

USING FINANCIAL ANALYSIS AND INTERPRETATION AS A FOUNDATION TO COMPREHEND FINANCIAL HEALTH

by

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Submitted in fulfilment of the requirements for the degree of

DCOM FINANCIAL MANAGEMENT SCIENCES

in the

DEPARTMENT OF FINANCIAL MANAGEMENT

in the

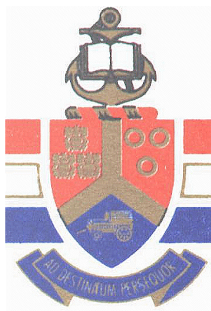
FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

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PRETORIA

OCTOBER 2012

ACKNOWLEDGEMENTS

I would like to express my sincere gratitude and appreciation to everyone who was involved in the completion of this thesis. In particular, I would like to thank the following people:

- Prof. Johannes de Wet and Prof. Frans Vermaak, the supervisor and co-supervisor of this thesis, for their patient guidance and the motivation they gave me to complete this study;
- Mr. Phillip de Jager, previously from the Department of Financial Management at the University of Pretoria, for his input with the statistical tests;
- Mr. Sollie Millard and Mrs Joyce Jordaan from the Department of Statistics at the University of Pretoria, for their input with the interpretation of the statistical test results and Mrs Rina Owen from the Faculty of Economic and Management Sciences for her inputs in developing the questionnaire and in assisting me with the statistical analysis thereof;
- Prof Daan Gouws and Prof. Leon Brümmer for their efforts in improving the final document;
- Miss Marlaine Kruger for the professional language editing of the final document;
- my late father Carel du Toit and my loving mother Vida du Toit, for their patience, understanding, encouragement and for continuing to believe in me when I failed to do so; and
- my wonderful Creator for giving me the health, strength and patience to complete this thesis.

DEDICATION

I dedicate this thesis to Jaco Delpont, who believed in me and was there to support me every step of the way while I was completing the study.

I will forever remain thankful to you.

ABSTRACT

The ability to measure the financial health of a company is becoming an increasingly serious issue. One only needs to think of the widely published irregularities in companies such as Enron, Parmalat and Macmed to grasp something of the magnitude of the losses and other problems that investors can face if they do not have the ability to “predict” possible problems. There are individuals who are constantly identifying new and ingenious ways to deceive their customers, investors, the government and others.

It is important for parties with an interest in a company to devise new ways to identify how financial analyses can be used to protect their interests. Managers are primarily responsible for the prevention and identification of accounting irregularities. Unfortunately, at the same time, they may also be assumed to be the primary perpetrators of accounting irregularities, because they are in a position to manipulate accounting records and bypass control measures more easily than anyone else in a company.

The main aim of this study is to determine whether financial analysis and interpretation can be applied by interested parties to measure financial health and by implication identify accounting irregularities. Proof that this is possible has the potential to be used in analyses, by all parties with an interest in a company, to determine financial health and to identify irregularities in the financial statements.

The study begins with a literature review, which provides an explanation of accounting irregularities and related matters, as well as an overview of previous uses of financial analyses to determine whether such analyses are useful in the identification of irregularities in the financial statements.

The objectives of the study are as follows:

- An investigation into the characteristics, as identified by researchers locally and abroad, that are displayed by companies with a higher risk of or occurrence of accounting irregularities.
- A survey of the media by means of a literature review to identify case study companies that had allegations of accounting irregularities against them.
- The analysis of the case study companies in a quantitative and qualitative way to determine whether the characteristics that are identified as part of the first objective hold true in practice.
- Statistical analyses of the share price data of the case study companies in the form of an event study, a regression analysis and a structural break analysis to determine when and under what circumstances significant changes happened.
- Conduct a survey involving the creators and the users of financial statements in order to observe their experience regarding the usefulness of financial statements to reveal financial health. This is done by means of questionnaires that are analysed statistically, designed to derive conclusions of what practitioners tend to experience in practice and what their feelings are regarding the use of financial statements and accounting data in an analysis of the financial health of a company.

On the basis of the case studies, nine of 18 identified characteristics were found to be useful in the identification of accounting irregularities by parties other than managers.

They are:

1. company age;
2. company culture;
3. debt levels;
4. directors' behaviour and character;
5. financial distress;
6. industry or sector;
7. liquidity;
8. management's behaviour and character; and
9. remuneration policies.

A further eight additional characteristics were also identified as useful in the identification of accounting irregularities. They are:

1. acquisitions, mergers and other restructuring;
2. dividends;
3. opposite movements from the industry or sector;
4. period before irregularities are detected;
5. “preparing” interested parties for the annual report;
6. share price changes;
7. significant changes; and
8. tax.

The results of the review of the companies’ financial information are supplemented with a statistical analysis of the companies’ share price data as well as a questionnaire that are submitted to the users and compilers of financial statements. The aim of the first statistical analysis, consisting of event studies, regression analyses and structural break analyses, is to support the findings regarding the characteristics of companies with increased risk of accounting irregularities. The questionnaire set out to relate the subjective opinions of the users and compilers of financial statements with the findings of the study.

The results of the study provide proof that interested parties have the ability to use the identified company characteristics to indicate increased accounting irregularity risk.

Key Words

Accounting

Financial distress

Ratio analysis

Characteristics

Fraud

Financial analysis

Irregularities

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*“Many have made a trade of delusions
and false miracles, deceiving the stupid multitude.”*

- Leonardo da Vinci

*“Blinding ignorance does mislead us.
O! wretched mortals, open your eyes!”*

- Leonardo da Vinci