FINANCIAL REPORTING

Analysis and Interpretation of Financial statements

USERS OF FINANCIAL INFORMATION

There are many users of financial information and each one of them has their own interests in the financial information.

The process of analysis starts with understanding the user and what their needs are. Users include;

- Management (performance since it's a measure of their success as stewards)
- Shareholders (return on their investment)
- Potential investors (Value of the entity and potential of providing return on investment)
- Suppliers (ability of entity to pay its obligations)
- Financial institutions (security of their debt to the entity and ability to pay)
- Employees (concerned about the profitability of the entity and ability of entity to provide remuneration)
- Governments and subdivisions of government (compliance with rules/laws and regulations)
- Customers (ability to continue as a going concern especially if they have long term commitments with the entity).

RATIO ANALYSIS

There are various number of ratios used to interpret financial statements categorized into; profitability, liquidity, gearing, investment, activity, assets, growth ratios, among others.

From the examination perspective, not all of them are required and given the time constraint, a few of them need to be computed and used as a benchmark of interpretation.

It is important for student to assess the scenario to which the question relates and subsequently tailor the answer (analysis) to that scenario.

It is important if the examiner is not specific on certain ratios to compute, to choose ratios relevant to the scenario in the question. Hence a student needs to read the question and additional information to better his or her choice making. It is important not to choose all ratios from one category of ratios and neglect the rest of the categories.

After computation of the ratio, commenting comes next, and it most definitely takes the biggest percentage of the marks allocated if sensible. The following checklist can be followed to provide sensible comments

- What the ratio means
- What the change in the ratio means
- What could likely have led to the change.

RATIO ANALYSIS CONT'D

Profitability ratios

Gross profit margin

A margin an entity achieves on its sales. The bigger the margin, the better for the entity.

$$\text{Gross profit margin} = \frac{Gross\ profit}{Sales\ revenue} x\ 100$$

Movements can be attributable to;

- Selling prices changes (due to competition or entry into a new market or trying to increase market share)
- Purchase cost changes/production costs for manufacturers
- Sales mix (introduction of a new brand or its discontinuation)
- Decision to recognize certain expenses to cost of sales such as depreciation, amortization etc.

Operating profit margin

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{Sales\ revenue} x\ 100$$

Movements can be attributable to;

- Changes in operating costs. You may need to study the individual categories of costs such as administration costs and selling and distribution costs to determine reasons for materially significant movements and whether or not the change is as a result of a one-off item that will not be consistent in future accounting periods.

Movement in costs in comparison with movement in revenue but bearing in mind that some expenses are fixed and hence may not exactly move in the same proportion as revenue.

RATIO ANALYSIS CONT'D

Return on capital employed (ROCE)

This shows the ability of the entity to turn its long-tern financing into profit.

$$\text{ROCE} = \frac{\text{Profit}}{\text{Capital employed}} x\ 100$$

Where;

Profit is the operating profit or profit before interest and tax

Capital employed is equity plus interest bearing finance (including lease liabilities) or total assets less current liabilities

Movements can be attributable to reasons why profit moved as well as changes in long-term funding such as loans and issue of shares. Sometimes ROCE could be affected by policies such as revaluation of the entity's assets.

ROCE should also be compared to the entity's cost of borrowing with emphasis in instances where ROCE is less than cost of borrowings in which case could reduce the entity's profitability and hence EPS if additional borrowings are made.

ROCE can as well be compared to the entity's target ROCE as well as industrial ROCE.

Return on equity (ROE)

$$\text{ROE} = \frac{\text{Profit after tax}}{\text{Equity}} x\ 100$$

Analysis of this ratio is similar to return on capital employed.

RATIO ANALYSIS CONT'D

Efficiency ratios

Inventory turn over and inventory holding days

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}}$$

This examines the number of times inventory is turned into sales. Higher times are good for the entity and vice versa.

$$\text{Inventory days} = \frac{\text{Inventory}}{\text{Cost of sales}} x\ 365$$

An increasing number of days compared to lower inventory times are not desirable and may indicate poor inventory control, lack of market for the entity's products, poor quality products, poor market research, increase in inventory holding costs such as damage, obsolescence, storage costs among others.

Nonetheless, an increase in the number of days is sometimes okay more so if an entity purchases in large quantities to gain from trade discounts and also avoiding stoppages in production. However, the nature of business is an important factor as well.

RATIO ANALYSIS CONT'D

Receivables collection period

This looks at how long it takes to collect from trade receivables.

$$\text{Receivables days} = \frac{\text{Trade receivables}}{\text{Credit sales}} x\ 365$$

However, in absence of credit sales, the total sales figure is used.

The results of this ratio is normally compared to the previous year's figures as well as the credit policy objective.

Increasing days may signal a poor credit policy hence exposing the entity to a risk of bad debts although sometimes maybe an entity trying to capture a certain market.

Check trade receivables for factors that affect it such as recognizing end year figure in receivables as well as factoring receivables which reduces that receivables figure.

Payables payment period

This indicates the period taken by the entity to pay its liabilities. A longer credit period may signal liquidity problems as failure of the ability to clear off its debts as and when they fall due, losing supplier relations, reputation losses.

$$\text{Payables days} = \frac{\text{Trade payables}}{\text{Credit purchases}} x\ 365$$

Failure to get purchases, cost of sales may be used to compute this ratio.

RATIO ANALYSIS CONT'D

Asset turnover

It measures management's efficiency in generating revenue from the assets at its disposal.

$$\text{Asset turnover} = \frac{\text{Sales revenue}}{\text{Total assets}}$$

The higher the turnover, the better the efficiency of management

Liquidity ratios

These measure the entity's ability to pay off its short term obligations as and when they fall due.

Current ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

An increasing ratio is desirable and good although it may be largely made up of slow moving inventory and receivables. It may also be large sums of redundant cash that could be put to other use.

Nature of business is also a key factor here for example supermarkets that have less receivables but huge payables.

Quick ratio/acid ratio

$$\text{Quick ratio} = \frac{\text{Current assets} - inventory}{\text{Current liabilities}}$$

whether the entity has sufficient liquid resources to settle its obligations.

RATIO ANALYSIS CONT'D

Gearing ratios

Gearing: looks at the degree of risk attached to the entity. A high proportion of date means that the company is highly geared hence at a greater risk of insolvency and limited scope to increase borrowing incase potential profitable venture emerge.

Gearing ratio $= \frac{Debt}{\text{Equity}}$ or Gearing ratio $= \frac{Debt}{\text{Debt+Equity}}$

Interest cover

This measures the ability of the entity to pay interest out of profits generated. A low interest cover means the entity may face difficulties financing its debts when profitability falls. Shareholders also perceive a risk of failure to pay dividends since most of the profits shall be eaten up by interest

An interest cover of 2 and above is considered satisfactory.

Interest cover $= \frac{Profit\ before\ interest\ and\ tax}{\text{Finance costs}}$

Investment ratios

Earnings per share (As per IAS 33)

Price/earnings ratio (As per IAS 33)

It represents the market's perspective of the entity's shares. What potential investors would be willing to pay for the entity's shares. If the ratio is high, it suggests that the share is expected to grow and hence the entity's future EPS.

Dividend cover

The higher the dividend cover, the more likely it is that the current dividend level can be sustained in the future

Dividend cover $= \frac{Profit\ after\ tax}{\text{Dividends}}$

RATIO ANALYSIS CONT'D

Dividend yield

This can be comparable to the yields on other investments to assess efficiency. the lower the dividend yield, the more the market is expecting future growth in the dividend.

$$\text{Dividend yield} = \frac{Dividend\ per\ share}{\text{Current share price}}$$