Critical number

Finance

Part I (a) The sustainability of companies is dependent on managers being able to identify their weaknesses and taking corrective actions to fix problems. A good way to find alternative solutions to problems is by providing incentives to the employees and by using teamwork and cooperation. The author of the article describes a technique used in his company which is to compare the financial ratios of the firm with the competition. Upon comparison of the ratios the weakest ratio is identified in order to implement a plan to improve the metric. The weakest ratio identified by management is the firm's critical number. The ratios of the competition are calculated by retrieving the financial statements of the companies using the internet. Databases such as Dun & Bradstreet provide the ratios of the industries. It is beneficial for the employees of the company to think like owners. Employees that surpass the market in terms of performance should receive above market wages. Three incentives that managers can give its employees to help them improve upon its critical number are bonus programs, profit sharing or variable compensation. " Tying bonuses or profit-sharing to the critical number creates an insurance policy for the company that makes certain that we are all focusing on our biggest weakness" (Stack, 2010). Some potential critical numbers are debt to equity ratio, cash flow, sales per employee, gross margin, inventory turnover, and overhead. (b) Ratio analysis is a great tool to analyze the financial statements of a company. One of the greatest virtues of ratio analysis is comparability. Once the ratios of a company are calculated they can be compared against the results of other companies or against the industry standard. Despite all the pros of ratios analysis it also has its limitations. One of the limitations of ratio analysis is that it does not show trends in the performance of the company over time. A second limitation of ratio analysis is that it looks at the past instead of the future (Tutor2, 2012). A third limitation of ratio analysis is that it does not provide qualitative information. c) Prior to buying the shares of a company I would perform vertical and horizontal analysis of the financial statements of the company. A valuable quantitative method that can provide information regarding the future of the company is sales projections. A third analysis that I need to perform prior to buying shares of a company is technical analysis. In terms of qualitative information I would retrieve information regarding the management team, corporate governance, products and services, strategic planning, mission and vision, and corporate social responsibility of the firm. Part II The two companies that I selected to perform a ratio analysis on are Tesco (TSCO. L) and Sainsbury's (SBRY. L). Both companies are public firms in the food industry whose stocks are traded in the London Stock Exchange (LSE). A ratio analysis showing six ratios of both companies is illustrated below. TSCO. L SBRY. L ROCE 22. 39% 6. 39% Acid test 56. 34% 98. 74% Debtors ratio und. und. Dividend cover 3 1. 99 Debt to equity 1. 85 1. 19 Earnings per share ? 34. 98 ? 32. 0 The return on capital employed (ROCE) of Tesco is 22. 39%, while the ROCE of Sainsbury's is 6. 39%. The desirable outcome is to have a high ROCE due to the fact that the metric shows the profitability of a company (Garrison & Noreen, 2003). The acid test ratio of Sainsbury's is much better than Tesco. The acid ratio shows the ability of a company to pay off its short term debt (Investopedia, 2013). Sainsbury's has better liquidity than Tesco. The debtors ratio was undetermined due to the fact that neither company had credit sales. The debt to equity ratio of Tesco was 1. 89. Sainsbury's had a much lower debt to equity ratio at 1. 19. Both companies had similar EPS ratios of ? 34. 98 and ? 32. 0 respectively. " Earnings per share allow us to compare different companies' power to make money" (Investing-school, 2010). Part III The profitability of Tesco is more than three times better than Sainsbury's. Companies that have good profitability are able to accumulate wealth. The liquidity position of Sainsbury is superior to Tesco. The high debt of Tesco and low solvency are both troublesome signs. My critical number for the comparison of the financial ratios of these two companies is debt to equity. The debt to equity of Tesco is 59% higher than Sainsbury's. Sainsbury's has the luxury of using additional debt to spur the growth of the company, while Tesco is capped out. The company that I recommend to invest the ? 10 million is Sainsbury's. Part IV Performing this assignment helped me understand the importance of the use of ratio analysis. By utilizing ratio analysis I was able to compare the financial performance of two public companies. I had used ratio analysis in the past, but only to evaluate the performance of one company. After performing this assignment I realized that ratio analysis is very useful to compare companies. The article Do You Know Your Critical Number was very insightful. I had never heard before of the critical number concept. I think that managers can use the critical number methodology to improve the operation of their business. References Garrison, R., Noreen, E. (2003). Managerial Accounting (10th ed.). Boston: McGraw-Hill Irwin. Investing-school. com (2010). Earnings Per Share (EPS). [Accessed 4 April 2013] Investopedia. com (2013). Acid-Test Ratio. [Accessed 4 April 2013] Stack, J. (2010). Do You Know Your Critical Number? Tutor2u. com (2012). Accounting Ratios: Drawbacks and Limitations. [Accessed 3 April 2013]