Interpretation of Financial Statements

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Abstract: This paper gives consideration to analyze the financial statement. The main method to analyze financial statement is ratios analysis. Main includes three aspects: profitability ratios, liquidity ratios and long-term financial stability ratios. As is known to all, financial statements are an important part of a company. The main statements include the statement of financial position, the statement profit or loss and other comprehensive income, the cash flow statement, the statement of changes in equity. Through the analysis of financial statements, users can have a general understanding of the operation and management of the company. It is helpful for report users to make judgment and decisions. It is also conducive to the performance evaluation for managers. It reflects the concept of fiduciary responsibility and decision usefulness. Of course, the ratios analysis has some limitations, so we need some other information to help to analyze. This information includes both financial and non-financial information.

1. Users of financial information

When interpreting financial statements it is essential to ascertain who the users of accounts are and what information they need:

•Shareholders and potential investors –primarily connected with receiving a return on their investment, but it must at least provide security and liquidity.

•Suppliers and other lenders-concerned with the security of their debt or loan.

•Management-connected with the trend and level of profits, because this is the main measure of their success.

•Other users include: bank, financial institutions, employees, professional advisors to investors and so on.

2. Ratio analysis

A number of ratios can be calculated to help interpret the financial statements. Main includes three ratios: profitability ratios, liquidity ratios and long-term financial stability ratios.

2.1 Profitability Ratio

2.1.1 Gross profit margin

Gross profit margin is: Gross Profit / Sales Revenue *100%.

This is the margin that the company makes on its sales, and would be expected to remain reasonably constant. Since the ratio is affected by only a small number of variables, a change may be traced to a change in: Selling prices – normally deliberate through sometimes unavoidable; Production cost – materials, labor or production overheads; Inventory – mistakes in counting, valuing or cut – off, inventory shortages.

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Low margins usually suggest poor performance but many be due to expansion costs (launching a new product) or trying to increase market share. Lower margins than usual suggest scope for improvement. Above – average margins are usually a sign of good management although unusually high margins may make the competition keen to join in and enjoy the rich pickings.

2.1.2 ROCE

ROCE = Profit / Capital employed *100%

Note: Profit is measured as: 1.Operating (trading) profit, or

2. The PBIT (profit before interest and tax)

Capital employed is: Equity+ interest – bearing finance.

The ratio shows how efficiently a business is using its resources. If the return is very low, the business may be better off realizing its assets and investing the proceeds in a high interest bank account! (this may sound extreme, but should be considered particularly for a small, unprofitable business with valuable assets such as property.) Furthermore, a low return can easily become a loss if the business suffers a downturn.

Further point: 1, Treatment of associates and investments: where the profit excludes investment income the statement of financial position carrying amounts for associates and investments should be excluded from the capital employed. 2, this gives accurate measure of trading performance. If associations and investment are not excluded, the overall profit figure should include income from investments and associates. 3, large cash balance are not contributing to profits and some analysis therefore deduct them from the capital employed. However, it is usually acceptable not to make this adjustments as ROCE is a performance measure and management have decided to operate with that large balance.

2.2 Liquidity and working capital ratios

2.2.1 Current ratio

The current ratio is measured as: Current assets /Current liabilities

The current ratio measures the sufficiency of current assets to meet the liabilities as they fall due. A high figure may seem as safe but should be regarded with suspicion because it may be due to: 1, High levels of inventory and receivables (check out working capital management ratios); 2, High cash levels that could be put to better use (e g investing a non-current assets).

Traditionally, a current ratio of 2:1 or higher was regarded as appropriate for most businesses to maintain creditworthiness. However, more recently a figure of 1.5:1 is regarded as the norm.

At the same time, company should use this ratio to consider more worth issues, such as the availability of further finance; seasonal nature of the business; long-term liabilities and nature of the inventory.

2.2.2 Inventory turnover period

Inventory turnover period is defined as: Inventory /Costs of goods sold *365 days

An rising number of days indicates that inventory is turning over less quickly which is regarded as not a good sign as it may indicate: 1, demand for the goods is lacking; 2, poor inventory control; 3, an rising in costs (such as storage, obsolescence, insurance, damage)

However, it may not so bad where management are: 1, buying inventory in large quantities for using trade discounts. Or 2, rising inventory level to avoid stock outs.

A manufacturer should take Reliability of suppliers and Demand into consideration.

2.2.3 Receivables collection period

This is normally expressed as: Trade receivables / Credit sales * 365 days

Rising receivables collection period is usually a bad sign suggesting lack of proper credit control that may lead to irrecoverable debts. However, be due to: 1, A deliberate policy to attract more deals; 2, A major new customer being allowed different terms.

Decreasing receivables day is usually a good sign, but it could indicate that the company is suffering a cash shortage.

The result should be compared with the sated credit policy. A period of 30 days or 'at the end of the month following delivery' are common credit terms.

2.2.4 Payable payment period

<u>This is usually expressed as: Trade payables / Credit purchases * 365 days</u>

The ratio is usually compared to previous yeas:

A long credit period may be good when it represents a source of tree finance;

A long credit period may suggest that the company is unable to pay more quickly because they have liquidity problems.

In most sets of financial statements the figure for purchases will not be available so cost of sales is usually used as an approximation in the calculation of the payable payment period.

2.3 Long-term financial stability

The major points to consider when evaluating the long-term financial position are:

▪Gearing

▪Overtrading

2.3.1 Gearing

There are two method used to calculate gearing as follows:

①Debt / Equity ratio:

<u>Loans + Preference share capital / Ordinary share capital + Reserves +</u> <u>Non-controlling interest.</u>

②Percentage of capital employed represented by borrowings:

<u>Loans + Preference share capital / Ordinary share capital +Reserves +</u> <u>Non-controlling interest + Preference share capital.</u>

Gearing ratios indicate:

◆The degree of risk attached to the company

◆The sensitivity of earnings and dividends to changes in profitability and activity level.

In highly gearing business, it indicate a large proportion of fixed-return capital is used. There is a greater risk of insolvency and suggest that the returns to shareholders will grow proportionately more if the profits are growing.

In low-geared business, the company can usually borrow more easily and provide scope to increase borrowings when potentially profitable projects are available.

Not all companies are suitable for a highly-geared structure. A company must have two important characteristics if it is to use gearing successfully.

•Loan stock interest must be paid if or not profit are earned.

•Most issues of loan capital are secured on some or all of the company's assets with erratic profits may have insufficient fund in a bad year with which to pay the interest.

2.3.2 Overtrading

The symptoms of overtrading are:

•Inventory rising, mostly more than proportionately to revenue.

•Receivables rising, more than proportionately to revenue.

•Cash and liquid assets declining at an alarming rate.

•Trade payables rising rapidly.

The methods to overcome overtrading are: 1, Opening source throttling 2, Downsizing

This is a particularly difficult stage for small-to medium-sized companies. They have reached a stage in their life when conventional payables and overdraft facilities are being stretched to the maximum, but they are probably too small to manage a flotation. In many cases, by proper planning, the company can arrange fixed-term loan funding from the bank rather than exclusively on overdraft finance.

3. Limitation of ratio analysis for finance statement

3.1 Historical cost accounts

Ratios analysis help to focus attention systematically on important areas and summarize information in an understandable form.

However, ratios are not predictive because they have used historical information.

- They ignored future actions by management.
- They can be manipulate.

3.2 Change in accounting policies

It is important to be able to assess the effect of accounting policies on the calculation of ratios. Comparison between company which follow different polices becomes a main problems if accounting standards give either choice a judgment to business.

3.3 Inter-firm comparison

It is useful to compare ratios for an individual company with other firms that in the same industry. Though comparing the finance statement of similar businesses can be misleading because:

- The company may use different accounting policies.
- Companies with different reporting date would have different financial results in a highly seasonal industry.
- Companies with major asset acquisition the end of the accounting period would invalidate the comparison with another company even in the same industry.

4. Additional information

Because using ratio analysis for financial statement have some limitations, so we need some other useful additional information to help us analyze the finance statement better. Such as:

- Budgeted figures
- Other management figures
- Industry averages
- Figures for a similar business
- Figures for the business over a period of time.

<u>Non-financial information</u>:

- Market share
- Key employee information
- Sales mix information
- Product range information
- The size of the order book
- The long-term plans of management

5. Conclusion

With modern corporatization, the widespread application of the agency system. The ownership and management of company is separated. So the shareholders need to know how well the company is doing and assess the ability of managers. The analysis of financial statement is an important part of a comprehensive evaluation of a company. Using financial date in financial statements for ratio analysis and combine some non-financial information can help users make decision better. It reflects the concept of fiduciary responsibility and decision usefulness.

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