

INSIGHTS INTO FINANCIAL STATEMENTS ANALYSIS

MAKING SENSE OF YOUR COMPANY'S TRUE PERFORMANCE

Financial statement analysis presents several challenges for investors, financial analysts and investment managers. This is due to the fact that information on a company's performance is presented in the form of financial statements and myriad notes. All this information needs to be read together – the need to properly understand the inter-relationship of the financial statements and the notes cannot be over-emphasised.

Another consideration is that many undisclosed assumptions underpin the items presented in the historical income statement, cash flow statement and balance sheet. Indeed, such historical information reflects merely a snapshot in time. Furthermore, the financial statements do not provide qualitative information on the underlying value of intangible assets such as brand and operational leverage, among others. Consequently, determining changes in a company's fundamental performance over time becomes difficult. Further, the predictive value of traditional ratio analysis is not certain.

Accounting standards have been introduced to promote comparability and ensure that standard reporting is achieved. Nevertheless accounting policy choices may distort company comparisons. Additionally, due to the pressure to report increasing profits some organisations apply creative accounting in an attempt to show better financial performance. For example, International Accounting Standard (IAS) 16 on property, plant and equipment (PPE) allows PPE to be carried either at valuation or depreciated historical cost. A business could opt not to revalue its assets because, in the event that a significant revaluation surplus occurred, this would in turn increase the depreciation charge,

thus impacting negatively on profitability.

A proper review of the financial statements requires focus on a company's performance. This is achieved through an analysis of the operating metrics. For example, the analyst should make appropriate adjustments to the operating cash flow and earnings for exceptional circumstances or non-recurring items. This process will hopefully result in a proper assessment of the company's performance and remove any ambiguity in the reported numbers.

For the analyst to give a responsive analysis he/she must also be aware of the causes of stock underperformance, which will include, among other factors, aggressive accounting (now talked about widely since the Enron and WorldCom scandals), performance deterioration (which could be present even where a company has an attractive income statement), and changes in the industry or competitive situation. The latter may occur when an entire industry starts to deteriorate, or a company loses its competitive advantage or engages in a bad acquisition.

While analysing financial information there are mainly four areas that an investor must consider, namely: earnings quality, operating efficiency, cash flow quality, and balance sheet quality.

For **earnings quality** the major considerations include the accrual rate, one-time items, depreciation rate, pension plan gains, bad debt allowances and expenses, inventory adjustments, amortisation of intangibles, industry averages, interest cover, etc.

An evaluation of a company's **operating efficiency** requires an investor to focus on the following, amongst others: turnover rate of the different types of company assets such as debtor and creditor days, cash conversion

cycle; gross and net margins; EBIT (earnings before interest and taxes); cash flow from operating activities, SG&A (selling, general, and administrative expenses); and return on capital. The cash conversion cycle is a measure that reflects how long it takes to convert a company's inventory into cash. Essentially, it is a shortcut to determining how efficiently the company generates cash.

Cash flow quality is a key frontier in financial analysis for detecting problems within a company. For cash flow quality one should consider several areas, including cash flow from discontinued operations. Although discontinued operations are generally excluded from earnings, they can be included in operating cash flow and may require an adjustment. Non-operating items (defined to include anything that is not generated by the underlying business) must also be examined.

For **balance sheet quality**, consider items such as the capital structure, liquidity and accruals. Accruals could include unpaid expenses, deferred charges, taxes (including deferred taxes) and contingent liabilities.

In spite of what appears to be overwhelming work, the detection of hidden problems is possible. Successful analysis requires systematic and consistent effort. Strangely enough, it is one of the most difficult things for investors and their advisors to implement. Nevertheless, the net result is that this kind of analysis will improve the probabilities of investing wisely.

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