

WORKING WITH YOUR ACCOUNTANT

Reading Your Accounts: A Plain-English Guide

What the profit and loss account, balance sheet and cash flow statement tell you, and the few figures every owner should watch.

FOR: OWNERS AND DIRECTORS • NEW TO READING ACCOUNTS

Accounts are a story in three parts

A set of accounts looks intimidating until you see that it tells one story in three ways. The **profit and loss account** says what you earned and spent over a period. The **balance sheet** says what you own and owe at a moment in time. The **cash flow statement** explains how your cash changed. Each answers a different question, and you need all three to understand the business.

The profit and loss account

Also called the income statement. It starts with sales, deducts the direct costs of making those sales to give **gross profit**, then deducts overheads to give **operating profit**, then deducts interest and tax to give **profit after tax**.

- **Gross profit** shows whether each sale makes money before overheads.
- **Operating profit** shows whether the business covers its running costs.
- **Profit after tax** is what belongs to the owners, and can be kept or paid out.

Watch the percentages as well as the amounts: gross profit as a percentage of sales (the gross margin) and operating profit as a percentage of sales.

The balance sheet

It lists **assets** (what the business owns and is owed), **liabilities** (what it owes), and the difference, which is **net assets** or the owners' stake. Within it:

- **Fixed assets** such as equipment and vehicles.
- **Current assets**: stock, debtors (money owed to you), and cash.
- **Current liabilities**: creditors (money you owe), tax and VAT due, short-term loans.
- **Long-term liabilities**: loans repayable over more than a year.
- **Equity**: share capital and retained profits.

Who this is for

- Owners who file accounts but rarely read them
- First-time directors
- Anyone preparing for a lender or investor

Key points

- Profit, assets and cash are three different things.
- Compare to last year and to your plan, not just the total.
- Watch margins, debtor days and cash.
- Ask your accountant to explain anything you do not follow.
- Management accounts show it sooner than statutory accounts.

The cash flow statement

It shows where cash came from and where it went: from operating activities (the business itself), from investing (buying or selling assets) and from financing (loans and share capital, and repayments). It helps explain why a profitable business can run short of cash, for example when profits are tied up in stock and money owed to you.

Five figures worth watching

FIGURE	HOW TO WORK IT OUT	WHAT IT TELLS YOU
Gross margin	Gross profit ÷ sales	Whether pricing and direct costs work
Operating margin	Operating profit ÷ sales	Whether overheads are under control
Debtor days	Debtors ÷ credit sales × 365	How long customers take to pay
Current ratio	Current assets ÷ current liabilities	Whether you can meet near-term bills
Cash and runway	Cash ÷ average monthly spend	How many months you could last

Trends matter more than single figures: compare each with last year, with your plan, and, if you can, with others in your sector.

Statutory and management accounts

Statutory accounts are prepared once a year for Companies House and HMRC, in a prescribed format, and are filed publicly in a form depending on the size of the company. **Management accounts** are prepared more often, such as monthly, in a format that helps you run the business. If you read your accounts only once a year, you are reading history. Regular management accounts let you act while it can still make a difference.

Questions to ask your accountant

- What are the two or three numbers I should watch?
- What changed most since last year, and why?
- What would worry a lender about these figures?
- How do we compare with similar businesses?
- What would you do differently?

Related guides

If this is useful, you may also want:

- Management reporting
- Budgets and cash forecasts
- Cash collection

When reading a set of accounts

- Start with the profit and loss
- Check the margins
- Look at cash and what is owed
- Compare with last year
- Read the notes
- Note your questions

How King Street can help

0161 835 2080
client@mtmlp.co.uk

We explain your accounts in plain English at the year-end meeting, and for clients who want more, we prepare regular management accounts with the figures that matter to your business, set against your budget and last year.

Manchester: 3rd Floor, 82 King Street, M2 4WQ · Wilmslow: Cresta House, 42 Water Lane, SK9 5AL