# FINANCIAL STATEMENT ANALYSIS

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# Answers for Practice Questions



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# Common Size Financial Statements

## Q01

Prepare the Common Size Financials and analysis report for a potential investor on Nawaloka Hospitals Corporation PLC and Durdans Hospitals PLC for the Year ended 31/3/20X9







# Common Size – SFP @ 31/3/X9

| Rs.Mn | Nawaloka | Durdans |
|---|---|---|
| Non-Current Assets | | |
| Property Plant and Equipment | 86% | 79% |
| Other Non-Current Assets | 0.1% | 1% |
| Total Non-Current Assets | 86% | 80% |
| Current Assets | | |
| Inventory | 3% | 4% |
| Trade and Other Receivables | 8% | 4% |
| Other Financial Assets | 2% | 7% |
| Cash and Cash Equivalents | 1% | 5% |
| Total Current Assets | 14% | 20% |
| Total Assets | 100% | 100% |

| Rs.Mn | Nawaloka | Durdans |
|---|---|---|
| Equity | | |
| Stated Capital | 7% | 10% |
| Other Components of Equity | 7% | 23% |
| Retained Earnings | 8% | 25% |
| Total Equity | 22% | 58% |
| Non-Current Liabilities | | |
| Interest Bearing Borrowings | 39% | 7% |
| Employee Benefits | 2% | 3% |
| Deferred Tax Liabilities | 6% | 8% |
| Total Non-Current Liabilities | 47% | 18% |
| Current Liabilities | | |
| Trade and Other Payables | 10% | 6% |
| Bank Overdraft | 10% | 9% |
| Interest Bearing Borrowings | 11% | 3% |
| Total Current Liabilities | 31% | 17% |
| Total Liabilities | 100% | 100% |

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# Common Size Profit or Loss F/T/Y/E 31/3/20X9

| Rs.Mn | Nawaloka | Durdans |
|---|---|---|
| Revenue | 100% | 100% |
| Cost of Service | (50%) | (38%) |
| Gross Profit | 50% | 62% |
| Other Income | 4% | 2% |
| Admin Expenses | (43%) | (43%) |
| Other Expenses | (1%) | (9%) |
| Finance Cost | (15%) | (2%) |
| Profit Before Tax | (4%) | 9% |
| Tax | (2%) | (3%) |
| Profit After Tax | (6%) | 6% |

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To - Board of Directors
From - Financial Consultant
Subject - Common Size Financials Analysis of Nawaloka and Durdens Hospitals PLC for the Year ended 31/3/20X9
Date - 05/6/20X2

Hospitals are generally an asset heavy business as the operation requires significant requirement of fixed assets. The situation is clear as both entities are having nearly 80% of their assets as fixed assets. However, Nawaloka is having comparatively higher fixed assets may be as a result of new constructions they made recently. Same point is proved by having 50% of a debt position compared to 10% in Durdens.
In terms of trade and other receivables despite hospitals being a cash business Nawaloka is having 2 times higher trade receivables. This may indicate comparatively higher recoverability risk.
Durdens is having 4 times higher short-term investments, cash and cash equivalents. Therefore, Durdens is at a better liquidity position than Nawaloka.
The equity analysis reflects Nawaloka has comparatively lesser equity position as Durdens is having 3 times higher revaluation gains and retained profits. As explained above with the asset purchases & constructions Nawaloka is having higher debt position creating higher solvency risk.

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Even the trade and other payables are higher in Nawaloka, which might create relationship issues with doctors and other suppliers.

The cost of service is 32% high in Nawaloka. This may be due to higher doctor charges and depreciation from fairly new assets compared to aged assets in Durdens. The operational inefficiencies in Nawaloka has directly impacted the gross profits. The finance cost is 7.5 times higher in Nawaloka due to excessive debts taken at a higher interest rate due to high risk profile in company compared to other entities in industry. However, Durdens is having higher other expenses which may be an one off expense.

Overall the profitability reflects Nawaloka at a loss of 6% compared to Durdens having a profit of 6%.

Conclusion
Durdens is a better investment than Nawaloka

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# Profitability Ratios

## Q02

Prepare a Profitability Ratio analysis report for a potential investor on Kingsbury PLC and Cinnamon Lakeside PLC for the Year ended 31/3/20X9





## SFP @ 31/3/X9

| Rs.Mn | Kingsbury | Lakeside |
|---|---|---|
| Non-Current Assets | | |
| Property Plant and Equipment | 3,707 | 7,061 |
| Other Non-Current Assets | - | 7 |
| Total Non-Current Assets | 3,707 | 7,068 |
| Current Assets | | |
| Inventory | 70 | 36 |
| Trade and Other Receivables | 157 | 594 |
| Other Financial Assets | 124 | 65 |
| Cash and Cash Equivalents | 253 | 51 |
| Total Current Assets | 605 | 746 |
| Total Assets | 4,312 | 7,814 |

| Rs.Mn | Kingsbury | Lakeside |
| --- | --- | --- |
| Equity | | |
| Stated Capital | 836 | 1,113 |
| Other Components of Equity | 826 | 1,528 |
| Retained Earnings | 912 | 3,803 |
| Total Equity | 2,574 | 6,444 |
| Non-Current Liabilities | | |
| Interest Bearing Borrowings | 551 | 33 |
| Employee Benefits | 65 | 142 |
| Deferred Tax Liabilities | 271 | 381 |
| Total Non-Current Liabilities | 887 | 555 |
| Current Liabilities | | |
| Trade and Other Payables | 389 | 576 |
| Bank Overdraft | 71 | 104 |
| Interest Bearing Borrowings | 392 | 133 |
| Total Current Liabilities | 852 | 814 |
| Total Liabilities | 4,312 | 7,814 |

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# Profit or Loss F/T/Y/E 31/3/20X9

| Rs.Mn | Kingsbury | Lakeside |
| --- | --- | --- |
| Revenue | 2,956 | 2,825 |
| Cost of Service | (1,526) | (1,169) |
| Gross Profit | 1,430 | 1,657 |
| Other Income | 9 | 179 |
| Admin Expenses | (1,020) | (692) |
| Marketing Expenses | (151) | (293) |
| Other Expenses | (29) | (269) |
| Finance Cost | (66) | (58) |
| Profit Before Tax | 173 | 524 |
| Tax | (72) | (53) |
| Profit After Tax | 101 | 471 |



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# Q2 Answer

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| Ratios | | Kings | Lake | Variance |
|---|---|---|---|---|
| GP | $\frac{\text{Gross Profits}}{\text{Sales}}$ *100 | = 1,430/2,965 X 100<br>= 48% | = 1,657/2,825 X 100<br>= 59% | -19% |
| OP | $\frac{\text{Operating Profit}}{\text{Sales}}$ *100 | = (173+66)/2,956 X 100<br>= 8.1% | = (524+58)/2,825 X 100<br>= 20.6% | -61% |
| NP | $\frac{\text{PAT}}{\text{Sales}}$ *100 | = 101/2,956 X 100<br>= 3.4% | = 471/2,825 X 100<br>= 16.7% | -79% |

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| | Ratios | Kings | Lake | Variance |
|---|---|---|---|---|
| ROCE | Operating Profit / Capital Employed *100 | =(173+66)/(2,574+551+ 392) X 100<br>= 6.8% | =(524+58)/ (6444+33+133) X 100<br>= 8.8% | -23% |
| ROE | PAT-Pref Dividends / Equity *100 | = 101/2574 X 100<br>= 3.9% | = 471/6,444 X 100<br>= 7.3% | -47% |
| ROA | Operating Profit / Total Assets *100 | =(173+66)/4,312X 100<br>= 5.5% | =(524+58)/7,814 X 100<br>= 7.4% | -26% |

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To - Investors
From - Financial Consultant
Subject - Profitability Ratio Analysis of Kingsbury and Cinnamon Lakeside PLC for the Year ended 31/3/20X9
Date - 24/10/20X2

**Profitability**

Kingsbury is showing a 19% lower gross profit margin than the Lakeside given both entities operate in same industry within closer proximity. Both entities have similar revenue with slightly higher figure in Kingsbury. However, the cost of service in Kingsbury is 31% higher which may be due to higher operating expenses caused by higher cost inefficiencies, waste or lack of controls or higher human resources cost may be. This has a direct impact on bottom line profits.

At operating profits level, Kingsbury is showing further worsen performance of 61% lower profitability. This is mainly due to 47% higher administration cost and absence of other income sources as in Lakeside. Higher admin cost represent the inefficiencies as observed in cost of services. This reduction in operating profit has resulted in lower Return on capital employed by 23% in Kingsbury. Further, it can be observed that Lakeside is having higher capital employed which is mainly coming from equity through retained profit and reserves. A point to note is despite having the higher capital employed, Lakeside has generated a better return on capital employed/

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Further, long-term liabilities are low in Lakeside than Kingsbury. The finance cost vs and ROCE analsyis reveals that both entities finance cost is higher than ROCE. However, Lakeside is having Excessively high finance cost which may be due to a classification error.
Return on assets represent a similar reduction of 26% due to reasons explained under ROCE.

The net profit margin is 79% lower in Kingsbury. Apart from reasons mentioned above it was observed that the finance cost is 14% higher in Kingsbury due to higher interest-bearing borrowings. Further, the tax expense is 310% higher, which may be due to either prior year adjustments or deferred tax expenses.
The return on equity is 47% lower due to lower profitability in Kingsbury.

Conclusion
Lakeside has a better profitability than Kingsbury.

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# Q03

Prepare an analysis on investor ratios for Three Acre Farms PLC and Bairaha Farms PLC on Latest Financials available.



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# Profit or Loss

| Rs.Mn | Bairaha | Three Acre |
|---|---|---|
| Revenue | 4,723 | 2,626 |
| Cost of Sales | (3,648) | (1,911) |
| Gross Profit | 1,076 | 715 |
| Other Income | 74 | 218 |
| Admin Expenses | (263) | (12) |
| Distribution Expenses | (302) | (25) |
| Finance Cost | (76) | - |
| Profit Before Tax | 510 | 896 |
| Tax | (97) | (147) |
| Profit After Tax | 413 | 749 |





# SFP

| Rs.Mn | Bairaha | Three Acre |
|---|---|---|
| Non-Current Assets | | |
| Property Plant and Equipment | 2,196 | 1,397 |
| Biological Assets | 52 | 556 |
| Investments | 920 | 0 |
| Total Non-Current Assets | 3,168 | 1,953 |
| Current Assets | | |
| Biological Assets | 478 | 18 |
| Inventory | 216 | 111 |
| Trade and Other Receivables | 631 | 324 |
| Short Term Investments | 39 | 0 |
| Cash and Cash Equivalents | 429 | 1,956 |
| Total Current Assets | 1,792 | 2,410 |
| Total Assets | 4,960 | 4,363 |

| Rs.Mn | Bairaha | Three Acre |
|---|---|---|
| Equity | | |
| Stated Capital | 256 | 626 |
| Other Reserves | 413 | 0 |
| Retained Profits | 3,197 | 3,014 |
| Total Equity | 3,866 | 3,637 |
| Non-Current Liabilities | | |
| Interest Bearing Borrowings | 298 | 0 |
| Employee Benefits | 79 | 22 |
| Deferred Tax Liabilities | 164 | 209 |
| Total Non-Current Liabilities | 541 | 221 |
| Current Liabilities | | |
| Trade and Other Payables | 366 | 495 |
| Interest Bearing Borrowings | 187 | 0 |
| Total Current Liabilities | 553 | 495 |
| Total Liabilities | 4,960 | 4,363 |

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# Other Information required

| Rs.Mn | Bairaha | Three Acre |
|---|---|---|
| Gross Dividend | 112 | 71 |
| Market Price Per Share | 115 | 101 |
| No. of Shares (Mn) | 16 | 24 |

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# Q3 Answer

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| | Ratios | | Bairaha | Three Acres | Variance |
|---|---|---|---|---|---|
| EPS | PAT – Pref Dividend / Weigh. Avg. No of Shares | | 25.8 | 31.2 | -17% |
| Earnings Yield | EPS / MPS | X 100 | 22% | 31% | -29% |
| PE | MPS / EPS | | 4 | 3 | 33% |
| DPS | Gross Dividend / Weigh. Avg. No of Shares | | 7 | 3 | 133% |
| Dividends Yield | DPS / MPS | X 100 | 6% | 3% | 100% |

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| | Ratios | | Bairaha | Three Acres | Variance |
|---|---|---|---|---|---|
| Dividend Cover | EPS / DPS | | 3.7 | 10.4 | -64% |
| Dividend Payout | DPS / EPS | X 100 | 27% | 10% | 170% |
| Book Value per Share | BV of NA / Weighted Avg No. of Shares | | 242 | 152 | 59% |
| Market Value to Book Value | MPS / BPS | | 0.48 | 0.66 | -27% |





To - Investors
From - Financial Consultant
Subject - Investor Ratio Analysis of Bairaha and Three Acre Farms PLC for the Year ended 31/3/2019
Date - 06/02/2021

Investor

The earnings related ratios reflect that Bairaha is having lower earnings than Three acres farms. The earnings per share, ratio is 17% lower and Earnings yield is 29% lower. This may be due to the fact that Three Acre being a subsidiary of a larger group Prima, certain admin, selling expenses borne by parent and finance being provided by parent. Therefore, the potential investors might consider Three Acres as a better investment which provides more return to the investors. The lower profitability in Bairaha is mainly due to 66% lower other income and excessively high admin, distribution and finance expenses. It can be observed that Three acre does not have any loans, while Bairaha is having a significant loan figure.

Overall in terms of earnings Three Acre is generating better profits to the shareholders despite the market share is lower. As a result, the investors will be motivated to invest in the company as it has better growth potential with high retained earnings and absence of any loans.

The dividend per share is 133% higher in Bairaha, resulting in 100% higher dividend yield and 170% higher dividend payout. This reflect the company is encouraging the dividend oriented investors. However, higher dividend will impact business growth.

In both entities the book value to market value ratios are lower indicating possible impairments and off balance sheet liabilities. Further, on a another perspective, both shares may be understated creating a valuable business opportunity as well. Comparatively, Bairaha seemed to be a riskier investment.

Conclusion
Depending on the risk appetite, Three Acre is recommended for a long-term investment and Bairaha is recommended for a dividend expected short-term investment.

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# Q04

Prepare an analysis on liquidity and leverage ratios for John Keells Holdings PLC and Hayleys PLC for the year ended 31st March 20X9.

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# Profit or Loss F/T/Y/E 31/03/20X9

| Rs.Mn | JKH | Hayleys |
|---|---|---|
| Revenue | 135,456 | 219,182 |
| Cost of Sales | (107,669) | (170,207) |
| Gross Profit | 27,787 | 48,975 |
| Other Income | 6,978 | 2,786 |
| Admin Expenses | (12,411) | (25,188) |
| Distribution Expenses | (5,939) | (9,889) |
| Other Expenses | (7,128) | (405) |
| Finance Cost | (2,722) | (13,369) |
| Finance Income | 12,051 | 2,566 |
| Profit Before Tax | 18,616 | 5,476 |
| Tax | (2,378) | (2,726) |
| Profit After Tax | 16,237 | 2,750 |







## SFP @ 31/03/20X9

| Rs.Mn | JKH | Hayleys |
|---|---|---|
| Non-Current Assets | | |
| Property Plant and Equipment | 126,086 | 89,343 |
| Intangible Assets | 3,406 | 14,174 |
| Investments | 60,355 | 2,226 |
| Other Non-Current Assets | 78,528 | 15,024 |
| Total Non-Current Assets | 268,375 | 120,767 |
| Current Assets | | |
| Inventory | 9,547 | 39,743 |
| Trade and Other Receivables | 14,421 | 55,241 |
| Other Non-Financial Assets | 5,742 | 3,160 |
| Short Term Investments | 52,757 | 3,685 |
| Cash and Cash Equivalents | 12,955 | 8,971 |
| Total Current Assets | 95,421 | 110,980 |
| Total Assets | 363,796 | 231,747 |

## SFP 31/03/20X9

| Rs.Mn | JKH | Hayleys |
|---|---|---|
| Equity | | |
| Stated Capital | 62,806 | 1,575 |
| Other Reserves | 84,718 | 45,345 |
| Retained Profits | 82,834 | 14,958 |
| Total Equity | 230,358 | 61,878 |
| Non-Current Liabilities | | |
| Interest Bearing Borrowings | 21,277 | 39,662 |
| Insurance Contract Liabilities | 32,833 | - |
| Employee Benefits | 2,086 | 8,500 |
| Other Non-Current Liabilities | 11,929 | 4,419 |
| Deferred Tax Liabilities | 7,757 | 5,191 |
| Total Non-Current Liabilities | 75,881 | 57,772 |
| Current Liabilities | | |
| Trade and Other Payables | 19,745 | 28,540 |
| Other Current Liabilities | 3,072 | 9,165 |
| Income Tax Payable | 1,505 | 769 |
| Interest Bearing Borrowings | 33,237 | 73,622 |
| Total Current Liabilities | 57,557 | 112,096 |
| Total Liabilities | 363,796 | 231,747 |

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# Q4 Answer

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| Ratios | | JKH | Hayleys | % |
|---|---|---|---|---|
| Current | Current Assets / Current Liabilities | 1.7 | 0.99 | -42% |
| Quick Asset | Quick Assets / Current Liabilities | 1.5 | 0.64 | -57% |
| Cash | Cash and Cash Equivalents / Current Liabilities | 0.23 | 0.08 | -65% |

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| Ratios | | | JKH | Hayleys | % |
|---|---|---|---|---|---|
| Total Debt | Total Assets – Equity / Total Assets | X 100 | 37% | 73% | 97% |
| Gearing | Interest Bearing Debt / Equity + Interest Bearing Debt | X 100 | 19% | 65% | 242% |
| Interest Cover | Operating Profit / Interest Expense | | 3.4 | 1.2 | -65% |

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To - Investors
From - Financial Consultant
Subject - Liquidity and Leverage Ratio Analysis of Hayley's and JKH PLC for the Year ended 31/3/20X9
Date - 07/11/20X2

**Liquidity**

The current ratio, quick asset ratio and cash ratio of Hayley's is 42%, 57% and 65% lower than JKH. This shows that the liquidity position of Hayley's is comparatively weaker and getting worsen when it comes to highly liquid asset.
The main reasons may be, the 95% higher current liabilities in Hayley's. 66% of those current liabilities include current portion of long term loans. This shows that the company is overly burdened with debt liabilities and significant portion of short term funds are utilized to settle these liabilities. Other main liability trade payables which consist of 25% of the current liabilities and which is 45% higher than JKH. This may indicate lagged trade payables which might incur relationship issues in future.
36% of the total current assets in Hayley's is inventory, and which is 274% higher than JKH. Inventory being a less liquid asset with impairment risk may negatively impact liquidity position

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Further, 283% higher trade receivables indicate significantly high amount of money being tied up as receivable causing impairment risks.
Another fact to observe is that 69% of the total current assets of JKH is in the form of short term investments and cash. This shows a strong liquidity position opposed to Hayley's.

**Leverage**

The total debt ratio and gearing ratio are 97% and 242% higher in Hayley's. This indicate that Hayley's is a highly geared entity facing higher risk of solvency, earnings pressure through interest and ability of obtain further loans. This is mainly due to Hayley's obtaining heavy loans compared to JKH. Further, based on profitability it may conclude that the internal funding such as positive operation cash flows may be supporting JKH to expand business than Hayley's.
The interest cover ratio is 82% lower in Hayley's. This is mainly due to 391% higher finance cost and lower profitability caused by higher cost of sales, admin and sales expenses.
Thus, after paying for interest JKH is having 239% higher profit. Therefore, Hayley's is having higher solvency and risk of obtaining further loans.

**Conclusion**

JKH is better in terms of both liquidity and leverage

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# Efficiency Ratios

Q05

Prepare a report analyzing efficiency ratios of Kegalle Plantations PLC and Namunukula Plantations PLC for the Year ended 31/3/20X9

Assume – *All Inventory to be finished goods*







## Profit or Loss

| Rs.Mn | Kegalle | Namunukula |
|---|---|---|
| Revenue | 2,422 | 2,414 |
| Cost of Sales | (2,310) | (2,078) |
| Gross Profit | 112 | 336 |
| Other Income | 589 | 176 |
| Admin Expenses | (83) | (148) |
| Finance Cost | (285) | (65) |
| Profit Before Tax | 333 | 300 |
| Tax | 65 | (44) |
| Profit After Tax | 398 | 256 |

# SFP

| Rs.Mn | Kegalle | Namunukula |
|---|---|---|
| Non-Current Assets | | |
| Property Plant and Equipment | 480 | 864 |
| Biological Assets | 2,567 | 2,837 |
| Financial Assets | 1,490 | 134 |
| Total Non-Current Assets | 4,537 | 3,836 |
| Current Assets | | |
| Inventory | 354 | 266 |
| Trade Receivables | 256 | 56 |
| Other Receivables | 186 | 130 |
| Short-Term Investments | 2,611 | 250 |
| Cash and Cash Equivalents | 17 | 22 |
| Total Current Assets | 3,425 | 725 |
| Total Assets | 7,962 | 4,561 |

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| | | |
|---|---|---|
| Equity | | |
| Stated Capital | 250 | 350 |
| Other Reserves | 306 | - |
| Retained Profit | 2,809 | 2,313 |
| Total Equity | 3,364 | 2,664 |
| Non-Current Liabilities | | |
| Interest Bearing Borrowings | 772 | 213 |
| Deferred Income | 213 | 132 |
| Employee Benefits | 489 | 551 |
| Deferred Tax Liabilities | 145 | 255 |
| Total Non-Current Liabilities | 1,619 | 1,150 |
| Current Liabilities | | |
| Trade Payables | 252 | 404 |
| Other Payables | 116 | 252 |
| Bank Overdraft | 1,957 | 26 |
| Interest Bearing Borrowings | 656 | 65 |
| Total Current Liabilities | 2,979 | 747 |
| Total Equity and Liabilities | 7,962 | 4,561 |

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# Q05 Answer





| | Ratios | KEG | NAM | Var % |
|---|---|---|---|---|
| TA T/O | Sales / Total Assets | 0.30 | 0.53 | -43% |
| FA T/O | Sales / Fixed Assets | 0.53 | 0.63 | -16% |
| WC T/O | Sales / Working Capital | 5.43 | -109.7 | -105% |
| Inventory T/O | COS / Inventory | 6.53 | 7.81 | -16% |
| Inventory Holding Days | 365 / RM T/O | 56 | 47 | 19% |

| Ratios | | KEG | NAM | Var % |
|---|---|---|---|---|
| Debtor T/O | Credit Sales / Debtors | 9.46 | 43 | -78% |
| Debt Collection Days | 365 / Debtor T/O | 39 | 9 | 333% |
| Creditor T/O | Credit Purchases or COS / Creditors | 9.17 | 5.14 | 78% |
| Credit Settlement Days | 365 / Creditors T/O | 40 | 71 | -44% |
| Operating Cycle | Inventory Holding Days+ Debt Collection Period | 95 | 56 | 69% |
| Cash Cycle | Operating Cycle – Credit Settlement Days | 55 | -15 | -467% |

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To - Board of Directors
From - Financial Consultant
Subject - Efficiency ratio analysis of Namunukula and Kegalle Plantations PLCs for the year ended 31st March 20X9
Date - 18/11/20X2

Efficiency

The total asset turnover and the fixed asset turnover of Kegalle Plantations is 43% and 16% lower than Namunukula. This may indicate an underutilization of assets and a comparatively weaker maintenance of assets to generate better revenue.

It can be observed that 96% of the total fixed assets of Namunukula represent the property plant and equipment and biological assets, while it's only 70% in Kegalle. The reason is that Kegalle has invested more on financial assets as 51% of the total assets of Kegalle represents the financial assets to the value of Rs.4Bn. It's only 8% in Namunukula. These investments have generated Rs.589Mn other income whereas the plantation business alone has generated a gross profit of Rs.112Mn. This shows that Kegalle may have shifted their business motive from plantation to investments. Thus, the excess money generated are being invested in financial assets than investing in the plantation business.

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The working capital cycle of Namunukula is subject to negativity effect as Namunukula is having a negative working capital of Rs.22Mn compared to Rs.446Mn working capital in Kegalle. If we ignore the negativity impact, the working capital gap is lower in Namunukula, creating a better working capital turnover. The main reason for Kegalle to have a higher current assets is the short-term investments to the value Rs.2.6Bn, and on the other side Kegalle has a higher bank overdraft facility of nearly Rs.2Bn. Comparatively, Namunukula has Rs.250Mn worth of investments and only Rs.26Mn worth bank overdrafts.

The inventory holding period is 19% higher in Kegalle. As a result, the inventory will remain additional 09 days in Kegalle. This will increase the risk of perishability, obsolescence, impaired inventory, cash tied up in inventory etc.. Similarly, the debt collection period of Kegalle is 30 days higher in Kegalle. This shows that Kegalle, comparatively has a weaker debt recovery process. This will expose them for an increased risk of impaired debtors and cash tied up in debtors.

The credit settlement period shows Namunukula to have a lagged period of 71 days compared to 40 days in Kegalle. Lagged credit settlement period is beneficial from the liquidity point of view, this may impact the relationships with the suppliers of Namunukula.

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The operating cycle shows 69% higher days in Kegalle caused with higher inventory holding days and debt collection periods in Kegalle. As a result, the cash cycle shows 55 days gap to be covered by Bank overdraft. However, the cash cycle of Namunukula is negative, indicating a minimum requirement for a bank overdraft.

Conclusion

It can be observed that comparatively Namunukula is having a better efficiency compared to Kegalle.

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# Q06







The following financial statements of Mean PLC are given to you.

Profit or Loss F/T/Y/E 31 December

| Rs.000 | 2019 | 2018 |
|---|---|---|
| Revenue | 386,175 | 304,754 |
| Cost of Sales | (266,366) | (254,403) |
| Gross Profit | 119,809 | 50,351 |
| Other Income | 445 | 11,590 |
| Admin Expenses | (60,258) | (81,307) |
| Distribution Expenses | (34,605) | (38,256) |
| Finance Cost | (23,007) | (21,381) |
| Profit Before Tax | 2,384 | (79,003) |
| Tax | (3,286) | - |
| Profit After Tax | (902) | (79,003) |
| Other Comprehensive Income | 287 | 639 |
| Total Comprehensive Income | (615) | (78,364) |

## SFP as at 31 December

| Rs.000 | 2019/12/31 | 2018/12/31 |
|---|---|---|
| Non-Current Assets | | |
| Property, plant and equipment | 38,429 | 46,803 |
| Investments | 755 | 584 |
| Total Non-Current Assets | 39,184 | 47,387 |
| Current Assets | | |
| Inventories | 146,131 | 168,722 |
| Trade and other receivables | 58,554 | 63,834 |
| Advances and prepayments | 1,763 | 2,089 |
| Cash and cash equivalents | 495 | 559 |
| Total Current Assets | 206,943 | 235,204 |
| Total Assets | 246,127 | 282,591 |

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## SFP as at 31 December

| Rs.000 | 2019 | 2018 |
|---|---|---|
| Equity | | |
| Stated capital | 109,187 | 109,187 |
| Accumulated losses | (293,475) | (292,860) |
| Total equity | (184,288) | (183,673) |
| Non-Current Liabilities | | |
| Interest bearing borrowings | 132,340 | 127,160 |
| Retirement benefit obligations | 1,225 | 1,180 |
| | 133,565 | 128,340 |
| Current Liabilities | | |
| Trade and other payables | 215,733 | 251,885 |
| Interest bearing borrowings | 81,117 | 86,039 |
| | 296,850 | 337,924 |
| Total Liabilities | 246,127 | 282,591 |

50

Required:

Analyze the comparative financial performance and financial position of Mean PLC in terms of its capital employed, profit margins, assets utilization, interest cover and gearing for the year ended 31 December 2019. (10 Marks)







# Q06 Answer

| | | 2019 | 2018 | Var |
|---|---|---|---|---|
| **ROCE** | EBIT / Capital Employed X 100 | =(2,384+23,007)/ (-184,288+132,340+ 81,117) X 100 =87% | =(-79,003+21,381)/ (-183,673+127,160+ 86,039) X 100 =195% | |
| **ROE** | PAT – Pref Div / Equity X 100 | =-902/-184,288 X 100 =0.5% | =-79,003/-183,673 X 100 =43% | |

53

| | Ratios | 2019 | 2018 | Var |
|---|---|---|---|---|
| **GP** | GP / Sales X 100 | **31%** | **16.5%** | **88%** |
| **NP** | NP / Sales X 100 | **-0.2%** | **-25.9%** | **-99%** |
| **Inventory Holding Period** | Closing Stock / Cost of Sales X 365 | **200** | **242** | **-17%** |

54

| | Ratios | | 2019 | 2018 | Var |
|---|---|---|---|---|---|
| **Debtor Period** | Closing Debtors / Sales | X 365 | **55** | **76** | **-27%** |
| **Interest Cover** | EBIT / Interest Expense | | **1.1** | **-2.7** | **-59%** |
| **Gearing** | Interest bearing Debt / Interest bearing Debt + Equity | X 100 | **731%** | **722%** | **1%** |
| **Total Debt** | Total Debt / Total Assets | X 100 | **175%** | **165%** | **6%** |

55

To – Board of Directors
From - Financial Consultant
Subject – Financial Performance and Financial Position analysis of Mean PLC
Date – 22/11/2020

The following report consist of brief analysis on Financial Performance and Financial Position of Mean PLC.

Profitability

100% increase in gross profit to sales can be observed. It can be noted that such an increase is particularly due to increase in sales by 26% compared to cost of sales increase by around 5%. Therefore, it can be assumed that the company has increased it's sales price by a significant amount.
If the selling price increase is common to industry as a whole or if switching cost is higher, it may be beneficial as customer's may not switch to a competitor. However, if the increase is done by Mean PLC by it's own to overcome the losses, and if the switching cost to a customer is trivial, competitors may capitalize this opportunity.

56

Net Loss Margin has been reduced by 99%. This is mainly due to increased gross profits explained above, drop in administration expenses by 25% and reduction in marketing expenses by 10%.
The expense reduction reflects company's attempts to reduce it's overheads to reduce the losses. Company may has reduced number of administration and sales staff and implemented cost reduction strategies and controls.
As a result the losses have reduced. However, reduction of sales and distribution expenses might impact the future sales of the company.

The company's equity capital is a negative balance in both financial years due to prior year losses made. Therefore, the ROCE and ROE ratios are subject to negativity effect which is a limitation in financial statement analysis.
It can be noted that Mean PLC is at a serious loss of capital situation the equity balance is lesser than 50% of the stated capital as per Section 220 of Companies Act.
However, it can be noted that the company is showing a progress compared to year 2013 in terms of profitability as explained above, as a result the ratios have improved slightly.

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Efficiency
Inventory holding period is generally high in Mean PLC, therefore the risk of impairment, slow moving, non moving inventory risk, cash tied up in inventory and obsolescence risk is generally high.
However, it has been reduced by 21% compared to last year. The reason for this reduction is mainly due to 13% reduction in inventory. It may be due to company's attempts to increase the efficiency in warehouse management and keeping lesser inventory with the reduced sales volume due to current high price low volume strategy.
Debt collection period has reduced by 39%. This is as a result of reduction of debtor balance by 8% while revenue has increased by 26%. It may be due to strengthened debt recoveries in the company. Aggressive recoveries will be beneficial in terms of reducing the impairment risk, and in cashflow management. However, it may affect the relationships with customers.

Leverage
The interest cover has increased from negative situation to positive situation which reflects a good sign in terms of leverage. This is particularly due to increased earnings.
Yet the earnings are merely enough to pay the interest, Therefore, company is continuing overall net loss situation.

58

The gearing ratio which reflects debt to equity balance shows a highly geared position which has slightly increased compared to prior year.
The total debt ratio which reflects how total assets were financed using debt has increased by 6%.
The interest bearing debt balance remains almost the same. Therefore, may be company has not settled the debt during the financial year or has obtained further loan facility to repay the existing loans and to cover the losses.

As a result solvency risk and risk of obtaining further loans has significantly increased. Continuing this situation may lead to a going concern risk.

Conclusion
Mean PLC reflects signs of improvement in profitability due to short term pricing adjustments which might not last long, and working capital management efficiency has increased due to deliberate attempt to realize cashflows. However, company is at a serious capital loss and highly leveraged debt position which indicates probable going concern risk.

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# Q07



60

Computer Tech PLC (CT) is in the business of selling computers and related accessories. The extracted income statements are provided below:

Profit or Loss F/T/Y/E 31 March

| Rs.000 | 2019 | 2018 |
|---|---|---|
| Revenue | 645,311 | 576,171 |
| Cost of Sales | (428,815) | (374,510) |
| Gross Profit | 216,496 | 201,661 |
| Admin Expenses | (64,531) | (60,497) |
| Distribution Expenses | (83,890) | (63,378) |
| Operating Profit | 68,075 | 77,786 |
| Finance Cost | (32,265) | (14,404) |
| Profit Before Tax | 35,810 | 63,382 |
| Tax | (16,114) | (18,379) |
| Profit After Tax | 19,696 | 45,003 |

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## Some other Information

| | 2019 | 2018 |
|---|---|---|
| Return on capital employed (ROCE) | 7% | 13% |
| Debt ratio | 32% | 20% |
| Gearing ratio | 54% | 38% |
| Earnings per share (EPS) (Rs.) | 0.26 | 0.60 |
| Market price per share (Rs.) | 28 | 35 |

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Note:
The market interest rate during 2019 was 8% - 11% compared to 11% - 15% in the previous year.
Damith, an investor, expects to make a few equity investments and CT is one entity he has identified for his investment.

Required:
(a)Assess the profitability and solvency of CT, based on the given financial results. (06 marks)
(b) Advise Damith on the limitations of financial statements analysis of CT. (04 marks)



# Q07 (a) Answer

| Ratios | | | 2019 | 2018 | Var % |
|---|---|---|---|---|---|
| GP | GP / Sales | X 100 | =216,496/645,311 X 100 =33.5% | =201,661/576,171X 100 =35% | -5% |
| NP | NP / Sales | X 100 | =19,696/645,311 X 100 =3.05% | =45,003/576,171X 100 =7.8% | -60% |
| Interest Cover | EBIT / Interest Expense | | =68,075/32,265 =2.1 | =77,786/14,404 =5.4 | -61% |

65

To : Mr.Damith
From : Financial Consultant
Subject : Profitability and Solvency analysis of CT PLC
Date : 07/02/2020

Profitability

Gross profit to sales shows a slight decline of 5% as a result of increase in cost of sales by 14.5% than revenue increase by 12%.

As per the above variance in gross profits it can be assumed that revenue increase may be due to a volume increase with marketing efforts such as sales promotions, discount offers, the same is verified by 32% higher distribution expenses. Cost of sale increase may be partly due to volume increase and partly due to manufacturing deficiencies.

Net profit margin has reduced by 160%. The reasons for this situation, other than the increased cost of sales are as follows.

Due to intense competition in technology industry, company may be aggressively promoting the business using various advertising and marketing attempts, as a result the distribution expenses has increased significantly by 32%. Given the revenue increase is only 12%, it can be noted that the marketing strategies may not be effective as expected. The same is confirmed as the increase in distribution expenses is Rs.6mn higher than increase in gross profits.

66

Despite the drop-in market interest rates by 26%, the finance cost has increased by 124%. This may be due to existing loans taken in previous years at higher interest rates and obtaining further loans at low interest rates to capitalize the benefit of reduced interest rates. This position is evident from increase in total debt ratio by 60%.
Effective tax rate has increased by 57%. This may be due to increased disallowable expenses such as marketing expenses or due to under provision of tax expense in the previous year.
The return on capital employed has reduced by 46% as a result of above-mentioned earnings drop and increased debt position. ROCE is lower than the cost of debt which indicates that the company's earnings are not adequate enough satisfy the shareholders.
The reduction in overall profitability will affect in terms of savings to the company and its shareholders which could have either reinvested or distributed among shareholders.

Solvency

The debt financing of assets has increased by 60%. The gearing ratio which reflects the debt to equity balance reflects a highly geared situation in year 2018. Further the adequacy of operating profits to pay the interest has dropped by 61%. This may be due to investments in non-current assets utilizing the benefit of reduction in interest rates. The interest cover has reduced due to excessive interest expense and lower earnings.

67

Though having higher debt position is beneficial for the growth of a company, CT's excessive leveraged position indicates solvency risk, risk of obtaining further loans, risk of servicing the debts.

Conclusion

CT PLC reflects significant reduction in profitability due to ineffective marketing strategies and excessive finance cost. Further the leveraged position has increased significantly due to excessive debts taken. Damith must reconsider his investment in CT.

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# Q07 (b) Answer





Limitations of FSA

Not futuristic

Ratios are based on historical data which does not reflect the future plans of a company, and macro economical changes in industry, country and world. Being a potential investor you must consider such future plans and macro economical changes prior making the investment decision.

Manipulations

Financial statement figures can be manipulated using techniques such as window dressing in terms of leading the collections and lagging the settlement, revenue recognition adjustments and changes in accounting estimates to reflect better liquidity position and profitability. Therefore, ratios may not reflect the true picture of a company. You must make sure the financials are not manipulated, where you can rely on unqualified audit opinions.

Subjectivity

The ratios interpretation may vary from country to country, industry to industry, company to company, individual to individual. Therefore, the analysis points and recommendation comments made are not conclusive, it may vary depending on interpreter and circumstance. Therefore, you must not conclude your decision solely based on these analysis points.

Limitations of FSA

Accounting policies

Accounting policies may vary from entity to entity. Depending on the policy applied financial statement figures and the ratio may be vary. For an example total asset turnover ratio of a cost model based company may be higher than revaluation model based company. Therefore, you must consider difference in accounting policies before making the decision.

71

# Q08

Ashaa Medical PLC is one of the leading health care service providers in Sri Lanka. The table below presents some key ratios of the company with industry averages for the year ended 31 March 2019.



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| | Formula | Company | Industry | Var % |
|---|---|---|---|---|
| Liquidity ratios | | | | |
| Current ratio | Current assets/Current liabilities | 0.7 | 0.9 | -22% |
| Quick ratio | Quick Assets/CL | 0.6 | 0.8 | -25% |
| Working Capital Turnover | Sales/Working Capital | (40.0) | (253.1) | -84% |
| Activity ratios | | | | |
| Total Asset Turnover | Sales/Total assets | 6.6 | 8.5 | -22% |
| Fixed Asset Turnover | Sales /Fixed Assets | 19.6 | 25.1 | -22% |

73

| | Formula | Company | Industry | Var % |
|---|---|---|---|---|
| Profitability ratios | | | | |
| Rate of return on assets | Earnings before taxes / Total assets *100 | 3.7 | 11.1 | -67% |
| Rate of return on equity | Earnings before taxes / Total equity *100 | 47.8 | 48.2 | -1% |
| Coverage ratios | | | | |
| Debt to equity | Total liabilities / Total equity | 11.8 | 10.4 | 13% |
| Interest Cover | Earnings before interest and taxes /interest expense | 1.6 | 4.6 | -65% |

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Required:

(a)Interpret the above ratios of Ashaa Medical PLC with industry averages for the year ended 31 March 2019. (6 marks)

(b) Recommend two (02) measures that Ashaa Medical PLC can use to improve each ratio category. (04 Marks)







# Q08 (a) Answer

To - Board of Directors
From - Financial Consultant
Subject - Ratio analysis of Asha Medical vs Industry
Date - 01/07/2021

The following report consist of brief analysis on profitability, activity, liquidity and coverage ratios of Asha Medical vs Industry averages.

Liquidity Ratios
The adequacy of current assets to service the current liabilities and adequacy of quick assets to service current liabilities are respectively 22% and 25% lower in Asha Medical compared to industry. This may be due to having comparatively higher current liability position in Asha.
Sales to working capital ratio which reflects the efficiency of working capital in producing sales is 84% lower in Asha. This may be due to comparatively lower sales and higher working capital gap in Asha. Industry is maintaining a current assets less current liabilities gap of 0.1 compared to 0.3 in Asha.
Higher liquidity risk will lead to short term solvency concerns, further it may affect the working capital management as well.

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Activity Ratios
Fixed assets to equity reflects how many times fixed assets were generated from equity capital. This ratio is 10% higher in Asha. This reflects excessive fixed assets acquired using debt financing.

The asset turnover and fixed asset turnover ratio which reflect number of times sales were generated from total assets and fixed assets are 22% lower than the industry. Therefore, Asha is not efficiently using it's assets to generate sales.
This may be due to lower sales volume in Asha and or the existence of idle and unnecessary assets or probable overstatement in assets or due to absence of efficient asset maintenance function or Asha may be having fairly new assets compared to industry or Industry may be using operating leased assets compared to purchased or finance leased assets in Asha.

Profitability
Return on assets reflects the earnings generated to both equity and debt capital providers. Asha is having a 67% lower ROA compared to industry. The reason may be the existence of overstated assets position purchased using debt capital, which does not generate sufficient earnings. Continuance of this situation may lead the finance providers to move towards other competitors in Industry which provide better earnings potential.

78

Return on equity reflects how well equity capital is utilized in generating earnings. ROE situation is slightly better in Industry where ratio in both company and industry are nearly around 48%. The ratio is generally high as health care industry is a leveraged industry in general.

Coverage

Industry by nature is highly geared, which means having higher debt capital compared to equity. However, Asha's gearing situation is higher than the industry by 13%. Thus, Asha's reliance on debt financing is comparatively high.

Cash flow to current maturities of long term debt reflects adequacy of operational cash flows to service current portion of loans. This ratio is 7% lower in company compared to industry. This may be due to lower operating cash flows and higher debts position in Asha.

Adequacy of earnings to service the interest payments is measured through interest coverage ratios. Compared to industry, Asha's interest cover is lower by 65%.

Asha is having an excessive debt situation which has lead to increased risk of solvency, risk of obtaining further loans, risk on debt servicing. Though debt capital is required for growth continued excessive debt may lead to a going concern risk.

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Conclusion

Asha is having comparatively unfavorable liquidity position, inefficient asset usage, lower profitability and highly leveraged financial position compared to industry. Therefore, overall Asha needs to improve in all aspects.

80

# Q08 (b) Answer





Liquidity Ratios
- Convert the short term liabilities to long term liabilities through rescheduling
- Dispose or write off slow moving inventories
- Strengthen the collections from debtors if any
- Introduce effective cash flow management mechanisms.
- Dispose idle, unnecessary assets and settle short term liabilities

Activity Ratios
- Consider renting out the equipment than out right purchase
- Conduct an analysis of total assets and identify idle assets, unnecessary assets, impairments and reduce overstatement in assets.
- Implement effective branding strategies to increase sales.
- Strengthen the asset maintenance to ensure effective utilization
- Implement proper evaluation systems for PPE purchase which assess ability to generate revenue, technology, warranties, maintenance etc.
- Eliminate or reduce underutilized or idle assets
- Expand the product mix (Cafeterias, Laboratory services) or geographic coverage (Branches)

Profitability Ratios

- Reduced expenses through techniques such as budgetary control, Kaizen, Lean, TQM etc.
- Increase bargaining power to demand lower costs for procurements
- Reduce operating expenses through controls and engaging the skilled labor and latest technology
- Implement effective branding strategies to increase sales.
- Change the pricing and product mix to increase revenue

Coverage Ratios

- Existing debt shall be rescheduled at a lower rate and for extended loan periods.
- Funds from disposal of idle assets shall be utilized to settle the existing debt liabilities obtained at higher rates.
- Increase earnings through sales and cost reductions.

83



# Q09



84

(a) It has been suggested that ratio analysis is not necessarily the best way of assessing the performance of a company.

Required

List two limitations of using accounting ratios in the appraisal of financial performance (02 Marks)

(b) Below are the financial ratios for the year ended 31 March 2019 for Decimal (Pvt) Ltd, a company engaged in the buying and shipment of agricultural products. The ratios for the industry are also provided.



| | Decimal | Industry Average |
|---|---|---|
| Quick ratio | 0.52 : 1 | 0.84 : 1 |
| Current ratio | 1.20 : 1 | 1.80 : 1 |
| Debtor Collection Period | 46 Days | 41 Days |
| Inventory Holding Period | 58 Days | 48 Days |
| Price-Earnings Ratio | 1.4 times | 3.4 times |
| Gross Profit Margin | 18% | 28% |
| Net Profit Margin | 8% | 12.8% |
| Return on Capital Employed | 28% | 14% |

Required

Prepare a memo to the shareholders of Decimal (Pvt) Ltd assessing its performance in comparison with the industry average under profitability, liquidity and shareholder's investment (08 Marks)

# Q09 (a) Answer





# Limitations of FSA

- Historical
- Subjectivity
- Only Monetary
- Negativity Effect
- Inflation Ignored
- Absence of Standard
- Differences in Acc. Policies
- Financial Position is a Snap Shot
- Manipulations (Window Dressing, Changes in Ac. Estimates etc.)

# Q09 (b) Answer





| Formula | Company | Average | Variance % |
|---|---|---|---|
| Quick ratio | 0.52 | 0.84 | -38% |
| Current ratio | 1.2 | 1.8 | -33% |
| Inventory as a percentage of CA | 57% | 53% | |
| Debtor Collection Period | 46 | 41 | 12% |
| Inventory Holding Period | 58 | 48 | 21% |
| Price-Earnings Ratio | 1.4 | 3.4 | -59% |
| Gross Profit Margin | 18% | 28% | -36% |
| Net Profit Margin | 8% | 12.80% | -38% |
| Opex, Fin and Tax exp as a % Sales | 10% | 15.2% | |
| Return on Capital Employed | 28% | 14% | 100% |

To - Board of Directors
From - Financial Consultant
Subject - Profitability, Liquidity and Shareholder’s investment analysis
Date -

Profitability

The gross profit to sales in decimal is 36% lower than industry. This may be due to inefficiencies in Operations or lower pricing strategy to capture a larger market share and to obtain the benefit of economies of scale, the evident by comparatively higher inventory position. As a result the company has lesser gross savings to cover other overheads and to earn a higher net profit.

The net profit to sales ratio is 38% lower than the industry. This may be mainly due to the lower gross margins. Further, it can be noted that Decimal is showing an improvement than the industry in terms of managing the administration, sales overheads, finance cost and tax expenses. As such expenses to sales are 34% lower in Decimal. Thus, it’s can be assumed that Decimal is having economies of scale in administration and sales expenses, and may be Decimal has lower debt capital resulting in lower finance cost. The same is verified by having 100% higher ROCE. Or it can be assumed that compared to Decimal other competitors may be spending on Marketing which has realized a higher sales income than Decimal.

Lower net profits will result in lower savings for shareholders thus lower dividends and lower amount to reinvest in the business.

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ROCE is 100% higher in Decimal. This may be particularly due to lower debt capital in Decimal compared to industry. Having higher ROCE will encourage the investors as they are getting higher return.

Liquidity

The current and quick asset ratios are 33% and 38% lower in Decimal than the industry.

Thus, Decimal’s short term liquidity strength is lower than the industry.

A point to note is that industry is maintaining 53% of inventory to it’s current assets where as in Decimal it’s 56%. Since the industry is Agricultural products having higher inventory will lead to higher impairment risk as the items are perishable. Same risk is evident in 21% higher inventory holding period in Decimal. The debt collection period is 12% higher than industry, thus the risk of debt recoveries, and impairment is comparatively high in Decimal.

Shareholder Investment

The price earning ratio which the investment recovery period is 59% lower in Decimal. Generally the PE ratio reflects the shareholder’s confidence over the investment. Given a lower PE, it can be assumed that Decimal may be a high risky or matured entity and shareholders are expecting short term realization of returns.

92

# Q10







Win Lanka PLC and Sun Lanka PLC are two leading biscuit manufacturing companies. Extracts from the financial statements of each company, for the financial year ended 31 March 2019, are listed in the table below.

| Rs.Mn | Win | Sun |
|---|---|---|
| Earnings before interest and tax | 257 | 274 |
| Earnings available for equity holders | 151 | 113 |
| Total assets | 1,856 | 1,775 |
| Total Debt | 464 | 976 |
| Total Equity | 1,392 | 799 |
| Total Interest | 48 | 117 |
| Total Sales | 5,568 | 5,680 |
| Effective Tax Rate | 28% | 28% |

Required:
(a) Calculate the following ratios for each company for the financial year ended 31 March 2019, based on the available information in the above table.

(i)Operating profit margin
(ii)Net profit margin (after tax)
(iii)Return on equity
(iv)Debt ratio
(v)Interest cover (7 marks)

(b)Discuss the underlying reasons for a comparatively higher net profit margin in Win Lanka PLC and a lower net profit margin in Sun Lanka PLC, based on the ratios computed in (a) above. (3 marks)



95



# Q10 (a) Answer



96

| Ratios | | Win | Sun | Variance |
|---|---|---|---|---|
| Op Margin | $\frac{\text{Operating Profit}}{\text{Sales}} \times 100$ | | | |
| NP | $\frac{\text{PAT}}{\text{Sales}} \times 100$ | | | |
| ROE | $\frac{\text{Equity Attributable to Ord. Shareholders}}{\text{Total Equity}} \times 100$ | | | |
| Total Debt | $\frac{\text{Total Assets - Equity}}{\text{Total Assets}} \times 100$ | | | |
| Interest Cover | $\frac{\text{Operating Profit}}{\text{Interest Expense}}$ | | | |

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# Q11



98

The finance manager of Sepala PLC has calculated following ratios for the financial year ended 31/03/2019.

| | |
|---|---|
| Gross Profit Margin | 33.3% |
| Interest Cover | 3 Times |
| ROE (Profit Att. Ord. Sh./Equity X 100) | 4% |
| Stock Turnover Period (360 days a year) | 90 |
| Debt Collection Period (360 days a year) | 60 |
| Debt : Equity | 12.5% : 87.5% |
| Acid Test | 1.1 Times |
| ROCE | 7.5% |
| EPS | 1.4 |
| P/E | 22 Years |

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99

Financials of Sepala PLC is provided with few blanks

| | |
|---|---|
| Revenue | 3,000,000 |
| Cost of Sales | |
| **Gross Profit** | |
| Admin Expenses | (300,000) |
| Distribution Expenses | |
| Operating Profit | |
| Finance Cost | (100,000) |
| **Profit Before Tax** | 200,000 |
| Tax | |
| **Profit After Tax** | |
| Preference Dividends | |
| **Profits Attributable to Ord Shareholders** | 140,000 |
| Ordinary Dividends | (40,000) |
| **Retained Profit for the Year** | 100,000 |
| **Retained Profit B/F** | 2,400,000 |
| **Retained Profit C/F** | 2,500,000 |

100

| | | | |
|---|---|---|---|
| **Non-Current Assets** | | | |
| **Current Assets** | | | |
| Inventories | | | |
| Trade and other receivables | | | |
| Other Receivables | 100,000 | | |
| Prepayments | 25,000 | | |
| Short-Term Investments | 25,000 | | |
| Cash at Bank | 75,000 | | |
| Cash in Hand | | | |
| **Current Liabilities** | | | |
| Trade Payables | 300,000 | | |
| Bank Overdrafts | 450,000 | | |
| Accrued Expenses | 100,000 | 850,000 | |
| **Working Capital** | | | |
| **Shareholder's Funds** | | | |
| Share Capital | | | |
| Reserves | | | |
| **Non-Current Liabilities** | | | |
| 10% Bank Loan | | | |
| 10% Preference Shares | | 100,000 | |
| | | | |

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Following additional information available

- Nominal value of an ordinary share is Rs.10/-
- Corporate tax rate is 12.5%

Using the ratio knowledge calculate

1. Gross Profit
2. Operating Profit
3. Shareholder's funds
4. Trade receivables



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5. Non-Current Liabilities
6. Current Assets
7. Market price of an ordinary share
8. Inventory
9. 10% bank loan
10. Cash in hand





# Q11 Answer

| | |
|---|---|
| Gross Profit | Gross Profit Margin = Gross Profit/Revenue X 100<br>33 = Gross Profit/3,000,000 X 100<br>0.33 = Gross Profits/3,000,000<br>Gross Profits = 3,000,000/0.33<br>Gross Profits = 1,000,000 |
| Cost of Sales | Gross Profit = Revenue – Cost of Sales<br>1,000,000 = 3,000,000 – Cost of Sales<br>Cost of Sales = 3,000,000 – 1,000,000<br>Cost of Sales = 2,000,000 |
| Operating Profits | Interest Cover = Operating Profit / Interest expense<br>3 = Operating Profit/100,000<br>Operating Profit = 100,000 X 3<br>Operating Profit = 300,000 |

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| | |
|---|---|
| Distribution Expenses | Operating Profit = Gross Profits – Admin Expenses – Distribution Expenses<br>300,000 = 1,000,000 – 300,000– Distribution Expenses<br>Distribution Expenses = 400,000 |
| Tax Expense | Effective Tax Rate = Tax Expense/Profit Before Tax X 100<br>12.5 = Tax Expense/200,000 X 100<br>0.125 = Tax Expense/200,000<br>Tax Expense = 25,000 |
| Profit After Tax | Profit After Tax = Profit Before Tax – Tax Expense<br>Profit After Tax = 200,000 – 25,000<br>Profit After Tax = 175,000 |

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| | |
|---|---|
| Preference Dividends | Preference Dividends = Profit After Tax – Profit Attributable to Shareholders<br>Preference Dividends = 175,000 – 140,000<br>Preference Dividends = 35,000 |
| Equity | Return on Equity = Profit Attributable to Ord. Sh/Equity X 100<br>4 = 140,000/Equity X 100<br>0.04 = 140,000/Equity<br>Equity = 3,500,000 |
| Number of Shares | Earnings Per Share = Profit Attributable to Ordinary Shareholders/Number of Ordinary Shares<br>1.4 = 140,000/Number of Shares<br>Number of Shares = 100,000 |

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| | |
|---|---|
| Share Capital | Share Capital = Number of Shares X Nominal Value Per Share<br>Share Capital = 100,000 X 10<br>Share Capital = 1,000,000 |
| Reserves | Reserves = Equity – Share Capital<br>Reserves = 3,500,000 – 1,000,000<br>Reserves = 2,500,000 |
| Inventory | Inv T'O days = Inv/COS X 360<br>90 = Inv/2,000,000 X 360<br>Inventory = 500,000 |
| Debtors | Debt T'O days = Deb/Sales X 360<br>60 = Deb/3,000,000 X 360<br>Debtors = 500,000 |

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| | |
|---|---|
| Debt | Debt to Equity = Debt : Equity<br>12.5 : 87.5 = Debt : 3,500,000<br>Debt = 500,000 |
| Bank Loan | Bank Loan = Non-Current Liabilities – Preference Share Capital<br>Bank Loan = 500,000 – 100,000<br>Bank Loan = 400,000 |
| Current Assets | Acid Test = (Current Assets – Inventory - Prepayments)/Current Liabilities<br>1.1 = (Current Assets – 500,000 – 25,000)/850,000<br>1.1 X 850,000 = Current Assets – 500,000 – 25,000<br>935,000 = Current Assets -525,000<br>Current Assets = 1,460,000 |

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| | |
|---|---|
| Cash in Hand | Cash in Hand = Current Assets – Inventory – Trade Receivables - Other Receivables – Prepayments and Advances – Short Term Investments – Cash at Bank<br>Cash in Hand = 1,460,000 – 500,000 – 500,000 – 100,000 – 25,000 – 25,000 – 75,000<br>Cash in Hand = 235,000 |
| Working Capital | Working Capital = Current Assets – Current Liabilities<br>Working Capital = 1,460,000 – 850,000<br>Working Capital = 610,000 |
| Non-Current Assets | Non-Current Assets + Working Capital = Equity + Non-Current Liabilities<br>Non-Current Assets = Equity+ Non-Current Liabilities - Working Capital<br>Non-Current Assets = 4,000,000 – 610,000<br>Non-Current Assets = 3,390,000 |

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## Financials of Sepala PLC is provided with few blanks

| | |
|---|---|
| Revenue | 3,000,000 |
| Cost of Sales | (2,000,000) |
| **Gross Profit** | 1,000,000 |
| Admin Expenses | (300,000) |
| Distribution Expenses | (400,000) |
| Operating Profit | 300,000 |
| Finance Cost | (100,000) |
| **Profit Before Tax** | 200,000 |
| Tax | (25,000) |
| **Profit After Tax** | 175,000 |
| Preference Dividends | (35,000) |
| **Profits Attributable to Ord Shareholders** | 140,000 |
| Ordinary Dividends | (40,000) |
| **Retained Profit for the Year** | 100,000 |
| **Retained Profit B/F** | 2,400,000 |
| **Retained Profit C/F** | 2,500,000 |

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| | | | |
|---|---|---|---|
| **Non-Current Assets** | | | 3,390,000 |
| **Current Assets** | | | |
| Inventories | 500,000 | | |
| Trade and other receivables | 500,000 | | |
| Other Receivables | 100,000 | | |
| Prepayments and Advances | 25,000 | | |
| Short-Term Investments | 25,000 | | |
| Cash at Bank | 75,000 | | |
| Cash in Hand | 235,000 | 1,460,000 | |
| **Current Liabilities** | | | |
| Trade Payables | 300,000 | | |
| Bank Overdrafts | 450,000 | | |
| Accrued Expenses | 100,000 | 850,000 | |
| **Working Capital** | | | 610,000 |
| **Shareholder's Funds** | | | |
| Share Capital | | 1,000,000 | |
| Reserves | | 2,500,000 | 3,500,000 |
| **Non-Current Liabilities** | | | |
| 10% Bank Loan | | 400,000 | |
| 10% Preference Shares | | 100,000 | 500,000 |
| | | | 4,000,000 |

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# Q12

Gagana Company is an international airline which flies to destinations all over the world. Gagana Company experienced strong initial growth but in recent periods the company has been criticized for under-investing in its non-current assets. Extracts from Gagana Co's financial statements are provided below.



Statement of Financial Position

| | 31/12/2019 | | 31/12/2018 | |
|---|---|---|---|---|
| | Rs.000 | Rs.000 | Rs.000 | Rs.000 |
| Non-Current Assets | | | | |
| Property Plant and Equipment | 317,000 | | 174,000 | |
| Intangible Assets | 20,000 | 337,000 | 16,000 | 190,000 |
| | | | | |
| Current Assets | | | | |
| Inventory | 580 | | 490 | |
| Trade and Other Receivables | 6,100 | | 6,300 | |
| Cash and Bank | 9,300 | 15,980 | 22,100 | 28,890 |
| Total Assets | | 352,980 | | 218,890 |

## Statement of Profit or Loss and Other Comprehensive Income and Cashflow Statement Extract

| | 2019<br>Rs.000 | 2018<br>Rs.000 |
|---|---|---|
| Revenue | 154,000 | 159,000 |
| Operating Profit | 12,300 | 18,600 |
| Finance Charges | (9,200) | (10,200) |
| Cash Generated from Operations | 18,480 | 24,310 |

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## Statement of Financial Position

| | 31/12/2019 | | 31/12/2018 | |
|---|---|---|---|---|
| | Rs.000 | Rs.000 | Rs.000 | Rs.000 |
| Equity and Liabilities | | | | |
| Equity Shares | 3,000 | | 3,000 | |
| Retained Earnings | 44,100 | | 41,800 | |
| Revaluation Surplus | 145,000 | 192,100 | Nil | 44,800 |
| | | | | |
| Non-Current Liabilities | | | | |
| 6% Loan Notes | 130,960 | 130,960 | 150,400 | 150,400 |
| | | | | |
| Current Liabilities | | | | |
| Trade and Other Payables | 10,480 | | 4,250 | |
| 6% Loan Notes | 19,440 | 29,920 | 19,440 | 23,690 |
| Total Equity and Liabilities | | 352,980 | | 218,890 |

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The following information is also relevant:

(i) Gagana Company had exactly the same flight schedule in 2019 as in 2018, with the overall number of flights and destinations being the same in both years.

(ii) In April 2019, Gagana Company had to renegotiate its licences with five major airports, which led to an increase in the prices Gagana Company had to pay for the right to operate flights there. The licences with ten more major airports are due to expire in April 2020, and Gagana Company is currently in negotiation with these airports.

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Required:

(a) Calculate the following ratios for the years ended 31/12/2019 and 2018:
(i) Operating profit margin;
(ii) Return on capital employed;
(iii) Net asset turnover;
(iv) Current ratio;
(v) Interest cover;
(vi) Gearing (Debt/Equity).
Note: For calculation purposes, all loan notes should be treated as debt. (3 marks)

(b) Comment on the performance and position of Gagana Company for the year ended 31/12/2019. Note: Your answer should highlight any issues which Gagana Company should be considering in the near future.

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# Q12
# Answer
## Each ratio 0.5 marks







| | Ratios | | 2019 | 2018 | Var % |
|---|---|---|---|---|---|
| OP | Operating Profit / Sales | X 100 | = 12,300/154,000 X 100<br>= 7.9% | = 18,600/159,000 X 100<br>= 11.7% | -33% |
| ROCE | Operating Profit / Equity + Long Term Interest Bearing Debt | X 100 | = 12,300/ (192,100+130,960+19,440) X 100<br>= 3.4% | = 18,600/ (44,800+150,400+19,440) X 100<br>= 8.7% | -61% |
| NA T/O | Sales / Equity | | = 154,000/192,100<br>= 0.8 times | = 159,000/44,800<br>= 3.5 times | -77% |

| Ratios | | 2019 | 2018 | Var % |
|---|---|---|---|---|
| Current | Current Assets / Current Liabilities | = 15,980/29,920<br>= 0.53 | = 28,890/23,690<br>= 1.2 | -56% |
| Interest cover | Operating Profit / Interest Expense | = 12,300/9,200<br>= 1.3 times | = 18,600/10,200<br>= 1.8 times | -27% |
| Gearing | Interest Bearing Long Term Debt / Equity | =(130,960+19,440)/<br>192,100<br>=0.78 | =(150,400+19,440)<br>/44,800<br>=3.79 | -79% |

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To - Board of Directors
From - Financial Consultant
Subject - Ratio analysis of Gagana Company for the years ending 31 December 2019 and 2018
Date - 13/11/2020

Profitability

The operating profit margin shows a 33% decline in the current year. Case states that during the year company has renegotiated five major license agreements with airports. As the case states the negotiations have led to increase in costs in return reduced profitability. Further, case states that Gagana maintained the exact same flight schedule. Therefore, if the same volume of passengers used Gagana, ideally there should be an increase in revenue. The reduction of revenue suggests that customers may have shifted to another rival may be due to pricing impact or service quality. Further, renegotiated license agreements may have increased the costs to the air lines as well. A point to note is next year another 10 more license are expected to be expired and this might have further worsening impacts on profitability.

It can be observed that during the year company has done a revaluation exercise resulting in a significantly high revaluation reserve, which is 40% of total assets and 75% of equity. This may have result in an additional depreciation charges depending on the date of revaluation. The depreciation might have impacted on higher expenses to lower profits.

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Profitability
The return on capital employed has been reduced by 61% impacting the capital contributors to Gagana. This is mainly due to reduction in operating profits as explained above and the increase in the capital employed due to revaluation reserve.
The comparison of finance cost vs ROCE states that the finance cost of 6.3% was lower than ROCE in 2018 and in 2019, finance cost has been higher. This indicates that the equity contributors' profits are been utilized for interest payments in year 2019, resulting in negative impact for them.

Efficiency
Gagana was criticized for underinvestment in their non-current assets being an airline. This year a significant increase in non-current assets can be observed mainly due to revaluation reserve. A concern may arrive on authenticity of the revaluation exercise. It can be observed that previous year revaluation reserve is Zero and company is asset heavy and established company. This sudden revaluation reserve indicates a change in accounting policy to satisfy criticizers than to reflect the reality of entity. The increase in non-current assets and reduction in revenue has caused a 77% reduction in net asset turnover. This indicate yet an underutilization of assets.

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Liquidity
The cash position of Gagana shows a drastic decline of 58%. The trade and other payables have increased by 146%. This shows company has used their cash resources as well as lagged the payments to the suppliers. As a result, the current ratio has a drastic decline by 56%. This has changed the Gagana's previous sound liquidity position in 2018 to a much weaker position in 2019. This may be due to increased operational expenses with renewed licenses.

Leverage
The company's ability to pay the interest has reduced by 27%. Company has been servicing their bank loans smoothly and another 06 years more to go. Overall decline in operational profits by 33% and decline in operational cash flows by 24% has impacted the company's ability to pay the interest. Company from a highly geared position, the gearing has reduced to low geared. This is mainly due to revaluation reserve explained earlier. If we eliminate the revaluation effect, company is yet highly geared, and it has slightly reduced with the loan repayment. Therefore, overall the leverage risk is high in Gagana, which may be the reason why company is unable to invest in non-current assets.

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Conclusion
Overall, the profitability, efficiency, liquidity and leverage ratios company has worsened performance than the previous year.

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