Good example of finance case study

Business, Company

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Analysis of Electronic Arts: Ratio Analyis and Effect of Alternative Accounting Methods on Ratios

Profitability Analysis:

The ratio analysis reveals that over the years, the profitability of the company is improving. In terms of net profit margins, the company has made an applausable leap from -25. 8% to 2. 6% over the years.(2009-2013) This year the net profit margin of the company has surpassed industry benchmark of 2%.

Analyzing the ratios relating to decomposition of profit figures provides us with a better picture relating to working of the company over the years. Both Gross Profit Margins and Operating Margins have increased gradually over the years. Also in comparison to industry benchmarks, the results have been good in recent years. In comparison to Gross Profit and Operating Margin Ratio benchmark of 22. 8 % and -6. 6% respectively, Electronics Arts have Gross Margin of and Operating Margin of 63. 4% and 5% respectively. However, the only area of profitability where the company lacked in comparison to industry benchmarks was Comprehensive Income Growth. The comprehensive income growth of the company was -. 2% while that of industry was 2%.

Risk Factors:

Measuring risk factors in the company in the form of Liquidity, Solvency, Asset Turnover and Bankruptcy Risks we had the following observations for the company:

Liquidity Risk:

Measuring the liquidity position of the company through current ratio and quick ratio, we found that over the years the company has been struggling with its liquidity as the ratios have been been consistently decreasing. However, the ratio of operating cash flow to current liabilities indicates that the condition seems to be improving with increased percentage as against 2012.

Solvency Risk:

Solvency Ratios indicate the extent to which an organization is exposed to financial risk. Analyzing the solvency ratios we find that the company is getting exposed to more and more financial risk over the years. Where by the end of 2011, company was operating in zero debt structure but now the debt equity ratio is 23% while the industry average is 20%. Also the interest coverage ratio has been low in comparison to industry standards of 61. 2, although a slight improvement in this ratio during 2013 was noticed.

Overall the group of solvency ratios indicates that over the years the financial risk in the company is on rise.

Bankruptcy Risk:

Measured by non-conventional set of ratios, these set of ratios indicate that during 2013 company has shown improvement in terms of Bankruptcy Probability and Earning’s Manipulation with these ratios going low during 2013.

Answer 2)

The company prepares it financial statements as per Generally Accepted Accounting Principles(GAAP) and makes assumptions and estimates that affect the reporting our consolidated financial statements.

Inventory:

Following GAAP Accounting Standards, the company reports its inventory on the balance sheet as lower of cost or market using weighted average cost method). Under this method, the average cost per unit of inventory is computed by dividing the total cost of goods available for sale by the total quantity available for sale.

However, had the company followed the alternative inventory valuation method of FIFO or LIFO, because of different assumption of both these methods relating to COGS, they will have varied impacts over the ratio analysis.

Effect of Alternative reporting standard related to Inventory on Financial Ratios:

Following the rules of FIFO or LIFO for Inventory reporting:

Ending Inventory Value: Since FIFO provides the current cost approximation to the ending inventory, in other words provided that ending inevntory in FIFO is made up of most recent purchases, the amount of inventory under FIFO will be higher. Thus, because of high inventory, current assets will be bigger and as a result, following FIFO costing method, both Current Ratio and ratios related to working capital will be higher. Similarly followinf LIFO costing will end up with low current ratio and

Cost of Goods Sold: At times of rising prices, LIFO COGS will be higher than

FIFO and when prices are falling, LIFO COGS will be lower than FIFO COGS. Thus, assuming that current period being of inflation, had the firm followed FIFO method, net income will be more than LIFO method and this will result in higher taxes and lower cash flows.

Thus, all the ratios relating to net income, taxes and cash flow will be affected and the direction of change in ratio will depend on the costing method which the company follows.

Depreciation:

Company follow straight line depreciation method for accounting the total depreciation expenses on property, plant and equipment. This method is a predominant method of computing depreciation for financial reporting. Depreciation is the same amount each year over the asset’s estimated life:

Depreciation Expense: Original Cost- Salvage Value/ Depreciable Life

However, had the company follwed accelerated depreciation method, although the total depreciation expense over the years would have been same, but following this method of depreciation, more depreciation expense is recognized in the early years of an asset’s life and less depreciation expense in the later years. Thus, accelerated depreciation results in lower net income in the early years of an asset’s life and higher net income in the later years compared to straight line depreciation.

Effect of Alternative reporting standard related to Depreciation on Financial Ratios:

Following the alternative method of depreciation i. e Accelerated Method of Depreciation, the profitability ratios would have the largest effect. Whereas, following straight line method of depreciation, the depreciation expense remains same through the years until the asset is left with salvage value, in the alternative case, the depreciation expense will be greater in the initial years and will keep on diminishing.

Thus, in the years of higher depreciation expenses:

- pre tax income will be lower
- tax expenses will be lower

and finally ;

- a lower net profit and vice versa.

Following Ratios will be affected:

Net Profit margin: With lower net profits in the initial years because of high depreciation expenses, Net Profit Margin Ratio will be lower and will increase over the years.

Return on Assets(Based on reported amounts): Since the ratio uses Net Profit margin as part of calculation, using accelerate depreciation will result in use of low profit margins that will lead to lower return on assets which just like Net Profit Margin will pick up in late years.

Debt to Equity: With lower net profits, accelerated depreciation method will lead to higher debt to equity in the initial years which will decrease further as net profits increase over the years and so does equity with net profit being part of equity.

EBIT/EBT Ratio(Tax Index): With low tax expenses on account of low pre tax income, the Tax Index Ratio will be higher on account of low Earnings before Tax(EBT). However, over the years, this ratio will decline with increase in EBT amount.

Did the company used most appropriate accounting method?

Refering to other companies in the industry, Electronic Arts is following appropriate accounting method as the gaming industry is based on software development and in light of their dynamic industry environment, weighted average cost valuation seems appropriate.