

MANAGEMENT OUTLOOK



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HOW TO READ AN ANNUAL REPORT

Stock value is derived from a company's long term ability to create cash profits from invested capital; and financial statements are intended to give a snapshot of how successfully this creation of value is being accomplished. But unless you're a professional accountant, you may find that a look at an annual report is like a visit to an alien planet; you'll encounter odd terminology, strange calculations, and of course big numbers.

This guide should help make things more accessible. It explains the three important financial statements from the annual report of a fictitious company:

But first, here's an interactive diagram of the big picture that the annual report is trying to convey. Arrows indicate the movement of cash.

Income Statement

Stock investors like to look at the income statement (a.k.a. "earnings statement" or "statement of operations") because it shows the company's "bottom line": its earnings, or profit. Most of the income statement details the company's operations

Income Statement

How good the company is at making money

Cash Flow Statement

How they're paying for their operations and their future growth

Cash Flow Statement

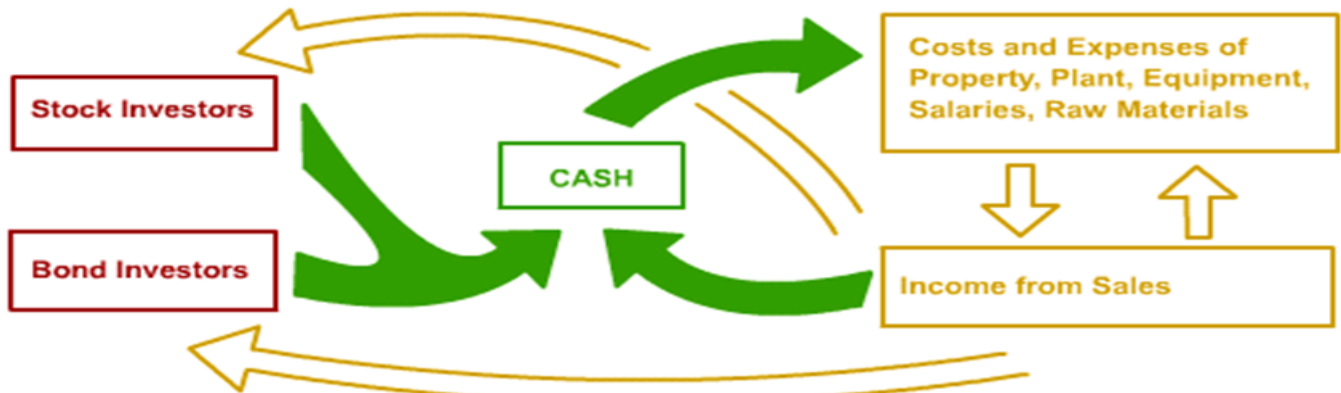
The Cash Flow Statement shows how the company is paying for its operations and future growth, by detailing the "flow" of cash between the company and the outside world; positive numbers represent cash flowing in, negative numbers represent cash flowing out.

Balance Sheet

What the company owns and owes

Balance Sheet

The balance sheet shows what a company owns and what it owes; the difference is what the company is "worth", at least on paper. One huge



CASH

A business needs sufficient amounts of cash to sustain its daily operations and to pay for future growth. The cash flow statement details the flow of cash between the business and the outside world, and classifies it into three main categories -- Operations, Financing, and Investing -- represented by the three solid green arrows.

Stock Investors

Proceeds from new stock sales is shown in the Financing section of the cash flow statement; the total amount raised from stock sales is detailed within the shareholders' equity section of the balance sheet.

problem is that the fair market value of many assets can be very different from the "book values" shown here. So people looking for "value" stocks need to do more research, beyond the balance sheet.

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Bond Investors

Proceeds from new bond sales is shown in the Financing section of the cash flow statement; interest paid to bond holders is shown on the income statement; and the company's total amount of bond debt is included in the liabilities section of the balance sheet.

Cash Flow from Financing (detailed on the Cash Flow Statement)

This is the easiest way to raise cash: issuing new stocks or bonds and selling them to the public. Both of these methods cause problems for shareholders. Issuing new stocks "dilutes" the value of each individual share; issuing bonds commits the company to paying interest, which will punish future earnings. In a really healthy company this arrow can flow backwards: they can be buying back shares and paying off debt, all of which will help to improve earnings per share in the future.

Cash Flow to Investing (detailed on the Cash Flow Statement)

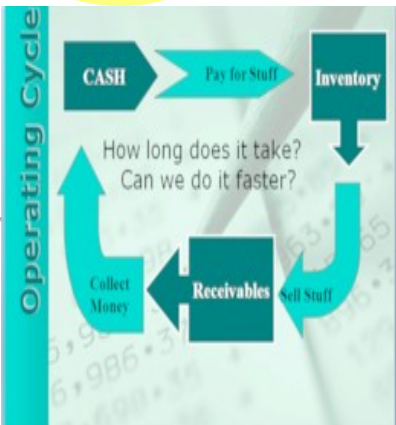
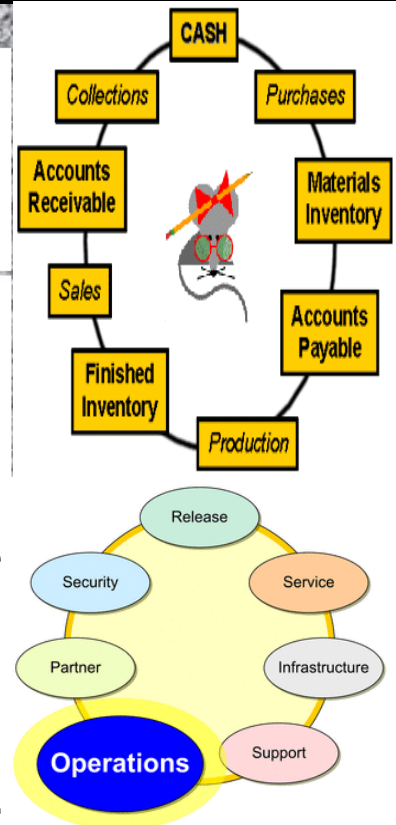
The obvious way a company can increase its earnings from operations is to keep doing everything the same way, but on a larger scale. This requires spending cash to buy additional property and equipment. Investors like to see that growth is sustainable, meaning that the company can cover this spending with cash flowing in from Operations, without having to raise additional cash from the left side of the diagram.

Cash Flow from Operations (detailed on the Cash Flow Statement)

This is the company's sustainable, "healthy" source of cash: its profits from operations. The "operations" category of the cash flow statement starts out with the earnings number from the income statement, and then adjusts it, removing the effects of "on paper" expenses like depreciation, to reflect the actual amount of cash that entered the company from the outside world.

Operations (detailed on the Income Statement)

This is where a company actually "makes" money, by creating and selling whatever it is that it sells. Part of the revenue from sales is cycled back to pay costs and expenses. The net result -- the earnings, or profit -- is shown as the "bottom line" on the income statement, and becomes the Cash Flow from Operations on the cash flow statement.



How to read a company's balance sheet

The essence of savvy investing is to research your investments carefully and make use of all the information that is available.

Publicly listed companies are obliged to release their basic financial information regularly and these form the starting point of any systematic research. The three main statements released are the balance sheet, the income statement and the cash flow

statement.

In this article we look at balance sheets and how they help us understand a company's strengths and weaknesses.

What is a balance sheet?

A balance sheet is a snapshot of a company's financial position at a particular point of time in contrast to an income statement, which measures income over a period of time.

In India a balance sheet is usually calculated for March 31, last day of the financial year. A financial year starts on April 1 and ends on March 31. The period between April 1, 2006 and March 31, 2007 will complete a financial year.

A balance sheet measures three kinds of variables: assets, liabilities and shareholder's equity.

Assets are things like factories and machinery that the company uses to create value for its customers.

Liabilities are what the company owes to outside parties, say to its vendors.

And equity is the money initially invested by shareholders plus the retained earnings over the years.

These three variables are linked by the relationship: Assets = Liabilities + Shareholder's equity.

Both assets and liabilities are further classified based on their liquidity, that is, how easily they can be converted into cash.

Current assets are assets, which can be converted into cash in less than a year. Examples include cash, inventories and money owed by customers (accounts receivables).

Current liabilities are liabilities that are due within a year and include interest payments, dividend payments and accounts payable.

Long-term assets include fixed assets like land and factories as well as intangible assets like goodwill and brands. Finally, long-term liabilities are basically debt with maturity of more than a year.

Financial ratios and the questions they answer

To answer various questions about a company, two or more entries in a balance sheet are often combined in the form of financial ratios.

There are many such ratios but let's look at three of them along with the questions that they help answer: Current ratio is the ratio of current assets to current liabilities. This tells how well the company can meet its short-run obligations since current assets are those which can most quickly be converted into cash to meet short-run liabilities. A current ratio less of than 1 indicates that current liabilities exceed current assets and that may be a dangerous sign for an investor. Debt/ Equity ratio: This is the ratio of long-term debt (loans for instance) to shareholder's equity. A high ratio indicates a greater reliance on debt on the part of the company and may indicate long-term solvency (Any company's ability to meet its long-term debt) problems.

Finally, the sales-to-fixed assets ratio tells us how efficiently a company is using its fixed assets (say factories owned and real estate) to generate sales and revenues. A low ratio may indicate that the company has excess capacity or possibly

problems in the supply of raw materials that reduce production.

Don't look at them in isolation

It's important not to look at financial ratios in isolation. They should be compared with the same ratios in previous years in order to get a sense of how the company's financial position has changed over time.

They should also be compared with the ratios of similar companies in the industry because different industries have different financial norms and debt/equity ratios that might look alarming in one industry but may be normal in another.

There are limits to what a balance sheet can convey

It's also important to keep in mind the limits of balance sheet information.

Most obviously since the balance sheet is a snapshot at a particular point of time, it may become less relevant particularly in a fast-moving industry or if the company makes a dramatic decision like a take-over (Like the takeover of the UK-based Corus by India-based Tata Steel

Balance sheets are also less useful in evaluating a company with a lot of intangible assets like brands and knowledge since accounting methods can only offer rough estimates of the value of such assets. This is especially a problem in evaluating companies in the Information Technology sector (like TCS, Infosys, and Wipro for example).

Finally assets are often valued according to their original cost minus depreciation (the fall in value of an asset; like the value of your car goes on decreasing year after year and more so if your car is damaged in an accident) rather than their current market value.

Despite these problems balance sheets are still an invaluable tool. They may not provide the final answer in figuring out how much a company is worth but they are an indispensable first step.

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