ANALYSIS OF FINANCIAL STATEMENTS

Financial Management from Islamic Perspective

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DEDICATION

THIS EBOOK IS DEDICATED TO...

Our beloved family members for always loving and supporting us;

Our esteemed colleagues for sharing knowledge and encouraging us continuously in this wonderful journey;

Our students who have struggled and persevered in seeking knowledge.

ACKNOWLEDGEMENT

As this is the first time trial of publishing e-book on the particular topic, we can't claim that this module will be exhaustive by any means. However, we have carefully pieced together what we consider to be the key frameworks and approaches to assist readers for better understanding of financial management from Islamic perspectives. Without the great support from our Management of Commerce Department Politeknik Nilai (PNS), this module would not exist. Having an idea and turning it into a module is as hard as it sounds. The experience is internally challenging and rewarding. Alhamdulillah for every blessing that Allah has given us; hidden and apparent and for everything that Allah has protected us from, whether we know or not. Indeed, Allah is with those who fear him and those who are doers of good. Jazakallahukhair.

‘Allah does not bless usury, and He causes charitable deeds to prosper, and Allah does not love any ungrateful sinners’ The Quran 02:276

ABSTRACT

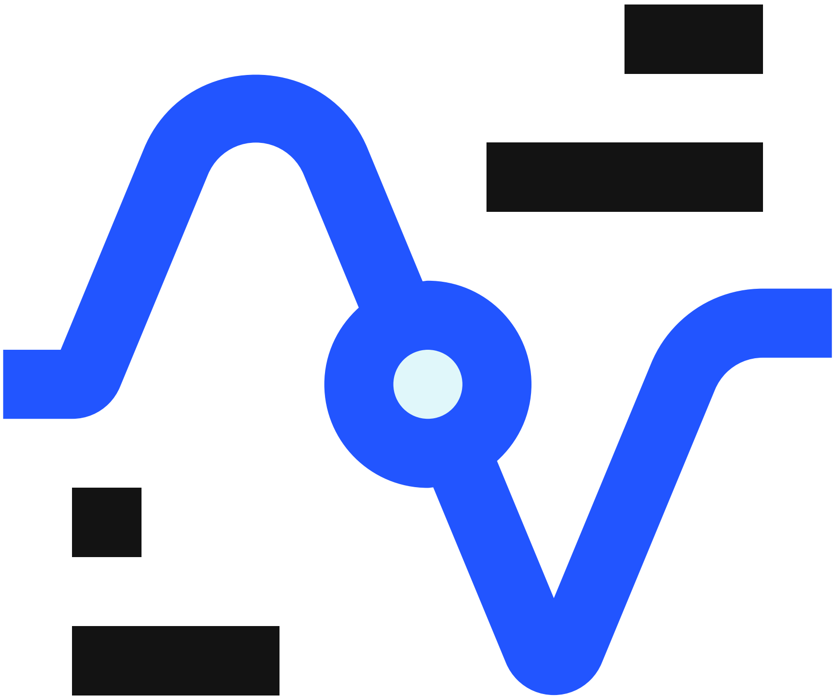
Financial managers must understand the financial information for some purposes. It is used to communicate with external parties who have interests in the company shareholders. Financial statement is also used to monitor employee's performance and for tax calculation or analysis purposes. The analysis of financial statements is a process of translating data contained in the financial statement of a business into meaningful information for users who are the interested parties of the business. There are several financial statements analysis approaches used by analysts as indicators of the company's performance. Financial ratio analysis is also a tool used by the individual or organization to conduct a quantitative analysis of information for the company's financial statement. Financial ratios are calculated from the current year numbers and then compared to previous years with other companies, industry, and economy to verify the performance of the company.

TABLE OF CONTENT

LEARNING OUTCOME

AT THE END OF THE CHAPTER STUDENT WILL BE ABLE TO:

1. Determine the concept and the purposes of financial Statement to different groups of users

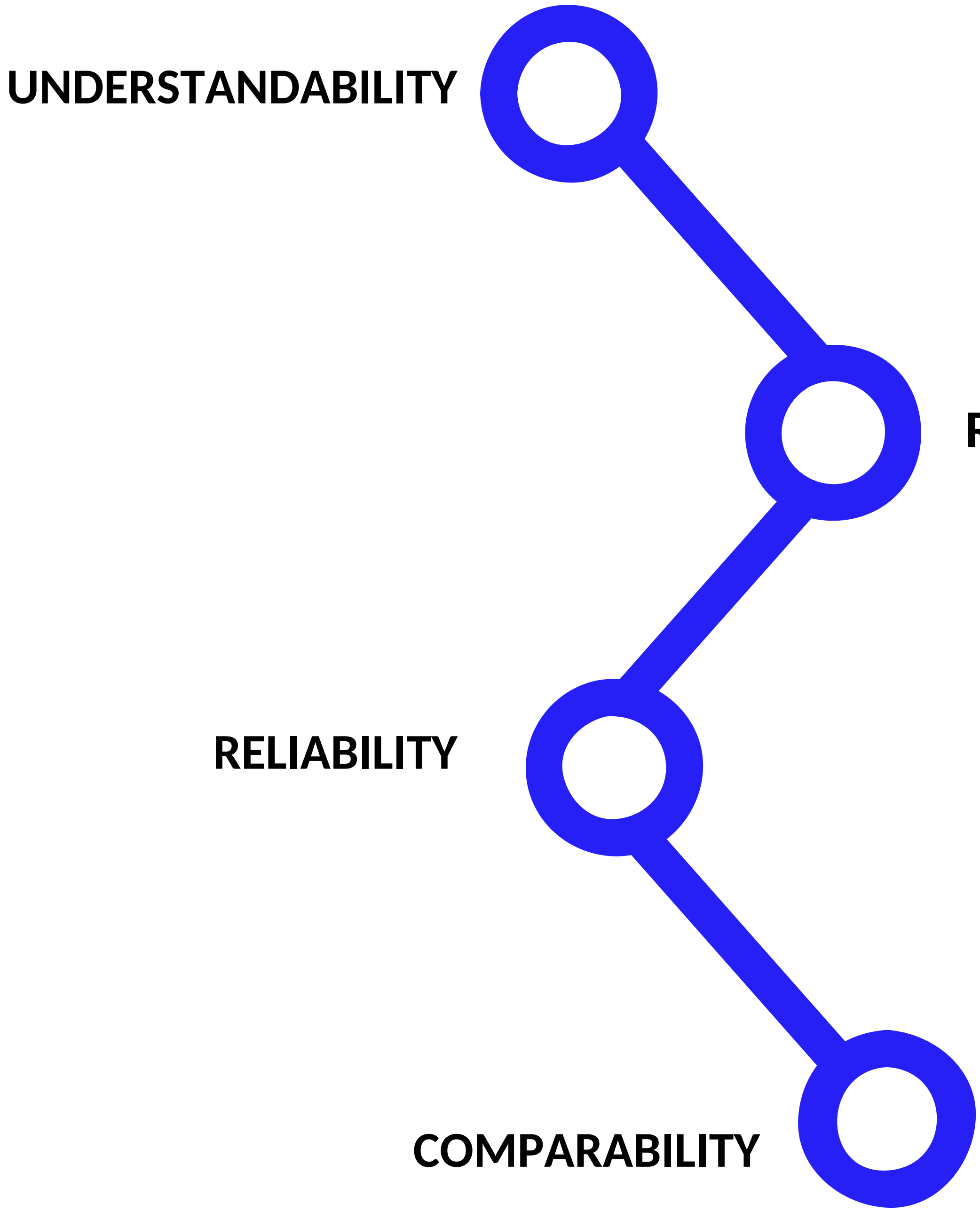


2. Characterize functions and purposes of financial statement

3. Explain the importance of financial statement

CHARACTERISTICS OF FINANCIAL STATEMENT

CHARACTERISTICSOF FINANCIAL STATEMENT



CHARACTERISTICSOF FINANCIAL STATEMENT

Understandability

The information must be readily understandable to users of the financial statements. This means that information must be clearly presented, with additional information supplied in the supporting footnotes as needed to assist in clarification.

Relevance

The information must be relevant to the needs of the users, which is the case when the information influences their economic decisions. This may involve reporting particularly relevant information, or information whose omission or misstatement could influence the economic decisions of users.

Reliability

The information must be free of material error and bias, and not misleading. Thus, the information should faithfully represent transactions and other events, reflect the underlying substance of events, and prudently represent estimates and uncertainties through proper disclosure.

Comparability

The information must be comparable to the financial information presented for other accounting periods, so that users can identify trends in the performance and financial position for the reporting entity.

THE PURPOSES OF FINANCIAL STATEMENTS

PURPOSES OF FINANCIAL STATEMENTS

The purpose of financial statements is to provide pertinent information on the financial position (Balance Sheet), profitability (Income Statement) and operating, investing, and financing activities (Cash Flow Statement) of a company.

Financial statements are used by existing shareholders, executives, employees, investors, existing and potential institutional stakeholders such as banks or vendors, and any other persons or institutions who need to analyze a company.

PURPOSES OF FINANCIAL STATEMENTS

Financial statements are written records that convey the business activities and the financial performance of a company. Financial statements are often audited by government agencies, accountants, firms, etc. to ensure accuracy and for tax, financing, or investing purposes.

IMPORTANCE OF FINANCIAL STATEMENTS

The most important use of the financial statements is to provide information about the financial position of the business on a given date. This piece of information is used by various stakeholders in order to take important decisions regarding the business.

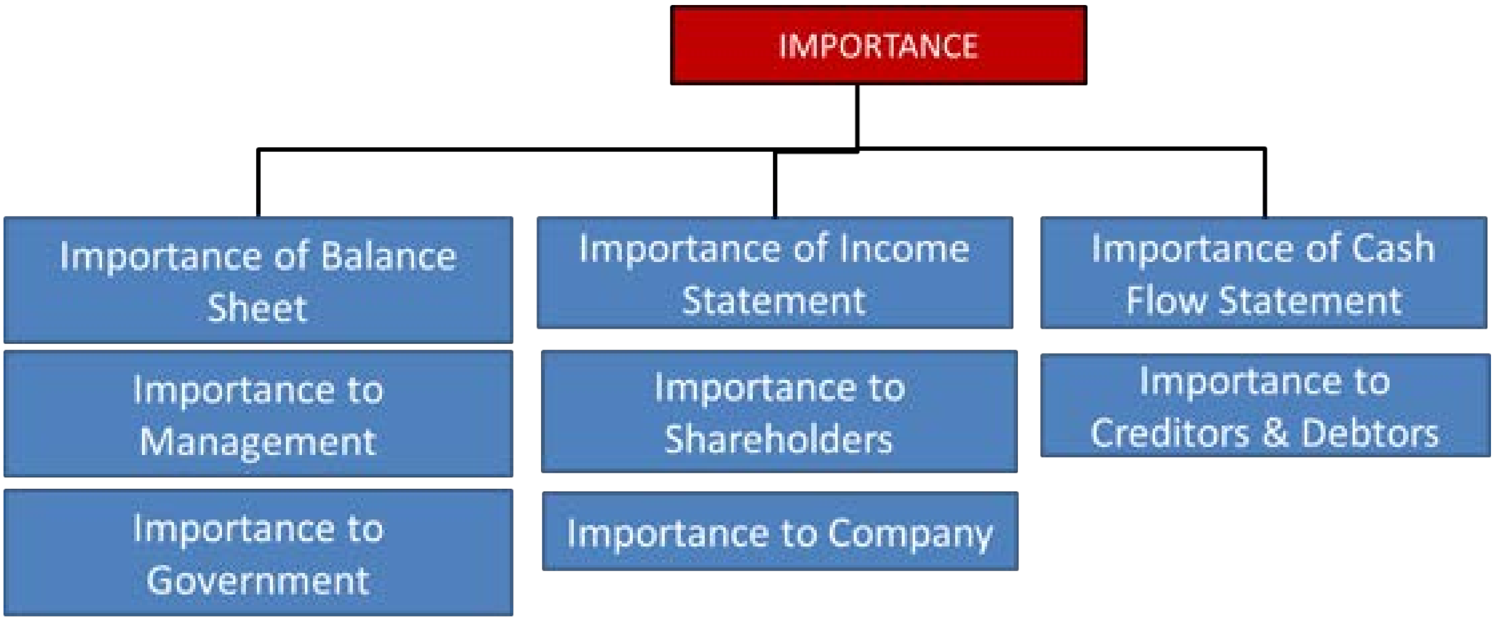
It provides internal and external stakeholders with the opportunity to make informed decisions regarding investing. Financial statement analysis also provides lending institutions with an unbiased view of a business's financial health, which is helpful for making lending decisions.

USERS AND THEIR PURPOSES

INTERNAL
Owners, managers, and employees

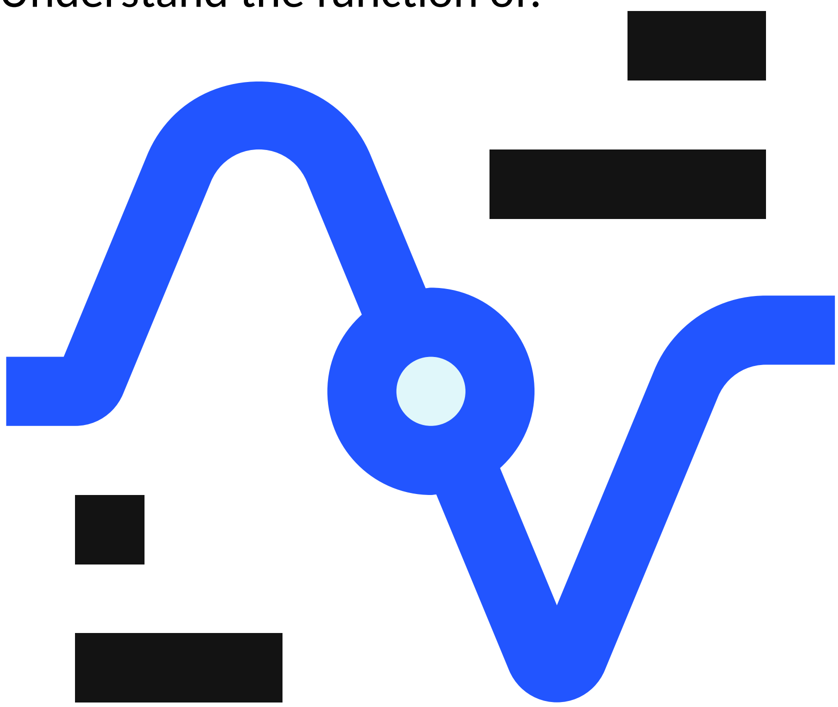
EXTERNAL
People outside the business entity (organization) who use accounting information. Examples of external users are suppliers, banks, customers, investors, potential investors, and tax authorities.

IMPORTANCE OF FINANCIAL STATEMENTS



AT THE END OF THE CHAPTER STUDENT WILL BE ABLE TO:

Understand the function of:



Income statement

Cash flow statement

Balance sheet

BALANCE SHEET

The balance sheet shows the financial position of the company and provides detailed investments of the companies asset investments. The balance sheet also contains the companies debt and equity levels. This capital mix helps investors and creditors understand the position and the companies performance

The balance sheet is a snapshot of the companies assets, liabilities, equity, and debt. It does not show what actually happened in the period that caused the company to get to the position where it is now.

WHAT IS A BALANCE SHEET?

A balance sheet is a financial statement that communicates the so-called "book value" of an organization, as calculated by subtracting all of the company's liabilities and shareholder equity from its total assets.

A balance sheet offers internal and external analysts a snapshot of how a company is currently performing, how it performed in the past, and how it is expected to perform in the immediate future. This makes balance sheets an essential tool for individual and institutional investors, as well as key stakeholders within an organization and any outside regulators.

Balance sheets are arranged according to this equation:

Assets = Liabilities
+ Shareholders' Equity

1. ASSETS

An asset is anything a company owns which holds some amount of quantifiable value, which means that it could be liquidated and turned in to cash. They are the goods and resources owned by the company.

Assets can be further broken down into current assets and non-current assets.

Current assets are typically what a company expects to convert into cash within a year time, such as cash and cash equivalents, prepaid expenses, inventory, marketable securities, and accounts receivable.

Non-current assets are long-term investments that a company does not expect to convert into cash in the short term, such as land, equipment, patents, trademarks, and intellectual property.

2. LIABILITIES

A liability is anything a company or organization owes to a debtor. This may refer to payroll expenses, rent and utility payments, debt payments, money owed to suppliers, taxes, or sukuk payable.

As with assets, liabilities can be classified as either current liabilities or non-current liabilities.

Current liabilities are typically those due within one year, which may include accounts payable and other accrued expenses.

Non-current liabilities are typically those that a company does not expect to pay within one year. They are usually long-term obligations, such leases, sukuk payable or credit facilities

3. SHAREHOLDERS' EQUITY

Shareholders' equity refers generally to the net worth of a company and reflects the amount of left over money ifall assets were sold and liabilities paid. Shareholders' equity belongs to the shareholders, whether they be private or public owners.

Just as assets must equal liabilities plus shareholders' equity, shareholders' equity can be depicted by this equation:

Shareholders' Equity = Assets - Liabilities

HOW TO PREPARE BALANCE SHEET?

1. Determine the Reporting Date and Period

2. Identify the Assets - non-current assets & current assets

3. Identify the Liabilities – non-current liabilities & current liabilities

4. Calculate Shareholders' Equity

5. Add Total Liabilities to Total Shareholders' Equity and Compare to Assets

EXAMPLE OF BALANCE SHEET

Kenyalang Company Ltd.

Balance Sheet as at 31 December 2020

	RM('000)
Assets	
Cash	9.5
Acc. Receivables	233.2
Inventories	133.9
Total current assets	RM 376.6
Plant and net equipment	203.8
Total assets	RM 580.4
Liabilities and shareholders' Equity	
Accounts payable	
Notes payable	66.2
Accrued expenses	77.7
Total current liabilities	RM 162.7
Bonds	74.4
Long-term liabilities	19.6
Total Liabilities	RM 256.7

EXAMPLE OF BALANCE SHEET

Kenyalang Company Ltd.

Balance Sheet as at 31 December 2020

	RM('000)
Preferred share	10.0
Common shares	45.4
Retained earnings	268.3
Total equity	RM 323.7
Total liabilities and shareholders' equity	RM 580.4

INCOME STATEMENT

Income statement format contains sales, expenses, losses, and profit. Using these statements can help investors to evaluate the companies past performance and determine the future cash flows

WHAT IS INCOME STATEMENT?

An income statement is a financial statement that shows the company's income and expenditures. It also shows whether a company is making profit or loss for a given period.

The income statement, along with balance sheet and cash flow statement, can help you understand the financial health of your business.

HOW TO PREPARE THE INCOME STATEMENT

To prepare an income statement, small businesses need to analyze and report their revenues, expenses and the resulting profits or losses, for a specific reporting period.

The income statement, also called a profit and loss statement, is one of the major financial statements issued by businesses, along with the balance sheet and cash flow statement.

Income statements show how much profit a business generated during a specific reporting period and the amount of expenses incurred while earning revenue.

Three main Elements of Income Statement:

Revenues

Expenses

Profits or Loss

EXAMPLE OF INCOME STATEMENT

Kenyalang Company Ltd.

Income statement for the year ended December 31, 2020

	(RM'000)
Sales	546.9
Cost of goods sold	(286.3)
Gross profit	RM 260.6
Selling expenses, general & administrative	186.2
Depreciation and amortization	(22.7)
Earnings before interest and tax	RM 51.7
Interest expense	(7.7)
Earnings before tax	RM 44.0
Tax	(8.1)
Net profit	**RM 25.9**

EXAMPLE OF INCOME STATEMENT

Kenyalang Company Ltd.

Income statement for the year ended December 31, 2020

	(RM'000)
Sales	546.9
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Earnings before interest and tax	RM 51.7
Interest expense	(7.7)
Earnings before tax	RM 44.0
Tax	(8.1)
Net profit	**RM 25.9**

Preferred for common shares	(1.0)
Net profit for common shares	RM 24.9
Dividends on common shares	(4.5)
Additional to retained earnings	RM 20.4

Share Information:	
Earnings per share (EPS)	RM 2.77
Per share Dividend	RM 0.50
Share 'Outstanding'	9,000 units

CASH FLOW STATEMENT

Cash flow statement shows the in flow and the out flow of the cash flow in and out of business during the financial period. This gives the investors ideas whether the company has enough funds to pay for its expenses and purchases.

The cash flow statement has all three main headings; i.e Operating, Investing, and Financing. This gives the business an overview of the entire business as a whole.

WHAT IS CASH FLOW STATEMENT

A cash flow statement is a financial statement that provides aggregate data regarding all cash in flows a company receives from its ongoing operations and external investment sources.

It also includes all cash out flows that pay for business activities and investments during a given period.

3 SECTIONS OF THE STATEMENT OF CASH FLOWS

Operating Activities:
The principal revenue-generating activities of an organization and other activities that are not investing or financing; any cash flows from the current assets and current liabilities.

OPERATING

Investing Activities:
Any cash flows from the acquisition and disposal of long-term assets and other investments that are not included in the cash equivalents

INVESTING

Financing Activities:
Any cash flows that result in changes in the size and composition of the contributed equity capital or credit facilities of the entity (i.e., sukuk, stock, dividend)

FINANCING

EXAMPLE OF CASH FLOW STATEMENT

Kenyalang Company Ltd.

Statement of Cash Follows for the year ended

December 31, 2020

	(RM'000)
Cash Flows from Operating Activities	
Net profit	RM 25.9
Depreciation and amortization	22.7
Reduction in Acc. Receivables	(29.9)
Decrease in inventories	(15.1)
The increase in Acc. Payable	4.1
Increase in accrued expenses	15.7
Cash from net operating activities	RM 23.4
Cash Flows from Investing Activities	
Purchase of plant and equipment	RM (59.5)
Cash Flows from Financing Activities	
Increase in notes payable	RM 33.0
Net publication of long-term debt	4.2
Increase in other long-term liabilities	1.9
Cash dividend (common shares & preferred share)	(5.5)
Net cash from financing activities	RM 33.6
The increase (decrease) in cash	RM (2.5)
Cash at beginning of year	12.0
Cash balances at the end	RM 9.5

THE PURPOSES AND THE USES OF EACH FINANCIAL RATIOS

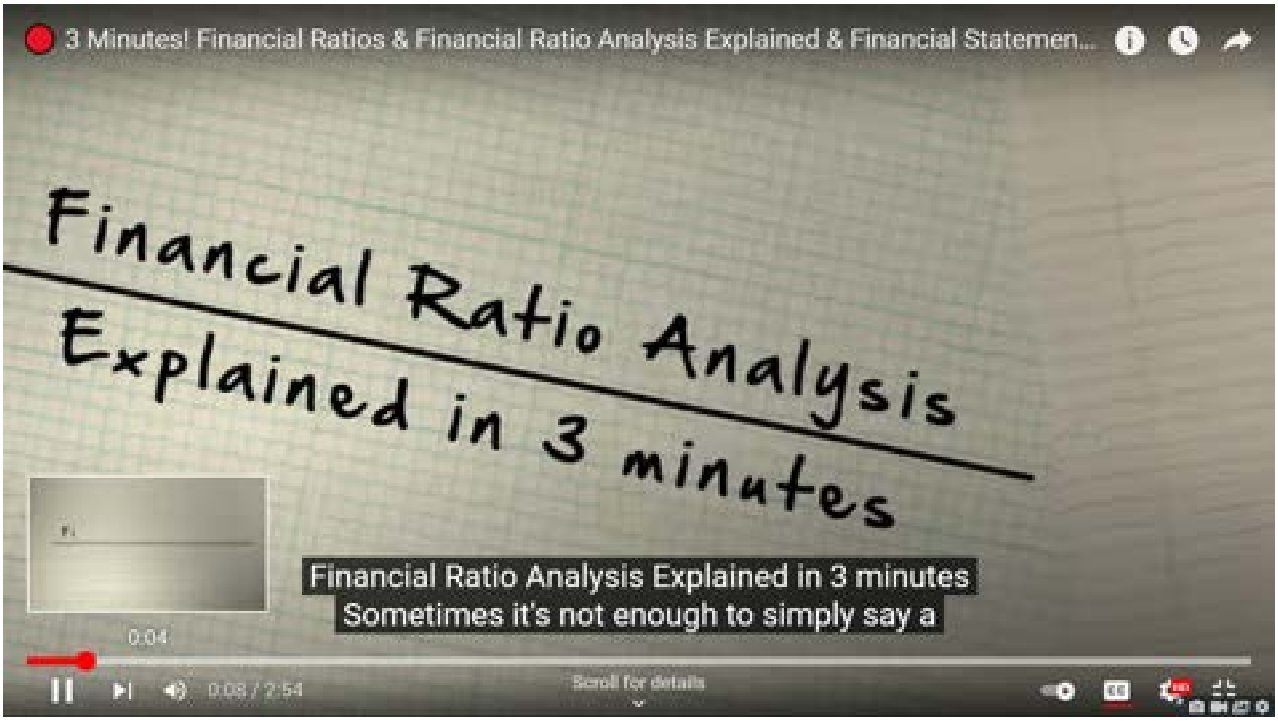
TYPES OF FINANCIAL RATIOS

LIQUIDITY RATIOS

ACTIVITY RATIOS

LEVERAGE RATIOS

PROFITABILITY RATIOS



https://www.youtube.com/watch?v=TZZFBkbC2lA

3 MINUTES! FINANCIAL RATIOS ANALYSIS

LIQUIDITY RATIOS

Emphasize on the ability to pay off short- term obligations as they come due.

Quickly impacts day to day operation.

Focus bankers and creditors on the ability to generate timely cash flow.

Determine a company's ability to pay off short-term debt obligations.

The higher the value of the ratio, the larger the margin of safety that the company possesses to cover short- term debts.

ACTIVITY RATIO/ EFFICIENCY RATIO

This ratio measures the extent of efficiency of firms in using its resources to generate sales.

This ratio also marks the effectiveness or efficiency of the company in managing its investment in inventory.

LEVERAGE RATIOS

This ratio indicates the degree to which an investor or business utilizes the fund from credit facility.

Companies that are highly leveraged maybe at risk of bankruptcy if they are unable to make payments for debts: they may also be unable to find new financiers in future.

This ratio also shows how the firm is being financed and whether it is able to meet its interest or financier's profit expenses.

PROFITABILITY RATIOS

The ability of management to generate adequate profits from the use of firm's capital and assets.

Measure return (profit) on sales, total assets and shareholders' capital.

Examine the effective employment of resources.

Depend to the adequacy of sales level.

Influence share price performance and thus, are important to equity investors and security analyst.

LIQUIDITY RATIOS

Liquidity Ratios

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

CURRENT RATIOS

This ratio indicates the extent of a firm’s liquidity, as measured by the firm’s liquid assets (current asset) relative to its liquidity liabilities (current liabilities). This ratio analyses from the firm's assets that are relatively liquid in nature and match them to the short-term liabilities of the firm.

EXAMPLE

$$\textbf{Current ratio} = \frac{\textbf{Current assets}}{\textbf{Current liabilities}}$$

$$\textbf{Current ratio} = \frac{186{,}000}{207{,}000}$$

$$= 0.90\text{ x}$$

Industry average = 1.80 x

QUICK RATIOS

Quick ratios measure a company's capacity to pay its current liabilities without needing to sell its inventory or obtain additional financing.

EXAMPLE

Quick ratio/ Acid Test Ratio $= \dfrac{\textbf{Current assets – Inventories}}{\textbf{Current liabilities}}$

Quick ratio $= \dfrac{\textbf{186,000 – 136,500}}{\textbf{207,000}}$

= 0.24 x

Industry average = 0.70 x

ACTIVITY RATIOS

INVENTORY TURNOVER

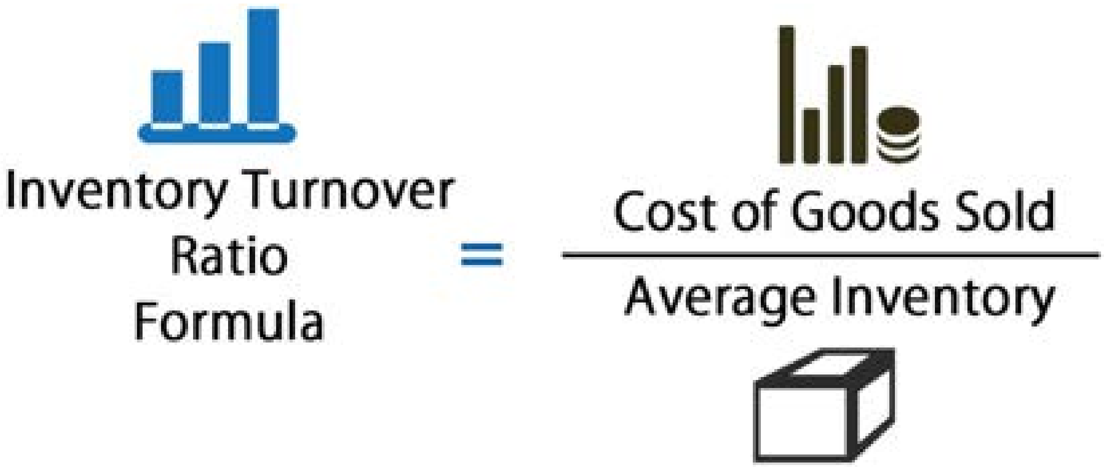
AVERAGE COLLECTION PERIOD

TOTAL ASSET TURNOVER

FIXED ASSET TURNOVER

ACCOUNT RECEIVABLES TURNOVER

INVENTORY TURNOVER



It measures the speed with which inventory is sold.

EXAMPLE

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

@

$$\text{Inventory turnover} = \frac{\text{Sales}}{\text{Inventory}}$$

$$\text{Inventory turnover} = \frac{288{,}000}{136{,}500}$$

$$= 2.1\text{ x}$$

AVERAGE COLLECTION

$$\text{Average Collection Period} = \frac{\text{Accounts Receivable Balance}}{\text{Total Net Sales}} \times 365$$

It measures how long it takes for a firm to collect its accounts receivables

EXAMPLE

$$\textbf{Average collection period} = \frac{\textbf{Accounts receivable x 365 days}}{\textbf{sales}}$$

$$\textbf{Average collection period} = \frac{\textbf{48,000 x 365 days}}{\textbf{480,000}}$$

$$\textbf{= 36.5 \sim 37 days}$$

ACTIVITY RATIOS

ASSET TURNOVER

$$\text{Asset turnover} = \frac{\text{Revenue (sales)}}{\text{Net assets}}$$

It measures the overall efficiency of the firm in managing its assets to generate sales

Revenue = RM21,450
Net Assets = RM4,455
Asset Turnover = 4.8 times

EXAMPLE

$$\textbf{Total asset turnover} = \frac{\textbf{Sales}}{\textbf{Total assets}}$$

$$\textbf{Total assets turnover} = \frac{480{,}000}{450{,}000}$$

$$= 1.07\text{ x}$$

Industry average = 1.14 x

FIXED ASSET TURNOVER

$$\text{Fixed asset turnover ratio} = \frac{\text{Revenue}}{\text{Fixed assets}}$$

It measures the efficiency in which the management uses its long term assets to generate sales.

EXAMPLE

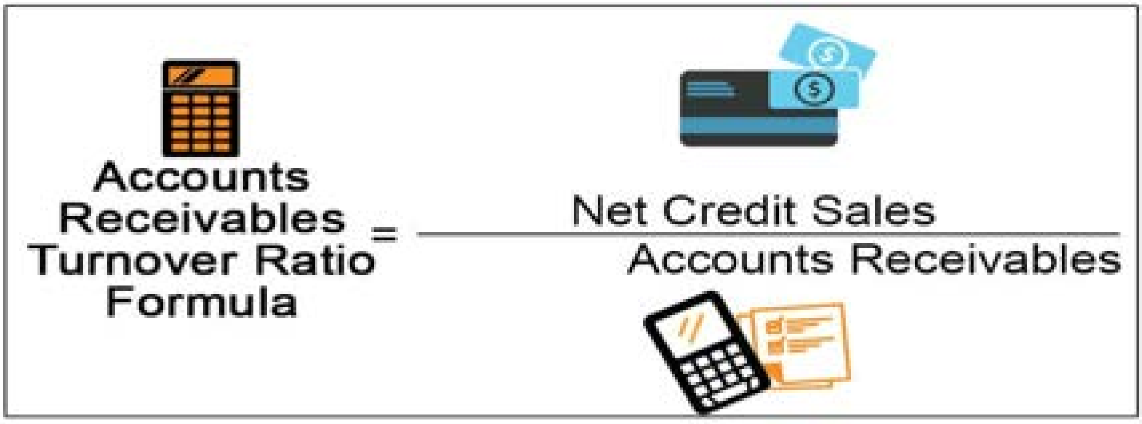
$$\textbf{Fixed asset turnover} = \frac{\textbf{Sales}}{\textbf{Fixed assets}}$$

$$\textbf{Fixed asset turnover} = \frac{\textbf{480,000}}{\textbf{264,000}}$$

$$= \textbf{1.8 x}$$

Industry average = 1.4 x

ACCOUNT RECEIVABLES TURNOVER



Is an efficiency ratio or activity ratio that measures how many times a business can turn its accounts receivable into cash during a period

EXAMPLE

$$\text{Account Receivables Turnover} = \frac{\text{Credit Sales}}{\text{Account Receivables}}$$

$$\text{Account Receivables Turnover} = \frac{480{,}000}{48{,}000}$$

$$= 10\text{ x}$$

LEVERAGE RATIOS

DEBT RATIO

RETURN ON INTEREST/ INTEREST COVERAGE RATIO

DEBT EQUITY RATIO

DEBT RATIO

it measures the extent to which a firm uses debt financing.

EXAMPLE

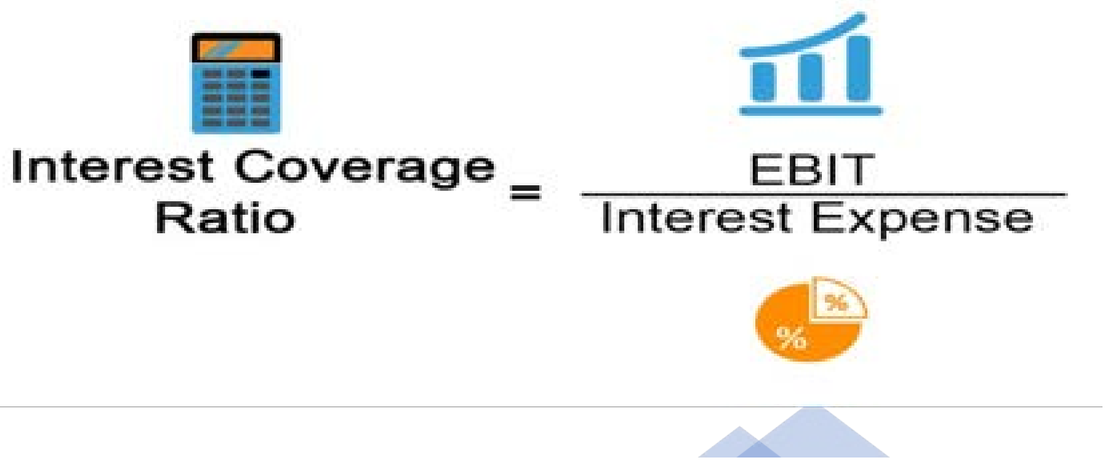
$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

$$\text{Debt Ratio} = \frac{207{,}000 + 68{,}850}{450{,}000}$$

$$= 61.3\%$$

Industry Average = 50%

INTEREST COVERAGE RATIO



To measure firm's ability to service its debts

EXAMPLE

Return on interest = $\dfrac{\text{Earnings before interest and tax (EBIT)}}{\text{Interest expense}}$

Return on interest = $\dfrac{51{,}000}{18{,}300}$

= 2.8 x

Industry average = 3.8 x

DEBT EQUITY RATIO

Shows the proportion of equity and debt a company is using to finance its assets and signals the extent to which shareholder's equity can fulfill obligations to creditors, in the event of a business decline

EXAMPLE

Debt equity ratio = Total liabilities (debt) / Shareholders' equity

Debt ratio = (207,000 + 68,850) / 174,150

= 1.58 x

Industry average = 1.42 x

PROFITABILITY RATIOS

GROSS PROFIT MARGIN

OPERATING PROFIT MARGIN

NET PROFIT MARGIN

RETURN ON ASSET

RETURN ON EQUITY

GROSS PROFIT MARGIN

To measure the percentage of gross profit to sales.

EXAMPLE

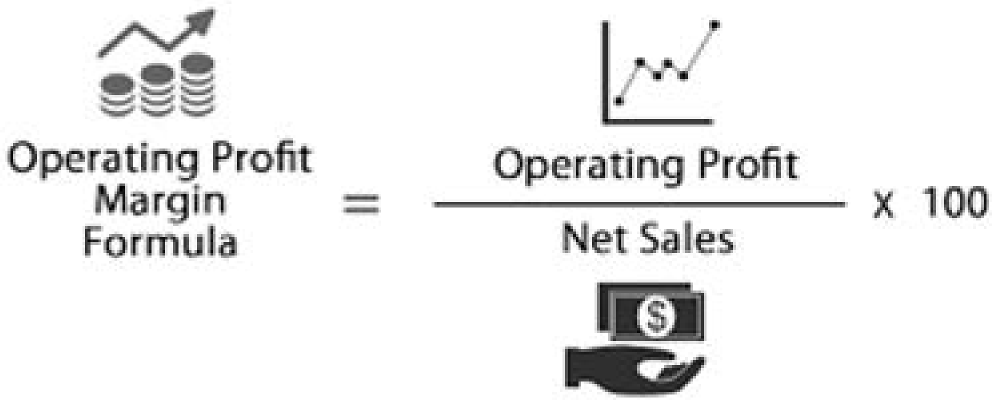
$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}}$$

$$\text{Gross profit margin} = \frac{192{,}000}{480{,}000}$$

$$= 0.4 \ @ \ 40\%$$

Industry average = 38%

OPERATING PROFIT MARGIN



It reflects the percentage of profit a company produces from its operations, prior to subtracting taxes and interest/ financier's profit charges.

EXAMPLE

$$\textbf{Operating profit margin} = \frac{\textbf{Net Operating Income (EBIT)}}{\textbf{Sales}}$$

$$\textbf{Operating profit margin} = \frac{32{,}700 + 18{,}300}{480{,}000}$$

$$= 0.11 \text{ @ } 11\%$$

Industry average = 10%

NET PROFIT MARGIN

To measure the percentage of profit after tax to sales.

EXAMPLE

$$\text{Net profit margin} = \frac{\text{Net Income}}{\text{Sales}}$$

$$\text{Net profit margin} = \frac{16{,}350}{480{,}000}$$

$$= 0.034 \text{ @ } 3.4\%$$

Industry average = 3.5%

RETURN ON ASSETS

To measure how efficient a company's management is in generating earnings from their economic resources or assets on their balance sheet.

EXAMPLE

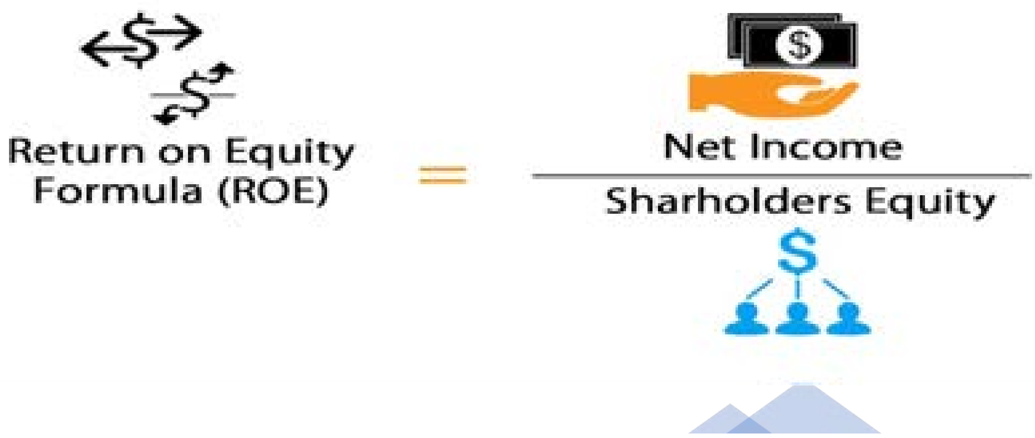
Return on total assets (ROA) = $\dfrac{\text{Net income}}{\text{Total assets}}$

Return on total assets (ROA) = $\dfrac{16{,}350}{450{,}000}$

= 0.0363 @ 3.6%

Industry average = 4.0%

RETURN ON EQUITY



To measure the rate that the firm is earning on the stockholders’ investment.

EXAMPLE

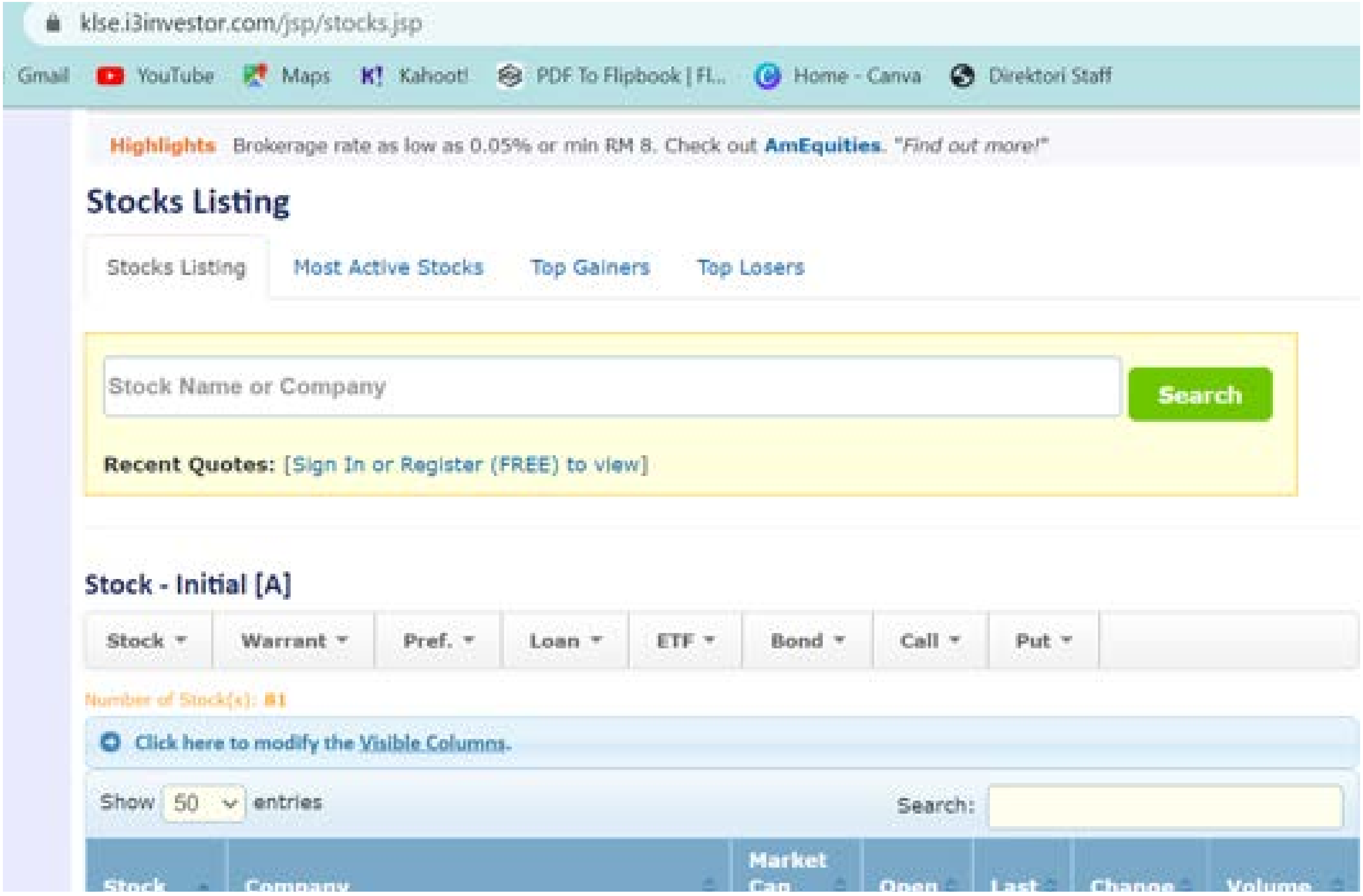
$$\text{Return on owners' equity (ROE)} = \frac{\text{Net profit}}{\text{Equity owners}}$$

$$\text{Return on owners' equity (ROE)} = \frac{16{,}350}{174{,}150}$$

$$= 0.094 \text{ @ } 9.4\%$$

Industry average = 9.5%

PRACTICAL EXERCISE



https://klse.i3investor.com/jsp/stocks.jsp

1. CHOOSE ANY SHARIAH COMPLIANT COMPANY

2. ANALYZE COMPANY'S PERFORMANCE BASED ON ITS FINACIAL RATIO

https://www.youtube.com/watch?v=SHAaBeVKak4

TUTORIAL EXERCISE

https://docs.google.com/document/d/14DY__ae0xs3f1Y2DGvQrfU-ZiATyIUx2TBoeDLcKwRA/edit?usp=sharing

This eBook facilitates students to understand the topic of Financial Statement Analysis in Financial Management From Islamic Perspective course

Simple *Focus* *Informative*

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