# Financial Analysis: Unlocking Real Value

In collaboration with

ACCA Think Ahead

## Unlocking real value from your financial statements is underpinned by several elements, which include the motive of the stakeholder, the ability to assess the information beyond numbers and ultimately understanding what the statement is depicting in real terms.

Furthermore, it is important to relate to the notion of what a financial statement represents, which demonstrates an entities performance and cash flow at a specific point in time, hence historical financial performance cannot be relied upon for a company's future performance. That said, companies are encouraged to assess market events and news which may occur post the issuance of a financial statement as these may often help understand how subsequent relevant information may impact the way the historic results are interpreted.

**To analyse data effectively whilst unlocking real value it is important to understand the motives of key stakeholders who assess such information, namely the investors, employees and suppliers. To demonstrate further how such stakeholders, interpret financial statements and other publicly available information we highlight a working example of a UK public listed retailer (company A).**

**Their five-year history of reported key numbers and ratios are as follows:**

| | 2017<br>£ million | 2016<br>£ million | 2015<br>£ million | 2014<br>£ million | 2013<br>£ million |
|---|---|---|---|---|---|
| Revenue | 2,335 | 2,342 | 2,323 | 2,313 | 2,282 |
| Cost of sales | (2,046) | (2,040) | (2,024) | (2,033) | (1,983) |
| **Gross profit** | **289** | **302** | **299** | **279** | **300** |
| Distribution costs | (125) | (115) | (111) | (99) | (98) |
| Administrative expenses | (57) | (56) | (54) | (52) | (47) |
| **Operating profit** | **108** | **131** | **134** | **129** | **155** |
| Gross profit margin [%] | 12.4% | 12.9% | 12.9% | 12.1% | 13.1% |
| Operating profit margin [%] | 4.6% | 5.6% | 5.8% | 5.6% | 6.8% |
| Net current liabilities | 620 | 619 | 594 | 623 | 647 |
| Total equity | 918 | 884 | 853 | 767 | 744 |

Subsequent to the issue of the September 2017 results, Company A issued three profit warnings. It was further reported in the media that during the 2018 financial year the retailer was facing a potential cash crunch, after credit insurers refused to or were reducing cover for its suppliers.

When news is released after the publication of the financial statements, how can this influence a user's view of the most recently issued financial statements? What type of questions might each interested stakeholder be asking? We explore examples of how three different groups of stakeholders might consider when interpreting financial statements using the example of the retailer.

**Investors**

Existing investors have experienced unrealised paper losses. The share price has reduced from 30 pence at the time the annual report was released to 12 pence by the end of August 2018.

Profit warnings may unnerve existing investors who will be concerned whether there is sufficient dividend cover to maintain previous dividend payout levels.

Given the profit warnings, is there now a concern that the asset values reported in the September 2017 financial statements are now impaired and asset write downs are likely in future financial results? Accounting standards are complex and asset values are often subject to critical estimates in areas such as impairment of goodwill. Any reduction in earnings drives down the level of operating cash flows, which are used in forecasting recoverable values of assets.

On the flip side, some potential investors may review the retailer's financial statements and recent news with more optimism, the market capitalisation of the company is lower than the value of the net assets. The company, despite facing challenging market conditions, like their competitors, are still forecast to generate profit, positive cash flow from operations and to pay a dividend, even if not at previous levels.

Questions that potential and existing investors might consider:

- Is the company undervalued as the market capitalisation of the company is lower than the book value of its assets?
- Are the current carrying values of assets over valued? The market considers the company to be worth less than its book value, which are impairment indicators.

## Employees

An employee's main concern in the context of financial statements may be around the going concern basis of preparation, and whether their employment is secure. If an employee is a member of a defined benefit pension scheme they will be seeking assurance that the company has sufficient cash resources to fund the retirement obligations of the company.

Analysts of financial statements will review the pension note in detail. Future liabilities are forecast by actuaries and are sensitive to large adjustments, from what can appear to be minor revisions in estimates. Such forecasts are used to determine the value of liabilities being recognised. for the retailer, the notes to the financial statement outline how sensitive the impact of slight variations in judgements are. See below an extract from the company's retirement obligations note regarding the sensitivities of changes in estimates to its pension liability:

| | 2017<br>£ million | 2016<br>£ million |
|---|---|---|
| Increase in schemes' liabilities arising from a 0.5% increase in inflation | 113.2 | 117.8 |
| Increase in schemes' liabilities arising from a 0.5% reduction in the discount rate | 123.3 | 128.4 |
| Increase in schemes' liabilities arising from a one-year increase in life expectancy | 27.3 | 28.4 |

**As noted above, these sensitivities are of a such a quantum that the balance sheet would be significantly impacted if these sensitivities were realised.**

Questions employees might ask:

- Do profit warnings and declining profitability change the outlook of the company? Will the company change its strategy by reducing the number of stores that are not profitable thereby reducing employee numbers?
- What is the likelihood of the sensitivities on judgements used to calculate the pension liability crystalising? If such sensitivities become more likely than not, is the company generating sufficient cash flows to fund any future deficit?

## Suppliers

On renewal of established credit limits provided to a company, a supplier will review the financial statements of that customer.

Liquidity will be a concern when goods and services are provided on credit and customer financial statements will be reviewed to establish financial strength. An analysis of liquidity ratios such as the current ratio and liquid ratio can be indicative of the health of a company. Suppliers of a company will not rely solely on an analysis of financial information and will review non-financial warning signs.

> Such non-financial information may include rumours of creditor pressure (as reported in the media in the company's case), slower bill payments and workforce reductions.

The supplier will review and analyse profit margins of the Company. Profitability ratios indicate the success of the management team in generating returns for shareholders and giving comfort to those who are providing capital to the company. Ratios will not be meaningful unless compared to comparable companies. It is important to note that a normal ratio in one industry may not be considered a healthy ratio in another industry.

**Company B, as a retail department store could be considered as a competitor for comparison purposes. See the comparison below, albeit different years.**

| | Company A | | Company B | |
|---|---|---|---|---|
| | Year 1<br>£ million | Year 2<br>£ million | Year 1<br>£ million | Year 2<br>£ million |
| Sales | 2,335 | 2,342 | 841 | 818 |
| **Gross profit** | **289** | **302** | **487** | **480** |
| Distribution costs | (125) | (115) | (368) | (358) |
| Administrative expenses | (57) | (56) | (97) | (93) |
| **Operating profit** | **108** | **131** | **22** | **28** |
| Gross profit margin [%] | 12.4% | 12.9% | 57.9% | 58.6% |
| Operating profit margin [%] | 4.6% | 5.6% | 2.7% | 3.5% |

We can see that when looking at gross profit margins, company A generates considerably lower gross margins compared to Company B, although we expect higher gross margins for Company B as it sells premium end merchandise. Company A better protects its profitability at the operating profit level. In comparing the two companies results it is apparent that the fundamental driver of the reduced profitability for Company A's' competitor is distribution costs. Company A is incurring £0.05 of distribution costs for every £1 of revenue being generated, compared to Company B who are incurring £0.44.

Questions a supplier of Company A may ask:

- Do deteriorating operating profit margins significantly impact the solvency ratios?
- If credit insurer rumors are real, does the company have unutilised funding facilities available from its banks to weather a short term working capital squeeze?

## Conclusion

To fully understand the performance of a company a user may wish to perform a peer review against similar companies to understand how the company fairs compared to its competitors. IFRS, being the most common accounting framework in use is a principles-based accounting framework. Care needs to be taken when comparing companies; the accounting policies may differ and can materially impact the reported results and interpretation thereof, particularly in capital intensive industries like oil and gas and mining.

If a thorough review of financial statements is conducted more questions will arise than answers, particularly if a thorough review of the notes is performed as part of the exercise.

**Ultimately, the quality of questions being asked, and the resulting further research will drive the value received from any analysis.**

**Contact us:**

**Grant Thornton** – United Arab Emirates

Dubai,
Rolex Tower,
23rd Floor,
Sheikh Zayed Road

**T** +971 (0) 4 388 9925
**E** info@ae.gt.com

Abu Dhabi,
Al Kamala Tower,
11th Floor,
Zayed 1st Street

**T** +971 (0) 2 666 9750

Sharjah,
Al Baker Tower 5,
3rd floor,
7/9 Al Khan 2 Street

**T** +971 (0) 6 525 9691

**ACCA Middle East**

Dubai Knowledge Village,
Block No.19,
Office No.S01,
Dubai, United Arab Emirates

**T** +971 (0) 4 391 5451
**E** info@ae.accaglobal.com

Grant Thornton
An instinct for growth™

**grantthornton.ae**