# ACCOUNTING CASE STUDY

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Course code

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This report is addressed to analyse the AUSTRALIAN FUNGHI IMPORTER PTY LTD's last three years financial reports in order to make a decision on a loan requested by the company.

**The Profitability Analysis**

The profitability indicators are used to understand whether the business entity is able to generate earnings and assess its future possibilities to exist and maintain activities. The trend analysis shows that operating profit after tax more than doubled from the 2010, thus the analysis of the profitability coefficients may provide the detailed picture of the firm's profitability.

As the Return on Assets (ROA) ratio is the measure of the firm's ability to earn through operating total assets provided by both creditors and owners, a ROA of 28,7% in 2012 comparing to 15,5% in 2010 suggests that a company's management is efficient at using its assets to generate earnings. The comparison of the ROA of AUSTRALIAN FUNGHI IMPORTERS PTY LTD with industry data shows that AUSTRALIAN FUNGHI IMPORTERS PTY LTD has roughly 9% lower rate than industry average, nonetheless the company entered the market only 3 years ago showing the positive profitability trend. According to Kimmel, P. D. and Weygandt, J. J. (2011), "return on common stockholders' equity is widely used ratio that measures profitability from the common stockholders' viewpoint". The Return on Equity (ROE) is an indicator that measures how much profit a company creates with the money owners have invested. AUSTRALIAN FUNGHI IMPORTERS PTY LTD showed positive dynamics of ROE ratio starting with 15,9% in 2010 and managing promising 31,4% in 2012. A 31,4% return on equity is good result, yet here, it is important to understand the nature of profit using the DuPont Model (Zane, Kane & Markus). Assuming that AUSTRALIAN FUNGHI IMPORTERS PTY LTD was completely debt-free company allows leaving out the equity multiplier and calculating ROE on the basis of net profit margin and asset turnover. A 16,4% ROE, in our case, would suggest that 16.4% of the return on equity was generated by profit margins and sales, while 15% was gained due to returns earned on the financial leverage. Generally, the company with a comparable valuation and same ROE, but a greater percentage from internally-generated sales, would be more attractive. A constantly growing earnings per share, the coefficient that shows the profit earned on each ordinary share, reaches 1,46$ in 2012 stating the increase in profits as the number of shares stays constant. The earnings yield (the inverse of the P/E ratio) measures the profit earned on each ordinary share. It is often used by the investors to check id the stock of the company is not over valuated; however AUSTRALIAN FUNGHI IMPORTERS PTY LTD is not publicly traded company, so this indicator is not that relevant for making meaningful conclusions. Price to earnings ratio (P/E) of 5,0 shows that investors are willing to pay 5$ for a dollar of earnings. Usually, high P/E of the company is a sign of higher growth of earnings in future than that of companies possessing lower P/E. That is why the P/E ratio may be useful when comparing the companies within the industry rather than evaluating the profitability of particular company. Dividend yield ratio of 16,3% as it measures the rate of return to shareholders based on current market price suggests the 16,3% earning on investing in firm's stock. According to R.D. Cohen (R.D. Cohen, 2002), high dividend ratio may also be a sign for the associated risk with the investments in the company, therefore high dividend yield ratio serves as a risk premium. Nonetheless, investors and scholars have no common view on the problem, so we won't use this ratio to make any decisions. The dividend payout ratio of 81,1% gives an idea that earnings greatly support the dividend payments. As far as more mature companies tend to have a higher payout ratio, the 13,4% increase in dividend payout ratio suggests that AUSTRALIAN FUNGHI IMPORTERS PTY LTD is getting larger and more developed. One of the most important financial metrics for entity, gross profit margin at a rate of 57,8% shows that AUSTRALIAN

FUNGHI IMPORTERS  PTY LTD is healthy company and has enough reserves for paying future expenses and savings, as it even prevails the 49% average for the industry.

**The Liquidity Analysis**

The analysis of the firm's liquidity allows evaluating its ability to meet the short-term liabilities.

As the current ratio is a measure of the company's ability to meet its short-term debts from its current assets a current ratio of 3,36:1 reveals that the firm has a solid liquidity position and would be able to meet its current liabilities within appropriate period. William Hettinger,John Dolan-Heitlinge suggest that the quick ratio is more accurate indicator of the firm's liquidity that shows whether the company is able to meet unexpected demands from liquid current assets. The higher quick ratio tells that firm has better liquidity position. As we may see from the calculations, both current and quick ratios of AUSTRALIAN FUNGHI IMPORTERS PTY LTD are decreasing each year, though staying at the admissible level.

The debtors' turnover indicates the speed of debt collection of a firm. Specifically, in AUSTRALIAN FUNGHI IMPORTERS  PTY LTD average debtors (receivable) are turned 9,2 times over a year, thus a duration of a collection period is 40 days. As there is no norm for this ratio and period, it is important to know that the shorter is the period, the more liquid are the debtors. According to the 3-year analysis, the collection period increased from 33 to 40 days what is not a very good sign for the liquidity evaluation. As the inventory turnover ratio indicates the liquidity of inventory it is important that the firm keep sufficient inventory in business. AUSTRALIAN FUNGHI IMPORTERS PTY LTD inventory was sold on average 4,1 times per year whereas the mean for the industry shows 6,4 times. The downfall trend for inventory turnover velocity of AUSTRALIAN FUNGHI IMPORTERS PTY LTD suggests inefficient management of inventory as it requires higher carrying costs.

## The Financial Stability Analysis

The financial stability indicators are used to evaluate firm’s ability to maintain operations in the long term prospective. The AUSTRALIAN FUNGHI IMPORTERS PTY LTD has 43,5% of its assets financed by debts. The debt/equity ratio for AUSTRALIAN FUNGHI IMPORTERS PTY LTD is 79% whereas an average for the industry is 58%. A company with higher dependence on debt is more likely to experience difficulties in the long term. Generally, even the 100% debt/equity ratio is acceptable, while the company manages an adequate interest coverage ratio. AUSTRALIAN FUNGHI IMPORTERS PTY LTD increased its time earned interest ratio from 6,0 in 2010 to 9,3 in 2012 which is very good indicator of financial stability as the company has additional funds to meet its liabilities early and invest in business. Another indicator of financial stability is an asset turnover ratio that measures company's efficiency at using its assets in generating sales. AUSTRALIAN FUNGHI IMPORTERS PTY LTD improved the ratio from 1,07 in 2010 to 1,23 in 2012, though it doesn’t approach to industry average of 3,70. On the other hand, the low asset turnover suggests that the firm’s pricing strategy is based on the high profit margins, which is really the case of AUSTRALIAN FUNGHI IMPORTERS PTY LTD whose gross profit margins are 8,8% higher than an industry average.

## Conclusions and Recommendations

The overall analysis of the AUSTRALIAN FUNGHI IMPORTERS PTY LTD profitability reveals that over the past 3 years the company shows steady development and constantly increases its profitability. In addition, the AUSTRALIAN FUNGHI IMPORTERS PTY LTD has good results compared to industry average. For instance, the AUSTRALIAN FUNGHI IMPORTERS PTY LTD has 8,8% higher gross profit margin rate and 2,2% higher operating profit before tax margin rate than the average for the industry. This means that

AUSTRALIAN FUNGHI IMPORTERS PTY LTD works on a high performance rate and has good prospects for the future development.

To sum up the liquidity analysis, it is significant to notice that the liquidity coefficients of AUSTRALIAN FUNGHI IMPORTERS PTY LTD show negative changes in firm's position. Although the current and quick ratios are appropriately high, the inventory and debtors turnover ratios fell over the past three years. According to Sallem and Rehman (Saleem & Rehman, 2011), the liquidity and profitability are closely related as the increase in one is accompanied by the decrease in other. Thus, we may interpret the letdown in the liquidity position as the compensation for the improvements in profitability.

The financial stability analysis of AUSTRALIAN FUNGHI IMPORTERS PTY LTD suggests that the company is stable in its development and works efficiently. Times interest earned and debt to equity ratios show the solid stable position of the company, whereas relatively small asset turnover ratio indicates the high margins pricing strategy of the firm.

In conclusion, the careful consideration on the analysis of AUSTRALIAN FUNGHI IMPORTERS PTY LTD financial statements supports the decision in favor of satisfying firm's request for 315,000 $ loan.

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