

In tray item 2

Finance



I. Introduction This report is submitted to the management for aiding the management in raising the overdraft limit with existing banks. The recent pressure from suppliers of Gainsborough to reduce the credit period from three months to one month has lead the company to request the banks for an increase in the overdraft limit.

II. Factors Considered by Banks

The two main factors that banks consider for granting overdraft limit are Liquidity and Cash Flow. Banks need to be sure that a company has enough liquidity to meet its obligation in the event of a crisis. Cash flow is important because a healthy cash flow shows that the company generates enough cash flow to meet the short term debt obligation.

III. I Analysis of Gainsborough Fashions based on the Factors

Based on the factors considered by banks, this report analyses the liquidity and cash flow position of Gainsborough by using Current Ratio, Quick Ratio, Debt Ratio, Interest Coverage Ratio and Cash Flow to Debt Ratio.

Current Ratio: The current ratio of the company is 1. 04 which shows a good liquidity position. Gainsborough is at a good liquidity position if all its current assets have the potential to be turned around easily.

Quick Ratio: A quick ratio is done in order to look at the liquidity position more conservatively. The quick ratio of Gainsborough stands at 0. 02 which is at an unacceptably lower level. The company has only very few high liquid assets in its current assets.

Debt Ratio: Debt ratio of the company is 0. 85 or 85%. This ratio indicates that the company is highly leveraged. Gainsborough has depended on a huge amount of borrowed funds in order to generate assets.

Interest Coverage Ratio: Interest Coverage Ratio of the company is 7. 6. This

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is a healthy ratio. It shows that Gainsborough generates enough cash flow to meet its yearly interest expense obligation.

Cash Flow to Debt Ratio: The cash flow to debt ratio of the company is 0.67 which is not at a healthy position. It shows that the actual debt of the company is more than its operating cash flow.

IV. Conclusion and Recommendations

At the current liquidity position of the company, it is not of advantage to the bank to grant an increase in the overdraft. The main ratio that the bank should consider in granting overdraft is quick ratio. It is evident that Gainsborough has very few cash equivalent current asset that can help to meet the current liabilities. It should be noted that the company does not maintain any cash or cash equivalent assets that can meet its current level of overdraft position itself.

IV. I Recommendations

Gainsborough should improve its current assets level. Majority of the current assets of the company are inventories which are not as liquid as that of cash. Therefore, Gainsborough should plough back profits and always maintain a certain level of cash. This in turn will help to improve its quick ratio. Over years, the company should focus on bringing the quick ratio to a level more than 1. The debt ratio of Gainsborough does not show a good picture. In fact, the company uses more borrowed funds than shareholder's funds in order to generate assets. In future Gainsborough should focus on bringing the debt ratio to a level below 0.50 or 50%. This is to make sure that the company is not at the risk of being controlled by creditors. As regards to cash flow to debt ratio, Gainsborough should always maintain a ratio more than 2. The company should make sure that it does not maintain a debt level that cannot

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be serviced by its operating cash flow.

Works Cited

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Appendix:

1

Current Ratio

Current Assets/Current Liabilities

Current Assets =

201, 000

Current Liabilities =

194, 000

Current Ratio =

1. 04

2

Quick Ratio

(Current Assets - Inventories)/Current Liabilities

Current Assets - Inventories =

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3,000

Quick Ratio =

0.02

3

Debt Ratio

Total Liabilities/Total Assets

Total Liabilities = (40,000 + 162,000 + 10,000 + 17,000 + 5,000)

234,000

Total Assets =

275,000

Debt Ratio =

0.85

4

Interest Coverage Ratio

EBIT/Interest Expense

EBIT = (23,000 + 10,000 + 5,000)

38,000

Interest Expense =

5,000

Interest Coverage Ratio =

7.6

5

Cash Flow to Debt Ratio

Operating Cash Flow/Total Debt

Operating Cash Flow =

38,000

Total Debt = (40, 000 + 17, 000)

57000

Cash Flow to Debt Ratio

0. 67

Note: As there are no adjustments given for calculation, operating cash flow is considered to be same as operating profit