Reading annual reports:

From glancing to dissecting

Part 2

Dissecting financial statements

Reviewing the financial statements help to assess various aspects of the business performance and risk from a quantitative perspective. Financial analysts normally look at certain financial statement ratios for guidance to justify their concerns about:

- Did the net profit rise or fall?
- Is cash cycle rising or falling?
- Is operating cash flow healthy?
- Is gearing too high?
- Is ROE improving or declining?
- Is shareholders' equity rising or falling?

1. Did the net profit rise or fall?

Net profit reveals information about the company's operating results. When assessing the financial position of a company, you always need to see improvements in sales and margins of all levels. It is a good sign if net profit increases as a result of increase in sales, recurring gains of operating margin. Two important ratios that need to be considered are:

- **Operating margin ratio = Operating Income / Net sales:** this ratio measures what proportion of a company's revenue is left over after paying all of variables cost of production. This means that, if the operating margin ratio is increasing, the company is earning more per dollar of sales. For example, if operating margin ratio is 15% (calculated in dollar terms), the company can earn $0.15 (before interest and tax) for every single dollar of sales.
- **Net profit ratio = Net Income / Net Sales:** is similar to the operating margin ratio. Net profit ratio indicates how well a company can convert sales into profit after all expenses are paid off. If the net profit ratio is increasing, the company is efficient in generating profit because both reducing expenses and increasing sales revenue can help increase the net profit ratio.

Consistently increasing net profit indicates whether the company is sustainable or not. Thus, red flags would be a steady decline in margins or an increase in net profits as a result of increasing non-recurring gains.

2. Is the cash-cycle rising or falling? Why?

Looking at the cash cycle or cash conversion cycle will give you a better idea of management effectiveness. It measures how fast a company can convert cash on hand into even more cash. The cash conversion cycle is a combination of several activity ratios involving accounts receivable, accounts payable and inventory turnover. Cash conversion cycles look at the number of days that cash is locked in receivables and inventories minus the number of days that payables are not paid.

If the cash cycle is rising, inventory and receivables might be piling up too fast, which means cash is locked up for a longer term. As a standalone number, the cash cycle doesn't mean very much. It should be used to track a company over time and to compare the company to its competitors. A decrease or steady cash cycle is preferable because the company is able to convert to cash quicker and hence is more effective in their operation and management.

3. Is operating cash flow healthy?

Operating cash flow measures the amount of cash generated during business operations. This is an important figure because it reveals whether the company is able to generate sufficient cash flow to maintain and grow or whether it needs external financing. Operating cash flow is calculated by adjusting net income for items such as depreciation, changes to accounts receivable and changes in inventory. Normally, if the company is not growing fast, then a negative operating cash flow is a red flag because it raises the question of where the cash has been used.

When assessing the health of operating cash flow, you need to look at the current reality of the business operation, especially looking at accounts receivable and inventories. Accounts receivable is the money that is owned by customers. If it is increasing faster than sales, the company is having a hard time collecting their cash. The same thing goes with inventories, if the number is increasing faster than sales then the company is having trouble turning their products to cash. Both scenarios may be the reason that leads to decreasing operating cash flow, an indicator of an unhealthy cash flow. If this is the case, then there could be a problem with the company's performance.

4. Is gearing too high?

Gearing is a term used to compare total long-term debt to equity capital and is expressed as a percentage. It is also known as a measure of financial leverage, which explains how a company finances its operations, that is either through outside lenders or through shareholders. In common practice, a company with higher levels of financial leverage (normally Net Gearing > 50%) is considered to be more vulnerable to downturns in the business cycle than those that have a low net gearing because it has to service its debts regardless of how bad sales are. However, financial leverage levels are industry specific. Hence, they are best benchmarked against companies within the same industry.

5. Is Return on Equity (ROE) improving or declining?

Return on Equity (ROE) measures the profitability of a company by revealing how much profit a company generates with the money shareholders have invested. ROE equals Net Income divided by Shareholders' Equity and is expressed as a percentage. For example, an ROE of 15% represents that, for every single dollar of shareholders equity, the company makes $0.15 of net income. When analysing ROE, if there is a rise in earnings with a steady decline in ROE, a red flag should be noted. On the contrary, if ROE is improving, there is a good sign that the company is doing great in making profits.

6. Is shareholders' equity rising or falling?

Is actual dividend pay-out steady, rising or falling?

- Dividends per share rising faster than earnings per share: often indicates slowing growth prospects
- Earnings per share rising faster than dividends: indicates growing opportunities are still good

Companies with annual growth rates of 5-15% can theoretically afford 20-40% dividend pay-outs. Investors should also beware of high retained earnings without clear accompanied investment plans.

To be continued...

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