

UNIT 2

MANAGING FINANCIAL RESOURCES AND DECISIONS

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Credit Value: 15

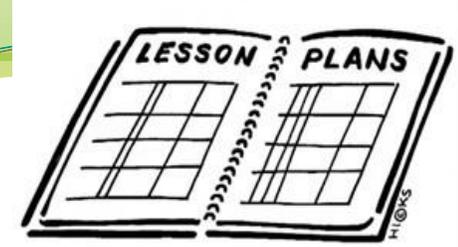


MANAGING FINANCIAL RESOURCES AND DECISIONS



- **LO 4: Be able to evaluate the financial performance of a business.**

THE BASIC SYLLABUS



- Understand the sources of finance available to business.
- Understand the implications of finance as a resource within a business
- Be able to make financial decision's based on financial information
- Be able to evaluate the financial performance of a business.

LEARNING OBJECTIVE



- At the end of the class students should be able to:
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- AC 4.3: Interpret financial statements using appropriate ratios and comparisons, both internal and external



OVERVIEW

- Ratio analysis can be used by management as to analyse financial results and trends over time, and provide key indicators of organizational performance. Managers will use ratio analysis to pinpoint strengths and weaknesses from which strategies and initiatives can be formed. Funders may use ratio analysis to measure your results against other organizations or make judgments concerning management effectiveness and mission impact.

PROFITABILITY RATIOS

- One of the most important measures of a company's success is its profitability. However, individual figures shown in the income statement/profit and loss account for gross profit and net profit mean very little by themselves. When these profit figures are expressed as a percentage of sales, they are more useful. This percentage can then be compared with those of previous years, or with the percentages of other similar companies. Changes in the gross profit percentage ratio can be caused by a number of factors.
- **Gross profit margin is calculated as follows:**
- **Gross profit / sales revenue x 100**

PROFITABILITY RATIOS

- The relationship between the gross and the net profit percentage gives an indication of how well a company is managing its business expenses. If the net profit percentage has decreased over time while the gross profit percentage has remained the same, this might indicate a lack of internal control over expense.
- **The operating profit margin or net profit margin is calculated as:**
- **$\text{Profit before interest and tax} / \text{sales revenue} \times 100$**

PROFITABILITY RATIOS

- The return on capital employed (ROCE) ratio is another important profitability ratio. It measures how efficiently and effectively management has deployed the resources available to it, irrespective of how those resources have been financed. The most common uses operating profit (defined as profit before interest and taxation) and the closing values for capital employed (although using averages for the year is more accurate).

PROFITABILITY RATIOS

- This ratio is useful when comparing the performance of two or more companies, or when reviewing a company's performance over a number of years.
- In simple terms ROCE measures how much operating profit is generated for every \$1 capital invested in the business.
- It is calculated as follows:
- **Profit before interest and tax / capital employed x 100**
- **Capital employed is measured as equity, plus interest-bearing finance, i.e. non-current loans plus share capital and reserves**

PROFITABILITY RATIOS

- **Net asset turnover**
- This is calculated as:
- **Sales revenue / capital employed = times p.a.**
- It measures management's efficiency in generating revenue from the net assets at its disposal. This is similar to ROCE but in this case we measure the amount of sales revenue generated for every \$1 capital invested in the business. Generally speaking, the higher the ratio the more efficient the business is.

LIQUIDITY RATIOS

- Liquidity refers to the amount of cash a company can generate quickly to settle its debts. A reasonable level of liquidity is essential to the survival of a company, as poor cash control is one of the main reasons for business failure.
- Current or working capital ratio:
- **Current assets / current liabilities.**
- This is usually presented as a ratio in the format of '4:1.'
- The current ratio measures the adequacy of current assets to meet liabilities as they fall due.

LIQUIDITY RATIOS

- **Quick ratio**
- This is calculated as:
- **Current assets - inventory / current liabilities**
- The quick ratio is also known as the acid test ratio because by eliminating inventory from current assets it provides the acid test of whether the company has sufficient liquid resources (receivables and cash) to settle its liabilities.
- Normal levels for the quick ratio range from 1:1 to 0.7:1

EFFICIENCY RATIO

- Most companies offer their customers credit in order to increase their sales. However, giving credit to customers incurs an opportunity cost as the cash is tied up in financing receivables/ debtors, and there is also the risk of the debts not being paid. Therefore, companies will normally seek to collect their debts as soon as possible.
- **Inventory turnover period**
- This is calculated as:
- **$\text{Inventory} / \text{cost of sales} \times 365$**

EFFICIENCY RATIO

- **Alternative**
- An alternative is to express the inventory turnover period as a number of times:
- **Cost of sales / inventory = times p.a. the average inventory is consumed.**
- This simply measures how efficiently management uses its inventory to produce and sell goods.

EFFICIENCY RATIO

- **Receivables collection period**
- This is normally expressed as a number of days:
- **Trade receivables / credit sales x 365**
- The ratio shows, on average, how long it takes to collect cash from credit customers once they have purchased goods. The collection period should be compared with:
 - - the stated credit policy
 - -previous period figures.

EFFICIENCY RATIO

- **Payables payment period**
- This is usually expressed as:
- **Trade payables / credit purchases x 365**
- This represents the credit period taken by the company from its suppliers.
- The ratio is always compared to previous years:
- -A long credit period may be good as it represents a source of free finance.
- -A long credit period may indicate that the company is unable to pay more quickly because of liquidity problems.

INVESTMENT RATIOS

- The **earnings per share ratio** of a company represents the relationship between the earnings made during an accounting period (and available to shareholders) and the number of shares issued. For ordinary shareholders, the amount available will be represented by the net profit after tax (less any preference dividend where applicable).
- Many investment analysts regard the earnings per share ratio as a fundamental measure of a company's performance. The trend in earnings per share over time is used to help assess the investment potential of a company's shares.

INVESTMENT RATIOS

1 Earnings per share (EPS)

The formula is:

$$\text{Earnings per share} = \frac{\text{Net profit after interest and tax and preference dividends}}{\text{Number of ordinary shares issued}}$$

This gives the shareholder (or prospective shareholder) a chance to compare one year's earnings with another in terms easily understood. Many people consider EPS to be *the* most important ratio that can be calculated from the financial statements.

INVESTMENT RATIOS

- The **dividend cover** ratio focuses on the security of the current rates of dividends, and therefore provides a measure of the likelihood that those dividends will be maintained in the future. It does this by measuring the proportion represented by current rates of dividends of the profits from which such dividends can be declared without drawing on retained earnings. The higher the ratio, the more profits can decline without dividends being affected.

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INVESTMENT RATIO

- **Dividend cover = $\frac{\text{Earnings per share}}{\text{Dividend per (ordinary) share}}$**
- **Dividend per (ordinary) share**
- This gives the shareholder some idea as to the proportion that the ordinary dividends bear to the amount available for distribution to ordinary shareholders. Usually, the dividend is described as being so many times covered by profits made. If, therefore, the dividend is said to be three times covered, it means that one-third of the available profits is being distributed as dividends.

INVESTMENT RATIO

- The **dividend yield** compares the amount of dividend per share with the market price of a share, and provides a direct measure of the return on investment in the shares of a company. Investors are able to use this ratio to assess the relative merits of different investment opportunities.
- **Dividend yield:**
- $\frac{\text{Dividend of the share for the year}}{\text{Current market value of the share}} \times 100\%$

INVESTMENT RATIO

- The **price earnings ratio** compares the benefits derived from owning a share with the cost of purchasing such a share. It provides a clear indication of the value placed by the capital market on those earnings and what it is prepared to pay for participation. It reflects the capital market assessment of both the amount and the risk of these earnings, albeit subject to overall market and economic considerations.

INVESTMENT RATIO

2 Price/earnings ratio (P/E)

The formula is:

$$\text{Price/earnings ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

This puts the price into context as a multiple of the earnings. The greater the P/E ratio, the greater the demand for the shares.

FINANCING RATIOS

- Current and potential investors will be interested in a company's financing arrangements. The extent to which a company is financed by outside parties is referred to as gearing. The level of gearing in a company is an important factor in assessing risk. A company that has borrowed money obviously has a commitment to pay future interest charges and make capital repayments. This can be a financial burden and possibly increase the risk of insolvency. Most companies will be geared to some extent.

FINANCING RATIOS

- The **gearing ratio** measures the company's commitments to its long-term lenders against the long-term capital in the company. The level of gearing will be influenced by a number of factors, for example the attitude of the owners and managers to risk, the availability of equity funds, and the type of industry in which the company operates.

FINANCING RATIOS

- There are two methods commonly used to express gearing as follows.
- (1) Debt/equity ratio:
 - This is calculated as:
 - $$\frac{\text{Long-term debt}}{\text{equity}} \times 100$$

FINANCING RATIOS

- (2) Percentage of capital employed represented by borrowings:
- This is calculated as:
 - Long-term debt
 - $(\text{equity} + \text{long-term debt}) \times 100$
- Long term debt includes non-current loan and redeemable preference share liabilities

FINANCING RATIOS

- The interest cover ratio measures the amount of profit available to cover the interest payable by the company. The lower the level of interest cover the greater the risk to lenders that interest payments will not be met. If interest payments and capital repayments are not paid when they fall due there can be technical consequences for a company.

FINANCING RATIOS

- In the event of a default, a lender may have the right to seize the assets on which the loan is secured and sell them to repay the amount outstanding. Where lenders do not have security on their loan, they could still apply to the courts for the winding up of a company so that assets can be liquidated and debts repaid.

FINANCING RATIOS

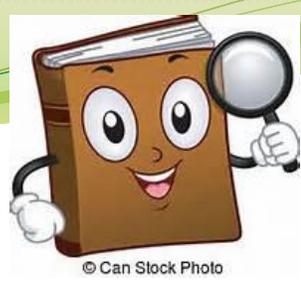
- Interest cover
- This is calculated as:
 - Profit before interest and tax
 - interest payable

COMPARISON BOTH EXTERNAL, INDUSTRY AND INTERNAL

- Comparative information is essential for any meaningful ratio analysis. A lack of information about either industry averages or previous years' performance will severely limit analysis. Ratios must always be compared, never looked at in isolation.
- Data from which ratios are compiled must be uniform and the calculation must be uniform otherwise comparisons will be misleading. Differences in accounting policies between different companies should be taken into account.

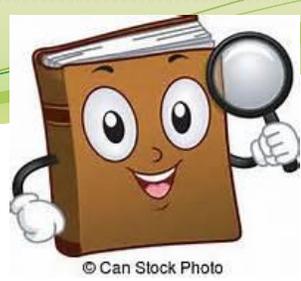
COMPARISON BOTH EXTERNAL, INDUSTRY AND INTERNAL

- Guidelines concerning ratios are generalisations – each case must be looked at and analysed on its own and not compared to a ‘normal’ figure.
- The timing of the year-end must be taken into consideration. A retail company making up its accounts to the end of February would have a significantly different balance sheet from a company in the same business having a November year-end.
- Ratios are confined to monetary items – they give an incomplete picture of the company as a whole.



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