Analysing Financial Information 2.13

Users of Financial Information

- **Management**
  - To identify any changes, good or bad, since last year. They are looking at the firm's performance
- **Shareholders**
  - Has the company made a big profit? Will they receive a good dividend
- **The Bank**
  - To see if loans will be repaid
- **The Workers**
  - To see if their jobs are secure
- **Creditors**
  - To see if they will be repaid

Financial Analysis

- Liquidity Ratios
  - Liquidity measures a firm’s ability to pay it’s bills when they are due
  - <u>Current Ratio</u>
    - Current Assets/Current Liabilities
    - Atleast 2:1 is ideal
  - <u>Acid Test Ratio</u>
    - (Current Assets minus closing stock)/Current Liabilities
    - At least 1:1 is the ideal ratio
    - Closing stock is deducted because stock is not readily convertible into cash
  - To improve liquidity a firm needs to raise cash. It may do this by
    - Selling a fixed assets
    - Taking out a long term loan
    - Selling shares in the business

Financial Analysis

- Profitability
  - Gross Profit Margin
    - $\frac{\text{Gross Profit}}{\text{Sales}} \times \frac{100}{1}$
    - The higher the gross profit margin the better. The firm will be able to pay the expenses of running the business
    - Tells us the percentage of each euro of sales that is returned to the business in Gross Profit (Profit from the buying and selling activities of the business. Profit before expenses)
    - A fall in gross profit margin could be due to:
      - Stock losses due to theft
      - Failure to pass on increased costs of purchases
      - Reduction in selling price due to competition
    - Can be improved by
      - Increasing selling price
      - Finding a new, cheaper suppliers for stock

Ratio Analysis

- Profitability Ratios
  - Net Profit Margin
    - $\frac{\text{Net Profit}}{\text{Sales}} \times \frac{100}{1}$
    - The higher the net profit margin the better.
    - Tells us the percentage of each euro of sales that is returned to the business in Net Profit (Profit after expenses have been deducted)
    - A fall in net profit margin could be due to:
      - Increase in Business Expenses
    - Can be improved by
      - Making cut backs (eg wages)
      - Finding new , cheaper suppliers for Light & Heat etc

Ratio Analysis

- Profitability Ratios
  - Return on Investment/Return on Capital Employed
    - $\frac{\text{Net Profit}}{\text{Capital Employed}} \times \frac{100}{1}$

    Shows the business and shareholders how much the business is making on the investment. Can be compared with a banks to see if return is better

Financial Analysis

- Activity Ratios
  - Stock Turnover
    - <u>Cost of Sales</u>

    Average Stock (opening + closing stock divided by two)

    - Answer given in times
    - The higher the better because the firm is “turning over” its stock more often

Solvency

- A business is solvent if its total assets (current and fixed) are greater than its external debt (Current Liabilities and Long term loans)
- The opposite is “insolvent”. This is when a business owes more than it can repay and it forced to close.

Overtrading

- This occurs when a business is run without sufficient working capital.
- Current Liabilities are greater than Current Assets.
- The business either owes, or is owed, too much money and it cannot survive

Stock Control

Too much Stock

- If it is perishable it may go off
- May lead to over trading (too little working capital)
- Increased storage and insurance costs
- Not easily converted into cash
- May depreciate in value

Too little Stock

- May lose sales
- Damage the reputation

Stock Control

- Stock Taking
  - Where a business completes a count of all stock it owns
- Reasons for Stock Taking
  - To calculate closing stock for the financial year
  - To identify damaged or obsolete stock
  - To identify is stock theft has been happening

Limitations of Financial Information

- Does not show customer loyalty
- It does not show staff morale (is there industrial unrest?)
- Does not provide key information about the target market
- Does not provide information about the economic/business climate
- Fixed assets may be over valued
- Key staff may have left the business
- Future Trends and changes in fashion are not estimated