Interpretation of Accounts

Users of Financial Information

Employees - job security, wages, pensions
Shareholders - dividends, long term stability
Financial Institutions - debentures and interest repayments
Creditors - allow business credit periods

How Might A Company Overcome Liquidity Problems?

1. Issue extra shares in order to take in extra cash.
2. Sell investments (again to take in more cash).
3. Reduce the level of dividends paid to shareholders.
4. Sell and leaseback fixed assets.

How Might A Company Overcome Gearing Problems?

1. Issue more shares and use the income to pay off long-term debt.
2. Reduce or repay long term debt
3. Increase retained earnings

Benefits of low gearing

1. Low interest repayments means more profits are available for investment elsewhere in the business.
2. Shareholders are more likely to get a dividend when gearing is low.
3. The business should find it easier to raise additional loan finance.
4. Less risk of liquidation due to not being able to make interest payments.

Why Might Gross Profit % Fall?

1. If purchase costs increase but sales price is kept the same.
2. If closing stock is undervalued.
3. If stock is purchased but can't be sold.
4. If stock is stolen or perishes.
5. If selling price is reduced but sales do not increase.

(The same reasons can be used for a fall in net profit %, but also mention an increase in expenses).

What Would Encourage Shareholders to Buy Shares?

1. Good liquidity – comfortable payment of short-term debt.

2. Profitability – Funds available to pay dividends.
3. An industry with good long-term prospects.
4. If the firm has ample fixed asset security to cover long-term debts.

What Would Encourage A Bank to Give a Loan?
1. If the purpose of the loan is for productive reasons.
2. If fixed asset security is available.
3. If the firm has a positive history of servicing debt.
4. If interest cover is currently comfortable.

A Rising Liquidity Ratio Is a Sign of Prudent Management. Briefly Discuss.
A rising liquidity ratio suggests that...
- 'Overtrading' is not a problem and that the correct volume of stock is being ordered.
- Excessive short-term debts are not being incurred.
- Credit control is operating effectively in the firm.

Limitations of Ratio Analysis.
1. Ratios only provide a 'snapshot' of the firm at one moment in time. This provides little evidence of past or future performance.

2. Ratios only take account of financial information. Important issues such as goodwill or the quality of industrial relations do not appear in these ratios.

3. The preparation and calculation of ratios varies from firm to firm and therefore comparisons are not always possible.

4. Ratios do not show seasonal fluctuations

What Might An Unfavourable Comparison of Stock Turnover Ratios Indicate?
1. Poor stock control.
2. Theft of stock.
3. Obsolescence of stock.
4. Fall in sales demand.

Liquidity and Solvency

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.