

ACCOUNTING

Word Count: 1193

Question

Calculate ratios for 2017, 2018, and 2019 for each company and comment on their outcome and compare with the competitor outcomes (YZ Limited). Having done all that, make recommendations where necessary to AB Limited for improving its financial performance.

Answer

1.1 Introduction

This report presents an analysis of the financial ratios of AB Limited (our company) and YZ Limited (our competitor) from the year 2017 to 2019. The report focuses much on comparing AB Limited's financial performance to YZ financial performance based on the financial ratios presented in table 1 below. The report, anchored on the financial ratio analysis, proffers recommendations for improving AB Limited's financial performance.

Table 1 Financial ratios of AB Limited and YZ Limited

Financial Ratios	AB Limited			YZ Limited		
	2017	2018	2019	2017	2018	2019
a. Net profit margin	2.56%	2.40%	1.52%	1.74%	1.38%	3.54%
b. Asset turnover	2.24times	2.29times	1.75times	2.65times	2.56times	2.32times
c. Current ratio	1.11times	1.13times	0.94times	1.14times	1.09times	1.09 times
d. Quick ratio	0.25times	0.24times	0.37times	0.41times	0.36times	0.48times
e. Debt (to assets) ratio	56.93%	62.84%	82.77%	66.37%	70.58%	79.14%
f. Days Inventory	58days	60days	68days	52days	57days	66days
g. Days Debtors	15days	14days	15days	21days	22days	21days
h. Days Creditors	14days	13days	16days	18days	20days	21days
i. Cash cycle days	60days	62days	88days	54days	67days	55days

1.2 Financial ratios

1.2.1 Net profit margin

Net profit margin shows how much of each dollar in the company's revenue translates into actual profit. In general, a higher net profit margin implies that a company is efficient in converting sales revenue into actual profit (Brit, Chalmers, Maloney, Brooks, & Oliver, 2017). As shown in

table 1, AB Limited converted \$2.56, \$2.40, and \$1.52 of each dollar of sales revenue to actual profit in 2017, 2018 and 2019, respectively. While AB Limited had the highest net profit margin in 2017, YZ Limited had the highest net profit margin in 2019. On average, the competitor (YZ Limited) had a higher net profit margin than us.

1.2.2 Asset turnover ratio

The asset turnover ratio shows how efficiently a company can use its assets to generate sales revenue. Conversely, a lower asset turnover ratio indicates that a company cannot effectively use its assets to generate revenue (Faello, 2015). In 2017, 2018, and 2019 AB Limited generated \$2.24, \$2.29 and \$1.75 of sales revenue for every dollar invested in the assets. In each of the past three years, YZ Limited had higher asset turnover ratios than us. However, for the past three years, our asset turnover ratios were consistently above 1, which means we could generate revenue from our assets without using debt capital.

1.2.3 Current ratio

The current ratio measures the adequacy of current assets to meet the current obligation of an organization. A current ratio that is below 1 shows that current assets cannot cover current liabilities. However, a current ratio that is too high implies that a company has excess investments in unprofitable assets (Restianti & Agustina, 2018). AB Limited had \$1.11 and \$1.13 of current in 2017 and 2018, respectively, of current assets available to pay for every \$1 of its current liabilities. However, in 2019 our current ratio was below 1; thus, we had \$0.94 of current assets for every \$1 of our current liabilities. The means in 2019, we could not fully settle our current liabilities from our assets. The competitor (YZ Limited) always had enough assets to pay for their current liabilities. Thus, the competitor always had a current ratio that was above in the past three years.

1.2.4 Quick ratio

The quick ratio is a more conservative test of a company's liquidity position. It measures the dollars of current assets, excluding stock for repaying a dollar of short-term obligations. The higher the ratio, the better a company's liquidity. A quick ratio below 1 indicates that a company cannot fully settle its current liabilities from its current assets without considering inventory (Faello, 2015). AB Limited had \$0.25, \$0.24 and \$0.37 of current assets (not including stock) in 2017, 2018, and 2019 respectively, for every \$1 of its current liabilities. The competitor's also had quick ratios below 1 in each of the past three years. However, YZ Limited's quick ratios in

each of the past three years were higher than ours. That means the competitor for the past three years was always better positioned to pay its short term using current assets (without considering stock) than us.

1.2.5 Debt (to asset ratio) ratio

The debt ratio shows the percentage of a company's financing that comes from investors and creditors. A debt ratio above 50% shows that a company relies much on debt capital than other capital (equity capital). A debt ratio that is less than 50% shows that a company relies much on equity capital than debt capital ((Brit, Chalmers, Maloney, Brooks, Oliver, & Bond, 2019). AB Limited's debt ratios were 56.93%, 62.84% and 82.77% in 2017, 2018 and 2019 respectively. In each year, the debt ratio kept increasing. For the past three years, the debt ratios were always above 50%, which means our company relies much on debt capital than equity capital. YZ limited had the same case, but our competitor relies much on debt capital than us on average.

1.2.5 Days inventory

Days inventory indicates the average number of days it takes for an entity to sell its inventory. Business entities should turn over inventories as quick as possible. Lower days inventory implies that an entity has a better stock management efficiency (Faello, 2015). AB Limited's days inventory were 58days, 60days, and 68days in 2017, 2018 and 2019. Our days inventory in each of the past three years was slightly higher than YZ Limited. Therefore, we were less efficient in turning over inventory when compared to the competitor.

1.2.6 Days debtors

Days debtors show the average number of days it takes for an entity to collect amounts overdue from its trade debtors. When doing business, organizations should collect outstanding amounts from their trade debtors earlier (Restianti & Agustina, 2018). AB Limited's days debtors were 15 days in 2017 and 2018 and 14 days in 2019. On average, we took 15 days to collect amounts due from our trade debtors for the past three years. The competitor had more days debtors than us for the past three years. In contrast, the competitor's days debtors were more than our days debtors in each of the three past months. On average, YZ Limited took 22 days to collect amounts overdue from its clients for the past three years. Credit customers trade with companies that have more days debtors than those with fewer days debtors.

1.2.7 Days creditors

Days creditors show the average number of days it takes for a company to settle its short-term obligations with its trade suppliers. Organizations should avoid paying late their short-term debt. Late payments can damage business relations and distort business reputation, hence losing suppliers (Faello, 2015). AB Limited's days creditors were 14days, 13days, and 16days, in 2017, 2018 and 2019. They increased by two days from 2018 to 2019. The competitor's day creditors for the past three years were always more than our days creditors. This means that we paid our credit suppliers earlier than YZ Limited paid its credit suppliers. Credit suppliers tend to do business with organizations that pay early.

1.2.8 Cash cycle days

The cash cycle refers to the period between paying for stock, selling the stock, and being paid for the stock. The ideal cash cycle should be short, and short cash cycles imply that the company's money is tied up in stock for a short period (Brit *et al.*, 2019). AB Limited's cash cycle days were 60 days in 2016 and increased to 62days, and 88days in 2018 and 2019, respectively. For the past three years, our cash cycle days were more than YZ Limited. Therefore, our competitor buys, sells its inventory, and receives cash from its customers earlier than us.

1.3 Recommendations

Most of the analyzed financial ratios of AB Limited were acceptable according to the general industry financial ratio benchmarking. Thus, AB Limited had a good financial performance for the past three years. For instance, asset turnover ratios, current ratios, and quick ratios are loosely good. However, AB Limited has to improve its financial performance because the analyzed financial ratios also revealed certain areas where the competitor (YZ Limited) was doing better than AB Limited. If carefully considered and properly implemented, the following recommendations can enhance the financial performance of AB Limited.

- AB Limited should avoid markdowns by improving inventory visibility to improve net profit margins. It should also optimize customer relationships to enhance sales volumes.
- AB Eagers Limited should liquidate obsolete assets and leasing idle assets to improve its asset turnover ratio.

- AB Limited should switch from short-term debt to long-term debt to improve its current ratios and quick ratios.
- AB Limited should also give discounts to customers who pay early to improve both creditors days and cash cycle days.

1.4 Conclusion

Overall, the financial ratios analysis made revealed that AB Limited's financial performance is good. However, the organization should also improve and strengthen its financial performance to stay competitive in the market. Although AB Limited's net profit margins, quick ratios, asset turnover ratios, and cash cycles day were good, they should be improved. The recommendations presented above can help AP Limited strengthen its financial performance.

References

- Brit, J., Chalmers, K., Maloney, S., Brooks, A., & Oliver, J. (2017). *Accounting business reporting for decision making*. (6th Ed.), Australia: Willey.
- Brit, J., Chalmers, K., Maloney, S., Brooks, A., Oliver, J., & Bond, D. (2019). *Accounting business reporting for decision making*. (7th Ed.), Australia: Willey.
- Faelo, J. (2015). Understanding the limitations of financial ratios. *Academy of Accounting and Financial Studies Journal*, 19(3), 75-85.
- Restianti, T., & Agustina, L. (2018). The effects of financial ratios on financial distress conditions in sub industrial sector company. *Accounting Analysis Journal*, 7(1), 23-33.

Appendix 1: Calculations

Calculations for AB Limited

• Net Profit Margin	Formula: $\times 100 = x \%$	
2017	2018	2019
$\times 100 = \underline{\underline{2.56\%}}$	$\times 100 = \underline{\underline{2.40\%}}$	$\times 100 = \underline{\underline{1.52\%}}$
• Asset Turnover	Formula: = x times	
2017	2018	2019
= <u>2.24 times</u>	= <u>2.29times</u>	= <u>1.75times</u>
• Current Ratio	Formula: = x times	
2017	2018	2019
= <u>1.11 times</u>	= <u>1.13times</u>	= <u>0.94 times</u>
• Quick Ratio	Formula: = x times	
2017	2018	2019
= <u>0.25 times</u>	= <u>0.24 times</u>	= <u>0.37 times</u>
• Debt Ratio	Formula: = $\times 100 = x \%$	
$\times 100 = \underline{\underline{56.93\%}}$	$\times 100 = \underline{\underline{62.84\%}}$	$\times 100 = \underline{\underline{82.77 \%$
• Days Inventory	Formula: $\times 365 = x$ days	

2017	2018	2019
$\times 365 = 58.1$	$\times 365 = 59.6$ or	$\times 365 = 67.5$ or
<u>58 days</u>	<u>60 days</u>	<u>68 days</u>
• Days Debtors	Formula: $\times 365 = x$ days	
2017	2018	2019
$\times 365 = 14.9$ or	$\times 365 = 14.4$ or	$\times 365 = 14.6$ or
<u>15 days</u>	<u>14 days</u>	<u>15 days</u>
• Days Creditors	Formula: $\times 365 = x$ days	
2017	2018	2019
$\times 365 = 14.1$ or	$\times 13.2 = 130.4$ or	$\times 365 = 16.2$ or
<u>14 days</u>	<u>13 days</u>	<u>16. days</u>
• Cash Cycle	$\times 365 + \times 365 - \times 365 = x$ days	
2017	2017	2017
$\times 365 = 59.4$ or	$\times 365 = 15.3$ or	$\times 365 = 13.9$ or
<u>59 days</u>	<u>15 days</u>	<u>14 days</u>
Final Answer: 59 days + 15 days – 14 days = <u>60 days</u>		
2018	2018	2018
$\times 365 = 61.2$ or	$\times 365 = 13.8$ or	$\times 365 = 12.9$ or
<u>61 days</u>	<u>14 days</u>	<u>13 days</u>
Final Answer: 61 days + 14 days – 13 days = <u>62 days</u>		
2019	2019	2019
$\times 365 = 91.7$ or	$\times 365 = 19.4$ or	$\times 365 = 23.2$ or

92 days

19 days

23 days

Final Answer: 92 days + 19 days - 23 days = 88 days

Calculations for YZ Limited

• Net Profit Margin	Formula: $\times 100 = x \%$	
2017	2018	2019
$\times 100 = \underline{\mathbf{1.74\%}}$	$\times 100 = \underline{\mathbf{1.38\%}}$	$\times 100 = \underline{\mathbf{3.54\%}}$
• Asset Turnover	Formula: $= x \text{ times}$	
2017	2018	2019
$= \underline{\mathbf{2.65times}}$	$= \underline{\mathbf{2.56times}}$	$= \underline{\mathbf{2.32times}}$
• Current Ratio	Formula: $= x \text{ times}$	
2017	2018	2019
$= \underline{\mathbf{1.14 \text{ times}}}$	$= \underline{\mathbf{1.09 \text{ times}}}$	$= \underline{\mathbf{1.09times}}$
• Quick Ratio	Formula: $= x \text{ times}$	
2017	2018	2019
$= \underline{\mathbf{0.41 \text{ times}}}$	$= \underline{\mathbf{0.36 \text{ times}}}$	$= \underline{\mathbf{0.48 \text{ times}}}$
• Debt Ratio	Formula: $= \times 100 = x \%$	
$\times 100 = \underline{\mathbf{66.37\%}}$	$\times 100 = \underline{\mathbf{70.58\%}}$	$\times 100 = \underline{\mathbf{79.14\%}}$
• Days Inventory	Formula: $\times 365 = x \text{ days}$	
2017	2018	2019
$\times 365 = 52.1 \text{ or}$	$\times 365 = 57.02$	$\times 365 = 65.7$

<u>52 days</u>	<u>57 days</u>	<u>66 days</u>
• Days Debtors	Formula: $\times 365 = x \text{ days}$	
2017	2018	2019
$\times 365 = 20.8 \text{ or}$	$\times 365 = 21.9$	$\times 365 = 21.4$
<u>21 days</u>	<u>22 days</u>	<u>21 days</u>
• Days Creditors	Formula: $\times 365 = x \text{ days}$	
2017	2018	2019
$\times 365 = 17.6 \text{ or}$	$\times 365 = 19.9 \text{ or}$	$\times 365 = 20.9 \text{ or}$
<u>18 days</u>	<u>20 days</u>	<u>21 days</u>
• Cash Cycle	$\times 365 + \times 365 - \times 365 = x \text{ days}$	
2017	2017	2017
$\times 365 = 54.4 \text{ or}$	$\times 365 = 20.2 \text{ or}$	$\times 365 = 20.1$
<u>54 days</u>	<u>20days</u>	<u>20days</u>
<i>Final Answer:</i> $54 \text{ days} + 20 \text{ days} - 20 \text{ days} = \mathbf{54 \text{ days}}$		
2018	2018	2018
$\times 365 = 66.9$	$\times 365 = 23.6$	$\times 365 = 23.6$
<u>67 days</u>	<u>24 days</u>	<u>24 days</u>
<i>Final Answer:</i> $67 \text{ days} + 24 \text{ days} - 24 \text{ days} = \mathbf{67 \text{ days}}$		
2019	2019	2019
$\times 365 = 60.5$	$\times 365 = 12.3$	$\times 365 = 18.3$
<u>61 days</u>	12 days	18 days

Final Answer: 61 days + 12 days - 18 days = **55 days**