

Using Financial Information

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Matching terms

Definitions	Terms
The financial statement that outlines the sales, cost of goods sold, expenses and profit of a business	Revenue Statement
The financial statement that outlines the assets, liabilities and equity of a business	Balance sheet
Total revenue of a business minus the cost of goods sold	Gross Profit
The capacity of the business to pay both short and long term liabilities	Solvency
Funds contributed by the owners of a business	Equity
The ability of a business to meet its short-term financial commitments	Liquidity
Indicates how well current liabilities are covered by current assets	Working capital ratio
An intangible asset which places a monetary value on the reputation of a business in the marketplace	Goodwill
The ability of a business to minimise its costs for a given level of output	Efficiency
Debts that are owed by the business	Liabilities

True or False

- | | | |
|----------|----------|----------|
| 1. True | 5. False | 9. True |
| 2. False | 6. True | 10. True |
| 3. False | 7. True | |
| 4. False | 8. False | |

Multiple Choice

- 1 C The accounting framework
- 2 D The accounting framework
- 3 B The accounting framework
- 4 B Balance sheet
- 5 D Revenue statement
- 6 C Balance sheet
- 7 B Types of financial ratios
- 8 A Types of financial ratios
- 9 D Types of financial ratios
- 10 D Types of financial ratios
- 11 C Types of financial ratios
- 12 B Types of financial ratios
- 13 B Types of financial ratios
- 14 A Limitations of financial reports
- 15 D Limitations of financial reports

Short Answer Questions

Question 1

- (a) Revenue statement. Its role is to clearly outline the revenues and expenses of the company over a specific period of time. By subtracting expenses from revenue, it ultimately provides a net profit of the business for the period.
- (b) Net Profit Ratio = $(\text{Net Profit} / \text{Sales}) \times 100$
 For 2006 = $(8375 / 52000) \times 100 = 16.11\%$
 For 2007 = $(49975 / 126000) \times 100 = 39.66\%$
- (c) Fortune's net profitability has improved significantly from 16.11% to 39.66%
- (d) Expense ratio = $(\text{Expenses} / \text{Sales}) \times 100$
 For 2006 = $(16625 / 52000) \times 100 = 31.97\%$
 For 2007 = $(32025 / 126000) \times 100 = 25.42\%$
- (e) Given the decrease in the expense ratio, the ability of Fortune to minimise expenses per dollar of sales has improved.

Question 2

- (a) It is a Balance Sheet. The role of this statement is to provide information on the financial position of the company at a specific point in time. It provides information of a company's liquidity and solvency.
- (b) The accounting equation conveys the fact that a company's total Assets (A) are equal to the sum of its total Liabilities (L) and Owner's Equity (OE), i.e. $A = L + OE$. The Balance Sheet encompasses all three, with the assets listed on one side and the liabilities and owners' equity on the other side. The Balance Sheet must thus conform to the Accounting Equation, and one side must equal the other.

- (c) Current Ratio = Current Assets / Current Liabilities = 18480 / 11525 = 1.6:1
- (d) Either:
- Debt to Equity Ratio = Total Debt / Total Equity
= (11525 + 88000) / 105180 = 0.95:1 or 95%
 - Debt to Asset Ratio = Total Debt / Total Assets
= (11525 + 88000) / 204705 = 0.49:1 or 49%
- (e) Merlin's Liquidity position is marginally superior to the industry average. Its current ratio of 1.6:1 (compared to the industry average of 1.5:1) indicates that Merlin is better positioned to meet its short-term financial commitments as they fall due.

Merlin's solvency position is significantly worse than the industry average. Its Debt to Equity ratio of 95% means that it will have more difficulty to meet long-term financial commitments than most firms in the industry (the average of which was 45%). It also indicates a poor overall financial situation within the company.

(If a debt to assets ratio was used : Merlin's Assets ratio of 48% is double the industry average of 24% and indicates a high level of borrowing compared to its competitors. This represents a poor long term financial outlook for the company).

Question 3

- (a) Either:
- It is difficult to compare businesses which operate in different markets and/or are at different stages of the life cycle. Whilst Mario's and Luigi's are both in the clothing industry, there is no way for us to ascertain at which point of the life cycle they are at. For example, Mario's may be entering the growth phase whilst Luigi's may be in decline.
 - Businesses use varying accounting methods and policies. Whilst there are legal guidelines with which accountants must operate, different firms can still manipulate figures to improve certain ratios. This distorts figures and makes it harder to compare any two companies.
- (b) (i) Based on the current ratio, Mario's (1.5:1) is above the industry average of 1.3:1 whilst Luigi's is marginally below it. This means Mario is better able to meet short term financial commitments than Luigi and most of the industry.
- (ii) Two of the ratios can be utilised:
- Expense ratio: Mario's (31%) is above the industry average of 24%, whilst Luigi's is lower (22%). This means that Luigi is better able to minimise his expenses per dollar of sales and is thus more efficient.
 - Accounts Receivable Turnover Ratio: Mario's (14.2) is lower than both the industry average of 17.7 and Luigi's of 18.6. This means that on average, Mario's debtors take 25.7 days (365/14.2) to repay debts, compared with 19.62 (365/18.6) for Luigi. This indicates that Luigi is able to turnover more debtors per year than Mario. This ratio also confirms that Luigi's business is more efficient than Mario's and the industry in general.

(iii) Gross Profit Ratio: Before expenses other than COGS are taken into account, Mario's is making 56 cents per dollar, whilst Luigi's, at 35%, falls below the industry average of 40%. This means Mario is better able to earn gross profit per dollar of revenue.

Net Profit Ratio: Once all expenses have been taken into account however, Luigi's emerges as the more superior of the two, standing at 22%, whilst Mario's is at 16% and the industry average is 20%. This means that Luigi's is ultimately the more profitable of the two, however given Mario's better gross profit ratio indicates that Luigi's is not entirely superior in terms of profitability.

- (c) Whilst Mario's has a more positive short term outlook, particularly with regard to liquidity, Luigi's would be the recommended business. Luigi's appears to be more secure over the long term, with its significantly superior efficiency levels, not to mention its high net profit ratio, which will ultimately provide the investor with a greater level of return. As the gross profit ratio is not as useful as the net profit ratio in analysing a firm's profitability, Mario's superior ratio does not provide enough evidence to recommend investment in his company over Luigi's.