Analysing Company Statements

How to determine and analyze
the company's financial position

Today the greatest single source of wealth is between your ears.
- Brian Tracy

Nothing can substitute knowledge. if you have the inclination, then we are providing here the links to such resources which will help you take a studied and wise investment decision.

Preface
To understand and value a company, look at its financial position. If you borrow money from a bank, you have to list the value of all your significant assets, as well as all your significant liabilities. Your bank uses this information to assess the strength of your financial position; it looks at the quality of the assets, such as your car and your house, and places a conservative valuation upon them. The bank also ensures that all liabilities, such as mortgage and credit card debt, are properly disclosed and fully valued. The total value of all assets less the total value of all liabilities gives your net worth, or equity.

Evaluating the financial position of a listed company is quite similar, except investors need to take another step and consider financial position in relation to market value.

Starting with the Balance Sheet
Like your own financial position, a company's financial position is defined by its assets and liabilities. (But a company's financial position also includes shareholder equity.) All this information is presented to shareholders in the balance sheet.

Let's look at the 2003 financial statements of publicly-listed retailer, The Gap, to provide a real world example of evaluating financial position. The company's annual report can be downloaded from The Gap's website. The standard format for the balance sheet is assets, followed by liabilities, then shareholder equity.

Current Assets and Liabilities

Assets and liabilities are broken into current and non-current items. Current assets or liabilities are those with an expected life of less than 12 months. For example, the inventories that The Gap reported as of Jan 31, 2004, are expected to be sold within the following year, whereupon the level of inventory will fall and the amount of cash will rise.

Like most other retailers, The Gap's inventory represents a big proportion of its current assets, and so should be carefully examined. Since inventory requires a real investment of precious capital, companies will try to minimize the value of inventory for a given level of sales, or maximize the level of sales for a given level of inventory. The Gap appears to have managed its inventory well, as it saw a 20% fall in inventory value together with a 23% jump in sales over the prior year. This reduction makes a positive contribution to the company's operating cash flows.

Current liabilities are the obligations the company has to pay within the coming year, and includes existing (or accrued) obligations to suppliers, employees, the tax office and providers of short-term finance. Companies try to manage cash flow to ensure that funds are available to meet these short-term liabilities as they come due.

The Current Ratio

The current ratio - which is total current assets divided by total current liabilities - is commonly used by analysts to assess the ability of a company to meet its short-term obligations. An acceptable current ratio varies across industries, but should not be so low that it suggests impending insolvency, or so high that it indicates an unnecessary build-up in cash, receivables or inventory. Like any form of ratio analysis, the evaluation of a company's current ratio should take place in relation to the past: for The Gap, the current ratio is 2.68 - up from 2.11 the previous year.

Non-Current Assets and Liabilities

Non-current assets or liabilities are those with lives expected to extend beyond the next year. For The Gap, the biggest non-current asset is the property, plant and equipment the company needs to run its business. The $3.3 billion shown in its balance sheet is the written-down or depreciated value of the property, plant and equipment.

The Gap's biggest long-term liabilities are $1.178 billion in long-term debt and $1.38 billion in convertible notes. The footnotes at the back of the annual report reveal that most of this amount relates to obligations under property, plant and equipment leasing contracts, but importantly the note also shows that the company has access to around $732 million in borrowings.

Financial Position: Book Value

If we subtract $5.56 billion in total liabilities from $10.34 billion in total assets, we are left with shareholder equity of $4.78 billion. Essentially, this is the book value, or accounting value, of the shareholders' stake in the company. It is principally made up of the capital contributed by shareholders over time and profits earned and retained by the company, including that portion of the 2003 profit not paid to shareholders as a dividend.

While the book value of The Gap was just $4.78 billion at Jan 31, 2004, the market value of the company (900 million shares x the share price of $22.53) was around 4.2 times that, or $20.3 billion.

Market-to-Book Multiple

By comparing the company's market value to its book value, investors can in part determine whether a stock is under or over-priced. The market-to-book multiple, while it does have shortcomings, remains a key tool for value investors. Extensive academic evidence shows that companies with low market-to-book stocks perform better than those with high multiples. This makes sense since a low market-to-book multiple signals the company has a strong financial position in relation to its price tag.

Determining what can be defined as a high or low market-to-book ratio also depends on comparisons. To get a sense of whether The Gap's book-to-market multiple of 4.2 is high or low, you need to look at the multiples of other publicly-listed retailers.

Conclusion

Financial position, embodied by its accounting value, tells investors about a company's general well being. A study of it (and the footnotes in the annual report) is essential for any serious investor wanting to understand and value a company properly.