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Commentary

More than the bottom line

Investors should not just rely on net income as the sole measure of financial performance

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For The Straits Times

Investors are always interested to know how a company is performing financially. Headlines and attention are usually focused on the "bottom line" – the net profit or net income.

Many incorrectly assume all the line items that make up net income are equal in importance to the users. This is not the case.

To better understand the underlying performance of a business, investors need to understand three important accounting concepts: revenue recognition, realisation and cash flow from operations.

1. REVENUE RECOGNITION

A large part of a company's performance is its ability to generate sales for the goods or services that it offers.

The amount recognised as revenue is governed by an accounting standard called "revenue from contracts with customers".

Generally, revenue is recognised only when performance obligations are fulfilled, and the amount of revenue is measurable.

Revenue can be recognised even before cash is collected as long as the obligation to deliver goods or services is satisfied.

But cash collected from customers is not recognised as income until the company has satisfied its performance obligations.

For example, customer deposits or prepayments are recorded as liabilities (usually called "deferred revenue" or "deferred income") until performance obligations are fulfilled.

Proper revenue recognition and robust cut-off rules ensure that an income statement reflects the actual accomplishments of a company for the reporting period.

Companies are required to disclose how their revenue is recognised in the financial statements.

When the accompanying cost of sales is deducted from revenue, the margin is known as gross profit. It is how much a company earns from its underlying trading activity.

Generally, gross profit as a percentage is relatively constant unless there is a structural market change in prices and cost of materials.

After adding and deducting other line items, a net profit or net income is shown at the end of the income statement.

2. REALISATION

Many companies, notably those with large holdings in marketable securities, investment properties or biological assets, use mark-to-market or fair value accounting practices.

Mark-to-market accounting reports assets at fair values instead of their historical prices when the companies acquire them.

It aims to provide a more contemporary valuation for a company's assets.

Fair value is the price that would be received to sell an asset between market participants at each reporting date.

Changes in such valuations are recognised in the income statement. Some call these incomes unrealised or "paper gain/loss".

For example, a company may be "growing" as a result of mark-to-market valuations, with profitability rising in tandem.

While this method provides more relevant and faithful information on the balance sheet, it may cloud the actual business performance of a company on the income statement.

3. CASH FLOW FROM OPERATIONS

Ultimately, all companies need to be able to generate positive cash flow.

Specifically, cash flow from operating activities (CFO, shown in the statement of cash flows) should reflect the company's ability to generate cash to fund investments (cash flow for investing activities or CFI), and loan repayments to creditors and dividends to shareholders (both are cash flow for financing activities or CFF).

In short, the CFO is the difference between cash receipts and cash payments from transactions related to providing goods and services to customers in a year.

While CFO may be affected by timing issues, for example, receipts of cash from the prior year's sales or prepayment for a future year's expenses, it is generally regarded as a measure that is less affected by revenue recognition or valuation policies.

INCOME, FAIR VALUE CHANGES AND CASH FLOWS

Let's use a particular company as an example of how these concepts tie in together.

Hongkong Land had net income of US$5.63 billion in the 2017 financial year and US$2.46 billion in 2018. At first glance, it looks like its performance in 2018 had worsened significantly compared with 2017.

However, the 2017 income was boosted by a "paper gain" resulting from fair value changes in investment properties amounting to US$4.68 billion (compared with US$1.22 billion in 2018).

In other words, underlying performance excluding such gain was actually higher in 2018 (US$1.24 billion) than in 2017 (US$948 million).

Its operating cash flows for 2017 and 2018 respectively were US$800 million and US$604 million. It was able to generate larger operating cash flows in 2017, despite the lower net income excluding fair value changes.

Another example is UOL's second-quarter results released recently. Net profit increased by $110 million, a whopping 57 per cent from $192 million to $302 million. This can be attributed to fair value gains of $182 million versus $64 million the year before.

Therefore, investors should not just rely on the net income as the sole measure of financial performance.

They need to look deeper into what is earned and collected from operations versus income resulting from valuation adjustments.

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• This is the second instalment of a three-part series on financial literacy.

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