Kingdom of Saudi Arabia
Capital Market Authority

هيئة السوق المالية
Capital Market Authority

Reading Financial Statements

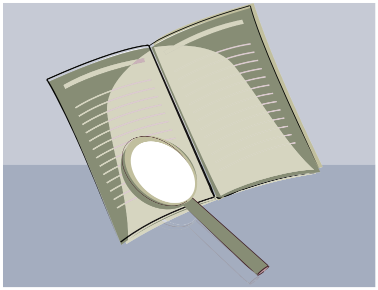
Introduction

The company's quarterly financial statements are considered a good place to start a research when thinking in investing in some company or when monitoring a stock that is already invested in. As a person checks his own check book to balance between his income and expenditure, companies generally register and control the income and supplies of their obligations. Not only this, but they are required also to publish these information as a quarterly financial statement.

By the end of each financial quarter (three months), joint stock companies are obligated by the Capital Market Law to publish their financial statements to the public. Financial statements seem to be as a confusing group of numbers but the investor can analyze and understand these numbers to get to important results concerning the company's current performance. All in all, the quarterly financial statements help the investor to estimate the potential growth, the company's market value, and to acknowledge the company's strengths and weaknesses.

How an Investor Reads the Quarterly Financial Statements

The quarterly financial statements are a good example of the detailed information that reflect the company's partial performance. Keep in mind that these financial statements can reflect the general direction of the company when it is added with the other statements of other companies in the same area. So, reading the quarterly financial statements by the investor gives him useful information that helps him in evaluating the company's performance for the past three months and compare it with other companies that have the same business.



The quarterly financial statements are usually divided into the following parts :

1. Statement of Financial Position (The Balance sheet).
2. The Income Statement.
3. Cash Flow Statement.

Originally after detailing the previous, a detailed part concerning explanations about the financial statements follows, plus a report from the external auditor. Each one of these parts explains a different side of the company's current performance. The first three parts are repeatedly mentioned in all the listed companies' statements and has a certain pattern in presenting it. So, we will focus in explaining and simplifying them.

The phrase " Reading quarterly financial statements" may seem somewhat vague because they contain a lot of numbers and a few words but knowing what these figures indicate when reading and analyzing it, gives the investors the ability to reach very important results.

Statement of Financial Position (The Balance Sheet)

Originally, the balance sheet is included in the first part of the quarterly financial statements. It represents a detailed image of the company's financial status when published. The balance sheet includes the company's assets, liabilities and shareholders' equity which gives a clear idea on its book value. It is a known fact that it is not a good sign if the company's liabilities outperformed its assets because that means that its losses are more than its capital which could lead the company to be unable to practice its business and maybe bankrupted.

That's not only what the company's balance sheet could explain; it can also point out the assets' availability in it to the sufficient amount that helps in expanding its business through the acquisition of another company or to develop a new product or to resort to borrowing to maintain its operational activities. Reading the balance sheet enables the investor to know if there is additional stock in excess of the market need as a result of the inaccurate assumption of the management for the expected demand on the products. That could be a strong indicator that the company handles its assets badly.

Although the numbers shown in the companies' statement of financial position vary greatly, but the general framework of the statements of all companies remain united. It means that it is possible to compare the performance of two companies in two different trading fields. It is possible to summarize the three elements which, as a whole, generate the balance sheet for a company as the following:

- Assets.
- Liabilities.
- Shareholders' Equity.

Assets:

Companies can own assets, just as the individual has assets of value, like real estate or jewelry. One of the differences between an individual and a company's assets is the company's obligation to publish what it owns to the public.

Companies can own tangible assets such as computers, machinery, money and real estate. It can also have intangible assets such as trademarks, copyrights or patents.

Generally a company's assets are categorized according to the ability to change it into cash in two types:

1. *Current Assets:* Cash and other properties owned by the company and could be easily converted into cash in one year. It is an important indicator of the company's financial status because it is used to cover short term commitment of the company's operations. If the company suffers from a decline in its current net assets then that means it needs to find new means to finance its activities. One of the answers to this is to issue extra stocks by the company. We can generally say that increasing the company's current net asset means an increase in the company's opportunities in maintaining its growth.

Some of the important current assets for companies:

- Cash and its equivalents
- Short term investments
- Payable sales
- Inventory

2. *Non-current Assets:* an asset that the company owns and needs more than a year to convert to cash or it is the asset that the company does not have a plan to convert to cash during the next year. Fixed assets such as lands, buildings, machinery and so on, come under non-current assets. The importance of the company's non-current assets volume is based on its sector's type. For instance, companies in the banking sector don't need (fixed) non-current assets compared to what a company in the industrial sector.

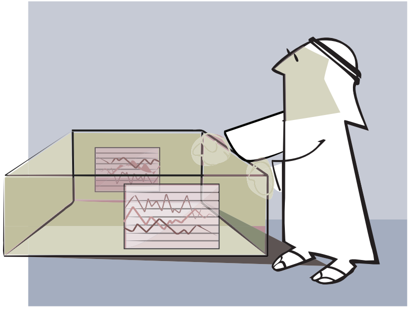
Liabilities:

All companies- even those profitable- have debts. In the balance sheet, debts are called Liabilities. A company's management successfulness is based on its ability in managing its various liabilities which are considered a part of its business.

Examples of a company's liabilities:

- Debt of suppliers and shareholders
- Payable Expenses
- Long-term loans
- Zakat

A company's liabilities in the balance sheet is divided into two parts:



1. *Current Liabilities:* The commitments the company should pay in no more than one year. The company usually refers to liquidating some of its current assets to cover these expenses.

Some of the important types of current liabilities are:

- Payables.
- Undistributed dividends.
- Zakat.
- Installments of long-term loans.

2. *Long-term Liabilities:* The commitments the company is not restricted to pay within at least one year such as Long- term loans. Although theses debts are not to be paid through the next financial year, but at the end it should be paid. It is important to keep that in mind when evaluating the company.

Shareholders' Equity:

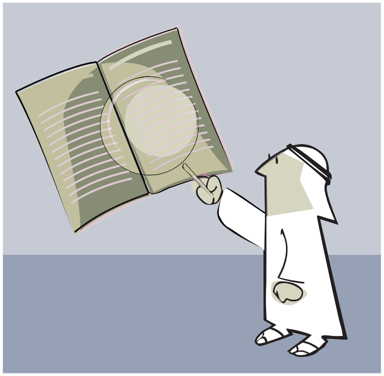
Shareholders' equity is mentioned in the company's balance sheet report. Shareholder's equity equals the invested money that was distributed as shares plus the undistributed profits, which represents retained earnings held and re-invested by the company. They are not distributed to shareholders. To make it simple, shareholders' equity represent the main source in financing the company's business. The more equity the shareholders have, the size of the company's own operational money increases.

Shareholders' equity is calculated in balance sheet by subtracting total liabilities from total assets. For example, if the company's total assets is 100 million Riyals while its liabilities is 75 million Riyals then the shareholders' equity equals 25 million Riyals. (100 million – 75 million = 25 million Riyals)

Shareholders' Equity =
Total Assets – Total Liabilities

Income Statement

The income statement is easier to understand and less complicated than the balance sheet. But still, it is the most analyzed part of the quarterly financial statements. It is because it details the company's profit sources based on its performance in selling products, offering services or in its investments' income. To explain that, the income statement shows the company's income out of its sales and the outgoing cash to cover these expenses.



Reading the income statement is not only on deducting the total income expenses. In general, the company has more than one source for income and several different kinds of expenses. The company details the different sources for its income and expenses in the income statement and that reflects a clear image of the company's performance. Here are some of the main points in an income statement:

- Income or sales
- Expenses
- Gross profit
- Net profit
- Operating profit "income from the company's major operations"
- Gains and losses from other than the major operations
- Earnings per share
- Zakat

The investor can, when he understands what these numbers refer to and the relationship between them, determine the company's strengths and weaknesses. For instance, a troubled company – which is obviously not a good investment- suffers from increasing expenses and decreasing income which leads to a decrease in its total net profit.

Income and Expenses:

As an individual gains profit through his work or his investments' revenues, the company can also profit from selling its products or services or its investments' revenues. Some companies have only one source for profits and others have more than one. The income statement shows the company's sales and incomes. By following the statement, the size of the company's financial profit could be accurately known. It can also let you know from which of the company's sources the profit is generating.

Income: it is the company's total funds which are gained from its major activity that includes selling goods or the services it produces.

Total Profits (or losses): if any company can find a way to develop and manufacture products and offer services without incurring any expenses, it would be the richest company in the world. Reality, on the other hand, proves that spending money is important to gain more money. To calculate the company's total profits (or losses), a deduction should be made by deducting its direct expenses from its income.

Operating Profit: production expenses are not the only expenses the company has to pay to succeed. After the product is produced, it is supposed to be advertised and sold and this of course brings in other and more expenses. In addition to marketing and advertising expenses, the company is obligated to pay its employees' salaries, office supplies and its management expenses. The company's operating profit (or loss) could be reached by deducting all the operating expenses mentioned from the profits' total.

Net Profit: in addition to operational expenses, the company has to pay other expenses such as the Zakat. When the company deducts these expenses from the operational profit and add what income it gains from outside its area, then what is left forms the company's net profit. One of the clear indicators that the company's performance is doing good is the increase in the net profit from one quarter to the next.

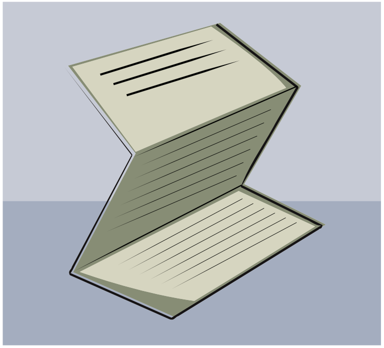
Cash Flow Statement

The cash flow statement is considered one of the important financial statements to any corporation. It explains in detail the amount of incoming and outgoing cash flows in the past three months. It also details the sources of the money and how to spend it on terms of operating, investing and financing. The cash flow statement offers the details, in a detailed clearer way, on the available monetary sources for the company and the nature of its uses. Add to that, mentioning explanations on the company's monetary accounts or assets that can be quickly converted into cash from the beginning of the financial quarter to its end.

What makes Cash Flows so important? The answer is that the company can't win without the availability of cash or similar assets. That is to pay its operational expenses and debts benefits…etc. A company can't fund its investments to develop its business without the availability of cash.

Contents of Cash Flow Statement:

Companies usually have many sources of cash and similar assets of cash that can appear in its cash flow statement. Its increase demonstrates the strength of the company's financial status. A company usually divides it cash flow statements into the following categories:



- *Cash flow resulting from operating activities:* Cash received or expended as a result of the company's internal business activities.

- *Cash flow resulting from investing activities:* Cash received or expended as a result of the company's investments.
- *Cash flow resulting from financing activities:* Cash received from the issue of debt and equity, or paid out as dividends, share repurchases or debt repayments.

The details in the three above categories represent the sources of cash and assets the company achieved. Moreover, it has a detail on the uses of this cash. If the company does not spend all the achieved cash, the rest of it will be shown in net cash flows component. It exactly equals the cash balance and what's similar to it in the balance sheet by the end of the financial quarter.

Because the cash flow statement is a result of the change in cash in most of the items of both the company's balance sheet and income statements, the cash flow statement would highlight all the variables on these items such as :

- Short-term investments.
- Long-term debts.
- Dividends.
- Zakat.
- Accounts receivable.
- Inventory
- Tangible assets.

What to look for in the cash flow statement?

The three important things that should be looked for in the cash flow statement are that the flow should be positive, large and increases with time. Putting aside the level of the achieved cash flow for the company, it is supposed to carefully check the three mentioned categories in the cash flow statement. They are (operational, investment and financial activities). The investor should also know the activities that bring the largest cash flows to the company and the modality in which these cash flows would be used. By this, it is possible to judge the company's future performance. Usually the company that has a large cash reserve, would be able to pay its obligations, distribute its profits and to go beyond emergency financial problems without the need to borrow or sell its assets.

It is important to note that the company's high profits does not necessarily mean a positive cash flow. It is possible that there are some terms in the cash flow statement that rises the profits when it is not cash. It is possible that there are negative cash flows sometimes which does not give a bad impression on the company's performance if the company used its cash in buying investment assets that supports the expansion in its area to achieve a good future performance.

Sectored Comparison

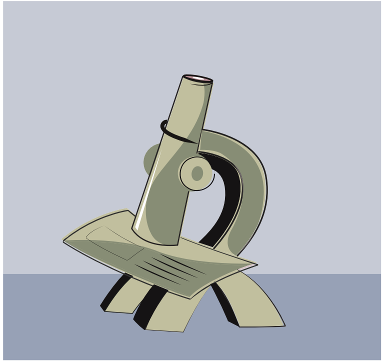
Earnings per share:

It is not a secret that most shareholders – if not all- want to invest in the companies that gain more profit than its major activity or the ones that have the ability to do that in the future. So, it is natural to say that the most known way to evaluate companies is to revise its profits.

Earnings per share represents the shareholders share of the company's net profit for every share they own if the company distributed its net profit as dividends. It is calculated by dividing the net profit of the company on the number of shares issued. For example, if we assume that the net profit of the company is 100 million Riyals in one quarter and that it has 50 million exported shares, then the earning per share is two riyals (100 million ÷ 50 million = 2).

$$\frac{\text{Company's Net Profit}}{\text{Number of exported shares}} = \text{Earnings Per Share}$$

This percentage – if was adopted for several financial periods- measures the company's improvement when compared to other competing companies in the sector.



If the company distributed all its net profits on investors, then there won't be any enough money to cover its operational expenses or to develop its activities through it. The part where the company keeps its net profit and reinvests it is called retained earnings. The Board of Directors of the company often recommends, if the accumulation has large reserves of retained earnings, to distribute some profits to shareholders.

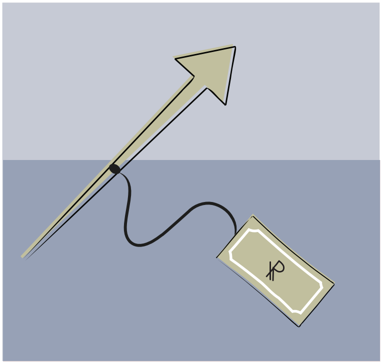
The investor should keep in mind that the earnings per share does not take into account the current stock price. So the interest rate would be limited if taken separately. He /She should also examine the operating profits that focus on gains from the company's main activity. That is because the net profit includes – in addition to operating profits- the gains and losses.

Understanding Accounting Ratios

It is a ratio of two selected numerical values. Although some shareholders think that the complex financial accounting ratio (indicators) is only useful to those shareholders and financial analysts who have experience, but this is not true especially if we keep in mind the amount of the enterprises' financial information that is currently available on the Internet and Tadawul website.

Financial accounting ratios give the investor a quick and easy way to judge the company's financial performance in a specific period of time. These ratio could also be used in comparison between companies' performance in the same sector or compare it with the average of the companies' performance in the market. Although many of these ratios or indicators are present, but most of them are expressed in either the form of percentage (%) or a multiple digital Celsius.

Certainly, there are many figures that contribute to explain the company's financial performance as well as the sector in which they operate in general. Thus, the part of the process used to determine the fair value of the stock is concentrated in the study of these figures and determine the most useful for measuring the performance of the company or the sector.



The assessment of stocks or even making sure of its current fair value is somewhat difficult on the contrary of physical assets of the immovable property or tangible assets. For example, you can evaluate a fair selling price for a new car just by looking at it, but does a stock selling price reflects its real value? The answer to this question is a very complicated matter due to the variety of the affecting factors that cannot be fully measured or at least translated into numbers. For example, the levels of the company's expected growth is listed in the asking price for its shares because companies that have strong future growth in profits exceed prices of those predicted to have modest growth. However, through our understanding of financial accounting ratios, we can pave the way for better governance on the company's share price and whether the value is exaggerated or not.

Since companies vary in their offered services according to the variety of sectors, then some financial ratios become more credible in describing the performance of one sector compared to the others. For example, the financial ratio could explain in detail the banking companies performance, where its use does not give the same result when dealing with agricultural companies. The following are some of the ratios used by analysts and investors to help them in determining the fair values of companies.

The Financial Ratio:

1. Price – to – Earnings Ratio (P/E)

To examine the company's profits attributable to its share price, investors should view the so-called Price – to – earnings ratio (P/E). It is sometimes called the multiplier. To calculate the multiplier, the share's market value is divided by the earnings per share.

$$\frac{\text{Price per-share}}{\text{Annual Earnings per-share}} = \text{P/E Ratio}$$

The P/E refers to the price level that investors want to pay for each real profits of the company. It also refers to the time required to cover the amount paid by the investor to buy the stock on the assumption that the company would deliver the same returns in the coming years. The higher the company's Price-to-Earnings ratio the more indication there is for the share's market value inflation. But if the company has a high P/E value and at the same time has great opportunities for achieving high profits or high growth in the future, its stock will remain attractive for investors despite the high price.

And contrary to the previous, the decline in price to earnings ratio for the company below the sector's average indicates the reduction in the assessment by investors of the company's share price in the sense that investors in the company price its stock for less than the potential or expected price. The investor should pay attention to the possibility that a company with low price to earnings per share suffers from poor management or that there are substantial reasons for its failure to attract investors to invest in its stock.

2. Price – to – Sales Ratio (PSR)

Even if the company didn't profit from managing its business, it gets revenue every time a service is offered or a product is sold. The price to sales ratio is a way to evaluate the company's value based on its revenue. This ratio is presented as a multiplier and is calculated by dividing the company's current capital value by the per-share revenue in the past year.

$$\frac{\text{The current capital value}}{\text{Past year's per-share revenue}} = \text{Price-to-Sales Ratio}$$

For example, if the company's capital value in the current market price is 100 million Riyals (20 million shares x 5 Riyals per share) and its last twelve months sales is 300 million Riyals, then the PSR equals (100 million ÷ 300 million = 0.33).

Whenever the PSR is decreased, the investment value in the company is better. Most analysts think that an investor should search for a PSR below 1.0 when choosing between a group of companies to invest in one of them.

3. Price – to – Book Ratio (P/B)

It is used to compare a company's book value to its current market price P/B. An investor could calculate the price-to-book ratio per share by dividing the shareholders' equity (Assets – Liabilities) on the number of the company's issued shares. For example, if a company shows in its balance sheet that it has assets worth 200 million Riyals and liabilities worth 125 million Riyals then the company's book value would be 75 million riyals, if there was 25 million issued shares, the book value per share would be 3 riyals.

$$\frac{\text{Market value per-share}}{\text{Book value per-share}} = \text{Price -to -Book Ratio (P/B)}$$

According to the above, and assuming that the share's market value is 27 Riyals then the P/B equals 9.

It is better if the value, the investor pays to buy shares, is close to the book value per-share. That is because the outstanding share value is covered and guaranteed by the company's available liabilities. The rise in this percentage might reflect, in a way, the investors' high evaluation of the company's performance.

4. Rate of Return on Shareholders' Equity Rate (ROE)

The ROE measures the percentage of the company's profit to shareholders' equity in it. It is calculated by dividing the company's net income on shareholders' equity.

$$\frac{\text{Net Income}}{\text{Shareholders' Equity}} = \text{Return on Shareholders' Equity}$$

For example, if the company's net income for the past year is 400 million Riyals and the total of its shareholders' equity is 800 million Riyals, then the ROE is 0.5 or
(400million ÷ 800million = 0.5).

> In general, whenever there is a rise in the rate of return on shareholders' equity (ROE), that shows a strength in the company's performance. It is considered a clear indication on the good management where the company's (ROE) would be with time ahead of the companies' average in the same sector (ROE). This average increase might sometimes reflect the company's tendency to finance its activities in debt even with a weak rate of return on assets It is useful for this indicator not be considered separately from other indicators.

5. Rate of return on assets

The rate of return on assets could give the investor an idea on how a company manages and invests its assets. It could be calculated as:

$$\frac{\text{Net Income}}{\text{Total Assets}} = \text{Return on Assets Rate}$$

In general, whenever the rate of return on assetsis increased it indicates an efficiency in the company's management and assets investment.

6. Current Ratio

It measures the company's available cash at the current period. It could be calculated by dividing the company's current assets by its current liabilities. For example, if the company's current assets is worth 50 million Riyals and current liabilities worth 33 million Riyals then the current ratio is 1,5.

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{Current Ratio}$$

> In general, if the company's current ratio is greater than 1 and less than 2 then that means that the company is ready to cover its obligations and short term operating expenses. But if the current ratio exceeds this, it might indicate the management's failure in reinvesting the assets in order to develop its work and that could negatively reflect on the company's long term reve-

nue. As previously noted in talking about financial accounting ratios, it is important to compare the current ratio of the company in question with other competitors operating in the same sector as well as with the companies operating in the entire sector's average current ratio.

7. Quick Ratio

It is calculated by dividing the current assets subtracted by the inventory on current liabilities. By subtracting the inventory from the current assets we can know the company's ability to cover its current obligations without liquidating the inventory which could be considered a great loss since it is the least current assets that are able to be liquefied.

$$\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}} = \text{Quick Ratio}$$

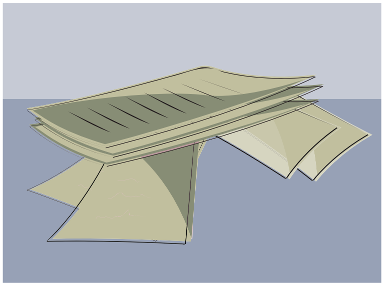
If we used the previous example, if the company's inventory are 10 million Riyals then its quick ratio would be (50 million – 10 million = 40 million ÷ 33 million = 1.21).

1.0 or more quick ratio is considered a good indicator that the company could cover any immediate expenses and that it is running smoothly in its area.

8. Liquidity Ratio (Cash Ratio)

It is considered the least used indicator but it is useful when the investor wants to know the liquidity size of a company compared to others. It could be calculated by dividing the company's cash plus its marketable securities on the company's current liabilities.

A liquidity ratio could be beneficial when comparing two small emerging companies that have high growth potential and are extremely competitive. If these two companies are equal in everything, the company that has a higher liquidity ratio would be prepared to win over its competitors.



For more information, please don't hesitate to contact us on the following address:

Capital Market Authority

Al-Faisaliah Tower, King Fahad Road

Riyadh, Kingdom of Saudi Arabia

PO. Box 87171 Riyadh 11642

Toll-Free 800 245 1111

Contact Center 00966 11 205 3000

Fax 00966 11 490 6599

Email info@cma.org.sa

You can also visit our website on the following address

www.cma.org.sa

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