Bigger is not always better

ASSIGN
BUSTER

Juan should refer to the income statement and the balance sheet over the past 3-5 year period. While referring, he should prepare a cash flow statement, common size income statement and common size balance sheet. The accounting statements provide the raw data from which the other statements can be prepared. The cash flow statement helps decide where the cash came from and where it was spent throughout a year. The common size statements provide useful information regarding the relative trends of the various assets, liabilities, revenue sources, and expense items. They also help the analyst make meaningful comparisons between firms of varying sizes.

2. Juan knows that he should compare Auto fix condition with an appropriate benchmark. How should he go about obtaining the necessary comparison data?

On the basis of Auto fix's industry classification code, Juan should collect industry averages of the key financial ratios. Some useful sources for industry ratios include: Value Line Moody's, Standard & Poor. In addition to the industry average, the industry leaders which are within the size category ratios can also be collected from the Internet such as Marketguide. com and many more which can be used for comparison.

3. Besides comparison with the benchmark what other types of analyses could Juan perform to comprehensively analyze the firm's condition? Perform the suggested analyses and comment on your findings.

Besides comparison with the benchmark, Juan could perform common size analyses of the financial statements and a DuPont analysis of the return on assets and the return on equity.

The common size income statement indicates that the firm's cost of goods sold has increased quite a bit since 2007. Miscellaneous expenses have also increased from . 3% of sales to 1. 5% of sales. On the other hand, selling and administrative expenses and interest charges have come down a bit. The firm needs to look into its cost structure and try and reduce the overall costs of doing business.

The common size balance sheet shows that the firm's inventory and accounts receivables levels have gone up sharply, while its cash balance has significantly declined. Fixed assets have increased over the past 5 years. The firm has taken on significantly larger amounts of short and long-term debt relative to its total assets. Equity has not increased proportionately with debt. As a result its capital structure has become more leveraged.

4. Comment on Autofix's liquidity, asset utilization, long-term solvency, andprofitability ratios. What arguments would have to be made to convince the bankthat they should grant Autofix the loan?

Autofix Liquidity:

The firm's overall liquidity is quite good with a current ratio of approximately 3. 79 and it has enhanced moderately a bit over the past three years. However, much of its current assets are tied in inventory, since its quick ratio is only 0. 62 approximately. The capacity of the firm to pay off its current liabilities from its cash reserves is not very good either and has deteriorated significantly over the past five years.

Asset utilization:

The firm's inventory turnover has declined considerably in the year 2006. There was vast improvement in 2007, but there is still a lot of room for further improvement. The receivables turnover ratio has declined as well. An average collection period of 32 days is pretty high for a retail business. The total asset turnover although not very high is at its highest level in five years.

Long-term solvency:

Autofix Auto's debt ratio is 64% approximately of total assets. Its debt level has gone up by almost 37% since 2007. Since the firm's coverage ratios are fairly low, the firm's financial structure can be considered to be fairly risky.

Profitability:

The firm's profitability ratios have declined significantly in the past three years. The firm is currently making losses. Arguments that can be made to get the loan:

Ø Improving liquidity (current ratio) and total asset turnover.

Ø Improving cash coverage and interest coverage ratios.

Ø Proof of better inventory management system (if possible)

5. If you were the commercial loan officer and were approached by Salman Ahmed for a short term loan of BD25, 000, what would your decision be?

Given the firm's poor profitability and cash flow situation, I would not grant the loan. However, I would tell him that if he can demonstrate improvement inventory management and better profitability over the next 2 quarters, we

would reconsider. I would also further advice him to have a keen look on his daily transactions and good maintenance of all the financial statements.

6. What recommendations should Juan make for improvement, if any?

The firm needs to improve its inventory management, and credit collection policies. Further, the cost of sales and miscellaneous costs should be looked into and brought down more in line with its level in 2007. This will improve the liquidity and profitability of the company.

7. What kinds of problems do you think Juan would have to cope with when doing a comprehensive financial statement analysis of Autofix Parts? What are the limitations of financial statement analysis in general?

The general problems which Juan would have to cope up with may be the selection of comparison benchmark and further the different financial accounting procedures in different fiscal years and moreover the type of business of auto parts is quite seasonal which one more problem to Juan was. The other reasons may also be related to specific problems.

Many things can impact the calculation of ratios and make comparisons difficult. The limitations of financial statement analysis in general are:

- The use of estimates in allocating costs to each period. The ratios will be as accurate as the estimates.
- The cost principle is used to prepare financial statements. Financial data is not adjusted for price changes or inflation/deflation.
- Companies have a choice of accounting methods (for example, inventory LIFO vs FIFO and depreciation methods). These differences impact ratios and make it difficult to compare companies using different methods.

- Companies may have different fiscal year ends making comparison difficult if the industry is cyclical.
- Diversified companies are difficult to classify for comparison purposes.
- Financial statement analysis does not provide answers to all the users' questions. In fact, it usually generates more questions!

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CALCULATIONS:

Ø Acid Test Ratio = (cash + marketable securities) / current liabilities

2005= 155000

65000

= 2. 38

2006= 309009

160606

= 1. 92

2007 = 75948

167329

= 0. 45

2008 = 28826

173296

= 0. 97

Ø Bad Debts Ratio = bad debts / accounts receivable.

2005 = 10000/10000

= 1

2006 = 10506/12000

= 0. 875

2007 = 19998/20000

= 0. 99

2008 = 15995/ 77653

= 0. 205

Net Income

Return on Assets (ROA) = ——————————————-

2005= 23082 = 0. 026

Average Total Assets

874406

Ø Assets Turnover Ratio

Sales

Assets Turnover Ratio = ——————————-

Average Total Assets

= 3921976/

874406

= 4. 485