Reading and Interpreting Financial Statements

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01 Introduction

Introduction

Financial statements represent the clearest picture of the historical and *as at* position of the business.

Through this snapshot, we can:

1. Generate relevant insights into the present state of the company
2. Develop forecasts regarding the future prospects of the business

Throughout this presentation, we will be taking a look at the financial statements, the stories they tell and how relationships between the statements and the data allow us a peek into the future of the company.

02

Understanding Financial Statements: Balance Sheet

Balance Sheet

01 What is the balance sheet?

Snapshot of the company's assets, liabilities and equity components at a specific point in time

02 Preliminary Insights

- Is the company sufficiently liquid in the short-term?
- How does its debt compare to its equity?
- Has it been historically profitable?
- Is the asset base growing?
- How is the company funded?

03 Example

Company ABC:

- Relatively stable
- Small retail company
- Generally profitable

04 Further Insights – Ratios and Analysis

Liquidity Ratios
Solvency Ratios
Movement Analysis

Example 1 – Balance Sheet

Company ABC
Balance Sheet

		Year 2024	Year 2023	Change
	ASSETS			
	Cash	7,315	6,419	896
	Accounts Receivable	1,817	1,972	(155)
	Inventories	8,456	8,908	(452)
	Total Current Assets	17,588	17,299	
	Property Plant & Equipment	15,436	16,141	(705)
4	Total Assets	**33,024**	**33,440**	
	LIABILITIES			
	Accounts Payable	14,412	15,257	(845)
1	Revolving Credit Line	–	1,283	(1,283)
	Total Current Liabilities	14,412	16,540	
	Long-Term Debt	6,309	6,283	26
	Total Liabilities	20,721	22,823	
	EQUITY			
2	Common Equity	4,845	4,099	746
3	Retained Earnings	7,458	6,518	940
	Total Shareholders' Equity	12,303	10,617	
	Total Liabilities & Equity	**33,024**	**33,440**	

Preliminary Insights and Movement Analysis

1. The company repaid or cancelled its revolving line of credit without acquiring significant amounts of additional debt (Compare to statement of cash flows and the notes)

2. The company potentially issued shares to its owners during the year (Compare to statement of changes in equity (SOCE) and statement of cash flows if acquired for cash and the notes)

3. The company appears to be historically profitable based on the accumulation of its retained earnings and has made a profit in the current year (Compare to the SOCE and income statement)

4. The company has had a slight decline in its total assets over the prior year, a further decline in the total assets which results in a net minimal movement on the equity

Example 1 - Ratio Analysis

We are also able to look at the relationships between the data and determine appropriate ratios for the tests of liquidity, solvency and efficiency. These ratios are not to be considered in isolation and must be thought of in terms of the industry, internal corporate strategy and other factors which make understanding the business vital.

Our liquidity ratios indicate whether a particular company will be able to pay off its short-term debts with its existing liquid/current assets. This analysis excludes the business' ability to raise capital in the short-term.

Generally, the higher this ratio, the less likely that an entity will experience a liquidity shortfall in the short term. However, this is not always the case

Example 1 – Liquidity Ratios

Liquidity Ratios

				2024	2023		2024	2023
Current	=	Current Assets / Current Liabilities	=	17,588 / 14,412	17,299 / 16,540	=	1.22x	1.05x
Quick	=	Current Assets - Inventory / Current Liabilities	=	9,132 / 14,412	8,391 / 16,540	=	0.63x	0.51x

Current ratio of approximately 1.22 suggests that Company ABC has $1.22 in current assets for every dollar of current liabilities, indicating a reasonable level of liquidity.

The **quick ratio** is a more stringent measure of liquidity. It excludes inventories from current assets before dividing by current liabilities as the inclusion of inventories involves certain assumptions.

We see that Company ABC has generated a quick ratio of less than 1 for both years. This may raise additional questions if further analysis indicates that inventory is slow-moving and the entity may experience a shortfall

Example 1 – Solvency Ratios

Solvency Ratios

All figures in USD thousands unless stated

				2024	2023		2024	2023
Total Asset to Equity	=	Total Assets / Equity	=	33,024 / 12,303	33,440 / 10,617	=	2.68x	3.15x
Debt to Equity	=	Total Liabilities / Equity	=	20,721 / 12,303	22,823 / 10,617	=	1.68x	2.15x

While our liquidity ratios take a short-term view, our solvency ratios consider the ability of the company to be able to pay off its long-term debts and meet longer term obligations. This class of ratios provides insight into the long-term viability of the company.

Common ratios considered are debt to equity, total assets to equity and the interest coverage ratio.

Example 1 – Solvency Ratios (cont’d)

The **Debt to Equity** Ratio is calculated by dividing a company's total liabilities by its shareholders' equity. This ratio indicates the proportion of debt and equity used to finance the company's assets

Based on the example above, the company has a debt to equity ratio of 1.68 which indicates a moderate level of leverage, suggesting that the company is using debt to finance its operations but not excessively

The **Interest Coverage Ratio** measures a company's ability to pay interest on its outstanding debt. It is calculated by dividing the company's earnings before interest and taxes (EBIT) by its interest expenses. This ratio indicates how easily a company can cover its interest obligations with its operating income. A higher ratio suggests that the company is more capable of meeting its interest payments, which is a sign of financial stability.

Red Flags in Balance Sheets and related notes

Common red flags in the balance sheet include:

1. High Debt Levels Relative to Equity (Debt-to-Equity Ratio)
2. Declining or Negative Cash Flow
3. Consistently low or declining current ratio
4. Long Outstanding Accounts Receivable
5. Increasing accumulated deficit
6. Significant related party funding

Red Flags in Balance Sheets - Liquidity

COMPANY XYZ
Statement of Financial Position
______________, 2024
(Expressed in Jamaican dollars)

	2024	2023
CURRENT ASSETS		
Cash and cash equivalents	397,227	271,706
Short-term investment	-	300,633
Accounts receivable and prepayments	1,944,157	1,479,682
Inventories	2,499,921	2,217,836
Taxation recoverable	28,888	27,316
Due from other related party	-	10,434
	4,870,193	4,307,607
CURRENT LIABILITIES		
Accounts payable	4,749,229	5,256,049
Current maturities of long-term loans	1,609	3,909
Due to immediate holding company	2,725,526	5,356,597
Debenture	911	911
	7,477,275	10,617,466
NET CURRENT LIABILITIES	(2,607,082)	(6,309,859)
Current Ratio	**0.65**	**0.41**

Insights and Movement Analysis

The financial results of Company XYZ indicate net negative working capital for the periods ended in 2024 and 2023. In both years, the company has had current and quick ratios below 1 which suggests that the company may have difficulty covering its short-term liabilities with its short-term assets.

One may consider:

1. How do these ratios compare to the industry average?
2. What is the quality of the current assets listed on the balance sheet such as the collectability of the receivables and salability of inventory?
3. Does the company have plans in place to arrest the working capital deficit?
4. Are there any concerns arising in relation to going concern?

Red Flags in Balance Sheets - Solvency

Company XYZ	2024	2023
Equity and Liabilities		
EQUITY		
Capital and reserves		
Share capital	5,426.00	5,426.00
Additional capital	152,579,701.00	152,579,701.00
Accumulated surplus	78,542,617.00	44,706,337.00
	231,127,744.00	**197,291,464.00**
NON-CURRENT LIABILITIES		
Provision	23,333,480.00	32,470,480.00
Long-term loans	768,989,121.00	152,143,561.00
	792,322,601.00	**184,614,041.00**
CURRENT LIABILITIES		
Due to related parties	63,043,509.00	576,768,667.00
Accounts payable	118,993,679.00	4,275,555.00
	182,037,188.00	581,044,222.00
TOTAL EQUITY AND LIABILITIES	**1,205,487,533.00**	**1,162,088,444.00**
Total Liabilities	974,359,789.00	765,658,263.00
Total Equity	231,127,744.00	197,291,464.00
Debt to Equity Ratio	4.22	3.88

$$\text{Debt to Equity} = \frac{\text{Total Liabilities}}{\text{Equity}}$$

Insights

The financial results extract of Company XYZ indicate a high debt to equity ratio for the periods ended in 2024 and 2023.

One may consider:

1. Does the entity generate sufficient cash to meet these debt obligations?
2. Are there any covenants attached to this debt which need to be considered?
3. If there are covenants which have failed, does this impact going concern?
4. What is the resulting interest coverage ratio arising from these debts?

03
Income Statement

Income Statement

01 What is the income statement?

- Key focus on the financial performance of the Company during a particular period
- Summary of the company's revenues and expenses including tax, interest, depreciation, etc.

02 Preliminary Insights

- Has there been a reduction or growth in the revenue?
- How well does the company manage its expenses?
- How well does the entity maintain its gross profit and profit margins?

03 Example

Company ABC:

- Relatively stable
- Small retail company
- Generally profitable

04 Further Insights – Ratios and Analysis

- Profitability Ratios
- Movement Analysis

Example 2 – Income Statement

Income Statement	Year 2024	Year 2023	Change
1 Revenue	112,640	116,199	(3,559)
COGS	(97,429)	(99,938)	2,509
2 **Gross Profit**	**15,211**	**16,261**	(1,050)
SG&A	(10,899)	(11,445)	546
Other	(63)	(65)	2
EBITDA	**4,249**	**4,751**	**(502)**
Depreciation [1]	(1,029)	(1,127)	98
EBIT	**3,220**	**3,624**	**(404)**
Interest Expense	(113)	(124)	11
Interest Income	90	104	(14)
EBT	**3,197**	**3,604**	
Provision for Taxes	(1,139)	(1,227)	88
Net Income	**2,058**	**2,377**	(319)

Preliminary Insights and Movement Analysis

1. The income statement analysis reveals that Company ABC experienced a decline in revenue and gross profit from 2023 to 2024.

2. The gross profit margin remained relatively stable, suggesting that the company managed to maintain its cost structure despite the revenue drop.

Example 1 – Profitability Ratios

				2024	2023		2024	2023
Gross Margin	=	Gross Profit	=	15,211	16,261	=	13.50%	13.99%
		Revenue		112,640	116,199			
Net Profit Margin	=	Net Income	=	2,058	2,377	=	1.83%	2.05%
		Revenue		112,640	116,199			

Gross Profit Margin: Indicates the efficiency of production and pricing strategies – For certain industries, there is an expectation that the gross profit margin will remain consistent year on year. Significant deviations from the gross profit margins may indicate inefficiencies in production, operations, pricing

Net Profit Margin: Reflects the overall profitability of the company.

Example 1 – Profitability Ratios (cont'd)

				2024	2023		2024	2023
Return on Equity	=	Net Income	=	2,058	2,377	=	16.73%	22.39%
		Equity		12,303	10,617			
Return on Assets	=	Net Income	=	2,058	2,377	=	6.23%	7.11%
		Total Assets		33,024	33,440			

We can also look at other profitability ratios which allow us to focus on the relationships between the statements. These "return" ratios show how effectively the company is utilizing its assets.

Red Flags in Income Statements and related notes

Common red flags in the income statement include:

1. Declining gross and net profit margins
2. Eroding earnings quality indicated by a significant proportion of non-operating income, including one time gains, when compared to operating income on a continuous basis
3. Significant provisions made for receivables for revenue earned
4. Significant increase in operating expenses (SG&A) without a corresponding increase in revenue.
5. Significant fluctuations in revenue from one period
6. Significant deviations in industry benchmarking
7. Lack of transparency in revenue streams and revenue recognition

Red Flags in Income Statements

Company XYZ	2024	2023
Interest income from investments	804,505	873,775
Interest expense	(868,391)	(866,411)
Net interest expense	(63,886)	7,364
Gains from disposal of interest in associate	725,820	181,427
Operating expenses		
Impairment losses on financial assets	(268,242)	(150,000)
Other operating costs	(352,539)	(165,652)
Profit before income tax	41,153	(126,861)
Income tax credit	25,000	19,500
Profit for the year	66,153	(107,361)

Insights and Movement Analysis

The financial results of Company XYZ indicate:

- Eroding earnings quality indicated by a significant proportion of non-operating income, including one time gains, when compared to operating income on a continuous basis – the company's operating profit for the current year was primarily driven by the one-time gains from the disposal of the associate. In the prior year, the company also made a loss.
- The net interest expense arising from the company's investments and borrowings are an indication that the Company is not appropriately managing its interest rate risks
- In addition, there was a significant increase in the company's expenses in relation to the prior year which are not tied to an increase in revenues for the year

04
Statement of Cash Flows

Statement of Cash Flows

01 What is the statement of cash flows?

- Summary of the cash inflows and outflows for a business over a specific period.
- Divided into three main sections: operating activities, investing activities, and financing activities.

02 Preliminary Insights

- What are the major sources of cash?
- How does the net cash provided by operating activities compare to net income?
- What are the primary uses of cash in investing activities?

03 Example

Company ABC:

- Relatively stable
- Small retail company
- Generally profitable

04 Further Insights – Ratios and Analysis

Example 3 – Statement of Cash Flows

Statement of Cash Flows	Year 2024
Profit	2,058
Adjustments for:	
Depreciation	1,029
Interest Expense	113
Interest Income	(90)
Provision for Taxes	1,139
	4,249
Movements in Operating Assets and Liabilities	
Accounts Receivable	155
Inventories	452
Accounts Payable	(845)
Revolving Credit Line	(1,283)
Interest Received	90
Interest Paid	(113)
Tax paid	(1,139)
Cash from operating activities	1,566
Investing Activities	
Additions to PPE, being total cash used in investing activitie	(324)
Financing Activities	
Repayment of Long-Term Loan	(74)
Proceeds from long-term loan	100
Dividends Paid	(1,118)
Issue of shares	746
Cash generated from financing activities	(346)
Movement in cash	896
Opening cash balance	6,419
Closing cash balance	7,315

From the company's cash flow statement, we are able to identify the following:

1. The company has positive cash flow from its operating activities as well as positive overall cash flow
2. The company has added to its PPE balance and this represents its sole spending on investing activities
3. The company relies on both debt and equity financing and issued shares for cash during the year
4. The company has issued a dividend to its shareholders in the current year
5. There is no significant deviation between the cash flows from the operating activities and the net income of the company

Red Flags in Statement of Cash Flows

Common red flags in the statement of cash flows include:

1. Negative or significantly declining cash flows from operating activities
2. Significant deviation between the cash flows from the operating activities and the net income of the company
3. Heavy reliance on cash inflows from financing activities as the company acquires more debt without indication of expansion, etc.
4. Continuous significant write-offs of property, plant and equipment

Red Flags in Cash Flows

Company XYZ
Statements of Cash Flows
Year ended December 31, 2024

	2024 $'000	2023 $'000
CASH FLOWS FROM OPERATING ACTIVITIES:		
Profit for the year	398,194	116,225
Adjustments for:		
Depreciation	-	-
Amortisation of intangible assets	6,286	6,286
Share of profits in associate	(193,370)	(164,411)
Impairment losses on financial assets	268,242	208,248
Change in employee benefit obligation	-	-
Amortisation of transaction costs	68,886	77,961
Unrealised exchange gains on foreign currency balances	(1,511)	(5,496)
Gains from investment activities`	(725,820)	(266,990)
Interest income	(795,741)	(864,847)
Dividend income	(8,764)	(8,928)
Interest expense	868,391	866,411
Interest expense on lease liabilities		
Income tax credit	(127,406)	(65,224)
	(242,613)	(100,765)
Changes in operating assets and liabilities	195,733	(57,499)
Interest received	753,753	785,510
Interest paid	(873,921)	(885,785)
Income tax paid	(20,139)	(72,856)
Net cash provided by/(used in) operating activities	55,426	(230,630)

Insights and Movement Analysis

In the review of the statement of cash flows, we can identify

1. Negative cash flows in 2023 or significantly declining cash flows from operating activities
2. Significant deviation between the cash flows from the operating activities and the net income of the company in both 2023 and 2024

In response to these, we may consider:

1. Is the entity generating enough cash to support its operations?
2. Is there significant reliance on external financing including from related parties to finance the operations?
3. Are the operations of the entity viable in the long-term and what is the impact on going concern?

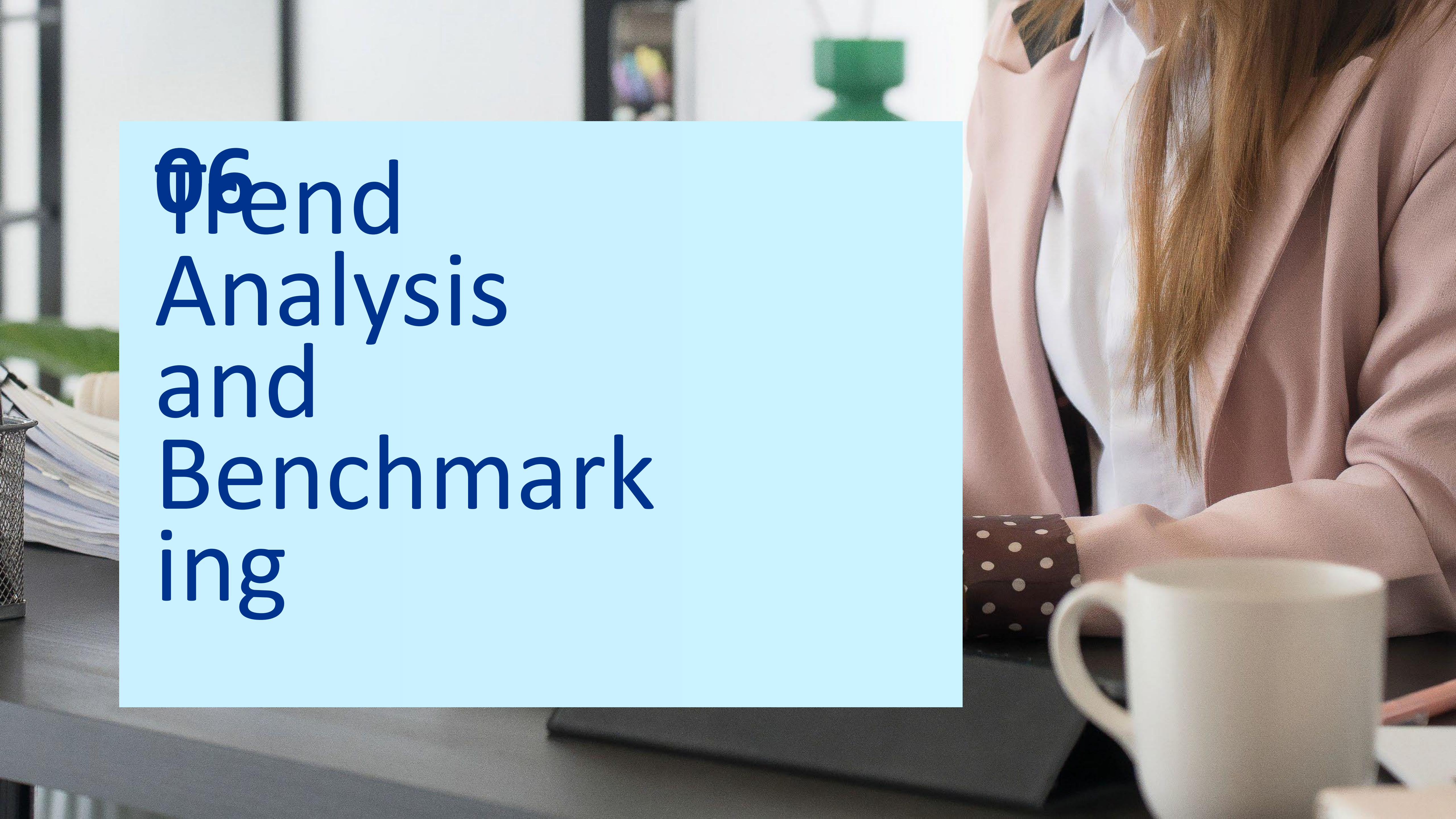
05 Notes to the Financial Statements

Notes to the Financial Statements

The notes form an integral part to the financial statements. They allow us to boost our understanding of the information presented as a summary in the main statements. They may provide further details on transactions during the year, non-cash transactions, etc. which may not be described in sufficient detail in the main statements. The notes to the financial statements also provide information regarding the impact of regulations on the financial statements. For example, regulations may indicate that particular reserves, etc. need to be established.

06

Trend Analysis and Benchmarking



Trend Analysis and Benchmarking

The current year numbers of a company should not be considered in isolation and appropriate steps should be taken to analyse the balances in comparison to other metrics including historical performance of the same entity or comparison of ratios against the industry participants