

# BSVI - FSA Guide

## Topics discussed:

- Financial Statement Reclassification
- Trend Analysis
- Qualitative Aspects
- Ratios Construction
- Final Comprehensive comment

## RECLASSIFICATION

Often the legal format required by certain countries for the disclosure of a company's financial information is not appropriate for an efficient valuation.

Before starting any attempt to evaluate the financial statements of a company, it is crucial to reorganize the different items of each financial statement through an appropriate reclassification.

Reclassification accounting refers to the process of changing the classification of certain financial items or transactions in an organization's financial statements and is a crucial aspect of financial reporting that enables businesses to adjust the presentation of their financial statements. By reclassifying certain items, companies can provide more accurate and transparent information to stakeholders, enhancing their understanding of financial performance and position. We can benefit from the use of this practice in different ways:

- Increased Transparency
- Enhanced Financial Analysis
- Improved Decision Making

### Liquidity/Exigibility Criterion:

Reclassifying financial statements based on the liquidity/exigibility criterion involves rearranging the items in the balance sheet (both assets and liabilities) to present them in a way that reflects their conversion into cash or their due dates for payment. This reclassification provides a clearer picture of the company's financial position. Here's how to do it

1. **Identify Liquidity and Exigibility Categories:**  
Separate assets and liabilities into different categories based on their liquidity (for assets) or exigibility (for liabilities)

Common categories include:

- **High Liquidity Assets:** Cash, cash equivalents, and highly liquid investments.
- **Intermediate Liquidity Assets:** Marketable securities, accounts receivable, and inventory
- **Low Liquidity Assets:** Long-term investments, property, plant, and equipment.
- **Short Term Liabilities:** Accounts payable, short-term debt, and current portion of long-term debt.
- **Long Term Liabilities:** Long-term debt, deferred tax liabilities, and other non-current obligations

2. **Rearrange the balance sheet** by listing assets in descending order of liquidity, starting with the most liquid assets at the top. For liabilities, list them in ascending order of exigibility, with the most immediate obligations at the top.
3. **Accurately read financial statements notes** to have an appropriate description of each item and be able to appropriately reclassify it.

Reclassification of financial statements using the liquidity/exigibility criterion helps stakeholders, including investors and creditors, better understand the company's short-term financial strength and obligations. It also provides insights into the company's ability to meet its financial commitments and manage liquidity effectively and it is fundamental for the construction of liquidity/solvency ratios.

### Income Statement by functional areas:

Reclassifying the income statement into different functional areas is a financial reporting practice that enables a detailed analysis of how a company generates income and incurs expenses based on its various operational activities. Each functional area represents a specific category of revenues and expenses, providing a clearer picture of the financial dynamics within the company.

The first functional area is **Core Management**, which encompasses the revenues and expenses associated with the company's core and central activities. This includes revenues generated from the sale of the company's primary products or services and expenses

directly linked to these core activities, such as costs for materials, labor, and production. Calculating the operating income in this category involves subtracting the expenses from the corresponding revenues, giving insight into the profitability of the core business operations.

The second area, **Accessory Management**, focuses on activities that are ancillary or complementary to the core business. It includes revenues from ancillary services or related products and the associated expenses. The aim here is to separate the revenues and expenses derived from these supplementary activities from those of the core business, providing clarity on their financial impact. We also insert in this section revenues that derive from the use of extra cash in different assets such as bonds or other securities.

**Financial Management** is the third area, concentrating on the financial aspects of the company. This includes interest income, interest expenses, and other financial income or expenses, such as dividends paid. Financial management reflects how the company manages its financial resources, which can involve investments and financing decisions that impact its overall financial performance.

The fourth functional area is **Extraordinary Management**, designed to account for exceptional events or transactions that fall outside the regular course of business and are not part of daily operations. Examples include gains or losses from the sale of assets, corporate restructuring, or other non-recurring transactions. Separating these extraordinary events from regular operations helps provide a clear view of their impact on the company's financial performance.

Finally, **Tax Management** relates to income taxes, encompassing tax compliance and the corresponding tax expenses. This category includes current income taxes and deferred taxes. The goal is to clearly distinguish tax expenses from core management and other functional areas, facilitating a better understanding of the tax burden and its impact on the company's financials.

Reclassifying the income statement into these functional areas offers a more detailed and transparent view of the company's financial performance, helping stakeholders, including corporate executives, investors, and financial analysts, make well-informed decisions based on a nuanced understanding of income generation and expense management across different operational aspects.

### Balance Sheet by functional areas:

The reclassification technique discussed above for the income statement aims to measure how different areas of management relevance (core, accessory, financial, extraordinary, tax) contribute to a company's profitability and cash flows.

When comparing balance sheet values (stock) with income values (flow), as is done when calculating ROI, it is essential to ensure the consistency of the analyzed index.

The need to compare income and asset values for the calculation of certain profitability indices also necessitates defining which reclassified Balance Sheet schema should be used to obtain value aggregates useful for comparing with income results. Given that the Income Statement is always reclassified by management areas, it follows that the Balance Sheet must also be reclassified according to management relevance. The reclassification of the balance sheet according to the criterion of management relevance distinguishes assets and liabilities based on whether they belong to the characteristic operational management and whether they can be attributed to the current activity related to the "input-transformation-output" cycle.

They are distinguished as follows:

- **Core Assets**, further divided into Current (e.g., receivables from customers, inventory, etc.) and Fixed (tangible and intangible)
- **Accessory Assets** (net of any accessory liabilities)
- **Current Core Liabilities** (e.g., payables to suppliers, employees, and provisions for risks or expenses)
- **Financial Liabilities** (third-party loans explicitly onerous)
- **Net tax position** (balance of advances and debts to the tax authorities)

- **Extraordinary Assets and Liabilities** (related to extraordinary management)
- **Equity.**

The term "current" does not refer to the timing of collection or payment of assets and liabilities, but rather to the fact that these assets and liabilities are generated in a current manner, meaning they are "recurrent," resulting from the normal activities of purchase, transformation, and sale typical of the characteristic operational cycle.

## TREND ANALYSIS

Trend analysis is a pivotal aspect of financial statement analysis, offering a deep and comprehensive understanding of a company's financial health and trajectory. It involves a meticulous examination of how various financial metrics and performance indicators have evolved over time. This process is instrumental in uncovering patterns, identifying anomalies, and gaining insights into the company's historical financial performance.

One of the key advantages of trend analysis is its ability to reveal the direction in which a company is heading. By scrutinizing trends in revenue growth, investors and analysts can gauge the company's ability to generate increasing sales or identify stagnation or declines. Steady revenue growth over multiple periods may indicate a healthy and expanding business, while declining revenues could signal challenges that need addressing.

Profitability trends are equally crucial. Analyzing changes in profit margins over time provides insights into the company's efficiency in managing costs and pricing strategies. Consistent improvement in profitability margins suggests effective cost management and competitive positioning. Conversely, declining profit margins may indicate cost pressures, pricing issues, or increased competition that requires further investigation.

Furthermore, examining trends in key financial ratios helps uncover financial strengths and weaknesses. For instance, tracking the trend of liquidity ratios, like the current ratio or quick ratio, provides insights into the company's ability to meet short-term obligations. A consistent decline in these ratios may signal liquidity

concerns, while improving ratios suggest enhanced short-term financial stability.

Solvency ratios, such as the debt-to-equity ratio, are vital for assessing a company's long-term financial health. By analyzing trends in this ratio, you can identify whether the company is becoming more or less leveraged over time. Increasing debt levels without corresponding growth in equity could raise solvency concerns, whereas a decreasing ratio may indicate a healthier capital structure.

Efficiency ratios, like asset turnover or inventory turnover, help assess how efficiently a company utilizes its assets and manages its working capital. Examining these trends can highlight operational improvements or inefficiencies. A rising asset turnover may signify better asset utilization, while a declining figure may suggest underutilized resources.

In summary, trend analysis offers a comprehensive view of a company's financial performance by examining historical data and identifying patterns, shifts, or anomalies. This historical context is invaluable for making informed decisions about investing in or lending to a company. However, it's essential to remember that while trend analysis provides valuable insights, it should be complemented by an examination of current conditions and qualitative factors to form a holistic view of a company's financial health and prospects.

## QUALITATIVE FACTORS

In financial statement analysis, qualitative factors assume a critical role in offering a comprehensive understanding of a company's financial health and performance, particularly when considering the broader industry environment and the threats it may pose. The industry landscape itself can present various challenges, some of which can be exemplified by recent events like the COVID-19 pandemic.

One of **the industry environment threats** to consider is disruptive technological advancements. Industries that rely heavily on traditional business models can face significant challenges when new technologies emerge. For instance, the rise of e-commerce has disrupted the

retail industry, causing traditional brick-and-mortar retailers to adapt quickly to online shopping trends or face obsolescence.

One crucial qualitative factor to consider is the quality of the company's **management team**. A capable and experienced management team can make a substantial difference in a company's ability to navigate challenges, seize opportunities, and execute its strategic plans effectively. Evaluating the track record, leadership style, and decision-making capabilities of the management team can provide valuable insights into a company's future prospects. Regulatory changes and compliance requirements represent another potential threat. Industries subject to evolving regulations or stringent compliance standards, such as healthcare or financial services, may experience increased costs and operational complexities. Companies must navigate these changes effectively to remain competitive and compliant.

**Market volatility and economic fluctuations** are persistent threats across industries. Economic downturns, like the global financial crisis of 2008, can impact consumer spending, corporate investments, and overall industry health. These fluctuations can lead to reduced revenue, tightened credit markets, and increased operational risks for companies.

Moreover, **geopolitical tensions** and global events can have far-reaching consequences. The COVID-19 pandemic, for instance, exposed vulnerabilities in various industries, including travel, hospitality, and supply chain-dependent sectors. Lockdowns and travel restrictions significantly disrupted operations and revenue streams, highlighting the importance of adaptability and contingency planning.

Environmental and sustainability concerns are increasingly relevant qualitative factors. Industries that are resource-intensive or have significant environmental impacts, such as energy or manufacturing, may face heightened scrutiny and pressure to adopt sustainable practices. Failure to address these concerns can result in reputational damage and regulatory challenges.

Lastly, competitive pressures within an industry are a continual threat. Rapid market changes and the emergence of new competitors can erode market share and profitability. For instance, the rise of

streaming services posed a challenge to traditional cable television providers.

Incorporating these industry-specific threats into financial statement analysis is crucial for a well-rounded assessment. Recent events, such as the COVID-19 pandemic, have underscored the importance of evaluating a company's resilience and adaptability in the face of unforeseen challenges. By considering both quantitative data and qualitative insights into industry threats, analysts, investors, and stakeholders can better gauge a company's ability to mitigate risks and capitalize on opportunities in a dynamic business landscape.

For that reason, the FSA Division operates in parallel with the **Sector & Strategy Division** in order to offer a comprehensive valuation.

## RATIOS CONSTRUCTION

### Profitability Evaluation:

Profitability ratios are vital tools in financial statement analysis and valuation. They help assess a company's ability to generate profit from its operations efficiently. By comparing these ratios with industry peers, analysts identify trends and evaluate relative performance. Sustainable profit is a key consideration for long-term valuation. These ratios also influence investment decisions, play a role in valuation models, and impact a company's creditworthiness. For management, profitability ratios inform strategic decisions, such as cost-cutting or pricing strategies. Additionally, they aid in forecasting future earnings and are integral to assessing a company's financial health. Now we are going to explore some of the most important profitability metrics:

**Gross Profit Margin:** The gross profit margin is a fundamental metric that measures the profitability of a company's core operations. It calculates the percentage of revenue remaining after deducting the cost of goods sold (COGS). In essence, it reveals how efficiently a company can produce and sell its products or services. A high gross profit margin suggests that a company has a healthy pricing strategy and efficient production processes, while a low margin may indicate cost inefficiencies or pricing pressures.

**Operating Profit Margin:** The operating profit margin delves deeper into a company's profitability by considering not only the cost of goods sold but also operating expenses such as salaries, rent, and utilities. It reflects the percentage of revenue that remains after both COGS and operating expenses are subtracted. This metric provides insights into how well a company manages its day-to-day operational costs. A higher operating profit margin indicates better cost control and operational efficiency.

**Net Profit Margin:** The net profit margin is a key indicator of a company's overall profitability. It takes into account all expenses, including taxes and interest, and calculates the percentage of revenue that represents actual net profit. This metric is crucial for investors as it provides a comprehensive view of a company's ability to generate profit after all expenses are considered. A higher net profit margin signifies strong financial health and effective management.

**Return on Assets (ROA):** ROA measures a company's ability to generate earnings from its total assets. It assesses how efficiently a company utilizes its assets to produce profit. A higher ROA indicates better asset utilization and management. It is a valuable metric for evaluating a company's operational effectiveness, particularly in relation to its asset base. This index can differ based on the level of capital intensity in an industry. High capital intensity industries, like manufacturing, tend to have lower ROA because more assets are tied up in capital investments. Conversely, low capital intensity industries, like technology and services, often achieve higher ROA since they require fewer assets to generate revenue. ROA is influenced by the balance between net income and total assets, making it essential to consider industry-specific capital requirements when assessing a company's performance. Understanding capital intensity provides context for evaluating a company's ROA relative to its industry.

**Return on Equity (ROE):** ROE focuses on a company's ability to generate profit relative to shareholders' equity, making it a crucial metric for investors. It

reveals how effectively a company can use shareholders' investments to generate earnings. A higher ROE suggests that a company is providing strong returns to its equity investors. It's a key metric for assessing a company's attractiveness to shareholders.

It should be said that the ROE can be computed in different ways depending on the deduction of non-controlling interests from the net income.

**Return on Comprehensive Earnings:** Return on comprehensive earnings considers a broader view of earnings that includes not only net profit but also other comprehensive income items like changes in the fair value of investments or others that are not directly included in financial statements due to accounting rules. It provides a more comprehensive picture of a company's financial performance by encompassing all items that affect shareholders' equity. This metric is especially relevant for companies with significant non-operational income or investments affected by market fluctuations.

In summary, these financial metrics offer insights into different aspects of a company's profitability and financial performance, but we need to consider the differences that emerge from different industries for that reason these metrics should be compared and evaluated in relation to industry averages.

### Activity and Efficiency Evaluation:

The following ratios measure the operational efficiency of the firm, i.e., the number of times assets flow into and out of the company during a period (firm's ability of putting assets to work).

**Total Asset Turnover Ratio:** The total asset turnover ratio is a measure of a company's efficiency in using its total assets to generate revenue. It assesses how effectively a company deploys its assets to generate sales. A higher total asset turnover ratio indicates that a company is efficient in utilizing its assets to generate revenue, while a lower ratio suggests that assets may not be utilized optimally. It's a valuable metric for assessing operational efficiency and asset management.

**Fixed Asset Turnover Ratio:** The fixed asset turnover ratio specifically focuses on a company's fixed assets, such as property, plant, and equipment. It measures how efficiently a company uses these long-term assets to generate sales. A higher fixed asset turnover ratio indicates effective utilization of fixed assets to generate revenue, while a lower ratio suggests underutilization. This ratio is particularly relevant for capital-intensive industries.

**Accounts Receivables Turnover Ratio:** The accounts receivables turnover ratio evaluates how effectively a company manages its accounts receivable. It measures the frequency with which a company collects payments from its customers. A higher ratio indicates efficient credit management and quicker collection of outstanding payments, while a lower ratio may suggest credit management issues or slower collection.

**Accounts Payable Turnover Ratio:** The accounts payable turnover ratio gauges how efficiently a company manages its accounts payable. It assesses how quickly a company pays its suppliers. A higher ratio suggests efficient management of accounts payable, whereas a lower ratio may indicate delayed payments or strained supplier relationships.

**Inventory Turnover Ratio:** The inventory turnover ratio evaluates the efficiency of a company's inventory management. It measures how quickly a company sells its inventory during a specific period. A higher ratio indicates efficient inventory turnover and potentially lower carrying costs, while a lower ratio may suggest overstocking or slow inventory turnover.

**Operating Cycle:** The operating cycle encompasses the entire process from the purchase of raw materials to the collection of cash from the sale of finished goods. It represents the time it takes for a company to convert its investments in raw materials and production into cash. A shorter operating cycle is generally favorable, as it signifies quicker cash conversion and efficient working capital management. Understanding the operating cycle is crucial for managing cash flow and optimizing working capital.

These financial metrics provide insights into various aspects of a company's operations, including asset utilization, efficiency in managing receivables and payables, and the overall flow of resources in the business. Each metric focuses on a specific aspect of a company's financial performance and can help identify areas for improvement or efficiency in the operational processes.

#### **Liquidity Evaluation:**

Liquidity is firm's ability to satisfy short-term obligations using assets that can be more readily converted into cash. Liquidity is very important during financial crisis. For example, during the 2007/2008 financial crisis those firms with more liquid resources were less affected.

**Current Ratio:** The current ratio is a fundamental liquidity ratio that assesses a company's ability to meet its short-term financial obligations with its short-term assets. It is calculated by dividing current assets by current liabilities. A higher current ratio indicates a company has more current assets than current liabilities, suggesting it is well-positioned to cover its short-term debts. However, an excessively high current ratio may imply that a company is not effectively utilizing its assets.

**Quick Ratio (Acid-Test Ratio):** The quick ratio is a more conservative measure of liquidity compared to the current ratio. It excludes inventory from current assets, focusing solely on the most liquid assets, typically cash, marketable securities, and accounts receivable. This ratio provides insight into a company's ability to meet its short-term obligations without relying on selling inventory. A higher quick ratio suggests a stronger ability to cover short-term liabilities.

**Cash Ratio:** The cash ratio is an even more conservative liquidity metric that assesses a company's ability to meet its short-term obligations with cash and cash equivalents alone. It excludes accounts receivable, inventory, and marketable securities from current assets. A higher cash ratio indicates a company has a significant portion of its assets in cash, which can be readily used to cover immediate liabilities. This ratio is particularly relevant for assessing extreme short-term liquidity.

**Treasury Margin:** Treasury margin, also known as treasury yield, refers to the difference between the interest income earned on investments in government or corporate bonds and the interest expense incurred on borrowed funds, such as loans or bonds. A positive treasury margin implies that a company is earning more from its investments than it is paying in interest on its debts. This margin can serve as an indicator of a company's financial stability and the effectiveness of its treasury management practices. A positive treasury margin can contribute to overall profitability and financial health.

### **Solvency Evaluation:**

As with the liquidity ratios we analyzed the ability of the firm in meeting the obligations due within 12 months, we now run an analysis on the solvency of the firm to assess whether it is able to satisfy all the debt obligations, including also the long-term ones.

**Capital Structure Ratios:** Capital structure ratios assess the composition of a company's funding sources, primarily equity and debt. These ratios include metrics like debt to equity ratio and equity ratio. They provide insights into the proportion of a company's capital financed through debt versus equity. A high debt to equity ratio indicates a heavier reliance on debt, while a low ratio suggests a more equity-driven financing structure.

**Coverage Ratio:** Coverage ratios, such as interest coverage and debt service coverage ratios, measure a company's ability to meet its financial obligations, particularly interest and debt payments. They assess the company's capacity to service its debt from its operational earnings. Higher coverage ratios indicate a stronger ability to meet debt obligations without financial strain.

**Solvency Ratio:** Solvency ratios gauge a company's overall financial health and its ability to meet long-term obligations. One common solvency ratio is the debt to asset ratio, which assesses the proportion of total assets financed by debt. A higher debt to asset ratio suggests a higher degree of financial leverage, while a lower ratio signifies lower financial risk.

**Debt to Asset Ratio:** The debt to asset ratio specifically measures the percentage of a company's assets financed by debt. It provides a clear picture of the company's leverage and the extent to which it relies on borrowed funds to support its operations and investments. A higher debt to asset ratio indicates a greater reliance on debt financing.

### **Debt to Asset and Gearing Ratio:**

The Debt to Asset Ratio gauges a company's financial leverage by assessing the percentage of assets funded by debt. A higher ratio indicates greater reliance on borrowing, potentially elevating financial risk. Conversely, a lower ratio suggests a conservative financing approach with more equity funding. Analyzing this ratio helps stakeholders assess financial health and risk tolerance.

The gearing ratio is a variation of the debt to equity ratio and evaluates the company's financial risk by comparing long-term debt to shareholders' equity. It helps assess the balance between equity and debt in the capital structure. A higher gearing ratio signifies a higher level of financial risk associated with a greater proportion of debt relative to equity.

These financial ratios collectively provide a comprehensive view of a company's capital structure, its capacity to service debt, overall financial health, and the extent of financial leverage employed. Analyzing these ratios helps stakeholders, such as investors and lenders, assess the company's risk profile and financial stability.

### **Accounting policies and earnings manipulation:**

Ratios and financial metrics can be influenced by real earnings management strategies employed by CEOs to artificially boost a company's earnings. One such strategy involves overproduction in manufacturing firms. CEOs may decide to produce more goods than necessary, resulting in additional production and holding costs for the surplus items that often remain unsold. The consequence is a misalignment between cash flows from operations and expected levels based on sales. While this tactic may reduce the average cost of production, thus inflating profits, it can also make the company appear inefficient due to high inventory or low asset turnover ratios.

Another earnings management technique involves sales manipulation. Managers might temporarily increase sales by offering more lenient credit terms to customers. While this approach can lead to reported lower cash flows from operations in the current period and higher production costs compared to the norm for the given sales level, it can be used to inflate reported earnings. These strategies highlight the complex relationship between earnings management and activity ratios, as they demonstrate how actions to boost earnings can impact various financial metrics.

## COMPREHNSIVE COMMENT

Next, we discuss the positive aspects that emerged from our analysis, such as strong revenue growth, healthy profit margins, efficient asset utilization, or a solid competitive position. We support our assessment with specific data or ratios. Conversely, we identify and address areas of concern or weaknesses that we identified during our analysis, which may involve declining profitability, high debt levels, liquidity challenges, or operational inefficiencies. We are clear about the potential risks these weaknesses pose.

We also integrate qualitative factors into our comment, considering aspects such as the quality of management, industry dynamics, regulatory challenges, and market conditions that could impact the company's financial performance. We highlight any qualitative insights that provide context to our analysis. Additionally, we relate the company's financial metrics and performance to industry benchmarks if applicable, discussing how the company's performance compares to industry norms and explaining the implications of these comparisons.

Providing our outlook for the company's future performance, we offer recommendations or insights based on our analysis. For instance, we might suggest cost-cutting measures, exploring new markets, or investing in research and development to remain competitive. We also address any risk factors that could impact the company's financial health, such as market volatility, economic uncertainties, or industry-specific risks. We assess how well the company is prepared to mitigate these risks.

Throughout our final comment, we maintain a balanced and objective tone, acknowledging both the strengths and weaknesses of the company. We avoid overly optimistic or pessimistic language to ensure a fair and unbiased assessment. In conclusion, we summarize our overall assessment with a concise summary statement that encapsulates our key findings and leaves the reader with a clear understanding of our analysis and its implications for the company's financial prospects.

## RELEVANT INFO

While the provided ratios and methodologies are valuable tools for financial analysis, it's essential to recognize that they are not the only ones available. Analysts have the flexibility to incorporate additional metrics they consider important to gain a comprehensive understanding of a company's financial health.

Our commitment to providing comprehensive resources includes a full guide on these ratios and a table containing all the relevant formulas, which can be found on our website page in the **knowledge center section**. This guide equips analysts with the knowledge and tools they need to expand their analysis beyond the provided metrics, tailoring their approach to specific industry nuances or unique business situations. We encourage analysts to explore and adapt their analysis methods to best suit their analytical objectives.



