Factors to consider in annual accounts

Financial Accounting

A friend of yours has a sizeable portfolio of investments; mainly ordinary shares in UK listed companies. While talking to him about this you realise that he never looks at the annual accounts of those companies to help him assess his position, relying instead on tips and hints given in the quality newspapers.

Do you feel that this is a sensible strategy, and why?

It is sensible to gather opinions from quality newspapers and experts' comments from the media. As the answer will later explain, the market sentiment reflected in the share price involves a group of factors that alter the price. However, a sensible strategy would demand the use of financial accounts as a major source of information becoming the most important tool for making decisions on any given company.

Over the last years the improvement in reporting systems imposed by financial regulators have led investors to play a more active role when holding ordinary shares in public listed companies. In principle, shareholders should constantly review the level of earnings per share compared to the return on investment expected, which is based on the horizon projected when the investment portfolio is created.

During the investment period any shareholder can follow the performance and the sector in which the company operates in order to assess if the position adopted is beneficial and at the same time evaluate the company's ability to deliver returns. In this order of ideas, financial accounts are a primary source of data reflecting the financial position of the company (normally at the end of each quarter) and producing effective comparisons on the operations against previous years and its competitive position with industry competitors.

From the investor's point of view, accounts exercise a pivotal source of data through providing financial and economic variables that measure the value of the investment; for instance the liquidity prospects and the company's capacity to sustain profitability and growth.

In relation to public ordinary shares, since they are traded on a daily basis offering market liquidity and flexibility to modify (buy or sell) the composition of the portfolio, common shares (ordinary shares in the US) entitle the holder to share when a distribution of dividends takes place and, in normal circumstances, their vote at company's meetings (Black, p335). Being holder of ordinary shares increases the need for assessing accounts as the investment return is materialised only in earnings per share or when they are sold at a premium price.

To summarise, it is highly recommendable to establish constant access to primary source channels linking the company's performance in the past and present with the capacity to forecast the future. Farmer (1986, p247) explains that the share price in the market is influenced by several factors such us: interest rates, inflation, technology changes, factors changing the business environment, oil prices, etc. Therefore, the ability to combine the market sentiment over any given company and the company's earnings generates an integral mechanism to guide shareholders' decision on a particular stock.

Do you think there are any matters he should definitely examine in the annual accounts, and if so, what?

McKenzie's contribution in interpreting financial data, define financial accounts as the way to show if the business is efficient in terms of profitability trend and the strengths acquired in relation to liquidity to fund working capital and capital expenditure and the company's ability in keeping growth momentum reflected on P and L and balance sheet statements (Mckenzie, 1998, p 8-9). Before any type of assessment on the accounts, a shareholder needs to have a comprehensive view on the company and its ability to perform in the future.

By narrowing the answer down, Kettell (2001, p152) and Blake (1984, p26) agree in affirming that the importance of accounts for shareholders is the valuation of stocks held using earnings indicators. Dividends are paid out of earnings, in the case of all earnings paid out as dividends the Profit and Loss statement accounts them as dividends; if the earnings are retained by the company, a reinvestment of capital policy is expected to support future plans. Blake (1984, p26) uses the term " investor ratios", which relates the accounts to shareholders' main interest. Refer to (i) and (ii):

(i) Earnings per share ratio: Earnings

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Number of ordinary shares

(ii) Dividends per ordinary share: Dividends

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Number of ordinary shares

As mentioned before, accounts link the performance of the company in the past with the present and historically produce data to forecast the financial position highlighting growth, liquidity, profitability and debt structure as the most relevant. Farmer (p248, 1994), explain how investor ratios can be related to the market and how they efficiently assess the performance trend in terms of investors’ returns by associating the current market price of ordinary shares. Refer to: (iii) and (iv):

(iii) Price-earnings to ratio (PER): Market price per ordinary share x 100

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Earnings per ordinary share

(iv) Earnings Yield: Earnings per Share x 100

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Market price per ordinary share

The investor ratios translated into facts for the shareholders demonstrate that the growth of earnings over time and subsequent rise in share prices is largely caused by the company management and workforce, and shows evidence of the company’s operating efficiency. Positive trends out these ratios identify the company’s competitive position; however, it is relevant to affirm that earnings are not dividends. Thus, the overall analysis for each investor has to validate whether a cash flow position is met in line with the boards of directors decision on either distributing or retaining dividends going forward. (Farmer, p249-250).

Finally cash flow, according to McKenzie (1998, p271) explains that two observations should be made in relation to cash position, a. Operating Cash Flow and b. Cash Generation. The cash position as a result of operating activities indicate if the core of the operation is generating working capital, capital investment reserves and liquidity to responds to dividends' policies.

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