LECTURE 3 – FINANCIAL STATEMENT ANALYSIS – 19/08/2016

- Learning Objectives
  - LO1: Understand the nature of financial statement analysis.
  - LO2: Calculate and interpret horizontal and vertical analysis.
  - LO3: Assess profitability through the calculation and interpretation of ratios.
  - LO4: Assess liquidity through the calculation and interpretation of ratios.
  - LO5: Assess solvency through the calculation and interpretation of ratios.
  - LO6: Calculate and interpret a DuPont analysis.

LO3 – PROFITABILITY

- **Profit Margin Ratio**
  - Compares net income to net sales
  - The ability of a company to generate profits from sales
  - Higher ratio → greater ability to generate profits from sales
  - PROFIT MARGIN = TOTAL COMPREHENSIVE INCOME ÷ NET SALES

- **Return on Equity**
  - Compares profits (comprehensive income) to the average balance in shareholders' equity during the year
  - Represents how effectively a company uses the resources (equity) provided by shareholders during the year to generate additional resources for its owners
  - Shareholders naturally want this ratio to be as high as possible.
  - ROE = TOTAL COMPREHENSIVE INCOME ÷ AVERAGE SHAREHOLDERS EQUITY
  - AVERAGE SHAREHOLDERS EQUITY = (Beginning + ENDING EQUITY) ÷ 2

- **Return on Assets**
  - Compares in come to average total assets
  - The ability to generate profits from its entire resource base (not just the ones provided by owners)
  - Higher ratio → greater ability to generate profits
  - RETURN ON ASSETS = TOTAL COMPREHENSIVE INCOME ÷ AVERAGE TOAL ASSETS
  - AVERAGE ASSETS = (BEGINNING + ENDING ASSETS) ÷ 2

- **Earnings per Share (EPS)**
  - Compares a company's profits to the average number of shares
  - Return on each share owned by an investor
  - Cannot be compared as EPS differs due to the differing no. of shares
  - EPS = TOAL COMPREHENSIVE INCOME ÷ AVERAGE NUMBER OF SHARES
  - AVERAGE NUMBER OF SHARES = (BEGINNING + ENDING SHARES) ÷ 2

- **Price Earnings Ratio**
  - Compares income to current market price of the company's shares
  - Investors perception of the company
  - Ratio of 10 → investors pay 10X current EPS to buy one share
  - Higher P/E → investors are more optimistic about future prospects
  - P/E = CURRENT MARKET PRICE OF SHARE ÷ EPS

FINAL EXAM NOTES

Question 1: NCA – 10 Marks

PURCHASE PRICE
- Purchase price, Taxes/duties paid, Fees, Delivery, Insurance, Installation, Training

RECORDING PURCHASE
- Dr NCA – Name
  - Cr Cash
- Dr Other Expenses
  - Cr Cash

RECORDING DEPRECIATION
- Dr Depreciation Expense (expense increasing)
  - Cr Accumulated Depreciation (contra asset increasing)

CARRYING AMOUNT = Cost – Accumulated Depreciation

STRAIGHT LINE DEPRECIATION:
- (Cost – Residual Value) ÷ Useful Life

REDUCING BALANCE DEPRECIATION:
- 2 * (1/Useful life) * Carrying Amount

UNITS-OF-ACTIVITY DEPRECIATION:
- Depreciation expense per unit = (Cost – Salvage Value) ÷ Useful life in units
- Depreciation expense = Depreciation expense per unit * Actual units of activity

RULE FOR CALCULATING THE GAIN/LOSS/DISPOSAL
- Record any necessary depreciation expense (possibly for a partial period) to update the accumulated depreciation account.
- Calculate any gain or loss on the disposal by comparing the asset's carrying amount.
- Prepare a journal entry that decreases the asset account and its related accumulated depreciation account.
- Record any gain or loss on the disposal.

GAIN OR LOSS IN DISPOSALS
- Sales price – Carrying amount = Gain/Loss on sale
- Is the correction of depreciation ➔ Gain = over expense, Loss = Under expensed

RECORDING GAIN/LOSS ON DISPOSAL
- Dr Cash
- Dr Accumulated Depreciation
- Dr Loss on Disposal
  - Cr Gain on Disposal
  - Cr Equipment - Name

"AMORTISING" INTANGIBLE ASSETS
- The 'depreciation' of INTANGIBLE assets
- Dr Amortisation Expense
  - Cr Accumulated Amortisation - Patent

ASSET REVALUATION
- Value Up
  - Dr Asset
    - Cr Asset revaluation Reserve

ASSET IMPAIRMENT
- Value Down
  - Dr Impairment Expense – Asset Name
    - Cr Asset