CHAPTER 19
INTERPRETATION OF FINANCIAL STATEMENTS REVISITED

Take it further

Question 1

Overview
The following points should be included in this overview:

- Differences in key figures:

Revenue	Goldie generates 2 x revenue of Pink
Operating profit	Pink has loss; Goldie a profit
Operating profit excluding impairment losses	Goldie's profit is twice that of Pink
Total assets	Goldie's total assets are twice those of Pink
Intangibles	Goldie has intangibles 2.3 x intangibles of Pink
Cash and cash equivalents	Pink has higher cash
Retained earnings	Pink's retained earnings are less than one tenth of Goldie's – retained loss in current year
Other assets and liabilities	Goldie's figures generally 2 x those of Pink
Dividends	Amount per share similar in both companies despite Pink's loss

- Revenues – strong competition and pricing pressures
- Intangible assets by far the most significant asset in both companies – 63% of total assets for Pink; 70% for Goldie – common in telecommunications industry
- Judgements needed in measuring these assets, which will have a considerable effect on financial performance and financial position

Ratios

	Pink		Goldie	
Performance and efficiency				
Return on capital employed (ROCE)	(240) / (4,320 + 2,060)	(3.8)%	1,510 / (9,890 + 4,070)	10.8%
ROCE (excluding impairment)	760 / (4,320 + 1,000 + 2,060)	10.2%		10.8%
Operating profit %	(240) / 2,695	(8.9)%	1,510 / 5,220	28.9%
Operating profit % (excluding impairment)	760 / 2,695	28.2%		28.9%
Gross margin	1,100 / 2,695	40.8%	2,230 / 5,220	42.7%
Selling and distribution cost %	190 / 2,695	7.1%	430 / 5,220	8.2%

OXFORD
UNIVERSITY PRESS

© Oxford University Press, 2017. All rights reserved.

Administrative expense %	150 / 2,695	5.6%	290 / 5,220	5.6%
Asset turnover	2,695 / (4,320 + 2,060)	0.42 times	5,220 / (9,890 + 4,070)	0.37 times
Financial position ratios				
Current ratio	1,095 / 910	1.20	1,470 / 1,320	1.11
Trade receivables collection period	460 x 365 / 2,695	62 days	990 x 365 / 5,220	69 days
Trade payables payment period	565 x 365 / 1,595	129 days	700 x 365 / 2,990	85 days
Gearing (net debt / equity)	(2,060 – 620) / 4,320	33.3%	(4,070 – 450) / 9,890	36.6%
Interest cover	(240) / 75	(3.2) times	1,510 / 160	9.4 times
Investor ratios				
Dividend cover	(510) / (0.065 x 1,335)	(5.9) times	890 / (0.062 x 2,660)	5.4 times
EPS	(510) / 1,335	(38.2)p	890 / 2,660	33.5p

Evaluation

The following points should be made:

- Goldie is twice the size of Pink. The interpretation of this is that it has twice the number of customers or contracts as there is strong competition and competitive pricing structures exist in the industry. Further details of volumes and prices for customers are needed to complete the picture.
- The impact of this on the interpretation is that line-by-line comparisons are irrelevant, and the ratios are far more useful.

Financial performance

- Before interpretation of the ratios is carried out, it should be noted that the major effect on Pink's profitability is the impairment loss of £1 billion. If the loss is added back, profit from operations is approximately half that of Goldie, which is comparable given the relative sizes of the companies.
- The impairment loss arises from the comparison of carrying amount of intangibles to recoverable amount – clearly the fair value (market value) has decreased. This can be viewed as a technical accounting adjustment – although unlikely, market value may increase in the future resulting in a reversal of losses. Impairment losses are subjective and based on management's judgement. It is surprising that Goldie has no impairment losses given the companies are in the same industry.
- Pink's profitability ratios excluding the impairment loss are a better comparison to Goldie than just the net statement of profit or loss figures. Pink's ROCE is slightly smaller than Goldie's, giving an indication that Pink's management is marginally less efficient in employing the resources of the company.

© Oxford University Press, 2017. All rights reserved.

- However Pink's asset turnover is greater than Goldie's reflecting greater revenues earned from the company's net assets. The impairment charge has reduced the asset base, which has a positive effect on the ratio. Asset turnover is generally low for this industry which is capital intensive (tangible and intangible assets).
- Pink's gross margin is 2 percentage points lower than Goldie's. Mobile phone companies tend to have a large fixed cost base and relatively low marginal costs. It appears that Pink's fixed costs such as network depreciation charges, intangibles amortisation or wage costs of operational staff are larger. Alternatively the mix of services it provides may be different.
- Pink's operating margin excluding impairment charges is marginally smaller than Goldie's. The difference is not as great as the difference in gross margin, indicating that Pink controls its overhead costs better.
- Pink's selling and distribution costs are lower as a percentage of revenue. This needs further investigation since the company has spent £10 million on advertising and sponsorship, implying these costs would have risen. Information about cost allocation and previous year's costs are needed to further explain.
- The two companies' administrative costs are consistent with their revenues.
- Interest costs are comparable in the companies given the level of borrowings.

Financial position and liquidity

- Pink's gearing is lower than Goldie's. This is despite the reduction in equity from the impairment loss which will have increased the ratio. Neither company is highly geared. Note also that companies in the telecommunications industry have many intangibles, such as internally generated brands, which are not represented on the statement of financial position.
- Both companies are generating cash and this is supported by the strong underlying profits (excluding the impairment loss).
- Interest cover in Pink is negative due to the operating loss, but Goldie can comfortably cover its interest from its profits over 9 times.
- The current ratio in both companies at over 1 is strong indicating they can meet their current liabilities from their liquid assets. Note, consistent with the industry, inventories are immaterial so there is no need to calculate the liquid ratio. Cash balances and overall liquidity in Pink are marginally higher.
- Pink's trade payables are significantly higher than Goldie's, and the company is taking 44 days extra on average to pay its suppliers. This may have contributed to increased cash balances. There are risks in this, as suppliers may not wish to carry out business, although the year-end balance may be influenced by the timing of payments.
- Pink's trade receivables collection period is lower by 7 days, again having a positive effect on cash balances. This may be explained by different payment terms for its customers.

<u>Conclusion</u>

Main points to include:

- The key question concerns cause of impairment losses in Pink – are they caused by external factors, such as fall in values of assets in industry, or are there internal causes, which could potentially affect the future performance of Pink. More

© Oxford University Press, 2017. All rights reserved.

information on the assets affected, estimates made, and management's assumptions is needed to assess judgements and sensitivities.
- Otherwise Pink's financial performance has been similar to Goldie's in a demanding, competitive industry.
- Goldie's profitability is slightly better than Pink's mainly from its higher gross margin.
- Pink's financial position is marginally stronger – it has lower gearing, positive cash flows and better liquidity.
- Additional information to assist analysis:
  - Cash flow statements, particularly to review the quality of profits by comparing operating cash flows with operating profits.
  - Segmental analysis to show revenues and profits from different product lines (voice, messaging, data, internet, etc.).
  - Details of customers leaving and joining network to assess growth potential of the businesses.
  - Forthcoming regulatory changes and their impact on the businesses.
  - Details of cost of sales to explain the difference in gross margins.
  - Details of selling and distribution costs and any one-off costs in this area.
  - Details of capital expenditure made and future capital expenditure planned.
  - Details of borrowing – importantly when is it due for repayment
  - Dividend policies

OXFORD
UNIVERSITY PRESS

© Oxford University Press, 2017. All rights reserved.

Question 2

Changes in key figures:

Revenue	+12%	(Goal: increase business and market share)
Operating profit	+17%	(Goal: improve operating margins)
Profit for the year	+15%	
Basic EPS	+14%	
Total comprehensive income	-25%	(Large actuarial loss in 20X8: gain in 20X7)
Total assets	+3%	
Non-current assets	-5%	
Current assets	+20%	(From inventories and receivables; cash is lower)
Equity	< +1%	
Total borrowings	< +1%	(More in current)
Reduction in generation of cash from all activities		
Cash & cash equivalents	-62%	
Same dividend in both years		
Market price of shares	-35%	

Key ratios:

				*without intangibles**	
		20X8	***20X7***	***20X8***	***20X7***
Investor ratios					
ROE	Profit after tax / Equity	17.3%	15.2%		
EPS	Disclosed	9.1p	8.0p		
P/E	Market price / EPS	12.5	21.9		
Dividend per share	Dividends / No. of shares	6.8p	6.8p		
Dividend cover	Profit after tax / Dividends	13.1	11.4		
Dividend yield	Dividend per share / Market price	6.0%	3.9%		
Shareholder's return	(Change in market price + dividend per share) / Opening market price	-31.0%			
Financial leverage	Net assets / Equity	1.8	1.8	1.6	1.6
Gearing	Net debt (Total borrowings – cash) / Equity	80.1%	75.7%		
Interest cover	Operating profit / Finance costs	5.4	4.8		
Profitability ratios					
ROCE	Operating profit / (Equity + total borrowings)	16.0%	13.8%		
ROCE	Operating profit / (Equity + non-current liabilities – deferred tax + current borrowings)	12.4%	10.8%		
Return on net assets	Operating profit / Net assets	16.6%	14.3%	22.7%	19.3%

© Oxford University Press, 2017. All rights reserved.

Gross margin	Gross profit / Revenue	50.5%	53.7%	51.5%	54.8%
Net margin	Operating profit / Revenue	5.0%	4.8%	5.9%	5.8%
Asset turnover	Revenue / Net assets	3.3	3.0	3.6	3.3
Liquidity ratios					
Current ratio	Current assets / Current liabilities	0.86	0.77		
Liquid ratio	(Current assets – inventories) / Current liabilities	0.34	0.35		
Efficiency ratios					
Inventory turnover	(Inventories x 365) / Cost of sales	86 days	77 days		
Receivables collection period	(Receivables x 365) / Revenue	27 days	25 days		
Payables payment period	(Trade payables x 365) / Cost of sales	78 days	84 days		

* Because of the subjectivity of the valuation of intangible assets, and for reasons of comparability with other companies, some ratios have been calculated without the intangible assets and their associated amortisation charges.

Interpretation

The following points could be made:

Overview

1. There has been reasonable growth in revenue, and higher growth in profits. The aggregate financial statements do not show where this has come from – segmental analysis would be needed to see which business segment(s) were growing. Quarterly figures would be needed to see whether all year round business was improving. It is impossible to tell whether the company has increased its market share without external industry data.
2. There has been a substantial increase in inventories and receivables – possibly from the building up of different types of business?
3. Total comprehensive income has fallen due to the accounting methods for estimating pension scheme liabilities – the company does have a substantial pension scheme deficit at over 20% of total liabilities. The actuarial loss reversed the previous year's actuarial gain, and could be caused by underpinning estimates and judgements, or interest rates applied. This resulted in only a marginal increase in equity.
4. The company appears less liquid with a fall in cash and cash equivalents, and less cash generated from operations despite a higher operating profit.
5. There has been a substantial fall in the market price of shares.

Ratios

1. Most investor measures have improved in 20X8 – the increase in EPS reflects the higher return on equity.

© Oxford University Press, 2017. All rights reserved.

2. As the company maintained the same level of dividend, with increased profits, the dividend cover increased. The company reinvests a substantial portion of its profits – good for an investor seeking growth.
3. However, as the market price of the shares has fallen, the PE ratio shows a significant decrease – this indicates the markets have less confidence in the company at the end of 20X8. The general level of equity share prices and for this industry would also need to be assessed to evaluate this further.
4. As a result of the fall in market price, the real return, measured by the dividend yield, has almost doubled, but the overall shareholder return is negative, since the dividend per share is relatively small compared to the share price.
5. The company is relatively highly geared, which in a small/medium-sized organisation is a risk. Gearing has also risen, although this is partly from the static equity as a result of the actuarial estimates used in valuing the pension scheme liabilities. Operating profits do cover finance costs 5 times, so there does not appear to be an issue with the servicing of the debt.
6. All profitability ratios, except the gross profit, have increased in 20X8.
7. Return on capital employed, whichever way it is calculated, has increased but this is due to increased profits and fairly constant equity and liabilities. Increased generation of revenues from the company's assets and profitability also contribute to a higher ROCE.
8. The gross margin has decreased by 3 percentage points as the direct costs have increased proportionately more than revenues – this may be connected to efforts to increase revenue streams and particularly export sales, or it may be indicative of a cost control problem.
9. Since the net profit margin is similar in both years, the company is seemingly keeping control of its overheads.
10. Inventory and receivables have increased far more than payables and this fact, together with the efficiency ratios, shows that the working capital cycle (operating cycle) is slower and less efficient.
11. Cash is generated from operating activities and increases in borrowings and is used primarily on the purchase/lease of PPE, interest payments and dividends. Due to the slower working capital cycle, substantially less cash has been generated from operations, leading in part to lower cash balances at the end of 20X8. However overall liquidity levels have not changed substantially.

Conclusion

Overall, the company is increasing its sales revenues in line with its long-term goals, and overall profitability has also improved. The changes in gearing and liquidity may be cause for concern, together with the large pension scheme deficit. Why the share price has fallen so much is also an issue. Buying shares in the company at a relatively low price may be a smart move, if the price is going to increase as the company's growth and prospects improve.

However further details from the company's financial statements, plus external industry and stock market information are needed before a final investment decision can be reached.

© Oxford University Press, 2017. All rights reserved.

Question 3 – Next plc

See solution to Chapter 19's case study

OXFORD
UNIVERSITY PRESS

© Oxford University Press, 2017. All rights reserved.