

Your Guide to Understanding your Businesses' Financial Statements

Introduction

Running a business in South Africa is exciting and rewarding - but it also comes with a great deal of responsibility. As a business owner, one of your most powerful tools is your financial information.

Unfortunately, many entrepreneurs shy away from financial statements, leaving them solely to accountants or bookkeepers.

The risk?

Without a clear understanding of what those numbers mean, you could miss early warning signs, misunderstand your profitability, or make decisions that hurt your growth.

This guide is designed to change that. It will break down financial statements in simple, practical language and show you how to turn raw numbers into business insights. By the end, you'll be able to:

- Interpret key numbers and ratios to assess your company's financial health.
- Understand the three main financial statements that every business produces
- Spot red flags before they turn into serious problems.
- Use financial statements to make smarter, more confident decisions.

Whether you run a retail store in Durban, a consulting practice in Johannesburg, or an online shop serving the whole of South Africa, the principles remain the same. Think of this as your roadmap to taking control of your business finances; without needing to become an accountant.

The Big Picture

Financial statements act like a medical check-up for your company.

Just like a doctor monitors vital signs such as blood pressure, heart rate, and temperature, financial statements provide a snapshot of your business's health.

There are three main 'vital signs' to monitor:

1. Balance Sheet -what your business owns and owes at a point in time.
2. Income Statement (Profit & Loss) - whether you're making or losing money over a period.
3. Cash Flow Statement - how cash moves in and out of your business.

Why this matters:

- SARS Compliance: South African Revenue Service requires accurate record-keeping for VAT, PAYE, provisional tax, and corporate tax. Poor bookkeeping can lead to penalties, audits, or even business closure.
- Funding & Loans: Whether you're applying for a bank loan at Standard Bank or seeking investment from a private funder, your financial statements will be scrutinised. Lenders want proof you can repay debt, while investors want assurance you can generate returns.
- Strategic Decisions: Should you expand into Cape Town? Can you afford to hire another staff member? Should you buy that new delivery van? The answers often lie in your financial statements.

Balance Sheet Deep Dive

The Balance Sheet provides a snapshot of your business's financial position at a specific moment; like freezing your business on the last day of the month to see where it stands.

It has three main parts:

1. Assets - what your business owns

Assets are resources that have economic value and can help you generate income. They can be split into:

- Current Assets: Cash or items you can convert to cash within a year (e.g., bank balances, accounts receivable, inventory).
- Non-Current Assets: Long-term resources like property, vehicles, or equipment.

Examples:

- Cash in your FNB or ABSA business account.
- R50,000 in stock at your Durban warehouse.
- A delivery bakkie used for transporting goods.
- A laptop for your consulting work.

2. Liabilities -what your business owes

These are obligations your business must pay in the future. Like assets, they can be:

- Current Liabilities: Debts due within a year (accounts payable, SARS provisional tax, UIF contributions).
- Non-Current Liabilities: Long-term loans (e.g., 5-year bank loan for equipment).

Examples:

- VAT payable to SARS.
- R100,000 outstanding business loan from Nedbank.
- Supplier invoices from Cape Town wholesalers.

3. Equity - the owner's share

Equity represents the residual interest in the assets of the business after deducting liabilities. In simpler terms:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

It reflects the portion of the business you truly own.

Example Balance Sheet:

Item	Amount (ZAR)
Cash	100,000
Inventory	50,000
Equipment	150,000
Total Assets	300,000
Loan (Bank)	120,000
Accounts Payable	30,000
Total Liabilities	150,000
Owner's Equity	150,000

Understanding the balance sheet isn't just about knowing what your assets and liabilities are. It's also about interpreting the numbers. This is where financial ratios come into play.

Key ratios to watch:

1. Current Ratio = Current Assets ÷ Current Liabilities

- Measures liquidity; should ideally be greater than 1.
- Example: If your current assets are R80,000 and current liabilities R40,000, the ratio = 2 → a healthy sign.

2. Debt-to-Equity Ratio = Total Liabilities ÷ Equity

- Indicates how leveraged your business is.
- Example: R150,000 ÷ R150,000 = 1 → equal debt and equity.

Checklist for business owners:

- Do you know what your assets and liabilities are?
- Is your cash readily available for short-term obligations?
- Are you comfortable with your current debt level?

Income Statement Overview

The Income Statement (also called the Profit & Loss Statement) tells you whether your business is making or losing money over a specific period; usually monthly, quarterly, or yearly.

It tracks:

1. Revenue (Sales): Money earned from selling goods or services.

Example: A retail store selling clothing, or a consulting business charging hourly fees.

2. Cost of Sales / Cost of Goods Sold (COGS): Direct costs of producing or buying what you sell.

Example: Supplier costs, import duties, shipping fees.

3. Gross Profit = Revenue – COGS
- Shows profitability before running expenses.

Example Income Statement:

Item	Amount (ZAR)
Revenue	250,000
Cost of Sales	120,000
Gross Profit	130,000
Salaries	50,000
Rent	15,000
Utilities	5,000
Marketing	10,000
Depreciation	5,000
Net Profit	45,000

Profit Margins & KPIs

Key metrics every business owner should track:

1. Gross Profit Margin = $\text{Gross Profit} \div \text{Revenue} \times 100$
- Example: $\text{R}130,000 \div \text{R}250,000 \times 100 = 52\% \rightarrow$ healthy margin.
2. Net Profit Margin = $\text{Net Profit} \div \text{Revenue} \times 100$
- Example: $\text{R}45,000 \div \text{R}250,000 \times 100 = 18\% \rightarrow$ indicates overall profitability.
3. Operating Expense Ratio = $\text{Operating Expenses} \div \text{Revenue} \times 100$
- Helps control spending.

Tip: Compare your margins to industry standards (e.g., retail often 40–50% gross margin, consulting 60–70%).

VAT and Tax Considerations

If your business is VAT-registered (turnover greater than ZAR 1 million per year or voluntarily registered), your Income Statement must account for VAT:

- Revenue should exclude VAT (VAT collected is not your profit).
- Expenses can include VAT paid (which may be claimed as input tax).

Example:

- Sales = R115,000 (includes 15% VAT).
- Revenue for P&L = $R115,000 \div 1.15 = R100,000$.
- VAT = R15,000 → payable to SARS.

Other tax notes:

- Provisional tax affects net profit after tax planning.
- Wear and tear can reduce taxable income.

Common Mistakes in Income Statements

Business owners often misinterpret their P&L:

1. Confusing cash flow with profit → just because your statement shows profit, doesn't mean you have cash in the bank.
2. Ignoring VAT and tax liabilities → can lead to surprise SARS payments.
3. Failing to track small expenses → they add up and reduce net profit.
4. Mixing personal and business expenses → makes financial reporting messy and can raise red flags in audits.

Checklist:

- Are all sales recorded excluding VAT?
- Are all operating expenses categorized correctly?
- Is net profit reconciled with your bank statement?

Cash Flow Statement Overview

The Cash Flow Statement shows how cash moves in and out of your business over a period. It helps you understand if your business can pay its bills, invest, and grow.

It is divided into three main activities:

1. Operating Activities – cash generated from daily business operations.
2. Investing Activities – cash used for buying or selling assets like equipment or property.
3. Financing Activities – cash from loans, equity, or owner withdrawals.

Example Cash Flow (SME):

Item	ZAR
Net Profit	50,000
Increase in Receivables	-20,000
Equipment Purchase	-30,000
Net Cash Movement	0

Operating Cash Flow Example

Operating cash flow shows cash from core business activities:

- Cash collected from customers.
- Payments to suppliers and employees.

Example:

Item	ZAR
Cash received from customers	120,000
Cash paid to suppliers	-60,000
Salaries paid	-40,000
Operating Cash Flow	20,000

Investing & Financing Cash Flow

Investing activities:

- Buying office equipment, vehicles, or property reduces cash.
- Selling old equipment increases cash.

Financing activities:

- Borrowing from a bank increases cash (loan proceeds).
- Owner contributions or withdrawals affect equity.

Example:

Activity	Cash Flow (ZAR)
Buy Vehicle	-150,000

Bank Loan Received	100,000
Owner Withdrawal	-20,000
Net Cash Flow	-70,000

How the 3 Statements Link Together

The three statements are interconnected:

- Net Profit from Income Statement flows into Equity on Balance Sheet.
- Cash Flow Statement explains changes in the Cash line on Balance Sheet.
- Depreciation reduces profit (Income Statement) but not cash, reflected in Cash Flow Statement.

Key Ratios & KPIs Every Owner Should Track

Liquidity Ratios:

- Current Ratio = Current Assets ÷ Current Liabilities.

Profitability Ratios:

- Net Profit Margin = Net Profit ÷ Revenue × 100.

Efficiency Ratios:

- Debtor Days = Accounts Receivable ÷ Revenue × 365.

Solvency Ratios:

- Debt-to-Equity = Total Liabilities ÷ Equity.

Tip: Track these monthly to spot trends early.

Common Red Flags in Financial Statements

- Negative cash flow despite profit.
- Declining gross or net profit margins.
- High debt-to-equity ratio (>2 in many SMEs).
- Rapid increase in accounts receivable.
- Expenses growing faster than revenue.

Checklist:

- Review ratios monthly.
- Investigate unusual trends immediately.
- Seek accountant advice if unsure.

Practical Tips for Better Financial Control

- Keep personal and business finances separate.
- Use accounting software (Xero, QuickBooks, Pastel, Sage).

- Reconcile bank statements monthly.
- Track VAT and tax obligations carefully.
- Review KPIs and financial statements regularly.
- Maintain proper documentation for SARS compliance.

Summary

Understanding your financial statements is key to making informed decisions.

In summary:

- Balance Sheet: Know what you own and owe.
- Income Statement: Track profitability.
- Cash Flow Statement: Ensure liquidity.
- Ratios and KPIs: Monitor health and trends.
- Red Flags: Detect issues early.
- Regular Review: Stay in control.

Conclusion

Financial literacy is your superpower as a business owner. By understanding your statements, you can:

- Make better operational decisions.
- Plan for growth and investment.
- Avoid financial surprises with SARS and lenders.

Need help interpreting your financial statements? Contact our team of experts today and turn your numbers into actionable insights.