Interpretation of Accounts Theory | Accounting

Outline potential users of financial statements and why they would use them. (2017 Examcraft mock):

- Banks and Lending Institutions – to establish if a loan applicant firm would be capable of repaying a new loan;
- Creditors – to see if it is safe to sell goods/services on credit to a firm;
- Debenture-holders -to establish if existing loans plus interest are capable of being repaid;
- Existing Shareholders – to see what return they can expect on their investment;
- Potential Shareholders – to see what return shareholders could expect when compared to other investments;
- Management – to see how efficiently they are managing the resources of a business;
- Employees – to see how secure their jobs are and any potential for bonuses;
- Competitors – to see how they compare with rival firms in a similar industry;
- Financial Commentators/Media – public limited companies are always being commented on by various media outlets;
- The Revenue Commissioners – to see if the appropriate amount of taxes are being paid.

Explain the term "Gearing". (2016):

- This is a measure of how a business is financed on a long-term basis. It measures the relationship between fixed interest debt (loans/debentures + preference shares) and total capital employed/equity. When this is less than 50%/100%, the business is lowly geared. Above 50%/100% is highly geared. Low gearing is preferable.

Benefits of low gearing. (2016):

- When fixed interest debt is a small proportion of overall capital it has the following benefits:
- Low interest repayments mean more profits are available for investment elsewhere in the business.
- Shareholders are more likely to get a dividend when gearing is low.
- The business should find it easier to raise additional loan finance.
- Less risk of liquidation due to not being able to make interest payments.

Possible ways to reduce gearing. (2016):

- Sell more ordinary shares.
- Reduce or repay loans.
- Increase reserves/retained profits.
- Convert long-term debt to ordinary shares.
- Reduce dividends paid.

Factors that cause the price of shares to rise (2016 Examcraft mock):

- Profitability, i.e. if it is expected that a company is going to be profitable into the future.
- Expansion, i.e. when a company is seen to be expanding it is normally a sign that it is doing well and expecting to improve.
- Industry (Sector), i.e. certain sectors can be high risk but highly profitable (e.g. mining) and others can be ones with low risk with steady growth (e.g. Banks, Food companies, etc.).
- Key Personnel, i.e. when a company has a management team with a proven track record this can encourage confidence and therefore an increase in share price.

Distinguish between "liquidity", and "solvency". (2014):

- **Liquidity** measures the ability of the company to pay its short-term debts as they fall due. The acid test ratio is a good indicator of liquidity as it includes only liquid assets i.e. cash and debtors.
- **Solvency** is the ability of a company to pay all of its debts as they fall due for payment (long term). Solvency is the most important indicator of a business's ability to survive in the long term. A business is solvent if its total assets exceed its outside liabilities. Debt to equity or total debt to total assets are good guides. A firm is solvent if its total assets are greater than its total liabilities.

Reasons for decrease in net profit %. (2006 Examcraft mock):

- A fall in Gross Profit.
- An increase in expenses or overheads (e.g. salaries, wages, selling expenses etc.)
- Late payment of bills may result in a loss of discounts.

Net Profit % = [(Net profit + interest) x 100]/Sales

Reasons for decrease in gross profit %. (2012):

- Cash losses - cash sales not recorded.
- Stock losses - pilferage of stock or obsolescent stock.
- Change in sales mix - more sales of low mark-up goods.
- Mark downs during sales - to get rid of out-of-date stock.
- Incorrect valuation of stock - overvalue of opening stock, undervalue of closing stock.
- Increased cost of sales - without an increase in sales price.
- Falling sales price - without corresponding drop in cost of sales.

Briefly discuss whether a rising liquidity ratio is a sign of prudent (careful) management. (2008):

- A rising liquidity ratio is not **always** a sign of prudent management.
- A rising liquidity ratio could be a sign of prudent management because it indicates that it is easier for the firm to pay its short-term debts on time and thus avoid paying interest or enables it to avail of cash discounts.
- However, if the liquidity ratio rises significantly above 1:1, it could mean that too much of the company’s resources are tied up in liquid assets when they could be used to earn more profits. Management may be leaving cash resources idle.

<u>Explain why the financial information of a company would be of interest to you if you were an employee of that company. (2017):</u>

- To assess job security.
- To see if shareholder dividends are increasing which could be used as a negotiation strategy.
- To see if the company can continue to pay existing wage rates or can it afford a pay rise.
- To see if the company plans to expand and thereby assess the prospects for promotion.
- To assess pension security.

<u>How might a company overcome liquidity problems?</u>

- Issue more shares.

- Sell investments.
- Cut dividends paid to shareholders.
- Sell fixed assets.
- Cut back on expenses

Limitations of ratio analysis. (2015):

- It analyses past figures only and these figures are quickly out of date (historical). It merely gives us clues to the future.
- Ratios do not show seasonal fluctuations
- Firms use different accounting bases and therefore company comparisons are not accurate.
- Financial Statements give limited pictures of a business.
- Financial Statements do not reveal other important aspects of a company
- Accounts alone cannot measure aspects which may be extremely significant such as monopoly position, economic climate, staff morale and management/staff relationships.

How might a company overcome profitability problems?

- Buy their materials from a cheaper source.
- Cut overheads by replacing workers with machines.
- Advertise more in order to increase sales.

When would shareholders buy extra shares in a company:

- When the company is liquid // profitable // lowly geared // has good long term prospects.
- When the dividend yield // dividend cover is relatively high.
- If the trends for profits and share prices are good.
- If the company is giving a good discount on the market price of the shares.

Explain the term "Overtrading":

This is when the firm is trying to carry on a level of business which is too great for the amount of working capital in the business. A sign that the business is overtrading is when current liabilities are greater than current assets.

What might encourage a bank to give a loan to a company?

- If the purpose of the loan is for productive reasons.

- If the interest cover is at least 4 times.
- If their current gearing position is less that 50%.
- If the company is retaining plenty of profits (Dividend cover > 2).
- If the real market value of their fixed assets is enough to offer adequate security on the loan.
- If the industry has good long-term prospects.
- The company must also be liquid and profitable and its trends in profits and share price must be improving.

Definitions:

- *P/E ratio:* This is how long it would take to recover the current share price based on present earnings.
- *EPS:* This is the profits in cents that each ordinary share is generating.
- *Dividend yield:* This is the percentage return that shareholders are receiving annually from their investment.
- *Dividend cover:* This figure shows the proportion of earnings paid to shareholders and the amount retained in the firm.
- *Interest cover:* This measures the ability of a firm to meet its loan interest payments from earnings (i.e. profits).