

Understanding balance sheets & profit & loss statements

We explain how balance sheets and profit and loss statements work, as well as some financial ratios that can help inform your investing decisions.

As a shareholder or would-be shareholder it's important to know as much as you can about a company's financial health to inform your views about its potential to perform in line with your investment strategy

Understanding two key financial statements and some commonly used financial ratios can help you make sense of what a company's report is really telling you.

The balance sheet

A balance sheet is also called the statement of financial position. It outlines a company's assets, its liabilities and its shareholders' equity at a point in time. The balance sheet always follows the following formula:

Assets (what the company owns) = **Liabilities** (what the company owes) + **Shareholders' Equity** (the amount of money invested by shareholders plus retained earnings available after all company debts are paid)

Below is an example of the kinds of items you might find on a company's balance sheet. These are not actual figures.

	Notes	2015 \$'000	2014 \$'000
ASSETS			
Current assets			
Cash and cash equivalents	8	70,000	100,000
Trade and other receivables	9	75,000	60,000
Total current assets		145,000	160,000
Non-current assets			
Plant and equipment	10	25,000	20,000
Intangible assets	11	100,000	90,000
Other non-current assets	9	25,000	10,000
Total non-current assets		150,000	120,000
Total assets		295,000	280,000
LIABILITIES			
Current liabilities			
Trade and other payables	14	40,000	40,000
Current tax liabilities		15,000	20,000
Total current liabilities		55,000	60,000
Non-current liabilities			
Other non-current payables		1,000	-
Deferred tax liabilities	8	5,000	4,000
Total non-current liabilities		6,000	4,000
Total liabilities		61,000	64,000
Net assets		234,000	216,000
EQUITY			
Issued capital	15	200,000	200,000
Retained earnings		30,000	10,000
Equity attributable to owners		230,000	210,000
Non-controlling interest		4,000	6,000
Total equity		234,000	216,000

Twitter: @commsec

Produced by Commonwealth Research based on information available at the time of publishing. We believe that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made as at the time of its compilation, but no warranty is made as to accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Bank of Australia ABN 48 123 123 124 nor any of its subsidiaries accept liability to any person for loss or damage arising from the use of this report.

The report has been prepared without taking account of the objectives, financial situation or needs of any particular individual. For this reason, any individual should, before acting on the information in this report, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice. In the case of certain securities Commonwealth Bank of Australia is or may be the only market maker.

This report is approved and distributed in Australia by Commonwealth Securities Limited ABN 60 067 254 399 a wholly owned but not guaranteed subsidiary of Commonwealth Bank of Australia. This report is approved and distributed in the UK by Commonwealth Bank of Australia incorporated in Australia with limited liability. Registered in England No. BR250 and regulated in the UK by the Financial Services Authority (FSA). This report does not purport to be a complete statement or summary. For the purpose of the FSA rules, this report and related services are not intended for private customers and are not available to them.

Commonwealth Bank of Australia and its subsidiaries have effected or may effect transactions for their own account in any investments or related investments referred to in this report.

Current assets are those expected to be converted to cash within a year, while current liabilities are those due for payment within a year.

There is a separate section for notes relating to the financial statements which provide more detail on the line items.

Listed companies post their half-year and full-year financial reports on the ASX's announcements page on the day they are released.

The profit and loss statement

A profit and loss statement is also called an income statement, or the statement of financial performance. It measures how the company earns its revenues and incurs its expenses during a period and, importantly, shows the company's resulting net profit or loss.

Below is an example of the kinds of items you may find on a profit and loss statement. Again, these are not actual numbers and the individual line items will depend on the nature of a business, how it earns its revenues and the type of costs it incurs.

	Notes	2015 \$'000	2014 \$'000
Revenue	3	3,500,000	3,400,000
Cost of sales		(2,500,000)	(2,700,000)
Gross profit		1,000,000	700,000
Other income		500,000	500,000
Sales and marketing expenses		(200,000)	(150,000)
Occupancy expenses		(100,000)	(100,000)
Other expenses		(60,000)	(50,000)
Finance costs	4	(5,000)	(4,000)
Profit before tax		1,135,000	896,000
Income tax expense	5	(340,500)	(268,800)
Net profit after tax		794,500	627,200

What are financial ratios?

Financial ratios can be useful to investors because they allow for easier comparisons between companies in a certain sector, for example.

With all ratios, however, there are some traps to be aware of and most investors would want to consider a number of different variables on which to base buy or sell decisions.

Market ratios

A market ratio is one that relates a company's financial situation to its shares to provide some insight into the value of the shares. Below are two examples.

Earnings per share

EPS = Net profit available for ordinary shareholders ÷ Number of ordinary shares in the company

Earnings per share (EPS) is the portion of a company's profit that can be attributed to each ordinary share in the company.

EPS can be useful in looking at whether a company is growing its earnings from one reporting period to the next, although it is also important for an investor to look at the reason behind the growth or contraction.

Price/earnings ratio (P/E)

P/E = Current share price ÷ Earnings per share

A P/E ratio shows how the market price of a company's shares relates to its earnings per share. In other words, it represents the amount of money investors are willing to pay for a share in the company's earnings.

While a higher P/E ratio may mean a stock looks expensive, what investors are willing to pay for a share generally comes down to views on what will happen to the earnings of the company in the future. So it's often necessary to probe slightly deeper and ask why a P/E ratio is where it is.

Liquidity ratios

Companies typically run into trouble when they are low on cash. Liquidity ratios show how well a company could cover the payments it's required to make.

Current ratio

Current ratio = Current assets ÷ current liabilities

One example of a liquidity ratio is the current ratio, which shows a company's ability to repay short-term debts quickly were it to get into trouble.

Regardless of the environment, an investor would probably be looking for a current ratio of at least 1, which indicates that in a worst-case scenario the company would at least be able to pay its most pressing debts.

Analysts will also typically be interested in what is included within current assets, the details of which should also be found within the notes, to double-check that this isn't overweighted to something like inventory that a company could conceivably struggle to convert to cash under pressure

Profitability ratios

These typically look at both the profit and loss statement and the balance sheet to show a company's ability to use the assets and borrowings it has in order to make a profit.

Return on equity (ROE)

Return on equity (ROE) = (Net profit ÷ Shareholders' equity) x 100

An example of a profitability ratio is return on equity, which measures how well a company is using the money shareholders have invested to generate a profit.

A company will often highlight its return on equity in its financial report.

Some industries will naturally be predisposed to have a higher return on equity than others, depending on the amount of large assets required before they can generate a profit. Because of this, ROE is best used to compare companies that operate in the same industry.

There are also things a company can do to impact ROE - such as a buyback, which would typically give ROE a bump as the profit would be divided by a smaller amount of equity.

Assets and liabilities

Looking at a company's balance sheet or 'statement of financial position' gives you an idea of how healthy a company is by telling you what it owns (assets) and what it owes (liabilities).

When you look at a balance sheet, quite simply you are interested in discovering whether a company is solvent – that is, does it have enough assets to cover its liabilities?

It's important to remember that when a company goes bust it does so on the basis that it has run out of money, regardless of whether it is still selling products.

When a company reports an asset writedown this effectively reduces the amount the company is worth. It happens when the carrying value of an asset no longer aligns with what the market would pay for the asset – its 'fair value'.

Companies often report writedowns in the lead-up to the release of earnings results.

Writedowns affect a market's view of a company in a number of ways. For one, a writedown will impact a company's gearing ratio – which measures the degree to which a company is funded by its owners' funds, versus creditor's funds, on which it must pay interest.

A higher gearing ratio makes a company riskier.

The company must also book the writedown as an expense, which means that it will also affect its profit figure and therefore the amount of money available to return to shareholders.

How much is the company making?

The first number on the company's profit and loss statement is sales revenue. While many investors like to look at this figure on the grounds that it is relatively pristine, it's also important to be aware of how much growth is costing.

After the sales line, costs start to get removed. Subtracting the cost of generating those sales will give you gross profit.

A better indicator of the direction in which a company's profit is heading is earnings before interest, tax, depreciation and amortisation (EBITDA), which takes out administrative expenses plus depreciation and amortisation, which are non-cash expenses.

The purpose of depreciation and amortisation is to put a number on the amount by which a company's assets have declined in value over the year.

Once this is factored in you have the earnings before interest and tax (EBIT) figure, which is the amount a company has made from its business activities over the reporting period.

The next step is taking out the costs associated with a company's financing activities – this includes interest and of course tax.

Net profit after tax (NPAT)

This is also referred to as the “bottom line”. In essence it reflects what the company has left over from the money it has generated after all costs have been removed.

There are, however, some things that can distort this figure in a given period. For example, if a company sold off a major asset during the year and subsequently booked a large profit on the back of that, the bottom line would look very strong.

Although this reflects the result for the year, it makes it hard to conduct a meaningful comparison with the company's performance in previous years and also doesn't really reflect how well the company is using its assets to generate income.

How to choose which shares to buy

As a consequence of this, many investors prefer to look at the ‘underlying profit’ figure which excludes one-off, or ‘exceptional’ items.

Underlying profit, which also goes by the terms ‘normalised profit’, ‘cash profit’ or ‘adjusted earnings’ is a non-statutory profit measure.

It is worth noting that the definition of exceptional items is flexible, which means it can help to read the explanatory notes within the report that cover the reasons they were included and how they've been quantified.

Analysts will typically look at the rate at which revenue, EBIT and NPAT have changed when compared with a company's previous results and will also be interested in how these results all relate to each other.

For example, if underlying profit grows faster than sales, this could indicate that margins—the money actually made on sales—have widened, or that expenses within the business have been reduced.

Earnings per share, which is net profit divided by the number of shares on issue, is another important measure as it ends up determining whether the company has “beat expectations”, which will typically drive up its share price, or “missed expectations”, which could cause it to fall.

Why cash is so important

Company reports also include a cashflow statement, which shows the money running through a company for the period in question.

Without a steady flow of cash then a company will find itself in trouble.

Why you need to spread your investment risk

The statement of cashflow is presented in three sections.

The first tells how much money is coming in from operating activities, which as a general rule will start with receipts from customers, subtract payments to suppliers and employees and take into account any interest received or paid, as well as payment of taxes.

The second covers off cashflow from investing activities such as any gains or losses on investments in the financial markets and any payments related to acquiring capital assets such as plant and equipment.

Finally cash flows from financing are taken into account, which will include money coming in as a result of loans or from the sale of shares and money that has been paid out to shareholders as dividends.

This then leaves you with the net increase or decrease in cash for the period and allows you to assess how well the company is generating cash from its business activities.

Outlook statements

Often companies will provide outlook statements in which they will outline expectations for the coming financial year.

This can provide insights on how management is reading developments at both the company and industry level.

Sometimes companies will also provide guidance which can be useful to compare against previous guidance to gauge how the market and business is measuring up to the management's narrative. Although guidance is of course subject to change throughout the financial year.