turnover =	$\frac{\text{Sales}}{\text{Average total assets}}$	1.89	1.95	1.99	Asset turnover measures the efficiency of a company's use of its assets in generating sales revenue to the company. Asset turnover increased throughout the financial years indicating that the company had increased the efficiency of use of its overall resources to generate sales revenue.
Fixed asset turnover =	$\frac{\text{Sales}}{\text{Average fixed assets}}$	3.88	4.17	4.14	Fixed asset turnover indicates how well the business is using its fixed assets to generate sales. Fixed asset turnover increased throughout the financial years indicating that the company had increased the efficiency of use of its fixed assets to generate sales revenue.
Working capital turnover =	$\frac{\text{Sales}}{\text{Average working capital}}$	- 25.91	- 17.58	- 26.21	Working capital turnover indicates a company's effectiveness in using its working capital. Working capital turnover was negative throughout the financial years as the company's current liabilities exceeded its current assets.
Debtor days =	$\frac{\text{Average debtors} \times 365}{\text{Sales}}$	52.71	49.88	52.59	Debtors days measures how quickly cash is being collected from debtors. It took the Company between 49.88 days to 52.57 days to collect the debtors throughout the financial years. This is significant and is in this example is reflecting of the fact that the customer was a related party and could delay payment.
Inventory days =	$\frac{\text{Average inventory} \times 365}{\text{Cost of sales}}$	39.56	37.05	37.22	Inventory days measures the average number of days the company holds its inventory before selling it. It took the Company between 37.05 days to 39.56 days to sell the inventory after purchase throughout the financial years. This may be considered high depending on the industry, however this company was involved in selling stationery products and printing on a large scale for TNT, ATO and what was then known as the RTA, a lot of stock would have been required to be held and for some time to fulfill orders. It was not on a JIT basis.

XYZ PTY LIMITED
 ABN 51 678 425 761

Ratio	Formula	FY2014	FY2015	FY2016	Comment
Trade creditor days =	$\frac{\text{Average trade creditors} \times 365}{\text{Purchases}}$	79.23	93.44	98.15	Trade creditor days estimates the average time it takes a business to settle its debts with trade suppliers. It took the Company between 79.23 days to 98.15 days to pay its trade creditors throughout the years. The trade creditors days had increased indicating that it took the company longer period to pay its trade creditors. This could be reflective of a cashflow problem with the company.
Current ratio =	$\frac{\text{Current assets}}{\text{Current liabilities}}$	0.80	0.80	0.93	Current ratio is a liquidity ratio that measures a company's ability to pay short-term liabilities. A current ratio below one (1) indicates that the company is unable to meet its current liabilities when they fall due. The current ratio of the company was below one (1) throughout the financial years. However, the ratio had increased, which indicates that the company's ability to pay short-term liabilities was improving.
Quick or acid test ratio =	$\frac{\text{Cash assets (and equivalents)} + \text{Short-term investments} + \text{receivables}}{\text{Current liabilities}}$	0.51	0.52	0.63	Quick or acid test ratio measures the ability of a company to use its near cash or quick assets to extinguish or retire its current liabilities immediately. A quick or acid test ratio below one (1) indicates that the company's quick assets are unable to meet its current debt obligations. The quick or acid test ratio of the company was below one (1) throughout the financial years. However, the ratio had increased, which indicates that the company's ability to pay short-term liabilities using quick assets was improving.
Debt equity Ratio=	$\frac{\text{Total liabilities}}{\text{Equity}}$	1.32	1.48	1.73	The debt-to-equity ratio (debt/equity ratio, D/E) is a financial ratio indicating the relative proportion of entity's equity and debt used to finance an entity's assets. It is also a measure of a company's ability to repay its obligations. A lower debt equity ratios (0.4 or lower) are considered better debt ratios. The Debt equity ratio of the company was above one(1) through out the financial years, which indicates that company has borrowed more than the ability to pay back.

Extract from Financial Statements	FY2014	FY2015	FY2016
Sales	104,885	108,074	107,310
Purchases	80,175	83,073	81,119
Cost of sales	80,134	83,526	81,086
Net Profit After Tax	(137)	735	2,545
Current assets	24,972	25,029	25,822
Current liabilities	31,037	31,257	27,783
Cash assets (and equivalents)	988	1,540	1,178
Short-term investments	-	-	-
Receivables	14,857	14,680	16,243
Total assets	57,467	53,622	54,316
Fixed assets	27,011	25,941	25,927
Inventory	8,705	8,252	8,285
Trade Creditors	18,775	23,757	19,868
Working capital	(6,065)	(6,228)	(1,961)
Average Total Assets	55,570	55,545	53,969
Average fixed assets	27,431	26,476	25,934
Average working capital	(4,048)	(6,147)	(4,095)
Average debtors	15,146	14,769	15,462
Average inventory	8,685	8,479	8,269
Average trade creditors	17,403	21,266	21,813

Calculation of Purchase				
	2013	2014	2015	2016
Inventories	8,664	8,705	8,252	8,285
Costs of sales of goods	85,670	80,134	83,526	81,086
Opening Bal. of Inventories		8,664	8,705	8,252
Closing Bal. of Inventories		8,705	8,252	8,285
Purchase		80,175	83,073	81,119