D19 Accounting reporting, financial analysis and business valuation – Solutions

1

Such an approach would be contrary to the principle of caution:

- Revenues may only be recognized when the good has been sold or service rendered, the buyer's payment has been received or an irrevocable claim is made. The booking of presumed revenues constitutes a breach of the realization principle.
- Losses and risks that are apparent but have not yet arrived must be recognized, even if they become known only after the ending date of the balance sheet date but before it is created (imparity principle). Max Müller must accordingly already have recognized the risk of possible compensation (litigation risk) in the current accounting period.

2

a The principle of comparability (consistency) is violated because the depreciation rate is no longer the same.

b The principle of completeness is violated because all assets must be presented.

c The principle of clarity is violated because such a balance sheet is no longer sufficiently clear.

3

a The current situation in terms of assets, debts, revenue, and liquidity

b External auditing firms check the accuracy of the reported figures. The auditing of the accounting reporting thus guarantees the correctness of company statements within the framework of legal requirements. The positive report an external auditing firm increases the reliability and credibility of information for all stakeholders, which is very important in terms of the significance of the statements as a decision-making foundation for various stakeholder groups.

4

a

Ratio	Formula	Result
Liquidity ratio I	$\frac{\text{Cash and equivalents}}{\text{Short-term debt}} \cdot 100$	40.3%
Liquidity ratio II	$\frac{\text{Cash + accounts receivable}}{\text{Short-term debt}} \cdot 100$	85.1%
Liquidity ratio III	$\frac{\text{Current assets}}{\text{Short-term debt}} \cdot 100$	159.7%
Return on equity	$\frac{\text{Profit}}{\text{Equity}} \cdot 100$	11.8%
Equity ratio	$\frac{\text{Equity}}{\text{Total capital}} \cdot 100$	49.1%
Debt ratio	$\frac{\text{Debt}}{\text{Total capital}} \cdot 100$	50.9%

ISBN 978-3-06-450883-5
©IWP-HSG
2015-01-01

b

Ratio	Goal	Assessment
Liquidity ratio I	25–40%	40.3% lies slightly above the target range. Too high a liquidity ratio I would reduce profitability.
Liquidity ratio II	100%	85.1% is below the target of 100%. This means that short-term debts are not covered by the totality of cash and cash equivalents and short-term receivables. In such a situation, Müller's Carpentry would be obliged to repay the debts (current liabilities) by either selling fixed assets (machinery, vehicles, etc.) or by taking on new debt. If the came conditions were to continue over the longer term, the enterprise would have to file for bankruptcy because, at some point, either fixed assets are depleted or the enterprise simply drowns in its debts.
Liquidity ratio III	150–200%	159.7% is within the target range.
Return on equity	≥ 8%	Within the target range. Müller's Carpentry can be satisfied with the return on capital he has employed (equity).
Equity ratio	> 30%	The proportion of equity to total capital is acceptable at 49.1%. Müller's Carpentry might consider reducing own equity, which would increase the return on equity.
Debt ratio	< 70%	The proportion of debt to total capital is also in order at 50.9%. As already mentioned, the return on equity could be bumped by taking on additional debt over equity.

Conclusion: The financial situation of Müller's Carpentry is solid. Optionally, however, the short-term receivables could be reduced in order to improve the situation in the area of liquidity ratio II. Consideration should also be given to whether the equity base could be reduced in order to increase the return on equity.

5

A high level of liquid assets guarantees the solvency of an enterprise at all times. The enterprise has to the ability to immediately pay off debts to lenders and suppliers at any time. However, at the same time, a high degree of liquidity prevents capital from being invested more profitably or can cause unnecessary capital costs.

ISBN 978-3-06-450883-5
©IWP-HSG

6

a Return on sales provides information about the percentage of sales that remains as profit. It thus shows the proportional profit of every Franc applied. A return on sales of 2.5% conveys that a profit of 2.5 Rappen was generated from each applied Franc.

b A declining return on sales points to declining productivity and thus rising costs. A rising return on sales indicates – if prices remain constant –increasing productivity.

c The return on sales of an enterprise is in a less competitive market (e.g., monopolistic market) is usually higher than in a competitive market. A high return on sales thus indicates a strong market position of each enterprise. A weak return on sales can be indicative of an intensely competitive market environment.

7

Positive value factors	Negative value factors
- Future-oriented products and markets	- Cyclical and structural industry problems
- Positive enterprise image	- Dependence on a few key customers
- Favorable location	- Unfavorable location
- Qualified and motivated staff	- Lack of management personnel
- High productivity	- Low productivity
- Effective organization	- High inventories
- High capacity utilization	- Unutilized capacity
- Continuous sales and earnings growth	- Declining sales and earnings
- Advantages over competitors	- Disadvantages compared to competitors
- Appropriate technical equipment	- Investment backlog

©IWP-HSG
ISBN 978-3-06-450883-5 2015-01-01

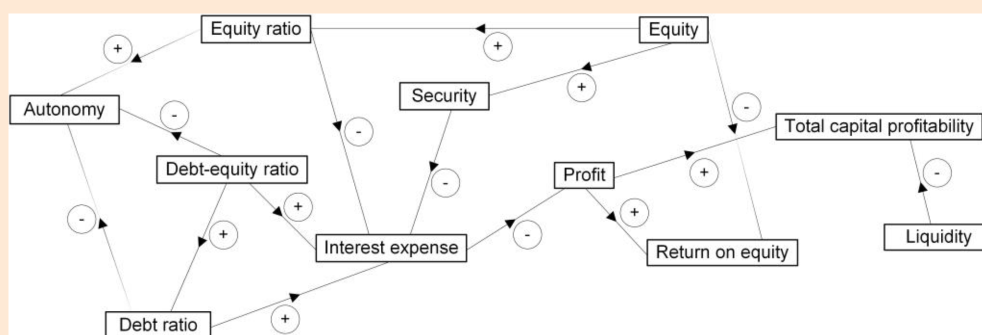
8

a This depends on which valuation method is pursued: Using the German income approach, the value of a business is determined based on the sum of discounted future profits. Reporting higher profits would thus have a positive impact on the value of the business if this method were to be used.
In practice, a combination of methods is most often used to determine the most comprehensive possible final value. The DCF approach (discounted cash flow) is now regarded as a “best practice” approach in the valuation of businesses, as it is based on the valuing the cash flow and not, as with the German income approach, based purely on profit. The reporting of profits depends on the balance sheet policy (e.g., in terms of depreciation and amortization) of an enterprise or on its choice of accounting reporting standards. However, enterprise management has very little influence on the recognition of the cash flows, which is why the method based on them (DCF) offers higher valuation objectivity. Under the DCF method, an accounting correction of profits will not affect the valuation of the business.

b If an impairment of assets exists and the corresponding write-down is not carried out or is only carried out to an insufficient extent, this would be a breach of the principle of "caution" and Art. 666 OR. This means that assets should not be overvalued. In addition, depreciation must be calculated each year according to the same principle (the principle of "consistency").

9

Individual solutions.
Suggestion:



ISBN 978-3-06-450883-5
©IWP-HSG