Tips on Reading Financial Statements

Scanning the Big Picture

Statement of Financial Position

Also Known as the Balance Sheet, which represents the financial position of your company at a given date, providing detailed information about a company's assets, liabilities and equity

Assets are things that your company owns or controls that have value. (cash, inventory, plant and machinery, etc…)

Liabilities are amounts of money that a company owes to others. This can include all kinds of obligations .(Creditors, bank loans, etc…)

Equity is sometimes called capital or net worth. It's the money that would be left if a company sold all of its assets and paid off all of its liabilities.

ASSETS =LIABILITIE+ EQUITY

STATEMENT OF FINANCIAL POSITION	
Assets	
Non - Current Assets	XX
Current Assets	
Cash	XX
Accounts receivable	XX
Stock	XX
Other current assets	XX
Total Current Assets	XX
Total Assets	**XXX**
Equity & Liabilities	
Capital & Reserves	
Paid-up capital	XX
Retained Earnings	XX
Total Equity	XX
Current Liabilities	
Accounts payable	XX
Other current liabilities	XX
Total Current Liabilities	XX
Total Liabilities & Equity	**XXX**

Statement of Comprehensive Income

Is an important component of a set of financial statements. It measures the performance of your business during an accounting period (usually one year) by showing how much revenue your company earned; it also shows the costs and expenses associated with earning that revenue.

The "bottom line" of the statement usually shows your company's net earnings or losses. This tells you how much the company earned or lost over the period.

STATEMENT OF COMPREHENSIVE INCOME	
Sales	XX
Cost of goods sold	XX
Gross Income	XX
Expenses	XX
Profit (Loss)	XX

Statement of Changes in Equity

Statement of changes in equity summarizes the movement in the equity accounts during the year namely Capital, Reserves, Retained Earnings, Dividends Payments, etc.

Statement of changes in equity is an important component of financial statements since it explains the composition of equity and how has it changed over the year.

STATEMENT OF CHANGES IN EQUITY	
Paid-Up Capital	
Beginning Balance	XX
Capital increase	XX
Ending Balance	XX
Retained Earnings	
Beginning Balance	XX
Profit	XX
Dividends	XX
Ending Balance	XX

The Cash Flow Statement

Is an important component of a set of financial statements. When analyzed in a rational, logical manner, it can illuminate a treasure trove of clues as to how a company is balancing its receivables and payables, paying for its growth , and otherwise managing its flow of funds.

The cash flow statement is divided into three sections:

Cash flow from operating activities; describes how cash is being generated or used by primary activities of the company.

Cash flow from investing activities; here you can see cash flow associated with purchases and sales of non-current assets, such as building and equipment purchases, or sales of investments or subsidiaries.

Cash flow from financing activities; here are all the flows associated with financing the firm, everything from selling and paying off bonds to issuing stock and paying dividends.

STATEMENT OF CASHFLOWS	
Cashflow from Operations	XX
Cashflow from Investing	XX
Cashflow from Financing	XX
Net change in cash	XX

Importance of Financial Statement

Financial statements are used by Owners, managers and creditors to evaluate the company's financial performance.
Each one of the four Financial Statements focuses on different area of the financial performances.

Financial Conditions

The financial conditions are a major concern to owners and creditors. As owners and creditors rely on the financial conditions of the company for both safety and profitability. More specifically, they need to know where their money went and where it is now. The Statement of Financial Position addresses such issues by providing detailed information about the company's assets, outstanding debt and equity.

Operating Results

Financial conditions shown in the balance sheet are snapshots of assets, liabilities and equity at the end of the year; they don't reveal what happened during the year from operations that may have caused changes to financial conditions. Statement of Comprehensive Income reports operating results as sales, expenses and profits or losses. Using it, Owners can both evaluate the company's past income performance and assess the uncertainty of future cash flows.

Shareholders' Equity

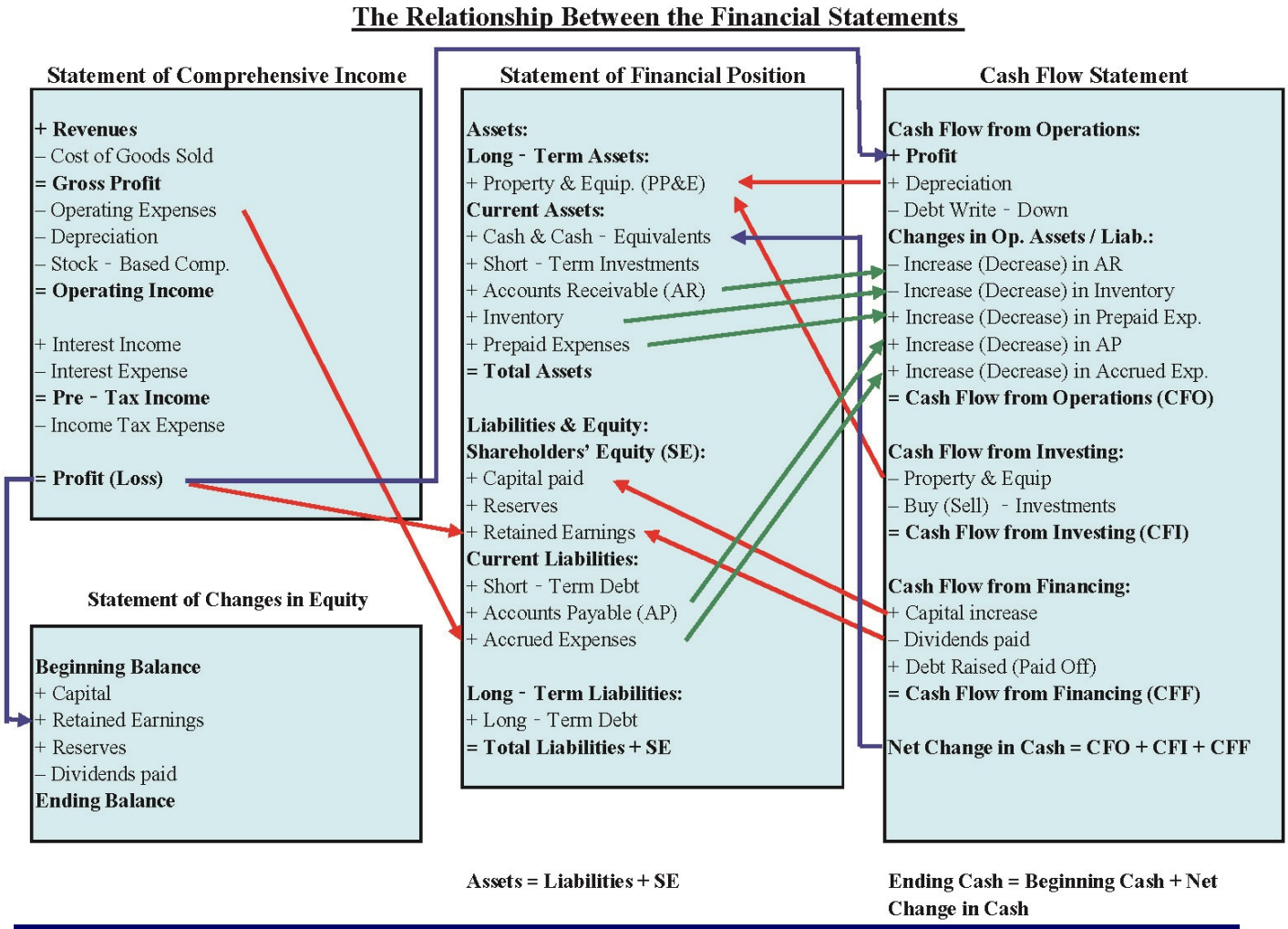
The statement of shareholders' equity is especially important to owners because it shows the changes in various equity components, including retained earnings, during the year. The amount of shareholders' equity is the company's total assets minus its total liabilities, representing the company's net worth

Cash Flows

The company's profit reported in the Statement of Comprehensive Income is an accounting income and most likely contains certain non-cash elements, providing no direct information on a company's cash exchange during the year. Moreover, the company also incurs cash inflows and outflows during the year from other activities, namely investing and financing. To Owners, cash from all sources, not just accounting income from operations, is what pays back their investment. The importance of the cash flow statement is that it shows the exchange of cash between the company and the outside world during the year, and so owners can know if the company has enough cash to pay for expenses and asset purchases.

Read the notes to the financial statements; the footnotes to financial statements are packed with useful and important information.

The Relationship between the Financial Statements



Bringing it all Together

The income statement, balance sheet & cash flow statement are all interrelated.

The income statement describes how the assets and liabilities were used in the stated accounting period.

The cash flow statement explains cash inflows and outflows, and it will ultimately reveal the amount of cash the company has on hand, which is also reported in the balance sheet.

By themselves, each financial statement only provides a portion of the story of a company's financial condition.

Together, they provide a more complete picture.

UNDERSTANDING FINANCIAL REPORTS

Calculating and analyzing financial data can give business owners, managers, and decision makers the information they need to make critical decisions.

We have prepared this section to provide you with a clear and practical explanation on how to analyze your financial statement: by listing the most important of the many ratios that you can calculate from information on financial statements and then use to evaluate your business activities & performance and ultimately gain better control of your business. As a general rule, desirable ratios vary by industry.

Now, sit back with your company's annual report and follow these steps:

Liquidity Measurement Ratios:

Liquidity ratios attempt to measure a company's ability to pay off its short-term debt obligations. This is done by comparing a company's most liquid assets or, those that can be easily converted to cash, to its short-term liabilities.

In general, the greater the coverage of liquid assets to short-term liabilities the better, as it is a clear signal that a company can pay its debts that are coming due in the near future and still fund its ongoing operations. However, a company with a low coverage rate should raise a red flag for investors as it may be a sign that the company will have difficulty meeting running its operations, as well as meeting its obligations.

Current Ratio

The current ratio compares a company's current assets (those that can be converted to cash during the current accounting period) to its current liabilities (those liabilities coming due during the same period). The formula is:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The current ratio measures the company's ability to repay the principal amounts of its liabilities.

The current ratio is closely related to the concept of working capital. Working capital is the difference between current assets and current liabilities. Is a high current ratio good or bad? Certainly, from the creditor's standpoint, a high current ratio means that the company is well-placed to pay back its loans. Consider, though, the nature of the current assets: they consist mainly of cash and cash equivalents. Funds invested in these types of assets do not contribute strongly and actively to the creation of income. Therefore, from the standpoint of stockholders and management, a current ratio that is very high means that the company's assets are not being used to the best advantage.

Quick Ratio

The quick ratio is a variant of the current ratio. It takes into account the fact that inventory, while it is a current asset, is not as liquid as cash or accounts receivable. Cash is completely liquid; accounts receivable can normally be converted to cash fairly quickly, by pressing for collection from the customer. But inventory cannot be converted to cash except by selling it. The quick ratio determines the relationship between quickly accessible current assets and current liabilities:

$$\text{Quick Ratio} = \frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}}$$

The quick ratio shows whether a company can meet its liabilities from quickly-accessible assets.

In practice, a quick ratio of 1.0 is normally considered adequate, with this caveat: the credit periods that the company offers its customers and those granted to the company by its creditor must be roughly equal. If revenues will stay in accounts receivable for as long as 90 days, but accounts payable are due within 30 days, a quick ratio of 1.0 will mean that accounts receivable cannot be converted to cash quickly enough to meet accounts payable.

Profitability Indicator Ratios:

Profitability Ratios measures the company's profitability and financial performance. These ratios, much like the operational performance ratios, give users a good understanding of how well the company utilized its resources in generating profit and shareholder value.

Gross Profit Margin

A company's cost of sales, or cost of goods sold, represents the expense related to labor, raw materials and manufacturing overhead involved in its production process. This expense is deducted from the company's net sales/revenue, which results in a company's first level of profit, or gross profit. The gross profit margin is used to analyze how efficiently a company is using its raw materials, labor and manufacturing-related fixed assets to generate profits. A higher margin percentage is a favorable profit indicator.

The formula is:

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

The gross profit margin measures the amount that customers are willing to pay for a company's product, over and above the company's cost for that product. This is the value that the company adds to that of the products it obtains from its suppliers. The gross profit margin also depends heavily on the ability of the sales force to persuade its customers of the value added by the company.

Net Profit Margin

The net profit margin narrows the focus on profitability, and highlights not just the company's sales efforts, but also its ability to keep operating costs down, relative to sales. The formula generally used to determine the net profit margin is:

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Net Sales}}$$

Return on Assets

This ratio indicates how profitable a company is relative to its total assets. The Return on Assets (ROA) ratio illustrates how well management is employing the company's total assets to make a profit. The higher the return, the more efficient management is in utilizing its asset base. The ROA ratio is calculated by comparing net income to average total assets, and is expressed as a percentage. There are several ways to measure this return; one useful method is:

$$\text{Return on Assets} = \frac{\text{Net Profit}}{\text{Total Assets}}$$

Return on Equity

This ratio indicates how profitable a company is by comparing its net income to its average shareholders' equity. The Return on Equity Ratio (ROE) measures how much the shareholders earned for their investment in the company. The higher the ratio percentage, the more efficient management is in utilizing its equity base and the better return is to investors. The formula is:

$$\text{Return on Equity} = \frac{\text{Net Profit}}{\text{Shareholders Equity}}$$

The principal difference between the formula for return on assets and for return on equity is the use of equity rather than total assets in the denominator, and it is here that the technique of comparing ratios comes into play. By examining the difference between Return on Assets and Return on Equity, you can largely determine how the company is funding its operations.

If the Return on Equity ratio is much larger than the Return on Assets ratio, you can infer that the company has funded some portion of its operations through borrowing.

Activity Ratios:

Activity ratios, referred to as operating ratios or management ratios, measures how effectively a company is able to generate revenue in the form of cash and sales based on its assets, liability and capital. The more commonly used operating ratios are the average collection period, the inventory turnover, .

Average Collection Period

The average collection period is how long the company takes on average to collect its debts; generally speaking, the shorter the period the better for the company. One formula for this ratio is:

$$\text{Average Collection Period} = \frac{\text{Accounts Receivable}}{\text{Credit Sales / Days}}$$

Where Days is the number of days in the period for which Accounts Receivable and Credit Sales accumulate.

You should interpret the average collection period in terms of the company's credit policies. If, for example, the company's policy as stated to its customers is that payment is to be received within two weeks, then an average collection period of 30 days indicates that collections are lagging. It may be that collection procedures need to be reviewed, or it is possible that one particularly large account is responsible for most of the collections in arrears. It is also possible that the qualifying procedures used by the sales force are not stringent enough.

Regardless of the cause, if the average collection period is over-long, it means that the company is losing profit. The company is not converting cash due from customers into new assets that can, in turn, be used to generate new income.

Inventory Turnover Ratio

The average collection period is This ratio measures the number of times a company's inventory is turned over during a given year. The higher the turnover ratio, the better, since the company with a high turnover requires a smaller investment in inventory than one producing the same level of sales with a low turnover rate. Company management has to be sure, however, to keep inventory at a level that is just right in order not to miss sales.

This ratio indicates the efficiency in turning over inventory and can be compared with the experience of other companies in the same industry. It also provides some indication as to the adequacy of a company's inventory for the volume of business being handled. If a company has an inventory turnover rate that is above the industry average, it means that a better balance is being maintained between inventory and cost of goods sold.

The formula for the Inventory Turnover Ratio is:

$$\text{Inventory Turnover} = \frac{\text{Cost of goods sold}}{\text{Average Inventory}}$$

where the Average Inventory figure refers to the value of the inventory on any given day during the period during which the Cost of Goods Sold is calculated.

The figures for cost of goods sold and average inventory are taken directly from the Statement of Income's cost of sales and the Balance Sheet's inventory. In a situation where you know only the beginning and ending inventory, you would use the average of the two levels: hence the term "average inventory."