**FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE FOUR SESSION FOUR PARTICIPANTS’ NOTES**

**INTERPRETATION OF POSITION STATEMENT**

1. **The objectives of the session;**
2. To help the participants understand and be able to interpret the balance sheet.
3. To explain to participants the importance of key ratios to investors and financial statements users.
4. To explain drawbacks and limitations of ratios analysis
5. To demonstrate the effect of going concern issues to the business

**1.1 Balance Sheet**

The balance sheet is a statement of a company's wealth position constituted by [assets](http://financial-dictionary.thefreedictionary.com/Assets), liabilities, and [shareholders’ equity](http://financial-dictionary.thefreedictionary.com/Stockholder+Equity) at a given period of time. A balance sheet is a record of what a company has and how it is financed. A balance sheet is divided into two main sections, one that records assets and one that records liabilities. The assets should equal the liabilities. Assets include fixed assets such as land and machinery, investments such as shares in other companies and working capital. Working capital is the net of current assets including work in progress, inventory, accounts receivable cash and bank, less current liabilities such as accounts payables. Examples of liabilities include [accounts payable](http://financial-dictionary.thefreedictionary.com/Accounts+Payable), bank overdraft, long-term loans and equity. Overleaf is the balance sheet of Munaku Contractors Ltd.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2006** | |  | **2007** | |
|  | **shs'000** | **shs'000** |  | **shs'000** | **shs'000** |
| **Fixed (Capital) Assets:** |  |  |  |  |  |
| **Land and buildings** |  | **-** |  |  | **1,500,000** |
| **Plant and machinery** |  | **6,000,000** |  |  | **5,800,000** |
|  |  | **6,000,000** |  |  | **7,300,000** |
| **Current Assets:** |  |  |  |  |  |
| **Work in progress** | **840,000** |  |  | **1,280,000** |  |
| **Stocks** | **130,000** |  |  | **250,000** |  |
| **Accounts receivables** | **650,000** |  |  | **840,000** |  |
| **Cash and bank** | **35,000** |  |  | **(999,000)** |  |
|  | **1,655,000** |  |  | **1,371,000** |  |
| **Current liabilities:** |  |  |  |  |  |
| **Accounts payables** | **960,000** |  |  | **650,000** |  |
| **Current loan** | **200,000** |  |  | **200,000** |  |
|  | **1,160,000** |  |  | **850,000** |  |
| **Net working capital** |  | **495,000** |  |  | **521,000** |
| **Total assets** |  | **6,495,000** |  |  | **7,821,000** |
| **Financed by:** |  |  |  |  |  |
| **Share capital** |  | **2,000,000** |  |  | **2,000,000** |
| **Retained profit /loss** |  | **3,545,000** |  |  | **5,071,000** |
| **Bank loan** |  | **950,000** |  |  | **750,000** |
|  |  | **6,495,000** |  |  | **7,821,000** |

**1.2 Interpreting balance sheet figures**

A balance sheet shows:

* How wealthy the business is
* How solvent the business is
* How liquid its assets are and how easily they can be converted into cash.
* How the business is financed
* Into what assets are its funds invested in.

A balance sheet is only a snapshot of a business' financial position on one particular day. The individual figures can change dramatically in a short space of time but the total net assets (assets less liabilities) would only change dramatically if the business was making large profits or losses. For example:

* If the business holds large inventories of finished products, a change in technology might mean their value is suddenly reduced to almost nothing; that they are not saleable. The net assets will reduce by the loss of value of that inventory.

The basic concept underlying a balance sheet is simple enough: total assets equals total liabilities. (You should note carefully that equity is money the business owes to its shareholders and is therefore a liability). A lot of investors tend to focus on the income statement, but the balance sheet is just as important a source of information. The balance sheet lists assets starting from the least liquid to the most liquid and liabilities from the most permanent to the least permanent. From it, one can see all the specific assets and liabilities of the company. The following shows how to read a balance sheet and use the information from it to find out the company's current financial standing.

* **Fixed assets: These are assets whose useful life is more than one year and are intended to be used by the business for production e.g. a lorry or a grader.** They are assets that cannot be turned into cash quickly.
* **Investments: These are assets held to earn investment income other than revenue from the normal operations of the business. An example is owning shares of another business.**
* **Working capital: Comprised of current assets less current liabilities. These are items that turn around at short intervals during the year and constitute the cash cycle. Materials, labour and other consumables take out cash and are used up to do works that is billed to clients to become accounts receivable from which the client pays cash into the business after some weeks or months.**

Working capital shows how much liquid assets the company has available to build its business. The number can be positive or negative. In general, companies that have good working capital will be more successful since they can easily expand and improve their operations. Companies with negative working capital may lack the funds necessary for growth.

* **Current Assets:** Are defined as assets that can or will be converted into cash quickly (generally within one year). Current assets include cash and bank, inventories and accounts receivables (uncollected bills from its clients).
* **Current Liabilities** are the opposite of current assets. They are the money that the company expects to pay out within the year. Current liabilities include trade accounts payables (bills due to suppliers), loan instalments, taxes, staff dues and declared dividends.
* **Non-Current Liabilities** These are liabilities that are due for payment over a year. This includes long-term loans and equity.

**1.3 Ratio analysis of balance sheet**

**1**.3.1 **Solvency and liquidity ratios**

* **Current Ratio**: The current ratio takes the total of current assets and divides it by its total current liabilities. If this number is greater than one, then the company has more current assets to cover its short term liabilities. By rule of thumb this number should range between one and two depending on the nature of the industry. A number higher than two would probably indicate too much liquidity and possibly idle resources. A number less than one indicate that the company may experience problems with liquidity.
* **Acid Test**: Also known as the quick ratio. The acid test ratio is similar to the current ratio. It considers quick current assets to current liabilities. Inventory and accounts receivables that may not be readily convertible into cash are excluded from the current assets to determine the quick current assets. The reason why the acid test disregards inventories is because in many industries inventory is not easily liquidated into cash; thus it can't be used to pay off short term debt. Ideally, this ratio should be one or slightly less. Anything higher than one should be an indicator of too much liquidity. Less than 0.5 should be an indication of an impending cash crisis.
* **Inventory holding ratio (days)**: This is the number of days stock would last if none was added. It is calculated by the average value of inventory divided by cost of works multiplied by 365. The period found will reflect the procurement cycle. If the procurement cycle is long, stock holding days will also be many and vice versa. A high number of days stock will indicate overstocking and a risk of high storage costs and obsolescence. Too few stockholding days however will highlight the risk of stock outs and likely work stoppages.
* **Collection period ratio:** Is calculated as **Accounts receivable ÷ Credit Sales x 365 Days.**  The ratio is helpful in analyzing the collectability of accounts receivable, or how fast a business can increase its cash supply from clients. The number of days should be close to the credit terms the business offer to its clients. While each industry has its own average collection period (number of days it takes to collect payments from customers), some feel that more than 30 days over terms should be of concern. A high number of days indicates likely delinquent debt while if the number is low, too tight a credit different from industry practice could be hurting the business by chasing away potential clients due to insufficient credit.

# 1.3.2 Activity ratios

Activity ratios indicate how efficiently the business is utilising its assets. Efficiency ratios measure the quality of a business' receivables and how efficiently it uses and controls its assets, how effectively the firm is paying suppliers, and whether the business is overtrading or under trading. These ratios are basically turnover ratios. The most widely used ratios are:

* **Assets turnover ratios:** Assets turnover ratios may be computed for any class of assets, fixed, current or inventory as the need may be. **It is equal to revenue divided by assets (any class of assets)**. An abnormally low ratio may indicate that a business is not being aggressive enough in its sales efforts, or that its assets are not being fully utilized for example that too much inventory is kept or too much machinery is owned. A very high ratio may indicate that a business is overtrading i.e. that it is handling more business than can be safely covered by its assets or that it is growing too fast. Such a business may need to be capitalised. From this we can derive the following five ratios:
* **Fixed assets turnover ratio**
* **Inventory turnover ratio**
* **Accounts receivable turnover ratio**
* **Working capital turnover ratio and**
* **Total assets turnover ratio**

**1.3.3 Leverage ratios**

A company's leverage relates to how much debt it has on its balance sheet, and it is another measure of financial health. Generally, the more debt a company has, the riskier it is, since debt holders have first claim to a company's assets. This is important because, in extreme cases, if a company becomes bankrupt, there may be nothing left over for its stockholders after the company has satisfied its debt holders. Leverage is also known as gearing. Whereas leveraging a business increases its financial risk it also increases its profitability.

**Equity to debt ratio:** The equity to debt ratio measures how much of the company is financed by equity or debt. It is expressed as numbers say 1:2, where the first refers to equity and the second to debt. A company with a big debt will have a high equity to debt ratio, while one with little debt will have a low equity to debt ratio.

**Equity to debt ratio =** **1: (Debt/Equity).**

Leverage may also be computed by looking at the debt to assets ratio.

**Debt to assets ratio**: The ratio shows the extent of the company's assets financed through debt. Put differently, it indicates how much assets cover each unit of debt. It can be computed for different category of assets.

**Debt to assets ratio = 1: (Assets/debt)**

For a low geared business the ratio should be higher than one. If the ratio turns out to be less than one, then that means that most of the company's assets are financed through debt. If the ratio turns out to be greater than one, then the company is financing most of its assets through equity. If the ratio is less than one, the business is mostly financed by debt. Such a business will be said to be highly geared. Companies that have ratios lower than one are said to be "highly leveraged." This means that they are carrying excessive amounts of debt and could be in danger if creditors start to demand repayment.

**Interest cover**: This is the number of times interest is covered by income before interest and taxation. It is calculated by Income before interest and taxation divided by interest. The higher the figure the lower the business is financed through debt. A business whose interest cover is low is highly geared and experiences higher finance risk.

# 1.4 Key ratios for investors

## 1. ROI: Income after interest and tax divided by equity%

## 2. EPS (Earning per share): Income after interest and tax divided by number of issued participating shares.

## 3. Dividend payout ratio: Dividend divided by profit after interest and tax or dividend per share/EPS. It tells you the percentage of available profits for the period that are paid out as cash to shareholders. Same ratio can be expressed as

## 4. Dividend cover ratio: The inverse of the dividend pay out i.e. Profit after interest and tax divided by dividends. It tell how secure dividend pay out is.

## 5. ****Dividend Growth Rate:**** Why? If a company increases its dividend on a regular basis the returns over the long term can be jaw dropping. The future of a dividend can be more important than the present.

# The Importance of ratios to investors.

Investors rely on important financial ratios to gauge corporate profitability and long-term solvency. They also use these metrics to set companies with strong growth potential apart from businesses experiencing fits and starts. The most important accounting metrics cover various factors, running the gamut from efficiency and safety to liquidity and profitability.   
  
**Working Capital:** Working capital helps investors to assess the liquidity position of the business and to indicate the ability to meet loan instalments or to pay out dividends once declared.

**Capital Structure:** Capital structure and gearing ratios indicate to potential lenders the extent of the debt burden to the business and its ability to borrow and be able to service new loans. To potential shareholders it will indicate the level of exposure to interest payments and to prior claims by lenders in case of liquidation.

**Turnover ratios:** Turnover ratios are important for investors as they show how well the business is managing its resources to generate revenue.

## Net profit margin; Net profit margin will indicate how much income the business is turning out from its revenues.

## Gross profit margin: It appraises how well a business’ pricing policy is succeeding and how able it is to earn money from its operations

## Current ratio; By calculating a firm's current ratio, investors can figure out whether the business will have sufficient money to repay its short-term liabilities, such as accounts payable and salaries and dividends when declared.

## Return on equity: Return on Equity, or return on investment, indicates to shareholders the kind of returns to expect from the business, whether a company is a good bet.

## Debt-to-equity ratio: A company's debt-to-equity ratio signals to investors the potential risk of default the business could face if it doesn't reduce its liability levels.

# **1.6 Drawbacks & limitations of ratio analysis**

Ratio analysis is widely used in practice in business.  Teams of investment analysts pour over the historical and forecast financial information of quoted companies using ratio analysis as part of their toolkit of methods for assessing financial performance.  Venture capitalists and bankers use the ratios featured here and others when they consider investing in, or loaning to businesses.

The main strength of ratio analysis is that it encourages a systematic approach to analysing performance.

However, it is also important to remember some of the drawbacks of ratio analysis.

* Ratios deal mainly in numbers – they don’t address issues like product quality, customer service, employee morale and so on though those factors play an important role in financial performance.
* Ratios largely look at the past, not the future.  However, investment analysts will make assumptions about future performance using historical ratios.
* Ratios are most useful when they are used to compare performance over a long period of time or against comparable businesses, set targets or industry averages; this information is not always available.
* Financial information can be “massaged” in several ways to make the figures used for ratios more attractive.  For example, many businesses delay payments to trade creditors at the end of the financial year to make the cash balance higher than normal and the creditor days figure higher too.

**1.8 GOING CONCERN**

The going concern concept assumes the business will continue to trade in the foreseeable future and will not go insolvent.  A company’s financial statements must be prepared using the going concern basis, which will be stated in the accounting policies in the notes to the financial statements. Going concern is important since it shows other entities the company is going to be operating in the long term, therefore encouraging other entities to do business and build up trading relationships.

When preparing the financial statements the directors of the company have to sign to confirm the company is a going concern and will continue to trade for at least twelve months from the date the director’s report and balance sheet are signed.

 When assessing the going concern basis there are certain indicators that are used to suggest the company is not a going concern, such as these below:

* Cash flow constraints.
* Poor solvency and liquidity ratios, big overdrafts and loans accompanied by low interest cover.
* Overtrading.
* Loss of key contracts, customers or suppliers.
* Loss of key employees that drive the company forward.
* A downturn in activity and major loss of market share.
* Cumulative or continued trading losses.
* Looking at financial statements in totality plus knowledge of the operations of the business can make one raise going concern question.
* A new competitor entering the market and taking the company’s market share

The above is not an exhaustive list but provides the sort of things that need to be looked at and considered when deciding if a company is a going concern or not. Since each company is different it is likely there are industry specific indicators that need to be regularly assessed.

If the company has been historically profitable and has made a profit in the period between the year end and the date of approval; and

* Has significant cash reserves in the bank and
* Is continuing to follow up debts on a regular basis and
* Is operating well within its current bank facilities and these are not due to expire shortly or have recently been renewed and
* Everything is going as it should be;

Then there should be no problems with the going concern basis.

If there are significant doubts over the going concern basis but the company is still trading this note should be highlighted in the financial statements. This is mandatory statutory disclosure however including it in the financial statements may have adverse effects on the company. For example, customers may hold off paying their debts (possibly in the hope the company will fail and the debts will be written off), suppliers may stop all credit and call in overdue debts that may well have been overlooked for a few weeks if the company was a going concern and the bank may well call for all overdrafts to be repaid, most of which are repayable on demand, and may assess covenants on all outstanding loans to see if the company is in breach so the loans can be called in also.

In the circumstances above there is little the company can do other than to reassure creditors they will be paid as they fall due and put pressure on the customers so they pay their bills on time, using the threat of legal proceedings if necessary.

**1.9 Group discussions:**

1. Explain what ratios you should look out for as a supplier of material to a road contractor.
2. What kind of information would you look at if you were a bank approached by a road contractor for a loan?
3. “Understanding of past performance is a prerequisite for anticipating the future.” Discuss.
4. If you were to invest in Munaku Contractors Ltd, what ratios would you look out for?
5. Discuss Munaku Contractors Ltd as a going concern.