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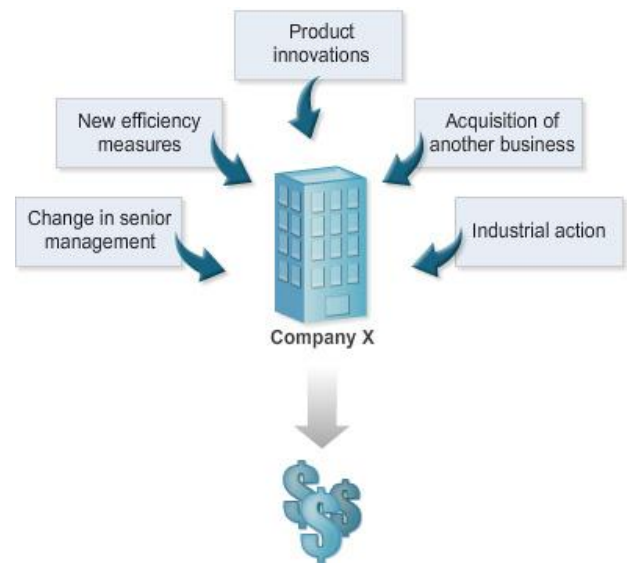
## Topic 1: Fundamental analysis - an introduction

Fundamental analysis is the study of the various factors that affect a company's earnings and dividends. Fundamental analysis studies the relationship between a company's share price and the various elements of its financial position and performance.

Fundamental analysis also involves a detailed examination of the company's competitors, the industry or sector it is a member of and the broader economy.

Fundamental analysis is forward looking even though the data used is by and large historical. The objective of fundamental analysis is to determine a company's intrinsic value or its growth prospects. This intrinsic value can be compared to the current value of the company as measured by the share price. If the shares are trading at less than the intrinsic value then the shares may be seen as good value.

Many people use fundamental analysis to select a company to invest in, and technical analysis to help make their buy and sell decisions.



### Analysing individual companies

The analysis of an individual company has two components:

- The 'story' - what the company does, what its outlook is
- The 'numbers' - the financials of the company, balance sheet and income statement and ratio analysis.



Unfortunately, balance sheet and ratio analysis is probably the most daunting part of fundamental analysis for non-professional investors. A large number of numerical techniques appear to be used. However, you can make it less painful by adopting a methodical approach and by always remembering that behind all the numbers is a real business run by real people producing real goods and services, this is the part we call 'the story'.

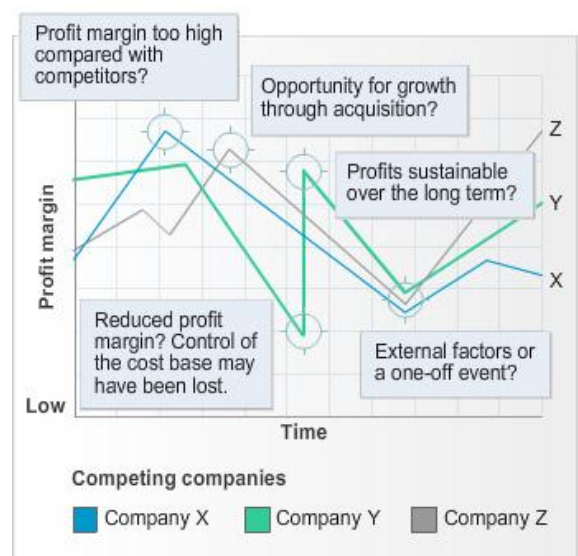
It is unlikely that you will need to do the number crunching for every company, your time will be more profitably spent developing the company story. Balance sheets and ratio analysis, both historical and forecast, can be obtained from either a full service or discount stockbroker.



### What are you trying to learn about a company?

Before trying to leap into the calculations behind fundamental analysis there are some basic questions that are worth considering as a starting point:

- Where is the growth in the company coming from?
- Is the growth being achieved organically or through acquisition?
- Is turnover keeping pace with the sector and with competitors?
- What about the profit margin - is it growing? Is it too high compared to competitors? If it is too high then new competitors could enter on price reducing margins. Low earnings could suggest control of the cost base has been lost or factors outside the company's control are squeezing margins.
- To what extent do profits reflect one-off events?



- Will profits be sustainable over the long term?
- Companies are multidimensional. For example debt funding may have increased - this may be a positive move if the funds produce new productive assets.

This course will not qualify you to become an accountant or stock broking analyst. However we will introduce you to the financial statements, (the place where the numbers come from) and introduce the concept of ratio analysis. We will look at some of the most commonly quoted financial ratios; dividend yield, Price Earning Ratio (PE) and earnings per share (EPS).

In the final topic of this course we have included a Share Appraisal Form. This is a worksheet that you can use to give some structure to your share selection process. The worksheet builds on what you will learn about sourcing information from annual reports and basic ratio calculation.

## Topic 2: Annual Report

### Sourcing information

The key source of information for all analysts when constructing the ratios used in fundamental analysis is a company's annual report. The annual report is a comprehensive document that provides details on the company's activities over the previous year and what its plans for the future are.



Some key elements to the annual report are:

- Chairman's report
- Director's report, and
- Financial Statements

Annual reports are sent to shareholders of the company. If you are not a shareholder and would like an annual report they are made available in the [company announcements](#) section of the ASX website.

Annual reports are generally released at the same time each year during what is known as 'reporting season'.

It is in the annual report that you can find a company's balance sheet. The aim of the balance sheet is to provide information about the financial position, financial performance and cash flows of an entity.

Financial reports also show the results of management performance. This information has a wide number of users so a standard method is set out by the [Australian Accounting Standards Board](#) for how to display financial reports.

Balance Sheet		Joe's BBQ's Ltd.	
for the year ended 30 June 2010		2010 \$	2009 \$
<b>ASSETS</b>			
Cash and cash equivalents	345,363	130,069	
Receivables	100,062	236,000	
Inventories	207,700	300,110	
<b>Total current assets</b>	<b>653,125</b>	<b>666,179</b>	
Property, plant and equipment	150,008	181,475	
<b>Total Non-current assets</b>	<b>150,008</b>	<b>181,475</b>	
<b>Total assets</b>	<b>803,133</b>	<b>847,654</b>	
<b>LIABILITIES</b>			
Payables	189,436	279,521	
Employee entitlements	57,983	108,270	
Current tax liability	13,289	2,624	
Interest bearing liabilities	20,554	25,442	
<b>Total current liabilities</b>	<b>280,262</b>	<b>423,857</b>	
Employee entitlements	65,824	51,857	
Payables	396,574	336,918	
Interest bearing liabilities	18,123	23,166	
<b>Total non-current liabilities</b>	<b>480,521</b>	<b>411,941</b>	
<b>Total liabilities</b>	<b>760,783</b>	<b>835,798</b>	
<b>Net assets</b>	<b>42,350</b>	<b>11,856</b>	
<b>EQUITIES</b>			
Contributed equity	10,050	10,050	
Retained earnings	32,300	1,806	
<b>Total equity</b>	<b>42,350</b>	<b>11,856</b>	

Financial reports provide information about an entity's:

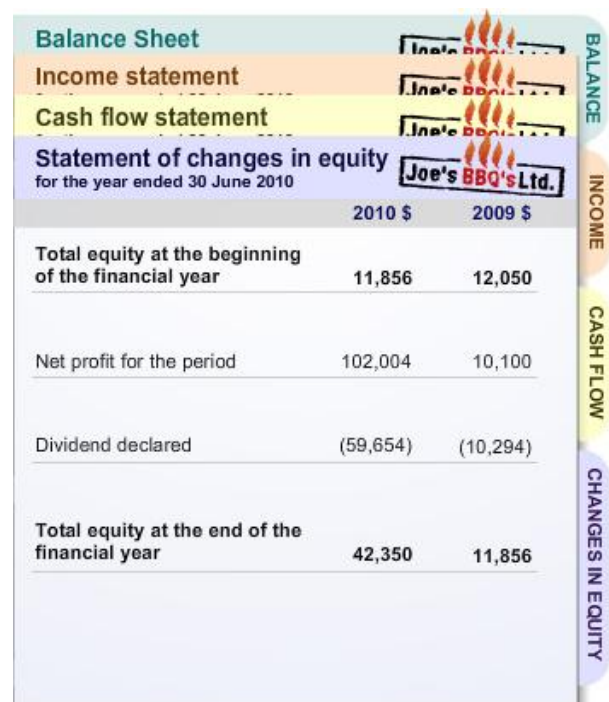
- Assets - what the company owns
- Liabilities - what the company owes
- Equity
- Income and expenses, including gains and losses
- Other changes in equity
- Cash flows.

This information, along with other information in the notes, assists users of financial reports in predicting the entity's future cash flows and, in particular, their timing and certainty.

### The main components of a financial report

A financial report comprises:

1. A balance sheet (showing assets and liabilities)
2. An income statement (showing revenue and expenses)
3. A statement of changes in equity showing either:
  - All changes in equity, or
  - Changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders
4. A cash flow statement
5. Notes, comprising a summary of significant accounting policies and other explanatory notes.



Statement of changes in equity		2010 \$	2009 \$
Total equity at the beginning of the financial year		11,856	12,050
Net profit for the period		102,004	10,100
Dividend declared		(59,654)	(10,294)
Total equity at the end of the financial year		42,350	11,856

Now what do all these various forms and tables in the financial reports really mean? It can appear a little confusing at first, but the more time you spend reading annual reports and studying the basic accounting principles that are used in constructing financial reports the easier it becomes to make sense of them.

Easy things you can do are check the headline figures such as net profit also check cash flow, and level of debt. If you like checking the fine print, the notes to the figures can provide very interesting reading as some key information can get buried in there. You will also find the salaries of the most senior management and a list of the largest shareholders in the company.

If you do find the figures a little daunting, try reading the director's report, usually at the beginning of the annual report. It is a good review of the key achievements of the previous year, and will usually give an indication as to what lies ahead.





## Topic 3: Dividend per share & dividend yield

### Introducing financial ratios


When you are researching shares to buy and sell you may make use of analyst reports. These reports are put together by professionals that specialise in reading and interpreting annual reports. Analysts use the raw data from annual reports to create forecasts and calculate financial ratios. Analysts use financial ratios to compare the performance of a company to its previous results, to its competitors, and to industry averages.

There are limitations on the effectiveness of ratio analysis, you may experience too much data, the data may be imperfect, or it may have already been factored into a company's share price reducing its use as a timely signal to act.

These limitations aside, reviewing the balance sheet and analyst reports contribute to building an objective case for your share investment decisions. Objectivity means removing the emotion from your decisions. Objectivity is one of the key advantages attached to having an investment strategy.

A basic step towards successful investing is to relate a company's performance to the price of its shares. By calculating 'per share' data we can compare earnings, debt and corporate health to a company's share price. There are a multitude of ratios used by analysts to make valuations about a company's shares. In this topic we will look at two important ratios used by investors, dividend per share and dividend yield.

**Case study**



**Anthony (aged 26)**

Anthony goes online to check his share portfolio and watch-list every day and is always spouting jargon about earnings revisions, capital utilisation and the like. So his friends were surprised to learn that he uses a full-service broker as well as an internet broker. For Anthony it makes a lot of sense. 'I'm an accountant,' he says, 'so I know how to read company reports and form my own views. But my broker follows the resources sector – what he knows about mining and exploration would take me years to learn. And for trades over a certain amount, the brokerage isn't that expensive.'

Income statement		<b>Joe's BBQ's Ltd.</b>	
for the year ended 30 June 2010			
	2010 \$	2009 \$	
Revenue	19,032,800	18,030,000	
Other income	150,200	2,200	
Changes in inventories	63,600	120,600	
Raw materials and consumables	(9,995,000)	(9,497,500)	
Employee benefits expense	(6,245,540)	(5,909,900)	
Freight and cartage	(583,000)	(627,000)	
Depreciation and amortization	(194,000)	(146,000)	
Commissions paid	(363,000)	(577,000)	
Other expenses	(718,560)	(689,600)	
Finance costs	(366,000)	(294,000)	
Profit before income tax	769,000	401,000	

<b>DPS = <math>\frac{\text{Total dividend paid}}{\text{Number of shares on issue}}</math> = cents per share</b>		
Dividends per share (cents) <sup>a</sup>	12.5	11.0
EPS	67	53

## Dividend per share (DPS)

This is the amount that the company chooses to pay out of net profit to its shareholders, expressed as a number of cents per share. The company has the choice of paying out all of the net profit as a dividend, part of, or none of the net profit. It depends on whether or not the company needs the money to fund growth or repay debt.

$$\text{DPS} = \frac{\text{Total dividend paid}}{\text{Number of shares on issue}} = \text{cents per share}$$

A thorough analyst does not merely observe consistent dividend payment over many years and then determine the investment to be 'safe' and the company a 'Blue chip'. It is essential to check if the dividends were paid from the current year's earnings or from retained earnings from previous years.

To do that you can check the payout ratio or dividends/earnings which show what percentage of earnings was paid out as a dividend. The reciprocal is earnings/dividends which is the dividend cover ratio. If the dividend cover ratio is less than one then the dividends must have been paid out of retained earnings.

Sometimes paying out all the earnings as dividends is not a good thing, for example, in the case of a company being able to obtain an above average rate of return funding expansion or acquisition instead of paying a dividend.

At other times, if the company has surplus cash it may pay out a special dividend or announce a return of capital.

Income statement		Joe's BBQ's Ltd.	
for the year ended 30 June 2010		2010 \$	2009 \$
Revenue		19,032,800	18,030,000
Other income		150,200	2,200
Changes in inventories		63,600	120,600
Raw materials & consumables		(9,995,000)	(9,497,500)
Employee benefits expense		(6,245,540)	(5,909,900)
Freight & cartage		(583,000)	(627,000)
Depreciation & amortization		(194,000)	(146,000)
Commissions paid		(363,000)	(577,000)
Other expenses		(718,560)	(689,600)
Finance costs		(366,000)	(294,000)
Profit before income tax		769,900	401,320
Income tax expense		(180,918)	24,000
<b>Profit attributable to members of the entity</b>		<b>588,982</b>	<b>425,320</b>
Dividends per share (cents) <sup>†</sup>		12.5	11.0
EPS		67	53

Joe's BBQ's Ltd.		2009 \$	2008 \$
Revenue		18,030,000	18,030,000
Other income		2,200	2,200
Changes in inventories		120,600	120,600
Raw materials & consumables		(9,497,500)	(9,497,500)
Employee benefits expense		(5,909,900)	(5,909,900)
Freight & cartage		(627,000)	(627,000)
Depreciation & amortization		(146,000)	(146,000)
Commissions paid		(577,000)	(577,000)
Other expenses		(689,600)	(689,600)
Finance costs		(294,000)	(294,000)
Profit before income tax		401,320	401,320
Income tax expense		24,000	24,000
<b>Profit attributable to members of the entity</b>		<b>425,320</b>	<b>220,765</b>
Dividends per share (cents) <sup>†</sup>		11.0	4.0
EPS		53	47

## Dividend yield

$$\text{Dividend yield} = \frac{\text{DPS}}{\text{Share price}} = \%$$

The dividend yield is the dividend expressed as a percentage of the share price. This is the rate that can be used to compare the income generated from one investment to that from other investments.

High dividend yields are attractive but they are a representation of past payouts. They are not a guarantee of future dividend amounts. The dividend yield figure may also be affected by fluctuating share prices.

It is important to check to see the level of franking attached to the dividend and what the forecasts are for next year.

(Franking: the amount of tax the company has paid which attaches to the share.)

Income statement		
for the year ended 30 June 2010		
	2010 \$	2009 \$
Revenue	19,032,800	18,030,000
Other income	150,200	2,200
Changes in inventories	63,600	120,600
Raw materials and consumables	(9,995,000)	(9,497,500)
Employee benefits expense	(6,245,540)	(5,909,900)
Freight and cartage	(583,000)	(627,000)
Depreciation and amortization	(194,000)	(146,000)
Commissions paid	(363,000)	(577,000)
Other expenses	(718,560)	(689,600)
Finance costs	(366,000)	(294,000)
Profit before income tax	766,000	404,000

Dividend yield = $\frac{\text{DPS}}{\text{Share price}} = \%$		
Dividends per share (cents) <sup>4</sup>	12.5	11.0
EPS	67	53

## Topic 4: Earnings per share & PE ratio

### Earnings per share (EPS)

The earnings per share is the portion of the profit earned for every ordinary share on issue. It shows at a glance the growth in earnings from one year to the next and the relative size of earnings to dividends. It is also essential for calculating the Price Earnings ratio. EPS is calculated by taking the net profit, if any, and dividing by the number of ordinary shares.

$$\text{EPS} = \frac{\text{Net profit after tax (NPAT)}}{\text{Number of shares on issue}} = \text{cents per share}$$

An EPS figure on its own means very little. The company may not pay this amount out as a dividend or it could include non-recurring items. It is important that the analyst looks at net profit after tax before any of these non-recurring items referred to as 'abnormal items'.

After determining the current EPS, look for trends. Has EPS been growing or falling, and how much is from normal operations rather than one off events? If EPS is the same as last year, has there been an increase in the shares on issue?

Remember EPS does not lend itself to the determination of 'quality'. In bear markets analysts look much more closely at the quality of earnings and quickly dismiss one-off items.

(Bear market: a term used to describe a market that is falling, this is the opposite of a bull market.)

Income statement		Joe's BBQ's Ltd.	
for the year ended 30 June 2010		2010 \$	2009 \$
Revenue		19,032,800	18,030,000
Other income		150,200	2,200
Changes in inventories		63,600	120,600
Raw materials and consumables	(9,995,000)	(9,995,000)	(9,497,500)
Employee benefits expense	(6,245,540)	(6,245,540)	(5,909,900)
Freight and cartage	(583,000)	(583,000)	(627,000)
Depreciation and amortization	(194,000)	(194,000)	(146,000)
Commissions paid	(363,000)	(363,000)	(577,000)
Other expenses	(718,560)	(718,560)	(689,600)
Finance costs	(366,000)	(366,000)	(294,000)
Profit before income tax		769,900	401,320
Income tax expense		(180,918)	24,000

EPS = $\frac{\text{Net profit after tax (NPAT)}}{\text{Number of shares on issue}}$ = cents per share		
EPS	67	53

### Price earnings ratio - PE ratio

The PE ratio is simply the share price divided by the earning per share (EPS).

$$\text{PE ratio} = \frac{\text{Share price}}{\text{EPS}} = \text{times earnings covered by price}$$

The PE ratio shows how many times, in years, it will take for your purchase to be covered by earnings.

The PE ratio reflects the market's view of the earnings potential of the company.

A low PE ratio suggests that the market expects no growth or lower profits, while a high PE ratio suggests that the market expects high growth and a higher profit.

Compare the PE ratio of a company you are looking at to that of other companies in the same sector and the market as a whole.

Income statement		Joe's BBQ's Ltd.	
for the year ended 30 June 2010		2010 \$	2009 \$
Revenue		19,032,800	18,030,000
Other income		150,200	2,200
Changes in inventories		63,600	120,600
Raw materials and consumables	(9,995,000)	(9,497,500)	
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Other expenses	(718,560)	(689,600)	
Finance costs	(366,000)	(294,000)	
Profit before income tax		769,900	401,320
Income tax expense		(180,918)	24,000

<b>PE ratio</b>		=	$\frac{\text{Share price}}{\text{EPS}}$	=	times earnings covered by price
EPS					

## Topic 5: Share appraisal form

We have included a resource that you may find useful in developing your own approach to conducting fundamental analysis. We have called it the Share Appraisal Form. Essentially it is like a health check for companies and provides a methodology that you can work through to help give some order to your decision making.

Remember to read through the disclaimers on the form, this is not a guaranteed method for investment success but one approach that may provide you with assistance.

SHARE APPRAISAL FORM					
Valuation date:					
1	2	3	4	5	6
Total value:					
Total assets:					

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## Summary

- When you buy shares you are becoming a part owner in that business.
- To make an informed decision if you want to be an owner in that business, it is important to understand how that company operates and what its prospects are.
- To understand a company you can read its annual report which is one of the most important publications it releases to the market.
- Analysing an annual report gives you the ability to build a good picture of how that business has performed over the past 12 months and what its prospects might be for the future.
- To compare the annual reports and prospects of different companies, there are commonly used financial ratios, these include dividend per share, dividend yield, PE ratio and earnings per share.