TASK 7.18 ⌘ YO Gift Shop: Consolidation of all major financial indicators

7.18.1	(a) Calculate the following financial indicators from the Income Statement for 20.6 (the percentage in brackets relate to the previous year):

Percentage gross profit on sales (20.5: 47.4%)

$\frac{1\ 014\ 000}{2\ 366\ 000} \times \frac{100}{1} = 42.9\%$

Percentage gross profit on cost of sales (20.5: 90%)

$\frac{1\ 014\ 000}{1\ 352\ 000} \times \frac{100}{1} = 75\%$

Percentage operating expenses on sales (20.5: 29.7%)

$\frac{660\ 600}{2\ 366\ 000} \times \frac{100}{1} = 27.9\%$

Percentage operating profit on sales (20.5: 12.8%)

$\frac{353\ 400}{2\ 366\ 000} \times \frac{100}{1} = 14.9\%$

Percentage net profit on sales (20.5: 10.1%)

$\frac{313\ 000}{2\ 366\ 000} \times \frac{100}{1} = 13.2\%$

	(b) You are told that the total sales increased by R500 000 in 20.6. Comment on the financial indicators calculated in part (a) above. Should the partners be satisfied? Explain, quoting financial indicators to support your answer.

The mark-up percentage dropped from 90% to 75% which led to an increase in customers and therefore sales went up by R500 000. This strategy worked well for the business. Although the percentage gross profit on sales decreased to 42.9% this was because of the lower mark-up percentage and increased total sales.

The operating expenses were well-controlled. As a percentage of the bigger sales volume the expenses decreased from 29.7% to 27.9%. This increase in efficiency consequently led to the business earning an increased operating profit of 14.9% of sales, up from 12.8% in the previous year).

The net profit percentage on sales for 20.6 is 13.2% (up from 10.1%) due to the effect of the mark-up strategy, the control of the expenses and the lower interest on the loan (due to the significant decrease in the loan).

7.18.2 (a) Calculate the following financial indicators from the Balance Sheet for 20.6 (the ratios in brackets relate to the previous year):

Solvency ratio (20.5: 2.9 : 1)
(1 641 000 + 140 000 + 400 000 : (240 000 + 218 000)
2 181 000 : 458 000 = 4.8 : 1

Current ratio (20.5: 5.4 : 1)
400 000 : 218 000 = 1.8 : 1

Acid-test ratio (20.5: 2.1 : 1)
(400 000 – 225 000) : 218 000 **OR** (170 000 + 5 000) : 218 000
175 000 : 218 000 = 0.8 : 1

(b) Comment on the financial indicators calculated in part (a) above. Should the partners be satisfied? Explain, quoting financial indicators to support your answer.

The solvency ratio increased from 2.9 : 1 to 4.8 : 1 due to the significant decrease in the liabilities. This means that the business is in a much stronger solvency position as its assets outweigh the liabilities by almost 5 times.

The current ratio has decreased significantly from 5.4 : 1 to 1.8 : 1 due to the decrease in all the current assets and the high bank overdraft in 20.6. However, the business is still liquid as the current assets are almost double the current liabilities. The business has financial assets which can be cashed in, or it can increase loans in the event of an emergency.

The acid-test ratio has reduced from 2.1 : 1 to 0.8 : 1 but the business might be a lot more efficient in managing its resources now because the debtors have decreased significantly despite the increase in sales. The business should be able to manage as the liquid assets are 80% of the current liabilities, and it does have other assets that it can use in the medium to long-term to repay the bank overdraft.

7.18.3 (a) Calculate the following financial indicators relating to working capital (net current assets) for 20.6 (the days in brackets relate to the previous year):

Stock holding period (20.5: 44 days)

$$\frac{\frac{1}{2}[225\,000 + 285\,000)}{1\,352\,000} \times \frac{365}{1} = \frac{255\,000}{1\,352\,000} \times \frac{365}{1} = 68{,}8 \text{ days}$$

Debtors' collection period (20.5: 69 days)

$$\frac{\frac{1}{2}[170\,000 + 405\,000)}{2\,366\,000 \times 50\%} \times \frac{365}{1} = \frac{287\,500}{1\,183\,000} \times \frac{365}{1} = 88{,}7 \text{ days}$$

Creditors' payment period (20.5: 60 days)

$$\frac{\frac{1}{2}[162\,000 + 138\,000)}{352\,000} \times \frac{365}{1}$$

$$\frac{150\,000}{1\,352\,000} \times \frac{365}{1} = 405 \text{ days}$$

OR

$$\frac{\frac{1}{2}[162\,000 + 138\,000)}{1\,292\,000} \times \frac{365}{1}$$

$$\frac{150\,000}{1\,292\,000} \times \frac{365}{1} = 42.4 \text{ days}$$

	(b) Comment on the financial indicators calculated in part (a) above. Should the partners be satisfied? Explain, quoting financial indicators to support your answer.

The stock holding period increased from 44 days to 69 days, which means that more stock is being kept in relation to goods sold. This business should not run out of stock.

The debtors collection increased from 69 days to 89 days. This means that debtors are not being well-controlled despite the increase in sales. The partners can still try to get this figure down to the normal credit terms of 30 days.

The creditors are being paid faster, now in 40 (or 42) days compared to the 60 days of the previous year. The creditors will be happier with this, and it might be the reason for the bank overdraft in 20.6.

7.18.4	**(a) Calculate the debt / equity ratio for 20.6 (the ratio for the previous year was 0.4 : 1).**

240 000 : (1 520 000 + 203 000) = 0.1 : 1

	(b) Comment on the debt / equity ratio. Should the partners be satisfied? Explain, quoting financial indicators to support your answer.

The debt/equity ratio has dropped from 0.4 : 1 to 0.1 : 1 which indicates a lower degree of financial risk in 20.6. The R400 000 decrease in the loan has led to a significant saving on interest expense. However the interest on the loan is 11.5% and as the business is earning a bigger return than this, it might be profitable to make use of more loans, particularly if these can be used to replace the overdraft where interest rates are a lot higher. The business could gear up profits even further if they make use of loans.

7.18.5	**(a) Calculate the following financial indicators relating to the percentage returns for 20.6 (the percentage in brackets relate to the previous year):**

% Return earned by the business (20.5: 16.5%)

$$\frac{313\,000}{\frac{1}{2}[1\,520\,000 + 1\,400\,000 + 203\,000 + 70\,000]} \times \frac{100}{1}$$

$$\frac{313\,000}{1\,596\,500} \times \frac{100}{1} = 19.6\%$$

% Return earned by Young (20.5: 16%)

$$\frac{196\,000}{\frac{1}{2}[800\,000 + 800\,000 + 126\,000 + 50\,000]} \times \frac{100}{1} = 19.6\%$$

$$\frac{196\,000}{888\,000} \times \frac{100}{1} = 22.1\%$$

% Return earned by Old (20.5: 17%)

$$\frac{117\,000}{\frac{1}{2}[720\,000 + 600\,000 + 77\,000 + 20\,000]} \times \frac{100}{1}$$

$$\frac{117\,000}{708\,500} \times \frac{100}{1} = 16.5\%$$

	(b) Comment on the percentage returns calculated in part (a) above. Should the partners be satisfied? Explain, quoting financial indicators to support your answer.

Yes, they should be satisfied because all of these returns exceed returns on alternative investments.

The business' return increased from 16.5% to 19.6% which indicates a positive trend. Young's return has improved from 16% to 22.1% which is now a very good return. Old's return decreased slightly from 17% to 16.5% and he is now earning a significantly lower return than Young. This is probably due to the increase in his capital investment of R120 000 as the interest on capital appears to be low (5%).

The profit-sharing ratio is 3 : 2 while there is only a 10% difference in their capital. Old is earning a significantly lower salary and bonus than Young is, which might be based on the hours worked by them, but he might want to ask for a change in the profit sharing ratio to approximately 1 : 1 to address the imbalance in their returns.