NATIONAL OPEN UNIVERSITY OF NIGERIA

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Faculty of Management Sciences, Department of Financial Studies
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COURSE CODE: ACC. 316
COURSE TITLE: ANALYSIS OF FINANCIAL STATEMENT
CREDIT UNIT: 2

MARKING GUIDE

1. **a) CLASSIFICATION OF ACCOUNTING RATIOS:**
   - **I.** Profitability ratios
   - **II.** Activity ratios
   - **III.** Leverage (Debt) ratios
   - **IV.** Liquidity ratios
   - **V.** Investment ratios

   5 marks

   b)

   - **i.** **Gross profit %= Gross Profit/Sales x 100/1= 40/160 x 100= <u>25%</u>**
   - **ii.** **Cost os Sales/Av. Inventories= 160-40/10=120/10= <u>12 times</u>**
   - ***iii.*** **Net Profit/Sales x 100 =32/160 x 100 =<u>20%</u>**
   - **iv.** **Net Profit/Capital Employed x 100 =32/118 x 100 =<u>27%</u>**
   - **v.** **Current Ratio= current assets/current liabilities=20/10=<u>2:1</u>**
   - **vi.** **Quick Ratio or Acid Test=CA-Inventories/Current Liabilities=20-10/10=<u>1:1</u>**

   18 marks

c)

	Davidson Eng. Services Ltd	Atiku Eng. Services Ltd
Gross profit as a percentage of sales	25%	25%
Rate of inventory turnover	10times	12times
Net profit as a percentage of sales	10%	20%
Net profit to total capital employed	12%	27%
Current ratio	1:1	2:1
Quick asset (acid test) ratio	0.5:1	1:1

5 marks

Atiku Engineering Services Limited is performing better. ***2 marks***

2.

Meaning of Qualitative Characteristics

According to the Framework, qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The Framework identifies four principal qualitative characteristics, namely: understandability, relevance, reliability and comparability.

Understandability

Information in financial statements should be readily understandable by users who have business, economics and accounting knowledge and willingness to study the information carefully. Although financial reports should be understandable, complex matters that are relevant to economic decision-making should not be excluded merely because they are too difficult for users to understand.

Relevance

To be useful, financial information should be relevant to the decision-making needs of users. According to the Framework, information has the quality of relevance when it influences the economic decision of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Information may be considered relevant either because of its nature (e.g. employee benefit expense) or because it is material. Financial information is material if its omission or misstatement could affect the economic decisions of users. Although materiality is not classified as a threshold or cut-off point any information that fails the test of materiality need not be disclosed separately in the financial statements.

Reliability

According to the framework, information is said to be "reliable" when it is free from material bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be accepted to represent. In view of the inherent difficulties in identifying certain transactions or in finding appropriate methods of measurement or presentation, financial statements cannot be perfectly "accurate", hence faithful representation might be regarded as describing the closet that accountants can come towards the absolute of total accuracy (Lewis and Pendrill, 1996).

Comparability

(a) Users should be able to compare the financial statements of an entity through time (that is, over a period of time), to identify trends in its financial position and performance.

(b) Users should also be able to compare the financial statements of different entities to determine their relative financial positions, performance and changes in financial positions.

To effectively compare an entity's financial information over time, accounting transactions should be consistently treated and correspondingly, information of preceding periods should be disclosed. Similarly, to compare financial information across entities, the financial statements of the different entities should comply with the requirements of a set of accounting standards and their separate accounting policies should be disclosed.

20 marks

3.

A cash flow statement should disclose the following:

(a) Cash flows from operating activities

Profit before taxation for the period covered by the financial statements is appropriately adjusted, for non-cash items such as:

1. Depreciation and amortization charge on fixed assets;
2. Profit or loss on disposal of fixed assets; and
3. Provision for unfunded pension plan.

(b) Changes in Current Assets and liabilities

Increase or decrease in current assets and liabilities when compared to those in the preceding year is accounted for under this sub-head to reflect:

1. Increase or decrease in stock;
2. Increase or decrease in creditors and accruals; and
3. Increase or decrease in foreign currency deposit for imports;
4. Increase or decrease in creditors and accruals.

(c) Payments in connection with operations, such as income tax and retirement benefits paid during the period covered by the financial statements are deducted from the addition of (a) and (b) above, before arriving at net cash inflow or outflow from operating activities.

(d) Cash flows from investing activities
Actual cash outflows or inflows of the following, during the period covered by the financial statements, are disclosed:

1. Purchase of fixed assets, investment or intangible assets.
2. Proceeds from sale of assets, investment or intangible assets; and
3. Dividends and interests received on investments.

(e) Cash flows from financing activities
Actual cash inflows or outflows on the following during the period covered by the financial statements are disclosed:

1. Dividends paid to shareholders;
2. Repayment of debenture stock; and
3. Proceeds from issue of shares and debenture stock.

(f) Movement in net liquid funds
The net figure arrived at by pooling together all the net figures obtained in (a) – (e) above, represents net increase or decrease in cash and cash equivalents at the beginning of the period covered by the financial statements are added to the net increase or decrease, we arrive at cash and cash equivalents at the end of the period covered by the financial statements which may consist of:

1. Cash and bank balances;
2. Bank overdrafts; and
3. Investments in commercial papers and other short-term financial

20 marks

4. A)Main Components of Financial Statement

There are three main components of financial statement. They are as follows:
(a) Balance Sheet or Statement of Financial Position
(b) Income Statement
(c) Cash flow Statement

(a) Balance Sheet or Statement of Financial Position

Balance sheet shows the present statement of a business. The business as a single entity shows the financial condition of an accounting entity as at a particular point in time.
Balance sheet consists of assets (probable future economic benefits obtained and controlled by an entity as a result of past transactions or events). They may be physical assets such as land, buildings, stocks, or inventory. Assets may also be intangible such as trademarks, goodwill, copyright, or patent. For instance, assets are normally categorized into current and long-term. This will be discussed in detail in subsequent units.

5 marks

(b) Income Statement
Income statement is otherwise known as profit and loss account. Other scholars refer to it as statement of income, statement of earnings and statement of operations. It is a summary of income and expenses, gains and losses of a business organisation and ends with the determination of net income for a specific period.
Income statement reveals the revenue (income) and expense (disbursements); hence the profit and loss is expressed with the true position of the net income. Management will have the profitability index and decision will be taken based on this.

5 marks

c) Cash Flow Statement
Basic elements of cash flow include the following:
(1)Operating Activities: consist of all transactions plus other events that are not investing or financing activities. Cash flows from operating activities are generally the cash effects of transactions and other events that are added to determine the net income.
(2) Investing Activities: consist of lending money and collection of these loans and acquiring and selling investments and productive long-term assets.
(3) Financing Activities: consist of cash flows relating to liability and owners' equity.

5 marks

B) The elements of income statement are:
(i) Net sales (revenue/income)
(ii)Cost of goods sold or cost of sales
(iii)Other operating revenue
(iv)Selling expenses
(v) Administrative expenses
(c) Cash flow Statement

5 marks

5. LIQUIDITY RATIO

This is a tool generally used to express the extent to which a business can meet its short-term obligations as at when due. When an enterprise owes short-term debts (bills – water electricity etc.) the liquidity is the loop to show the capability.

Types of Liquidity Ratio
Liquidity position is assessed with the following:

1. Current ratio
2. Quick (Acid-test) ratio
3. Cash ratio
4. Net working capital ratio

Current Ratio

This ratio compares all current assets with current liabilities in the financial statement and indicating the ability of an enterprise's ability to meet its short-term obligation with its current assets.
Current ratio = Current Assets /Current Liabilities
A low current ratio indicates that the enterprise may not be able to pay its future bills on time especially, if a it is slow in debt collection. A high current ratio indicates an excessive amount of current assets and management's inability to utilize the enterprise's resources effectively.
To be able to withstand the sudden adverse consequences of such eventualities and reduction of creditors (or exceptional ants of bad it debts) is necessary to ensure that it is necessary that the current assets adequately cover the current liabilities.
To determine whether this ratio is high or low or just right, comparisons should be made with current ratio of previous periods and of similar businesses. As a general rule (convention) a current ratio 2:1 is accepted as ideal. This ratio is regarded as industry average. A comparison with this should be made to determine typical current ratio for similar firms.
In some other industries, a current ratio slightly or substantially below 2 is adequate, while other industries require a much larger ratio. In general, the shorter the operating cycle of a business, the lower the current ratio. The longer the cycle, the higher the current ratio.
A comparison of the firm's current ratio with prior periods, and a comparison with industry averages, will help to determine if the ratio is high or low. These comparison do not indicate why it is high or low.
Possible reasons can be found from analysis of the individual current asset and current liability, a/c often found in a detailed analysis of a/c receivable and inventory stock.

Quick (Acid Test) Ratio

This ratio expresses the relative amount of cash and other assets that can be easily converted to cash that are available to meet current liabilities. This is a more conservative measure of liquidity as only liquid assets are considered. It excludes stocks (inventory) from current assts. The ratio emphasizes more on assets easily converted into cash (or to a reasonable period without loss of value.
Therefore, stocks are deducted from current assets used in the current ratio above. (In practice, an analysis of debtors is performed to enable debtors' balances which are doubtful of recovery will be deducted from the current assets – for examination purposes this is avoided).

Quick (Acid Test) ratio = Current Assets – Stock (inventory) divided by Current Liabilities

As a general rule quick ratio is 1:1 is accepted as ideal.
You should note the striking difference as a financial analyst that the current ratio evaluates an enterprise's overall liquidity position considering current assets and current liabilities. On the contrary, the quick (or acid-test) ratio relates the more liquid assets to current liabilities.

The usual guideline for the acid-test ratio is 1. A comparison should be made with the enterprise's past acid-test ratios with major competitors and the industry averages. Some industries find that a ratio less than 1 is adequate, while others require a ratio greater than. For example, a grocery store may sell only for cash and not have receivables. This type of business can have a quick ratio which is below the 1 guideline and still have adequate liquidity.
It also worthy of note that before computing quick ratio, compute debt (at receivable) turnover for this should help you form an opinion of the quick ratio.

Cash Ratio

This ratio examines cash and its equivalent (marketable securities) in relation to current liabilities. It measures most liquid asset of an enterprise by considering only cash and marketable securities in the current asset (numerator).
Cash ratio = Cash + Marketable Securities divided by Current Liabilities

Cash ratio is an analyst need to view the liquidity of an enterprise from an extremely conservative view point. For example, the enterprise may have pledged its receivables and its stock (inventory) or he/she suspects severe liquidity problems with stock (inventory) and receivables. The best indicator of the enterprise's short-term liquidity may be the cash ratio.

Net Working Capital (NWC) Ratio

Working capital is defined as the excess of current assets over current liabilities and is regarded as being available for supporting current operations.

20 marks