MPA701 ACCOUNTING

EXAM NOTES – THEORY RELATED QUESTIONS

Trimester One, 2017

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NOTE: THESE NOTES ARE ONLY FOR THEORY RELATED QUESTIONS. I HAVE INCLUDED SOME NUMERICAL QUESTIONS WHICH WERE COVERED IN THE TEXTBOOK BUT NOT IN THE LECTURE SLIDES. AS PART OF YOUR REVISION BE SURE TO COMPLETE ALL TUTORIAL NUMERICAL QUESTIONS AS WELL AS ALL THE NUMERICAL QUESTIONS IN THE LECTURE SLIDES!

10 Financial Statement Analysis

Who uses financial statement analysis?

- Managers, for strategic and operational decision making.
- Investors and financial analysts, to evaluate management performance and to make investment decisions.
- Creditors, to make lending decisions.
- Suppliers, to assess opportunities and ability to repay.
- Auditors, to assess the reasonableness of financial statement values.

Common Size Financial Statements

The preparation of common size financial statements involves the presentation of all balance sheet items as a percentage of total assets and profit and loss items as a percentage of total sales. Common size financial statements attempt to factor out the size of the company and assists in comparing companies and analysing trends for a single company.

Du Point Formula

The Du Pont system of ratio analysis is a system that links ratios together. The Du Pont formula uses the idea of leverage, which is an important objective and consequence of borrowing money, then using it to generate returns. Leverage, also called 'trading on the equity', 'financial leverage' and 'gearing', refers to the increased rate of return on shareholders' equity when assets earn a return larger than the interest rate paid for debt financing of them. The benefit of the Du Pont system is it allows management to better understand whether a change in ROA is mainly caused by a change in profit margins or asset turnover. In addition, it outlines the relationship between ROE, ROA and leverage. The relationship between the return on equity ratio and its two components is shown below:

$$ROE = ROA \times Leverage$$

$$\frac{Operating\ profit\ after\ tax}{Shareholder's Equity} = \frac{Operating\ profit\ after\ tax}{Total\ Assets} \times \frac{Total\ Assets}{Shareholder's Equity}$$

Benefits of Financial Statement Ratios

- Many ratios are **related**, and any analysis will benefit from an understanding of these relationships.
- Ratios **summarize** large amounts of financial statement information.
- Ratio analysis **adds meaning** to the information in financial statements.
- Ratios are scaled measures, so that values of the same ratio can be **usefully compared** over time or across companies.
- Ratios are useful in making various kinds of **decisions**.

Limitations of Financial Statement Ratios

- Ratio comparisons across companies can be misleading if they use different accounting methods
- Ratio comparisons across companies can be misleading is they operate in different industries
- Ratios only explain part of a story
- Ratios showcase at a point in time and the point in time generally does not reflect the performance of the company
- Ratios operate on the belief that past performance influences future performance, which is generally not the case

What is the purpose of financial statement analysis?
The purpose of financial statement analysis is to use the financial statements to evaluate an enterprise's financial performance and financial position.

What ratios would you calculate to evaluate a company's profitability?
To evaluate a company's profitability the following ratios would be calculated:
i Return on equity.
ii Return on assets.
iii Profit margin.
iv Gross margin.
v Cash flow to total assets.
vi Earnings per share.
vii Price to earnings ratio.
viii Dividend payout ratio.
ix Return on funds employed.

What ratios would you calculate to evaluate a company's activity or turnover?
To evaluate a company's turnover the following ratios would be calculated:
i Total asset turnover.
ii Inventory turnover.
iii Debtors turnover.

What ratios would you calculate to evaluate a company's liquidity?
To evaluate a company's liquidity the following ratios would be calculated:
i Current ratio.
ii Quick ratio.

What ratios would you calculate to evaluate a company's financial structure?
To evaluate a company's financial structure the following ratios would be calculated:
i Debt to equity.
ii Debt to assets.
iii Leverage ratio.
iv Interest coverage ratio.