Layman’s approach to understanding financial statements.

Listed companies do release their financial statements on a quarterly basis and are made available to the public. These financial statements are the main indicators for the public and shareholders to ascertain the performance of the company. Published financial statements would have many set of accounts and notes, of which the most important would be the Income statement (or the Profit & Loss account), Balance Sheet and the Cashflow Statement. Shareholders and/or potential investors would scrutinize these three statements to analyze and obtain judgment on the financial performance of the company since it would have details pertaining to the current accounting period along with the corresponding accounting period a year ago. It is most beneficial to view and analyze these three statements in unison since each of the set of accounting statements would provide information attributable to different financial indicators or the position of the company.

Income Statement (Profit & Loss Account)

The most important aspect for shareholders would be the profitability and profit growth in the company, hence the attention should be directed at the “profit attributable to the shareholders of the company” and not necessarily total net profit. The profit attributable to shareholders divided by the number of shares in issue would provide the earnings per share (EPS) figure which is widely used in the stock market to calculate the PE multiple. In companies having many subsidiaries the profit attributable to minorities may also be relatively large and hence would reduce shareholder profit though the company’s total net profit consist of these two elements. When focusing on shareholder profit, the reader of accounts also needs to pay attention to whether the profit is generated from ordinary operations of the company or by way of any extraordinary outcome. If the company has divested its assets at a gain or they have received some extraordinary income, such would lead to a boost in the net profit figure though the investor should be mindful that such windfall of net earnings may not recur. Therefore the investor should focus more attention on the recurring shareholder profit and the trend of profit growth.

The reader of accounts should then attempt to understand the drivers for the growth in recurring net profit. Is it driven by revenue growth, cost reduction or slower growth in the cost base vs. the growth in revenue etc.? While scrutinizing the income statement on this basis, the reader could also keep a tab on Gross Margins (Gross profit divided by Net revenue) and Operating Margin (Operating Profit divided by Net revenue) and their performance.

Some companies do report its EBITDA which is an acronym for earnings before charging for depreciation, amortization, interest and tax. Hence EBITDA provides a more pure view on the firm’s operating earnings which are within the control of the entity. Operating profit differs from EBITDA since it takes into account the impact of depreciation and amortization. The performance of operating profit would not be always mirrored by the profit before tax, since this would be affected by the changes in the interest cost on borrowed money. The use of leverage

or borrowings to finance the growth or operations of the company is considered a positive, since this would increase the returns for the shareholders if incremental profit is generated after servicing the debt. Hence if the operating profit or EBIT is many folds vs. the interest cost indicates a company in good financial health. When comparing the interest cost year on year, the reader of accounts should focus his or her attention to the reasons for which the interest charge has changed. Has the interest cost changed because the company has taken more borrowings or due to a change in payable interest rates. Profit before tax would be the net earnings prior to the payment of corporate tax. Taxation would deteriorate the generated profit and as readers of accounts it is of less use focusing on the tax cost since it is beyond the company's control.

Balance Sheet

The Balance Sheet would provide a snap shot view of the financial position of the company. Growth in the total asset base of the company when compared to the previous corresponding period indicates a growing company. However the reader should then pay attention to how the assets of the company has been financed, i.e. is it through equity or by way of liabilities. Debt-to-Equity is a widely used measure in ascertaining financial health of the company though opinion is divided as to what the best ratio would be. It is considered that a 50%, long term debt to equity is an ideal level though this cannot be used as a blanket rule across all companies. For a rapidly growing entity, with high cash flows and ability to service its interest cost rather comfortably, a higher debt-to-equity is not a concern.

Further the Balance Sheet could provide the opportunity for the reader of accounts to analyze how well the company has matched its short term assets with short term liabilities. A company having sound financial health would match its short term liabilities with short term assets and long term assets and liabilities separately. The use of short term liabilities to finance long term assets is not a prudent exercise and increase the risk level with regard to the financial stability of the company. This can be analyzed further by considering the Current Ratio (current assets divided by current liabilities) which provides indication of the company's ability to pay its short term obligations. The current ratio which theoretically is a multiple should be more than one times, so that the assets are sufficient to meet the short term obligations without much difficulty.

Balance Sheet also provides a much valued indicator or statistic for the shareholder, i.e. the net asset value of the company and concurrently the net asset value per share (which is commonly known as the book value per share). Net assets of a firm is the amount excluding the minority shareholders' funds which is available for the ordinary shareholders. Therefore in reality despite the total asset size of the listed company, the true accounting value would be represented by the net assets of the firm. Net assets (or shareholder funds) consist of the stated capital, other reserves and retained earnings of the firm. Sum of these divided by the issued number of shares would provide the book value per share. Book value per share which would derive the multiple Price-to-Book-Value is widely used in the analysis of stocks to ascertain the premium or discount offered in the market when transacting shares in the stock market. However it is not prudent to go solely on the basis of reported book value when analyzing a company, since the reported accounts could have assets held at cost whereas if a revaluation was done the true

value would be much higher. Furthermore the Price-to-Book Value multiple would vary from industry to industry and a higher multiple would be a norm in asset lite business models.

Cashflow Statement

This statement would provide the reader of accounts an actual understanding of the cash generation of the business. The profit figure represented in the Income Statement could be affected by many noncash items hence the cashflow statement provides an understanding of the cash position of the company. Depreciation and amortization are notional non-cash charges which actually does not affect the actual cashflows. Changes in working capital requirements and the management of both debtors and creditors would either shorten or lengthen the working capital cycle resulting with impact on actual operational cash flows. A positive operating cashflow, provides indication of a cash generating business which makes business sense. Thereafter the cashflow statement would provide information with regard to cash used in financing and investment. The use of cash in investments and repaying high cost debt is always a positive but may lead to a depletion of the final cash balance. The net impact on the cash balance would also impact the company's ability to pay dividends.

In general all of the above financial statements should be viewed and analysed concurrently to obtain a better understanding of the company's performance. Though our discussion above was limited to the main aspects of understanding and reading financial statements, more time and effort could be used in conducting a detailed analysis calculating multiple ratios to ascertain profitability, working capital management, cashflow generation, debt servicing etc. Nevertheless we believe the discussion above would assist in understanding financial statements, though as shareholders/investors the reader should keep in mind that the published financial statements are historic and hence provide no guarantee of the future performance of the company.