Upsizing Financial Intelligence in a Financial Crisis

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*Many people have called the current global economic meltdown a financial tsunami. Do you have the necessary financial intelligence to ride out these challenging economic waves to protect your company's and your own financial interests? **James Leong**, Chartered Accountant and Certified Financial Planner, is the managing director and principal consultant of VisionsOne Consulting Pte Ltd. His experience includes teaching as an Adjunct Associate Professor with National University of Singapore. His highly popular workshop, Finance for Non-finance Managers, has been attended by international participants from more than 18 countries. He shares with you some quick tips on assessing companies and how to separate the good from the bad. James can be reached at jamesleong@visions1.com.sg or www.visions1.com.sg.*

A world in crisis

Around the world, demand is falling, banks are failing, and companies are faltering. The result is a rising trend in corporate frauds, financial misstatements and company failures. As corporate managers and investors, how can you ensure that you or your company does not become the next casualty in this swirling financial tide?

3 ways you are exposed

Firstly, with bank financing hard to come by, your customer could be using you as their long term financier for free, by stretching their payment. This would add to your company's own cash flow problems. Secondly, your supplier may have asked for advanced payment and gone bust before they deliver the goods to you. Or alternatively, they may be in such financial troubles that their failure would seriously disrupt your supply chain. Thirdly, your personal investments are at risk from the companies in your portfolio going bust due to cash flow problems.

Can you tell who is naked?

Accordingly to legendary investor Warren Buffett, he said that it is when the tide goes out that you know who is naked. It could be your customer, supplier or the company in your investment portfolio that are already or showing signs of vulnerability of financial collapse. When you read about how they went bust in the local newspapers, it would be too late for you to take precautions. To protect yourself, you must be able to see who are the vulnerable players (the naked ones) and take pre-emptive action early, before the tide goes out. This could mean selling on cash terms, switching suppliers or rebalancing your personal portfolio ahead of the curve.

Foretelling corporate fortunes

What form of business intelligence is needed for you to remain ahead of the curve? It is none other than the ability to read financial statements. Financial statements are like autobiographies of companies. They tell you volumes about a company, such as its strength, risk and potential. When you are able to master reading of financial statements, you will be able to foretell the fortunes of companies. This would enhance your ability to make financially intelligent decisions when it comes to managing businesses and money.

3 quick indicators

The 3 key financial statements that each company must prepare are:

Balance Sheet

This reveals the strength and risk of the company. The three elements of the balance sheet are Assets, Liabilities and Equity. The Law of Balance says that all Assets must be funded either by shareholders' money (Equity) or borrowed money (Liabilities). The higher the amount of funding that comes from borrowings, the higher the fixed costs and cash outflows for the business. With declining profits and cash inflows, this increases the riskiness of businesses that are highly leveraged in today's environment. This is also the key reason that brought down many once venerable financial institutions.

What to watch out for:

Companies with high Liabilities relative to their Equity are vulnerable. In particular, if their current assets (such as cash, trade debtors and inventories) are less than their current liabilities (bank borrowings and trade creditors), be very cautious. This is a sign that the company may not be able to convert its assets quickly enough into cash to pay for its obligations when they become due.

Income Statement

This measures the performance of the company. Essentially, Sales less Cost of Sales less Operating Expenses equals Profit. If you take Profit and divide by Sales, you obtain the Profit Margin of the business. If the margin is 10%, what it means is that for every dollar of sales, the company is able to extract 10 cents as profit (think of a juice extractor). The other 90% has gone to pay for costs and expenses.

What to watch out for:

Companies that have high margins before the downturn would be in a better position to weather the current economic climate. If you compare a business with a 2 % margin with a 20% margin business, the margin for error is very slim for a low margin business. A slash in the selling price of its products to compete would quickly erode whatever profit it has previously to a loss. Marginal players would be the first to leave the game as they run out of chips fast, while strong players will remain in the game during this shake out and consolidation phase and emerge stronger.

Cash Flow Statement

This measures the ability of the company to generate sufficient cash from its business operations to sustain its normal business and for investing in growth. It also shows you the extent of reliance on external sources of funding for its survival.

What to watch out for:

Check if their Cash Flows from Operating Activities are positive or negative. If it is negative, check if their trade debtors and inventories are swelling. This is a clear sign that the company is suffering from a cash crunch or liquidity crisis, caused by the inability to convert its current assets into liquid resources quickly enough.

Conclusion

The more you are able to make sense of financial jargon, you more you can appreciate and fully utilize financial statements as a readily available tool to size up companies instantly and make snap decisions about them. In this perfect financial storm, financial intelligence is the ark to shelter our assets and cash flow from unnecessary and preventable loss.