Analysing companies’ Financial Statements !

Is a company healthy or heading towards Insolvency… spotting early signs…management tools to thwart insolvency.

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Credit: Google images; score.org

A company’s financial statement (popularly know as Balance sheet or annual report) comprises Balance sheet, Income statements and cash flows along with notes to accounts. Balance sheet reports a company’s assets, liabilities and shareholders equity. Income statement covers company income, expenditures and profit and losses. Cash flow summaries the amount of the cash or cash equivalent to/from company resulting the cash position of the company and how well the company manages its cash to pay its debt obligations and to fund its operating expenses. Analysis of the company’s financial statement has become now a requirement and no more excuse as the threat of corporate

insolvency is looming large for poorly managed companies. Analysis of financial statement helps to spot the trend of poorly managed companies much in advance without exposing to the financial loss.

Emergence of Zombies companies have further compounded the problem. Zombies are "walking dead" as a concept meaning the earnings before tax are unable cover its interest expenses. Lack of profitability over an extended period is obviously important reason. The bad news is zombies are on rise. As per Economist[1], the average proportion of zombies among listed companies increased from less than 6% in 2007 to 10.5% in 2015. Such companies are the fence sitters for insolvencies as it is easier for the companies to become insolvent for reallocating the capital from inefficient use to efficient use. This may be one of the business failure which is well understandable but there are the situation where zombies are existing due to other reasons such as transactions related to preferable, undervalue, extortionate or fraudulent. In a well-functioning market economy, the creative-destruction process compels poorly performing firms to improve their efficiency or exit the market. The emergence of Insolvency & bankruptcy Code 2016 and lenders with stretched balance sheet have further exacerbated the options for insolvencies for such companies. The investors (mostly other than promoters) take a big hit on their finances as zombies, post insolvency, typical lead to either liquidation or big haircuts.

Each one of us is involved with direct or indirect investments with various companies thereby it is all the more important to learn to analyse the financial statements of the companies to protect our own investment. Analysis of financial statements doesn't need the requirement for being a financial wizard or financially qualified professionals and can be dealt easily with some important aspects. The financial statement of a company in India are prepared as per section 129 of Company Act 2013 with the accounting standards as notified and reflect true and fair view of the state of affairs of the company. Now to analyse any financial statements, some of the important sections which need to be read for its compliances and red flag issues for deliberations. One of the suggested sequence to read the financial statements could be to start with firstly management (board) report with annual report, secondly - notes to the accounts, statutory auditors report, Balance sheet - Assets, liabilities & equity and cash flows. The typical problem with the data at times is that they reveal less than hide more. What we do not know, at times:

a) how major financial decisions by a company are made (process is prudent or simply one person hunch) for all non-routine decisions
b) what determines project risks and present value - if the projects are decided on a positive net present value (NPV)
c) risks and returns , what risks a firm should take
d) strategy to keep solvency ratios as per the firms defined yardsticks
e) activity and profitability ratios with trend analysis

[1] The Economist Jul 15 2017

Let us deliberate the sequence of various portions of financial statements one by one. Why firstly we should go through the management report because it may give sufficient information company's overall corporate governance such as to how the leadership & board of the company has over the period has performed their responsibilities. This includes business report, CSR report, secretarial audit report, risks report and independent auditors report. Good management reports, also include company's contracts/related party transactions, corporate policies & ESG report. At times, financial statements[2] cover key trends over a period of last 05 years on major issues like Revenue, EBITDA, Net Profit, Free Cash flows, EPS, Return of Equity, Nos of clients and Revenue per employee. These trends are helpful to understand the growth/decline of the company if any. Publicly listed companies also issue the forward guidance which are again very helpful. After the read of this section, one can reach to a good background of a company to go into the next section of the financial numbers.

Before we get into the financial numbers, the notes to the account & statutory auditors report should be read simultaneously so as to further ascertain the red flag issues like qualification, if any, or any other issues which in the eyes of the auditors reveal any inconsistencies in the company's affairs.

Financial statements of the company are prepared as per Indian Accounting Standards (IndAS). Each company has to prepare the financial statements a) on a standalone basis and b) consolidated basis, if a company has subsidiaries, affiliates & associates and their accounts are required to be consolidated with the company.

Balance sheet of the company covers Assets, Liability and Equity. In other words balance sheet is nothing but computation sheet of Application & Sources of the funds of a company and both the figures should match hence called balance sheet. Assets are further listed in two major categories i) Non-current Assets and ii) Current Assets. Non-current assets include property, plant & equipment (PPE), capital work in progress, goodwill, intangible assets, financial assets (investments and loans) and other non-current asset. Current assets include trade receivables, cash and cash equivalent, inventory etc. Likewise Liabilities are also classified into Non-current & current liabilities. Non-current liabilities include debt obligations, lease liabilities and deferred tax liabilities whereas Current liabilities include trade payables, income tax & provisions.

Statement of Profit & Loss (P&L) include revenue (including other income), expenses (cost of operations), employees cost and administrative costs. EBITDA = Revenue - Expenses. EBITDA (earning before interest, tax, depreciation & amortisation). If we remove Depreciation & Amortisation then it becomes EBIT (earning before interest & tax). Further removing finance cost becomes PBT or profit before tax. Profit after Tax (PAT) or net profit is the net profit after tax adjustment. Additionally, P&L statement also include earning per share (EPS) which is calculated based in the Net income divided by the nos of equity share.

[2] Infosys annual report 2019-2020

Cash flow statement is very important section which basically computes the cash coming to and leaving from the company to ascertain how efficiently a company has managed its cash. So the way it works that Cash flows from the operating activities, cash flows from investing activities, cash flows from financing activities are computed to calculate net increase/decrease in the cash for the year. Cash flows from the operating activities include the reconciliation from net profit to net cash by adding a) Profit (after adjusting non cashflow depreciation & Amortisation, impairment loss, finance costs, Dividend (-), change in assets and liabilities like trade receivables & payables (+/-). Cash flows from investing activities include Expenditure in PPE, deposits, loan/investments into subsidiaries, acquisition/sale of assets, acquisition/sale of assets. Cash flows from financing activities include payment of lease liabilities, buyback of shares, payment of dividend etc. At the end the computation of the above heads lead to either increase or decrease in the cash. finally closing balance is arrived after adjusting this increase/decrease with the opening balance of the year. This is very important sheet which basically is summary of the cash a company has got at the end of the year. Decrease in the cash may be due to some bad management decisions or any external environment which has to be evaluated and one should correlate with the management report if the management has identified the reasons for improvement.

Ratio analysis is extremely important tool to evaluate any financial statement. Although, there are plenty of ratios which are available to ascertain the health of the company, however, for the purpose of this article, evaluation of the Profitability ratios, Liquidity ratios, Activities ratios and Solvency ratios are suggested to have a kind of 360º evaluation for its profitability, operations & solvency. "/" - indicates divided by.

1) Profitability ratios indicate how well the company is making profit relative to its revenue. Important Ratios:

- Gross Profit Ratio = EBITDA/Sales
- Net Profit Ratio = PAT/Sales
- Return on Capital Employed (ROCE) = EBIT/((Fixed Assets)+(Current assets - Current Liabilities))
- Return of Net worth (RNW)= EBIT/NW, Net worth = Assets - Liability.
- EPS = PAT/numbers of equity shares
- PE ratio = Market share price/EPS

2) Liquidity ratios - are an important class of financial metrics used to determine a debtor's ability to pay off current debt obligations without raising external capital. It measures the short term outlook of debt repayment of the company. Important ratios:

- Current ratios= Current Assets/Current Liability. It measures a company's ability to pay off its current liabilities (payable within one year) with its current assets such as cash, accounts receivable and inventories. The higher the ratio, the better the company's liquidity position.
- Quick ratios (acid test ratio) = (Cash+ Accounts receivables)/Current Liabilities. It measures a company's ability to meet its short-term obligations with its most liquid assets and therefore excludes inventories from its current assets.

3) Activity Ratios - indicate how efficiently a company is leveraging the assets on its balance sheet, to generate revenues and cash. These are also called operational efficiency ratios.

- Assets Turnover ratio = Sales/total assets - to decipher how proficiently a business uses its assets. Smaller ratios may indicate that a company is struggling to move its products.
- Accounts Receivable ratio = Net credit sales/Accounts Receivables. A low ratio suggests a deficiency in the collection process.
- Inventory turnover ratio = Cost of goods sold/Av inventory. Higher ratios suggest that a company can move its inventory with relative ease.

4) Solvency Ratios - A solvency ratio indicates whether a company's cash flow is sufficient to meet its long-term liabilities and thus is a measure of its financial health or insolvency leading to default. These are very important ratios, keeping in view the recent Insolvency & Bankruptcy Code 2016 and to asses the financial health for looming insolvency. Important Ratios are:

- Debt/Equity ratio = Total Liabilities/ Total shareholders equity. The higher the ratio, the more debt a company has on its books, meaning the likelihood of default is higher.
- Debt service cover ratios (DSCR)= EBIT/(Principal+Interest). Higher the ratio better the company is able to meet its debt obligations. Lenders typically insist of > 2.5.
- Interest Coverage Ratio= EBIT/Interest Expense. The higher the ratio, the better, and when the ratio reaches 2 or below, then it indicates that a company will have difficulty meeting the interest on its debt.

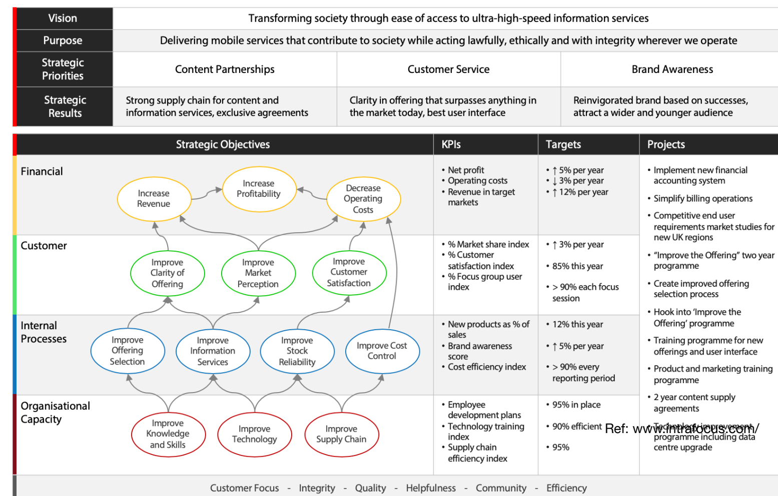
The best way to use various ratios is have relativity with its industry peers, with its own past performance or trend analysis, with its business sector and the scale of operations. Robust trend of ratios over a period indicates a particular direction for the health of a company. Additionally there are accepted range of ratios for every business segments which are very helpful to refer and to evaluate the performance of the company.

Corporate Insolvency and bankruptcy have gain much more importance now-a-days for the various stakeholders and the companies are all out to implement various management strategic tools to thwart not only to alleviate the insolvency threat but also run the business with efficiency & profitability. One of such tool which is being propagated is Balanced Score Card method. The tools was initially published by Robert Kaplan & David Norton in 1992 have gained a wide spread success. The tool basically measures Key Performance Indicators (KPIs) for a company in four areas ie Financial, Customer, Internal Processes and Organisation capacity to balance across all organisational functions. The methodology suggests to measures the specified key indicators which are continuously mapped to plot over the period with the targets.

The Balanced Scorecard[3] Links Performance Measures:

- How do customers see us? (customer perspective)
- What must we excel at? (internal perspective)
- Can we continue to improve and create value? (innovation and learning perspective)
- How do we look to shareholders? (financial perspective)

Typically 2 to 3 most important indicators are identified in each organisation functional areas such as Financial, Customers, Business process & Organisational capacity. Financial objectives are usually the easiest to define and measure. For example: Improve profitability, Improve Revenue and Reduce operating cost. The targets are defined and KPIs are continuously mapped against the targets. Another area would be to measure customers perception and satisfaction on the company. The attributes can be measured against market share, customers satisfaction. Business process is 3rd area to evaluate which necessarily focussed on the company's business processes to improve the products or launch new products, services, cost control etc. KPIs for this could be like New product revenue, cost efficiency index, Brand awareness etc. Lastly the most important area of the company is the organisational capacity having requisite knowledge, technology and supply chain with the measurements of KPIs like employee development plan, technology training index and supply chain efficiency index. This management tool is being advised in practice to its clients by the author and results are amazing.



Ref: www.intrafocus.com/

Disruptive innovation is a familiar term wherein the established companies were shown insolvencies due to being replaced by new product innovations. The existing players did not recognise the writing on the wall and vanished. While, Balanced score Card strategic tool is very helpful for the operating companies but it can not suitably handle such business failure due to external reasons. One of the good management tool which should be periodically used to evaluate the company's competitive positions against the rivals is Porter's Five Forces by Michael Porter.

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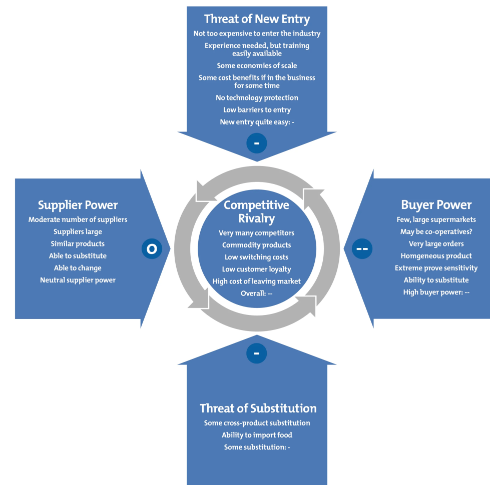
[3] HBR 1992 The Balanced Scorecard—Measures that Drive Performance by Robert S. Kaplan and David P. Norton

This management tool identifies the five forces:



1. Competition in the industry
2. Potential of new entrants into the industry
3. Power of suppliers
4. Power of customers
5. Threat of substitute products

The number and power of a company's competitive rivals, potential new market entrants, suppliers, customers, and substitute products influence a company's profitability. Five Forces analysis can be used to guide business strategy to increase competitive advantage including business strategy to exist or timely exit. Author believes that this tools used in conjunction with Balanced score Card methodology may yield the best outcome to undertake the right decisions for not only thwart insolvency but also running companies with operations efficiency with favourable competitive environment.

To summarise, it is now imperative for each one of us to start analysing the financial statements. We have seen the recent insolvency cases of large companies wherein the investors & creditors have lost their hard earned money. The analysis will arm to take the proactive measures to protect the investment.

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