SCHOOL OF TECHNOLOGY & MANAGEMENT

AFFILIATED TO UNIVERSITY OF EAST LONDON (UEL)

ASSIGNMENT

MANAGEMENT OF FINANCE

BY

SHARAD AGARWAL

STUDENT ID – 292RDRDEN03

COURSE - MBA (INTAKE- NOVEMBER'03)

EXAMINER : PROF VIJAY SHENAI

TABLE OF CONTENTS

Klaxon Limited

Introduction:

On basis of the Profit and Loss statement and Balance sheet, a report is prepared to compare the performance of Klaxon Limited in year 20X3 vis a vis performance in year 20X1 and 20X2 and against the firms in the paper and packaging industry.

As Klaxon Limited is planning to raise capital through an equity Issue in the near future some changes have been suggested, so that the equity issue is a successful one.

PART A

The following has been noticed in the account statements of Klaxon limited

- The sales have increased by almost 50% from the year 20X1 and 25 % from 20X2 in the year 2003. As a result of which the other direct and indirect costs have also gone up.
- Indirect costs such as distribution expenses have constituted 15.12 % in 20X1, 13.26 % in the year 20X2 and 17.62 % in the year 20X3 of the sales revenue. This is more or less in proportion to the sales in the respective years.
  Administrative expenses have also followed the same trend of increase according to the sales in the respective years.

The financial ratios of Klaxon Limited for the year 20X1, 20X2 and 20X3 have been calculated and evaluated using the data provided in the balance sheet and income statements and also evaluated in relation to Industry Average

I PROFITABILITY RATIOS:

	Formula	**20X1**	**20X2**	**20X3**	**Industry Average**
Gross margin	<u>Gross profit </u>X 100 Sales	0.44 (307/701)	0.43 (359/837)	0.48 (500/1050)	0.40
Operating margin	<u>NPBIT </u>X100 Sales	0.14 (97/701)	0.16 (135/837)	0.15 (160/1050)	0.18
Return on Capital Employed	<u>Operating Profit</u>X100 Capital Employed	0.13 (97/737)	0.19 (135/709)	0.14 (160/1184)	0.20

- Klaxon's Gross profit margin has increased to 48% of sales revenue in the year 20X3 from 44 % in year 20X1 and 43% in the year 20X2, which shows the company is taking into account the market and company's own cost structure and making use of the correct pricing strategy It seems that in the year 20X3 the company has gained economies of large scale production which is reflected by higher operating margin than in the previous years.
- As compared to other firms in the same industry Klaxon's Gross operating margin has always been above the Industry average, which is at 40%. <u>This shows that the company has a good control over the direct costs involved in making the goods available to the customer.</u>
- Klaxon's operating margin has increased slightly compared to the year 20X1 this may be the <u>benefits gained by purchasing own distribution</u>

vehicles in the year 20X3. But when compared to 20X2 the operating margin has reduced slightly.

- Klaxon's operating margin is much below the industry average which is 18 %. This concludes that Klaxon is spending more on indirect costs such as administration, Distribution and others as compared to firms in the same industry. This has to be leveled to at least the Industry average for better prospects.
- Klaxon has shown a mixed performance in 20X3 as compared to the preceding two years, wherein the ROCE has slightly increased by 1 % in 20X2 and decreased by 5 % in 20X2.
- When Klaxon's ROCE is compared to the ROCE of industry it is very low and its should be pared up with the ROCE of the industry average.

II LIQUIDITY RATIOS

	Formula	20X1	20X2	20X3	Industry Average
Current Ratio	Current Assets / Current Liabilities	.99 X (174/176)	1.78 X (196/110)	1.51 X (426/282)	1.32 X

- In the year 20X1 Klaxon had a much lower Current Ratio than in following years, It has managed to increase the ratio from 0 .98 times in 20X1 to 1.78 times in 20X2 but again has pulled it down to 1.51 times in the year 20X3. The current ratio in 20X3 when compared to the industry average which is 1.32 times, it is quite higher than the other firms in the same industry.
- This means that Klaxon can quite reasonably convert the short term assets such as Debtors Stocks, Prepaid Expenses and make use of the available cash to cover the short term claims such as Creditors, Bank O/D, Other Accrued Expenses and Dividends.
- It has been noticed that available Liquid cash is not been utilized efficiently for the reason that though a cash balance of £ 65,000 was available, it was not used to pay the overdraft which reflects a debit balance of £ 151,000 at the end of the year 20X3, which leads to the extra interest charges.
- The credit extended to the debtors in 20X3 have increased by 95 % from year 20X1 and 106 % from year 20X2, which means Klaxon has extended more credit to its customers which should be reduced and the payment should be collected more promptly and in line with the collection as in years 20X1 and 20X2.This might be the reason for increase in the sales in the 20X3.

III ACTIVITY RATIO

	Formula	20X1	20X2	20X3
Inventory turnover	Sales Inventory	17.1 (701/41)	19.46 (837/43)	10 (1050/105)

- As a rough approximation each item of Kalxon's inventory is sold out or restocked or turned over 17.1 times per year in the year 20X1, 19.48 times in the year 20X2 and 10 times in the year 20X3.The inventory turnover in the year 20X3 is much lower than the turnover in the preceding years.

	Formula	20X1	20X2	20X3	Industry average
Stock Days	Stock held X 365 Stock used	79 Days (41/190*365)	62 Days (43/253*365)	118 Days (105/325*365)	75 Days

- This suggests that in 20X3 Kalxon is holding too much inventory which is unproductive or in other words an investment with low or zero rate of return. This low turnover ratio also affects the current ratio. It is nither in line with the number of days in 20X1 and 20X2, nor with the industry average.

	Formula	20X1	20X2	20X3	Industry average
Debtor Days	Trade Debtors X 365 Credit Sales	64 Days	51 Days	83 Days	35 Days

- The credit extended to the debtors in 20X3 have increased by 95 % from year 20X1 and 106 % from year 20X2, which means Klaxon has extended more credit to its customers which should be reduced and the payment should be collected more promptly and in line with the collection as in years 20X1 and 20X2.
- The credit policy needs to revised soon, and customers should be made to pay the bills on time, so that the funds can be used in more productive assets.
- As compared to the industry average which is 35 Days, the credit days extended to the customers is much higher, so measures should be taken immediately.

	Formula	20X1	20X2	20X3	Industry average
Creditor Days	Tradecreditors X365 / Credit Purchases	84 Days (43/187*365)	64 Days (45/255*365)	52 Days (45/318*365)	50 Days

- Klaxon has managed to get free credit for a quite long time in the years 20X1 and 20X2 as compared to 20X3 and the industry as a whole. But in the year 20X3 it has just come in par with the industry average.
- Klaxon should try and increase the credit extension period so that it can meet its liquid cash demand with much use of Bank O/D or it should try to take discounts from the suppliers for early repayment of the bills.

IV SOLVENCY RATIOS

	Formula	20X1	20X2	20X3	Industry average
Debt /Equity	Total Debt / Total Equity	1.09 : 1 (386/351)	0.73 : 1 (300/409)	1.73 : 1 (751/433)	0.80 : 1
Interest Cover	Operating Profit / Interest	2.94 X (97/33)	4.5 X (135/30)	2.22 X (160/72)	3.50 X

- Klaxon debt ratio in the year 20X1 is 1.09: 1, which means it is financed more by interest bearing loan than the equity capital. The scenario is changed in the year 20X2 as the Klaxon has repaid the Bank O/D and the debt ratio being 0.73: 1. Coming to the debt ratio in the year 20X3, the company has arranged a short term loan of £300,000 @ 12% to purchase machinery and distribution vehicles and therefore its Debt ratio has become 1.73: 1.
- The Fact that Klaxon's debt ratio exceeds the industry average in 20X1 and 20X3 raises a Red Alert and may it costly for the company to borrow additional money from the market, without first raising an Equity Capital.
- Klaxon's interest is covered 2.94 times, 4.5 times and 2.22 times in the years 20X1, 20X2 and 20X3 respectively. Since the industry average is 3.5 times. Klaxon is covering its interest charges by a relatively low margin of safety in the year 20X3. This reinforces that Klaxon would meet difficulties if it would not raise and equity issue soon.

V SHAREHOLDERS RATIO

	Formula	**20X1**	**20X2**	**20X3**	**Industry a Average**
Earnings per share	Profit after Tax No of Shares	0.23 (46/200)	0.39 (78/200)	0.32 (63/200)	
Price earnings ratio	Per Share price EPS	15.17 (3.49/0.23)	8.95 (3.49/0.39)	12.56 (4.02/0.32)	16.00

- Klaxon's P/E ratio for the year 20X3 is much lower than in the year 20X1 and the same is higher than the same in year 20X2.
- But since Klaxon's P/E ratio is below the average for other paper and packaging industry, the company is will be regarded as a little riskier company than most, as having poorer growth prospects, or both.

PART B

Klaxon Limited should make the following restructuring in its balance sheet before making an Equity issue in the market in the forthcoming years.

KLAXON LIMITED (All figures in £'000)

Particulars	**Balance sheet as on 31st December 2003**	**Balance sheet after Proposed Restructuring**
Assets Empolyed		
Net Fixed Assets	889	889
Current Assets		
Stocks	105	45
Debtors	240	215
Prepaid Expenses	16	16
Cash	65	0
Sub Total	*426*	*276*
Current Liablities		
Bank Overdraft	151	86
Trade Creditors	45	45
Accured Expenses	22	22
Taxation	25	25
Dividends	29	39
Sub Total	*282*	*217*
Net Current Assets	144	59
Total Assets Current Liablites	1033	948
Crediotrs >1 year		
10 % Secured Loan Stock	300	300
12 % Short Term Loan	300	215
Net Assets	433	433
Financed By		
Share Capital (par value £ 1)	200	200
Profit and Loss Account	233	233
Shareholders Fund	433	433

APPENDIX

Klaxon Limited: Summary of Financial Ratios (All figures in £' 000)

Ratio	Formula for Calculation	Ratio for 20X1	Ratio for 20X2	Ratio for 20X3
Profitability ratios				
Gross margin (%)	Gross profit X 100 Sales	43.79 (307/701)	42.89 (359/837)	47.62 (500/1050)
Operating margin (%)	NPBIT X100 Sales	13.84 (97/701)	16.13 (135/837)	15.24 (160/1050)
Return on Capital Employed (%)	Operating ProfitX10 Capital Employed	13.16 (97/737)	19.04 (135/709)	13.51 (160/1184)
Liquidity ratio				
Current	Current Assets Current Liabilities	.99X	1.78 X	1.51 X
Quick , Acid	Liquid Assets Current Liabilities	0.76 X	1.39 X	1.14 X
Activity Ratio				
Inventory turnover	Sales Inventory	17.1 (701/41)	19.46 (837/43)	10 (1050/105)
Net asset Turnover	Sales Total Assets – C L	1.07 X	1.18 X	1.02 X
Stock Days	Stock held X 365 Stock used	79 Days (41/190*365)	62 Days (43/253*365)	118 Days (105/325*365)
Debtor Days	Trade Debtors X 365 Credit Sales	64.04 Days	50.59 Days	83.43 Days
Creditor Days	Trade CreditorsX365 Credit Purchases	83.93 Days (43/187*365)	64.14 Days (45/255*365)	51.65 Days (45/318*365)
Solvency Ratios				
Debt /Equity	Total Debt Total Equity	1.09 X (386/351)	0.73 X (300/409)	1.73 X (751/433)
Interest Cover	Operating Profit Interest	2.94 X (97/33)	4.5 X (135/30)	2.22 X (160/72)
Share Holder Ratio				
Earnings per share	Profit after Tax No of Shares	0.23 (46/200)	0.39 (78/200)	0.32 (63/200)
Return on Equity	Profit after Tax Share Capital and Reserves	0.13 (46/351)	0.19 (78/409)	0.15 (63/433)
Price earnings ratio	Share price EPS	15.17 (3.49/0.23)	8.95 (3.49/0.39)	12.56 (4.02/0.32)

REFERENCE

1. Business Finance, Eddie McLaney, Sixth Edition, 2003

2. Financial Management, Eugene F Brigham, Michael C Ehrhardt, Tenth Edition, 2002

3. Mastering Finance, Financial Times, 1998.