Seven reasons why you should exercise caution when interpreting financial statements

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Being a Psychologist issues of finance never used to worry me until I started running my own business 12 years ago. Ever since I started the journey of self-learning financial matters, I have discovered things that I never thought mattered. I have missed opportunities where I could have added value on issues to do with business performance discussions. I wish I had learnt some of the issues early but never the less I now know. The tragedy of business performance is that financial outcomes are largely the ultimate measures of business success. In the process of understanding financial statements I have a few reasons why I won't trust Accountants 100% and I am sharing these with you below:

1. Accountants use so many assumptions and estimates when preparing financial statements. Without understanding these assumptions you can misread the financial statements of companies. In some case, some financial statements do not disclose all the assumptions and estimates used when they publish their financial statements.

2. The treatment of income – what constitutes income depends on the interpretation (or definition) of income. When should the revenue be recognised again depends on who is in charge of the finances?

3. Capital or expense item – while there are accounting standards to guide accountants I have also noted that accountants can use their judgement to decide what constitute an expense and or capital item depending on what they want to achieve. This treatment can significantly alter the profitability of the organisation.

4. There is subjectivity on the treatment of depreciation, accruals, amortisation and one time charges. All these are based on assumptions which if not disclosed tend to mislead those not involved in the preparation of financial statements. For me, how do we compare the financial statements of different companies when they use different assumptions to account for all these things? Accountants, for example, guided by different standards, decide on how to depreciate capital items and these can vary from company to company.

5. Not reporting on quantities and prices for both outputs (products) and inputs/resources (costs). We know income goes up and down on the basis of either quantity (volume) or price changes. This happens for both income and cost – why are accountants not telling us what is driving income? Why are they not telling us what is driving changes in major cost categories e.g. raw materials, energy, labour and capital? Are the upwards trends as a result of quantity changes (volumes) or price movement. That is crucial information that is hidden from the public domain by accountants. If volumes of outputs have increased what is happening to the volume of resources or inputs used? The scandalous part of all this is that most accountants want to account for value only and not price and quantity. Why can't an accountant tell me

the quantities of any resources used in the business at any time I want? Most accounting IT systems are configured to record value and not quantities and unit price per resources consumed. Without knowing the quantities and prices of the respective resources consumed by the business, the accountants are not giving the full story of how the business is doing. They are hiding important information that will help us make sense of financial statements. In some case where they inform you about volume and price movement, it normally relates to outputs and they say nothing about inputs. Take for example if staff costs have gone up (8%) between two accounting periods why are they not telling us this was as a result of new employees who joined or the same employees that are now being paid more? By disclosing quantities and prices for both outputs and inputs it makes it easier to see if the revenue growth of a business is price-driven or volume-driven and that matters a lot for business leaders.

6. Cash and profit are different – The revenue and profit figures do not reflect the real money generated in the business. Do you know that profit is an estimate? Ordinary employee, unfortunately, looks at the two figures and end up making outrageous demands. Why are accountants not taking the initiative to educate all employees about this important distinction?

7. Free Cashflow – I have perused a lot of financial statements especially in the local context and none of the listed companies reports on free cash flow; the real lifeblood of the business. I have noted companies that are reporting profits but when you calculate free cashflow you find the company is on its knees. Free cash flow also shows you how the company is using its cash resources.

These are not the only areas of concern in preparing financial statements. There are so many of them; hopefully, we will cover them in the future. The lesson here is that accountants use estimates and assumptions to prepare financial statements. In that case, is it feasible to then compare the financial statements of different companies? I leave you to make your own conclusions on that and many other issues raised in this article.

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