# Financial Statements

This week's article focuses on financial statements and how to analyse them. A company's financial statements provide information on its performance and this information is valuable to different types of stakeholders. Management is interested in assessing the success of its strategies and plans relative to its past, as well as forecasted, performance and comparatively to its competitors' performance. Employees are concerned with the company's financial success since this affects their bonuses, job security and compensation. Investors utilise this information to determine the expected return on their investments. Broker-Dealers and investment advisers use financial statements to guide recommendations made to clients about whether to buy or sell the securities, such as equities and bonds, issued by that company.

Financial statements are summaries of past performance. They can indicate, among other things, how successful a company has been at generating a profit to, repay or reward, investors. Although financial statements are historical they are also simultaneously forward-looking. They provide information on past performance but also provide some indication of a company's possible future performance. Financial statements typically include the balance sheet, the income statement and the cash flow statement.

- The **balance sheet** (also called the ***statement of financial position***) shows what the company owns and how it is financed. The financing includes what it owes others and shareholders' investment. Essentially, it displays:
    - the resources the company controls (assets),
    - its obligations to lenders and other creditors (liabilities or debt), and
    - owner-supplied capital (shareholders', stockholders' or owners' equity).

The fundamental relationship underlying the balance sheet, known as the accounting equation, is Total assets = Total liabilities + Total shareholders' equity, hence why the nomenclature "balance".

The value of the assets must be equal to the value of the financing provided to acquire them. In other words, the balance sheet must balance as demonstrated in Diagram 1. below.

*Diagram 1 - The Balance Sheet*

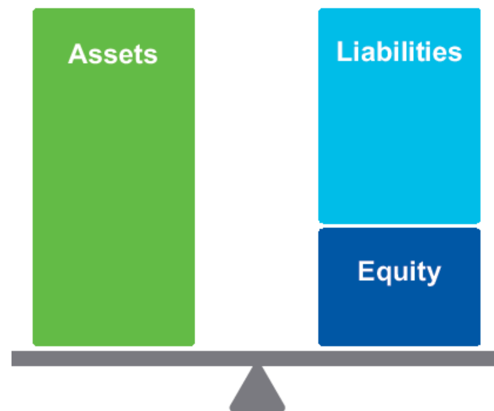


DIAGRAM - **Financial Statements**

- The **income statement** (also called ***statement of profit or loss***) identifies the profit or loss generated by the company during the period covered by the financial statements. Profitability is essential for a company to remain a going concern. Going-concern value is the idea that a company will continue to be in business and be profitable[i]. The income statement shows the company's financial performance during a given time period, normally one-year. It includes the revenues earned from the company's operation and the expenses incurred. The difference between the revenues and the expenses is the company's profit. In its most basic form, the income statement can be represented by the following equation: Profit (loss) = Revenues – Expenses

  Different measures of profit can be calculated from the income statement. These can include the following:

  Gross profit - subtracting the cost of sales (which represents the cost of producing or acquiring the products or services that are sold by a company) from revenues gives gross profit. Gross profit = Revenues – Cost of sales;

  Operating Income - Operating income is often referred to as earnings before interest and taxes. Operating income is the income (earnings) generated by the company before considering financing costs (interest) and taxes. Operating income = Gross profit – Other operating expenses.

- The **cash flow statement** shows the cash received and spent during the period and explains the change in the company's cash balance reported on the balance sheet. The cashflow can be classified as operating, investing or financing. This classification is critical to show investors and others not only how much cash was generated but also how this cash was generated. Cash flows from operating activities, reflect the cash generated from a

company’s operations, which is the main profit-creating activity. Cash flows from ***investing activities*** are typically cash outflows related to purchases of long-term assets, such as equipment or buildings, as the company invests in its long-term resources. Cash flows from ***financing activities*** are cash inflows resulting from raising new capital (an increase in borrowing and/or issuance of shares) and cash outflows for payment of dividends, repayment of debt, or repurchase of shares.

**Financial Statement Analysis**

Financial statement analysis involves the use of information provided by financial statements, and also by other sources, to assess a company’s performance. This is normally done through the use of ***financial ratios***. The use of ratios allows analysts and investors to standardise financial information and it provides a context for making meaningful comparisons. In particular, investors can compare companies of different sizes as well as the performance of the same company at different points in time. Ratios can assist in answering the following questions:

- How liquid is the company?
- Is the company generating enough profit from its assets?
- How is the company financing its assets?
- Is the company providing sufficient return for its shareholders?

Liquidity refers to a company’s ability to pay its outstanding obligations in the short term. Two ratios commonly used in assessing a company’s liquidity are the Current ratio (Current assets ÷ Current liabilities) and the Quick ratio (Current assets – Inventories ÷ Current liabilities).

A widely used ratio for measuring a company’s profitability is the net profit margin (Net Income ÷ Revenues). This ratio measures the percentage of revenues that is attributable to profit.

A common accounting ratio used for assessing financial leverage, that is the extent to which debt is used in the financing of the business, is the debt-to-equity ratio (Debt ÷ Equity). The debt-to-equity ratio shows the proportions of equity and debt a company is using to finance its assets and it signals the extent to which shareholder's equity can fulfil obligations to creditors, in the event a business declines[ii].

Investors are normally interested in whether the return made by the company is sufficient. A higher return will attract more investors. One measure of whether a company is providing sufficient return to its shareholders, is the return on equity (ROE) ratio. ROE = Net Income ÷ Equity. This ratio indicates how much return, as measured by net income is available to equity holders.

Financial statements are an important source of information for investment decision making. Investors are encouraged to carefully analyse a company’s financial statements before deciding to purchase or sell a security issued by a company. Next week we turn our attention to the investment process, in our five-part series on the topic of competent investment management.

[i] https://www.investopedia.com/terms/g/going_concern_value.asp

[ii] https://www.investopedia.com/ask/answers/062714/what-formula-calculating-debttoequity-ratio.asp

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