Investment analysis for jewellery business

Executive Summary

Babushka’s Baubles is a company producing jewellery at the budget end of the market and has seen a sharp decline in its financial position, in 2008. Despite this, sale levels are consistently high and gross profit margins are healthy. This report has uncovered potential problems in the costs attached to inventory such as administration and also in the way that the working capital is managed.

However, the investors are confident that the company has a positive future and is, therefore, maintaining an earnings-to-price ratio which is far higher than the industry average.

Introduction

This report aims to give a summary of the position of Babushka’s Baubles as reflected in the accounts of the company, year ending September 2008, with reference to the accounts for the previous year. The aim of the report is to provide investors with a snapshot of the current financial position of the company and to draw conclusions in relation to the previous period. The report will also draw comparisons with a similar company in the same market sector (Benny’s Bling plc), in an attempt to explain the key factors influencing the company. (In doing so, the different strategies in terms of marketing position will also be identified and taken into consideration). As well as analysing the accounts for the benefit of the investors, other potential users of the accounts will be considered. This will enable the company to identify areas of potential improvement for the company for the future [1] .

The report will first ask which groups are likely to be the key users of the accounts and what they would hope to achieve from reading and analysing the accounts, or the summary contained in this report. The report will then move on to consider the main body of the analysis, looking at the key ratios and what these tell the readers about the position of the company.

Finally, conclusions will be drawn as to the current position of the company and the suggested improvements that could be made for the future of the company.

User Groups

Accounts are used by a multitude of people and for a wide range of purposes. It is important to recognise this when it comes to reporting the financial status, so that these accounts can be geared towards ensuring the appropriate information is given to the correct people.

The primary users of any set of financial accounts are the investors. Looking at the figures and the trends of the company will allow investors to decide whether they should buy shares or sell the shares they own and what sort of return they should expect from investing in the company. As well as the investors, lenders will be keen to look at the financial status of the company so that they know the safety of the loans which they have forwarded to the company and also to make judgments if they are considering forwarding more loans to the company [2] .

Managers primarily use the set of management accounts to give them the necessary information to make decisions in relation to the running of the company. However, they will also use the financial ratios and accounts to help establish where they are in relation to the sector, as a whole, and in comparison to specific competitors. For example, in this case, the managers can consider their ratios in comparison to those of Benny's Bling in order to ascertain their competitive position and how potentially they could improve their own position in the future.

Other users will include customers identifying how likely the company is to be able to continue to supply them for the future. Employees may also be interested in relation to their job security and career prospects.

Financial Ratios

Financial ratios are used as a way of presenting the financial position of the company and to provide greater analysis of the underlying financial accounts. Trends can be identified and they are particularly useful when it comes to drawing comparisons with other companies in a similar sector. In some circumstances, financial ratios can even assist in order to predict bankruptcy while it is still possible.

Although ratios can be useful, there are also some limitations inherent in their use which can reduce their usefulness from the point of view of comparison with other companies. Each company is likely to follow slightly different accounting policies and standards, each of which will have an impact on the way that the ratios are displayed and may make the comparisons less useful than they could be.

The ratios will only be as useful and as accurate as the financial information upon which they are based. Where the ratios are based on summary accounts, this may not give a truly accurate view of the underlying position and more investigation may be necessary in order to obtain a full impression of the company's position [3] .

Financial statements are historic and in some cases can be substantially out of date. This means that that the ratios, based on these statements, may no longer be relevant as they have already been superseded, prior to the analysis being undertaken. Furthermore, comparison across different accounting periods can be misleading as it does not take account of any inflationary effects.

As the ratios will be compared with a competing company, caution should be exercised due to the naturally different structures and approaches being taken by the two companies. Different companies will inevitably have different approaches and comparing ratios directly may not take this into account.

Babushka's Baubles – Financial Ratio Analysis

A detailed analysis of the ratios in relation to the company has been undertaken and, at relevant points, these have been compared with Benny's Bling in order to try and obtain a rounded view of the company's position, both in relation to the previous period and to one of its main competitors.

Caution should be used as the two different companies have different market positions, with Benny's Bling aiming for the upper end of the market in terms of both price and quality and Babushka's Baubles focussing more on the budget end of the market, which is likely to lead to slightly different accounts.

Profitability

The gross profit figure simply shows how much is made on sales related to the cost of those sales; it does not include any reference to costs such as general administration or selling costs. The more complete figure is that of the net profit margin which shows the amount of money that is made once all cost of the sales have been taken into account. On a wider note, the return on capital employed shows how much is made for every £1 of capital that is invested in the company [4] .

In all cases, the performance of Babushka’s Baubles has weakened between 2007 and 2008. There has been a huge reduction in the net profit margin and also in the return on capital employed, with not such a large reduction in the gross profit margin. This indicates that non-direct costs such as administrative and selling costs have increased dramatically, but sales have not increased in proportion. The gross profit margin in Benny’s Bling has dropped from 26% to 25% in the last year which, although it reflects a reduction, is still considerably higher than the profit margins of Babushka’s Baubles.

Liquidity

Both tests for liquidity, the current asset and the quick ratio, are considered absolutely vital for all businesses. They reveal how readily the company can meet its liabilities with the cash that it has available. Cash is, of course, vital to the day to day running of the company and any weakness in this area could reveal imminent troubles for the company in terms of cash flow. This is one of the first indications of bankruptcy and should be taken seriously [5] .

The current ratio shows how easily the company can meet all current liabilities with the current assets available. A company should aim to have a ratio of at least 1 in relation to this ratio. Although it has reduced form 1. 85 to 1. 80, it is still well above the recommended minimum of 1. The quick ratio, on the other hand, considers the current ratio, but taking out the inventory element of the current assets as these cannot be easily converted into cash and, therefore, may not be relied upon to meet current liabilities. In this case, Babushka’s Baubles has a ratio of 0. 42 (up from 0. 41 in 2007). This is considerably below the desired minimum of 1. Moreover, it indicates that the company has insufficient cash and too much in the way of inventory. Benny’s Bling shows a similar trend, but its quick ratio is 0. 8 which is much closer to 1 and indicates a much better inventory management policy [6] .

Efficiency

Efficiency is the next area that we are going to consider, as this may give a clearer view of how inventory is being managed. Inventory has been identified as a potential problem and, therefore, this area should be carefully considered. These figures indicate how many days it takes from the point of the inventory entering the business to the point that the inventory leaves the business. Other figures indicate how long it takes for the company to pay debtors and how long it takes for the company to receive money from creditors.

The inventory period has become slightly longer, 32. 23 days (up from 31. 51 in 2007), which shows that the company takes around a month to produce the jewellery for sale. Benny’s Bling, on the other hand, takes just 22 days.

It takes the company 29. 98 days, on average, to pay its suppliers. This is up slightly from 2007, showing that cash is staying in the business longer. This in itself is a reasonably healthy figure, but when compared with the 75. 26 day period that the company takes to get money in from customers, it is clear to see that work needs to be done on getting cash into the business more quickly after the products have been sold. Benny’s Bling, conversely, takes an average of 46 days to pay suppliers, yet receives payments in 26 days, showing a much better control over cash flow.

Gearing

Gearing simply shows the value of loans the company has in relation to shareholders’ equity. Ideally, the amount of shareholders’ equity should be higher than loans, as this indicates that the company has fewer obligations in terms of interest payments and is, therefore, considered to be in a better position financially. The lower the gearing figure the better. The ratio has remained reasonably consistent at 7. 7% (down from 7. 8% in 2007). This is healthy and indicates a low level of long term loans. Benny’s Bling has a gearing ratio of 50%, which is considerably higher and indicates a much larger amount of long term loans within the company [7] .

Investments

‘ Earnings per share’ is a basic measure of how much money is earned in the business for every share. In the case of the company, it is expected that this will be lower than in Benny’s Bling, due to the large levels of shares and the relatively low dependence on long term debts [8] .

Price per share shows whether the purchase price of the share relates to the actual earnings the share is bringing in. If this figure is high relative to other companies in the sector, it indicates that the market is generally positive about the future of the company and is expecting an increase in performance in future periods. A low figure indicates a pessimistic view.

The company has earnings per share of 0. 21, which is down considerably from 2007 at 0. 35; this is due entirely to the substantial drop in net profits between 2007 and 2008. The price / earnings ration is 18. 10, considerably higher than the sector average of 9, indicating that the market is generally positive about the future of the company.

Conclusions

The company is in a generally positive position, with a good gearing position and solid sales. However, the company has potential difficulties in the way that it manages its efficiency and liquidity. Issues such as receiving money from customers and inventory management could have a dramatic impact on the short term ability of the company to meet its short term cash requirements [9] .

If the company could deal with the inventory and cash issues it would have a long term profitable future, a view shared by the investors in the earnings / price ratio.

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Appendix – Financial Ratios

Profitability

	Calculation	2007	2008
Net profit margin	Net profit / revenue	25, 200 / 450, 000 5. 6%	15, 200 / 420, 000 3. 6%
Gross profit margin	Gross profit / revenue	54, 000 / 450, 000 12. 0%	48, 000 / 420, 000 11. 4%

Return on capital employed	Net profit / capital employed	25, 200 / 118, 100 21. 3%	15, 200 / 120, 100 12. 7%

Liquidity

	Calculation	2007	2008
Current Ratio	Current asset / current liabilities	160, 300 / 86, 700 1. 85	156, 800 / 87, 200 1. 80
Quick Ratio	Current assets – stock / current liabilities	35, 500 / 86, 700 0. 41	36, 800 / 87, 200 0. 42

Efficiency

	Calculation	2007	2008
Inventory Turnover	Inventory / Cost of sales	124, 800 / 396, 000 31. 52	120, 000 / 372, 000 32. 23
Settlement period trade receivables	Trade receivables / trade revenue * 365	(34, 500 / 450, 000) * 365 27. 98	(34, 500 / 420, 000) * 365 29. 98
Settlement period trade payables	Trade payable / trade revenue	(86, 800 / 450, 000)	(86, 600 / 420, 000) *

	* 365	* 365 70. 40	365 75. 26

Gearing

	Calculation	2007	2008
Gearing Ratio	Long term loans / share capital + long term loans + reserves	10, 000 / (50, 000 + 10, 000 + 68, 100) 7. 8%	10, 000 / (50, 000 + 10, 000 + 70, 100) 7. 7%

Investors

	Calculation	2007	2008
Earning per share	Net profits / number of ordinary shares	17, 700 / 50, 000 0. 35	10, 600 / 50, 000 0. 21
Price / earnings	Price per share / earnings per share		3. 80 / 0. 21 18. 10

Footnotes

[1] Gillespie, Ian, Lewis, Richard, Hamilton, Kay, Principles of Financial Accounting, Pearson Education, 2004

[2] Siegel, Joel G., Shim, Jae K., Accounting Handbook, Barron’s Educational Series, 2006

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