

# USING FINANCIAL INFORMATION



## Multiple choice

- |      |       |       |
|------|-------|-------|
| 1. C | 6. D  | 11. D |
| 2. B | 7. C  | 12. D |
| 3. A | 8. A  | 13. A |
| 4. C | 9. C  | 14. B |
| 5. A | 10. C | 15. B |

## Short answer questions

### Question 1 (

- (a) The statement shown is a **Revenue Statement**, otherwise known as the **Statement of Financial Performance**.
- (b) **Net Profit Ratio (NPR) = Net profit / Sales**

$$2002: \text{NPR} = 20,250/95,000 \times 100/1 = 21.3\%$$

$$2003: \text{NPR} = 4,000/76,000 \times 100/1 = 5.3\%$$

- (c) The **Revenue Statement** summarises a business's revenues and expenses over a period of time, usually a year. It explains how a business has achieved its current financial position (profit).
- (d) **Giovanni's** has managed to erode a profit of over \$20,000 in 2002 to a small profit of only \$4,000 in 2003. As the statement shows, the business has, despite the \$19,000 (20%) decline in sales levels, managed to maintain a relatively stable gross profit in 2003. Thus the business's profit loss is not due to poor inventory management.

An examination of the business's expense ratio highlights the true root of the problem – poor expense management. From 2002 to 2003, **Giovanni's** expense ratio has increased from 31.3% to 57.9% - expenses in fact increased, despite falling sales. An examination of expenses shows that the major factor behind the increased expenses was an increase in wages. Wages increased by two-thirds, despite the 20% sales drop, indicating extremely poor staff management. Additionally, it is disappointing that sales dropped even though advertising levels stayed the same, compounding the profit decline.

**Question 2**

- (a) The statement shown is a **Balance Sheet**, otherwise known as the **Statement of Financial Position**.
- (b) The **Balance Sheet** is structured around the accounting equation (**A = L + E**) and highlights that assets must be funded by either debt (**L**) or equity (**E**).
- (c) **Current ratio = current assets / current liabilities = \$3,004/\$6,547 = 0.46:1**  
**NB** the total of current liabilities in the stimulus table is incorrect and should be \$6547 – but students should still be able to get the true figure from the accounts payable figure – the only current liability.
- (d) **Expense ratio = 18,200/52,00 x 100/1 = 35%**
- (e) The **Balance Sheet** only gives a snapshot of a business at a particular point in time. This limits its usefulness as it gives no indication of how the business got to that position or where it is going.
- (f) **1. The business's expense ratio of 35% is quite high when compared to the industry average of 25%. This tells us that the business is required to spend more to earn the same as its competitors and therefore is not efficient.**  
**2. The business's current ratio of 0.46:1 is dangerously low. This tells us that the business's liquidity position is in danger and that it may have serious difficulties meeting its short term obligations.**

**Question 3**

- (a) **Any TWO of:**
- **Accounting practices may differ greatly between businesses making comparisons inaccurate.**
  - **The businesses may not have a similar life cycle and thus the comparison will not be accurate.**
  - **The businesses may not be using the same reporting period.**
  - **The businesses may not be in the same industry – they may have different financial needs.**
  - **Ratios only give a snapshot of a business, and therefore only give a snapshot of a comparison.**
  - **Both businesses may be unlike the rest of the industry – i.e. you really should look at far more than two businesses to correctly judge a business's performance.**
- (b) **Comparisons against industry averages provide an excellent benchmark for judging a business's performance. Industry averages are a robust method of comparison, as we can be fairly confident that the businesses in the same industry will have been influenced by the same economic factors, and will often have the same financial needs and face the same financial reporting issues.**

- (c) **Current ratio – measuring liquidity:** Clearly Rubber'n'glue has a much lower level of liquidity than Fashion Heels but this is not that bad as the business has an excellent accounts receivable turnover ratio meaning it has more stable cash inflows than the others.

**Debt-to-equity – measuring gearing:** Fashion heels has a very low level of gearing compared to the other businesses but this is good as it has a **VERY** bad accounts receivable turnover and thus would have trouble maintaining stable cash flows to meet its obligations. Rubber'n'glue's ratio is normal – the industry average is actually quite high.

**Gross Profit Ratio (GPR) – measuring profitability:** Fashion Heels has an outstanding gross profit ratio, compared to Rubber'n'glue and compared to the industry. This suggests it has a access to very cheap inventory. Rubber'n'glue at the same time still has an excellent GPR compared to the industry.

**Net Profit Ratio (NPR) – measuring profitability:** Fashion Heels has a very lacklustre NPR, particularly given its GPR. This suggests that Fashion Heels has a very bad expense management system in place, and that expenses constitute 43% of sales, compared to Rubber'n'glue's 20% and the industry average of 18%. Rubber'n'glue on the other hand has done excellently with an NPR above average at 30%.

**Accounts Receivable Turnover – measuring efficiency:** Only Rubber'n'glue has a decent ratio here, giving it an average 21 day turnover, rather than the 2 and 6 months reported by the industry average and Fashion Heels.

**Question 4 (**

- (a) **There was a significant increase in the liquidity of HIT, measured by the current ratio from 2000 to 2002, especially when compared to the industry average.**
- (b) • **It is necessary to judge what improvements management have made overall or with regard to particular projects.**
- **Gives a benchmark for analysing current years and allows stakeholders to judge whether current year performance is just an anomaly.**
- (c) **From 2000 to 2001, the business's debt-to-equity ratio fell from 3:1 to 2.5:1. One possible reason for this change is the 20% increase in net profit that business saw that year. This increase was caused by reduction in the business's expense levels, and also an unknown increase in the business's gross profit ratio. This would have lowered the business's costs, thus lowering the business's funding requirements.**
- (d) **The business's liquidity position (measured by the current ratio) has increased from 2000 to 2003. However, this ratio has increased far above that of the industry average suggesting that the business may have excess amounts of working capital not being used – an inefficient change.**

**The business has greatly reduced its debt levels over the period, which is excellent and takes it back towards the industry standard. This reduces the cash burden on the company and frees up more cash for investment projects.**

**The business has managed a stable growth in its net profit level. Although the net profit ratio dropped in 2003, it still remains well above the industry average, suggesting highly successful financial management when it comes to expense reductions and inventory management.**

**The business has done well to reduce its expense ratio over the period. However, it has only managed to bring it back to industry levels suggesting not that management has not magically reformed their business, but rather that they just started to efficiently control expenses.**