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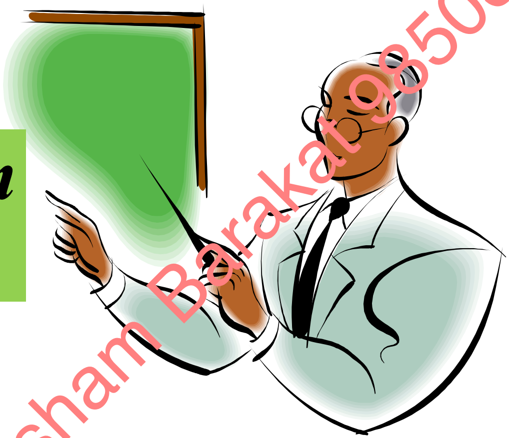

IWILL STAY BY YOUR SIDE

Dr.hesham barakat

Mid Term Review

Ch. 1
Financial statement analysis

1st Definition of Financial Analysis

means using Techniques to analyze Financial Data according to it's relative importance in order to evaluate the financial position of the company.

2nd Techniques of Financial Analysis:

Financial Ratios are a **relation** between two related items which gives a meaningful information. They are usually expressed in **% or times per period**.

1st we have to compute Financial Ratios by determining the relation between:

- Item in Balance sheet with Item in Balance Sheet.
- Item in Income Statement with Item in Income Statement.
- Item in Balance Sheet with Item in Income Statement.

2nd We have to Compare Financial Ratios with:

- Ratios of Previous Periods for the Same Company (Trend Analysis).
- Ratios of Current Period for another company.
- Ratios of Current Period for Industry (Industry Ratios).

Problems of Ratio Comparison:

Comparing Ratios with other companies has many problems because of:

1) Difference in Equations & Basis used by each company to compute ratios.

2) Difference in Fiscal Year Ends used by each company to prepare Financial Statements.

3) Difference in Accounting Methods used by each company.

Comparing between Different Size Companies is more difficult than Comparing between Equal Size Companies especially when using **Absolute Numbers.**

Common Size Analysis

Under Common Size Analysis; It is better to use **Percentages or Relatives (%)** rather than absolute numbers because using Percentages will help in comparing companies with different sizes.

Income statements for 2018 and 2019 of ABC Inc. are given below:

a) Express the income statement information in **common-size percents** for both 2018 and 2019. (20 pts) - Show calculations.

b) Assess whether this company's situation is favourable or unfavourable. (15 pts, 75 words)

	2019	2018
Sales	540,000	317,656
Cost of goods sold	356,400	183,973
Gross profit	183.600	133,683
Operating expenses	113,400	64,869
Net income	70,200	68,814

Req (a)

	2019	2018
sales revenue	100%	100%
COGS	66%	57,9%
Gross profit	34%	42,1%
operating exp.	21%	20,4%
Net Income	13%	21,7%

Common size for 2019	Common size for 2018
Sales $= \frac{540000}{540000} \times = 100\%$	Sales $= \frac{317656}{317656} \times 100 = 100\%$
COGS $= \frac{356400}{540000} \times 100 = 66\%$	COGS $= \frac{183973}{317656} \times 100 = 57{,}9\%$
Gross profit $= \frac{183600}{540000} \times 100 = 34\%$	Gross profit $= \frac{133683}{317656} \times 100 = 42{,}1\%$
Operating exp. $= \frac{113400}{540000} \times 100 = 21\%$	Operatingexp. $= \frac{64869}{317656} \times 100 = 20{,}4\%$
Net income $= \frac{70200}{540000} \times 100 = 13\%$	Net income $= \frac{68814}{317656} \times 100 = 21{,}7\%$

Answer (b)

Comment

As indicated, Net income as percentage of sales. declined. It was 21-7% in 2018 and became 13% in 2019. This is mainly due to the significant increase in both COGS and operating expenses, since the company spent 57-9% of its revenue as COGS in 2018 and this percentage increased to 66% in 2019.

For operating expenses, the company spent 20,4% of sales revenue as operating exp. in 2018 and this ratio also increased to 21% in 2019.

So the overall performance seen as to be unfavorable. Since the company does not manage its costs and expenses well.

Ratios used to measure Liquidity Analysis

Liquidity can be measured by using Ratios that compare between Current Assets & Current Liabilities:

working Capital= Current Assets - Current liability

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

=1.5 high better

Quick (Acid Test) Ratio:

$$\frac{\text{Current Assets} - \text{Inventory} - \text{Prepaid Expenses}}{\text{Current Liabilities}}$$

=1 high better

Current assets

Cash, Accounts receivable, inventory, prepaid expense, short term investment, Trading securities, marketable securities.

Current liabilities

Accounts payable, accrued expense, short term loan, salary payable, tax payable, interest Payable, Unearned revenue.

Exercise

a) Compare the liquidity position of this company at the end of 2018 and 2019 by computing the: **current ratio and acid-test ratio. (20 pts) - Show calculations.**

b) Comment on the ratios you computed in (a).

	2006	2005	2004
Cash	$ 30,800	$ 35,625	$ 36,800
Accounts receivable, net	88,500	62,500	49,200
Merchandise inventory	111,500	82,500	53,000
Prepaid expenses	9,700	9,375	4,000
Plant assets, net	277,500	255,000	229,500
Total assets	$518,000	$445,000	$372,500
Accounts payable	$128,900	$ 75,250	$ 49,250
Long-term notes payable secured by mortgages on plant assets	97,500	102,500	82,500
Common stock, $10 par value	162,500	162,500	162,500
Retained earnings	129,100	104,750	78,250
Total liabilities and equity	$518,000	$445,000	$372,500

a. **Current ratio:**

2006: $\dfrac{\$30,800 + \$88,500 + \$111,500 + \$9,700}{\$128,900}$ = 1.9

2005: $\dfrac{\$35,625 + \$62,500 + \$82,500 + \$9,375}{\$75,250}$ = 2.5

2004: $\dfrac{\$36,800 + \$49,200 + \$53,000 + \$4,000}{\$49,250}$ = 2.9

b. **Acid-test ratio:**

2006: $\dfrac{\$30,800 + \$88,500}{\$128,900}$ = 0.9

2005: $\dfrac{\$35,625 + \$62,500}{\$75,250}$ = 1.3

2004: $\dfrac{\$36,800 + \$49,200}{\$49,250}$ = 1.7

	2006	2005	2004
Current Ratio	1.87	2.52	2.90
Quick ratio	0.92	1.30	1.74
Current Ratio	Because CR is above 1.5, Current Ratio is fine	Because CR is above 1.5, Current Ratio is fine	Because CR is above 1.5, Current Ratio is fine
Quick ratio	QR is less than 1. It would be much better if it was above or around 1. However, it is 0.92 which is very close to 1, so acceptable.	QR is more than 1. Quick ratio is fine.	QR is more than 1. Quick ratio is fine.

We can say that this company's liquidity is fine, and the company has the ability to pay its short-term liabilities in the coming year. But we also need to warn management that the quick ratio has fallen below 1. A quick ratio of 0.90 is still acceptable, but company management needs to be careful. .

Note

In this example liquidity position of the company is fine. One more thing. If the company has a current ratio of more than 1.5 and a quick ratio of more than 1, this means that the company is holding more liquid assets than they need to pay current liabilities. So they are using liquid assets inefficiently

Chapter (3)

Analyzing Financing Activities

- Financing sources
- liabilities
- Equity
- Off balance sheet transaction

1) **Financing sources**: There 3 sources of financing

A- Liabilities.

B- Capital (stockholder's Equity).

C- Off balance sheet transactions.

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Note: More liabilities less equity → the co. is risky

Less liabilities more equity → the co. is less risky

2) Liabilities

Liabilities can be classified into (type of liab.)

Operating Liabilities
Obligations that arise from operating activities.

Ex:

- Accounts payable
- Unearned revenue (Deferred Revenue)
- Payment in advance
- Trade and other payables
- Tax payable
- Salary payable
- Postretirement liabilities
- Postemployment benefits
- Any accrued operating
- Expenses such as accrued utility expense.

Financing Liabilities
Obligations that arise from financing activities.

Ex:

- Short term debt or loans
- Long term debt or loans
- Bonds payable
- Notes payable
- Borrowing
- Leases (especially financing lease). [lease liability]
- Current portion of long term debts.
- Bank over draft.
- Murabaha payables.

Classification of liabilities in the financial statements (Balance sheet)

Based on payment time

Current (Short term) Liabilities	**Non-current (Long term) liabilities**
Obligations whose settlement require use of current assets or incurrence of another current liability within one year or operating cycle whichever is longer.	Obligation of payable within one year or operating cycle whichever is longer
(Liabilities ≤ one year)	(Liabilities > one year)
Examples	**Examples**
A/P or trade payable	Tax payable
Salary payable	Long term bank loan
Unearned revenue	Lease liability
Tax payable	
Short term bank loan	
Lease liability	

Some analysis issues

- Most of information related to liabilities can be found in the note to financial statements.

Such as:

- Payment method (one payment or installments)
- Payment dates and maturity dates.
- If there is interest applied, what is the interest rate.

- Interest rate is very important issue related to liabilities:

It is determined by the bank based on the riskness of the company.

In other words, there is positive relationship between interest rate and riskness of the company.

If the co. is more risky, the interest rate is determined to be high.

If the co. is less risky, the interest rate will be low.

- The company has to disclose average interest rate that it pay for its loans (average borrowing rate) because IFRs requires that.

For Example:

Co. ABC has three bank loans as follows:

5000 at 3% interest

2000 at 5% interest

3000 at 2% interest

10.000

So the average interest rate that should be disclosed in the notes is computed as follows:

5000 × 3% = 150

2000 × 5% = 100

3000 × 2% = 60

10.000 310

So average rate= $\frac{310}{10.000}$ × 100 = 3.1%

Questions)The below is the liability part of a Boursa firm in Kuwait.

		As at	
	Note	**2019**	**2018**
Liabilities			
Non-current liabilities			
Borrowings	12	9,288,487	3,240,649
Lease liabilities	3	712,905	-
Employees end of service benefits	13	1,567,228	1,446,693
		11,568,620	4,687,342
Current liabilities			
Trade and other payables	14	6,870,800	18,771,838
Borrowings	12	6,127,421	2,892,324
Lease liabilities	3	26,134	-
		13,024,355	21,664,162
Total liabilities		24,592,975	26,351,504
Total equity and liabilities		93,189,727	95,865,891

a) List the financial liabilities of the company and indicate the change in total financial liabilities from 2018 to 2019 in percentages**. (10 pts)**

b) List the operational liabilities of the company and indicate the change in total operating liabilities from 2018 to 2019 in percentages. **(10 pts)**

Req(a) List the financial liabilities

	2019	2018	Change
Non current liab.			
Borrowings	9288487	3240649	
Lease liabilities	712905	-	
Current liab.			
Borrowings	6127421	21892324	
Lease liabilities	26134	-	
Total financial liab.	16,154,947	6132973	163.41%

Change = $\frac{\overset{2019}{new} - \overset{2018}{old}}{2018\ old} \times 100$

$= \frac{16.154.947 - 6132973}{6132973} \times 100 = 163.41\%$

Increase in financial liab.

Req(b) List the operational liabilities

	2019	2018	Change
Non current liab.			
Employees end of service benefits	1,567,228	1,446,693	
Current liab.			
Trade and other payable	6,870,800	18,771,838	
Total operational liab.	8,438,028	20,218,531	- 58.27%

Change = $\frac{\overset{2019}{new} - \overset{2018}{old}}{2018\ old} \times 100$

$= \frac{8{,}438{,}028 - 20{,}218{,}531}{20{,}218{,}531} \times 100 = -58.27\ \%$

Decrease in operational liab.

Remember

Credit analysis

Liquidity analysis ↓ Short term analysis liquidity ratio

Solvency analysis ↓ Long term analysis to evaluate the firms long term debt payment ability

Liquidity analysis

- Current Ratio = $\frac{\text{current assets}}{\text{current liab.}}$
- Quick Ratio = $\frac{\text{curretn assets} - \text{inventory} - \text{prepaid exp.}}{\text{current liab.}}$

Solvency ratio

- Liabilities to equity ratio = $\frac{\text{Total liabilities}}{\text{Total equity}}$
- Debts to equity ratio = $\frac{\text{Total debts}}{\text{Total equity}}$

Note:

Debts = loans = financing liabilities, so all debts are liabilities but all liabilities are not debts.

Debt = Loans = Financing Liabilities

But dont forget that we have some other liabilities and they are not loans. For example AP is a liability but not a loan. Salaries payable is not a loan. But it is a kind of liability.

<u>The bigger the ratio, the riskier the company</u> because it means that the co. depends more on debt than equity.

Consolidated statement of financial position

	Note	31 Dec. 2021 KD	31 Dec. 2020 KD
Assets			
Non-current assets			
Goodwill	6.3	**3,603,180**	-
Property, plant and equipment	12	**9,771,992**	7,160,670
Right-of-use assets		**612,883**	-
Investment in associates	13	**86,168,913**	1,103,929
Investments at fair value through other comprehensive income	14	**129,097,281**	96,671,328
		229,254,249	104,935,927
Current assets			
Inventories	15	**35,196,042**	41,319,685
Trade accounts receivable	16	**31,788,814**	29,606,122
Other receivables and prepayments		**1,134,062**	657,532
Cash and cash equivalents	17	**18,981,488**	26,257,513
		87,100,406	97,840,852
Total assets		**316,354,655**	202,776,779
Equity and liabilities			
Equity			
Share capital	18	**20,993,131**	20,993,131
Share premium	18	**29,160,075**	29,160,075
Treasury shares	19	**(575,724)**	(454,480)
Statutory, voluntary and general reserves	20	**70,459,281**	68,740,454
Other components of equity	21	**82,741,073**	47,981,962
Retained earnings		**24,227,964**	19,437,247
Total equity attributable to the owners of the Parent Company		**227,005,800**	185,858,389
Non-controlling interests		**504,642**	441,798
Total equity		**227,510,442**	186,300,187
Non-current liabilities			
Provision for employees' end of service benefits		**4,410,937**	3,929,186
Term loans	22	**26,334,495**	-
Islamic financing facilities	23	**38,000,000**	-
Lease liabilities		**428,888**	-
		69,174,320	3,929,186
Current liabilities			
Trade accounts payable		**2,038,235**	1,702,884
Other payables and accruals	24	**9,662,081**	7,179,352
Lease liabilities		**151,416**	-
Term loans-current portion	22	**5,818,161**	3,646,476
Islamic financing facilities-current portion	23	**2,000,000**	-
Due to banks	17	**-**	18,694
		19,669,893	12,547,406
Total liabilities		**88,844,213**	16,476,592
Total equity and liabilities		**316,354,655**	202,776,779

Bader Naser Al-Kharafi
Chairman

The notes set out on pages 11 to 52 form an integral part of these consolidated financial statements.

2020

TOTAL LIAB / TOTAL EQUITY = 16476592 / 186300187=0.88

2021

TOTAL LIAB / TOTAL EQUITY = 88844213 / 227510442=0.391

Debt TO Equity 2020

Term Loans	F	-
Islamic Financing	F	-
Lease Liab	F	-
Term loans	F	3,646,476
Lease Liab	F	-
Islamic Financing	F	-
Due to bank	F	18,694
TOTAL FINANCING (debt)		**3,665,170**
TOTAL DEBT		3,665,170
DEBT to EQUITY = TOTAL DEBT /TOTAL EQUITY		
DEBT to EQUITY =3665170/186300187		
DEBT to EQUITY =		**0.020**

Debt TO Equity 2021

Term Loans	F	26,334,495
Islamic Financing	F	38,000,000
Lease Liab	F	428,888
Term loans	F	5,818,161
Lease Liab	F	151,416
Islamic Financing	F	2,000,000
Due to bank	F	-
TOTAL FINANCING		**72,732,960**
TOTAL DEBT		72,732,960
DEBT to EQUITY = TOTAL DEBT / TOTAL EQUITY		
DEBTtoEQUITY= 72732960 / 227510442		
DEBT to EQUITY =		**0.320**

Comment

In year 2020 BECAUSE BOTH LIAB TO EQUITY AND DEBT TO EQUITY ARE LESS THAN 1, THIS COMPANY IS NOT THAT RISKY.

In year 2021 BECAUSE BOTH LIAB TO EQUITY AND DEBT TO EQUITY ARE LESS THAN 1, THIS COMPANY IS NOT THAT RISKY

	2021	**2020**
Liab to Equity	**0.391**	**0.088**
Debt to Equity	**0.320**	**0.020**

-When we compare the ratios from 2020 to 2021 we see that company becomes RISKIER because the ratios are increasing.
- However, in both year Compoany is not that risky because thje ratios are less than 1.
- if this company asks long term loan from Burgan Bank, most probably Burgan Bank will provide the loan.

One argues that "The best for the company is to avoid from using debt because debt increases the company's riskiness". Do you agree? Why? *(75 words, 10 pts)*

I do not agree. Although using debts increases the company's riskiness, especially if the company adopts more aggressive debt financing policy, but it is preferable because it provides opportunity growth as long as the company uses the borrowed money more efficiently to generate profit and pay debts and interest on time. So obtaining more debts is risky only if the company is not able to invest the borrowed money in profitable investing opportunities, so having debt helps company to grow. However, if company is not doing good business company may become riskier and may even collap

Exercise

LIABILITIES AND EQUITY			
Equity			
Attributable to Parent Company's shareholders			
Share capital	9	22,000,000	22,000,000
Legal reserve	10	2,843,811	740,756
Retained earnings		11,683,441	7,343,773
Total equity		36,527,252	30,084,529
Non-current liabilities			
Post employment benefits	11	2,912,300	2,296,229
Maintenance payables	12	19,433,727	10,652,320
Lease liabilities	13	133,398,702	116,145,351
Murabaha payables	14	4,425,635	5,285,910
		160,170,364	134,379,810
Current liabilities			
Maintenance payables	12	7,531,410	11,245,173
Lease liabilities	13	22,485,345	20,674,479
Murabaha payables	14	849,285	840,000
Trade and other payables	15	29,201,588	21,598,732
Deferred revenue	16	14,355,356	6,364,706
Bank overdrafts	8	977,311	-
		75,400,295	60,723,090
Total liabilities and equity		272,097,911	225,187,429

LIABITITIES TO EQUITY = (160170364+75400295)/36527252=6.45

Company is risky. Total Liab is 6.45 times bigger than total Equity

Debt to equit

Term Loans	F	26,334,495
Islamic Financing	F	38,000,000
Lease Liab	F	428,888
Term loans	F	5,818,161
Lease Liab	F	151,416
Islamic Financing	F	2,000,000
Due to bank	F	-
TOTAL FINANCING		**72,732,960**
DEBt to EQUITY = 72732960 / 227510442→toal equity=0.320		

JAZEERA IS A RISK FIRM AS BOTH LIAB TO EQUITY AND DEBT TO EQUITY RATIOS ARE ABOVE 1. HOWEVER, IF THE COMPANY MANAGERS MANAGE DEBT SMARTLY (CAN GENERATE ENOUGH CASH FROM BUSINESS AND PAY THE LIABILIOTIES ON TIME) THIS HIGH AMOUNT OF LOAN CAN HELP THE COMPANY TO GROW.