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Deciphering financial statements in annual reports

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Commentary

Deciphering financial statements in annual reports

Investors need them to understand a firm's profitability, liquidity and cash position

Themin Suwardy, Ho Yew Kee and Edmund Keung

For The Straits Times

Most readers understand that financial statements are a summary of the performance position and cash flow of a company.

Yet, many readers often give up because they think they are too complicated to understand. But learning how to read and analyse them is critical if an investor wants to have a real understanding of a company's profitability, liquidity and cash position.

STATEMENT OF COMPREHENSIVE INCOME (ENCOMPASSING THE INCOME STATEMENT)

Basically, the income statement shows how a company makes money. In the old days, this was simply the sum of all revenue less the sum of all expenses, which equals the net profit or loss for the year.

But as businesses become more complicated, there are now many dimensions to "making money".

For starters, we need to understand that financial reporting is done on accrual basis. This means we account for transactions when the effects take place, not when cash changes hands.

So a credit sale in the current period would be recognised as sales revenue (along with the corresponding cost to make such sale) even when collection is in the next financial year.

Early payments or deposits from customers for delivery of goods or services are not recognised as income until the performance obligation from those contracts is completed.

Similarly, payments that are made for expenditures not yet consumed are recognised in the income statement if and only if the expenditure is subsequently consumed.

After deducting expenses and losses from revenue and gains for the year, the bottom line of the income statement shows the net profit (or loss) for the period. This is also where the "income statement" as part of the statement of comprehensive income ends.

Below the net profit, you will find a number of items under the heading "Other comprehensive income".

The simple definition of these items would be revenues, expenses, gains and losses that are yet to be realised in the income statement.

These could relate to investment, foreign currency, hedges and pension plan gains or losses, as well as revaluation gains on long-term assets valued at fair value.

THE STATEMENT OF FINANCIAL POSITION (ALSO KNOWN AS THE BALANCE SHEET)

The balance sheet shows the assets of the entity and how they are financed by shareholders (equity) and external parties (liabilities).

Assets and liabilities can be classified as current (short-term) or non-current (long-term). This helps users understand the availability of resources to settle obligations.

In the balance sheet, one thing to pay attention to is intangible assets. An intangible asset is an identifiable non-monetary asset without physical substance, such as copyright, patents, licences, trademarks, brand names and goodwill.

In most cases, intangible assets are recognised when a company acquires another company and allocates the purchase price based on an assessment of the fair value of assets and liabilities acquired.

Any unallocated amounts are recorded as goodwill on acquisition.

It is normal for companies to seek external funding as they grow and expand their businesses.

This is called gearing or leverage, generally measured by the amount of debt or interest-bearing loans against assets or equity.

An increase in gearing over time would be a sign of likely financial difficulties, especially if there are pressures on revenues in an economic downturn.

THE STATEMENT OF CASH FLOWS

The statement of cash flows depicts movements of cash in three categories: operating activities, investing activities and financing activities.

Operating activities are the primary revenue-earning activities of the business, investing activities are those related to outflows and inflows associated with long-term assets, and financing activities relate to cash movements within the capital structure.

In general, we would normally expect a positive cash flow from operating activities, a negative cash flow from investing activities and a negative cash flow from financing activities.

A profitable firm should generate cash flows, collecting more cash than what it spends on operations.

It should be making some investments, though not always major expenditure unless guided by company strategy.

In the absence of new borrowings, financing would generally be negative as a result of dividend payments to shareholders or loan repayments.

In addition, mature companies often seek to grow their cash reserves in anticipation of potential large investments or merger/acquisition opportunities.

Taken together, financial statements paint a picture of how a company is doing.

Examining their composition and how they have changed over the years will equip investors with useful information to make informed decisions.

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This is the first of a three-part weekly series on financial literacy.

Key things to note in financial statements

WHAT TO LOOK FOR IN THE INCOME STATEMENT

- Changes in revenue, gross margin, operating margin and net margin over the years
- An understanding of major categories of expenses
- How large are non-operating income/expenses in relation to net profit?
- Compare company's performance to industry or peer benchmarks
- How large are the other comprehensive income items?

WHAT TO LOOK FOR IN THE BALANCE SHEET

- Availability of short-term assets to settle short-term liabilities
- Level of borrowings over time and ability to roll over credit
- Amounts recognised as intangibles, in particular those valued through business acquisitions, and the amount of goodwill

WHAT TO LOOK FOR IN THE CASH FLOW STATEMENT

- Positive cash flow from operations, preferably higher than net profit if there is a large depreciation charge annually
- Ability to invest in replacement or new assets to maintain or expand capacity
- Cash flow patterns that are reflective of business strategy

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