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Expected errors / change in assumptions	***Liquidity Ratios***	***Profitability Ratios***	***Gearing Ratios***	***Business Valuation***
If the leases turn out to be finance leases	**Impact:** Unfavourable	**Impact:** Favourable	**Impact:** Unfavourable	**Impact:** Valuation will be higher.
	Justification: The current portion of lease liability will negatively impact the liquidity ratios.	**Justification:** In case of operating lease, normally the full cost is charged earlier than useful economic life of asset. Whereas in finance lease, depreciation and	**Justification:** Because of recording the finance lease obligations, gearing ratios may be negatively affected.	**Justification:** Profitability will increase. Moreover, recording of property will increase the asset base of the company. Both will have a
If convertible preference shares are accounted for as equity	**Impact:** Favourable	**Impact:** None.	**Impact:** Favourable	**Impact:** None.
	Justification: If these shares are recorded as equity, then liabilities for preference share dividends will be recorded when dividend is declared whereas	**Justification:** Any classification of preference shares will not affect the amount / income attributable to ordinary shareholders of the company	**Justification:** Because liability of preference shares will not be recognized.	**Justification:** Because net assets / income related to ordinary shareholders will remain the same.
If assumptions used in the actuarial valuation turn out to be incorrect	**Impact:** Either favourable / unfavourable (Both are possible)	**Impact:** Either favourable / unfavourable (Both are	**Impact:** None.	**Impact:** Valuation may be higher or lower. (Both are possible)
	Justification: If a certain assumption, for example, expected increase in salary* has been taken as higher than actual,	**Justification:** As discussed in the case of liquidity ratio, a higher than actual rate of increase in salary means that the reported	**Justification:** Actuarial liabilities do not affect long term liabilities. Hence there will be no impact on gearing ratio. However, it does	**Justification:** The impact on business valuation will be similar to the impact on profitability ratio and the impact on liquidity ratio.

Expected errors / change in assumptions	***Liquidity Ratios***	***Profitability Ratios***	***Gearing Ratios***	***Business Valuation***
If future cash flow or discount rate used for valuation of non-financial assets proves to be incorrect	**Impact:** Either favourable / unfavourable (Both are **Justification:** Liquidity ratios will only be affected due to impairment related to current assets like	**Impact:** Either favourable / unfavourable (Both are **Justification:** Profit may have been reported on a higher side if impairment is short recorded and vice versa. (In	**Impact:** Either favourable / unfavourable (Both are **Justification:** Any error will not affect the long term liabilities but may have significant impact on equity and	**Impact:** Valuation may be higher or lower. (Both are possible) **Justification:** The company may be overvalued if impairment is short recorded and vice versa.
Actual useful lives of property, plant and equipment may be more than the assumed lives	**Impact:** None. **Justification:** It does not affect the current liabilities or the current assets.	**Impact:** Favourable **Justification:** Profit may have been reported on a lower side because higher depreciation is charged if useful life is estimated on a conservative	**Impact:** None. **Justification:** Any change in useful lives do not affect long term liabilities. Hence there will be no impact on gearing ratio. However, it does affect the	**Impact:** Valuation may be higher. **Justification:** Increase in earnings will have a positive impact on valuation. On the other hand increase in net assets will also have a positive
If expected cost of decommissioning and discount rate used to determine its present value, proves to be incorrect.	**Impact:** None. **Justification:** It does not affect the short term liabilities or assets.	**Impact:** Either favourable / unfavourable. (Both are **Justification:** If the assumed discount rate is on the lower side or expected cost of decommissioning is on the higher	**Impact:** None. **Justification:** It will not affect long term liabilities. Hence there will be no impact on gearing ratio. However, it	**Impact:** Valuation may be higher or lower. (Both are possible) **Justification:** The impact will be similar to the impact on profitability ratio.

A-6

To: Board of Directors
From: Chief Financial Officer
Date: December 8, 2009
Subject: Financial and Operating Performance of Waris Limited

As requested, I have analyzed the financial performance of Waris Limited (WL) with the industry with a view to evaluate the feasibility of launching a takeover bid. My analyses of each category of ratios is as follows:

Profitability Ratios

The gross profit ratio is near to the highest while the operating profit is near to the lowest as compared to similar companies. It indicates that key issue which is affecting WL's profitability is its lack of control over operating expenses. The positive aspect of this situation is that we may be able to improve the profitability just by controlling the operating expenses without being required to make significant changes in the current operations of WL.

Return on shareholders' equity is around the average prevailing in the industry. This ratio is obviously, related to operating profit and as discussed above it can be improved by exercising greater control over operating expenses, after take over.

Working Capital Ratios

WL's working capital ratios specially the current ratio indicates that the company's liquidity position is in line with the industry average. Hence, it seems that the company's working capital is being appropriately managed although there may be some room for improvement.

The inventory turnover is among the lowest in the industry which shows that sound inventory management policies are in place.

However, the level of receivables is among the highest in the industry. The possible causes of the situation may be as follows:

- Poor efforts in making collections
- Lack of proper credit control policies or slackness in their implementation.
- Chances of bad debts which may not have been provided.
- Sales to related parties.
- Fictitious sales.

We need to seek appropriate explanations and investigate the matters if possible. **Gearing Ratios**

The debt equity ratio is on the higher side but can be restructured after acquisition. However, the interest cover is only 1.3. It is among the lowest in the industry and is indicative of a high degree of risk as the profits are barely able to cover the interest charges. Even a slight decline in the profitability of the company may have highly adverse impact on the company's bottom line.

Investor Ratios

Earning per share is on the lower side. However, it can be improved by improving profits as discussed while comparing performance ratios. WL's dividend payout is the lowest (22.2%) in terms of percentage among other similar companies. Generally, past history of dividend payouts is not relevant to our bid decision. However, low dividend may also be on account of liquidity problems and we should consider this aspect.

Conclusion

The company's performance indicates a mixed trend. However, it may be concluded that below average performance, (wherever applicable) can be improved by revisiting the situation and bringing about necessary changes in the policies.

(b) Following additional information could have been useful for a better analysis of the situation:

(i) Any recent audited or management accounts.

(ii) Comparison of accounting policies following by the companies in the same industry and the possible impact thereof on the above ratios.

(iii) Expected growth in future earnings

(iv) Alternative investment opportunities

(v) Effect of synergy

(vi) WL's market reputation;

(vii) Quality of human resource within the company;
(viii) Research and development activities
(ix) Legal framework and industry risks

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A.5 (a)

	AB Limited	XY Limited
Debt equity ratio		
Long term debts / Equity	60/400	105/305
	0.15	0.34

- Debt equity ratio is useful in assessing the risk that a company may face by utilizing excessive debt relative to its equity. The main risk may be the company's inability to repay the debt and interest thereon. However, profits after interest and tax earned by the companies on the opening equity are 66% and 36% for AB and XY respectively. At this level of profit, the above risk is less relevant in the case of AB Limited.
- It therefore seems that AB Limited is unduly risk averse and could have increased its profitability by increasing its gearing. In this regard, the policy being followed by XY Limited seems more appropriate

Liquidity position

	AB Limited	XY Limited
Current ratio:		
Current assets / Current liabilities	(125+130+10)/80	(45+50+6)/(60+21)
	3.31	1.25

Better current ratio is usually considered a positive sign indicating better liquidity position of the company. However, it appears that current ratio for AB Limited is too high.

This situation is indicative of any one or more of the following:
- High levels of inventory are being maintained.
- Too lenient credit policies are being followed.
- Full benefit of suppliers' credit is not being obtained.

The above ratios should also be compared with the industry averages to assess the performance in comparison with the general trend prevailing in the industry.

(b) Price earnings ratio (PE):

	AB Limited	XY Limited
Market price per share / Earnings per share	140/(159/ 21)	50/(80/21.5)
	18.49	13.44

PE ratio expresses in a single figure the relationship between the market price of an entity's share and the earnings per share. AB Limited recovers share market price in 18.49 years. In comparison, XY Limited is recovering market price in 13.44 years. A high PE ratio is an indication of investors' confidence in the company and expectation that profit will show an increasing trend.

However, if the ratio is too high as compared to the industry, it may indicate that the share is overpriced.

A-8

To: The bankers of Primate Mart Limited (PML)
From: Bashir Ahmed, Consultant

Subject: Financial performance 2010-12
Date: December 2012

1 Introduction

In accordance with your instructions, I set out below a review of PML's financial performance over the last three years. The main focus of this report is on the reasons for the increase in the quantum of bank borrowing by PML and to consider how the bank can safeguard its interest in the given situation. Relevant workings and accounting ratios are included in the attached appendix.

2 Bank lending

The main reason for the steep increase in bank lending is that the entity has not been generating sufficient cash from its operating activities over the past three years. During the year ended 30 June 2012 and 2011, the cash generated from operating activities (i.e. Rs. 11 million and Rs. 17 million respectively) has not been sufficient to cover interest payments.

Despite the above, PML is continuing to pay dividends. Such dividend and the income tax is also being funded through bank borrowings.

As at 30 June 2012, total bank borrowing amounted to Rs. 740 million out of a total facility of Rs. 750 million. Still, the company's BOD has approved 10% cash dividend which would amount to Rs. 9 million.

Consequently, debt equity ratio has increased from 52% in 2010 to 69% in 2012. Any increase in borrowing would further deteriorate the ratio.

3 Operating review

Revenue has been rising steadily over the period and operating profit as a percentage of sales has been more or less steady. The slight decline in operating profit is mainly on account of increase in other operating costs.

Increase in financial charges has had a significant effect on the net profit of the company which has decreased from 2.5% of sales in 2010 to 0.8% of sales in 2012, despite the fact that sales has increased by 35% in two years.

Moreover, there has been a large increase in trade receivables as well as stocks. Although the number of days sales in trade debts has fallen steadily over the period, the trade debts at the end of June 2012 still represent nearly a year's credit sales. This is excessive and seems to imply a poor or highly liberal credit control policy.

The increase in stocks and trade debts have used up most of the cash generated through operating activities leading to the present pressure on bank borrowings.

4 Matters for discussion

The bank should discuss the following issues with the PML's management.

- The need to undertake an urgent review of credit terms being offered by PML to its customers in order to reduce the levels of trade receivables.
- The need to reduce stock levels which seems excessive (representing over seven months' sales).
- The need to postpone dividend declaration till the company's cash position improves sufficiently.
- The need to review operating costs and introduce measures to control them as far as possible.
- While discussing the above, a comparison with the industry practices especially in respect of levels of trade debts and stock may be emphasized.

Appendix

		2012	2011	2010
1-	**Cash generated from operations**	**Rs. (millions)**	**Rs. (millions)**	**Rs. (millions)**
	Profit before interest	120	115	--
	Depreciation	33	36	--
	Increase in stock in trade	(80)	(100)	--
	Increase in trade debts	(58)	(41)	--
	Increase in trade creditors	(4)	7	--
2-	**Gearing (Debt equity ratio)**	11	17	--
	Bank loans / (Equity +Bank loans) x 100	67%	59%	52%
		740/1,500x100	555/(555+378)	412/(412+381)
3-	**Profit margin %**			
	Profit before interest /Salesx100	8.0%	8.7%	8.9%
		12/1,500x100	115/1,320x100	99/1,110x100
4-	**Interest cover**			
	Profit before interest /interest	1.18 times	1.46 times	1.74 times
		120/102	115/79	99/57
5-	**Net profit as % of sales**			
	Net profit / sales x 100	0.8%	1.8%	2.5%
		12/1,500x100	24/1,320x100	28/1,100x100
6-	**Stock turnover**			
	Cost of sales/sales x100	1.61 times	1.60 times	1.64 times
		996/620	864/540	723/440
7-	**Trade debtors turnover in days**			
	Cost of sales /credit sales x365	359 days	370 days	392 days
		443/450x365	385/380x365	344/320 x 365