Standard

| BASIC ARITHMETIC |

Understanding Basic Accounting

Basic knowledge needed for share-picking process

UNDERSTANDING SOME rudimentary accounting is not just for accountants – all investors should have some basic accounting knowledge that will help in the share-picking process. Here, we will briefly discuss each of the financial statements and the types of questions you should be asking as you read through them.

The balance sheet gives a snapshot of a company's financial position on a particular day (the period end). That snapshot shows you what the company's assets, liabilities and its net worth (assets minus liabilities) are. (The net worth is reflected as shareholder funds or net asset value (NAV) in the balance sheet.)

A balance sheet on its own will only provide you with limited information, so you should compare it to the company's past results. To judge the financial strength of a company, ask at least the following four basic questions:

- Has the value of the company's assets increased from six months ago, a year ago or two years ago? By comparing the current asset base to that of the past two financial years, you will be able to see if a company is growing in both size and financial strength.
- How do the individual items compare with those in the previous periods? In particular you should look at the growth in line items such as accounts receivable to ensure that debtors are being well managed.
- Look at the liabilities and ask how they (especially debt and accounts payable) are growing relative to assets. A company could experience a cash flow crunch if accounts payable grows faster than accounts receivable for some time. Debt that grows faster than the items on the other side of the balance sheet can be a red flag of pending financial problems.
- Is the company's NAV or shareholders' funds (equity) greater than the previous year's? In a financially healthy company, NAV will increase as earnings grow.

The income statement's purpose is to show the company's profit (or earnings or net income or bottom line) for the entire accounting period. Profit is simply the amount of money that's left over once all expenses (including operating costs, interest payments and taxes) have been subtracted from sales.

Investors should always compare this year's profit to last year's. A strong company should show consistent profit growth over time.

Investors should ask the following questions when they examine a company's income statement:

- Are operational earnings growing? Operational earnings are the portion of the bottom line that's made from the company's core activity. In other words, ascertain that the key contributor to a company's profit is its "real business" and not non-recurring items such as profit on the sale of assets.
- Are sales growing and why?
- Are expenses growing at a reasonable rate? Pay attention to one-off charges (such as a large bad debt write-off and determine whether they make sense).
- Is the company's tax payment in line with the corporate tax rate (of 30%) or are earnings inflated by the use of past tax losses?

If you only have time to look at one financial statement, it should be the cash flow statement because it shows how a company is managing its resources. A company could be profitable yet can go out of business if it manages its resources poorly – for example if it doesn't collect its accounts receivable, it may not be able to pay its bills and be forced into liquidation.

The cash flow statement shows all receipts and payments of cash. It's split into three key sections: cash flow from operating activities, cash flow from investing activities and cash flow from financing activities. It shows how the balance sheet line items have changed over the accounting period.

Cash flow from operating activities is, arguably, the most important section as it shows the underlying cash performance of the company's operations. Consistent negative operating cash flow can warn of future financial problems.

Cash flow from investing activities shows the money the company spends on investments, including capital expenditure and acquisitions. Cash receipts from sales of assets will also reflect in this section. Investors should check that a company is investing adequately to maintain its productive capacity – in other words that it's not artificially inflating profit now at the expense of its future earnings. One quick and easy way is to check that capital expenditure is at least equal to depreciation over a number of years.

Cash flow from financing activities reflects all cash flow of a capital nature, including equity injections, debt raised and debt repaid.

These three financial statements are not all. Investors can glean important extra information from both the Value-Added Statement and the Statement of Changes in Equity. Don't forget to read the notes to the financial statements, if anything this is even more important than reading the financial statements themselves. The notes contain the small print that you need to evaluate the balance sheet, income statement and cash flow statement. ¤

Evaluating management and the business plan

Good management often rewarded with higher share price

INVESTING IN SHARES is not just about investing in a company's assets, but in the people who run it and their strategies. For this reason, it's vital to evaluate both the management team, its ethics and its business plan. Novice investors should be aware that the market rewards quality management with a higher share price than the company might otherwise have had.

It's often difficult for a private investor to evaluate management, corporate governance compliance and the business plan directly, as it can be difficult to interact directly with top executives. However, you will see and hear them interviewed on television and radio and read their comments in the press. Ask yourself if the executive comes across as capable and confident, or couldn't he answer the journalist's questions adequately? In addition, attend as many investor presentations as you can. If you can't arrange for an invitation, Summit Television now broadcasts many of them live.

Richard Seddon, head of Online Share Trading at the Standard, points out that the bank's industry analysts do have the opportunity to interact with management. Their research is available on the website www.securities.co.za.

But ultimately the proof is in the pudding, and good management presents itself through consistent financial performance, shareholder value creation and anticipation of changes in market conditions. The bottom line is that track records do count. Individuals who have a history of mismanaging companies or of poor business ethics are unlikely to reinvent themselves into quality executives. In this regard, investors should always read the curriculum vitae of company management in the annual report or, in the case of new listings, in the prospectus.

Ask yourself questions like whether management has a credible track record, a history of delivering on its promises, is well-regarded by institutional investors and peers, and whether the team has worked together for some time. Sometimes, if management doesn't meet basic quality criteria, investors should rather move on.

Evaluating the business plan can be tricky, as companies don't publish formal documents outlining their business strategies for competitive reasons. But investors can pose questions about the business concept, particularly in the case of new listings.

The type of questions you will pose about a business model will depend on whether the company is a new or existing business. For a start-up company, the questions can include whether the business is feasible or not. For an established business, ask if the company's direction is clearly defined and whether it can maintain its market leadership position.

Investors should also look at a company's management of the sustainability of its business. Increasingly, companies report a tripple bottom-line that shows its performance financially, socially and environmentally as it's no longer enough to manage a business for financial performance alone.

If the answers to these questions are not satisfactory, it's better to invest your time and money elsewhere. ¤

Other useful information in financial statements

Assess before you invest

A COMPANY'S published annual financial statements provide not only the numbers that are the raw materials for any fundamental analysis of its business and prospects, but are also a window into the company's character. An annual report contains a wealth of information between its glossy covers – some of which is implicit in how the statements are packaged and presented. For example, often the first warning sign that all's not well in a company is when its financial statements are delayed or miss the JSE's mandatory publication date. All preliminary results announcements must be made within three months of the end of the relevant reporting period, and the annual report should be published within six months of its year-end.

Now, let's look more closely at the contents of the annual report itself.

Firstly, the chairperson of the board and the CEO will, at a minimum, discuss the past year's financial and trading performance and give a short evaluation of the outlook for the next financial year. This may be augmented by reports from other senior executives, including divisional heads and the chief financial officer or financial director. Read these reports carefully – they provide important information about a company, the industry in which it operates and – indirectly – about its competitors.

→ THE KEY SECTIONS OF AN ANNUAL REPORT

- Chairperson's report
- CEO's report
- Director's report
- Sustainability report
- Auditors' report
- Accounting policies
- Balance sheet
- Income statement
- Cash flow statement
- Statement of changes in equity
- Value-added statement
- Notes to financial statements
- Corporate information
- Announcement of annual general meeting
- Resolutions to be tabled at the annual general meeting

The second important section to read is the auditors' report. This will tell you which firm audited the company and whether that company's audit fully complied with all accounting rules or not. A qualified audit report is a major warning sign.

Thirdly look at the board's overall performance and evaluate its compliance with accepted corporate governance practices, always

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2 « remembering that good corporate governance is about the board's and management's integrity, not about ticking a lot of boxes. Look at whether the board has independent sub-committees that assess remuneration, risk management and accounting practices. Another vital aspect is board attendance: "absentee" boards cannot oversee a company by remote control and may point to an ineffective board.

Lastly, examine the company's sustainable development initiatives. Corporates play a vital role in bridging the developmental gap in this country. However, as an investor, you need to ascertain whether a company's corporate social responsibility (CSR) initiatives are mere marketing hype or making a real difference where it matters. In addition, remember that – internationally. ¤

Investigating the numbers

THE NUMBERS GAME is the most arduous part of the bottom-up analysis. Novice investors should remember that though it's helpful to know how to calculate certain ratios, most of these are freely available in either the financial press (such as *Finweek*'s share price page) or on the Online Share Trading from the Standard website (www.securities.co.za), which has the full published annual reports.

There are two parts to the investigation: pulling apart the company's own published financials (in the annual report or the abbreviated interim and final earnings announcements) and then using various calculated ratios to help make the investment decision.

Ultimately, the financials are the only way to test whether a company's management team is doing a good job or not. However, investors should remember that the numbers are the outcome of various accounting decisions that management and its auditors have taken. New accounting standards have improved financial disclosure almost unrecognisably over the last ten years and there is more to come. Stress-test the quality of accounting decisions by examining the cash flow statement in as much detail as the income statement and balance sheet: Accounting decisions can influence earnings, not the cash in the bank.

There are four reasons to buy shares in companies that are financially healthy. Firstly, companies in good financial shape are more likely to survive the bad times as they have the resources to stay afloat. Secondly, financially sound companies have the firepower to buy assets (ranging from equipment to other companies) that will strengthen their position. Thirdly, financially healthy companies can continue marketing to ensure their continued success. Lastly and most importantly, shareholders will benefit from good financial performance, which should translate into share price appreciation.

Table 1 shows a shortlist of some of the numbers that investors should look at. Time and experience will help you to condense the list to the numbers and ratios that give you the most information for the least amount of effort. However, investors should – at a minimum – always look at the following: growth trends in sales and earnings, operating margins, cash flow and return on equity. Remember that a company's financial situation is constantly changing, and diligent investors continue to review its numbers for as long as they hold it in their share portfolio.

It is also important to analyse the drivers of earnings growth. Investors should discount once-off (or exceptional) items that are not related to operations, such as property revaluation or profit on disposal of an asset. These line items do not reflect the company's true profit potential.

→ **BASIC NUMBERS TO LOOK AT**

Accounts payable days	Earnings
Accounts receivable days	Earnings before interest, tax, depreciation and amortisation (EBITDA)
Acid test ratio	Earnings per share
Book value (or NAV)	Gross margin
Capital expenditure	Interest cover
Cash flow	Market share
Current assets	Net profit margin
Current liabilities	Operating margin
Current ratio	Price/Book ratio
Debt	Price/Earnings ratio
Debt structure	Price/Sales ratio
Debt: equity ratio	Research & development expenditure
Depreciation	Return on equity
Dividend	Return on assets
Dividend cover	Revenue

The second part of the in-depth investigation of the numbers is the calculation of various valuation ratios – such as the price:earnings multiple (p:e multiple) or price:book. We will spend time on them next week.

In simple terms, those companies with the lowest valuation ratios are – all other things being equal – the cheapest shares in a particular share universe. ¤

→ **QUIZ**

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. Which television channel now broadcasts many results presentations live?
2. Which financial statement gives you a snapshot of a company's assets and liabilities on a particular day?
3. Which worldwide system is now being used by many South African companies to report on their sustainable business practices? ¤

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