TOPIC 5: KEY COMPONENTS OF FINANCIAL STATEMENTS FOR SINGLE ENTITIES

5.1 Introduction

Financial statements are formal records that show the financial activities and position of a business. Think of them as a report card for a company — they tell you how much the company earned, what it owns, what it owes, and how much cash it has.

In Uganda, companies like Stanbic Bank Uganda, MTN Uganda, or Uganda Breweries Limited (UBL) prepare financial statements every year and publish them so that shareholders, banks, and the public can understand how the company is performing.

5.2 Overview of the Four Main Financial Statements

Under the International Financial Reporting Standards (IFRS), a complete set of financial statements for a single entity includes four main statements plus notes. Each statement answers a different question:

Financial Statement	Question It Answers	Simple Analogy
Statement of Profit or Loss (Income Statement)	Did the company make a profit or a loss?	Your salary minus your expenses = savings or debt
Statement of Financial Position (Balance Sheet)	What does the company own and owe?	Your assets (house, car) minus your loans = net worth
Statement of Changes in Equity	How did the owners' share change?	Your savings account balance over the year
Statement of Cash Flows	Where did money come from and go to?	Your mobile money statement showing all transactions

5.3 Statement of Profit or Loss and Other Comprehensive Income

5.3.1 What is it?

This statement shows whether the company made a profit (revenue > expenses) or a loss (expenses > revenue) during a specific period — usually one year.

It is sometimes called the Income Statement or P&L (Profit and Loss) statement.

5.3.2 Main Components

Component	Explanation
Revenue (Turnover)	Total income earned from selling goods or services. E.g., MTN Uganda's total airtime and data sales in a year.
Cost of Sales	The direct cost of producing goods/services sold. E.g., the cost of network infrastructure for MTN.
Gross Profit	Revenue minus Cost of Sales. This is profit before overhead expenses.

Operating Expenses	Indirect costs: salaries, rent, marketing, utilities. E.g., salaries of Stanbic Bank tellers.
Operating Profit (EBIT)	Gross Profit minus Operating Expenses. Profit from core operations.
Finance Costs	Interest paid on loans. E.g., interest paid by a company to dfcu Bank.
Profit Before Tax (PBT)	Operating Profit minus Finance Costs.
Tax Expense	Corporation tax paid to Uganda Revenue Authority (URA). Currently 30% for companies in Uganda.
Profit After Tax (PAT)	The final profit available for shareholders.
Other Comprehensive Income	Gains/losses not in the main profit, e.g., revaluation of property or currency translation differences.

📌 **Ugandan Example**

Uganda Breweries Limited (UBL) sells beer across Uganda.

Revenue: UGX 500 billion (sales of Bell Lager, Tusker, etc.)
Less: Cost of Sales: UGX 300 billion (barley, bottles, production costs)
= Gross Profit: UGX 200 billion
Less: Operating Expenses: UGX 80 billion (staff salaries, marketing)
= Operating Profit: UGX 120 billion
Less: Finance Costs: UGX 10 billion (loan interest to Stanbic Bank)
= Profit Before Tax: UGX 110 billion
Less: Tax (30%): UGX 33 billion
= Profit After Tax: UGX 77 billion — this belongs to shareholders!

5.3.3 Other Comprehensive Income (OCI)

OCI includes items that affect equity but are NOT part of the normal profit or loss. These include:

- Revaluation surplus – when a building increases in value
- Foreign currency translation differences – for companies operating in multiple currencies
- Actuarial gains/losses on pension schemes

Total Comprehensive Income = Profit After Tax + Other Comprehensive Income

5.4 Statement of Financial Position (Balance Sheet)

5.4.1 What is it?

The Statement of Financial Position shows what a company OWNS (assets) and what it OWES (liabilities) at a specific date. The difference between assets and liabilities is Equity (the owners' share of the business).

The fundamental accounting equation is:

ASSETS = LIABILITIES + EQUITY

5.4.2 Structure of the Balance Sheet

Section	Sub-items	Ugandan Example
NON-CURRENT ASSETS (owned long-term)	Property, Plant & Equipment (PPE); Intangible assets (goodwill, patents); Long-term investments	MTN Uganda's mobile towers, Stanbic's office buildings, UMEME's power lines
CURRENT ASSETS (short-term, turned to cash within 1 year)	Inventories; Trade receivables; Cash & bank balances	Stock of beer at UBL warehouses; debts owed by supermarkets; money in Centenary Bank
NON-CURRENT LIABILITIES (owed long-term, > 1 year)	Long-term loans; Deferred tax; Pension obligations	A 10-year loan taken from dfcu Bank for a factory
CURRENT LIABILITIES (owed within 1 year)	Trade payables; Bank overdraft; Tax payable	Money owed to suppliers; an overdraft at Stanbic Bank
EQUITY (owners' funds)	Share capital; Retained earnings; Revaluation reserve	Shares issued to the public on Uganda Securities Exchange (USE)

📌 Ugandan Example

Imagine Roofings Group Uganda has the following:

NON-CURRENT ASSETS
Factory buildings in Namanve: UGX 80 billion
Machinery: UGX 40 billion
CURRENT ASSETS
Stock of steel sheets: UGX 20 billion
Cash at bank: UGX 10 billion
TOTAL ASSETS: UGX 150 billion

NON-CURRENT LIABILITIES
Long-term bank loan (dfcu): UGX 30 billion
CURRENT LIABILITIES
Supplier debts (payables): UGX 10 billion
TOTAL LIABILITIES: UGX 40 billion

EQUITY (Assets – Liabilities): UGX 110 billion
Share capital: UGX 50 billion
Retained earnings: UGX 60 billion

5.4.3 Key Definitions

- **A resource controlled by the company as a result of past events and from which future economic benefits are expected to flow. Example: A boda boda (motorcycle) owned by a delivery company.**
- **A present obligation to transfer an economic benefit. Example: A loan from DFCU or Centenary Bank.**
- **The residual interest in the assets after deducting all liabilities. It belongs to the shareholders.**

5.5 Statement of Changes in Equity

5.5.1 What is it?

This statement shows how the equity (owners' funds) of a company changed during the year. It connects the profit or loss from the income statement to the equity in the balance sheet.

5.5.2 Components

- **Equity at the start of the year**
- **Added from the P&L statement**
- **Revaluations, etc.**
- **Profits distributed to shareholders (reduces equity)**
- **If company issued new shares during the year**
- **Equity at the end of the year**

> 📌 **Ugandan Example**
>
> Stanbic Bank Uganda – Simplified Statement of Changes in Equity:
>
> Opening equity (Jan 1, 2024): UGX 1,200 billion
> Add: Profit for the year: UGX 300 billion
> Add: Revaluation of head office building: UGX 50 billion
> Less: Dividends paid to shareholders: (UGX 100 billion)
>
> Closing equity (Dec 31, 2024): UGX 1,450 billion
>
> Note: Dividends reduce equity because money is flowing out of the company.

5.6 Statement of Cash Flows (IAS 7)

5.6.1 Why is Cash Flow Different from Profit?

A company can show a profit on paper but still run out of cash. This is because profit is measured on an accrual basis — meaning revenue is recognised when earned, not when cash is received.

> 📌 **Ugandan Example**
>
> A supplier sells goods worth UGX 10 million to a supermarket on credit.
> The supplier records UGX 10 million as revenue immediately (profit increases).
> BUT if the supermarket has not yet paid, the supplier has NO cash.
>
> This is why cash flow analysis is very important — especially for small Ugandan businesses that often face delayed payments from large clients like government agencies.

5.6.2 Three Sections of the Cash Flow Statement

Section	Description & Examples
1. Operating Activities	Cash from the main business operations. Cash received from customers; cash paid to suppliers and employees; tax paid to URA.

	This is the most important section — it shows whether the core business generates cash.
2. Investing Activities	Cash used to buy or sell long-term assets. Purchase of land or machinery; proceeds from selling old equipment. E.g., UMEME buying new electricity transformers.
3. Financing Activities	Cash from raising or repaying finance. Loans received from banks; loan repayments; dividends paid; new share capital raised. E.g., Stanbic issuing new bonds.

5.6.3 Two Methods of Presenting Operating Activities

- **Lists actual cash receipts and payments (e.g., cash collected from customers, cash paid to suppliers). More transparent but harder to prepare.**
- **Starts with net profit and adjusts for non-cash items like depreciation and changes in working capital. This is the most commonly used method in Uganda.**

Remember: Net Profit ≠ Cash Generated

Adjustments under the Indirect Method include:
• Add back: Depreciation (non-cash expense)
• Add back: Amortisation
• Deduct: Increase in trade receivables (goods sold but not yet collected)
• Add: Increase in trade payables (goods received but not yet paid)
The goal is to convert 'accounting profit' into 'actual cash from operations'.

5.7 Notes to the Accounts

5.7.1 Purpose of Notes

The four financial statements alone do not give the full picture. Notes to the accounts provide additional explanations, breakdowns, and disclosures required by IFRS.

5.7.2 What Do Notes Contain?

- **How the company values its assets, recognises revenue, etc.**
- **E.g., a breakdown of property by type (land, buildings, vehicles)**
- **Possible future obligations, e.g., a court case pending against the company**
- **Dealings with directors, parent companies, or subsidiaries**
- **Details of dividends declared and paid**
- **Key assumptions made by management, e.g., useful life of assets**

📌 Ugandan Example

MTN Uganda's annual report notes might disclose:

Note 3 – Property, Plant & Equipment:
Network equipment: UGX 1,200 billion (net book value after depreciation)
Buildings: UGX 200 billion
Vehicles: UGX 50 billion

Note 9 – Contingent Liability:

'The company is subject to tax assessments by URA totalling UGX 15 billion. Management believes the company has a strong legal defence.'

This gives investors extra context they cannot see from the main statements alone.

5.8 Other Disclosures in Published Accounts

Published annual reports in Uganda (and internationally) contain more than just financial statements. They also include:

- **Overview of the business, strategy, and governance**
- **Independent opinion from external auditors (e.g., Deloitte, PwC Uganda, KPMG) on whether the accounts show a true and fair view**
- **How the board is structured and governed**
- **Environmental and social impact of the business**
- **Performance broken down by business line or geography**

TOPIC 6: INTERPRETATION OF ACCOUNTING POLICIES BASED ON IFRS

6.1 Introduction

When companies prepare financial statements, they must follow rules about how to recognise and measure different items. These rules are called accounting policies. They are based on IFRS — the International Financial Reporting Standards.

In this topic, we look at four key areas: (1) how revenue is recognised, (2) financial reporting for groups of companies, (3) accounting for business combinations, and (4) how IFRS applies in group scenarios.

6.2 Revenue Recognition (IFRS 15)

6.2.1 What is Revenue?

Revenue is the income earned by a company from its normal business activities. It is also called turnover or sales. Under IFRS 15 (Revenue from Contracts with Customers), revenue is only recognized when specific conditions are met — not simply when cash is received or an invoice is raised.

6.2.2 The Five-Step Model (IFRS 15)

IFRS 15 introduced a five-step model for recognising revenue from contracts with customers:

Step	What it means in simple terms
Step 1: Identify the contract with the customer	A contract is an agreement (written or verbal) between a company and a customer. E.g., MTN Uganda signing a contract to provide mobile services to a corporate client.
Step 2: Identify the performance obligations	What exactly has the company promised to deliver? E.g., MTN promises to provide airtime, data, and a SIM card — these may be separate obligations.
Step 3: Determine the transaction price	How much is the customer paying in total? E.g., the monthly fee for a corporate bundle is UGX 500,000.
Step 4: Allocate the transaction price to the obligations	If there are multiple obligations, split the price fairly between them. E.g., allocate UGX 300,000 to data and UGX 200,000 to calls.
Step 5: Recognise revenue when each obligation is satisfied	Recognise revenue when (or as) you deliver the goods or services. E.g., MTN recognises data revenue as data is used, not when the bundle is sold.

📌 Ugandan Example

Nile Breweries Ltd signs a contract with a hotel in Kampala to supply 1,000 crates of beer worth UGX 50 million. Delivery is in two stages:

Stage 1: 600 crates delivered in March → Revenue = UGX 30 million recognised in March

Stage 2: 400 crates delivered in April → Revenue = UGX 20 million recognised in April

Under IFRS 15, revenue is recognised when the goods are delivered (performance obligation satisfied), NOT when the contract was signed or when cash is received.

Compare this to old practice in some Ugandan SMEs that recognise revenue on invoice date regardless of whether goods have been delivered — IFRS 15 corrects this.

6.2.3 When is Revenue Recognised? — Over Time vs. At a Point in Time

- **Revenue is recognised when the customer takes control of the goods. E.g., when a customer buys cement from Hima Cement and it is loaded onto their truck.**
- **Revenue is recognised gradually as the service is delivered. E.g., a construction contract to build a road for Uganda National Roads Authority (UNRA) where revenue is recognised based on completion percentage.**

6.3 Financial Reporting by Groups of Companies

6.3.1 What is a Group?

A group exists when one company (the parent) controls one or more other companies (subsidiaries). Control means having the power to direct the activities of another company — usually by owning more than 50% of its voting shares.

📌 Ugandan Example

In Uganda, consider this simplified structure:

Umeme Limited (Parent Company) — Listed on Uganda Securities Exchange
|
├── Umeme Finance Ltd (Subsidiary — 100% owned) — handles borrowing
└── Umeme Services Ltd (Subsidiary — 80% owned) — meter installation

Another real-world example: Absa Bank Uganda is a subsidiary of Absa Group (South Africa). Absa Group prepares consolidated accounts that include Uganda.

Stanbic Bank Uganda is a subsidiary of Standard Bank Group (South Africa).

6.3.2 Consolidated Financial Statements

When a parent company controls subsidiaries, it must prepare consolidated (group) financial statements in addition to its own individual statements. Consolidated statements combine the financial results of the parent and all subsidiaries as if they were ONE single entity.

The relevant IFRS standards are:

- **Consolidated Financial Statements — defines control and requires consolidation**
- **Business Combinations — how to account when acquiring a company**
- **Separate Financial Statements — the parent's own individual accounts**

6.3.3 The Consolidation Process — Key Principles

- **Combine 100% of the parent's assets/liabilities with 100% of the subsidiary's assets/liabilities — even if the parent owns only 80%.**

- **Remove transactions between group companies (e.g., if the parent sold goods to its subsidiary — this is an internal transaction that shouldn't appear in group accounts).**
- **The share of the subsidiary NOT owned by the parent. E.g., if the parent owns 80%, the remaining 20% belongs to other (outside) shareholders — this is the NCI, shown separately in equity.**
- **The extra amount paid above the fair value of the net assets acquired in a business combination (see Section 6.4 below).**

6.4 Accounting for Business Combinations (IFRS 3)

6.4.1 What is a Business Combination?

A business combination occurs when one entity (the acquirer) obtains control of another entity (the acquiree). This is commonly called a merger or acquisition (M&A).

> 📌 **Ugandan Example**
>
> In 2022, Equity Bank Uganda acquired a significant stake in certain financial assets.
> In 2016, Stanbic Bank Uganda (then CfC Stanbic) merged operations in Uganda.
>
> Globally, consider: Airtel Uganda was created after Bharti Airtel (India) acquired Warid Telecom Uganda operations in 2013 — this was a business combination.
>
> Under IFRS 3, when Airtel acquired Warid, it had to:
> 1. Identify the acquirer (Airtel)
> 2. Determine the acquisition date
> 3. Recognise and measure assets and liabilities at FAIR VALUE
> 4. Calculate and recognise goodwill

6.4.2 Goodwill

Goodwill is the premium paid above the fair value of net assets when acquiring a company. It represents intangible value such as brand reputation, customer relationships, or skilled workforce.

Goodwill = Purchase Price – Fair Value of Net Assets Acquired

> 📌 **Ugandan Example**
>
> Suppose Equity Bank Uganda acquires a smaller MFI (Microfinance Institution) for UGX 20 billion.
>
> Fair Value of Net Assets of the MFI:
> Loans receivable: UGX 12 billion
> Office equipment: UGX 2 billion
> Cash: UGX 1 billion
> Less: Liabilities: (UGX 5 billion)
> = Net Assets: UGX 10 billion
>
> Goodwill = UGX 20 billion (paid) – UGX 10 billion (net assets) = UGX 10 billion

Why did Equity pay UGX 10 billion extra? Because they valued the MFI's customer base of 50,000 borrowers across rural Uganda and its strong brand in western Uganda.

6.4.3 Accounting Treatment of Goodwill

- Goodwill is recognised as an INTANGIBLE ASSET on the consolidated balance sheet
- Under IFRS, goodwill is NOT amortised (written off gradually over time)
- Instead, goodwill is tested for IMPAIRMENT annually (IAS 36)
- If the value of the subsidiary falls below what was paid — impairment loss is recognised in the P&L

6.5 When Consolidated Accounts Are NOT Required

Normally, a parent must prepare consolidated accounts. However, IFRS 10 provides certain exemptions:

Exemption	Explanation
Parent is itself a subsidiary	If Company A is 100% owned by Company B, then Company A may not need to prepare its own consolidated accounts — Company B will do this at group level.
Shares not publicly traded	If the parent's shares are not listed on any stock exchange (e.g., not on the Uganda Securities Exchange), it may be exempted.
Parent prepares IFRS accounts for public interest	If a higher-level parent already prepares consolidated IFRS-compliant statements that include the subsidiary.
Temporary control	When a subsidiary is acquired with the intention to sell it within 12 months — it may be classified as 'held for sale' (IFRS 5) rather than consolidated.

📌 Ugandan Example

Example of exemption in Uganda:

The Aga Khan Development Network (AKDN) has multiple subsidiaries in Uganda including:
- Jubilee Insurance Uganda
- Nation Media Group Uganda
- Diamond Trust Bank Uganda

Diamond Trust Bank Uganda Ltd is owned by Diamond Trust Bank Kenya (parent).
DTB Kenya is itself a subsidiary of the Aga Khan Fund for Economic Development.

In such a structure, DTB Uganda may benefit from consolidation exemptions because the ultimate parent already prepares group IFRS statements that include Uganda.

6.6 Multinational Accounting and Foreign Currency

6.6.1 The Challenge

When a group has subsidiaries in different countries, each subsidiary keeps its books in the local currency. When consolidating, all figures must be converted into one reporting currency (e.g., Ugandan Shilling or US Dollar).

6.6.2 Key Rules under IAS 21 (The Effects of Changes in Foreign Exchange Rates)

- **The currency of the primary economic environment where the entity operates. E.g., Stanbic Bank Uganda's functional currency is the Ugandan Shilling (UGX).**
- **The currency in which the group presents its consolidated financial statements. E.g., Standard Bank Group in South Africa presents in South African Rand (ZAR), but must translate Uganda's results.**
- **Assets and liabilities are translated at the CLOSING RATE (exchange rate at year-end). Income and expenses are translated at the AVERAGE RATE for the year.**
- **Any differences arising go to Other Comprehensive Income (OCI) — NOT to profit or loss.**

📌 Ugandan Example

MTN Uganda Limited is a subsidiary of MTN Group (South Africa).

MTN Uganda's profit for 2024: UGX 500 billion
Average UGX/ZAR rate for 2024: 1 ZAR = 330 UGX

Translation into ZAR: UGX 500 billion ÷ 330 = ZAR 1.52 billion

This is what appears in MTN Group's consolidated income statement for Uganda.

If the exchange rate changes significantly (e.g., UGX weakens against ZAR),
MTN Uganda's contribution to the group results will appear smaller in ZAR terms,
even if the actual UGX performance improved.

6.7 Application of IFRS to Group Scenarios

6.7.1 Associates and Joint Ventures

Not all investments involve full control (subsidiaries). IFRS also covers:

Type	Definition & Treatment
Subsidiary (IFRS 10)	Parent owns > 50% voting rights = control. FULL consolidation (100% of assets/liabilities combined).
Associate (IAS 28)	Investor owns 20%–50% = significant influence (but not control). EQUITY METHOD used — only one line in the balance sheet shows the investment.
Joint Venture (IFRS 11)	Two or more companies jointly control an entity. EQUITY METHOD used (same as associate).

📌 Ugandan Example

National Insurance Corporation (NIC) Uganda and a South African insurer jointly establish 'East Africa Re' (a reinsurance company) — each owning 50%.

This is a Joint Venture — neither party has full control.
Treatment under IFRS 11: Both parties use the EQUITY METHOD.

In NIC Uganda's balance sheet, this appears as ONE LINE ITEM:
'Investment in East Africa Re: UGX 5 billion'

NIC does NOT combine East Africa Re's full assets and liabilities into its own balance sheet — only its share of profit/loss is brought in.

6.7.2 Impairment of Investments (IAS 36)

After a business combination, the acquirer must annually test goodwill and other assets for impairment. If the recoverable amount of an asset falls below its carrying value, an impairment loss is recognized.

- **The higher of (a) Fair Value less costs of disposal, and (b) Value in Use (present value of future cash flows)**
- **Recognised in profit or loss. For goodwill, it cannot be reversed.**

📌 Ugandan Example

Suppose Equity Bank Uganda paid UGX 20 billion for a microfinance company.
Goodwill recognised: UGX 10 billion.

In 2025, due to economic slowdown, the MFI's portfolio deteriorates significantly.
The Value in Use drops to UGX 6 billion.

Goodwill impairment = UGX 10 billion – UGX 6 billion = UGX 4 billion

This UGX 4 billion impairment loss is charged to the Profit & Loss statement, reducing Equity Bank's reported profit for that year.

Remember: Once goodwill is impaired, it CANNOT be written back up in future years.

6.7.3 Other Important IFRS Standards in Group Contexts

Standard	What it Covers
IFRS 9 – Financial Instruments	How to recognise and measure financial assets and liabilities. Important for banks like Stanbic, dfcu, Centenary — how they classify loans and investments.
IFRS 16 – Leases	All significant leases must be brought 'on balance sheet' — the lessee recognises a right-of-use asset and lease liability. E.g., MTN's leased towers appear on its balance sheet.
IAS 12 – Income Taxes	Deferred tax arising from timing differences between accounting profit and taxable profit. Important given URA's tax assessment practices.
IAS 36 – Impairment of Assets	Annual impairment testing for goodwill and assets with indefinite useful lives.
IFRS 5 – Non-current Assets Held for Sale	Assets being sold are reclassified separately and measured at lower of carrying amount or fair value less costs to sell.

TOPIC 7: ANALYSIS AND EVALUATION OF FINANCIAL STATEMENTS

7.1 Introduction

Financial analysis is the process of examining a company's financial statements to understand its performance, liquidity, profitability, and overall health. It helps investors, managers, banks, and regulators make informed decisions.

In Uganda, financial analysis is used by: dfcu Bank when deciding whether to lend to a company; investors on the Uganda Securities Exchange (USE) before buying shares; the Uganda Revenue Authority (URA) when assessing tax compliance; and management at companies like Stanbic Bank Uganda to compare performance over time.

7.2 Horizontal Analysis (Trend Analysis)

Horizontal analysis compares financial figures across two or more periods to identify trends, growth, or decline. It is also called trend analysis.

Method: Calculate the change in monetary terms and as a percentage.

Formula: % Change = ((Current Year - Previous Year) / Previous Year) x 100

📌 Ugandan Example

Centenary Bank Uganda – Revenue Trend (UGX Billions):

	2022	2023	2024
Net Interest Income:	420	480	540
Operating Expenses:	280	310	350
Net Profit:	140	170	190

Horizontal Analysis (2023 to 2024):

Net Interest Income growth: (540 - 480) / 480 x 100 = +12.5%

Operating Expenses growth: (350 - 310) / 310 x 100 = +12.9%

Net Profit growth: (190 - 170) / 170 x 100 = +11.8%

Interpretation: The bank is growing revenue, but expenses are growing slightly faster. Management should investigate which cost lines are rising and whether this is sustainable.

7.3 Vertical Analysis (Common-Size Analysis)

Vertical analysis expresses each item in a financial statement as a percentage of a base figure. For the Income Statement, the base is Revenue. For the Balance Sheet, the base is Total Assets.

It helps compare companies of different sizes and identify the proportion each item takes.

> 📌 **Ugandan Example**
>
> MTN Uganda vs Airtel Uganda – Vertical Analysis of Income Statement (2024, UGX Billions):
>
> | | MTN Uganda | % of Revenue | Airtel Uganda | % of Revenue |
> |---|---|---|---|---|
> | Revenue: | 2,400 | 100% | 1,800 | 100% |
> | Cost of Sales: | 1,000 | 41.7% | 800 | 44.4% |
> | Gross Profit: | 1,400 | 58.3% | 1,000 | 55.6% |
> | Operating Expenses: | 600 | 25.0% | 500 | 27.8% |
> | Operating Profit: | 800 | 33.3% | 500 | 27.8% |
>
> Interpretation: MTN Uganda converts a higher percentage of revenue into operating profit (33.3% vs 27.8%), suggesting better cost management or stronger pricing power.
> This is useful for benchmarking even though MTN is larger in absolute terms.

7.4 Ratio Analysis

Ratios express relationships between figures in the financial statements. They are grouped into five categories:

Category	What it Measures	Key Ratios
Profitability	How efficiently the company generates profit	Gross Profit Margin, Net Profit Margin, Return on Equity (ROE), Return on Assets (ROA)
Liquidity	Ability to meet short-term obligations (pay bills)	Current Ratio, Quick Ratio (Acid Test)
Efficiency (Activity)	How well assets are being used	Receivables Days, Payables Days, Inventory Turnover
Gearing (Leverage)	Level of debt relative to equity	Gearing Ratio, Interest Cover
Investor (Market)	Returns to shareholders	Earnings Per Share (EPS), Price/Earnings (P/E) Ratio, Dividend Yield

7.4.1 Profitability Ratios

Ratio	Formula & Interpretation
Gross Profit Margin	= (Gross Profit / Revenue) x 100. Shows profit after direct costs. A higher margin means the company is more efficient at producing its goods/services.
Net Profit Margin	= (Net Profit After Tax / Revenue) x 100. Shows the overall profitability after ALL costs. Useful for comparing companies in the same industry.

Return on Equity (ROE)	= (Net Profit / Shareholders Equity) x 100. Shows how much profit is generated for every shilling of equity invested. Shareholders want a high ROE.
Return on Assets (ROA)	= (Net Profit / Total Assets) x 100. Shows how efficiently the company uses its assets to generate profit.

📌 Ugandan Example

Uganda Breweries Limited (UBL) – Profitability Analysis (Year 2024):

Revenue: UGX 500bn | Gross Profit: UGX 200bn | Net Profit: UGX 77bn
Total Assets: UGX 400bn | Shareholders Equity: UGX 250bn

Gross Profit Margin = (200/500) x 100 = 40%
Net Profit Margin = (77/500) x 100 = 15.4%
ROE = (77/250) x 100 = 30.8%
ROA = (77/400) x 100 = 19.25%

A 30.8% ROE is excellent — for every UGX 100 a shareholder invested, they earned UGX 30.80. Compare this to bank savings rates in Uganda (~9-11%) — investing in UBL would be more rewarding!

7.4.2 Liquidity Ratios

Liquidity measures whether a company can pay its short-term debts when they fall due.

Ratio	Formula & Interpretation
Current Ratio	= Current Assets / Current Liabilities. A ratio above 1.0 means the company can cover short-term debts. A ratio of 2:1 is often considered healthy, though it varies by industry.
Quick Ratio (Acid Test)	= (Current Assets - Inventories) / Current Liabilities. A stricter test — it excludes stock because stock may take time to sell. A ratio of 1:1 is often considered the minimum safe level.

📌 Ugandan Example

Hima Cement Uganda – Liquidity Analysis:

Current Assets: UGX 80bn | Inventories (cement stock): UGX 30bn
Current Liabilities: UGX 50bn

Current Ratio = 80 / 50 = 1.6:1 (healthy — can meet short-term obligations)
Quick Ratio = (80 - 30) / 50 = 1.0:1 (adequate — just enough liquid assets)

If the Quick Ratio fell below 1.0, Hima would struggle to pay suppliers and staff without first selling its cement stock — which could be a sign of cash flow stress.

Note: In Uganda, many construction companies are owed money by government contractors for months — this inflates receivables and can make the current ratio look healthy even when cash is tight.

7.4.3 Efficiency (Activity) Ratios

Ratio	Formula & Interpretation
Receivables Days (Debtor Days)	= (Trade Receivables / Revenue) x 365. Shows how many days on average it takes to collect money from customers. Lower is better — it means cash is collected faster.
Payables Days (Creditor Days)	= (Trade Payables / Cost of Sales) x 365. Shows how many days the company takes to pay its suppliers. Longer may indicate good negotiation — or cash flow problems.
Inventory Turnover (Days)	= (Inventories / Cost of Sales) x 365. Shows how many days it takes to sell stock. Lower is better for perishables; higher may indicate slow-moving stock.

📌 Ugandan Example

Nile Breweries Ltd – Efficiency Analysis:

Revenue: UGX 800bn | Cost of Sales: UGX 480bn
Trade Receivables: UGX 120bn | Trade Payables: UGX 80bn | Inventories: UGX 60bn

Receivables Days = (120/800) x 365 = 54.8 days
→ Nile Breweries waits 55 days on average to collect from its bar/hotel customers.
→ This is HIGH — in Uganda, many bars pay on extended credit. This ties up cash.

Payables Days = (80/480) x 365 = 60.8 days
→ Nile Breweries takes 61 days to pay its suppliers (barley, packaging).
→ This is slightly longer than receivables — a positive sign for liquidity.

Inventory Days = (60/480) x 365 = 45.6 days
→ Beer stock sits in warehouses for ~46 days before being sold. Can this be reduced?

7.4.4 Gearing Ratios

Gearing measures how much of the company is financed by debt vs. equity. High gearing means more financial risk — interest must be paid even when profits fall.

Ratio	Formula & Interpretation
Gearing Ratio	= (Long-term Debt / (Long-term Debt + Equity)) x 100. A ratio above 50% means the company is more debt-funded than equity-funded — considered high risk.
Interest Cover	= Operating Profit / Finance Costs (Interest). Shows how many times the company can pay its interest from operating profit. A ratio below 2x is a warning sign.

📌 Ugandan Example

Roofings Group Uganda – Gearing Analysis:

Long-term Debt (dfcu Bank loan): UGX 50bn
Shareholders Equity: UGX 110bn
Operating Profit: UGX 40bn
Finance Costs (interest): UGX 6bn

Gearing Ratio = 50 / (50 + 110) x 100 = 31.25% → Moderate gearing (below 50%)
Interest Cover = 40 / 6 = 6.67 times → Very comfortable (above 2x is acceptable)

Roofings can comfortably service its debt — operating profit covers interest 6.7 times. Contrast this with a heavily indebted company where interest cover might be 1.5x — a small drop in profit could mean it cannot pay its bank interest (default risk).

7.4.5 Investor Ratios

Ratio	Formula & Interpretation
Earnings Per Share (EPS)	= Net Profit After Tax / Number of Ordinary Shares. Shows how much profit is earned for each share. Shareholders want this to grow year on year.
Price/Earnings (P/E) Ratio	= Market Price per Share / EPS. Shows how much investors are willing to pay for each shilling of earnings. A high P/E means investors expect high future growth.
Dividend Yield	= (Dividend per Share / Market Price per Share) x 100. Shows the return an investor gets from dividends alone, relative to the share price.
Dividend Payout Ratio	= (Dividends Paid / Net Profit) x 100. Shows what proportion of profit is paid out as dividends vs retained in the business.

📌 Ugandan Example

Stanbic Bank Uganda – Investor Ratio Analysis (USE listed company):

Net Profit: UGX 300bn | Shares in issue: 5 billion shares
Market price per share: UGX 25 | Dividends paid: UGX 120bn

EPS = 300bn / 5bn shares = UGX 60 per share
P/E Ratio = 25 / 60 = 0.42 (NOTE: if price is UGX 25 and EPS is UGX 60, the share appears undervalued — common on emerging markets like USE)
Dividend per share = 120bn / 5bn = UGX 24 per share
Dividend Yield = (24 / 25) x 100 = 96% (illustrative — real yields are lower)
Dividend Payout = (120 / 300) x 100 = 40%

Interpretation: Stanbic pays out 40% of profits as dividends and retains 60% for growth. On the USE, dividend yield is an important metric for Ugandan retail investors who prioritise income over capital gains.

7.5 Limitations of Ratio Analysis

While ratios are very useful, they have important limitations:

- Historical data: Ratios use past figures — they don't predict the future.
- Inflation distortion: In Uganda, high inflation can distort asset values and comparisons over time (e.g., land bought in 2010 may be undervalued on the balance sheet).
- Creative accounting: Management can manipulate figures to improve ratios (see Topic 4 on accounting irregularities).

- Different accounting policies: Comparing two companies is difficult if they use different depreciation methods or inventory valuation methods.
- Industry differences: A current ratio of 1.2 may be excellent for a supermarket (fast cash flow) but dangerously low for a manufacturer.
- No qualitative factors: Ratios ignore management quality, employee morale, brand strength, or political environment — all critical in the Ugandan business context.

7.6 Cash Flow Analysis

Beyond ratios, analysts examine the Statement of Cash Flows to understand the quality of earnings and the company's ability to generate real cash.

Cash Flow Signal	What it Means
Operating cash flow > Net Profit	Healthy — profit is being converted into real cash. Good sign.
Operating cash flow < Net Profit	Warning — profit is not converting to cash. May indicate high receivables or aggressive revenue recognition.
Negative operating cash flow	Serious concern — the core business is consuming cash. Not sustainable.
Heavy investing outflows	Could be good (expansion) or bad (replacing worn-out assets). Look at context.
Persistent financing inflows	Company relying on loans/share issues to fund operations — dependency on external funding.

7.7 Earnings Management and EPS Analysis

Earnings management refers to the use of accounting choices and estimates to influence reported profit. It is not necessarily illegal, but it can mislead users of financial statements.

Common earnings management techniques include:

- Accelerating revenue recognition (recognising revenue earlier than appropriate)
- Deferring expenses (capitalising costs that should be expensed immediately)
- Changing depreciation methods or useful life estimates to reduce/increase charges
- Creating or reversing provisions to 'smooth' profit across years

Limitations of EPS

EPS can be manipulated by:

• Share buybacks — reducing shares in issue artificially inflates EPS even without profit growth

• Earnings management — inflating profits increases EPS without real business improvement

• Ignores capital structure — a highly leveraged company may show high EPS but carry enormous debt risk

• Ignores dilution — if the company has issued share options or convertible debt, future EPS may fall

Always look at EPS alongside cash flow, debt levels, and quality of earnings.

7.8 Value for Money (VFM) and Economic Value Added (EVA)

7.8.1 Value for Money Analysis

Value for Money (VFM) analysis is particularly important in the public sector and donor-funded organisations in Uganda (e.g., government ministries, NGOs, NSSF). VFM looks at three dimensions:

VFM Dimension	Meaning & Ugandan Example
Economy	Are inputs obtained at the lowest possible cost? E.g., Did UNRA get the cheapest price for road construction materials without compromising quality?
Efficiency	Are inputs converted into outputs effectively? E.g., How many kilometres of road were built per billion shillings spent?
Effectiveness	Are outputs achieving the intended outcomes? E.g., Did the new road reduce travel time and support economic growth in that region?

7.8.2 Economic Value Added (EVA)

EVA measures whether a company is generating profit ABOVE the cost of capital used. If EVA is positive, the company is creating real value for shareholders. If negative, it is destroying value — even if it shows an accounting profit.

Formula:

EVA = Net Operating Profit After Tax (NOPAT) – (Capital Employed x WACC)

> 📌 **Ugandan Example**
>
> Umeme Limited Uganda:
>
> NOPAT (Net Operating Profit After Tax): UGX 80bn
> Capital Employed (Assets - Current Liabilities): UGX 600bn
> WACC (Weighted Average Cost of Capital): 12%
>
> EVA = 80bn - (600bn x 12%) = 80bn - 72bn = UGX 8bn
>
> EVA is POSITIVE (UGX 8bn) — Umeme is generating returns above its cost of capital. This means Umeme is creating value for its shareholders beyond what they could earn by investing elsewhere at the same level of risk.
>
> If EVA were negative (e.g., NOPAT was only UGX 60bn): EVA = 60 - 72 = -UGX 12bn
> → The company is DESTROYING shareholder value despite showing an accounting profit!