

KEY RATIOS :-

GROSS MARGIN : $\frac{\text{GROSS PROFIT}}{\text{SALES}} \times 100 = \%$

NET MARGIN : $\frac{\text{NET PROFIT}}{\text{SALES}} \times 100 = \%$

WORKING CAPITAL : $\text{CURRENT ASSET} - \text{CURR. LIABLS}$
 $= ₹$

CURRENT RATIO : $\frac{\text{CURRENT ASSETS}}{\text{CURR. LIABLS}}$

ACID TEST RATIO : $\frac{\text{CURR ASSET} - \text{LESS STOCK}}{\text{CURRENT LIABILITIES}}$

DEBTORS DAYS _{OR} PERIOD OF CREDIT ALLOWED : $\frac{\text{DEBTORS}}{\text{SALES}} \times 365 = \text{days}$

CREDITORS DAYS _{OR} PERIOD OF CREDIT TAKEN : $\frac{\text{CREDITORS}}{\text{COS}} \times 365 = \text{days}$

STOCK TURNOVER : $\frac{\text{CLK STOCK}}{\text{COS}} \times 365 = \text{days}$

OR $\text{COS} / \text{STOCK} = \text{Times}$

OVERHEADS PER MONTH : $\text{OVERHEADS} \div 12$
(if annual accounts)

INTERPRETATION OF ACCOUNTS

POOR SOLVENCY

- Indicated by
- ↓ Working Capital
 - ↓ Current Ratio
 - ↓ Acid Test Ratio

Causes:

- (i) ↑ in fixed assets not matched by
↑ in - Share Capital } Long Term
- Bd on P/L ac } Liabilities
- Term Loans }

(ii) Poor Credit Control (cf: Debtors Days)

(iii) Build-up in stocks (cf: Stock T/b)

Remedies:

- (i) Review long term & replenish bank account
- (ii) Improve credit control procedures
- sending statements
 - evaluating new customers.
- (iii) Identify slow moving stocks.

↑ Debtors Days :-

- might be expected if Sales have increased by offering better terms to customers.
- if not expected, review credit control procedures. Review Debtors balances to determine if there exists any bad debts.

↑ Creditors Days :-

- this is always desirable.
- Creditors may not be getting paid if liquidity is poor
- should review Creditors balances if there exists any legal action pending.

PROFITABILITY

↓ Gross Margin:

- might be expected if market is more competitive &
- prices reduced to generate more sales

- if not expected:

- review procedures over recording of sales (perhaps cash business)
- review controls over custody of stocks (labelling etc)

↓ Net Margin

- review overheads to identify any costs that have increased unexpectedly.
- if overheads have not increased substantially (relative to any ↑ in sales) then economies of scale are being derived.

↓ Stock Turnover

- may indicate that some stock items are obsolete or slow moving. Put a stop on any further orders.

LIMITATIONS OF RATIO ANALYSIS

Some of the limitations of ratio analysis are as follows:

- (1) Many large businesses are involved with multiple lines of business, so that it is difficult to identify the industry to which a specific company belongs. A comparison of its ratios with other corporations may thus be meaningless.
- (2) Accounting and operating practices differ among companies, which can distort the ratios and make comparisons meaningless. For example, the use of different inventory-valuation methods would affect inventory and asset-turnover ratios.
- (3) Industry averages published by financial advisory services are only approximations. Therefore the company may have to look at the ratios of its major competitors if such ratios are available.
- (4) Financial statements are based on historical costs and do not consider inflation.
- (5) Management may hedge or exaggerate its financial figures. Hence certain ratios will not be accurate indicators.
- (6) A ratio does not describe the quality of its components. For example, the current ratio may be high but inventory may consist of obsolete merchandise.
- (7) Ratios are static and do not take into account future trends.

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THE NEED FOR PERIODIC STATEMENTS

Periodic statements summarise transactions of a past period, and in such a way provide useful information. The profit statement seeks to impress (i) the owners of the business and (ii) the lenders to the business. The owners of the business have invested their money in order to (a) earn a profit and (b) to increase the value of their investment.

People lend money in order to gain interest earnings and they hope to be repaid at the end of the time.

So what information do these investors and lenders need? They need information to answer the following;

1. Is the business financially sound?
2. Will the business make a profit?
3. Will the business increase in value?
4. Can the business pay its debts?
5. How well is the money advanced being used?

Periodic statements are drawn up to provide answers to these questions. The profit statement reflects management performance in the operations of the business. The balance sheet shows the financial position of the company at a particular point in time. A ratio analysis of these statements is also an aid in satisfying the information needs of these lenders and investors.

Who uses these periodic statements?

A People involved with the business

1. The business owners,
who want to know if the business is profitable/increasing in value.
2. The business managers,
who want to know if they are using the resources of the business efficiently and successfully.

B People not involved with the business

1. Bankers and lenders - interested in securing interest on the loan
2. Revenue commission - interested in assessing tax liability
3. Prices commission - monitor overcharging (if any)
4. Trade Unions - is the wage bill acceptable?
5. Suppliers - especially of goods on credit
6. Financial Commentators in the press to assist in the comparison of businesses
7. Investors -
8. Trade Associations - interested in generating statistics in particular areas of industry.

CASH FLOW STATEMENT:

Very often, a business can report considerable profits in their accounts and at the same time show a significant deterioration in its bank and cash balances. This is principally due to the following:

1. Payments can be made through the bank which are not reflected in the P&L a/c. Included here are repayments on loans (only loan interest is charged to P&L) and payments made for new fixed assets which are deferred on the balance sheet for charging to profit over useful life (by means of depreciation).
2. Poor stock control which can cause an unnecessary build up of stocks which have been paid for, but not sold. This ties up funds.
3. Poor credit control, a consequence of which can be a significant increase in amounts owed to the company by customers – amounts which, if collected, would have been lodged to the bank.

A requirement for all companies (with the exception of private companies) is the inclusion with its annual accounts of a Cash Flow Statement. This statement endeavours to reconcile the profit for the year to the movement on the bank and cash balances.

Consider the following:

You have been asked to review the accounts for a company. The company made an operating profit of €140,000 for the year ended 31st July 2008. Despite this, the bank balance moved into an overdraft position during the same period. The Balance Sheet figures for the last 2 years are set out below:

BALANCE SHEET					
	2008 Euro	2007 Euro		2008 Euro	2007 Euro
SHARE CAPITAL	10,000	10,000	FIXED ASSETS	500,000	180,000
BAL ON P&L A/C	438,600	298,600			
TERM LOAN	120,000	0			
CURRENT LIABILITIES:			CURRENT ASSETS:		
Creditors	130,000	108,000	Stocks	100,000	70,000
Bank Overdraft	117,400	-	Debtors	216,000	150,600
			Bank	-	16,000
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	816,000	416,600		816,000	416,600
	=====	=====		=====	=====

Difference is the
profit for the year
of 140,000

In order to explain the adverse cash position at the end of the financial year, you are requested to prepare a Cash Flow Statement.

SOLUTION:

The first stage is to determine the net cash flow arising from normal trading operations. The profit reflects sales, purchases and costs for the year. The movement in current assets is also part of trading – stock levels, extent to which customers still owe for sales and balances outstanding to creditors in respect of purchases. The following table should assist:

Movement	Source of funds	use of funds
Increase in Stocks		√
Decrease in Stocks	√	
Increase in Debtors		√
Decrease in Debtors	√	
Increase in Creditors	√	
Decrease in Creditors		√

The next stage is to look outside of trading items and at movements in Fixed Assets and Loan Balances. Very often, a significant increase in fixed assets is not matched by a similar increase in loan balances and therefore the company has used its short term banking facilities to finance these purchases. This is inappropriate as, in the main, any significant investment in fixed assets should be funded by long term borrowings and/or retained profits. The movements in these items affect cash flow as follows:

Movement	Source of funds	use of funds
Increase in Fixed Assets		√
Increase in Loans	√	
Decrease in Loans		√

SOLUTION:**CASH FLOW STATEMENT FOR YEAR ENDED 31ST JULY 2008:**

Profit for Year	140,000
Change in Working Capital Items:	
- Increase in Stocks	-30,000
- Increase in Debtors	-65,400
- Increase in Creditors	22,000
Net Source from operations	66,600
Other Sources	
- Term Loans	120,000
Other Uses	
- Purchase Fixed Assets	-320,000
Net Source/<Use> of Funds in Year	-133,4600
Represented by	
Opening Balance on Bank	16,000
Closing Balance on Bank	-117,400
Net Adverse Movement on Bank	-133,400