The Financial Statements of the Enterprise

4

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STUDY OBJECTIVES

After studying this chapter, you should be able to:

- briefly describe the financial statements (income statement, balance sheet and cash flow statement) of an enterprise
- distinguish between the income statement, balance sheet and cash flow statement
- describe the type of information included in each of these statements
- briefly explain the entries on the financial statements
- briefly explain the purpose of the financial statements
- explain why credit assessors analyse the financial statements of enterprises
- list and discuss the limitations of financial statements

In this course you will not be expected to draw up the financial statements of an enterprise. The overall aim of this chapter is to familiarise you with an enterprise's financial statements so that you will be able to analyse such statements.

INTRODUCTION

In the previous two chapters, we frequently referred to the financial statements of the enterprise. The financial statements of an enterprise or a person are one of the most important sources of credit information. However, people very seldom draw up financial statements for themselves, and so this chapter will **concentrate on the** financial statements of **enterprises**.

The information obtained from financial statements, together with all the other information, enables credit managers to make decisions about granting credit. The financial statements are an **aid** in the process of making credit decisions. Before making a credit decision, the prospective creditor needs information such as the following:

- What the **financial results of an enterprise** have been over a certain period (in other words, how profitable the enterprise has been, because this influences the enterprise's ability to pay)

- What the **enterprise's financial position is at a particular time**

To obtain this information, the annual financial statements of the enterprise concerned must be analysed.

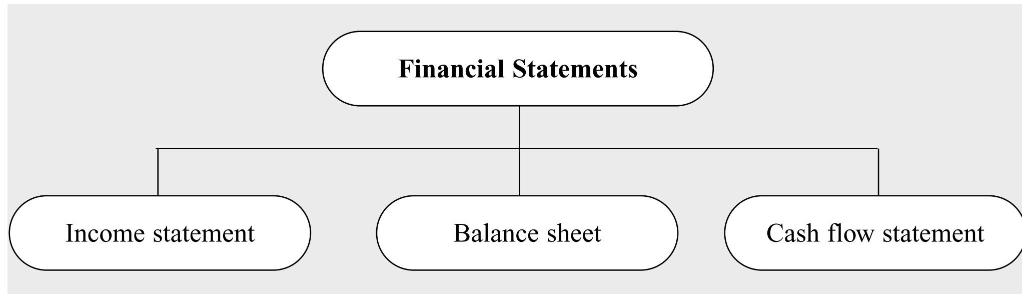
In this chapter we will concentrate on the financial statements as such. The analysis of these statements will be discussed in the next chapter. We will look at the following:

- The various components of the financial statements, namely the income statement, balance sheet and cash flow statement

- The reason why credit assessors are interested in enterprises' financial statements (in other words, the purpose of analysing the financial statements)

- The limitations of financial statements that credit assessors have to take into account

FINANCIAL STATEMENTS



An enterprise's financial statements consist of the **income statement**, the **balance sheet** and the **cash flow statement**. In terms of the Companies Act, enterprises that are companies must also have a **directors'** and **auditors' report**.

The financial statements are drawn up at the end of a financial period and represent the end product of the accounting system. That is, all the data that the enterprise's accountants have recorded is used to compile the financial statements. The accounting or financial period of enterprises usually covers one year, for example 1/1/97 - 31/12/97 or 1/3/97 - 28/2/97. The financial statements are issued on the closing date of the enterprise's financial year, also called the financial year-end.

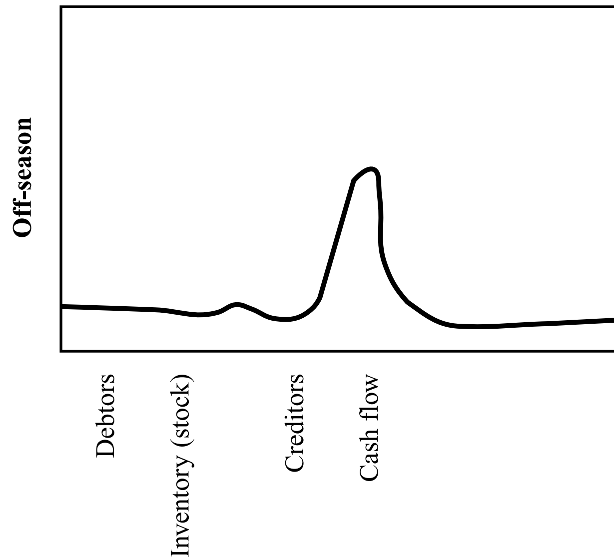
FAMILY PHARMACY (PTY) LTD
INCOME STATEMENT FOR THE FINANCIAL YEAR ENDED
31 DECEMBER 1995

closing date

The date of the financial statements is important for the users of the statements. Financial statements from the past mean very little to a credit manager and credit analysts. They are interested in the current or most recent statements. In determining the creditworthiness of an enterprise, the **current financial position** is investigated.

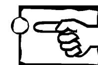
The date of the financial statements is also important for another reason. If the end of an enterprise's financial year falls in the off-season period, in other

words if it falls into a time of the year when the enterprise's business activities are not at their peak, the picture presented by the statements may differ drastically from the enterprise's normal situation. The off-season financial position can be more favourable than normal. In this time the debtors and inventory (stock) balances, as well as the creditors balance, are low, while the levels of cash are higher than normal.

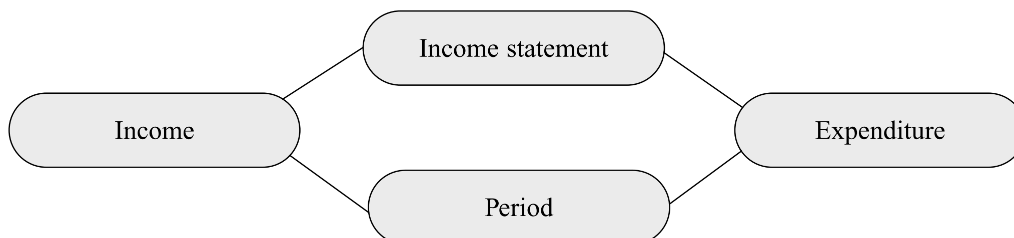


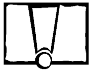
From the enterprise's point of view, there are thus certain advantages in having its creditworthiness assessed on the basis of financial statements compiled during the off-season. However, the credit manager is more interested in financial statements compiled during the business season.

Can you see why the date of the financial statements is important?



INCOME STATEMENT



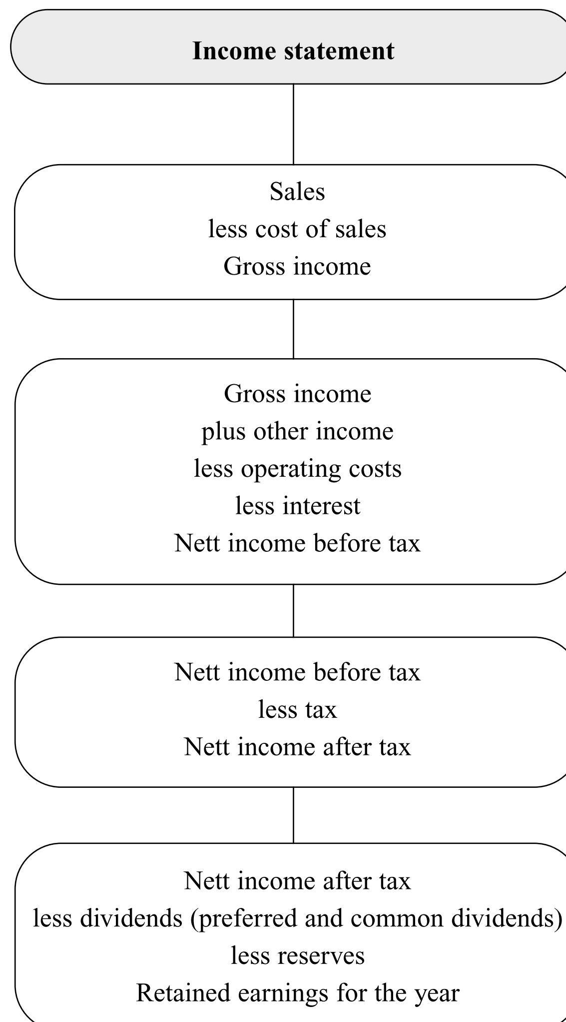


The income statement provides an overview of the enterprise's:

- income earned in a certain period (the accounting period)
- expenditure incurred in the same period

The income statement is drawn up for a **specific period**, for example for the financial year ended 31 December. It is thus a summary of the enterprise's income and expenditure during a financial year.

Let us look at a diagram of the income statement before explaining the entries on the statement with examples containing actual figures. The following diagram is a summary of the entries on the income statement and the order in which they appear:



Family Pharmacy (Pty) Ltd

Example

Income statement for the financial year ended 31 December 1995

	R'000
Sales	5 500
Less: Cost of sales	4 000
Gross income	1 500
Less: Operating costs	1 000
Nett income before tax and interest	500
Less: Interest	75
Nett income before tax	425
Less: Tax	204
Nett income after tax	221
Less: Dividends to shareholders	20
Earnings available to shareholders	201
Less: Reserves	50
Retained earnings	151

This example is explained below:

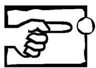
- **Sales** represent the enterprise's nett sales of goods or services during the financial year. These sales include both credit and cash sales. In the case of a service enterprise (for example a doctor or lawyer), this amount represents the sales in terms of the services offered by the enterprise. All discounts granted by the enterprise and exchanges made by customers ("credit notes") are taken into account when calculating the nett sales.

- To determine the gross income for the financial year ended 31/12/95 the **cost of goods sold** must be known. Here we are referring to the **price paid** by Family Pharmacy for all the products it sold. It also includes all direct costs involved in having the products on the shelf, for example the order and delivery costs. In the case of manufacturing enterprises, it includes the cost of materials and labour and direct manufacturing costs. The cost of inventory that has not been sold by the end of the financial year is not taken into account.

- The **gross income** is the difference between sales (cash and credit sales) and the cost of goods sold. It is the "profit" of the enterprise before all

expenditure, interest and tax are deducted. If the enterprise earns any other income that cannot be directly linked to the sales of its products or services, this must also be taken into account here. Examples of this type of income are dividends received, interest received and the profit made by selling fixed assets.

- It is necessary to have information about the **operating costs** of the enterprise to calculate the **income before tax**. The operating costs of the enterprise include expenses such as wages and salaries, water and electricity, telephone costs, sales costs and administrative costs. The interest the enterprise has to pay is also taken into account here, for example the interest on a bank overdraft facility or a long-term loan.



Although the interest an enterprise has to pay is part of the operating costs, we will show the interest separately in analysing the financial statements. We use these interest amounts in analysing the enterprise's ability to pay (its interest coverage ratio).

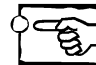
Example

GROSS INCOME			1 500
less:	*Operating expenses*		- 1 000
	Water, electricity, telephone	100	500
	Sales costs	250	
	Administrative costs	250	
	Directors' remuneration	100	
	Auditors' remuneration	250	
	Depreciation	50	
less: Interest paid			- 75
NETT INCOME before tax			= 425

- The **tax** the enterprise has to **pay** is calculated on the basis of the nett income the enterprise obtained before tax. When the tax has been deducted, the amount that remains is the nett income after tax.

- The **nett income after tax** is available for:
  - dividend payments - preferred dividends as well as dividends on common shares (that part of the nett income that is paid to the shareholders/owners)

- transfers to reserves (part of the nett income set aside for a general or specific purpose)



A company must have a nett income after tax before it can declare any dividends. If the company does not make a "profit" (does not have any nett income after tax), it cannot declare dividends. Dividends are paid from this income only. The company's general financial position should thus be taken into account when dividends are declared. The company's financial situation must be of such a nature that the dividend payments will not put any financial pressure on the company. For example, if the company only has a small nett income left after transferring funds to its reserves, it cannot pay large dividends to common shareholders. Furthermore, the declaration and payment of dividends are valid only when it has been approved at the annual general meeting.

- After all the abovementioned calculations have been done, the income statement ends with the **balance for retained earnings** for the financial year. In the balance sheet, this amount is added to the balance for retained earnings for the past year. It may also be shown under distributable reserves. On the balance sheet the retained earnings fall under own capital (it forms part of the total own capital).

Example

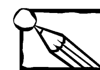
From the income statement of Family Pharmacy:

Retained earnings	R151 000

From the balance sheet of Family Pharmacy:

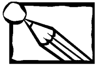
Retained earnings	R200 000

This R200 000 includes the R49 000 which has been brought over from the previous financial year.



Refer to the case study of Trailer (Pty) Ltd in chapter 3.

i) Work through the income statement of Trailer (Pty) Ltd and make sure that you can relate all the different entries to the diagram of the income statement.



ii) Give examples of typical operating expenses that Trailer (Pty) Ltd will incur.

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iii) What will be done with the retained earnings in the income statement of Trailer (Pty) Ltd?

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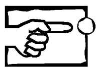
In analysing the credit risk of an enterprise, the credit assessor does not look at the entries on the income statement as such. The income statement provides certain relevant information that is necessary when the creditworthiness of an enterprise is analysed. However, this information only becomes valuable when it is analysed and related to, among other things, sales, income after tax, dividends and interest paid and the capital necessary to carry on with the enterprise's operations.

Example

During the analysis the credit assessor is interested in, for example, the income before tax and interest, and the interest obligations the enterprise had to meet during the financial year. With these two entries, the interest coverage ratio can be calculated. Creditors are interested in this ratio because it helps them to determine whether the income the enterprise generates before paying interest will be enough for it to pay the necessary interest.

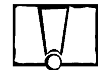


That is not to say, however, that the enterprise will have the necessary cash to meet these obligations. If this ratio, as well as other relevant ratios, shows that the enterprise struggles to meet its interest obligations, there will immediately be doubt about granting credit to the enterprise.

This is only one example of how creditors can use the information in the income statement. We will return to this analysis in chapter 5.

BALANCE SHEET

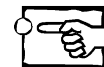
The balance sheet is a summary of the enterprise's **financial position** on a **certain date**. This date is the closing date of the enterprise's financial year.



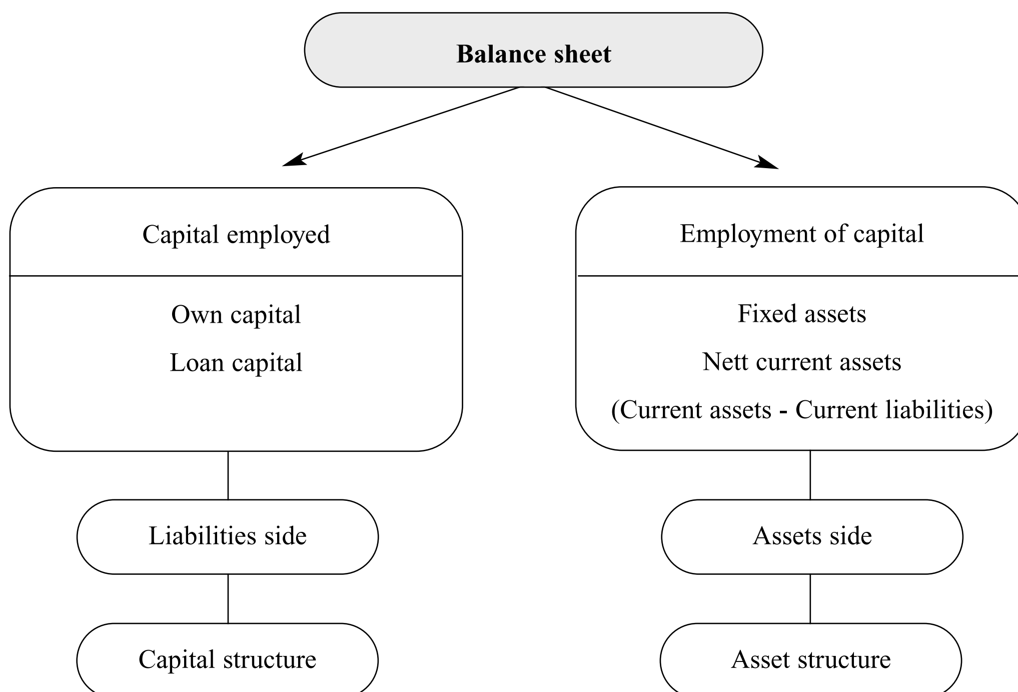
The balance sheet shows the following:

- The **total capital** of the enterprise (LIABILITIES SIDE) - the amount of capital that the enterprise has, and where the enterprise obtained it. The enterprise's capital consists of own capital and loan capital. Own capital is the capital provided by the owners of the enterprise, and loan capital is the funds made available by external suppliers of capital.

- The **way in which (how) this capital was employed** (ASSETS SIDE). The enterprise's capital is employed to acquire various kinds of assets (fixed assets and current assets).



Capital is the funds that the enterprise has available to buy goods and services which it can use to generate an income. The enterprise generates an income by providing products and services, and by buying and selling.



From this diagram we can see the following:

- The liabilities side of the balance sheet shows how the capital is divided between loan capital and own capital. This represents the **capital structure** of the enterprise.

- The assets side of the balance sheet shows how the assets are divided between fixed assets and current assets. This represents the **asset structure** of the enterprise.

Let us have a look at an example of a balance sheet with figures.

Example

Family Pharmacy (Pty) Ltd
Balance Sheet as at 31 December 1995

			1995
CAPITAL EMPLOYED			R'000
Own capital (shares)			+ 800
Reserves			+ 500
Retained earnings			+ 200
TOTAL OWN CAPITAL (shareholders equity)			= 1 500
LOAN CAPITAL			
Long-term loan			+ 500
			= 2 000
EMPLOYMENT OF CAPITAL			
FIXED ASSETS			2 000
Less: Depreciation			- 500
NETT FIXED ASSETS			= 1 500
NETT CURRENT ASSETS			+ 500
CURRENT ASSETS		1 000	
Cash	200		
Debtors	450		
Inventory (stock)	350		
CURRENT LIABILITIES		- 500	
Creditors	500		
			= 2 000

Notes to the financial statements of Family Pharmacy (Pty) Ltd

1. Loan capital R800 000
   Long-term loan at 15% per year

2. Inventory
   Inventory valuation based on first-in first-out method
   Inventory for 1994 R300 000

3. The total sales consist of:
   Cash sales R150 000
   Credit sales R400 000

When the financial statements are drawn up, **notes** to the statements are given with additional information about, among other things:

- the company's authorised capital (the capital that may be issued)
- the capital that was in fact issued
- the contributions of the partners or shareholders
- the nature of the enterprise's investments
- the way in which inventory valuation was done

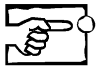
Note the following points about the balance sheet of Family Pharmacy:

- **The total own capital** (also known as shareholders' equity) consists of:
  - the common share capital
    plus
  - reserves (distributable and non-distributable reserves)
    plus
  - retained earnings

- If a company also owns **preferred share capital**, the total own capital is equal to the common share capital plus the preferred share capital. Preferred shareholders usually have a limited claim to the profits before common shareholders can receive dividends.

- As the balance sheet of Family Pharmacy shows, a **reserve** is part of the own capital. On the basis of the income statement we can define a reserve as that part of the income after tax that is retained for general or

specific use in the enterprise. Reserves can be held, for example, to provide for the rising replacement costs of fixed assets, or for paying a long-term loan. This type of reserve is known as **distributable reserves**. Reserves may also be non-distributable. An example of a **non-distributable reserve** is when land and buildings are revalued and a profit is recorded in this process. This profit, however, is regarded as an unrealised profit and thus cannot be distributed.



If you want more information about the various entries on the balance sheet and about reserves, you can consult the book Company Financial Statements in Context by Cilliers, H.S., Rossouw, S. & Mans, K.N. (published by Butterworths, 1995).

- You should already know the term **loan capital**. For those of you who may not remember the term, loan capital is the capital made available to the enterprise by external providers of capital, for example financial institutions such as banks.

Example

Examples of loan capital are long-term loans (for example a loan over a period of 15 years) and debentures.

If the enterprise has taken out a long-term loan or debentures, it must give the provider of the capital some kind of financial remuneration, for example interest payments or capital redemption.

- The entries under the heading "**capital employed**" show the composition of the enterprise's long-term capital (loan capital and own capital). This capital is employed in the enterprise to acquire assets.

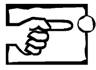
- The first group of assets shown in the balance sheet under "employment of capital" is **fixed assets**. Fixed assets are the enterprise's property with a relatively long life. They include, for example, land and buildings, and equipment such as vehicles, furniture and computers. Fixed assets are used to earn an income for the enterprise. They are not purchased with the aim of reselling them. Fixed assets can be divided into:
  - **tangible fixed assets** such as land, buildings, furniture and equipment
  - **intangible fixed assets** such as patents, trademarks and goodwill

Fixed assets

Tangible = furniture, equipment, buildings

Intangible = patents, trademarks, goodwil

- **Depreciation** on the fixed assets (except goodwill) is written off at the end of every financial year. ("Depreciation" means a loss of value - for example, assets such as buildings and computers all lose some value as they become older.) The book value of the tangible fixed assets on a particular day, for example 31/12/92, is the value after the accumulated depreciation (that is the sum of the amounts for depreciation that are written off every year after the date of purchase) has been deducted from the cost price. As a result of a high inflation rate there is a danger that the book value of a fixed asset may be much lower than the replacement cost of the asset. The result will be that an insufficient amount is written off for depreciation each year. The enterprise should thus have its fixed assets revalued regularly to bring the book value closer to the replacement value. In the same way, the enterprise should be careful that the replacement value of the inventory (current assets) is not much higher than its book value. Depending on the method used to value inventory, the effect of a high inflation rate on the replacement price of inventory should be kept in mind. This is especially the case when an enterprise uses the last-in first-out method of inventory valuation. The value of the inventory as shown on the balance sheet may, because of inflation, differ considerably from its replacement value. If the inventory is valued according to the replacement value method, inflation will not have a marked effect.



If you are interested in the various methods of inventory valuation, you can read more about it in the book Accounting 1,2,3 (details of the book are given in the list of references).

- The purpose of **investments** is to obtain an income from the investment. An example of an investment is when an enterprise makes loan capital available to other enterprises on the capital market. The enterprise obtains an income in the form of interest from the investment. Another example is where an enterprise buys shares in a company.

- **Current assets** are those assets that can be converted into cash within a short time, usually a year, or that already exist in the form of cash. The enterprise normally uses these assets (for example inventory) within one year. Examples of current assets are cash, debtors, bills receivable and inventory. The current assets supplement the fixed assets, and are kept in the enterprise to ensure that the fixed assets are used effectively. The current assets are employed to manage the fixed assets in the enterprise. For example, without the necessary raw and other materials (current assets - inventory), it will be impossible to operate the equipment in a factory (fixed assets).

    - **Debtors** represent the total amount that customers owe to the enterprise. The enterprise sells its products or services to customers, but the customers only pay later. There is always a possibility, however, that a certain number of the debtors will not pay their accounts - and thus also the possibility of bad debts. Most enterprises set up a reserve for bad debts (i.e. the enterprise has a reserve to provide for that part of the debtors that will not be collected). Where there is such a reserve, only the nett amount of debtors is shown in the balance sheet - that is debtors minus the provision for bad debts.

    - An enterprise may also have **bills receivable** as part of the current assets. A bill receivable is a document that the enterprise sends to debtors and that orders them to pay their debts before a certain date. The debtor must sign the bill. In this way debtors confirm that they owe the enterprise the amount for which the bill was issued and undertake to pay the due amount before or on the specified date. The enterprise is also entitled to discount its bills receivable at a financial institution (such as a commercial bank)

before the due date. This means that the enterprise can convert the bill receivable into money before the due date. After this it is the responsibility of the financial institution to collect the debtor's money. If the enterprise discounts the bill before the due date, it pays a percentage of the value of the bill to the financial institution. In this case, the cash amount the enterprise receives by discounting the bill will thus be lower than the value of the bill on the due date. However, the enterprise's risk with regard to bad debts is also lower.

- **Inventory** in the enterprise is also part of the current assets. The composition of the inventory depends on the type of enterprise and its activities. The inventory of an enterprise in the manufacturing industry usually consists of finished products, semi-finished products and raw materials. The inventory levels of enterprises are determined by the nature of the enterprise (for example, whether it is a manufacturing enterprise, an enterprise buying and selling finished products, or a service enterprise such as a dry-cleaning firm), and by seasonal influences on the enterprise's activities.

Example

A grocery store in a coastal town needs more inventory during the December holidays than during the quiet times of the year. You can thus see that seasonal influences, in this case the holiday season, have a direct effect on the level of inventory.

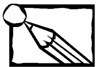
- Finally, the entry **prepaid expenses** may also appear under current assets. Any amount that the enterprise has paid in advance is regarded as a current asset. Examples are rent or tax paid in advance, and any other amount that has already been paid but for which services have not yet been provided.

- **Working capital** is the capital invested in current assets. The working capital or current liabilities consists of creditors, short-term loans, bank overdrafts, bills payable, amounts owed by the enterprise, and payments received in advance. The current liabilities are all the short-term obligations that the enterprise has to meet within a period of 12 months. These are transactions that the enterprise enters into so that it can continue with its activities.

- A **bill payable** is a bill that the enterprise offers when purchasing goods. In doing so it undertakes to pay the amount due on a certain date. The credit assessor should establish why the enterprise concerned issued the bills payable. Could it indicate that the enterprise had problems obtaining ordinary trade credit or bank credit? It might indicate that there are underlying problems with creditworthiness.

- **Amounts payable** by the enterprise refers to any amount the enterprise still has to pay. Here we mean amounts such as tax, interest, wages, dividends and rent that the enterprise still has to pay. Any amount the enterprise has received in advance for goods or services that still have to be provided also forms part of the current liabilities.

● The **nett current assets** are also shown on the balance sheet. The nett current assets are the difference between the enterprise's current assets and current liabilities. It is that part of the current assets that has been financed with long-term capital.



Refer to the case study of Trailer (Pty) Ltd.

i) What will Trailer's balance sheet mean to a credit assessor? Give a brief explanation.

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ii) What do Trailer's current assets and current liabilities consist of? Briefly explain each entry.

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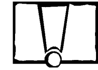
CASH FLOW STATEMENT

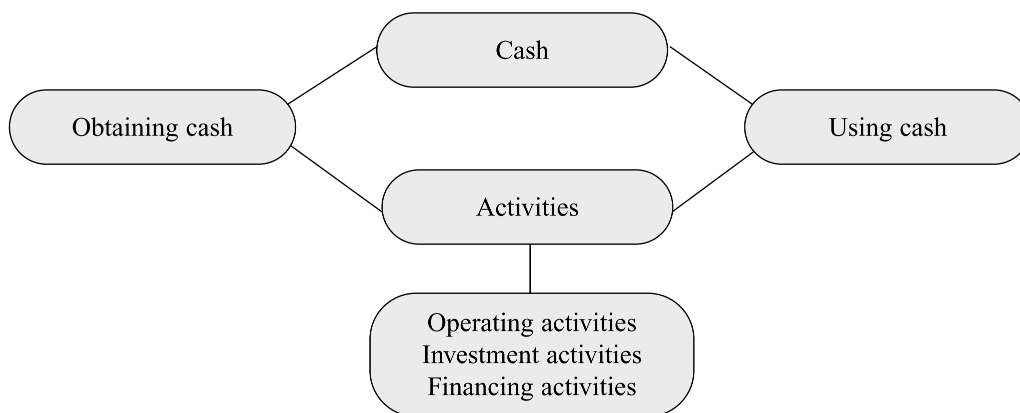
The third statement drawn up for the financial statements is the cash flow statement.

The cash flow statement gives information about the **flow of cash** in the enterprise during a certain period, usually the financial year.



We will discuss the statement of cash flows in more detail in chapter 5. The cash flow statement shows:

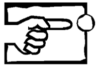
- the amount of cash that the enterprise's activities generated during the financial year
- the sources from which this cash was obtained
- how this cash was used during the same period
- whether the enterprise experienced an increase or decrease in the availability of cash during the period concerned



There are **three groups of activities** in the enterprise that involve obtaining and using cash:

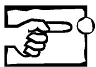
- **Operating activities** (operating flows). Cash involved in operating activities is the cash that is obtained and used during the enterprise's day-to-day activities, for example by selling the enterprise's products and services, paying the enterprise's creditors and paying current expenses (as shown in the income statement). Cash is also used for the

payment of interest and tax, dividends, depreciation and changes in inventory, debtors and creditors during the financial year.



- Although depreciation is deducted from income in the income statement, this does not result in cash flow. The actual cash flow is not influenced by depreciation. For this reason a non-cash expense such as depreciation is added to nett income before tax in the cash flow statement.
- Interest paid or received by the enterprise is shown separately in the cash flow statement.
- Tax and dividends paid are also shown separately.
- An increase in inventory and debtors during the financial year indicates that cash has been applied (that there has been an outflow of cash), while a decrease in the abovementioned current assets indicates that cash has been obtained (that there has been an inflow of cash). An increase in creditors indicates an inflow of cash, while a decrease indicates the outflow of cash.

- **Investment activities** (investment flows). Here it is indicated how the enterprise used cash to, for instance, replace fixed assets or obtain additional fixed assets. In selling some of its fixed assets or investments, the enterprise also obtains cash from investment activities.



The enterprise's investment activities involve **fixed assets** - such as property - and investments - such as **shares** - in other enterprises.

- **Financing activities** (financing flows). As regards financing activities, the cash flow statement indicates to what degree the cash from the enterprise's operations was sufficient to carry out its investment activities. If the cash from operating activities was more than the money the enterprise invested, the enterprise's liabilities will decrease (it has paid some of its debts). The reverse is also true. If the enterprise has used more cash for investment activities than it obtained from its operating activities, its liabilities will increase. In such a case the enterprise will, for example, have to borrow money or increase its overdraft facility at the bank to provide for all its investment activities.

An increase in liabilities because of a loan, for example, involves obtaining cash, while a decrease in liabilities involves the use of cash (the enterprise pays some of its debts).

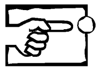
Cash flow statements usually have the following format: ***Example***

Cash flow statement for the financial year ended 31 December 1995

CASH FLOW FROM OPERATING ACTIVITIES	
Nett income before tax (as per income statement)	
Depreciation	
Interest paid	
Changes in inventory, debtors and creditors	
Tax	
Dividends	XXXXX
CASH FLOW FROM INVESTMENT ACTIVITIES	
Replacement of fixed assets	+
Purchase of additional fixed assets	
Sale of shares	XXXXXX
	XXXXXX
CASH FLOW FROM FINANCING ACTIVITIES	XXXXXX

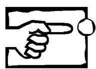
Cash flow statements usually give creditors (and also other users of the financial statements) an indication of the way in which the enterprise manages its cash. Credit assessors are interested in enterprises' cash flow statements because they provide information about:

- the type and amount of **funds** available during the year, and how these funds were applied
- the **sources** from which cash was made available
- the **changes** in the enterprise's **cash position** in the period between the two balance sheet dates - the inflow and outflow of cash
- the **factors** leading to the inflow and outflow of cash (were these operating activities, or investment and financing activities?)
- the enterprise's ability to **pay interest** and installments (or creditors)
- the enterprise's ability to **generate a positive cash flow** from its activities (also in future)



The enterprise's cash flow is influenced by many factors. By way of cash flow planning the enterprise can provide for different situations, for example a situation in which it has a surplus of funds (it can plan how it will apply these funds). Should it have a cash deficit (shortage), on the other hand, it can plan how it will eliminate this deficit.

Let us now use the financial statements of an enterprise, Business Ltd, to draw up a cash flow statement. This will help you to see where the different entries come from.



To draw up a cash flow statement, we need the financial statements of two subsequent years - more specifically, two balance sheets. The reason for this is that the cash flow statement gives us an indication of the changes in cash flow **between the two balance sheet dates during the financial year**.

Example

Business Ltd

Income statement for the financial year ended 31 December 1997

Sales		*5 000*
Less: Cost of goods sold		*- 3 000*
Gross income		*2 000*
Less: Operating costs		*- 1 600*
Sales costs	*700*	
Administrative costs (including auditors' fees)	*700*	
Depreciation	*200*	
Earnings before interest and tax (EBIT)		*400*
Less: Interest paid		*- 75*
Nett income before tax		*325*
Less: Tax		*- 100*
Nett income after tax (Earnings after interest and tax) (EAIT)	*225*	
Less: Preferred dividends		*- 15*
Nett earnings available for common shareholders		*210*
Less: Dividends to common shareholders		*- 15*
Earnings available		*195*
Less: Reserves		*95*
Retained earnings for the year		*100*

Business Ltd

Balance sheet on 31 December

Example

	1996	1997
CAPITAL EMPLOYED		
OWN CAPITAL		
Common share capital	*300*	*300*
Reserves	*105*	*200*
Retained earnings	*400*	*500*
Preferred shares	*50*	*50*
TOTAL OWN CAPITAL	*855*	*1 050*
LOAN CAPITAL		
Long-term loan	+ *400*	*650*
	1 255	*1 700*
EMPLOYMENT OF CAPITAL		
FIXED ASSETS		
Land and buildings	*1 100*	*1 500*
Machinery and equipment	+ *200*	*350*
Depreciation	- *(400)*	*(600)*
NETT FIXED ASSETS	*900*	*1 250*
INVESTMENTS		
Shares	*10*	*10*
NETT CURRENT ASSETS	*345*	*450*
CURRENT ASSETS	*595*	*740*
Cash	*175*	*240*
Debtors	*220*	*200*
Inventory	*200*	*300*
CURRENT LIABILITIES	*250*	*300*
Creditors	*150*	*200*
Short-term loan	*100*	*100*
	1 255	*1 700*

Notes to the financial statements

		1996	1997
1.	Common shares	R300 000	R300 000
	Authorised and issued		
	300 000 common shares of R1 each		

			1997	1998
2.	Preferred shares Authorised and issued 50 000		50 000	50 000
3.	Loan capital Long-term loan at 13,6% interest per year		400 000	650 000

4. Sales

Total sales consist of:

cash sales	1 500 000	2 000 000
credit sales	2 500 000	3 000 000
	4 000 000	5 000 000

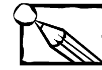
With the help of the details given in the income statement and balance sheet of Business Ltd we can now draw up a cash flow statement. Given the balance sheet dates as well as the date of the income statement, the cash flow statement will show changes in cash for the period 1/1/97 to 31/12/97.

Example

Business Ltd

Cash flow statement for the financial year ended 31 December 1997

CASH FLOW FROM OPERATING ACTIVITIES	
	R'000
Nett income before tax	*325*
Depreciation	*200*
Interest paid	*75*
Adjustments in:	
decrease in debtors	*20*
increase in inventory	*(100)*
increase in creditors	*50*
	570
Interest paid	*(75)*
Tax paid	*(100)*
Dividends paid	*(30)*
Cash flow from operating activities	*365*
CASH FLOW FROM INVESTMENT ACTIVITIES	
Purchase of additional assets	*(550)*
	(185)
CASH FLOW FROM FINANCING ACTIVITIES	
Increase in long-term loan	*250*
Increase in cash balance	*(65)*
	185



After studying Business Ltd's cash flow statement, what conclusion can you draw?

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The cash deficit created by operating and investment activities has been covered by the cash obtained from the financing activities - the loan was increased.

i) Give practical examples of the three groups of activities that appear in the cash flow statement.

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ii) Why will credit assessors be interested in the cash flow statements and position of Trailer (Pty) Ltd? Give reasons for your answer.

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THE PURPOSE OF THE FINANCIAL STATEMENTS

The general purpose of the financial statements is to provide information to people who wish to use these statements. The financial statements can be regarded as the means of communication between the enterprise and the users of the statements. There are various groups who use the statements, for example the owners and management of the enterprise, the employees, financial analysts, economists and stockbrokers. For the purposes of this course we will be concentrating on one group of users, namely the **prospective creditors** of the enterprise. This group includes the providers of loan capital and trade credit.

The credit manager is interested in the financial statements of a credit applicant because:

- the statements serve as a point of departure for sound/rational credit decisions (remember, however, that the decision cannot be based solely on the financial statements)

- the statements indicate what the applicant's ability is to pay

We already know that credit decisions are made in an environment of risk and uncertainty. Prospective creditors are often not completely sure what kind of credit risk the credit applicant represents. For example, there may be a risk involved in the applicant's profitability, the quality of management (this refers to the integrity of management that we discussed in chapter 2), and the applicant's ability to pay regularly and on time. Some of this uncertainty may be eliminated by analysing an enterprise's financial statements.

The providers of loan capital over the long and short term must know whether the applicant will be able to pay interest and debts regularly and on time. They are interested in the **liquidity** and **solvency** of the enterprise. They are also interested in whether the enterprise has the profit potential to ensure its growth and survival. The **profitability** of the enterprise is thus of importance here.

The providers of trade credit are also interested in all the abovementioned aspects. They want to have the assurance that all accounts will be paid regularly and on time. If the enterprise has liquidity problems, for example, its cash flow problems may result in irregular payments. If a provider of trade credit identifies this kind of problem during the analysis of the financial statements, it may decide to refuse the credit application concerned.

The financial statements of an individual credit applicant provide information about his or her assets, his or her liabilities, and his or her income and expenditure over a certain period. In the case of trade credit the credit manager is especially interested in the financial statements of an enterprise in one of the following situations:

- When an enterprise applies for credit for the first time

- When the order received is greater than a certain amount

An enterprise carries out all orders to the value of R10 000 or less directly if the purchasing enterprise has credit facilities. However, if the purchasing enterprise places an order of R20 000, a set of financial statements can be requested to establish if the enterprise will be able to pay an account of R20 000 as easily as one of R10 000.

Example

- When the credit applicant has only had the enterprise for a short while (in other words, when it is a new or a young enterprise)

- When the enterprise granting credit had a problem with collecting this account in the past

Essentially, the financial statements are analysed because the credit assessor wants answers to the following questions:

- Does the enterprise earn enough profit? What are the enterprise's long-term prospects - will it grow and survive? How effective is the management of the enterprise? Does it have the ability to function profitably and successfully over the long term?

- Does the enterprise have sufficient liquid means? Does it pay its accounts regularly and on time?

- How good is the enterprise's solvency - is it a safe investment? What is the guarantee function of the own capital?

- How does the enterprise manage its assets? For example, has it possibly invested too much capital in fixed assets? Overinvestment has a negative effect on the enterprise's ability to pay. Capital in fixed assets cannot be converted into cash quickly, and may cause liquidity problems in the long term.

An analysis of the financial statements (also the cash flow statement) thus enables the credit assessor to form an idea of:

- the enterprise's ability to generate a positive cash flow in the future

- the enterprise's ability to meet its obligations

- the enterprise's need for external financing (loan capital)
- the enterprise's financial position

In conclusion we can say that creditors obtain answers to their questions about an enterprise by assessing the profitability of this enterprise over a specific period, or by investigating its financial position at a specific time. This assessment process involves the analysis of the financial statements - an aspect we will discuss in chapter 5.

Although the analysis of the financial statements provides valuable information about an enterprise's financial position, the credit manager cannot make a credit decision on the strength of this information alone. Other factors such as the integrity of the enterprise, the type of product or service it provides and the market in which the enterprise operates must also be taken into account.

LIMITATIONS OF FINANCIAL STATEMENTS

In analysing financial statements, the credit manager must keep in mind that these statements have certain limitations. Accounting data is essential for the analysis of the statements. However, in spite of the fact that this information is vital for credit decisions (and also for financial decision-making by the financial manager of the enterprise in general), it does have the following limitations:

- Accounting data only contains **information that can be expressed in monetary terms**. We have already mentioned that the credit assessor also looks at the management of an enterprise in assessing its creditworthiness. An enterprise's management is one of its important assets. Without the management team, the other assets of the enterprise do not mean much. However, the value of the management team is not expressed in figures.

- The information in the financial statements is a **summary** and **simplification** of an enterprise's **financial activities**. There is no

complete, detailed information about every financial activity in the enterprise.

- Another shortcoming of the accounting data in the financial statements is that **no provision is made for inflation**.

- It is also possible that **different types of accounting policy** are applied in drawing up the statements. This must be stated in the financial statements, however. Different accounting policies may have different effects on the valuation of inventory, the valuation of goodwill and the disclosure regarding reserves.

- "**Window dressing**" may make the enterprise's cash flow look more favourable than it actually is. How? Inventory that has been purchased may not be entered in the books immediately. This will make the current ratio look better than it actually is.

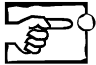
- Assets may be **valued more highly** than their actual value in the hope that the value of the inventory will increase. However, this will in turn have an influence on the enterprise's financial ratios (for example on the turnover rate of inventory).

- There may be **actual falsification** in the statements - for example, the figures of the balance sheet may have been added up incorrectly, the figures may all have been rounded off, or the date of the statements may have been given incorrectly.

- There may have been **substantial changes** in an enterprise's financial position in the period between the date of the financial statements and the date of the analysis.

Limitations

- monetary value only
- only summary
- no provision for inflation
- different policies
- "window dressing"
- higher value
- actual falsification
- substantial changes

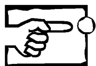


Because prospective creditors are interested in the financial statements of credit applicants, enterprises should ensure that they have a sound accounting system (for recording purposes). Enterprises should use qualified accountants or auditors to do their bookkeeping and check their books. Generally accepted accounting practice must be used.

After auditing an enterprise's statements, auditors issue one of the following types of reports:

- An **unqualified report**. In this type of report, the auditor expresses the view that the financial statements are a fair reflection of the financial position and financial results (of the enterprise's activities). The auditor has audited the financial statements and is satisfied that the statements have been drawn up according to generally accepted accounting practice.

- A **qualified report**. The auditor issues this type of report if there is too much uncertainty for him or her to give an opinion of the enterprise's financial position, or if the auditor can give such an opinion, but the opinion would be contrary to the contents of the financial statements.



To be of any value to a credit assessor, financial statements must (for the purposes of analysis):

- have been drawn up according to generally accepted accounting practice
- have been audited
- be up to date - i.e. they must be the most recent statements
- be available for at least the past two to three years, so that trends may be identified

CONCLUSION

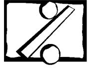
In this chapter we presented an overview of the enterprise's financial statements. We saw what the income statement, balance sheet and cash flow statement are and what information they contain. We also saw what types of entries are included in each of these statements. Important differences between the income and cash flow statement, on the one hand, and the balance sheet, on the other hand, are the following:

- The income statement and cash flow statement summarise the financial period concerned (usually the financial year)

- The balance sheet presents the financial position of an enterprise at a specific time (the last date of the enterprise's financial year)

For prospective creditors, the financial statements of an enterprise provide valuable information that they can use together with all the other information they have obtained about the enterprise. Financial statements are drawn up with the purpose of providing information to the users of the statements. We saw that creditors can use the statements to obtain information about, among other things, the enterprise's ability to pay and its financial position. Information about the liquidity, profitability and solvency of the enterprise can also be obtained by analysing the statements. We will discuss this aspect in more detail in the next chapter.

However, it is also important to remember that credit assessors cannot rely solely on the information they obtain from the financial statements. Information about aspects such as the enterprise's business risk, management, competition and credit life cycle is also very important and essential in making a decision about granting credit. You will remember that we discussed these aspects in the previous chapter.



QUESTIONS FOR SELF-EVALUATION

1. Complete the following definitions:
   i) The income statement is a

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   ii) The balance sheet gives

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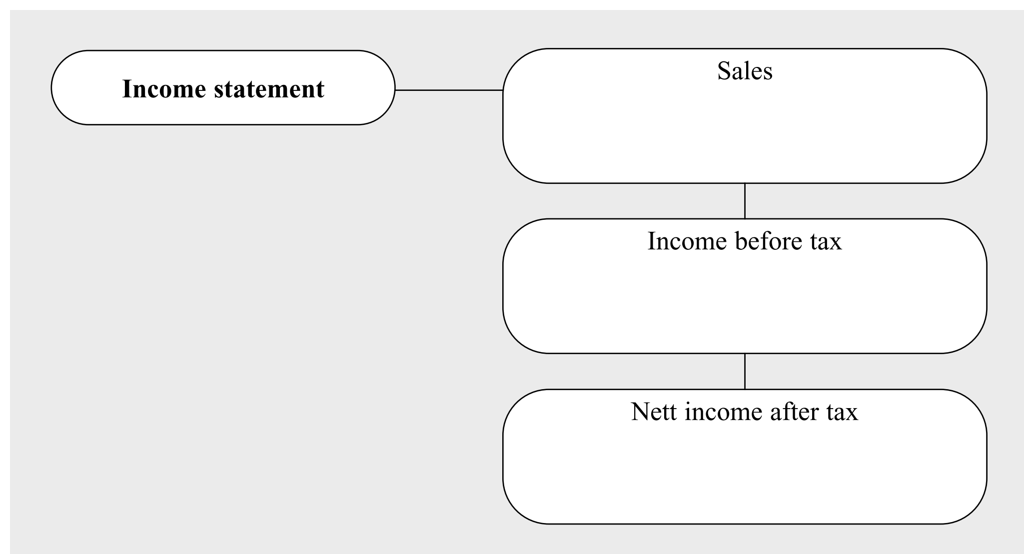
   iii) The cash flow statement indicates

   ____

2. i) Use the diagram to discuss the following entries on the income statement. Give keywords only.



   ii) Which costs and income must be taken into account to calculate the nett income before tax?

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3. Discuss the distinction made between the following two sections on the balance sheet:

* CAPITAL EMPLOYED:

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* EMPLOYMENT OF CAPITAL:

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4. Give practical examples of the types of activities found under each of the following in the cash flow statement:

* Operating activities:

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* Investment activities:

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* Financing activities:

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5. Explain why credit assessors are interested in an analysis of an enterprise's financial statements.

6. Discuss the limitations of financial statements that credit assessors have to take into account.

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