

**Assignment 2: Step One (ASS#2)**

**Unit:** ACCT11059

**Name:** Hope Lauritsen

**Student Number:** S0277539

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***“Whoever wishes to foresee the future must consult the past...”***

***Niccolo Machiavelli***

The above quote stood out to me whilst starting to read chapter four “Analysing Fianancial Statements”. This is because when you view Financial Statements you are looking at figures from past transactions and events of the particular firm. In order to add value to the firm in the present and future, us as students must be able to consult the past of our allocated companies. Looking at the past may help us to be able to identify what certain aspects of the business are affected, and what parts of the business need to be reviewed or looked into in order to be able to predict the future.

Whilst going through my allocated company ‘China Ting Group Holding Limited’ Annual Reports for Assignment one, we were required to go through past annual reports. Going through the history of Financial Statements of my firm, allowed me to get some insight into challenges they had faced, and are continuing to face. In both the 2017 and 2018 financial year, my company had reduced profits and also had issued a profit warning for the 2019 financial year. One of the reoccurring challenges that my allocated company faced was pressure in relation to the trade war between China and the U.S. This made me question what the 2020 Annual Report would look like, as the world is currently going through a world pandemic due to the coronavirus. This pandemic has had and will continue to have negative impacts on many businesses worldwide. Having to go through past financial statements in assignment one, allowed me to have a better understanding of why we must look at the history of a company in order to help us predict the future.

On the first page of chapter four it mentioned that having a framework to view a firm and how it adds value to its equity investors can help us use financial statements to understand and make sense of our firms economic and business realities. I think that this is crucial for us as students, to understand because adding value is an important aspect of accounting. My allocated company as mentioned above had reduced profits for both the 2017 and 2018 financial years, so being able to understand how we can add value to companies like this is of great significance. Working within an accounting firm, I have learnt that accountants do so much more than prepare taxation returns and financial statements. Accountants can also add value to clients businesses. I know that this is the case because senior accountants at my work prepare tax planning with clients, which is a value added service.

So far in this unit we have learnt about the basics of accounting including what accounting is, that there is two sides to accounting, the accounting equation, elements of accounting, how to understand the game including rules and regulations and have been introduced to the different financial statements. So even though at first glace seeing the different acronyms used in chapter four looked quite daunting, I was intrigued to learn more about analysing financial statements. Every week we are provided more information to expand our learning from the prior week, and I have found the key concepts and questions tasks of this unit to be very beneficial as it helps me to gain a better understanding of the content.

The section on how firms add value was interesting to read. This section pointed out that cash flow, like dividends is not itself a measure of creating value; rather it is a measure of transfer of value. Reading over this section made me question, what is value? How could understanding a firm financial statement help me to understand their value? I have learnt throughout my accounting degree that this is much more involved than looking at a firm’s income statement to see if they have simply made a profit or loss for that year. Dividends was not a new term to me, as this is something that I have heard of before from working within an accounting firm and being in my final year of my degree.

At work I prepare financial statements for clients, some of which have companies. Some of these clients we have had to issue dividends to the shareholders. After the dividends are issued, this is showed as income under the shareholders personal taxation return. This is not something that I regularly do, as I have only done this a few times, as this is something that my manager normally does or helps me with. From prior learning and experience, my understanding is that some companies issue dividends to their shareholders because they make enough profit. However even though a company may be profitable, they might have better use for the cash such as paying debt, investing in opportunities or making acquisitions. Other companies may not be able to if they are not making profits or generating cash. I also have an understanding that some companies are obliged to serve the shareholders. Therefore this section of the chapter was beneficial to me as this has furthered my understanding in relation to dividends, and to know that when dividends are issued this a measure of transfer of value.

The next concept discussed within this chapter is free cash flow (FCF). When I think of free cash flow relating this to my personal life, I understand that this is cash available once I have paid all living expenses and bills. This disposable money left over, I could either spend or save. This section taught me that FCF in relation to accounting is driven by two things: net cash invested into a firms operating assets and cash flow from operations. The free cash flow of a firm will be affected by the firm’s decision on how much they invest into their operating assets each year.

Section 4.2 on operating and financial activities, highlighted the importance of viewing a business as having separate operating and financial activities. This was not something that was new to me, as I understand that in accounting we prepare Income statements, which show operating activities and Balance sheets that show financial activities. Even though I was aware that these are separated it made me question whether I understood why this is done. Reading further it was evident that these activities are separated to allow us to be able to focus on understanding the firms operating activities, which is usually where the value is added or destroyed by a firm. I thought that the Kinder Surprise example used in this chapter to explain why these are shown separately was beneficial as I always have a better understanding of certain concepts when I relate these to personal aspects of my life, which I’m sure many of us could relate to the example provided (Who wouldn’t know what a kinder surprise is).

Reading over Assignment two was a little overwhelming as there was various sections of this to complete. It also made me realise that we are half way through the term and we are already onto our second assignment, which was a good feeling. Apart of this assignment was that we are required to restate our firm’s financial statements. This took me a while to comprehend why we would have to do this. The financial statements already appear to be easy to follow so why was this necessary? What can I learn from doing this? At work I haven’t had to restate financial statements before so this was something new to me.

However it was mentioned at the start of the study guide that by restating a firms financial statements, we are able to identify the key accounting drivers of economic profit and cash flow. Although this process looks quite time consuming, I am eager to find out what I will learn in relation to my company when I prepare this section of the assignment. This study guide was very daunting at first glance, when I skimmed through this seeing the different acronyms. However after reading through the study guide I was pleased that Martin did this, and also included a glossary to help navigate through these terms.

Analysing Financial Statements involves breaking things into bits, I seen this as like solving a puzzle. As social distancing is becoming the new norm, I have been getting into games at home such as puzzles, and reading through this section reminded me of this. Breaking things into bits will allow me to gain insight into how things work. This section started off by discussing economic profit, which is determined by the following formula:

**Economic Profit=(RNOA – costs of capital) x NOA**

**Where RNOA = OI/NOA**

**OI stands for Operating Income**

I therefore learnt that economic profit is made up of three things including return on net operating assets (RNOA), costs of capital and the amount of Net operating assets (NOA) invested in the business.

I also learnt that we could use this formula to analyse RNOA into a ratio that focuses on profitability (how much profit we make for each dollar sale) and also another ratio that will focus on efficiency (how much sales we make for each dollar invested in the business) as follows:

**RNOA = PM x ATO where, PM = OI/Sales and ATO = Sales/NOA**

**PM stands for profit margin**

**ATO stands for Asset turnover**

This ratio has enabled me to see the relationship between profitability and efficiency. This relationship is vital for me to understand, as this is the key to success in any business.