A ratio analysis comparison of rolls royce and ge

Rolls Royce and GE are two of the most renowned names in the global engineering sector. The GE is based in the US while the Rolls Royce has its origins in Europe. Due to the difference of the regions, the companies follow different accounting principles in reporting their performances. The GE uses the US GAAP and the Rolls Royce uses the IFRS. The difference in the formation of the reports is difficult for the interested parties to understand and it provides difficulty in the evaluation of the companies. In this case the ratio analysis is the best means for the evaluation of the companies. Due to the difference of the accounting principles of the companies, the accounting boards of IFRS and the US GAAP are working towards a convergence of the standards. This will solve the difficulty of the different companies operating round the world.

Introduction

The name of Rolls Royce brings to mind the image of a sophisticated high-class car. The company was set up to manufacture the high-class car in the first place. However, as the group grew the company was split and the license for the manufacturing of the cars was granted to BMW. In the present day, BMW manufactures the coveted car. The coveted trademarks are used by the parent group in the name of the Rolls Royce Plc. The group has been one of the renowned names in the engineering industry and operates in the aerospace and the marine sector. The clients of the company are the defense organizations of most of the countries. The brand has been synonymous with the quality of the products and its rich heritage has been drawing customers from all over the world. It is headquartered in London and follows the accounting principles of the country in publishing its reports. (History of the brand, n. d.)

GE or the General Electric has been the frontrunner in the global electronics industry. Like that of the Rolls Royce the main focus of the company has been the energy sector. The company has a rich heritage dating back to the days of Thomas Edison. From the days of Edison, the company has been involved in innovation of different techniques in the electronics sector. In its modern stature, the company has carried on its past heritage and created a global name for it. The global brand has been instrumental in the success of the company. The innovation in the company has been carried on from the days of Edison. The company has its main office in USA. In its financial reports the company uses the American GAAP principles. (Our history, n. d.)

The paper will divulge in the financial reports of the company and report the performance of the companies in a similar manner with the help of the ratio analysis. The difference in the reporting principles of the company will be emphasized upon.

The companies

The rationale behind choosing the companies is relevant in the case. Both the companies are similar because they operate in the same kind of industry. Both are renowned names in the industry and have distinctive brand values. The companies have been operating in the industry sector. The companies are based on different geographical locations and they follow different sets of principles in the case of the financial reporting. The stature of the companies fulfills the requirements of the report.

Financial strengths and weakness

This section will deal with the strengths and the weakness of the companies as reported in the financial reports of the companies. As the structure of the financial reports is different in the case of the two companies the help of the ratio analysis will be taken. The ratio analysis helps in maintaining uniformity in the reporting of the companies.

Rolls Royce

In the case of Rolls Royce, the financial evaluation will take place from the period of 2006 to 2009. The ratio analysis will help in the case of the evaluation. As the company has been based in England, Pounds has been the currency used in the report. All the figures in the analysis will be in millions of pounds except the earnings per share of the company.

Profitability analysis ratio

Return on Equity (ROE)

Net Income/ Shareholder’s Equity

The company has been performing fine in accordance with the money of the shareholders with the exception of 2008. In 2008, the company invested heavily on the R&D of the company and the financing of the company’s operations. The Investment has kept the company in good stead and the result of 2009 is a proof to the point.

The story is the same in the case of the ROA. With the exception of 2008, the company has been performing moderately well. In 2008, there were additional purchases of the assets as well as increase in the current assets.

This has been influential in the figure reflected. The company has been investing in the assets for the future growth of the company.

The current ratio depicts the short term solvency of the firm. The current assets should be able to pay off the current liabilities of the company. In the case of Rolls Royce, the current ratio has been good over the years which underline good case of solvency for the firm.

Activity analysis ratio

The ART of Rolls Royce clearly depicts that the company has been giving the clients more and more credit period over the years. The company may have reviewed the situation in the wake of the financial crisis in the latter part of 2008. This has been necessary for the company to maintain the growth of the business.

In accordance with the ART of the company, the ITR has also decreased over the years. This proves that inventory remains at the disposal of company for more days. The global turmoil and the competition in the market may have played a big role in the slowdown of the sales process.

Long term debt paying ability ratio

The D/E position of the company has improved over the years with more aggressive build up to the financing. This will help the company in the long run to grow.

The ratio analysis in the case of the Rolls Royce PLC points out that the company has been in a good position in the case of solvency and the return for the shareholders. The shareholders get a good return for the money. In the year of 2008, the company suffered a loss due to the investments in the R&D. The industry in which the company operates in needs a continuous flow of investment in the R&D. The investment made in the R&D has helped the company to reverse the situation in the case of profit in 2009. The company is expected to grow in the coming years. (Company Balance Sheet, 2007; consolidated income statement, 2007; Rolls Royce, 2009; Annual Report, 2006)

GE

To maintain uniformity in the report the financial statements of GE has been taken from the year of 2006 to 2009. The company has been based in the USA so the report will be based in the dollars. All the figures except the earnings of the share are depicted in millions of dollars.

Profitability analysis ratio

The ROE of the company has been constant during the years and the company has been performing well. In the year 2009, the ROE of the company fell drastically. This was due to the fact that the company had large amount of retained earnings of the shareholders. In addition to this, the business of the company decreased as an after effect of the economic slowdown.

The ROA of the company has been decreasing over the years. This is because of the decreasing sales. Like in the case of the ROE, the ROA for 2009 has decreased to a substantial extent because of the impact of the global financial crisis.

Liquidity Ratio

The current ratio has been increasing over the years, which state that the solvency position of the company has been good. The assets and the liabilities of the firm have been benefited by the involvement of the subsidiaries in the parent group. The management of the company has been paying off the debts in the market at regular intervals. This has helped in the decrease of the current liabilities of the firm.

Activity analysis ratio

The figures from the ART chart points out that the company has been maintaining a definite policy in the case of the giving credit. The policy has not been affected by the global turmoil.

I

The ITR has largely been constant with a slight dip in the case of 2009. However, that is understandable given the financial condition of the world. The management had to lower the velocity of sales as more and more business went bankrupt.

Long term debt paying ability ratio

The D/E ratio of the company has been comparatively higher pointing out that the earnings of the company will be volatile in the longer run. The equity changes over the years because of the retained earnings. (Invest and deliver, 2006; We are GE, 2008; 2009 annual report, 2009)

GE has been performing well over the years and there has been consistency in the performance. However, it has to be stated that the shareholders have not got their due share as the ROE suggests. The company has been troubled by the global financial crisis. Being incorporated in the USA, the division of the country performed badly. The company was saved by the other divisions situated in various parts of the world.

Industry overview

Rolls Royce has been a leader in the industry of production of the engines in the aircrafts and the marine artillery. The clients of the company have been the defense organizations of the world. In the case of the commercial aircrafts the company has been a leading player and most of the top aircraft companies of the world like the Boeing use the engines from the Rolls Royce. There are very few competitors in the industry. The competition is global as there are very few companies. GE and Pratt & Whitney are the major competitors of Rolls Royce. Given its stature and the clients, the company influences a major part of the market. (Profile: Rolls Royce, 19th October, 2001)

In the case of GE, the scene is different. Besides the power sector, the company has other variables. The competition in the case of the other variables is tough. GE operates in a large number of divisions and there are competitors in most of the divisions. One of the major competitors of GE has been Siemens which like that of GE has a wide scope and reach in the market. The other competitors are Honeywell, Bank of America, and The Walt Disney Company etc. The companies are from the different industries. (Industrial: GE competitors, n. d.)

Stock Price Performance

The price of the shares of both the companies will make their position clear in terms of the market.

Rolls Royce

In the case of Rolls Royce, the company is incorporated in UK and therefore, the price of the shares of the company is given in pounds. The share prices of the company can be described as follows:

In the case of GE, the company is incorporated in USA and thus the share prices of the company will be produced in Dollars. The share prices of the company from 2006 to 2009 are as follows:

Environment

The figures in the financial statements of both the company underline the fact that the management faced severe problems in the latter years of 2008 and 2009. This can be attributed to the fact that the global financial turmoil of the company had affected the positions of the company. The financial turmoil of the company meant that the prospects of the business were low. Both the companies were hit hard by the situation. Many of the companies went bankrupt. A company of GE’s stature suffered the most severe dip in its share prices in 12 years. (Cherniawski, 24th January 2009). Therefore, it was normal that the performance of the company will be inefficient during the phase and this got reflected in the financial statements of the company.

Differences of accounting styles: Convergence

The emergence of the accounting standards has been beneficial for the companies and the investors of the companies. The accounting standards help in the presentation of the financial information of the company in a format that can be understood by the investors of the companies. The investors of the companies are interested in the performance of the company and the financial results are referred to analyze the results. Therefore, the companies must be able to communicate information that is useful for the investors and the other related parties. The emergence of the standards has been helpful in introducing uniformity of the presentation in the companies. The investors have been benefited by the clarity of the information and the scope of the information. In the case of the companies, the management is able to garner more investments form the investors because of the clarity of the information. The clarity of the information in the case of the companies helps in attracting more capital. Therefore, in the true sense, the cost of capital decreases. The accounting world follows different kind of standards and formats in the case of the presentation of the financial information. With the globalization of the economy, it was felt evident to have a uniform standard all over the world. The existing standards of the different parts of the world are in the process of converging to make a globalized standard. The process is going on till now. In Europe, with the emergence of EU, the rules and regulations in the case of the business have been more stringent. The IAS/IFRS controls the presentation of the accounts in the case of the business houses in Europe. In the case of the US and the North American countries, the US GAAP is the most accepted standard. Therefore, there will be a difference in the presentation of the accounting and the financial information of the companies in these two spheres. In this case, the Rolls Royce Plc is commissioned in England and the company follows the IAS whereas, the GE follows the US GAAP. (Daske, n. d., pp. 1-6).

There are differences between the US GAAP and the IAS that hinders the presentation of the financial statements of the company. In some cases, there is difference in the valuation of some of the items in the company. The difference in the valuations of some of the items will be confusing for the investors. In the case of the measurement of the non-controlling interests of the company, the IAS allows it to be valued at fair value or at the proportionate value in the company. In the case of the US GAAP, the standard allows the valuation at fair values. This leads to the differences in the valuation of the companies. The structure of the presentation of the financial statements differs in the case of the IAS and the US GAAP. In the case of the IAS, the report should consist of the various divisions of the changes of the equity and the comprehensive income. However, in the case of the US GAAP, the comprehensive income will report all the changes. In the case of the IAS/IFRS, the comparison between the different years is required while in the case of the US GAAP, the comparison is “ desirable”. Deferred tax is always recognized in the case of the US GAAP while in the case of the IAS/IFRS, the deferred tax is recognized if the income is probable. The reporting for the segments also differs in the case of the standards. In the case of the US GAAP, one basis of segmentation is required while in the case of the IAS/IFRS, the whole segmentation has to be done. The segment must report the results in the case of the IAS/IFRS while in the case of the US GAAP it is not needed. These are the key differences in the case of the presentation of the financial statements. (Key differences between IFRS and US GAAP, June 2004; Business combinations, n. d.)

With the globalization of economy, the reporting of the accounts of the company became a problem. The EU became bigger and engulfed newer countries in its fold. About 7000 companies registered in the EU are required to comply by the IFRS by 2005. This is a problem as most of the companies are incorporated in the US. In the US, the companies can report in the IFRS from but they have to prepare reconciliation in the GAAP format. Therefore, the companies essentially have to prepare accounts twice. Moreover, the implications of the Sarbanes-Oxley Act require the preparation of the accounts in the best interest of the international business environment. Therefore, in October 2002, the board of the IFSB and the FASB (US GAAP) entered into a contract to converge the different accounting principles to prepare a global system. The bodies will take short-term projects to converge the different points of the standards. This will help the global business organizations. (Pacter, March, 2003) Also, Byard, Li Y., and Yu, Y. (2008) found that finance analysts made fewer mistakes forecasting future earnings, and that the accuracy was enhanced after the adoption of IFRS by the European Union.

Principles-based system VS Rules-based system

Before the convergence, and even in the process of it, debates over which set of standards is superior never stopped. The biggest issue rests with the essence of the two different accounting styles. Many scholars assert that IFRS is principles-based while US GAAP is rules-based. However, Bennett et al. assert that this distinction is futile, because the only distinction is in the degree of professional judgement required for the implementation of the two systems. (B. Bennett, M. Bradbury, H. Prangnell, 2006) Furthermore, Goldberg, and Kim (2005) assert that IFRS and GAAP are no different regarding reporting quality. Benston et al. argue that a principles-based approach with a ‘ true and fair’ override facilitates the exercise of professional judgement, and this is the distinction between the two systems. (G. J. Benston, M. Bromwich, A. Wagenhofer, 2006) In a global economy, accounting harmonization is getting more attention. Principles-based system is advocated by both academia and practical circles as a principles-based system i. e. IFRS provides flexibility for countries with diverse accounting traditions to comply with, while preserve its spirit to ensure a ‘ true and fair’ presentation. (S. Carmona, M. Trombetta, 2008) While the spirit of principles-based system is appreciated, there are cases indicating the failure of such system. R. G. Walker argues that the success of a principles-based system depends more on human factors such as willingness of auditors to comply, capacity of regulators to monitor, factors that rules-based system ignores because of its rigidity. The rigidity of rules-based system is also a curse. Berkowitz et al. argues that rigid rules leave more loopholes for accounting manipulation as manifested in the Enron scandal, in which the management managed to keep off-balance sheet transactions within the GAAP rules. (Berkowitz and Rampell, 2002) Zeff also argues that cultural differences lead to different accounting styles which might render the convergence ineffective.

Nevertheless, any reform comes with merits and downsides. We will go with one if the benefits outweigh the disadvantages. In order for the convergence to bear fruit, these debates provide abundant evidence for the task group to consider. Thus it will be reasonable to foresee that in the future with the convergence of the two different accounting styles, accounting standards will be more robust, providing more reassurance for investors. According to Leuz et al., convergence between IFRS and US GAAP lowers cost to raise capital due to benefits from both systems. (Leuz and Verrechia, 2000).

Fair value VS Historical costs

The IFRS advocates the use of fair value as fair value provides relevance and decision-usefulness. (J. M. Hitz, 2007) Historical cost is used in the US GAAP for its prudence and reliability. Problems that the convergence must counter focus largely on the adoption of costing system. Since historical cost is still being used in many countries, it has its inherent advantages. Nowadays, scholars argue that fair value costing might provide more accurate thus relevant information. Only with the exception in financial crisis, fair value causes fluctuations in accounting figures which makes it less dependable. Moreover, it introduces volatility even when economy is stable, although it on certain level prompts early reaction to control risks. (C. Laux, C. Leuz, 2009)

As in the principles-based system VS rules-based system debate, a tradeoff is needed to draw a plan for convergence. Evaluating the weight taken by relevance or reliability is thus important.

The Case: Impact of IFRS and US GAAP on accounting figures

In the case of Rolls Royce and GE, these differences were seen. In the case of GE, segmentation was done with the help of only one segment. In the case of the Rolls Royce, there were no other segments. In the case of the structure of presentation, there were key differences, which may have an effect on the investors. The information provided by the companies may confuse the investors. The Rolls Royce Company followed the IAS and the comparison of the figures with the years was provided. It was also provided in the case of GE, but the information was not present in some places. This can effect the information of the investors. In the case of the investments of the companies, the GAAP recognizes it at cost while in IFRS it is recognized at fair value. In the case of GE, there were heavy investments in the other sectors. This was recognized at cost while in the case of Rolls Royce, it was recognized at fair value. In the case of GE, this helped in properly reporting the profits of the shareholders of the company. In the case of the inventory, the GAAP values it in last-in-first-out basis. This helps in the recognition of the present conditions of the company. At the time or recession, the GE projected the profits according to the situation and the shareholders benefited due to this. In the case of the Rolls Royce, the inventory was valued in the firs-in-first-out basis, which did not subscribe to the situation. GAAP recognizes the revenue only when the delivery has been completed while in the case of the IFRS, delivery is not required. Therefore, the revenue recognition in the case of the GE was conservative and actual sales. In the case of the Rolls Royce, the revenue was recognized before the delivery was complete. This can have severe consequences as losses can happen at transit. (Lajara, 11th June, 2008)

Conclusion

The difference in the presentation of the accounting and the financial information can be detrimental to the interests of the company. The investors will not be able to garner the necessary information and the company will not be able to receive investments. This will be degrading for the performance of the company. The difference in the accounting standards can be confusing for the investors with the difference in the structures. The performance of the companies cannot be evaluated in the global context. Thus the true evaluation will not be done. Therefore, it is necessary for the convergence of the standards and gives rise to a global standard.