Financial ratio analysis essay

Financial statements are useful as they can be used to predict future indicators for a firm using the financial ratio analysis. From an investor's perspective financial statement analysis aims at predicting the future profitability and viability of a company, while from the management's point of view the ratio analysis is important as it helps anticipate the future conditions in which the firm should expect to operate and facilitates strategic decision making (Brigham and Houston 2007, p. 77).

Profitability analysis

Harry's Hamsters Limited (HHL) experienced growth in its profitability from 2007 to 2008; however, the net income reduced significantly during 2009. The return on equity (ROE) was 4. 24 percent in 2007, increased to 14. 68 percent in 2008 and decreased back to 5. 10 percent in 2010. Similarly, the return on assets (ROA) also initially increased and later declined in 2009; the decline was sharper compared to the decline in ROE as the ROA in 2009 of 1. 73 percent is lower than 2. 08 percent in 2007. The ROE comprises of two main components: the return on net operating assets (RNOA) and the return on debt (ROD). RNOA for HHL has also deteriorated during 2008 decreasing from 16. 61 percent in 2008 to 5. 08 percent in 2009. The RNOA is used to weigh the overall performance of the HHL management. The ROD component of the ROE has also deteriorated from 13. 68 percent in 2008 to negative 3. 32 percent in 2009 (Kemsley 2009, pp. 12-16).

The ROCE was the highest in 2008 estimated 11. 39 percent. It implies that the capital employed by HHL yielded high returns before the expansion period and that the company was significantly profitable. A considerable decline in 2009 to 4. 82 percent can be unfavourable for the investors; however, as the company has not sold its shares to the public a reduction in this ratio for a temporary period is not a major concern for the current owners.

The operating profit margins for HHL initially increased from 10 percent in 2007 to 17. 45 percent in 2008; however, the company reported lowered margins of 8. 53 percent in 2009. The decline in the operating profit margins of HHL is largely attributed to the increase in costs associated with the expansion of the business. The operating margins are expected to recover over the next year assuming that the new operations will become profitable as sales increase. The cost of goods sold have increased in absolute terms but the overall gross profit margins for the company have improved from 35 percent in 2007 to 42. 01 percent in 2009. This implies that the company is effectively managing its relations with suppliers and has kept a control over the costs attached to buying the hamsters for breeding; but the operating costs have increased due to the low sales activity in the new operations.

Liquidity analysis

The current ratio of HHL remains above the minimum threshold of one and is currently 1. 22; historically, the ratio has remained between 2. 73 and 3. 25 times. However, the quick ratio for the company reveals serious concerns as it has decreased from 1. 67 in 2008 to 0. 22 in 2009. The low quick ratio implies that a considerable portion of the current assets of the company are tied up as part of its inventory (Bragg 2007, pp. 14-16). This could also mean that HHL might be unable to sell the hamsters and sales might be suffering. The company must increase its working capital to meet its near term current liabilities and retain its solvency (Brigham and Houston 2007, pp. 42).

Efficiency analysis

The firm's efficiency has not necessarily decreased during the last year; an analysis of the efficiency ratios suggests a trend that is different from what is seen through the profitability and liquidity ratios. The inventory turnover has slightly deteriorated from 3. 00 in 2007 to 2. 89 in 2009; similarly impacting the day's inventory on hand from 121. 67 to 126. 35 during the same period. The long inventory holding period suggests that the company needs to improve its liquidity position to maintain its efficiency and aim to reduce its inventory turnover significantly (Brigham and Ehrhardt 2008, pp. 57-62). The days of accounts receivables have reduced from 45. 63 in 2007 to 40. 05 in 2009 and at the same time the days of accounts payables have reduced even more drastically from 40. 56 to 28. 08. The operating asset turnover for HHL has deteriorated considerably from 0. 87 in 2007 to 0. 60 in 2009, owing to a long inventory holding period and a quick payment of the accounts payables.

Capital structure analysis

The capital structure has significantly changed over the past two years as HHL has increased its financial leverage and is using a considerable debt to finance its expansion activities. The debt ratio of the firm has increase from 0. 47 in 2007 to 0. 60 in 2009; imply that HHL is now funding 60 percent of its assets through debt (Berry 2006, pp. 68-71). The interest coverage ratio of the company had improved considerably in 2008 and was 4. 29, but it has deteriorated to 1. 89 raising additional concerns for the banks. The ROD for the company has reduced considerably but remains positive implying that the current level of financial leverage is generating additional returns for the company. Operating cash flows (OCFs) for the company remain negative being typical of young firms experiencing a high growth rate, but the ability of HHL to raise additional financing is limited; therefore negative OCFs raise serious concerns for the bank management.

Report to credit committee

Analysis for reasons of results

HHL avails a long-term debt facility of £ 0. 45 million and has also utilised an overdraft of about £ 35, 000 from its current facility. The company performed exceptionally well during 2008, which led to an increase in its debt facility from £ 0. 275 million to £ 0. 45 million recently. The recent financial results revealed a tightening credit position of the company during 2009, which led to concerns regarding the excess usage of the overdraft facility by the company. Recent communication with the company reveals that it is facing liquidity problems due to its ambitious expansion program; however, the problem can be solved depending on the ability of the management to realise the seriousness of the situation (Madura 2006, pp. 17-32).

The company is running an overdraft without any immediate plans regarding its understanding to pay back the short-term loan. The overdraft is being utilised to fund the working capital needs of the company, which it did not anticipate during its expansion into southern England. The success or failure of the new operations is yet to be seen and the position will only be clear by next year. The current assets are largely financing the inventory requirements of the company, while the inventory cycles are long and not in a position to be liquidated on urgent need. The company needs to introduce additional capital in order to solve its working capital problems.

The working capital position of HHL can also improve by increasing the days of accounts payable ratio to higher levels or by reducing the inventory cycle if possible (Myers 1984, pp. 126-128). However, both options seem unlikely leading us to prescribe alternative solutions. The company has seen deterioration in the profitability ratios, which has reduced its ability to pay the interest commitments on the outstanding loan. However, the company still maintains an interest coverage ratio of 1. 89 and should be able to regain its position once the new operations become profitable.

The efficiency ratios of the firm have remained relatively stable with a slight decrease in the inventory turnover, an improvement in the accounts receivables turnover and a significant drop in the operating assets turnover. The company maintains a high debt ratio and about 60 percent of its assets are funded using debt; however, this is typical of most firms under the initial expansion phase.

The company remains committed to making profits but has not considered rising outside capital by going public in the near future; the only way to maintain its current pace of growth will be either through an injection of personal equity or through the offering of company stock to the public (Ronen and Yaari 2007). The owners have invested most of their life savings into the business and the company cannot possibly raise any further internal financing.

Recommendations regarding bank arrangements

The credit committee is recommended to raise concerns regarding the current liquidity position of the company and to prepare a schedule for the repayment of the overdraft amount over the next six months. The company is expected to recover from the current situation during the next year, but it is important to remain cautious until the sales position appears to improve. Also developing a degree of pressure on the management should clearly communicate the banks position to the firm (Gibson 2009, pp. 212-216). The intention is to educate the company management about the gravity of this situation and ensuring that it is able to recover smoothly from the liquidity crunch, while at the same time minimising the bank's exposure to the business risk HHL is facing.

The Managing Director of HHL is consistent in maintaining regular contact with the bank; therefore we need to educate him with the possible solutions for recovering from the credit crunch faced by the company. The recommended solutions include a consolidation of the business before considering any further expansion projects, a reduction in the days inventory on hand, increase in the days accounts payables, the retention of profits into the business allowing for no dividend payments over the next quarters, an injection of equity from any other sources available, an increase in collateral to support the bank's claims and a phasing out of the bank overdraft over the next six months as revenues from the sales are realised (Harvard Business School 2006, pp. 3-12).

Recommendations to management about improving finances of the company

Mr. Michael,

Thanks for a quick response pertaining to the overdraft issue. We have analysed the situation faced by HHL based on the recent financial statements and the qualitative information that we received during our recent correspondence. It is understood that your company has recently gone a major expansion and the short-term impacts are apparent on the financial results in terms of lowered profitability as anticipated. The concern raised by the bank is not directly related to the profitability of your company and we remain concerned about the liquidity position of HHL in months to follow (Bissessur 2008, pp. 142-146).

The understanding between the bank and the company was that the expansion will be fully funded by the increase in the loan facility. This increase in loan was to support both the fixed investment in the expansion project as well as the working capital needs of HHL. However, as it is seen the actual expansion investment has exceeded the anticipated amounts and the company is facing a severe liquidity crunch that needs to be resolved. The credit committee is concerned regarding the profitability of the expansion project and is not prepared to enhance the overdraft limit until the latest results for the company become available. HHL would have to independently solve this liquidity crunch by either an injection of equity to facilitate the increased working capital requirements or to raise additional external capital. The intention of the company to continue towards is expansion projects can be best facilitated through a public listing of the company to raise additional capital (Hill and Jones 2009, pp. 28-29).

The bank would require the company to pay the entire overdraft drawn in instalments over the next six months. This payment schedule has been drafted after a careful consideration of the credit history of your firm with the bank; in usual circumstances we would have required the repayment of the whole overdraft instantly. Moreover, it must be understood that this correction is in the best interest of your company as it serves to facilitate your understanding of the gravity of the situation faced by HHL.

A large proportion of the current assets held by HHL are tied up in the inventory and the company has no cash reserves available to pay for the maturing current liabilities including the bank’s interest payments. It is important to understand that the company would have filed for bankruptcy if the current overdraft was not available. Therefore, it is a very serious concern which should be resolved as soon as possible (Capon 1990, p. 1145).

The company can adopt some emergency measures to immediately improve its cash position, including a maximum delay in the payment to creditors that might be possible without significantly harming the supplier relations, a quicker recovery of accounts receivables without significantly harming the sales position and an immediate sale of ready inventory on a cash payment discount (David 2006; Ebert and Griffin 2005). Moreover, the company must not withdraw any retained earnings in the form of dividends until the liquidity position is resolved.

Waiting for your response,

Nick Cameron

Bibliography

Berry, A., (2006). Accounting in a business context. Brighton: Cencage Learning.

Bissessur, S., (2008). Earnings quality and earnings management: The role of accounting accruals. Rosenberg Publishers.

Bragg, S., (2007). Business Ratios and Formulas: A comprehensive Guide. New Jersey: John Wiley and Sons.

Brigham, E., and Houston, J., (2007). Fundamentals of Financial

Management. Mason: Thomson Publishing Limited.

Brigham, E., and Ehrhardt, M., (2008). Financial management: Theory and practice. Mason: Thomson Higher Education.

Capon, N et al., (1990). Determinants of financial performance: A Meta Analysis. Journal of Management and Sciences, Vol. 36 (10), pp. 1143-1159.

David, F., (2006). Strategic management: concepts and cases, 10th ed. Hong Kong: Pearson education.

Dominguez, K., (2006). Exchange rate exposure. Journal of International Economics, 68 (1), pp. 188-218.

Ebert, R., and Griffin, R., (2005). Business Essentials. Prentice Hall.

Finnerty, J., (2007). Project financing: Asset based financial engineering. New Jersey: John Wiley and Sons Publishing.

Kemsley, D., (2009). Financial Accounting Seminar: Practical Equity and Credit Analysis. New Orleans: Tulane University.

Kumar, K., and Dissel, V., (1996). Sustainable collaboration: Managing conflict and cooperation in systems. Journal of Information Management, 20 (3), pp. 279-300.

Gibson, C., (2009). Financial Reporting and Analysis: Using Financial Accounting Information. Mason: Cencage Learning.

Harvard Business School., (2006). Essentials of strategy. Boston: Harvard Business School Press.

Helfert, E., (2001). Financial Analysis: Tools and techniques, a guide to managers. New York: McGraw Hills.

Hill, C., and Jones, G., (2009). Strategic management theory: an integral approach. Mason: Cencage learning.

Madura, J., (2006). Introduction to business. Mason: Thomson publishing.

McDonald, B., and Morris, M., (1984). The statistical validity of the ratio method in financial analysis: An empirical examination. Journal of Business Finance and Accounting, 11 (1), pp. 89-104.

Myers, S., (1984). Finance theory and finance strategy. Interfaces, 14 (1), pp. 126-137.

Ronen, J., and Yaari, V., (2007). Earnings Management: Emerging insights, in theory, practice and research. New York: Springer Publishers.