Lynn's Kids Financial Analysis Report

YEARS 2015-2019

02-0081-0023, 02-0081-0016, 02-0081-0017

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Abstract

We were tasked with advising Lynn's Kids, a children's clothing boutique founded in Northampton, Massachusetts, by determining whether or not her stores should be shut down and how she should proceed to uplift her business with a decline in sales. This report highlights the factors which contribute to Lynn's Kid's poor economic performance and encompasses a number of suggestions that Lynn could undertake to improve the current condition of the business. We were tasked with completing a variety of financial statements such as the income and balance sheet for the company given certain financial data. Additionally, a trend analysis was completed to predict future sales and search for patterns in the company's overall growth, both with and without the suggestions.

The following acts as a skeleton for our analysis and recommendation:

- **Balance Sheet**
  - A consistent decrease in the total assets and cash assets from 2015-2019
  - A general increase in inventory from 2015-2019 with an overall decline in cash following a sharp spike in 2016
- **Financial Ratios and Analysis**
  - Remarkably low values for returns on equity and assets representing low profitability of Lynn's Kids business

    - Liquidity ratios are far below industry standards which identifies that they are poorly managing their assets
- **Inventory Turnover Analysis**
    - The inventory turnover rate is lower than industry standards.
        - It is currently wavering between 1.11 and 1.75
        - It needs to be between 6 and 7
- **LIFO Vs. FIFO**
    - FIFO inventory valuation should be used when selling
- **Trend Analysis**
    - From 2016 to 2019 there is a consistent decrease in total assets
- **Industry Standards**
    - Lynn must work to increase her quick ratio by raising the number of sales and turnover inventory which goes hand and hand with an increase in sales
- **Suggestion #1:**
    - Opt Into Equity Financing
    - Lessen the CEO Salary
- **Suggestion #2:**
    - Close Boston Store

- Open Online Market

- **Suggestion #3:**
  - Promote Social Media Marketing

- **Final Recommendation Pitch**
  - Due to abysmal new income and returns, advertisement spending, and a current lease taken on the location, Lynn's Kids should opt into equity financing and lessen the CEO salary, close their branch in Boston and open an online market, and proceed to market their products online with social media.

Balance Sheet

Company Comparative Balance Sheet

- Lynn's Kids current and long term (fixed) assets through the years 2015 – 2019
- Lynn's Kids current and long term liabilities through years 2015 - 2019
- Lynn's Kids Owner's Equity: years 2015 – 2019

Lynn's Kids

Balance Sheet

December 31

	2019	2018	2017	2016	2015
Assets					
Current Assets					
Cash	40,424	59,604	88,686	91,710	63,637
Inventory	112,832	99,795	87,495	79,935	81,212
Prepaid expenses	6,336	6,223	7,801	7,341	5,532
Total current assets	159,592	165,622	183,982	178,986	150,381
Property, Plant & Equipment					
Building(net)	127,989	132,789	137,589	142,389	147,189
Equipment & Store Fixtures(net)	66,600	74,500	82,400	90,300	98,200
Total Property, Plant & Equipment	194,589	207,289	219,989	232,689	245,389
Total Assets	**354,181**	**372,911**	**403,971**	**411,675**	**395,770**
LIABILITIES					
Current Liabilities					
Accounts payable	10,866	8,234	10,959	9,133	7,027
Line of Credit	160,199	110,820	75,643	40,021	16,418
Other Current Liabilities	9,281	8,379	10,303	9,443	9,427
Total Current Liabilities	180,346	127,433	96,905	58,597	38,872
Long-Term Liabilities					
Mortgage	105,000	114,000	122,500	130,500	138,000
Notes Payable	79,457	90,320	100,552	110,189	120,000
Total Liabilities	**364,803**	**331,753**	**319,957**	**299,286**	**296,872**
OWNER'S EQUITY					
Common Stock	52,403	52,403	52,403	52,403	52,403
Retained Earnings(January 1, 2015)	(60,025)	(11,245)	31,611	59,986	52,495
Total Liabilities & Stockholders' Equity	**354,181**	**372,911**	**403,971**	**411,675**	**395,770**

Liquidity Ratios

Current Ratio

Current Assets / Current Liabilities

- 2015: $\frac{150{,}381}{38{,}872} = 3.87$
- 2016: $\frac{178{,}986}{58{,}597} = 3.05$
- 2017: $\frac{183{,}982}{96{,}905} = 1.90$
- 2018: $\frac{165{,}622}{127{,}433} = 1.30$
- 2019: $\frac{159{,}592}{180{,}346} = 0.88$

Quick Ratio

Current Assets - Inventory/ Current Liabilities

- 2015: $\frac{63{,}637}{38{,}872} = 1.64$
- 2016: $\frac{91{,}710}{58{,}597} = 1.57$
- 2017: $\frac{88{,}686}{96{,}905} = 0.92$
- 2018: $\frac{59{,}604}{127{,}433} = 0.47$
- 2019: $\frac{40{,}424}{180{,}346} = 0.22$

Cash Ratio

Cash / Current Liabilities

- 2015: $\frac{63,637}{38,872} = 1.64$
- 2016: $\frac{91,710}{58,597} = 1.57$
- 2017: $\frac{88,686}{96,905} = 0.92$
- 2018: $\frac{59,604}{127,433} = 0.47$
- 2019: $\frac{40,424}{180,346} = 0.22$

NET WORKING CAPITAL

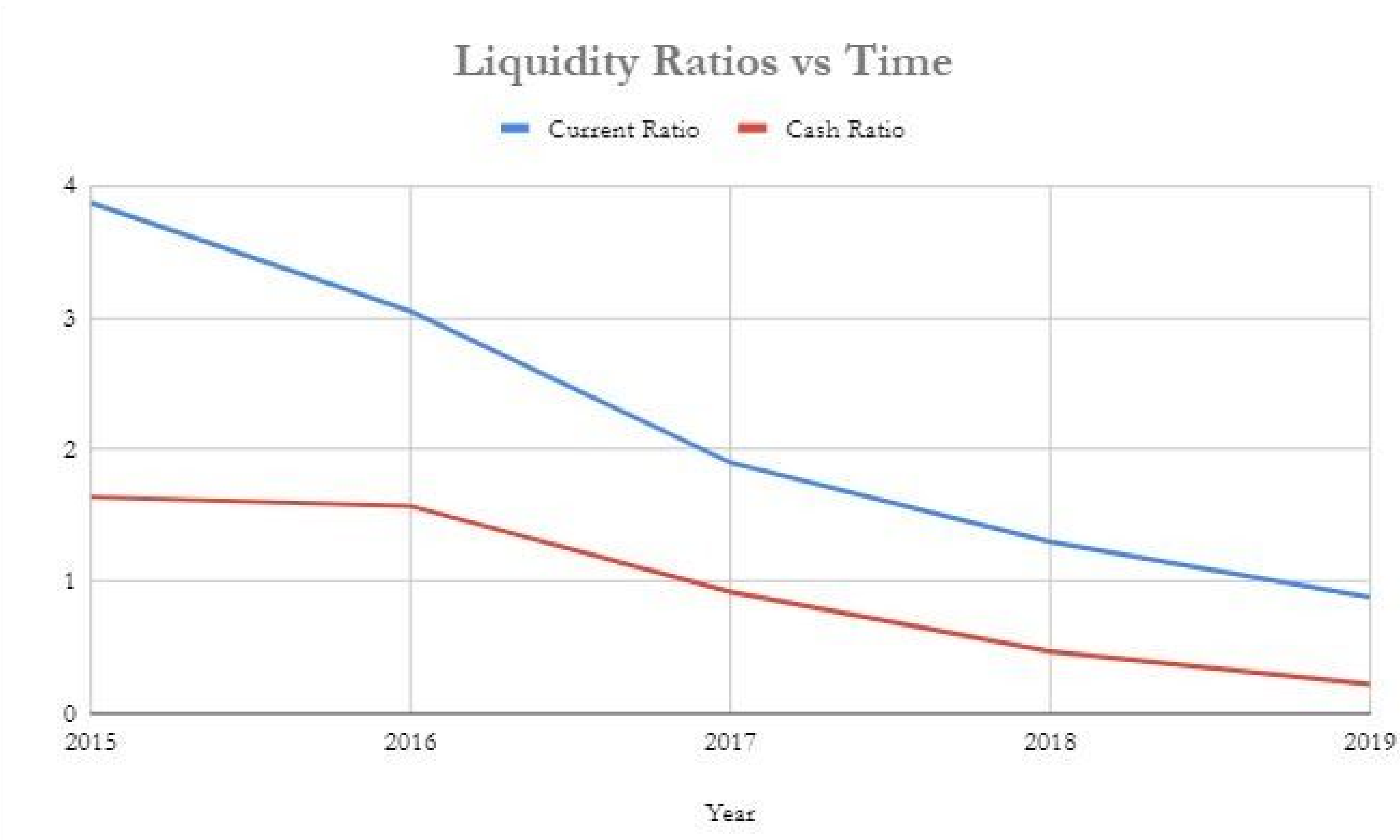
Current Assets - Current Liabilities

- 2015: $150,381 - 32,872 = 117{,}509$
- 2016: $178,986 - 58,597 = 120{,}389$
- 2017: $183,982 - 96,905 = 87{,}077$
- 2018: $165,622 - 127,433 = 38{,}189$
- 2019: $159, 592 - 180, 346 = -20{,}754$

GRAPH OF LIQUIDITY RATIOS

COMPANY LIQUIDITY RATIOS AND NOTABLE FEATURES

- Lynn's Kids current and cash ratios
- The gradual decrease in ratios from 2015 to 2019
  - The consistent drop in current ratio to abnormally low values



RATIO ANALYSIS

COMPANY LIQUIDITY AND PROFITABILITY ANALYSIS

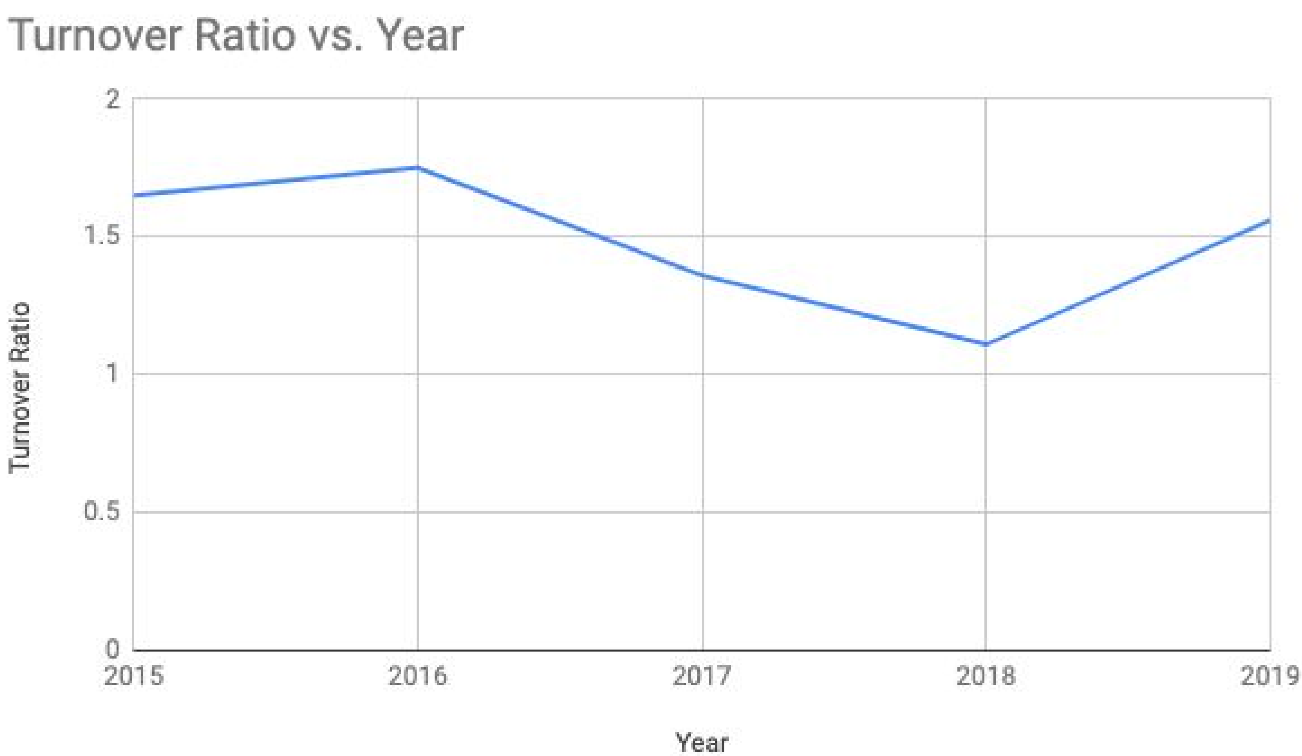
Lynn's Kids has maintained a decreasing trend in its current ratio through its five years of business. The current ratio was approximately 3.87 in the year 2015 and has sustained a drop to 3.05 in 2016 and a major decrease to 1.9 in 2017. The subsequent years show steadily decreasing values as well (2016 and 2017), but all of these values are too high, especially when compared to the industry averages. The visible trend in the drop in the liquidity ratios over time is graphed on page [9]. Generally, inventory, prepaid expenses, and supplies are current assets that are not as liquid. Additionally, when inventory is immediately needed to convert to cash, the seller may receive cash that is below the book value of the inventory. Thus, it is optimal to look at only cash and accounts receivable, which are much more liquidate than the rest of the current assets, in order to measure the liquidity of the company. These are measured by the declining cash ratio, which is lower than the current ratio but also very low for the industry standards, stooping below the average consistently for all five years; however, since they are much finer measurements of liquidity, they are more insightful into the success of Lynn's Kids. New working capital also shows a negative trend, which is detrimental to the company in the future. The cost of Liabilities exceeds that of assets by almost $20,000, meaning that the company lost lots of money in 2019. The cost-benefit analysis shows that the company is spending more than the amount of revenue they are bringing in, a red flag that business operations much change. Aspects of operation must change in order for the cost-benefit analysis to signal for financial prosperity in the future.

Inventory Turnover analysis

Inventory Turnover Ratio

(Inventory + Retained Earnings)/Inventory

- 2015: $\frac{81{,}212+52{,}495}{81{,}212} = 1.65$
- 2016: $\frac{79{,}935+59{,}986}{79{,}935} = 1.75$
- 2017: $\frac{87{,}495+31{,}611}{87{,}495} = 1.36$
- 2018: $\frac{99{,}795+11{,}245}{99{,}795} = 1.11$
- 2019: $\frac{112{,}832+63{,}025}{112{,}832} = 1.56$



Straight Line Depreciation Analysis of 2019 Inventory

(Inventory - Salvage Value)/Useful Life

- Salvage Value of Children Clothes = 5%

- Useful Life of Children Clothes = 1 year (12 months)

# of months	0	1	2	3	4	5	6	7	8	9	10	11	12
Total Assets													
Opening Book Value	112832	103,899	94,967	86,034	77,102	68,169	59,237	50,304	41,318	32,439	23,507	14,574	5,642
Depreciation	63025	63,025.00	63,025.00	63,025.00	63,025.00	63,025.00	63,025.00	63,025.00	63,025	63,025	63,025	63,025	
Ending Book Value	103899.47	94966.94	86034.41	77101.88	68169.35	59236.82	50304.29	41317.76	32439.23	23506.7	14574.17	5641.64	

An inventory turnover ratio indicates how well the company is able to sell its

products and restock their inventory on a regular basis. The ideal inventory ratio for a company that is the size of Lynn's Kids is in between 4 to 6. Our analysis indicates that the turnover ratio maintained by the company is wavering between 1.11 and 1.75. Taking that into consideration, they are at a point not ideal for a successful business in terms of selling their products and restocking. There seems to be no trend in terms of the change in turnover ratio, indicating that the company has reached a stagnant point. Thus a lot of changes needed to be made in order to increase the output by the company. Another factor that comes into play is the unavoidable truth of the fact that Lynn's Kids is a clothing retail store. Clothing stores should have a higher turnover rate than other stores because fashion is always rapidly changing. If the turnover ratio is kept somewhere in between 6 and 7 for Lynn's Kids, they will be able to accommodate themselves when new dress styles come into play. When the inventory is being switched out so often, it makes it easier to keep the styles up to date and in season. In return, doing so will entice more customers to shop at Lynn's, which directly increases their revenue. In addition to that, when a straight-line depreciation analysis was done, it is evident that the inventory needs to be restocked every 5 months in order to maintain a profit margin.

LIFO vs. FIFO

All businesses have to take risks and chances with new investment opportunities in order to prosper and expand, and appropriate capital analysis of the investment would give insight into understanding if the returns are profitable enough. First, it is important to know what method of inventory valuation would be best for Lynn's Kids as the type of valuation depends on the inflation: a higher inflation rate makes the two valuation methods of FIFO and LIFO increasingly different in effect. Currently, the US is recorded to be slightly under 2% inflation and will round off at 2% in the coming few years (considering 2% inflation rate is the equilibrium rate).

Based on the current analysis of Lynn's Kid's balance sheet, it is evident that the company logs its inventory and assesses its profit on the FIFO system. When the First-In-First-Out inventory system is used, the good that is sold first is the ones that have been produced first. According to general economic trends, the cost of production for a specific set of goods increases over time. Thus, if the FIFO system is used the profits from selling the "early" goods will be more than selling the "later" products because the cost of selling remains constant. On the other hand, the Last-In-First-Out inventory system is when the products that are made last are being sold first. Taking into consideration that it costs more to make those later products, it means that the income sheets are showing a lesser profit than when using a FIFO system. This is essential for the company because they will have to pay fewer taxes, due to their "lesser profits". In addition to that, the inventory that is available after specific good are sold also varies based on whether a LIFO or FIFO system is used. When using FIFO, you have more inventory left because the products that were produced later cost more to make. Whereas, LIFO means the inventory will be worthless because the early products are sold. Thus, using LIFO is a better option because having a slightly "lesser" inventory is a small price to pay for being able to pay less in taxes.

Trend Analysis

Lynn's Kids

Overall Trend Analysis

For the Years Ending [Dec 31, 2019; Dec 31, 2018; Dec 31, 2017; Dec 31, 2016; Dec 31, 2015]

	Projected		Current				
	2021	2020	2019	2018	2017	2016	2015
Total Assets							
Total Assets	293,365	327,051	354,181	372,911	403,971	411,675	395,770
Percent Difference	-10.30%	-7.66%	-5.02%	-7.69%	-1.87%	4.02%	-
Total Liabilities							
Total Liabilities	507,475	420,618	364,803	331,753	319,957	299,286	296,872
Percent Change	20.65%	15.30%	9.96%	3.69%	6.91%	0.81%	-

Cash is an indispensable asset for any company as it not only offers protection against tough times of immense debt but also gives companies more options for future growth. Declining cash reserves often warn of weak company performance, but it may also show that the management is making use of it in investment opportunities by increasing their other assets. The positive prospect, in this case, is likely due to the notable increase in inventory over the years: the cash drop signifies that the company is trying to use its assets to take on new investments, resulting in an increase in inventory. This brings new potential for the company as it has a low current ratio (dropped from 3.87 to 0.88 over five years) so making more efficient use of their assets in investments will increase it.

From 2016 to 2019, there is a consistent decrease in total assets. This drop of $57,494 in the given time period contributes to the overall analysis of the success of this company. Every year since 2016, the cash decreases, combined with depreciation costs, they take quite a toll on the total assets the business has. The inventory turnover (cost of goods sold divided by average inventory) measures how quickly the company is moving merchandise through the warehouse to customers. In the case of Lynn's Kids, the inventory turnover ratio peaked in 2016 (1.75) and has not fully recovered thus far (1.56 in 2019). This lack of full rebound shows that the company is having a harder time selling the inventory it has to consumers. The rise in inventory value of about $11,000 every year since 2016 is a good sign and is most probably due to Lynn's Kids gaining inventory, possibly for new investment. The inventory value could also be dependent on economic fluctuations in interest and inflation. Our analysis of the business determined that inventory turnover must be increased so it is more efficient. As a clothing store, optimal inventory turnover should be as high as possible.

INDUSTRY STANDARDS

Among the leaders in the retail industry, big-name companies have very different financials. However, the ideal current ratio for these successful companies varies around 1.3 to 1.5, currently averaging to 1.47 for the retail industry. Nike, Gap, and Macy's have respectable current ratios, coming in at 1.98, 1.43, and 1.28 respectively. Lynn's Kids currently has a current ratio of 0.88, significantly lower than that of many name brand companies in the children's clothing industry. This means that the company's current assets are not being used efficiently, its inability to secure financing, and its inefficiency in managing its working capital. Nike, Gap, and Macy's have respectable quick ratios as well, coming in at 0.62, 0.58, and 0.52 respectively. Industry standards have proved a quick ratio between 0.5 and 1 is ideal, and these industry tycoons have proved this average. In 2019, Lynn's Kids had a quick ratio of 0.25, significantly lower than the industry average and value not comparable to the top brands. The lower a company's quick ratio, the more likely it is to struggle to pay off debts, whereas a higher quick ratio indicates a company has greater liquidity and better financial health. Because the ratio is low, Lynn's Kids does not have adequate assets, without inventory, to cover imminent debts. This translates to a risky position for the business because a decline in sales could lead to a cycle of debt not desired by the private company. Therefore, Lynn must work to increase her quick ratio by raising the number of sales, and turnover inventory, which goes hand and hand with an increase in sales. This can be done by investing in social media marketing to further broadcast the products to the public and generate revenue for the company as a whole.

New Financial Opportunities

What is the goal of any company? To produce enough profit to keep the business thriving and competitive in the industry. Upon investment capital analysis, Lynn's Kids has definitely not made some good investment decisions, and with such a low return on equity and assets overall as well as an abysmal income for all five years, it needs to experience a drastic change to be geared for future success.

Suggestion #1: Opt Into Equity Financing & Adjust CEO Salary

Equity financing is when the company decides to open a vast portion of its shares to the general public. By doing so the general public can have a say in the company and weigh in with their losses and profits. When the company increases more equity it will allow it to raise capital quickly by attracting a large number of investors. The benefit is that the company will not have to face extra repercussions if they were to fail. In addition, by giving more shares to the public, it tends to increase publicity, thus increasing business opportunities for Lynn's kids. When companies equate more shares, they tend to get to charge a larger premium on their stock options, which directly increases the amount of money the company receives to make future investments. Equity financing is advisable but comes with a small drawback. It entails selling away some shares of the company, in exchange for the stockholder's equity in profits. This idea comes with the fact that if the company was to thrive in the market for the future, she would have to split her profits among the different investors at their respective ratios. Lastly, the CEO should take a 20% pay cut in order to allocate more money to promote the company and help buy new resources.

Suggestion #2: Sell Boston Store & Establish Online Market

Cost-Benefit Ratio

Retained Earnings/Operating Expenses at each store

- Boston: $\frac{18907.5}{230,033.02}$ = 0.08
- Westborough: $\frac{17647}{106,128.33}$ = 0.166
- Northampton: $\frac{26470.5}{167,377.64}$ = 0.158

Lynn's Kids

Expenses

	Projected		Current				
	2021	2020	2019	2018	2017	2016	2015
Boston							
Mortgage	0.00	0.00	87,552.72	79,620.72	76,789.68	71,828.64	69,809.28
Full Time Manager	0.00	0.00	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00
Part Time Workers	0.00	0.00	36,480.30	33,175.30	31,995.70	29,928.60	29,087.20
Advertising	0.00	0.00	56,000.00	56,000.00	0.00	0.00	0.00
Closing Fees	N/A	20,000.00	N/A	N/A	N/A	N/A	N/A
Total Boston expenses	0.00	20,000.00	230,033.02	218,796.02	158,785.38	151,757.24	148,896.48
Westborough							
Lease	23,830.04	22,748.06	21,888.18	19,905.18	19,197.42	17,957.16	17,452.32
Full Time Manager	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00
Part Time Workers	19,858.37	18,956.72	18,240.15	16,587.65	15,997.85	14,964.30	14,543.60
Advertising	16,000.00	16,000.00	16,000.00	16,000.00	0.00	0.00	0.00
Total Westborough expenses	109,688.40	107,704.78	106,128.33	102,492.83	85,195.27	82,921.46	81,995.92
Northhampton							
Lease	88,500.00	96,750.00	105,000.00	114,000.00	122,500.00	130,500.00	138,000.00
Full Time Manager	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00
Part Time Workers	4,810.43	4,594.03	4,377.64	3,981.04	3,839.48	3,591.43	3,490.46
Advertising	8,000.00	8,000.00	8,000.00	8,000.00	0.00	0.00	0.00
Total Northhampton expenses	151,310.43	159,344.03	167,377.64	175,981.04	176,339.48	184,091.43	191,490.46
Miscellaneous							
Lynn's CEO Salary	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Total Expenses	**360,998.83**	**387,048.81**	**603,538.99**	**597,269.89**	**520,320.13**	**518,770.13**	**522,382.86**

According to the Cost-Benefit Ratio for each store, it is evident that Boston Store provides the least value to the store. The other two stores have a ratio almost double that of Boston's, thus that store needs to be made negligible. Due to a small number of sales at this location, and the amount of money put into the store, it is profitable for the company and would be best if closed immediately. The general manager at the location makes $50,000 and the location spends $56,000 on advertising (in 2019), despite only accommodating for 30% of total sales for the company. The cost-benefit analysis exemplifies how this location yields fewer profits than the other 2, implying that its foreclosure proves beneficial for the company. In addition to lesser profits, the projected expenses charts indicate that the company will be saving $216,000 and $243,000 in 2020 and 2021 if the Boston shop is closed down. These funds, along with the money spent on paying the part-time workers and leasing the building, could be accommodated to a more profitable location or be spent on unique forms of advertising in order to boost sales. Although there will be closing sales associated with the closing of the Boston store, such as repairs and having to finance a broker to sell the property.

In order to compensate for the lost store, the company should establish an online website where people can buy clothes. By doing so, it negates the price of leasing outbuilding and having to pay for maintenance costs. The costs needed to pay for the store can be used towards maintaining the website and buying the servers needed. Another benefit of having an online store is that less money will need to be spent on an inventory because the orders made by the consumers can be directly sent to the suppliers, thus they do not need to have pre-supplied stocks like they do in real stores. Although, some repercussions are present if an online market were to be started. In order to make the operation successful, Lynn's Kids needs to outsource the delivery of products to an external company, which requires a substantial amount of money. A place is needed to store inventory, considering a store is not present to do so. These external costs can be adjusted for by gaining liquidated assets from the sold Boston Store.

Suggestion #3: Promote Social Media Marketing

Advertising takes up a large sum of the company's operating expenses and shall be something to be cut if Lynn wants her business to thrive. Social Media Marketing is advisable, as most platforms are free to use and are open to a diverse audience. Big social companies such as Facebook, Instagram, and Twitter are all websites that have been proven to generate financial success, as given in the study provided in tandem to the report. Lynn's Kids spent $80,000 dollars on advertising two years ago, meaning these funds could have been used to do more effective forms of advertising. A study titled <u>Effectiveness of Digital Advertising</u> by Pooja Jain, Muskan Karamchandani, and Anubhuti Jain published in Advances in Economics and Business Management journal claims that "Online advertising is really helpful and a great opportunity provider for new entrants and marketer." The expenses of social media marketing is almost close to none because the accounts that are provided by the social media companies are free. Professionals photographers and graphic designers might need to be hired in order to create advertisements that will entice the public to come shop at Lynn's. It is clearly a better option than physical advertising, especially in the 21st century. Although there are some imminent risks with social media marketing. The probability of bad publicity rises significantly because public opinion plays a very big role in it. It is very volatile and if previous employers or customers decide to write bad reviews, it can spread exponentially. In addition to this, concentrating resources on social media marketing can take a long time to get a return on investments. For example, it takes a lot of time to grow a social media account to the point where it can reach a variety of potential customers.

FINAL RECOMMENDATION

Based on the current intel, we recommend that Lynn's Kids should close down its location in Boston, continue operations with social media marketing, and depending on the condition of the market/level of interest rate, partake in equity financing. Many factors including the decrease in total assets, a sharp decline in the current ratio, a negative net working capital, and a spiking line of credit contribute to support this decision. Closing down the Boston store will terminate the lease and allow Lynn to allocate the funds used for advertising that location for other, more important purposes. Sales should be monitored in order to correct the abnormally low quick ratio, and social media marketing will help advertise the brand without costing the company much. Because the quick and current ratios have sharp declines over the years, there is evidence that the company has poor asset management and should follow the given advice. Other opportunities to change the course of the business would be starting an online marketplace where inventory would be reduced and there would be easier access for Lynn's intended audience to purchase products. This would increase sales without sacrificing much money from the business, as well as giving international customers the opportunity to buy from the business. If Lynn's Kids follows the given advice, the financial outlook for the near future is optimistic and the company can start to run the industry.