# Week 1 Model Assignment

## Section I: Financial Statement Analysis

First and Last Name

The University of Arizona Global Campus

BUS 401: Principles of Finance

Instructor Name

Due Date

Section I: Financial Statement Analysis

**Part 1: Overview of the company**

McDonald's Corporation is a franchisor and operator of the McDonalds restaurant chain. The company has 39,198 restaurants across 119 countries, 93% of which are franchised to private entities (McDonald's Corporation, 2019). McDonald's business is centered on the provision of high-quality food and beverages relevant in the local context. The company's shares were trading at $242.93 at the close of trading on 1st October 2021.

**Part 2: Income statements**

McDonald's recorded a 1% increase in total revenues in 2019, with revenues decreasing by 10% in 2020. The reduction in revenue is attributable to the lower patronage due to COVID-related restrictions. The sales from company-operated restaurants have decreased steadily since 2018 with franchisees accounting for 56% of total revenues in 2020, up from 52% in 2018. In 2019, the company's operating income increased by 3% as a result of the increasing sales and the reduction in total operating expenses. The company's operating income decreased by 19%. The higher drop in operating income when compared to the sales decline is attributed to the fixed nature of most of the company's costs, which prevent the company from cutting costs proportionally with the reduction in revenues. In 2019, the net income was 2% higher than in 2018, with the net income decreasing by 21% in 2021.

**Part 3: Common size income statements**

In its capacity as a franchisor McDonald's operations are similar to a service company; thus, the overall gross margin cannot be determined. The company's operating profit margin increased from 41.5% in 2018 to 42.5% in 2019 and dropped to 38.1% in 2020. The 2019

improvement in operating profit margin is attributable to better control of food & paper, payroll & employee benefits, and occupancy expenses. In 2020, the company showcased high control of the food expenses of company related restaurants, which were equivalent to 13% of sales, compared to the 14% of sales in 2019. The fixed nature of occupancy and other related expenses contributed to lower 2020 operating profit margin. As with the operating margin, the net income margin improved in 2019 before declining in 2020: in 2019, the company generated $0.28 in net profit for every dollar of sales with the net profit for every dollar of sales dropping to $0.25 in 2020.

**Part 4: Balance sheets**

McDonald's total assets have grown since 2018. The company's assets increased by 45% in 2019 and 10% in 2020. The high rate of asset growth in 2019 is a result of the recognition of right-of-use assets from operating leases, which were previously an off-balance sheet arrangement. The company's net property and equipment 6% and 3% in 2019 and 2020, respectively while current assets grew by 80% in 2020, following a 10% decrease in 2019. The 2020 current asset growth was concentrated in cash and equivalents, which is suggestive of external financing to improve the company's liquidity position.

Current liabilities increased by 22% in 2019, then by 71% in 2020. The 2020 increase in current liabilities is primarily in the current maturities of long-term debt, which increased to $2.24 billion from 59 million in 2019. Despite the repayment of a portion of the long-term debt in 2020, the long-term debt account increased by $3,042.8 and $1,078.7 in 2019 and 2020, indicating the issue of additional debt. The company reported deficits in total shareholders equity in all three years due to the large number of shares held in Treasury and accumulated other

comprehensive losses. In 2018, McDonald's held 893.5 million shares in Treasury with the number of treasury stock increasing to 914.3 million and 915.2 million in 2019 and 2020, respectively.

**Part 5: Common size balance sheets**

Total current assets accounted for 11.9% of total assets in 2020, which was higher than the 7.5% but lower than the 12.4% recorded in 2019 and 2018, respectively. In 2020, McDonald's held 6.6% of its total assets in cash and cash equivalents, which was considerably higher than the 1.9% and 2.6% in 2019 and 2018. The proportion of net property and equipment in total assets has decreased consistently from 69.6% to 47.4% in 2020. This does not indicate a decrease in the investment in net property and equipment, but rather, the growth in total assets from the recognition of right-of-use assets from operating leases following the change in reporting standards. Total current liabilities made up a smaller proportion of total assets in 2019 (7.6%) compared to 2018 (9.1%) but the figure was higher in 2020 (11.7%). In 2019, McDonald's long-term debt financed 94.7% of its assets. The company's leverage has decreased since then with long-term debt accounting for 66.9% of total assets in 2020. The company's retained earnings as a proportion of total assets decreased from 1534% in 2018 to 102.4% in 2019. In 2019, the treasury stock held by McDonalds was equivalent to 187.5% of total assets, with the figure decreasing to 127.4%.

**Part 6: Cash flow**

McDonald's simple cash flow for the 3-year period is calculated in Table 1 below. The 2019 simple cash flows increased by 2% due to the net income growth. Simple cash flows decreased by 20% in 2020. Compared to the simple cash flow, McDonald's cash from operating

activities was much higher in all three years. In 2018, the cash provided by operations was $6.97 billion with the amount increasing to $8.12 billion in 2019 then falling to $6.27 billion in 2020.

Table 1

*McDonald's Simple Cash Flow*

| Values in millions | 2020 | 2019 | 2018 |
|---|---|---|---|
| Net income | 4730.5 | 6025.4 | 5924.3 |
| Depreciation | 300.6 | 262.5 | 214.8 |
| Simple cash flow | 5031.1 | 6287.9 | 6139.1 |

**Part 7: Financial analysis conclusion**

McDonald's financial position is neutral. Even though most of the weaknesses in financial performance presented in Table 2 below were a market-wide consequence of the 2020 economic downturn, the company's revenue and net income growth was constrained in 2019. At the same time, McDonald's asset growth speaks to the availability of growth opportunities as most of the 2019 and 2020 asset growth was concentrated in property and equipment. Despite the issuance of additional debt, McDonald's proportion of long-term debt has reduced since 2018 with the company recording the lowest level of financial leverage in 2020.

Table 2

*Financial Strengths and Weaknesses*

| Line Item | Trend | Strength or Weakness |
|---|---|---|
| Revenue | Decreasing | Weakness |
| Operating income | Decreasing | Weakness |
| Net income | Decreasing | Weakness |
| Operating margin | Decreasing | Weakness |
| Net profit margin | Decreasing | Weakness |
| Total assets | Increasing | Strength |
| Current assets | Increasing | Strength |
| Current liabilities | Increasing | Weakness |
| Long-term debt | Increasing | Weakness |

| | | |
|---|---|---|
| Shareholders' equity | Increasing | Strength |
| Current assets as a % of total assets | Increasing | Strength |
| Current liabilities as a % of TA | Increasing | Weakness |
| Shareholders' equity as a % of TA | Increasing | Strength |
| Simple cash flow | Decreasing | Weakness |
| Net cash flow from operating activities | Decreasing | Weakness |

- Determine the strengths and weaknesses of the company based primarily on the trends in items discussed from the income statements, balance sheets, common size income statements, and common size balance sheets, as well as the comments on cash flow.
- Create a table that indicates whether each financial fact is a strength or a weakness.
- Determine the overall financial strength of the company based on the financial facts included as strengths or weaknesses.
    - Categorize the overall financial performance of the company as strong, neutral, or weak.
    - Justify your conclusion based on the table you created.