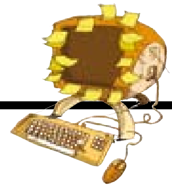


Financial Analysis

Tony Sweetman offers a model approach to answering a recent exam question that tested the candidates' ability to dissect and decipher financial statements.

Global contact details continued from page 43.

The analysis and interpretation of financial accounts represents 35 per cent of the syllabus content for paper P8. This means that it is highly examinable and should be addressed seriously by candidates preparing for this exam. In the May 2005 paper, question five in section C covered interpretation and analysis issues. The question was worded as follows.

Question five

DM, a listed entity, has just published its financial statements for the year ended December 31, 2004. DM operates a chain of 42 supermarkets in one of the six major provinces of its country of operation.

During 2004 there has been speculation in the financial press that the entity is likely to be a takeover target for one of the larger national chains of supermarkets that is currently underrepresented in DM's province. A recent newspaper report has suggested that DM's directors are unlikely to resist a takeover bid. The six board members are nearing retirement and they all own significant minority shareholdings in the business.

You have been approached by a private shareholder in DM. She is concerned that the directors have a conflict of interests and that the financial statements for 2004 may have been manipulated.

A balance sheet, with comparatives, at December 31, 2004 is shown in panel 1. The income statement and the summarised statement of changes in equity of DM, with comparatives, for the year ended December 31, 2004 are shown in panels 2 and 3.

DM's directors have reassessed the useful lives of non-current tangible assets during the year. In most cases, they estimate that their useful lives have increased. The depreciation charges in 2004 have been adjusted accordingly.

Six new DM stores have been opened during 2004, bringing the company's total to 42 supermarkets.

1 DM'S BALANCE SHEET AT DECEMBER 31, 2004

	2004		2003	
	$m	$m	$m	$m
Non-current assets				
Property, plant and equipment	580		575	
Goodwill	100		100	
		680		675
Current assets				
Inventories	47		46	
Trade receivables	12		13	
Cash	46		12	
		105		71
		785		746
Equity				
Share capital	150		150	
Accumulated profits	151		126	
		301		276
Non-current liabilities				
Interest-bearing borrowings	142		140	
Deferred tax	25		21	
		167		161
Current liabilities				
Trade and other payables	297		273	
Short-term borrowings	20		36	
		317		309
		785		746

2 DM'S INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2004

	2004	2003
	$m	$m
Revenue, net of sales tax	1,255	1,220
Cost of sales	(1,177)	(1,145)
Gross profit	78	75
Operating expenses	(21)	(29)
Profit from operations	57	46
Finance cost	(10)	(10)
Profit before tax	47	36
Income tax expense	(14)	(13)
Profit for the period	33	23

3 DM'S SUMMARISED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED DECEMBER 31, 2004

	2004	2003
Opening balance ($m)	276	261
Profit for the period ($m)	33	23
Dividends ($m)	(8)	(8)
Closing balance ($m)	301	276

Four key ratios for the supermarket sector (based on the latest available financial statements of 12 listed entities in the sector) are as follows:

- Annual sales per store: $27.6m.
- Gross profit margin: 5.9 per cent.
- Net profit margin: 3.9 per cent.
- Non-current asset turnover (including both tangible and intangible non-current assets): 1.93.

Part (a) of the question, worth 20 marks, requires you to prepare a report, addressed to the individual shareholder, analysing the performance and position of DM based on the financial statements and other information provided. The report should include comparisons with the key sector ratios and address the investor's concerns about the possible manipulation of the 2004 financial statements.

How to approach the question

The following method can be used to answer all interpretation and analysis questions, taking care to adjust your answer to the specific scenario outlined in a particular question:

1. Identify an appropriate format for your answer. This question requires a report addressed to an individual investor. One or two marks are likely to be available for using a suitable format. You should use appropriate headings or sections, write in professional language and compile an appendix that contains the calculation of any ratios used in your report. You might like to use a separate page for each section of the report for ease of compilation and effective presentation within the time allowed.
2. Identify specifically what is needed to address the matters raised in the question. This one requires a report analysing the performance and position of DM, bearing in mind two specific issues:
   - Concerns regarding possible manipulation of the 2004 financial statements.
   - The comparison of DM's ratios with the key sector ratios that were included in the narrative.

   You will earn few, if any, marks for calculating ratios that are peripheral to the key requirements. For example, a detailed analysis of each of the components of working capital is unlikely to address the main issues raised in this particular question. As before, marks will be earned for your application of the question requirement.
3. Analysis and interpretation requires more than a simple calculation of relevant ratios, or merely stating that a particular ratio has improved or deteriorated. What's needed is an explanation of what the ratios could indicate. Often this interpretation can be supported, at least partially, by using the narrative of the question.
4. Draw conclusions in your report that can be supported by the information you have already presented. Try not to be too enthusiastic or unduly pessimistic about the scenario. It's unlikely that you will have enough information to arrive at a single, definitive conclusion. In this question, marks will be earned by drawing conclusions about the issues that the shareholder asked to be addressed.

A model answer

The answer itself should be well spaced and logically ordered, with a title page, contents page, relevant sections of analysis and interpretation and conclusions, together with an appendix.

The title page should state the following:

Report on the financial performance and position of DM for the two years ended December 31, 2004.

Prepared for: A N Investor.

Prepared by: A N Adviser.

Date: May 2005.

Page one should state the following:

Report contents.

Introduction.	Section 1.
Company performance.	Section 2.
Company position.	Section 3.
Conclusions.	Section 4.
Ratio calculations.	Appendix.

Page two onwards should state the following:

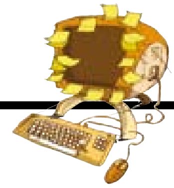
Section 1: Introduction.

This report summarises the financial performance and position of DM for the two years ended December 31, 2004, including observations relating to the possible manipulation of the financial statements by the directors of that company.

Section 2: Company performance.

The gross profit margin of DM has increased from 6.1 per cent to 6.2 per cent. This is better than the average gross profit margin for the whole sector of 5.9 per cent. Possible reasons for this improvement include DM's ability to negotiate beneficial terms of business with its suppliers and/or charge higher prices in individual stores that are subject to little competition.

Operating profit has increased by almost 24 per cent. It would appear that this has resulted largely from a reduction in operating expenses over the period. This might be because of a



reduction in the annual depreciation charge leading from the directors' extension of the estimated useful lives of most of DM's non-current assets. A review of the carrying values for non-current assets reveals an increase of $5m. It's unlikely that there have been significant disposals that would lead to a reduced depreciation charge. Without any further information to explain the reasons for this change, one could conclude that it was done deliberately in order to reduce operating expenses and thereby improve operating profitability.

The figure for annual sales generated per store has fallen from $33.9m to $29.9m, but this still compares favourably with the sector average of $27.6m. One reason for the decline is that, although DM has opened six new stores in 2004, they may not have contributed a full year of revenue generation. One possible reason for DM's good performance relative to the competition on this measure is that its stores are larger than average.

DM's net profit margin has improved from 1.9 per cent to 2.6 per cent, which is still lower than the sector average of 3.9 per cent. As previously indicated, the improvement in DM's performance may have been a consequence of the decline in operating expenses resulting from the reduction of the annual depreciation charge.

Section 3: Company position.

DM's current ratio has increased from 0.23:1 to 0.33:1. Firms in this industry predominantly make cash sales to individual customers while taking credit from suppliers. Trade and other payables within current liabilities have increased by $24m and there has been a significant increase in cash balances from £12m to $46m. These factors have combined to improve the current ratio, although it may still be regarded as low.

Property, plant and equipment have risen by $5m – an increase of less than one per cent. Part of this increase may have resulted from the creation of the new stores, together with the reduction in depreciation charge resulting from the extension of the estimated useful lives of those assets.

Non-current asset turnover has risen from 1.81 to 1.85, which still compares unfavourably with the sector average of 1.93. The improvement may have come from a more efficient use of store space, but there is insufficient information to be more specific about this.

Gearing has decreased from 50.7 per cent to 47.2 per cent. Because the current ratio has improved over the same period, including an increase in cash balances, this change would not appear to be of immediate concern.

Section 4: Conclusions.

Based on the available information, DM appears to be a profitable company. If the results of the six new stores it has opened are not reflected fully in its results to date, there may be further improvements in gross profit and operating profit margins in future years as they become fully operational.

The company would appear to have no immediate concerns over liquidity or the level of gearing used to finance the business.

It's impossible to conclude definitively whether there has been a deliberate manipulation of the financial statements by the directors to improve the company's position. As shareholders in the company, they would benefit personally from the sale of their stock in a takeover. But further information and explanation would be required from DM for me to arrive at a more specific conclusion on this matter.

Appendix: Ratio calculations.

See panel, below. **FM**

Tony Sweetman is a tutor with FTC in Glasgow. He was highly commended in the tutor of the year category of the 2004 CIMA Financial Management Awards.

APPENDIX: RATIO CALCULATIONS FOR DM

Ratio	2004	2003	Sector mean
Net profit	33 ÷ 1,255 = 2.6%	23 ÷ 1,220 = 1.9%	3.9%
Gross profit	78 ÷ 1,255 = 6.2%	75 ÷ 1,220 = 6.1%	5.9%
Operating profit	57 ÷ 1,255 = 4.5%	46 ÷ 1,220 = 3.8%	n/a
Stores	42	36	n/a
Annual sales per store ($m)	1,255 ÷ 42 = 29.9	1,220 ÷ 36 = 33.9	27.6
Non-current asset turnover	1,255 ÷ 680 = 1.85	1,220 ÷ 675 = 1.81	1.93
Current ratio	105 ÷ 317 = 0.33:1	71 ÷ 309 = 0.23:1	n/a
Gearing	142 ÷ 301 = 47.2%	140 ÷ 276 = 50.7%	n/a

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