

BIMx Academy guide · Advanced

# How to read a financial report

This course explains the structure and logic of the three main financial statements and how they complement one another. The focus is on interpreting the figures from an investor's point of view.

3 chapters

43 min reading time

Investors





# The Balance Sheet: Assets, Liabilities and Equity

You learn to read an issuer's balance sheet, assess its liquidity and calculate working capital.

## What the balance sheet shows

The balance sheet (in IFRS terminology, the statement of financial position) is a snapshot of the resources a company controls and the sources used to finance them, at a specific date – usually the end of the financial year. Unlike the income statement, which covers a period, the balance sheet captures a single moment.



### DEFINITION

#### The fundamental balance sheet equation

**Assets** are resources controlled by the entity that are expected to generate future economic benefits. **Liabilities** are present obligations that will result in an outflow of resources. **Equity** is the shareholders' residual interest in the assets after deducting all liabilities.

### THE BALANCE SHEET IDENTITY

$$\text{Total assets} = \text{Liabilities} + \text{Equity}$$

The equation always holds; any change in assets is matched by a change in liabilities or equity.



For an investor, the balance sheet answers three questions: **what the company owns, how much it owes and when**, and **how much is left for shareholders** in accounting terms. Public-interest issuers generally report under international standards (IFRS), which makes balance sheet structures comparable across companies.

## The structure of assets and funding sources

Items are classified by time horizon: current (realizable or due within 12 months or one operating cycle) and non-current (long-term).

- ◆ **Fixed (non-current) assets:** land, buildings, equipment, intangible assets, long-term financial investments.
- ◆ **Current assets:** inventories, trade receivables, other receivables, cash and cash equivalents.
- ◆ **Long-term liabilities:** bank loans and bonds maturing in more than one year, long-term provisions.
- ◆ **Current liabilities:** trade payables to suppliers, the current portion of loans, taxes and wages payable.
- ◆ **Equity:** share capital, reserves, retained earnings.

Balance sheet figures are largely accounting values: many assets are carried at historical cost less depreciation, so book value can differ substantially from market value. Internally developed brands or know-how often do not appear on the balance sheet at all.

## Liquidity and working capital

Liquidity describes a company's ability to meet its short-term obligations. A profitable issuer can still run into trouble if its current assets do not cover its current liabilities when they fall due.

### NET WORKING CAPITAL

**Working capital = Current assets - Current liabilities**

A positive value means short-term assets exceed short-term obligations.



### CURRENT RATIO AND QUICK RATIO

**Current ratio = Current assets ÷ Current liabilities; Quick ratio = (Current assets - Inventories) ÷ Current liabilities**

The quick ratio excludes inventories, which are the hardest to turn into cash quickly.





#### EXAMPLE

##### **Illustrative example: Nistru Agro SA (MDL thousand)**

The hypothetical company Nistru Agro SA has fixed assets of 42,000 and current assets of 18,000 (inventories 9,500, receivables 6,200, cash 2,300), for total assets of 60,000. Funding sources: equity 30,000, long-term liabilities 18,000, current liabilities 12,000 – a total of 60,000. Working capital =  $18,000 - 12,000 = \text{MDL } 6,000 \text{ thousand}$ . Current ratio =  $18,000 \div 12,000 = 1.5$ . Quick ratio =  $(18,000 - 9,500) \div 12,000 = 8,500 \div 12,000 \approx 0.71$ . With 2,000,000 shares outstanding, book value per share =  $30,000,000 \div 2,000,000 = \text{MDL } 15$ . The figures are illustrative.

Interpretation: a current ratio of 1.5 looks comfortable, but a quick ratio below 1 shows that coverage depends on selling inventories. For an agricultural company with seasonal production this may be normal; for a services company it could be a warning sign.

## Common pitfalls when reading a balance sheet

- ◆ Comparing ratios across sectors with different operating cycles.
- ◆ Ignoring asset quality: old receivables may be hard to collect, and inventories may be impaired.
- ◆ Analyzing a single balance sheet, without the multi-year trend and without the notes.
- ◆ Assuming that the book value of equity equals the true value of the business.



#### TIP

##### **Read the notes**

The notes to the financial statements detail accounting policies, debt maturities, guarantees given and contingent liabilities. Information that is essential for assessing risk is often found there, not on the face of the balance sheet.

## Key takeaways

- ◆ The balance sheet shows the financial position at a specific date:  $\text{Total assets} = \text{Liabilities} + \text{Equity}$ .
- ◆ Classifying items as current and non-current lets you assess liquidity and the funding structure.
- ◆ Working capital and liquidity ratios show the ability to meet short-term obligations.
- ◆ Book value often differs from market value; sound analysis requires a multi-year trend and reading the notes.

# The Income Statement

You analyze an issuer's revenue, margins, EBITDA, net profit and earnings per share.

## The cascading logic of the income statement

The income statement (profit and loss account) describes a company's performance **over a period** (quarter, half-year, year). It is structured as a cascade: starting from revenue, successive categories of expenses are deducted, producing intermediate profit levels that each tell you something different about the business.

01

### Revenue (turnover)

Amounts earned from selling goods and services, recognized when the obligation to the customer is fulfilled, not necessarily when the cash is received.

02

### Gross profit

Revenue minus cost of sales; it reflects production efficiency and pricing power.

03

### Operating profit (EBIT)

Gross profit minus distribution, administrative and other operating expenses, including depreciation and amortization.

04

### Profit before tax

EBIT plus finance income minus finance costs (mainly interest).

05

### Net profit

Profit before tax minus income tax; this is the result attributable to shareholders.

Each step of the cascade isolates a different type of decision. Gross profit mainly reflects production and pricing policy, operating profit adds the efficiency of the overhead cost structure, and net profit includes the effect of financing decisions and taxation. That is why an analyst does not stop at the bottom line: two companies with the same net profit may have very different operating businesses, offset by different financing structures. Comparing all the intermediate levels over several years shows where value is created and where it is lost.

## Margins and EBITDA



### DEFINITION

#### EBITDA

**EBITDA** (Earnings Before Interest, Taxes, Depreciation and Amortization) is profit before interest, taxes, depreciation and amortization. It is used to compare the operating profitability of companies with different financing structures and depreciation policies. It is not defined by IFRS, so the calculation method may vary from one issuer to another.

### PROFIT MARGINS

**Margin X = Profit at level X ÷ Revenue \* 100%; EBITDA = EBIT + Depreciation and amortization**

You calculate the gross margin, EBITDA margin, operating margin and net margin, each relative to the same revenue.

Margins let you compare companies of different sizes and track changes over time. A falling gross margin may signal pricing pressure or rising raw material costs; a falling net margin with a stable operating margin may point to a higher cost of debt.



#### WARNING

#### EBITDA is not cash

EBITDA ignores the investment needed to maintain assets, interest, taxes and changes in working capital. A company with high EBITDA can still have weak cash flows. Always check how the issuer defines its "adjusted" metrics.

## A complete example and earnings per share

| Item (MDL thousand)                                                        | Amount   | Margin on revenue |
|----------------------------------------------------------------------------|----------|-------------------|
| Revenue                                                                    | 50,000   | 100%              |
| Cost of sales                                                              | (32,000) | —                 |
| Gross profit                                                               | 18,000   | 36.0%             |
| Distribution and administrative expenses (including depreciation of 3,000) | (8,000)  | —                 |
| Operating profit (EBIT)                                                    | 10,000   | 20.0%             |
| EBITDA = 10,000 + 3,000                                                    | 13,000   | 26.0%             |
| Interest expense                                                           | (2,000)  | —                 |
| Profit before tax                                                          | 8,000    | 16.0%             |
| Income tax (illustrative rate of 12%)                                      | (960)    | —                 |
| Net profit                                                                 | 7,040    | 14.08%            |



#### EXAMPLE

##### Calculating EPS for Nistru Agro SA (illustrative)

Net profit is MDL 7,040 thousand, or MDL 7,040,000. The company has 2,000,000 ordinary shares outstanding and no preferred shares.  $\text{EPS} = 7,040,000 \div 2,000,000 = \text{MDL 3.52 per share}$ . Tax:  $8,000 \times 12\% = \text{MDL 960 thousand}$ ; net profit:  $8,000 - 960 = \text{MDL 7,040 thousand}$ .

#### EARNINGS PER SHARE (EPS)

**$\text{EPS} = (\text{Net profit} - \text{Preferred dividends}) \div \text{Weighted average number of ordinary shares outstanding}$**

Diluted EPS also takes into account instruments that could be converted into shares (for example, convertible bonds or options).



## Earnings quality

Not all profit is equally valuable to an investor. **Recurring** profit from the core business is more relevant for valuation than **non-recurring** gains, such as the sale of land or the reversal of a provision.

- ◆ Separate exceptional items from the result of the core business.
- ◆ Compare revenue growth with growth in receivables: if receivables grow much faster, the quality of revenue may be questionable.
- ◆ Track margins over at least three to five years, not just in a single financial year.
- ◆ Compare net profit with cash flow from operating activities.

Also check whether the number of shares changed during the period through new issues or buybacks. EPS growth achieved only by reducing the share count does not mean the same thing as growth in net profit generated by the core business.

## Key takeaways

- ◆ The income statement describes performance over a period, cascading from revenue down to net profit.
- ◆ Margins express each profit level relative to revenue and allow comparisons over time and across companies.
- ◆  $\text{EBITDA} = \text{EBIT} + \text{depreciation and amortization}$ ; it is useful for comparisons but is not the same as cash generated.
- ◆ EPS relates the profit attributable to ordinary shareholders to the weighted average number of shares.
- ◆ Recurring profit matters more for valuation than exceptional gains.

# The Cash Flow Statement

You understand how cash is generated and used, and why accounting profit is not the same as cash received.

## Why cash matters

Profit is calculated using accrual accounting: revenue and expenses are recognized when they are earned or incurred, not when cash is received or paid. That is why a company can report a profit and run out of cash at the same time. The cash flow statement reconciles these two perspectives.



### DEFINITION

#### The three categories of cash flows

**Operating activities** cover receipts and payments from the core business. **Investing activities** cover purchases and sales of long-term assets. **Financing activities** cover raising and repaying loans, share issues and dividend payments.

For an investor, the cash flow statement is often the hardest of the three reports to "adjust," because cash coming in or going out can be verified. It shows whether the core business funds its own investments, how far the company depends on new loans or shareholder contributions, and whether dividends are backed by the cash it generates. Read together with the balance sheet and the income statement, it completes the economic picture of the issuer.

## The indirect method for operating activities

Most issuers present operating cash flow using the indirect method: they start from net profit and adjust it for non-cash items and for changes in working capital.

**01**

### Start from net profit

This is the starting point of the reconciliation.

**02****Add back non-cash items**

Depreciation and amortization reduce profit but do not involve a cash outflow in the current period.

**03****Adjust for working capital**

An increase in receivables or inventories consumes cash (deducted); an increase in trade payables to suppliers keeps cash in the company (added).

**04****Arrive at cash flow from operating activities**

The result shows how much cash the core business actually generated.

The classification of some items, such as interest paid or dividends received, may differ between issuers, because IFRS allows certain choices. In the example below, interest is included in operating cash flow.

## Example: from profit to cash

| Nistru Agro SA – item (MDL thousand, illustrative) | Amount         |
|----------------------------------------------------|----------------|
| Net profit                                         | 7,040          |
| + Depreciation and amortization                    | 3,000          |
| - Increase in receivables                          | (1,200)        |
| - Increase in inventories                          | (800)          |
| + Increase in trade payables                       | 460            |
| <b>Cash flow from operating activities</b>         | <b>8,500</b>   |
| - Purchases of equipment (CAPEX)                   | (5,000)        |
| + Proceeds from the sale of equipment              | 300            |
| <b>Cash flow from investing activities</b>         | <b>(4,700)</b> |
| - Loan repayments                                  | (2,500)        |
| - Dividends paid                                   | (1,000)        |
| <b>Cash flow from financing activities</b>         | <b>(3,500)</b> |
| <b>Net change in cash</b>                          | <b>300</b>     |
| Cash at the beginning of the year                  | 2,000          |
| Cash at the end of the year                        | 2,300          |



#### EXAMPLE

##### Checking the calculations

Operating cash flow:  $7,040 + 3,000 - 1,200 - 800 + 460 = 8,500$ . Investing cash flow:  $-5,000 + 300 = -4,700$ . Financing cash flow:  $-2,500 - 1,000 = -3,500$ . Net change:  $8,500 - 4,700 - 3,500 = 300$ , so cash rises from 2,000 to MDL 2,300 thousand – exactly the balance shown on the balance sheet. Free cash flow =  $8,500 - 5,000 = \text{MDL } 3,500$  thousand.

## Free cash flow and warning signs

#### FREE CASH FLOW (FCF)

**FCF = Cash flow from operating activities - Capital expenditure (CAPEX)**

This is a simplified, widely used definition. Valuation uses more precise variants, such as free cash flow to the firm (FCFF), discussed in the lesson on DCF.

FCF shows the cash left after maintaining and expanding the asset base, available for repaying debt, paying dividends or buying back shares. In the example, the company generated MDL 3,500 thousand of FCF and used MDL 3,500 thousand for financing, keeping its cash position almost unchanged.

- ◆ Net profit rising while operating cash flow falls for several consecutive years.
- ◆ Dividends consistently funded by new borrowing rather than free cash flow.
- ◆ Receivables systematically growing faster than revenue.
- ◆ CAPEX below depreciation over the long term, which may indicate underinvestment.



#### TIP

#### The cash-to-profit ratio

Compare operating cash flow with net profit over several years. A ratio consistently above 1 (here  $8,500 \div 7,040 \approx 1.21$ ) usually suggests good-quality earnings, but the interpretation depends on the sector and on capital intensity.

## Key takeaways

- ◆ Accounting profit and cash differ because of non-cash items and changes in working capital.
- ◆ Cash flows are split into operating, investing and financing activities; their sum is the net change in cash.
- ◆ Increases in receivables and inventories consume cash; an increase in trade payables keeps it in the company.
- ◆  $\text{FCF} = \text{operating cash flow} - \text{CAPEX}$  shows the cash available to creditors and shareholders.
- ◆ Profit that does not turn into cash over the long term is a warning sign.

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