CIPS KNOWLEDGE

Simplifying Financial Analysis - ICEBERGS®

Making financial analysis easy.

This knowledge paper is supportive of Procurement professionals operating at operational level of the CIPS Global Standard

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Simplifying Financial Analysis - ICEBERGS®

Background/Introduction

Based on recent research, 'Financial Analysis' skills are crucial to people working in procurement roles. In a survey of experienced procurement practitioners, financial analysis skills ranked fifth in the 'top ten' contract management skills. In addition, respondents widely acknowledged that financial analysis skills are also applicable to most roles in procurement and supply.

Why? Finance is often the common language across different internal stakeholders and in the boardroom. Procurement professionals need to be able to communicate with all stakeholders, especially those within the organisation, so being 'fluent' in their language is important. But it is equally important that procurement professionals are confident about applying financial analysis to manage risk. Being able to spot early warning signals of potential supplier issues, for example, is a vital part of the procurement professional's job. Understanding a supplier's finances can also help achieve a better outcome from negotiations.

Not everyone is confident when dealing with numbers. It is not about being clever or not; we are all different and often we think differently. For those who are not confident with numbers being faced with a set of financial statements can be extremely daunting. Especially when working in a procurement role where the expectation of other stakeholders is that you will have a good level of financial analysis skills. But the good news is, you can get to grips with financial analysis by applying a structured approach. You do not need to be an accountant and it is not necessary to know how to calculate hundreds of ratios – far from it. The procurement and supply perspective provides clarity of focus on a relatively narrow number of key financial performance measures. Throughout this paper, I will be referring to assessing the financial performance of companies (both private and public).

Financial Statements

So, what do you need? A set of financial statements – in particular the Balance Sheet and Income Statement, which is often referred to as the Profit & Loss Account. Already we have highlighted a challenge. Do not panic. There are accounting terms that are frequently used interchangeably, so that can appear confusing. It is not really. For example, revenues are income (or sales); inventories are stock; payables are creditors; and receivables are debtors. What are sometimes referred to as fixed assets are now more commonly termed non-current assets. Understanding the concept of 'current' is important. Anything that is viewed as 'current' will be changing in value within the short-term, ie within less than twelve months. Inventories for example are a current asset. Why? Because inventories will be changing all of the time, often on a daily basis. Sometimes many times during a 24-hour period. So current assets and current liabilities are short-term. It follows then that anything that is non-current has a long-term impact, for example non-current assets (it has already been stated that these are fixed assets, for example land and buildings).

Ideally you need financial statements for two or three years or more. This is so you can identify what 'normal' is for the company and so you can see whether there are areas that are deteriorating or improving. If possible, an industry or sector report showing typical financial ratios would also be useful for benchmarking, but this is not essential.

Some Considerations

Most importantly you need to know what to look for and how to calculate and interpret the data and ratios. This is often the daunting part, but it is actually quite straightforward – think **ICEBERGS®**.

Why? First, it is important to recognise that the financial statements themselves represent only what is in public view – the tip of the iceberg. We should also be interested in what lies beneath the numbers and what are driving them. For example, what is the business model of the company and is it valid in the context of the markets in which it operates? Has the model changed? Does it operate in a market that is growing or is the market contracting? So, it can be seen that we need to be able to dig more deeply below just what is on the surface. Secondly, we need to focus on what is important to us from a procurement and supply risk perspective. This is important – we are not looking at the company like a lending bank or a potential investor would. We do not need to explore every single known financial ratio. Our framework for undertaking the financial assessment is provided by the **ICEBERGS®** mnemonic - Interest, Costs, Efficiency, Borrowings, Earnings, Revenue, Gearing, Solvency.

Applying The ICEBERGS® Framework

Interest	Shown in the Income Statement. What is the interest cost relative to the supplier's profit (ideally measured against EBITDA, see below)? Calculate the interest cover ratio. The higher it is the better.
Costs	This information is also shown in the Income Statement. Ascertain whether costs are going up or down in relation to revenues. Where cost growth is lower than revenue growth it is generally a good indicator that the business is well run in terms of cost management. Assess direct and indirect costs (these are often shown as cost of sales and expenses in the Income Statement. Note that direct costs relate directly to products/services; indirect costs are business overheads.
Efficiency	This part of the framework focuses on how effective the company is at working capital management. Using its own capital for funding the business is far cheaper than having to borrow money externally. Working capital comprises things like inventory, receivables, and payables. You can calculate inventory turnover/days, and receivables and payables days. This is where the Balance Sheet and Income Statement work together as you will need the inventory, receivables and payable information from the Balance Sheet and the revenues and cost of goods sold (direct costs) information from the Income Statement.
Borrowings	Debt can be a huge burden on any business as it is borrowed money. The two key implications of debt for the business are the obligation to repay it (often in regular instalments) and also to meet interest commitments. On larger borrowings there

	may be other significant conditions attached, for example financial covenants that must be met otherwise the company will be in default. Check out both long-term and short-term debt. This information is in the Balance Sheet. Is this increasing year-on-year? Look out for what it has been used for; has it been used to buy assets? Compare total debt against interest cover and gearing (see below).
Earnings	Also known as profits. There are several different types of profit. Gross profit is the difference between revenues and direct costs. When the expenses are also deducted this gives the net profit. EBITDA (earnings before interest tax depreciation and amortisation) is a commonly used measure of actual profit generated from operations. This is because it includes all direct and indirect costs, but is calculated before financing and other non-operating costs (eg depreciation and amortisation). Profit is important – many businesses can sustain losses but not for prolonged periods. But 'profit' does not equate with cashflow. It is entirely possible for a profitable business to go bust, if it does not have access to cash or credit when bills are due. Relevant information relating to profit is in the Income Statement. However, check the Balance Sheet (retained earnings or equivalent) to see how much previous profit has been retained within the business.
Revenues	Arguably the lifeblood of the business. The information is shown in the Income Statement. Typically, changes in revenues should at least reflect the market. So, for example, if a market is growing at 5%, revenues should be growing at the same rate. It is important to consider revenues and costs, because whilst revenues may be growing if costs are increasing more quickly then profitability is declining.
Gearing	This is without doubt a crucial ratio. It relates to how the business is funded long-term. It considers all of the long-term 'capital' whether debt or equity. The gearing ratio is long-term debt:equity. Why is this an important consideration? Debt must be repaid, whereas equity is generally regarded as permanent capital and so does not come with any commitment by the company to repay. In addition, with equity there is no interest to pay, although the company's board may declare a dividend but is under no legal obligation to do so on most classes of shares. So, the higher the gearing the more nervous we are in terms of debt affordability, especially if interest rates are expected to rise. The information to calculate the ratio is in the Balance Sheet. Gearing should be considered in conjunction with the level of interest cover and the current ratio (see below). Note – there are different methods of calculating gearing, but long-term debt:equity is one of the most commonly used.
Solvency	Arguably the most important measure in terms of business survival, because companies go bust due to insolvency. Solvency is all about ensuring that today's, tomorrow's and next week's obligations can be paid when they fall due. Relevant information is shown in the Balance Sheet. Look at the current assets against current liabilities. We have already seen that anything that is 'current' is short-term. Ideally, we are looking for more current assets than current liabilities. This is the current ratio. For many businesses we should exclude inventories from the current assets calculation as these are often worth very little or maybe even nothing at all. The acid test or quick ratio is the same calculation as the current ratio although inventories are excluded.

An Example

Here is an example for you to work through. The Income Statement is an extract only, ie it is incomplete, but you have all the information to complete the calculations. Further, the information is for one year only. To undertake a detailed assessment you should have a number of years' information (if available) so you can compare and identify how things are changing. The example will however provide the opportunity to work through the calculations. As you do so think about what the results are indicating.

Try calculating the following (without looking at the answers, which are provided at the end of this paper):

1. Interest cover
2. Gross profit margin
3. EBITDA margin
4. Gearing
5. Current ratio
6. Acid test ratio
7. Total debt
8. Inventory days/turnover
9. Receivables days
10. Payables days

Income Statement Items - Y/E DD/MM/202X*	
	CCY
Revenues	7,355,200
Cost of sales	5,884,160
Gross Profit	1,471,040
Expenses	882,624
EBITDA	588,416
Interest costs	98,069
Tax	235,366
Depreciation	58,842
* Extract only	

Source: Colin Linton

Balance Sheet at DD/MM/202X

	CCY		CCY	CCY
		Non-current Assets		
Shares issued	2,574,320	Land and buildings	3,597,116	
Retained earnings	1,103,280	Equipment	1,103,164	4,700,280
	3,677,600			
		Current Assets		
Long-term bank loan (20 years)	2,677,600	Inventories	956,176	
	6,355,200	Receivables	2,206,560	
		Cash	330,984	3,493,720
		Current Liabilities		
		Overdraft	279,498	
		Payables	1,323,936	
		Tax	235,366	1,838,800
				6,355,200

Source: Colin Linton

Conclusion

For many professionals whether in procurement and supply or other disciplines improving financial skills should be an important part of learning and development. Even those who feel they are competent in this area should consider a 're-fresh' on a regular basis, unless of course they are dealing with finance on a regular basis. There is no doubt that for some people, finance is viewed as an area to avoid. With the ICEBERGS® framework I have attempted to provide a logical structure and to ensure there is a focus on just the key areas of financial performance. Understanding the numbers can be insightful and might prove invaluable in terms of identifying early warning signs of potential issues.

Answers

1. Interest cover – 6x (CCY 588,416 ÷ CCY 98,069)
2. Gross profit margin – 20% (CCY 1,471,040 ÷ CCY 7,355,200 x 100)
3. EBITDA margin – 8% (CCY 588,416 ÷ CCY 7,355,200 x 100)
4. Gearing – 0.73 or 73% (CCY 2,677,600 ÷ CCY 3,677,600)
5. Current ratio – 1.9 (CCY 3,493,720 ÷ CCY 1,838,800)
6. Acid test ratio – 1.38 (CCY 2,537,544 ÷ CCY 1,838,800)
7. Total debt – CCY 2,957,098 (CCY 2,677,600 + CCY 279,498)
8. Inventory days/turnover – 59 days or 6.2x (CCY 956,176 ÷ CCY 5,884,160 x 365)
9. Receivables days – 109 days (CCY 2,206,560 ÷ CCY 7,355,200 x 365)
10. Payables days – 82 days (CCY 1,323,936 ÷ CCY 5,884,160 x 365)

About the Author

Colin Linton MRes MBA PGCHE DipM DipFS FCIB FCIM FCIPS FCIEA FHEA FInstLM is an academic and trainer in procurement, finance and marketing. The research mentioned in this paper contributed to a Masters in Research at the University of Leicester and is now part of an ongoing programme of data gathering and analysis. Contact him at: colin.linton@gideasolutions.com

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