

QUESTION 3 – Ratio Analysis (ICAP CAF5 S17)**Part (a)**

The following information has been gathered by an analyst, in respect of Dairy Foods Limited (DFL) which specializes in various dairy products.

Ratio	2016	2015	2014	Industry average
Profit margin (%)	11	10	8	10.45
Quick ratio	1.38	1.40	1.42	1.52
Current ratio	1.84	1.67	1.59	1.73
Days purchases in payables	80	91	89	82

In the latest annual report to the shareholders, directors of DFL have claimed that liquidity position of company has improved significantly.

Required:

Critically analyse and discuss whether you agree with the claim.

(03)**Part (b)**

Extracts from latest financial statements of two companies are as follows;

Extracts from statements of financial position

Equity & Liabilities	A		Assets	B	
	Rs. in millions			Rs. in millions	
Equity & reserves	51,690	72,114	Fixed assets	34,460	48,076
Long term loan	-	36,057	Stock in trade	21,700	20,000
Trade creditors	35,790	45,135	Trade debtors	24,470	44,030
Other payables	12,000	8,500	Cash and bank	18,850	49,700
	<u>99,480</u>	<u>161,806</u>		<u>99,480</u>	<u>161,806</u>

Extract from Statement of Comprehensive Income

	A	B
	Rs. in million	
Revenue	161,600	220,150
Cost of sales	<u>(135,160)</u>	<u>(180,520)</u>
Gross profit	26,440	39,630
Operating expenses	<u>(9,840)</u>	<u>(13,870)</u>
Interest expense	<u>(720)</u>	<u>(2,313)</u>
Profit before tax	15,880	23,447
Income tax	<u>(333)</u>	<u>(409)</u>
Profit after tax	<u>15,547</u>	<u>23,038</u>

Required:

Analyze the profitability, liquidity and working capital ratios of both the companies.

(12)

ANSWER 3 – Ratio Analysis (ICAP CAF5 S17)**Part (a)**

While analyzing liquidity positions of DFL, it is noted that current ratio has steadily increased over the years and is better than industry average. However, the quick ratio has steadily declined and is even lower than industry average. This is a clear evidence that the increase in liquidity is caused by an increase in inventory.

Further, by considering the nature of highly perishable inventories kept by a dairy food company, it is a possibility that DFL may bear high inventory losses due to short expiry.

Based on the above, I do not agree with the claim of DFL's directors.

Part (b)**Profitability ratios**

	A	B
Gross profit (GP/sales)	16.36%	18.00%
Profit to sales (Profit after tax/ sales)	9.62%	10.46%
ROCE (PBIT/capital employed)	32.11%	23.81%
Return on assets employed (PBIT/assets)	16.69%	15.92%

Company B's gross profit and net profit ratio is slightly higher as compared to Company A. The difference is not significant and may be on account of higher level of sales resulting in lesser fixed costs per unit.

Company A's return on capital employed ratio and return on assets employed ratio are better than Company B, because Company B has accumulated large balances of cash despite of availing long term loan. Had Company B had used its cash balances to pay off the long term loan, it would have both of these ratios better than Company A.

Liquidity Ratios

	A	B
Current ratio (current assets / current liabilities)	1.36	2.12
Quick ratio (current assets – inventory)/ current liabilities	0.91	1.75

Company B has better current and quick ratio. However, it appears that these ratios are better than Company A due to substantially high amount of trade debts in term of percentage of sales as sales days. It also represents a risk that these trade debts may prove irrecoverable. Moreover, they may be indicative of inefficient in debt collection as well.

Working Capital turnover ratios

	A	B
Stock turnover days (Stock / cost of goods sold x 365) [A]	58.60	40.44
Debtors turnover days (Debtors/ revenue x 365) [B]	55.27	73.00
Creditors turnover days (Creditors/ cost of goods sold x 365) [C]	96.65	91.26
Cash operating cycle [A+B+C] days	17.22	22.18

Stock turnover of Company B is better than that of Company A. Company B is turning over its stock 9 times whereas Company A is doing it 6 times a year.

Company A is more effectively collecting it's debtors than Company B. This could also be due to the fact that Company B is following a lenient credit policy to attract more revenue. This fact is also supported from higher stock turnover ratio of Company B.

Company A have availed better credit facility from its creditors but it may have forgone some settlement discounts which might have resulted in lower gross profit ratio than that of the Company B.

Overall cash operating cycle of Company A is better than Company B. Furthermore Company B has accumulated large balances of cash despite the fact that it has also availed long term loan. Excess cash balance should have been used to pay off the long term loan to reduce the finance cost.

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