THE 3 FINANCIAL STATEMENTS

How to interpret them, connect them and detect financial risks.

A complete view to understand your company's performance, solvency and cash generation.

1 WHAT EACH FINANCIAL STATEMENT SHOWS

BALANCE SHEET

Where the resources are and how they are financed.

ASSETS	LIABILITIES	EQUITY
Resources the company uses to generate value.	Obligations to third parties.	Shareholders' contributions and retained earnings.

INCOME STATEMENT (P&L)

Whether the business generates profit.

REVENUE	COSTS	NET PROFIT
Sales and other income from the activity.	Cost of sales, operating expenses, interest and taxes.	Final result for the period.

CASH FLOW STATEMENT

Where the money comes from and where it goes.

OPERATING CASH FLOW	INVESTING CASH FLOW	FINANCING CASH FLOW
Cash generated by the core activity.	Cash inflows and outflows from investments (CAPEX, etc.).	Cash inflows and outflows from debt and equity.

2 KEY INDICATORS FOR FINANCIAL ANALYSIS

The main ratios to assess your company's financial health, with their formulas and interpretation.

DIMENSION	WHAT IT MEASURES	KEY INDICATOR	FORMULA	HOW TO INTERPRET IT
Liquidity	Ability to meet short-term obligations.	**Current ratio**	$\frac{\text{Current assets}}{\text{Current liabilities}}$	> 1 indicates capacity to cover short-term obligations. A very high value may indicate idle resources.
Solvency	Debt sustainability.	**Net debt / EBITDA**	$\frac{\text{Financial debt} - \text{Cash}}{\text{EBITDA}}$	The lower, the greater the repayment capacity. Depends on the sector and the company's stage.
Profitability	Generation of profit and value.	**ROIC**	$\frac{\text{NOPAT}}{\text{Average invested capital}}$	> WACC: the company creates value. < WACC: possible value destruction.
Efficiency	Use of resources and working capital management.	**DSO** (Days sales outstanding)	$\frac{\text{Average receivables}}{\text{Credit sales}} \times 365$	The lower, the better. An increase may indicate collection problems.
Cash generation	Ability to generate real cash.	**Free Cash Flow (FCF)**	Operating cash flow – CAPEX	> 0: the company generates cash after investments. < 0: may require additional financing or reflect a growth phase.

3 HOW THE THREE STATEMENTS CONNECT

The three financial statements are interrelated. A change in one of them affects the others.

P&L

Generates profit (or losses).

Impacts

- Net profit
- Working capital (receivables, inventories, payables)

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BALANCE SHEET

Shows where resources are invested and how they are financed.

Affected by

- Profit for the period
- Investments (CAPEX)
- Changes in working capital
- Financing (debt and equity)

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CASH FLOW

Shows the real cash generated or consumed.

Built from

- Operating result
- Changes in working capital
- Investments (CAPEX)
- Financing

KEY IDEAS

1. Credit sales increase revenue (P&L) but also receivables (Balance sheet) and may reduce cash (Cash Flow).
2. Investments (CAPEX) do not affect the P&L, but they reduce cash and increase assets.
3. Net profit does not always translate into cash. Working capital, taxes and investments determine the cash available.

4 WARNING SIGNS FOR A CFO

These combinations of indicators may point to financial risks that are worth analysing in depth.

Rising EBITDA and negative operating cash flow

Possible deterioration in the conversion of profit into cash. Review working capital.

Rising sales and increasing DSO

More capital tied up in customers. May put pressure on liquidity.

ROIC below WACC

Possible destruction of economic value. Review the return on investments.

Positive net profit and negative Free Cash Flow

Review investment, working capital and financial sustainability. May reflect a growth phase.

KEY IDEA

A company can be profitable and still run out of cash.

Analysing the three financial statements together helps to understand the real situation of the business and to make better decisions.

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