FINANCIAL ANALYSIS AND CORPORATE GOVERNANCE OF AA: A CASE STUDY

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Abstract

This paper evaluates AA’s financial performances by analyzing its financial reports throughout 2010 to 2012 using ratio analysis. Strengths and weaknesses are identified. Quantitative ratio analysis (liquidity measurement, profitability indicators, financial leverage/gearing, operating performance and investment valuation) indicates AA scores satisfactory among the five indicators, implying good corporate governance positively enhances financial performance. Positive cash flows reveal satisfactory liquidity positions. Results provide implications for companies to maintain better corporate governance in future.

Keywords: Corporate Governance, Financial, Performance, Ratio Analysis

1. INTRODUCTION

AA Holdings Limited is a listed company in the stock exchange of HK. AA has the longest history in Macau and is the family-owned business with traditional Chinese culture. AA’s casinos’ are convenient to many tourist areas and thus attract many mainland and overseas visitors to gamble in its casinos. The casinos are situated on the Macau Island and the Taipa side. Various kinds of games can be found in their casinos including slot machines, VIP table gaming, and Mass Market tables. As at 31 December 2012, there are seventeen casinos and two slot machine lounges run by AA, including over 1,750 gaming tables and over 3,500 slots AA’s gaming business continued its growth in 2012. Increased visitation to Macau and spending per visitor combined to boost AA’s mass market table gaming revenue by 13.3% and AA’s total gaming revenue by 4.5% to a record level for the year, whilst appreciation to all levels of staff for their contributions to the company’s success during the past year, and to AA’s shareholders and business partners for their support.

2. CORPORATE GOVERNANCE

Corporate governance is an important governance concept (Horton, 2002). Research indicated that management has a strong influence in setting the overall tone for governance (Cohen et al., 2002). Claybrook (2004) found that upper management influences operations as well as the stakeholders. Top management should act as role models in organizations and communicate good ethical values and show them through example in the organizations (Hite et al., 1988).

AA strives to the achievement of good corporate governance practices, policies and procedures and its management team has strived to uphold the highest standards of corporate governance and transparency. The company was awarded the name of “Best Managed and Governed Companies – Asia Poll 2013”. It was a great achievement to the BOD. AA has complied with the corporate governance code as set out in the listing requirements in the HK stock exchange. As at 31
December 2012, the company has consistently followed with the relevance of the New CG Code.

2.1. Board composition

The company is governed and managed by the board of independent and executive directors (BOD). The BOD is accountable for directing, overseeing the business, strategic direction of the company and its subsidiaries (Rezaee, 2009). Management exercises the agent role by executing the BOD's decisions and operations. The board can delegate functions to management and that has to be formalized in writing. The BOD will review those arrangements and agenda on a continuous basis to ensure that all the ongoing and future projects are appropriate and beneficial to the company. There is a pool of experienced professionals sitting in the BOD for the daily operations of AA.

2.2. Audit committee

Goh (2009) found that the effectiveness of the audit committee was associated with firms' timeliness in the remediation of material weaknesses in internal control, which could help improving the financial reporting quality, and ultimately enhancing the corporate governance. Kaplan et al. (2009) found that audit committees of public companies with effective operating procedures could help minimize the likelihood of fraud occurrence to a certain extent. Besides, Persons (2009) found that firms with large and independent audit committee could also help prevent fraudulent financial reporting incidents in organizations. The AA's audit committee is accountable to the board and its primary role and function are to assist the board for monitoring the company's financial reporting process, to recommend the appointment of the auditor, to consider the nature and scope of audit reviews, to ensure that effective internal controls and risk systems are in place. The audit committee has access to and maintains an independent communication with, the external auditors and the management, including the Group's internal audit department, to ensure effective information exchange on all relevant financial and accounting matters (Rezaee, 2009). Under the guidelines of the audit committee, it is specified that any former partner of the AA's existing audit firm is not allowed to act as a member of the audit committee. The cooling period is for a period of one year starting on the time when one is leaving the company. The audit committee reports to the BOD the major items covered by the committee at each meeting, draw the board's attention to important issues that the board should be aware of, identify any problems where it is needed for rectifying or improvement (Rezaee, 2009). In 2012, the audit committee held six AC meetings and its principal work performed is considered satisfactory. In general, it has reviewed the audit reports, major weaknesses, accounting policies, and financial reporting issues.

3. LITERATURE REVIEW

There is not much literature on ratio analysis on companies. In capital markets, audit reports and financial statements are normally as the important and source of information for stakeholders for their decision making (Leventis, 2005). Prior works of literature have found that there are some relationships between firm performance and stakeholder management (Moore, 2001; Waddock & Graves, 1997; Berrone et al., 2007). Stakeholder management’s greatest contribution lies in its effectiveness through enhanced legitimacy (Suchman, 1995), which benefits firms over the long run (Laplume et al., 2008; Kaler, 2002). A company with good financial performance may be rated more favourably by investors. Stakeholder theory states that a firm is responsible to various parties in the market that include shareholders, management, creditors, customers, suppliers, political groups, employees and the society as a whole (Phillips & Freeman, 2003). The theory states that managers in firms ought to be accountable to all the parties who have interests in the company. Stakeholders include those parties such as shareholders, banks, creditors, employees, suppliers, potential customers, and the communities. The firm is to serve the various stakeholders and shareholders’ interests. It is the firm’s legal obligations and responsibilities that have to serve the interests of all the parties involved. Stakeholder theory (Figure 1) includes more parties in the society, including prospective customers, trade associations, governmental bodies, trade unions, political bodies, labor groups and the public (Donaldson & Preston, 1995). As a result, many users of the financial statements are interested in the financial performance of companies. Hence the study of ratio analysis of AA allows a more in-depth study so as to understand the corporate governance of this leading firm.

Figure 1. The stakeholder model

Source: Donaldson and Preston (1995)
4. METHODOLOGY

Companies’ culture are quite different and vary to each company. Hofstede (2001) indicate that western and eastern minds are different to various nations. The study of a local operator AA allows us to know the financial operations of a leading gaming operator in Macau (Law, 2010b). Since companies’ performance varies in different nations with different culture (Hofstede, 2001), this motivates us to conduct this financial statement analysis of AA. Many mainland visitors are attracted to gamble in casinos of Macau. Law (2010b) indicates that Chinese people enjoy the social networking in gambling and the excitement they can obtain. AA with the longest history in Macau, this study would nevertheless reveal whether a family-owned gaming company is operating efficiently and effectively. In today’s competitive gaming market with Venetian Macau, Wynn Macau, MGM, Melco Crown and Galaxy, the result of this study would be interesting and informative to many users. Hence ratio analysis is employed in this study. The key ratios are calculated so that it can reflect the performances of AA. The ratios are listed in below Table 1.

5. RESULTS AND ANALYSIS

5.1. Ratio analysis results

5.1.1. Liquidity measurement

We calculated 12 key ratios to measure AA’s performances. The current ratio measures the number of times that the short term current debts can be covered by the short-term current assets. Otherwise stated, it measures firms’ abilities to cover its short-term obligations as and when they fall due. A higher ratio is preferred. AA enjoys a satisfactory ratio in each of the three years (Table 2). The ratio ranges from 1.5 to 1.7 from 2010 to 2012, indicating satisfactory performance.

Quick ratio measures the ability of the firm to pay its short-term debts with its most liquid assets. The quick ratio is more conservative than the current ratio as it excludes ending stocks and other current assets that cannot be easily converted into cash in a short time. The ideal situation is 1:1. AA ranges from 1.53 to 1.69 from 2010 to 2012. Though the ratios are fluctuating each year, the ratios indeed meet the satisfactory requirement.

5.1.2. Profitability measurement

Net profit margin ratio measures the ultimate profitability. A higher ratio indicates better profitability of the sales. AA ranges from 0.061 to 0.085 from 2010 to 2012. The trend is increasing and indicates the operating performance is satisfactory.

Return on assets ratio measures how efficient the management’s employing company’s total assets to generate profit. A higher ratio indicates better efficiency of management on using its asset base. AA ranges from 0.12 to 0.18 from 2010 to 2012. The trend is increasing and indicates the operating performance on assets is satisfactory.

Return on equity measures how well investment in the company can earn for the investors. A higher ratio shows that management is employing efficiently its equity base and for a better return is to stakeholders. AA ranges from 0.27 to 0.34 from 2010 to 2012. The trend is increasing and indicates the operating performance on equity is satisfactory.

5.1.3. Financial leverage measurement

Equity ratio indicates the strength of the financial structure of the company. A higher equity ratio shows the strong financial position of the company. A low equity ratio reflects a worse situation as there is more debt to be covered in comparing with the equity. AA ranges from 0.46 to 0.53 from 2010 to 2012. The trend is increasing and indicates the financial structure of AA is satisfactory.

Debt ratio compares a company’s total debt to its total assets. Debt ratio gives a general picture of the firm’s amount of leverage being used by a company. AA ranges from 0.54 to 0.47 from 2010 to 2012. The trend is decreasing and indicates the debt is lower each year and the financial structure of AA is satisfactory.

Debt to equity ratio measures how much of the various users of financial statements have committed to the company in comparing with what the shareholders have contributed. This ratio also measures the amount of debt that is being covered by shareholders’ funds. A lower ratio represents a satisfactory position. However, a too low ratio reflects an in-efficient use of equity. AA ranges from 1.19 to 0.87 from 2010 to 2012. The trend is decreasing and indicates the financial structure of AA is satisfactory.

Interest coverage ratio calculates the times a firm can fulfill its interest expense. A lower ratio may indicate the company is burdened by debt expense. AA ranges from 16.4 to 56.09 from 2010 to 2012. The trend is increasing and indicates AA can sufficiently meet its interest obligations and the result is satisfactory.

5.1.4. Operating performance measurement

Total assets turnover shows the general efficiency with which the firm employs its assets to contribute sales. A high ratio reflects the more efficiently its assets have been utilized. AA ranges from 2.0 to 2.13 from 2010 to 2012. The trend is increasing and indicates AA is efficiently utilizing its total assets and the result is satisfactory.

Fixed assets turnover measures of the efficiency of a company’s fixed assets with respect to contributing sales. A high fixed assets turnover ratio is preferred since they show a better efficiency
in the employing of fixed assets. AA ranges from 6.08 to 9.78 from 2010 to 2012. The trend is increasing and indicates AA is efficiently utilizing its fixed assets and the result is satisfactory.

5.1.5. Investment valuation measurement

PE ratio measures how many percentages or times a stock is trading per the EPS in the stock market. A stock with high P/E ratio suggests that shareholders are expecting higher earnings growth and future in the market. This is because investors are paying a premium they are willing for this stock in anticipation of a future share price increases. Hence, stocks with this characteristic are considered to be growth stocks. A stock sometimes may have a low P/E ratio and that suggests that users have more modest or conservative expectations for its growth in future when compared to the stock market in general. AA ranges from 18 to 5 from 2010 to 2012. The trend is decreasing and indicates the stock price is not trading at the high level and is attractive to investors and the result is satisfactory.

5.1.6. Cash flow statement

Cash ending figure reflects a more accurate picture as it is based on a cash basis rather than accrual basis of accounting for ratio analysis. AA ranges from 10,138 to 11,931 from 2010 to 2012. The trend is fluctuating. However, the positive cash inflow indicates satisfactory cash position of AA and the liquidity is considered sound.

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<th>Table 2. Ratios results</th>
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<td><strong>Ratios</strong></td>
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**Note:** The amounts are in million

6. DISCUSSION AND IMPLICATIONS

6.1. Overall review

From the various ratios analysis, AA enjoys satisfactory rating on liquidity measurement, probability indicators, financial leverage, operating performance and investment valuation. The current and quick ratios are in line with the normal standard thresholds. All the three profitability ratios are increasing and indicate the satisfactory performance. Financial leverage of AA has been kept low, indicating the company has been efficiently monitoring the gearing of the company. The interest
coverage ratio can well sufficiently cover its finance cost. It is promising to note that the interest coverage has been satisfactory as AA has already announced to construct a new casino complex in the Cotai area and the expected completion date will be in 2016. Should the interest coverage is not satisfactory, the management of AA may need to consider ways to increase its profitability and at the same time to decrease its operating costs.

Operating performance ratios also indicate that AA is efficiently utilizing its fixed and total assets to generate revenue. In addition, the PE ratios indicate the stock price of SJM is not trading in the stock market at a particularly high level. There may be some rooms for its stock price to increase in future. However, investors should be cautious on any investment as the stock price of a company is affected by many factors, such as interest rate, monetary policy, and the economic climate, etc. PE ratio is only one guideline for reference. In addition, the cash flow figures of various years indicate SJM is doing well. AA can maintain positive cash inflow of the past few years. Since financial ratios only reflect the accrual basis of accounting, the positive cash flow figures prove to us that AA is doing well in today’s competitive market.

Having analyzed the financial ratios and cash flow position of AA which indicate a general good financial performance, we hope senior management could consider internal weaknesses so as to improve further the competitiveness of AA in the today gaming business. As there are still rooms for improvement of AA, rectifying those weaknesses could help AA continue to sustain and maintain a stable market share in the industry. Finally, the result supports the stakeholder model.

6.2. Corporate social responsibility

We should not neglect the corporate social responsibility of AA that has contributed to the economy. “From society to society” is a core value of the AA Group. In 2012 AA continued to support education, arts and culture, sports and other charitable activities to benefit the residents of Macau and to encourage employees to do likewise. The AA Scholarship Programme awards scholarships annually at the University of Macau for 10 outstanding students selected by the faculties. Beginning in 2013, AA is also providing two scholarships totalling MOP 200,000 for two-year study at the University of Macau by postgraduate students from the Mainland.

AA regularly sponsors cultural events in Macau such as art exhibitions and provides or subsidizes Hong Kong/Macau ferry tickets for arts and culture groups. AA also supports cultural activities such as Chinese Opera at the Kam Pek Community Centre in Macau’s Inner Harbour neighborhood and music performances at the Clube Militare de Macau. In November 2012 AA was also a sponsor of the 12th Macau Food Festival. AA has also actively donated scholarships to the Macau Foundation for students to make further studies. Sports events and community services are actively involved by the Group.

By knowing these kinds of CSR activities, AA is really contributing some of the resources back to the Macau community. This is the modern business strategy and AA is not only to earn their revenue from their gaming businesses but to contribute back some earnings to the local community.

7. CONCLUSIONS AND LIMITATIONS

7.1. Conclusions

This paper evaluates AA’s financial performance in recent years by studying its financial reports throughout 2010 to 2012 and identifying its strengths and weaknesses using ratio analysis so as to propose recommendations for AA in the competitive environment. We generate ratios which provide us those indicators of past performance in terms of critical success factors of the company. From a quantitative perspective by ratio analyses in the area of liquidity measurement, financial leverage/gearing, profitability indicators, operating measurement and investment valuation, AA scores satisfactory among the five indicators. Cash flow positions are also satisfactory. Results generate financial and strategic recommendations for future improvement of the company.

7.2. Limitations

There are several limitations of this study. We only include the 12 key ratios to examine the financial performance of AA. Some other ratios are not calculated in this study. Second, we analyses AA’s results with its prior years’ performance. Other competitors’ financial performances have not been compared; for example, Venetian Macau, Wynn Macau and MGM, etc. Besides, by comparing the industry average figures with AA would reveal a more accurate picture of the financial performance. The reasons of the above limitations are due to the limitation of time and resources constraint. Future detailed study can extend the research of these findings. Third, ratio analyses are based on the audited financial statements of AA. However, all those figures are not the most current figures and the figures in audit report are stated on historical basis of accounting. Finally, more discussion of future business plans of AA will be fruitful. As Macau gaming sector is becoming more intense in future, the future strategic plan of AA can help the Group to stand out from the crowd and maintain a cutting edge in the market share.

REFERENCES