**CASE STUDY ON FINANCIAL PERFORMANCE ANALYSIS.**

The following information refers to the period 1 January 2019 to 31 December 2020

*S plc*

*Income Statements (in £000)*

*2020 2019*

|  |  |  |
| --- | --- | --- |
| Sales revenues | 25,500 | 17,250 |
| Cost of sales | (14,800) | (10,350) |
| Gross profit | 10,700 | 6,900 |
| Administrative expenses | (3,300) | (1,850) |
| Selling & Distribution costs | (1,500) | (1,450) |
| Operating profit | 5,900 | 3,600 |
| Interest on long term loans | (650) | (100) |
| Profit before tax | 5,250 | 3,500 |
| Tax payable | (2,250) | (1,000) |
| Profit after tax (SHAREHOLDERS’ PROFITS) | 3,000 | 2,500 |
| Dividends | (750) | (1,500) |
| Retained profit for the year | 2250 | 1000 |

*S plc*

*Summarised position statements (in £000)*

*2020. 2019*

|  |  |  |
| --- | --- | --- |
| **Non-current assets** | 15,700 | 5,400 |
| **Current assets** |  |  |
| Inventory | 3,600 | 3,200 |
| Receivables | 1,200 | 2,000 |
| Bank & Cash | 3,200 | 2,000 |
|  | 8,000 | 7,200 |
| **Total assets** | 23,700 | 12,600 |
|  |  |  |
| **Equity** |  |  |
| Share capital (20 pence ordinary shares) | 4,000 | 4,000 |
| Share premium | 1,000 | 1,000 |
| Retained profits | 4,500 | 2,250 |
| Shareholders’ funds | 9,500 | 7,250 |
| **Non-current liabilities** |  |  |
| Long term loan (2030) | 9,000 | 2,000 |
| **Current liabilities** | 5,200 | 3,350 |
| **Total equity and liabilities** | 23,700 | 12,600 |

Additional Information: Current liabilities include payables of £1,200,000 and £900,000 in 2020 and 2019.

**Required: Using the information in the question, compare and comment on the financial performance in terms of profitability, liquidity and working capital management (efficiency) of S plc for the above 2 years ended 31/12/2020.**

**Please note:**

**This answer below (including the explanation) is far more than what is required to respond to such questions in an exam. It also depends on how much information is available and which ratios you want to rely on for the analysis. Some questions may specify the ratios that require commenting on.**

**Use your *knowledge* and use your *imagination* as much as possible and make straight forward comments / analysis that directly relate to the ratios used.**

**Comments on the financial performance of S plc**

**Introduction**

There are several broad aspects of financial performance of S plc that can be observed in the financial statements/information provided. These are:

* There is a large increase in investment in non-current (productive) assets from £5.4m in 2019 to £15.7m in 2020.
* This is mainly financed by a long-term loan of £7m in 2020. The financial analysis will examine the effect of this.

This financial analysis will cover the areas of profitability, liquidity and working capital management or efficiency. Other areas of financial performance is possible but this is outside the scope of the question

The main limitations of this analysis: it is applied to its most recent performance and may or may not have any direct relevance to how S plc will perform in the future. Besides the analysis uses summarised financial statements and this information may hide a more complex story of partial success offset by partial failures.

**Profitability**

A company’s profitability is usually assessed through the use of a range of different *financial ratios*.

Two profitability ratios as related to *sales* are:

1. *Gross profit (margin) ratio*.

2. Ne*t profit (margin) ratio*. (Profit before or after tax to sales ratio).

*Gross profit ratio* = Gross profit / Sales x 100

The gross profit ratio reflects the company’s “pricing strategy\*”.

A low ratio signals that the company is going for high sales volumes with low prices; a higher margin suggests a strategy of lower sales volumes with higher prices. Generally, we would expect this ratio to be *quite stable* over time.

*Net Profit ratio =* Profit before interest and tax (PBIT) or operating profit / Sales x 100

This ratio looks at the company’s ability to run its basic business at a profit – before considering interest and *corporation* *tax*.

It looks at how much such profit is generated on every £1 of sales. In conjunction with the Gross Profit ratio, the Net Profit ratio looks at how well the company is *controlling its costs/expenses (operating costs – i.e. admin costs, selling costs and distribution costs).* It can indicate the *competitive pressures* that the company is operating under.

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| --- | --- | --- | --- |
| **Ratio** | **Formula** | **Ratios for 2020** | **Ratios for 2019** |
| Gross profit ratio | Gross profit / Sales x 100 | £10.7m / £25.5m x 100 = 41.96% | £6.9m / £17.25m x 100 = 40% |
| Net profit ratio | Operating profit / Sales x 100 | £5.9m / £25.5m x 100 = 23.14% | £3.6m / £17.25m x100 = 20.87% |

Commentary on profitability ratios:

*Gross profit ratio*: There is a small increase in the GP ratio. This may be due an increase in selling prices or a decrease in purchase costs or both in 2020.

*Net profit ratio:* An increase here appears to show better management of operating expenses. The analysis of the operating expenses/costs ratios will provide better insight into this.

*Conclusion*: The higher net profit ratio in 2020 is mainly due better management (savings) operating costs.

**Liquidity:**

This looks at the company’s ability to pay for its expenses and current liabilities (such as payables, loan repayments, corporation tax, accrued expenses etc) as and when they fall due.

There are 2 liquidity ratios – the *current ratio* and the *quick (or acid test) ratio* that are used to asses liquidity.

*Current ratio* measures the current assets in relation to current liabilities. It is the amount of current assets available to pay the short-term liabilities/debts of the business. The benchmark (or norm or standard) for this can vary considerably and a commonly quoted norm is 2:1.

*Quick ratio* measures the liquid assets in relation to the current liabilities. The benchmark for this can also vary considerably and a commonly quoted norm is 1:1.

The difference between the two liquidity ratios is one of timing. The current ratio looks at liquidity and cash flow issues further ahead than the quick ratio. The quick ratio is more an immediate measure of liquidity – hence the reason why it is referred to as the acid test ratio.

It is more important to look at the *trends in the liquidity ratios over time* than comparing against the norms (or the standard ratios).

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| --- | --- | --- | --- |
| Ratio | Formula | Ratios for 2020 | Ratios for 2019 |
| Current ratio  Norm 2:1 | Current assets / Current liabilities | £8m / £5.2m = 1.54 or 1.54:1 or 1.54 times | £7.2m / £3.35m = 2.15 or 2.15:1 or 2.15 X |
| Quick or acid test ratio  Norm 1:1 | Current assets – Inventory/Current liabilities | £ (8 – 3.6) m / £5.2m = 0.85 or 0.85:1 or 0.85X | £ (7.2 – 3.2) m / £3.35m = 1.19 or 1.19: 1 or 1.91X |

Commentary on liquidity ratios:

*Current ratio*: This is lower in 2020 when compared to the 2019 ratio also against the norm – the trend may indicate problems with liquidity / cash flow in 2020.

Quick ratio: This appears to be adequate since it is closer to the norm even though this has decreased in line with the current ratio. This is a better ratio than the current ratio to rely on as an immediate measure of liquidity.

Conclusion: Does not require management attention since the quick ratio (which is more reliable and important for immediate liquidity) shows a trend around the norm for both years.

**Efficiency / Working capital management**

There are 3 Working Capital Day ratios and these are:

*Inventory days*......the shorter, the better.

*Receivable days*.......the shorter, the better.

*Payable days*......the longer, the better.... (within reason)

Working capital investment is *necessary*, but it is a *non-productive investment*. So, companies do not want to over invest in working capital than what they really need as this may be wasteful. Similarly, an under investment in working capital may be disruptive to business operations.

|  |  |  |  |
| --- | --- | --- | --- |
| Ratio | Formula | Ratios for 2020 | Ratios for 2019 |
| Inventory holding ratio | Closing inventory / Cost of sales x 365 days | £3.6m / £14.8m x 365  = 88.78 = 89 days | £3.2m / £10.35m x 365 = 112.85 = 113 days |
| Receivables ratio | Receivables / Sales x 365 days | £1.2m / £25.5m x 365  = 17.18 = 17 days | £2m / £17.25m x 365  = 42.32 = 42 days |
| Payables ratio | Payables/ Cost of sales x 365 | £1.2m / £14.8m x 365  = 29.59 = 30 days | £0.9m / £10.35m x 365 = 31.74 = 32 days |

Commentary on Efficiency / Working capital management ratios:

*Inventory holding ratio*: This has improved in 2020 and shows better management of inventory. Industry inventory holding ratio may show how effectively and efficiently S plc has managed its inventory

*Receivables ratio*: This too has improved in 2020. Shows better management of receivables in 2020. However, it is assumed that these do not exceed the credit period allowed by S plc on credit sales.

*Payables ratio:* There is a marginal improvement in 2020. The company’s credit period from its suppliers for credit purchases will provide a better picture of how payables is managed.

Conclusion: All 3 ratios do not require any management attention. Inventory holding receivables and payables days show trends of improvement in 2020.

**Summary and recommendations:**

Although the current ratio of 1.5:1 is on the low side of acceptability the quick ratio of 0.85:1 suggests no real immediate cash flow/liquidity problems.

It also shows that purchases / cost of sales has increased substantially in 2020. The company could have used this to extract better terms from its supply chains on its purchasing policy e.g. better purchase prices, discounts and credit period. Could this have led to the higher gross profit ratio in 2020?

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