Financial Analysis of Matalan PLC

This report is based on Matalan PLC, the retail company, in conjunction with their annual reports.

a)

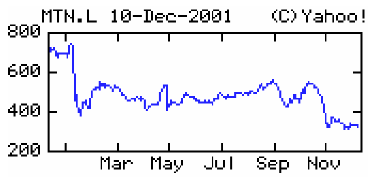
Matalan is a totally unique out of town retailer offering up to the minute fashion and homewares at up to half the equivalent high street price. With over 130 stores nation-wide, Matalan is currently the UK's the 5th largest fashion retailer. Its major competitor for the mid-market price range is Marks and Spencers.

John Hargreaves, the founder of Matalan, began as a market trader back in the 1970s. In the early '80s, whilst on holiday in the USA, John discovered the out of town retail concept that sold a range of food and non-food products at low prices. On his return, John decided to implement the same retail concept in the UK, so in 1985 the first Matalan Discount Club opened in Preston. Since then Matalan has grown significantly and by 1995 there were 50 stores across the UK. In 1997, in order to cope with Matalan's growth, the head office was relocated from Preston to Skelmersdale along with a new distribution centre. Matalan's success was reinforced by the flotation of the company in May 1998 and the company moved away from being Matalan Discount Club to simply Matalan, the value fashion retailer. Matalan opened it's 100th store at the start of 2000 and plans to have 200 stores by the end of 2005.

In the past year, Matalan have continued to strengthen the Matalan brand and have continued their emphasis on product development and have remained focused on cost control and improving their operating ratios. Also their clothing market share grew from 1.9% to 2.4% with increases across all major categories. The success of the Home Store range continued with market share increasing from 1.0% to

1.6%. Meanwhile trials of a number of new initiatives were launched during the year that took the brand into a financial service (Matalan Credit Card) venture with Yorkshire Bank and the Matalan From Home catalogue. However, there was one major resignation during the past year. On 27th April 2001, Angus Monro resigned his position as Group chief executive and director of Matalan PLC and its subsidiaries (www.matalan.co.uk).

In the past year, Matalan's share price reached a high of £7.50 with a low of £3.03. At the time of writing its share price stands at £3.31.



(Source:Yahoo Finance)

b)

Ratio Analysis enables the business owner/manager to spot trends in a business and to compare its performance and condition with the average performance of similar businesses in the same industry. We will now carry out a few financial ratios based on Matalan's financial statements such as the profit and loss account and the balance sheet (pgs. 18 and 19 in the annual report) and where applicable compare them to their closest rival, Marks and Spencers. The M&S ratios will be calculated in the same manner/and formulas. Therefore it will just be the input values in the formula that are different, based on M&S's financial statements (Statement found on www.marksandspencers.co.uk).

Liquidity Ratio:

Current Ratios. This ratio indicates the ease of turning assets into cash. The Current Ratio is one of the best known measures of financial strength. It is shown below:

$$\text{Current Ratio} = \frac{\text{Tota l Current Assets}}{\text{Total Current Liabilities}} = £109.9m /£\ 101.8m = 1.1 \text{ times}$$

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M&S: 3516.2/1981.6 = 1.8 times

From the above one can see that Matalan have a weaker liquidty position than M&S. A generally acceptable current ratio is 2 to 1. The minimum acceptable current ratio is obviously 1:1, but that relationship is usually playing it too close for comfort. If Matalan decide their business's current ratio is too low, they may be able to raise it by (Wood, 1996):

- Paying some debts.
- Increasing your current assets from loans or other borrowings with a maturity of more than one year.
- Converting non-current assets into current assets.
- Increasing your current assets from new equity contributions.
- Putting profits back into the business

Asset Management Ratio:

Evaluating Total Assets. Indicates how efficiently your business generates sales on each pound of assets. This is a chance to think how to improve sales volume with reference to the total assets position of the company, (ACCA, 2001).

$$\text{Total Asset Turnover ratio} = \frac{\text{Sales}}{\text{Total Assets}} = £586m / £234m = 2.5 \text{ times.}$$

M&S: 8075.7 / 7693.4 = 1.0 times

We can see that Matalan has a higher asset turnover ratio than M&S. However, companies with low profit margins tend to have high asset turnover, those with high profit margins have low asset turnover- it indicates pricing strategy. This ratio is more useful for growth companies (Matalan) to check if in fact they are growing revenue in proportion to sales. For companies in the retail industry you would expect a very high turnover ratio - mainly because of cut-throat pricing.

Debt Management Ratio:

Debt Ratio. The debt ratio gives an indication of the level of debt to equity. The right level of debt for a business depends on many factors.

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}} = £109.8m / £234m = 50\%$$

Creditors prefer lower debt ratios which implies higher degree of protection against losses if bankruptcy occurs.

M&S: 2716.7 / 7693.4 = 40%.

Marks and Spencers have a lower debt ratio than Matalan. Matalan have to be careful as creditors prefer lower debt ratios which imply greater protection against losses if bankruptcy occurs.

Profitability Ratios:

Return on Capital Employed. This ratio shows total company performance in the form of return on the assets employed available to all providers of finance (debt and equity). It thus includes the return to both equity and debt in the numerator and equity and debt financed assets in the denominator. It is widely regarded as the most important profitability ratio (Lewis and Pendrill, 1996).

$$\text{ROCE Ratio} = \frac{\text{Profit before Tax and Interest}}{\text{Total Assets less Current Liabilities}} = £81.0m /£132.2m = 0.61 \times 100 = 61\%$$

M&S: £467.0m / £5711.8m = 0.08 x 100 = 8%

We can see that Matalan' return on assets employed is significantly greater than the Return on Capital Employed by Marks and Spencers. A provider of finance for Matalan will be very pleased with this result when compared to M&S's. While such a ratio is particularly helpful for the above companies whose areas are mostly tangible and hence recognised in the financial statements, it has less preference for companies with a preponderance of intangible assets not so recognised e.g. for accountancy and consultancy firms.

Return on Investment Ratio:

This explains the generation of earnings to share price. It is the inverse of the price-earnings ratio, basically it is the amount of earnings you buy for every pound worth of stock.

Earnings Yield Ratio = Earnings Per Share_______________ = £0.145/ £3.31 = 0.04 x 100 = 4%

Current Market Price Per Equity Share

M&S: £0.114/£3.49 = 0.03 x100 = 3%

In terms of earnings yield, both companies produced a similar performance in the last year.

c)

(Please consult pages 1-5 in the annual reports)

The chief executive stated in the annual reports that he, "anticipates substantial sales growth in year ending 23rd February 2002 as a result of active membership growth and product development, and through the opening of new stores". He believes the outlook for the remainder of the year is encouraging and he is confident that Matalan will build on its success to date and will continue to deliver superior returns to shareholders.

While analysis of Matalan's financial ratios seem to support his claim, although as mentioned above they perhaps need to improve their liquidity. The annual reports provided by Matalan contain figures for Earnings per share, turnover, dividends and Profit before tax over the last five years. All of these figures have shown impressive rates of growth and therefore would seem to back up the chief executive's claims and prove attractive to potential investors. However although Matalan's current share price is a healthy price of £3.31, recent months has seen it dip from well over the £4.00 mark. Although there is no apparent internal problem, it would seem that the share price has reacted to the general slowdown of the economy. With no knowledge of how long the uncertainty in general market conditions will last (Matalan have no control over this), one perhaps should not be surprised if the figures in the next set of annual reports were not as flattering. Another point for the people at Matalan and investors to be aware of is that Marks and Spencers, its major rival has seen its share price go up recently after a dismal couple of years. Matalan will do well to be aware of their competition.

d)

Matalan's financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. We will now examine discretions used by Matalan with regard to accounting policies, (Consult pgs. 22-23 in the annual reports).
The first discretion shown is that by adopting a going concern concept. The going concern concept means that the financial statements are drawn up on the assumption that there is no intention or necessity to liquidate or curtail significantly the scale of the operation. The directors of Matalan and PWC, their accountants both have a responsibility to ensure that the company is indeed a going concern.

The second act of discretion that is noticeable from the Matalan accounts is the fact that the financial statements are prepared in accordance with the historical cost convention. They had the choice of using the current value measuring system. This is the basis of accounting prescribed by the companies act, (although the act does allow Alternative Accounting Rules that enable certain assets to be revalued and stated at their revalued amounts).

Another example of discretion shown by Matalan is the fact that their assets and liabilities are translated into sterling at rates of exchange ruling at the end of the financial year or where appropriate the rate of exchange fixed under the terms of the relevant transaction. The discretion shown by translating their assets and liabilities at the end of the year. SSAP 20, 'Foreign Currency Translation' does not stipulate a specific time when one has to translate the currencies. However, in accordance with SSAP 20, the all foreign exchange differences are taken to the profit and loss account in the year, which they arise.

For Stocks:

Stocks, all of which are held for resale, are stated at the lower of cost and net realisable value. Cost is based on a first in, first out basis (FIFO). This is in keeping with SSAP 9, stocks and long term contracts.

Definitions: Net realisable value is revenue (sale proceeds) expected to be earned in the future when the goods are sold, less any costs that will be incurred in selling them, (ACCA). Under FIFO, the assumption is made for costing purposes that the first items of stock received are the first items to be sold. Thus every time a sale is made the cost of goods sold is identified as representing the cost of the oldest goods remaining in stock. Closing stock at the end of the period therefore consists of the units purchased most recently. If Matalan were to use LIFO, their closing stock value would have been lower and therefore profit would have be lower

Justification: The concept of prudence is used when stock is valued. Stock should not be over-valued, otherwise profits shown will be too high. Therefore if the net realisable value of stock is less than the cost of stock, then the figure to be taken for the final accounts is that of net realisable value, i.e. following the concept of prudence. At one time the terminology was 'lower of cost or market value'. Changing it to lower of cost or net realisable value' gives a more precise definition to the terms used.

Difficulties: One difficulty involved in the estimation of net realisable value is the last phrase in the definition – 'less the anticipated costs that would be incurred in its disposal.' This sting in the definition's tail can be extremely significant, especially in the case of work in progress, in relation to which the estimation of anticipated additional costs may be difficult and subjective.

Tangible Fixed Assets:

FRS15 provides a general definition of depreciation: it is the measure of the cost or revalued amount of the economic benefits of the tangible fixed asset that have been consumed during the period.

Tangible fixed assets (e.g. freehold buildings; fixtures, fittings and equipment; motor and commercial vehicles) are stated at their purchase price, together with any incidental expenses of acquisition. Revenue costs relating to opening new stores are expenses incurred Provision for depreciation is made so as to write off the cost of tangible fixed assets less their residual value on a straight line basis over the expected useful economic life of the assets concerned.

Depreciation for the freehold buildings is charged over 50 years, motor and commercial vehicles over 3-4 years and fixtures, fittings and equipment over 3-10 years. Discretion has been used here in that FRS 15 does not state a preference for any particular method of depreciation but states that it is the business which must decide which is the most appropriate. Also the length of time they choose to depreciate fixtures and fittings, motor vehicles and freehold buildings was there own choice which is in line with FRS 15. This is an arbitrary method and also a subjective one as there is no real way of telling the life-span of buildings or motor vehicles for example.

However following the implementation of FRS 15, the group's policy on valuing freehold land has been revised so that these are not depreciated. This is fine as FRS 15 states that land does not normally require a provision for depreciation, unless it is subject to depletion by, for example, the extraction of minerals. With freehold land not being depreciated, profit will be higher.

However the value of freehold land may be adversely affected by considerations such as changes in the desirability of its location. The effect of this change was to reduce tangible fixed assets and shareholders' funds by 0.6m at 26th February 2000 and 24th February 2001.

Operating Leases:

Costs in respect of operating leases are charged on a straight-line basis over the lease term. The leasing agreements are treated as if the asset had been purchased outright The assets are included in fixed assets and the capital element of leasing commitments is shown as obligation under finance leases.

The finance leases are depreciated over the shorter of the lease terms and the useful lives of equivalent owned assets, as is in accordance with SSAP 21. There is some subjectivity here as the firm can choose the life of the lease.

Provision is made for deferred tax under the liability method at the tax rate anticipated at the reversal date on all material timing differences to the extent that it is probable that a liability or asset will crystalise. Under the liability method, whenever there is a change in the rate of tax, the balance on the deferred taxation account is adjusted to that current rate of tax on accumulated timing differences. The necessary adjustment is charged or credited to the profit and loss account and hence has an immediate impact on shareholder' interest. According to SSAP 15, Matalan had to provide, if it is likely that the liability (or asset) will crystalise.

Another form of discretion was shown by Matalan was to take advantage of the provisions of UITF 17 (Revised) to exclude the Inland Revenue approved sharesave scheme from this policy.

e)

The management of the company is responsible for the financial information and representations contained in the financial statements, notes and all other sections of the annual report. The financial statements have been prepared in conformity with generally accepted accounting principles appropriate under the circumstances to reflect, in all material respects, the substance of events and transactions, which have occurred. In preparing the financial statements, it is necessary that management make informed estimates and judgements based on currently available information in order to record the results of certain events and transactions. This brings us to a key point. It is important to realise that accounting is not an exact science – judgement and estimation are required to assess almost every item in the financial statements. For example we have met the need to use estimation techniques to arrive at depreciation charges and the provision for doubtful debts in accounts.

The potential benefits of a conceptual framework are related to the purposes stated by the ASB for the Statement of Principles. It provides a framework for setting accounting standards, it provides a basis for resolving disputes and fundamental principles do not have to be repeated in accounting standards. Drawbacks to a conceptual framework include: Owing to their general nature, the principles may not, in practice, reduce the options available. There may be further disagreement as to the contents of the framework in addition to disagreement over the contents of standards.

Accounting policies are the specific accounting bases selected and consistently followed by a specific business enterprise as being, in the opinion of the management, appropriate to its circumstances and best suited fairly to present its results and financial position. Disclosure of accounting policies is essential to the fair presentation of financial accounts. Validity of the Information:

- The information is backward looking. Most users are concerned with the future.
- There is a tendency in financial accounting for increased complexity. This results from the continuing need to satisfy user needs for information, but the end result may be that users do not understand the more detailed information presented.
- The changing purchasing power of money is not dealt with.

Also, the main function of the financial statements is to aid decisions relating to the future. However, the financial statements are historical in nature: they describe what has happened in the period just ended. This is not necessarily a good indication of what may happen in the future. There is thus a significant shortcoming in any interpretation as to its effectiveness in estimating the future (Lewis and Pendrill, 2001).

In this report we carried out some ratio analysis of Matalan. This allowed comparisons: with the performance of the business in previous years; the budgeted or planned performance in the current year; and the performances of similar businesses. However ratios are only a means to an end; they are not an end in themselves. By comparing the relationship between figures, they merely highlight significant features or trends in the accounts. The real goal of interpreting accounts lies in defining the reasons for the features and fluctuations disclosed. To do this effectively, one has to consider the following points:

i) The date at which the accounts are drawn up. Accurate information can only be obtained with certainty from up to date figures. Furthermore, seasonal variations should be taken into account. Final accounts tend to be drawn up at the end of seasonal trade when the picture they present is of the business at its strongest point financially.

ii) The accuracy of the position shown in the balance sheet. The arrangement of certain matters can be misleading and present a more favourable picture (window dressing), such as ordering goods to be delivered just after the year-end so that stocks and creditors can be kept as low as possible.

iii) The accounting ratios of one company must be compared with those of another similar company in order to draw meaningful conclusions. These conclusions will only be valid if that other company's trade is similar.

iv) The Chief Executive's outlook may be a bit biased/optimistic, in order to persuade potential investors to invest in the company.

Limitations of historical cost accounting:

Matalan PLC have based their financial statements on historical cost accounting.

Advantages of historical cost accounting include, records are based on objectively verifiable amounts, it is simple and cheap and the profit concept is well understood.

A disadvantage is that it overstates profits when prices are rising through inflation. Several factors contribute to this. For example, if assets are maintained at their original cost, depreciation is based on that cost. As inflation pushes prices up, the true value to the business of the use of the asset becomes progressively more than the depreciation charge. This disadvantage can be overcome by revaluing fixed assets. FRS 15 Tangible fixed Assets then requires depreciation to be based on the relevant amount (ACCA, 2001).

Other disadvantages include: Maintains financial capital but does not maintain physical capital, the balance sheet does not show value of the business, it provides a poor basis for assessing performance and there is no recognition of the loss suffered through holding monetary assets while prices are rising.

Finally it should be noted that the emphasis on information produced by Matalan's financial statements is financial. In many cases, non-financial data would be useful in order to see a complete picture of the state of the organisation. Non-financial data includes, for example, the number of employees in the organisation and the types of skills they possess, or indicators of efficiency with which the organisation addresses complaints from customers (Lewis and Pendrill, 2001).

References

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