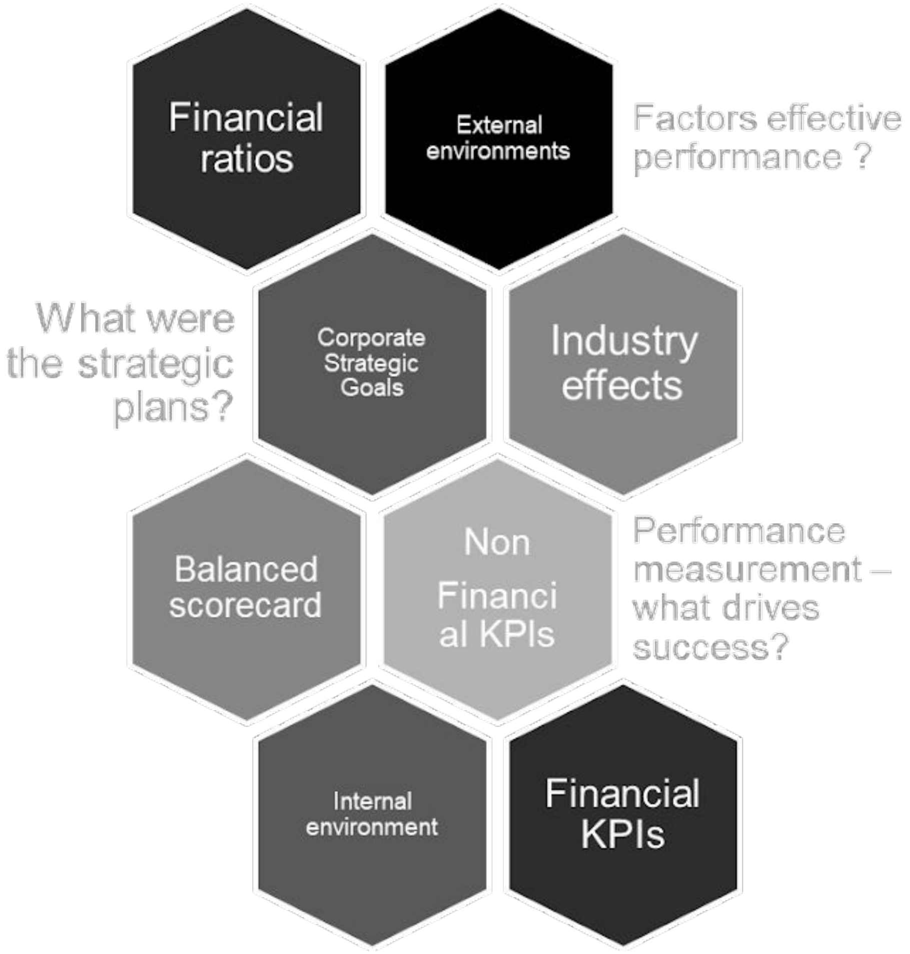
EVALUATING CORPORATE PERFORMANCE



OBJECTIVES

- ❑Calculate a range of financial ratios
- ❑Undertake horizontal and vertical analysis of financial statements and interpret the results
- ❑Interpret trends in order to undertake an in-depth financial analysis of a company
- ❑Interpret corporate performance using ratio analysis

TREND ANALYSIS

Trends in key figures can be extracted by horizontal and vertical analysis of the financial statements

Only focus on material items

Horizontal: compare one year with the next (used for all accounts)

Vertical: Compares income statement items with sales; cash flow items with operating cash flow; SOFP items with net assets

HORIZONTAL AND VERTICAL ANALYSIS

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	2019	2018	2017
Turnover (sales)	27,889	23,923	23,006
Cost of Sales	(9,290)	(8,853)	(7,323)
Gross Profit	18,599	15,070	15,683

Vertical:
e.g. Cost of Sales as % of Sales:

31.8% in 2017 (7323/23006) x100)

37% in 2018 (8853/23923)x 100

33.3% in 2019 (9290/27889)x100

Horizontal:
e.g. Turnover increased
4% in 2018 **((23923-23006)/23006)**
16.58% in 2019 **(27889-23923)/23923**

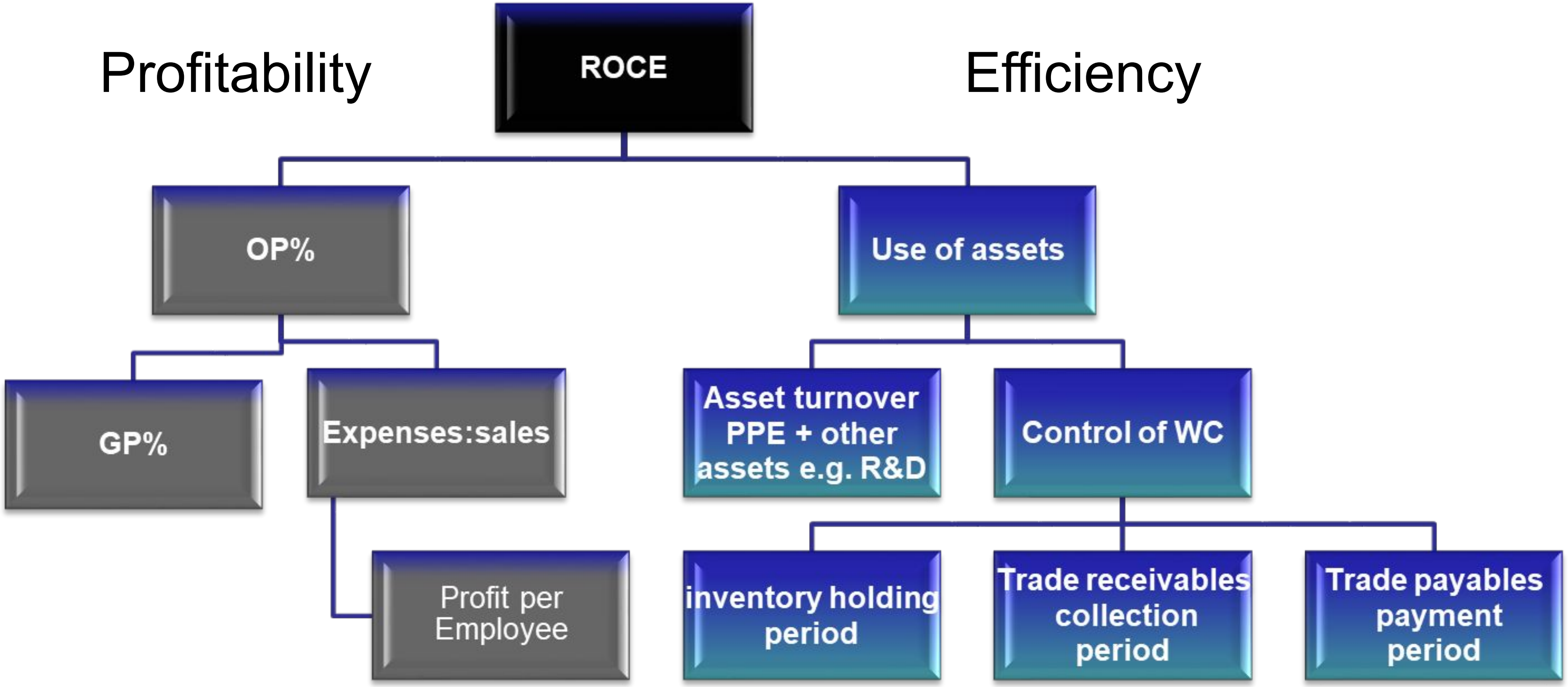
Financial Ratios

Financial ratio analysis compares relationships between items in the financial statements to identify the strengths and weaknesses of a company and evaluate its past performance

5 categories of ratio

1. **Profitability**- how well the company has controlled costs and generated sales
2. **Efficiency** – how effective assets are being used
3. **Risk** – how financial risk has been managed
4. **Liquidity** – ability to pay debts
5. **Investor ratios** – returns on investments

PYRAMID OF RATIOS



OTHER COMMON RATIOS

- **RISK**
  - Gearing
  - Interest Cover
  - Dividend cover

- **INVESTOR RATIOS**
  - EPS
    - Price: Earnings
  - Return on Equity
  - Dividend cover
    - Free Cash: Dividends

- **LIQUIDITY**
  - Current ratio
    - Acid Test
  - Operating cash to Sales
    - Operating cash to operating profit
  - Free cash to Operating cash

Calculating ratios

Formulae included as a separate hand out

Things to remember

1. Some data is only available in the notes to the accounts
   - E.g. Trade payables, trade receivables etc.
2. Some data is not available in the accounts so proxies are used
   - e.g. Inventory holding period and accounts payable - purchases can be replaced with cost of sales, use end of year figures rather than averages
3. Capital Employed (Used in ROCE, Use of Assets, Gearing) refers to how the company is financed in the long-term: not all non current assets are sources of finance and so have to be excluded. Only include:
   - Total equity finance (shareholder funds + reserves+ non-controlling interest)
   - Long term loan finance + amounts due under finance lease+ long term payables

ANALYZING RATIOS: WHAT NOT TO DO!

Ratio analysis is based on ANALYSIS, not description

You need to EXPLAIN the trends in the ratios, not just describe them.

- Providing a definition of the ratio is NOT analysis
- Stating the trend year-on-year is NOT analysis
- Providing advice for managers for the future is NOT analysis: ratio analysis is about interpreting what historically went well/badly.

If writing a report you will have to cover these points but to analyse you have to go further than this

ANALYZING RATIOS

Ratios should be benchmarked

- Compare year on year
- Compare with competitors or industry averages

In the pyramid of ratios the lower levels explain the higher levels

- e.g. OP% x Use of Assets = ROCE
- OP% largely explained by movements in GP% and expenses:sales etc

Use horizontal analysis, explore the underlying accounting numbers and provide detail of amounts.

ANALYZING RATIOS

Segment data is compulsory for PLCs & can enhance ratio analysis

It provides insight on the most important operating units of a company to facilitate decision making by investors/creditors

Companies can chose whether to disclose segment data according to geographical region or product line.

Segment data should provide a break down of the following for each segment:

- Revenues
- Interest
- Exceptional items

ANALYZING RATIOS

- Interpret in light of industry norms

E.g. Supermarkets have low current ratios; Manufacturing industries high current ratios; Service companies high ROCE; construction companies lower ROCE.

- Interpret in light of business model

E.g. Budget models (e.g. Easyjet, Aldi) have low margins but high turnover;

Luxury models (e.g. British Airways, Waitrose) have high margins and lower turnover

- Interpret in light of strategic plans

E.g. Plans for growth may necessitate reductions in margins (to gain market share), increases receivable days (due to expansion in different cultures): thes would not indicate reduced efficiency

ANALYZING RATIOS

- Look at the impact of the wider economic environment (social, political, legal, environmental).
- Business models such as PESTLE and SWOT help but <u>your results MUST link back to specific ratios:</u> It is pointless providing a generic business analysis in which the information is presented separate from the ratio analysis.
- For example if you identified that the Economic environment was sluggish then link this with ratios using Sales; If a weakness was outdated IT ordering or processing systems link this with efficiency ratios related to inventory or receivables.

ANALYZING RATIOS

Use sector specific key performance indicators (KPIs) where appropriate to support key ratios

For a hotel group RevPAR (revenue per room) or Occupancy rate is more useful than GP%

For an airline – load factor, available seat KM etc is vital

For a retail outlet – footfall or sales per m^2

All businesses will have KPI

These can be non-financial

LIMITATIONS OF RATIOS

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1. Ratios are based on accounting conventions which may change year on year or between companies
   - E.g. Nonsensical to compare Asset Turnover if one company uses fair value and the other historical cost
2. Ratios are based on summarized historic information
   - investors may be more interested in future prospects
3. A focus on financial measures is often inappropriate
   - how can a member of cleaning staff in a hotel influence Return on Capital Employed?
4. Quality of reporting: there may be intangibles missing from the accounts, or creative accounting

LIMITATIONS CONTINUED

4. Inflation: not accounted for under historic cost
   - Overstates ROCE, Overstates profit ratios,
5. Over reliance on prudence?
6. Impact of strategy may not be clear
   - E.g. Growth may be at expense of margins
7. Statement of financial position is just a snapshot on a single day

These limitations are not insurmountable if additional research is undertaken to provide richer information