



# EVALUATION

**Outstanding**  
**Very**  
**Satisfactory**

## How to deal with questions on assessing the performance of a company?

(Relevant to ATE Paper 7 – Advanced Accounting)  
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This article provides guidance for candidates in dealing with examination questions regarding the assessment of a company's performance. If the user is to make sense of the figures in the financial statements, these figures need to be properly analyzed using accounting ratios and cash flows and then compared with previous years' figures, figures from other companies or industry averages.

### Basic Techniques of Financial Statement Analysis

The analytical measures obtained from financial statements are often

expressed as ratios and percentages. There are different ways in which these measures can be analyzed.

#### Percentage analysis

##### (1) Vertical analysis

Vertical analysis is the percentage analysis used to show the relationship of each component to the total within a single statement. In vertical analysis of the statement of financial position, each asset, liability item and shareholders' equity item is stated as a percentage of the total assets, total liabilities and shareholders' equity, respectively. Vertical analysis

is useful in assessing relationships in a company's financial condition and operations.

##### (2) Horizontal analysis

Horizontal analysis is the percentage analysis of increases or decreases in related items in the comparative financial statements. The amount of each item on the most recent statement is compared with the related item on one or more earlier statements. Additional information may be required for evaluating the significance of the changes in the comparative figures; for example, a decrease in accounts receivable may

be due to increasing efforts in debt collection.

### Ratio analysis

#### (1) Profitability ratios

Profitability ratios measure the operating success of a company for a given period of time. When the profit figure is expressed as a percentage of sales or capital employed, these ratios can be compared with those of previous years, or those from companies in the same industry. Examples of ratios used in assessing profitability of a company are:

- + **Gross profit margin** – This ratio measures the gross profit generated per dollar sales. A decrease in this ratio may indicate more intensive competition in the market, declining selling prices or an increased cost of purchases. An increase in this ratio may indicate that the company has a competitive advantage in the market and therefore is able to charge higher prices for its products or can source its purchases at a lower cost. If this ratio remains constant while the net profit margin is falling, this might indicate control over expenses is weak.
- + **Return on capital employed (ROCE)** – This ratio measures how efficiently and effectively management has deployed the resources available to it. A change in the ROCE may be due to changes in profit margins, asset

utilization, sales mix or errors in inventory counting.

#### (2) Liquidity ratios

Liquidity ratios measure the company's ability to pay its maturing obligations and to meet unexpected cash needs in the short run. A reasonable level of liquidity is essential to the survival of a company. Liquidity problems may also be caused by overtrading. The most common ratios for measuring a company's liquidity are:

- + **Current ratio** – This ratio measures a company's ability to meet short-term obligations with current assets. As liquidity is essential to the success of a business, a higher current ratio is normally preferred to a lower one. Nevertheless, a very high ratio may suggest that funds are being tied up and may not be earning high returns. The current ratio should be between 1.5 and 2 to 1; however, it can vary depending upon the business that the company is engaged in.
- + **Quick ratio** – Limiting the numerator to very liquid current assets gives a stricter test of a company's liquidity since inventories cannot be readily converted into cash. If the liquidity ratios appear to be outside normal ranges, further review of inventory, receivables and payables is required. For example, a company may be forced to sell its inventories at a lower price than normal during a period of severe cash shortages.

Caution should always be exercised when drawing conclusions on the liquidity of a company because an entity's liquidity may be affected by many factors: these include the business cycle or seasons, manipulation of year-end balances, the nature of the business, overtrading or potential liabilities not included in the financial statements.

#### (3) Management efficiency ratios

Management's efficiency in managing a company's working capital is essential to the company's continuing operations. The following are examples of ratios that measure working capital management efficiency:

- + **Receivables' collection period** – This ratio measures a company's ability to collect cash from its credit customers. Most companies offer their customers credit in order to boost their sales. However, there are opportunity costs in holding cash for financing receivables, and there is also the risk of bad debts. A long receivables' collection period may be an indication of worsening credit control or that an allowance for doubtful debts is required.
- + **Payables' payment period** – This ratio links the value of accounts payables with the amount of goods and services that a company is purchasing on credit. If the payables' payment period is short, creditors are being paid relatively early or there may be unrecorded payables. However, if the payables' payment period is

too long, the company may have liquidity problems: this can also be harmful to its relationship with suppliers.

- **Inventory holding period** – This indicates how quickly a company is turning over its inventory. When deciding the appropriate level of inventory, a company should strike a balance between the cost of tying up capital and the demands from the customer. Generally, a high inventory turnover (short inventory holding period) is preferred. An unreasonably long inventory holding period may indicate an economic recession, obsolete inventory, poor sales and marketing, a change of customer taste or bad inventory management.

#### (4) Solvency ratios

Solvency ratios measure the company's ability to survive over a long period of time. Current and potential investors will be interested in a company's financing arrangements and also its 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. Examples of solvency ratios are:

- **Gearing ratio** – This measures the company's commitments to its long-term lenders against its long-term capital. High gearing is viewed as risky for companies as they may face difficulties in meeting their interest and debt

repayments as well as in raising further finance. Moreover, when a company borrows it increases its risk which in turn leads to higher cost of borrowing. The appropriateness of a suitable gearing level will be influenced by factors such as the risk preferences of owners and managers, industry norm, interest rates, required return to shareholders, stability of profits, the availability of equity funds, availability of suitable assets for security, and terms of loan agreements. In general, higher gearing can also benefit shareholders if the entity becomes more profitable since earnings of a highly-g geared company are more sensitive to profit changes.

- **Interest cover** – This ratio compares the amount of income that has been earned with the interest obligations for the same period. The lower the level of interest cover, the greater the default risk to lenders.

#### (5) Investment Ratios

There are ratios that use the current market price of a share to indicate the return an investor might earn by purchasing that share.

- **Earnings per share** – This ratio represents the earnings made and available to shareholders during an accounting period. The trend in earnings per share over time is used to help assess the investment potential of a company's shares. Some companies retain a significant proportion of the



earnings they generate, and hence their earnings per share will increase even if there is no increase in profitability.

- **Price/earnings ratio** – This ratio provides a clear indication of the value placed by the capital market on a company's earnings and what it is prepared to pay for investors. Subject to overall market sentiment and economic conditions, the price/earnings ratio reflects the capital market assessment of both the amount and the risk of these earnings.
- **Dividend yield** – This ratio gives the percentage return (dividend) on the investment in one share. It is a crude measure of the return to shareholders, but it does ignore capital growth, which is often much higher than the return on dividends.

### Analysis of Cash Flows

A statement of cash flows identifies whether cash has increased or decreased from the previous year to the current year and also the sources and applications of cash. The deterioration in cash position of a company can be relieved by operating cash inflows (and hence the liquidity of the company can be improved) in the near future if the ability to generate cash flows from operating activities is more than sufficient to pay interest, dividend and tax.

When analyzing the statement of cash flows, managers and analysts often calculate the free cash flow.

Free cash flow refers to the cash flow from operations minus dividends and capital expenditure. This gives a measure of a firm's ability to engage in long-term investment opportunities and its financial flexibility. The cash position of a company can be further analyzed into the following:

#### (1) **Cash flows from operating activities**

Cash flows from operating activities represent the cash receipts from trade debtors and cash sales less the cash paid for inventory, salaries and other activities to maintain the operations. To enhance the viability of the company, it is essential that interest, tax, dividend and short-term costs are funded from operating cash flows; then the company can use its surplus to finance any increase in property, plant and equipment.

A reduction in investments in both inventory levels and trade receivables may be the result of more efficient inventory control and receivables collection. However, when there is a reduction in inventory and trade receivables together with a large reduction in trade payable balances, this may indicate that trading volumes may be contracting.

#### (2) **Cash flows from investing activities**

Investing activities are the acquisition and maintenance of investments by companies to sell products or to provide services; this includes the acquisition and disposal of investments and in non-current

assets for operating a company. If a statement of cash flows shows considerable investment in property, plant and equipment and there are no significant disposals, an increase in investment represents an increase in capacity rather than the replacement of old assets and the company may have expanded.

#### (3) **Cash flows from financing activities**

Financing activities are those through which a company acquires and manages its financial resources so as to pay to maintain its daily operations and to expand further. Provided that a return on the new investments in property, plant and equipment can generate returns that are in excess of the loan interest and dividend yield, then the shareholders' wealth is not reduced.

### Points to note when assessing a company's financial performance

Most performance appraisal is based on interpreting various comparative ratios.

#### (1) **Environment faced by the company**

Performance assessment should take into account the business environment in which a business operates and separate the controllable from the uncontrollable. For example, if a company faces a difficult trading environment and a shrinking market, this is probably outside the control of the business and may lead to a reduction in sales volume and prices.



**(2) Nature of business**

Business nature is another factor to consider when assessing financial performance. Low-margin businesses (e.g. supermarkets) usually have a high asset turnover, while capital-intensive industries (e.g. electrical products manufacturers) usually have a relatively low asset turnover but higher margins.

**(3) Causes of a change in ratios**

There is usually no absolute answer to an interpretation question, and remember there may be clues in the scenario given that would account for identifying plausible causes for changes in a company's ratios and cash position. For example, liquidity may have deteriorated dramatically due to significant investment in non-current assets but without a proportionate increase in sales. Both financial and non-financial factors should be considered when determining what caused the change in ratios. For example, liquidity of a company may also be affected by availability of further finance and the due dates of long-term loans.

**(4) Related party relationship and transactions**

These transactions have the potential to distort the results of a company; for example, expertise provided to a group company without charge being made by the present company or another group company. A company may have entered into certain arrangements that make its previous results not directly comparable with

its current results; for example, a sale and leaseback arrangement.

**(5) Interrelationship among different types of ratios**

Looking at a single ratio in isolation is rarely useful in building a full financial picture. Instead, it is necessary to consider one type of ratios in combination with another type of ratios. For example, we have to look at management efficiency ratios when interpreting the current ratio.

**(6) Comparison among different periods and different companies**

For inter-company comparisons and comparisons made over time, considerations should be made on factors that can distort these comparisons; such factors may include differences in accounting policies, off-balance-sheet financing, inflation, creative accounting, and differences in the basis of calculating the ratios.

**Conclusion**

Accounting ratios and the statement of cash flows are important in interpreting accounting statements. Candidates should be aware of the limitations of financial performance assessment and be careful in formulating their conclusions. In the examination, it is suggested that you take a structured approach when dealing with this type of question:

- + Prepare a statement of cash flows, if required by the question
- + Calculate ratios in important areas such as profitability, liquidity, and gearing.
- + Use the background information given in question to identify possible causes of any changes in ratios and the cash position, express your opinions and draw conclusions on the company's financial performance.

