

Analysing financial statements.

Arthur Weiss, Managing Partner, AWARE a.weiss@marketing-intelligence.co.uk

Many CI analysts have difficulties understanding financial statements even though such statements can be crucial when evaluating a competitor. Passing the accounts to a company accountant is one option but the result may be a standard financial analysis, missing crucial clues to a competitor's business. Ideally, competitor analysts should do the work themselves.

I'd like to suggest three rules for analysing company accounts:

- 1) Understand what each of the figures on the financial statement mean
- 2) Use the notes to the accounts to explain the main figures and give additional detail
- 3) Calculate standard and non-standard ratios and compare across time periods to highlight relationships between figures and any discrepancies.

Rule 1

When looking at financial statements you need to understand what the figures actually mean. For example, "profit" can have several meanings – selecting the right profit value is important. For the stock market, profit after tax is the key value, as this is used to calculate price-earnings ratios and gives the sum available for dividend payouts.

However when looking at company operations, or comparing companies in different countries or markets, operating profit (i.e. profit before tax and interest charges) is a better indicator. Even better is to remove depreciation and amortization from the figure (termed EBITDA). This figure gives a measure of a company's operating efficiency – how it turns sales into profit.

Depreciation is essentially an accounting measure that spreads the value of capital equipment over the equipment's lifetime. Thus, this value as well as tax and interest charges are less important when looking at company performance. Further, interest and tax rates vary across borders, so including such figures when comparing companies in different countries may result in wrong conclusions on the relative merits of the companies.

This does not mean that these figures should be ignored. They, in fact, give clues to asset utilisation. Depreciation, for example, is a key measure when looking at how frequently a company renews equipment. Interest charges give clues as to the company's borrowings, as well as its relationships with investors.

Rule 2

An apparent complication when looking at company accounts is that not all values are declared on the main balance sheet or profit & loss account. This leads to rule 2 – look at the notes to the accounts. These often contain a wealth of information not in the basic accounts. It is here that you will find details of how depreciation is calculated, accounting policies, salary and employee breakdowns, and sometimes sales and profit detail by business unit or geography.

Rule 3

The final rule when looking at accounts is to dig deeper by calculating financial ratios and comparisons across time. It is crucial when comparing time periods to ensure that these are the same – sometimes, the accounting period may change and so an adjustment will be needed to compare like with like. Look also for large changes in any figures. Has the accounting method changed (and if so why)? Does this indicate a change in the business itself – perhaps a new product or acquisition impacting the values?

Common ratio formulae

Financial textbooks give common ratio formulae. It is important to understand what the formulae actually mean – what is being measured. If these are not understood, then incorrect conclusions may be drawn. For instance, one ratio used in understanding a company's credit policies is the debt collection period calculated by dividing debtors by turnover and multiplying by 365 to give the number of days the company takes to collect its debts. This is the textbook definition.

However, take the following example (based on a real case):

Turnover: \$100 million.

Debtors (as declared in the balance sheet's current assets section): \$50m.

This gives a debt collection period of 182.5 days, suggesting appalling credit control. Looking at the notes to the accounts showed that group undertakings and joint-venture companies owed most debts, while trade debtors amounted to \$10m. Using this value gives an acceptable debt collection period value of 36 days. (The remaining \$40m consisted of loans given to affiliated companies with special payback arrangements.)

Non-standard ratios

As well as the standard book ratios, also consider the relationships between figures and what they indicate. This may involve the creation of non-standard ratios. For example, the stock value in one company may break down as 30% raw materials, 40% work-in-progress and 30% finished products. Yet in the following year the breakdown could be 40% raw materials, 53% work in progress and only 7% finished products.

One explanation for such a change would be that the company had moved to a just-in-time production cycle, removing the need to hold finished products. Such observations are less likely to be spotted by the traditional financial analyst – but should be noted by a competent competitor analyst.

Article copyright 2002 SCIP. [SCIP.online](#), volume 1 number 2, February 3. 2002.

Published by [Society Competitive Intelligence Professionals](#).
Copyright © 2007 Society of Competitive Intelligence Professionals. All rights reserved.

Powered by [IMN](#)