

The right approach

The analysis of financial statements is very much a hands-on, practical matter and much of the rest of the week is devoted to hands-on, practical examples. However, you will get the best results if you have some clear ideas about the benefits and the best ways to set about the analysis. You should also know about the many traps that lie in wait. Our programme today is:

- The benefits of analysing financial statements
- The best methods to adopt
- Traps to avoid



The benefits of analysing financial statements

You may well think that the benefits are self-evident and, to some extent, they probably are. Nevertheless, it is worth thinking about because one or two advantages may have escaped you. The following are three of the most important:

A big step towards effective management

Effective management should be based on knowledge of the facts and the trends. Furthermore, effective management should be based on a comprehensive understanding of the facts and the trends. Without this, managers may act in a way that is inappropriate or has harmful consequences. Effective analysis of financial statements should help managers to get things right.

Help to ensure that wise investment and commercial decisions are made

Both investment and management involve many choices. Effective analysis should help to make the right decisions.

Help to reduce the losses caused by bad debts

When a company becomes insolvent, it is almost always found that published financial information had given warnings of the impending disaster. In particular, deteriorating performance and liquidity has usually been revealed. The published information needs analysis and interpretation, and the rewards for doing so can be great.

The best methods to adopt

Sometimes the analysis and conclusions will be so obvious that they almost jump out of the page at you. More often they have to be unearthed with diligent and skilful work. You should take care even when the conclusions seem obvious. There are a lot of traps and certain factors should make you doubt the obvious interpretation. Some of these traps are explained later in this chapter. For the best results you should keep the following points in mind.



Look for an explanation

There may be a good reason for an apparently bad figure. For example, a major advertising campaign at the end of a financial period may reduce profits in the short term, despite holding the promise of increasing sales and profits in the next period.

Ask the question 'What am I comparing it with?'

Most of the information is much more meaningful if it is compared with something. So compare it. Useful questions to ask include:

- How does it compare with last year?
- How does it compare with the industry average?
- Is it better or worse than budget?

Be sceptical

Financial statements are prepared according to rules and assumptions. If different rules and assumptions are used,

then different results will be obtained. Published financial statements may legitimately, within certain limits, use different rules and assumptions, which in most cases must be stated. There are only self-imposed restraints relating to data prepared for internal management purposes.

In some cases the correct profit is a matter of opinion and this can be true of many of the assets and liabilities. Cash, though, is almost entirely a matter of fact. It is there or it is not there. You should always approach your examination in a sceptical and enquiring state of mind.

Look for the trends

It is often very useful to examine the trends because they may be much more revealing than a single figure or comparison. Fortunately, published accounts of companies must by law give corresponding figures for the previous period. A deteriorating payment performance, for example, often indicates liquidity problems, although it can also mean that selfish managers are hoarding cash at the expense of suppliers. If a company has gone from paying in 30 days to paying in 90 days, it may be more worrying than if it has consistently taken 90 days to pay.

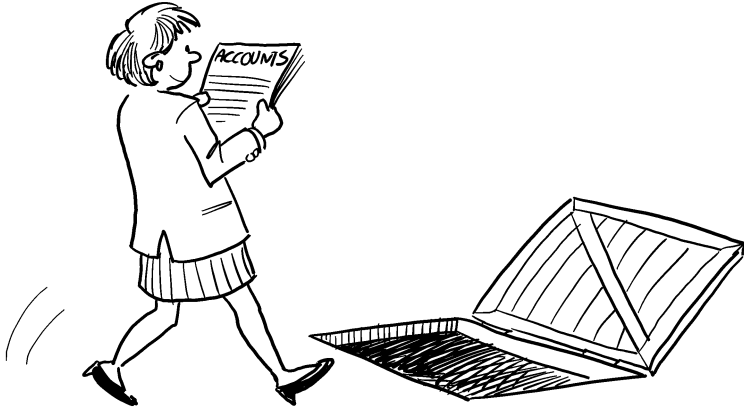
Look at the notes and the accounting policies

You may be familiar with the saying '*the large print giveth and the small print taketh away*'. Professional analysts always spend time studying the notes to published accounts and the accounting policies. You should do the same and you should pay particular attention to any changes in accounting policies. Laws and accounting standards govern certain information that must be disclosed in the notes to published accounts of companies, and also in the directors' report.

Be open-minded

Do not have too many preconceived ideas about what you will find. Be receptive to the unexpected.

Traps to avoid



Even experienced financial analysts can make mistakes and fall into one of the many traps that may be encountered, and it is more likely that someone not financially sophisticated will do so. Below are some of the mistakes to avoid.

Not taking full account of seasonal factors

This is a common mistake. Consider a specialist greetings card shop that commences business on 1 May. Its first two 6-monthly profit and loss accounts are shown below.

	6 months to 31 October	6 months to 30 April
Sales in period	£300,000	£306,000
Net profit before tax	£18,000	£18,600
Profit as a percentage of sales	6.0%	6.1%

This appears to show a steady performance with the second period being very slightly better than the first. However, this is misleading. A specialist greetings card shop would expect, because of Christmas, to make at least 25 per cent of annual sales in the month of December. Valentine's Day, Easter and Mother's Day also fall in the second period. When all of this is taken into account, the results in the second period will be seen as disappointing. Of course, an alternative explanation might be that results in the first period are particularly good.

Not making allowances for trading periods having different lengths
Consider the following:

	10 months to 31 October 2001	14 months to 31 December 2002
Sales in period	£1,000,000	£1,400,000
Net profit before tax	£100,000	£140,000

Although the second period seems better, if you allow for the different lengths the results are identical, with the profit percentage being 10 per cent in each case.

Not realising that the figures have been massaged

Consider a company that usually operates with a bank overdraft. However, the managers do not pay suppliers in the last 3 weeks of the trading period in order to show no bank borrowings in the balance sheet. This is unfair to suppliers but a common practice. The balance sheet will of course show trade creditors being higher than usual.

Forgetting that some things can only be known by insiders

Published financial statements reveal a great deal, but there are some things that can only be known by those with inside information. Consider two companies that manufacture and sell widgets.

	Company A	Company B
Sales	£1,000,000	£1,600,000
Cost of sales	£400,000	£720,000
Gross margin	60%	55%

Company A appears to be more efficient, but the figures could be affected by the different accounting treatment of certain factory costs, such as power and business rates. Company A might treat these costs as general overheads, whereas Company B might allocate them to production costs. Overall net profit will of course be unaffected.

Not always comparing like with like

A recent set of accounts from Marks and Spencer plc discloses the following:

Sales for year (in £m)	8,075.7
Trade debtors at the balance sheet date (in £m)	44.4

You can easily work out that customers take an average of two days to pay for their purchases. The calculation is:

$$\frac{44.4}{8,075.7} \times 365 = 2.0$$

You may think that this is stunningly good, and that Marks and Spencer must employ the world's best credit controllers. This may or may not be true, but it should not be deduced from these figures. The reason for this is that the great

majority of sales are made for cash. Trade debtors should really be compared with just the part of sales that are made on credit.

Now consider the widget manufacturer whose accounts disclose the following:

Sales for year	£900,000
Trade debtors at the balance sheet date	£100,000

This appears to show that customers take an average of 40.6 days to pay. The calculation is:

$$\frac{100,000}{900,000} \times 365 = 40.6$$

This too is probably wrong because sales will almost certainly exclude VAT and trade debtors will probably include it. If trade debtors all include 17.5 per cent VAT, the correct calculation is:

$$\frac{85,106}{900,000} \times 365 = 34.5 \text{ days}$$

Not taking note of a change in accounting policy

Consider a company that 2 years ago purchased a piece of machinery for £1 million and in the first year depreciated it by 20 per cent.

In the second year it changed its policy and depreciated it by only 10 per cent. Clearly declared net profit before tax will be £100,000 higher than if the change had not been made.

Fortunately, notes to the published accounts must disclose significant changes in accounting policies and spell out the consequences.

Failing to take full account of the notes

It is sometimes said that professional analysts spend more time studying the notes to the accounts than they spend studying the actual accounts. This is wise of them because the accounts are often just the starting point. In Britain (as in nearly all other countries) the law and various accounting standards specify a great deal of information that must be disclosed in the notes to published accounts or elsewhere. The following are among the things that must be disclosed:

- Details of the company's position in a group, if this is applicable
- Details of any contingent liabilities at the balance sheet date
- Details of any capital commitments at the balance sheet date
- Details of the depreciation charge
- Total employment costs
- Details of directors' remuneration

Applying percentages to small base figures

This is best illustrated with an example. Suppose that a company has a turnover of £1,000,000 in two successive years. The profit in the first year is £100 and the profit in the second year is £200. It would be true to say that the profit had doubled, but such a claim should be viewed in the context of the very low figures involved.

Summary

We have started the week by looking at different aspects of financial analysis. The following points are especially important:

- The analysis of financial statements is a valuable management tool
- It can help to prevent bad debts
- You should not analyse in a vacuum. It is usually a good idea to compare your results with something
- Remember the saying '*The large print giveth and the small print taketh away*'
- Persevere and be open-minded
- Do not rush in – there may be traps to avoid
- On no account neglect the notes to the accounts
- Always compare like with like
- Remember that there are some things that only insiders can know

Tomorrow we will get to grips with the profit and loss account.