ACCOUTING RATIOS

INDIVIDUAL ASSIGNMENT

TITLE: ANALYSIS OF ACCOUNTING RATIOS

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TABLE OF CONTENTS:

1.0 QUESTION 1 – OVERVIEW OF ACCOUNTING RATIOS:

Accounting Ratios are ratios that are calculated from the financial statements to reach at meaningful conclusions relating to liquidity, profitability, leverage and activity ratios. An accounting ratio is the relationship between accounting figures or numbers that are expressed mathematically. They are used to provide insights or clues about a company's financial position of concern in order to draw critical conclusions.

Hence, accounting ratios are tools that are used by a company to help with analysis of results and to allow the contrast of preceding years, other companies and the industrial sectors in the market. Accounting ratio analysis must formulate the basis of all investment decisions, since without knowing the exact financial position of a company, it is not easy to deduce proper decisions in which case, it will be merely guessing rather than providing factual information to be used in proper decision making of a company. Accounting ratios are used because of the impact they bring to a company in the sense of quantification and or technical analysis when it comes to investing share markets, personality dependencies, inclinations and spare time, while for investors they also provide an intellectual framework of the business, offer a sound and take an important position in performing informed share investment decision for a company.

The way accounting ratios are established in a company is only to those figures that are alike. Meaning, one can only compare two figures only if they have been made upon a similar basis. Meaning, if one company's sales are taken to be those that are sold and paid for in cash while another companies sales are those that are sold as soon as they are invoiced, these two situations cannot be considered as similar hence an accounting equation cannot be applied. Hence, if a company wants to calculate its stock turnover for example, they would use a stock turnover ratio to execute the calculation in order to come up with a precise usable answer to be used in decision making of the company's business.

2.0 QUESTION 2 – PURPOSES OF ACCOUNTING RATIOS:

The following are the list of all ratios and their purposes explained. The ratios have been categorized in their respective categories which are *liquidity ratios*, *leverage ratios*, *profitability ratios* and *activity ratios*. See below;

1. **Liquidity Ratios**: They measure a company's ability to pay off all of its current debts or obligations in a period of one year as they fall due. In general, a greater value is desired as it indicates the capacity to meet all debts obligated.
    i. **Current ratio**: Is a ratio used to measure a company's ability to repay all of its current liabilities such as accounts payable using current assets such as accounts receivable. The adequacy of a company to pay off its current liabilities or the chances of a company experiencing cash flow issues in the near term can be computed with a current ratio.
    ii. **Profit before Depreciation and Amortization to Current Liabilities (PDACL)**: Is defined as a net operating profit prior tax plus non-cash charges in relation to the current liabilities of a company. It is used to determine a company's margin of safety to meet all current liabilities using the cash flow produced from the trading operations within a business.
    iii. **Operating Cash Flow to Current Liabilities (OCFCL):** This pertains to the company's operations such as operating expenses subtracted from revenues plus depreciation, in relation to all current liabilities. It is executed in a business to compute a more precise amount of a business's profitability than net income since it only subtracts the real cash expenses and thus exhibits the strength of a business's operations. With a higher value in OCFCL, a lower level of risk is attained while with a lower value, a higher risk is attained.
    iv. **Quick Ratio or Acid Test:** This ratio is executed only when a company is trying to draw a definite conclusion on its liquidity as it uses the figures from the balance sheet. It is denoted as current assets subtracted from the inventory to the current liabilities of the company. In the processing of calculating a quick ratio or and acid test, the inventory/stock is always excluded as a current asset.

2. **Leverage Ratios**: These ratios measure the extent to which a company utilizes debts to finance its growth. They can provide an indication of company's non-current solvency.
    i. **Debt to Equity Ratio (DE Ratio)**: This ratio provides an understanding to a company's capital organization and whether the company is more dependent on borrowings or debts or the shareholders capital or equity to account for its activities and assets.
    ii. **Total Liabilities to Total Tangible Assets (TLTAI):** This ratio gives the relationship between a company's liabilities and its tangible assets. The usage of the tangible assets, as conflicting to total assets, is more traditional since it deliberates only those assets that can be appreciated and thus easily liquidated to cover liabilities. If the value of the TLTAI ratio is high, then the level of risk is also high.
    iii. **Interest Cover Ratio:** This ratio measure the ability of a company to meet all its interest expenses on debt using its profits. In general, if an interest cover ratio is greater than 2, it is considered to be a healthy position for the company to cover interest.

3. **Profitability Ratios:** These ratios provides an indication of a company's ability to generate profits and measure its performance. Since profits are used to help fund the business's development while paying off dividends to its shareholders, any company's profitability and how resourceful it is in generating profits is a very crucial factor to be considered.
    i. **Net Profit Margin:** This ratio indicates to what percentage of a company's sales would remain once all of the costs have taken into account. The company can use this ratio to help compare and analyze itself with other companies which are in the same industry while considering that variations from different years may be due to abnormal factors.

4. **Activity Ratios:** These ratios provide insights on the company's performance for the financial year in question. With the help of activity ratios, companies can deduce conclusions on the transactions that they performed and their financial position of the financial year.

i. **Total Asset Turnover:** This ratio indicates the overall usage of the sales of the company to its total assets of thee financial year. If a total asset turnover ratio is less than 1, this indicates that the company has a insufficient amount of assets to run its business.

ii. **Fixed Asset Turnover:** This ratio signifies the overall availability of fixed assets of the business to its sales. If the fixed asset turnover ratio is high, this indicates that the company has substantial assets to cover its liabilities in any case of debts. The company would be required to liquidate its assets in order to pay off its liabilities hence, the high the fixed asset turnover ratio, the better financial position of the company.

3.0 QUESTION 3 – IMPLEMENTATION OF ACCOUNTING RATIOS:

The following are ratio calculations of the MIECO Company that starts with the letter "M" in the 'www.bursamalaysia.com' website for the past 3 years. The ratio calculation will be based on all of the mentioned above.

3.1 CURRENT RATIO:

The following current ratios are of the past 3 years of MIECO Company, arranged in the sequence of the most current year to the last year.

2013 CURRENT RATIO:

		2013
CURRENT RATIO:	=	CURRENT ASSETS / CURRENT LIABILITIES
	=	RM 5,875 / RM 82,402
	=	0.071296813

In 2013, the company was able to achieve a current ratio of **RM 0.07** of assets for every **RM 1.00** of liabilities which suggests that it doesn't have sufficient assets to cover their liabilities.

2012 CURRENT RATIO:

2012

$$\text{CURRENT RATIO} = \frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$$

$$= \frac{\text{RM 5,475}}{\text{RM 106,949}}$$

$$= 0.051192625$$

In 2012, the company was able to achieve a current ratio of **RM 0.05** of assets for every **RM 1.00** of liabilities which suggests that it doesn't have sufficient assets to cover their liabilities.

2011 CURRENT RATIO:

2011

$$\text{CURRENT RATIO} = \frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$$

$$= \frac{\text{RM 3,933}}{\text{RM 38,460}}$$

$$= 0.10226209$$

In 2011, the company was able to achieve a current ratio of **RM 0.10** of assets for every **RM 1.00** of liabilities which suggests that it doesn't have sufficient assets to cover their liabilities.

Overall, it can be seen that the company's current ratios for the past 3 years have fluctuating a lot. Since in 2011 it was able to achieve a ratio of **RM 0.10** of assets for every **RM 1.00** and later in 2012 and 2013 it achieved **RM 0.05** and **RM 0.07**, it shows that the business that it is doing doesn't perform well and in that case, it is generating losses instead of profits.

3.2 PROFIT BEFORE DEPRECIATION AND AMORTISATION TO CURRENT LIABILITIES:

The following below are current ratios of the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 PDACL:

2013

PDACL: = PROFIT before (DEP & AMO) / CURRENT LIABILITIES

= RM 418,315 / RM 82,402

= 5.076515133

In 2013, the company was able to achieve a PDACL ratio of **5.08** showing that it has a relatively lower risk hence depicting a higher margin of safety. Meaning, the company needs to use their resources to meet the current liabilities because it has a lower margin of safety.

2012 PDACL:

2012

PDACL: = PROFIT before (DEP & AMO) / CURRENT LIABILITIES

= RM 514,979 / RM 106,949

= 4.815182938

In 2012, the company was able to achieve a PDACL ratio of **4.82** showing that it has a lower risk hence depicting a higher margin of safety. Meaning, the company needs to use their resources to meet their current liabilities because it has a lower margin of safety.

2011 PDACL:

2011

PDACL: = PROFIT before (DEP & AMO) / CURRENT LIABILITIES

= RM 527,561 / RM 38,460

= 13.71713469

In 2012, the company was able to achieve a PDACL ratio of **13.72** showing that it has a higher risk hence depicting a lower margin of safety. Meaning, the company does not need to use its resources to meet their current liabilities because it has a higher margin of safety.

Generally, since the company achieved a **5.08** PDACL in 2013, while in 2012 and 2011 it achieved **4.82** and **13.72** respectively, we can deduce that the companies PDACL has fluctuated heavily from 2011 to 2012 and a lower change is seen in 2013.

3.3 OPERATING CASH FLOW TO CURRENT LIABILITIES:

The following below are operating cash flow to current liabilities ratios of the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 OCFCL:

The calculations show how to obtain the Operating Cash Flow of a business.

Operating Cash Flow = Revenues - Other Operating Expenses + Depreciation

= 3,834 – 1,722 + 25

= 2,137

2013

OCFCL: = OPERATING CASH FLOW / CURRENT LIABILITIES

= RM 2,137 / RM 82,402

= 0.025933837

As show above, in 2013 MIECO Company achieved an OCFCL ratio of **0.26**. Since if a company has a lower value of the OCFCL ratio it indicates that is has a higher risk and therefore generates

sufficient cash from its operations to current liabilities, then MIECO is generating sufficient cash from its operations.

2012 OCFCL:

The calculations show how to obtain the Operating Cash Flow of a business.

Operating Cash Flow	=	Revenues - Other Operating Expenses + Depreciation
	=	3,679 – 1,358 + 25
	=	2,346

2012

OCFCL: = OPERATING CASH FLOW / CURRENT LIABILITIES

= RM 2,346 / RM 106,949

= 0.021935689

As show above, in 2012 MIECO Company achieved an OCFCL ratio of **0.22**. Since, if a company has a lower value of the OCFCL ratio it indicates that is has a higher risk and therefore generates sufficient cash from its operations to current liabilities, then MIECO is generating sufficient cash from its operations.

2011 OCFCL:

The calculations show how to obtain the Operating Cash Flow of a business.

Operating Cash Flow	=	Revenues - Other Operating Expenses + Depreciation
	=	2,960 – 1,314 + 80
	=	1,726

2011

OCFCL: = OPERATING CASH FLOW / CURRENT LIABILITIES

$$= \frac{\text{RM } 1{,}726}{\text{RM } 38{,}460}$$

$$= 0.044877795$$

As show above, in 2011 MIECO Company accomplished an OCFCL ratio of **0.04**. Since, if a company has a lower value of the OCFCL ratio it indicates that is has a higher risk and therefore generates sufficient cash from its operations to current liabilities, then MIECO is generating sufficient cash from its operations.

Generally, since the company attained an OCFCL ratio of **0.26** in 2013 and in 2012 and 2011 it attained **0.22** and **0.04** respectively, this show that the company has been able to sustain low OCFCL ratios which suggests that it performs well and it has a good strength in its business.

3.4 QUICK RATIO OR ACID TEST:

The following below are acid test or quick ratios of the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 QUICK RATIO:

2013

$$\textbf{QUICK RATIO:} = \frac{\text{CURRENT ASSESS - INVENTORY}}{\text{CURRENT LIABILITIES}}$$

$$= \frac{\text{RM } 414{,}456}{\text{RM } 125{,}794}$$

$$= 3.294719939$$

In 2013, the company was able to achieve a quick ratio of **RM 3.30** of assets for every **RM 1.00** of liabilities which suggests that it has sufficient assets to cover its liabilities 3 times as much. This shows that the company has enough assets to run its business.

2012 QUICK RATIO:

2012

QUICK RATIO: = CURRENT ASSESS - INVENTORY / CURRENT LIABILITIES

= RM 480,490 / RM 106,949

= 4.492702129

In 2012, the company was able to attain a quick ratio of **RM 4.50** of assets for every **RM 1.00** of liabilities which suggests that it has sufficient assets to cover its liabilities 4 times as much. This shows that the company has enough assets to run its business.

2011 QUICK RATIO:

2011

QUICK RATIO: = CURRENT ASSESS - INVENTORY / CURRENT LIABILITIES

= RM 511,994 / RM 38,460

= 13.3123765

In 2011, the company was able to achieve a quick ratio of **RM 13.31** of assets for every **RM 1.00** of liabilities which suggests that it has sufficient assets to cover its liabilities 13 times as much. This shows that the company has enough assets to run its business.

3.5 DEBT TO EQUITY RATIO:

The following below are debt to equity ratios of the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 DE Ratio:

2013

DE: = TOTAL DEBT / SHAREHOLDER'S EQUITY

= RM 0 / RM 0

= 0

Since the company has no debts or shareholder's equity for the year of 2013, all values are **0** and hence the debt to equity is also **0**.

2012 DE Ratio:

2012

DE: = TOTAL DEBT / SHAREHOLDER'S EQUITY

= RM 0 / RM 0

= 0

Since the company has no debts or shareholder's equity for the year of 2012, all values are **0** and hence the debt to equity is also **0**.

2011 DE Ratio:

2011

DE: = TOTAL DEBT / SHAREHOLDER'S EQUITY

= RM 0 / RM 0

= 0

Since the company has no debts or shareholder's equity for the year of 2011, all values are **0** and hence the debt to equity is also **0**.

Generally, it is not possible to calculate the value of debt to equity for MIECO Company since it does not have any debts or shareholder's equity recorder in their business hence the result is **0**.

3.6 TOTAL LIABILITIES TO TOTAL TANGIBLE ASSETS:

The following below are total liabilities to total tangible asset ratios of the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 TLTAI:

2013

TLTAI: = TOTAL LIABILITIES / TOTAL TANGIBLE ASSETS

= RM 125,794 / RM 424,165

= 0.296568552

In 2013, the company was able to achieve a TLTAI ratio of **RM 0.30** of liabilities for every **RM 1.00** of tangible assets which suggests that the company has a high level of risk since, if the TLTAI ratio is high then the level of risk will also be high.

2012 TLTAI:

2012

TLTAI: = TOTAL LIABILITIES / TOTAL TANGIBLE ASSETS

= RM 148,465 / RM 489,644

= 0.303210087

In the year 2012, the company was able to reach a TLTAI ratio of **RM 0.30** of liabilities for every **RM 1.00** of tangible assets which suggests that the company has a high level of risk since, if the TLTAI ratio is high then the level of risk will also be high.

2011 TLTAI:

		2011
TLTAI:	=	TOTAL LIABILITIES / TOTAL TANGIBLE ASSETS
	=	RM 177,615 / RM 518,887
	=	0.342299961

As seen in the year 2011, the company was able to reach a TLTAI ratio of **RM 0.34** of liabilities for every **RM 1.00** of tangible assets which suggests that the company has a high level of risk since, if the TLTAI ratio of a company is high then the level of risk will also be high.

Generally, as seen from the above calculations of the TLTAI ration for the years 2013, 2011 and 2012 with the results of **0.30, 0.30** and **0.34** respectively, we can deduce that the company has maintained a very stable TLTAI ratio for the 3 respective years and hence earned a higher level risk in their business.

3.7 INTEREST COVER RATIO:

The following below are the interest cover ratios for the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 INTEREST COVER:

		2013
INTEREST COVER:	=	PROFIT BEFORE INTEREST + TAX / INTEREST
	=	RM 45,324 / RM 116,974
	=	0.38747072

Since in 2013 the company was able achieve a low interest cover ratio of **0.39**, this shows that the company has a high risk to lenders that its interest payments will not be met. In this situation, we can see that the position of the company to meet its interest payments is not good.

2012 INTEREST COVER:

2012

INTEREST COVER: = PROFIT BEFORE INTEREST + TAX / INTEREST

= RM 120 / RM 139,873

= 0.000857921

Since in 2012 the company was able achieve a very low interest cover ratio of **0.0009**, this shows that the company has an extremely high risk to lenders that its interest payments will not be met. In this situation, we can see that the position of the company to meet its interest payments is not good.

2011 INTEREST COVER:

2011

INTEREST COVER: = PROFIT BEFORE INTEREST + TAX / INTEREST

= RM 587 / RM 166,853

= 0.003518067

Since in 2011 the company was able achieve a low interest cover ratio of **0.004**, this shows that the company has a high risk to lenders that its interest payments will not be met. In this situation, we can see that the position of the company to meet its interest payments is not good.

Generally, the attained interest cover ratios for the past 3 financial years of 2013, 2012 and 2011 which resulted to the following ratios, **0.39**, **0.0009** and **0.004** respectively, we can deduce that the situation of the company in terms of its interest ratios is not good. Should it encounter a situation in which it is required to pay off its interest, it will not be able to cover that charge.

3.8 NET PROFIT MARGIN:

The following below are the net profit ratios for the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 NET PROFIT MARGIN:

2013

NET ROFIT MARGIN: = NET INCOME / SALES x100

= RM 42,808 / RM 3,834

= 1,116.536255

In 2013, the company attained a net profit margin of **1,116.54** showing that it has substantial amounts of sales over the financial year. Since a decline in net profit margin ratio indicates a margin squeeze which may be because of increased competition or in rising costs, we can conclude that MIECO has increase in the net profit margin hence, it is in a good financial position.

2012 NET PROFIT MARGIN:

2012

NET ROFIT MARGIN: = NET INCOME / SALES x100

= RM 120 / RM 3,679

= 3.261755912

In 2012, the company attained a net profit margin of **3.26** showing that it did not have substantial amounts of sales in the financial year of 2012. Since a decline in net profit margin ratio indicates a margin squeeze which may be because of increased competition or in rising costs, we can conclude that MIECO has a very small increase in the net profit margin hence, it is not in a good financial position.

2011 NET PROFIT MARGIN:

2011

NET ROFIT MARGIN: = NET INCOME / SALES x100

= RM 612 / RM 2,960

= 20.67567568

In 2011, the company attained a net profit margin of **20.68** showing that it had a small substantial amount of sales in the financial year of 2011. Since a decline in net profit margin ratio indicates a margin squeeze which may be because of increased competition or in rising costs, we can conclude that MIECO has a very small increase in the net profit margin hence, it is in a fairly good financial position.

Generally as seen from the calculations above, in the years 2013, 2012 and 2011 the company was able to attain the net profit margin ratios of **1,116.54**, **3.26** and **20.68** respectively, we can deduce that the company had a noticeable change in the years 2011 to 2012 which was a drop and then it recovered significantly in the year 2013 to attain a very good net profit margin ratio and hence it has a good financial position.

3.9 TOTAL ASSET TURNOVER:

The following below are the total asset turnover ratios for the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 TOTAL ASSET TURNOVER:

2013

TOTAL ASSET TURNOVER: = SALES / TOTAL ASSETS

= RM 3,834 / RM 424,165

= 0.009038935

As seen in the total asset turnover ratio of 2013 above, the company was able to achieve a ratio of **0.0090** which is less than one. This suggests that the company has not enough assets to run its business for the financial year of 2013.

2012 TOTAL ASSET TURNOVER:

2012

TOTAL ASSET TURNOVER: = SALES / TOTAL ASSETS

= RM 3,679 / RM 484,644

= 0.007513622

However, in the total asset turnover ratio of 2012 above, the company was able to achieve a ratio of **0.0075** which is less than one. This suggests that the company has not enough assets to run its business for the financial year of 2013.

2011 TOTAL ASSET TURNOVER:

2011

TOTAL ASSET TURNOVER: = SALES / TOTAL ASSETS

$$= \frac{\text{RM } 2{,}960}{\text{RM } 518{,}887}$$

$$= 0.005704518$$

On the other hand, in the total asset turnover ratio of 2011, the company was able to achieve a ratio of **0.0057** which is less than one. This suggests that the company has not enough assets to run its business for the financial year of 2013.

Generally, throughout the 3 financial years of 2013, 2012 and 2011 in which the company attained total asset turnover ratios of **0.0090**, **0.0075** and **0.0057** respectively, we can conclude that the company been able to maintain an increase in the total asset turnover ratio although it is still less than 1 which suggest that it does not have enough assets to run its business.

3.10 FIXED ASSET TURNOVER:

The following below are the fixed asset turnover ratios for the past 3 years of the MIECO Company, arranged in the sequence of the most current year to the last year.

2013 FIXED ASSET TURNOVER:

2011

FIXED ASSET TURNOVER: $= \frac{\text{SALES}}{\text{TOTAL ASSETS}}$

$$= \frac{\text{RM } 3{,}834}{\text{RM } 418{,}290}$$

$$= 0.00916589$$

As shown in the 2013 fixed asset turnover ratio, the company was able to achieve a ratio of **0.0092** which suggests that it has insufficient fixed assets to cover its liabilities in case of a debt.

2012 FIXED ASSET TURNOVER:

2012

TOTAL ASSET TURNOVER: = SALES / TOTAL ASSETS

= RM 3,679 / RM 484,169

= 0.007598586

Meanwhile, in the 2012 fixed asset turnover ratio, the company was able to achieve a ratio of **0.0076** which suggests that it has insufficient fixed assets to cover its liabilities in case of a debt.

2011 FIXED ASSET TURNOVER:

2011

TOTAL ASSET TURNOVER: = SALES / TOTAL ASSETS

= RM 2,960 / RM 514,954

= 0.005748086

However, in the 2011 fixed asset turnover ratio, the company was able to achieve a ratio of **0.0057** which suggests that it has insufficient fixed assets to cover its liabilities in case of a debt.

Generally, the fixed asset turnover ratios of the company for the financial years of 2013, 2012 and 2011 in which it attained the following ratios; **0.0092**, **0.0076** and **0.0057**, suggest that the company's fixed assets are insufficient to cover its liabilities.

4.0 APPENDIX:

The following appendix contains all abbreviations used in the documented report above and other relevant materials that were referred to. See below;

4.1 ABBREVIATIONS:

The following appendix list of abbreviations are those that were used in the report above. The order in which they are listed in is alphabetical. See below;

i. AMO – Amortization.
ii. DE Ratio – Debt to Equity Ratio.
iii. DEP – Depreciation.
iv. EPS – Earnings per Share.
v. OCFCL – Operating Cash Flow to Current Liabilities.
vi. TLTAI – Total Liabilities to Total Tangible Assets.
vii. PDACL – Profit before Depreciation and Amortization to Current Liabilities.

NOTE: All answers in the report that were used in the justifications and explanations of the implemented ratios have been rounded off to 2 decimal places (2DL) and 4 decimal places (4DL) respectively.

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