TO: The PQR Company (Current Shareholders)
FROM: Financial Accountant
SUBJECT: Assessment of Financial Performance and Position of PQR
DATE: 10th December 2004

INTRODUCTION

The report that will follow will outline the financial performance of PQR for the past 3 years. The Company's financial statements will be reviewed from 2002 till 2004 in order to obtain a picture of the company's financial position.
The company's performance has been illustrated via Ratio Analysis. A detailed calculation of various ratios is obtainable from the appendix. However a summary table has been included below for reference.

RATIOS	2002	2003	2004
PROFITABILITY			
RETURN ON CAPITAL EMPLOYED %	12.1	12.7	13.0
LIQUIDITY			
CURRENT RATIO	4.3	3.5	2.6
QUICK RATIO	1.5	1.8	1.3
EFFICIENCY			
DEBTORS DAYS	61	48	47
CREDITORS DAYS	33	48	44
STOCK DAYS	136	107	81

The report will be split into Profitability, Liquidity and Efficiency, under which the company's financial statements will be analysis to some degree. The conclusion will bring the report together.

PROFITABILITY

As can be seen from the data supplied sales have increased from £3,600,000 to £4,010,000, an increase of 11%. Calculation based on the difference between 4,010 and 3,600, over 3,600. At the same time cost of sales fell. We can straight away tell the company's gross profit has also increased. Taking these into account, we are able to calculate the Return on capital employed (ROCE), which for 2002 is 12.1, 2003 figures are better but 2004 are even better (13.0), showing the company is making use of its assets. An increase of 0.9 % in ROCE can be significant, especially in comparison to the amount of money the company may have borrowed. Therefore the company needs to ask it self is the ROCE sufficient enough, if it is in need of extra funds by means of debt.

LIQUIDITY

Liquidity is just as important as profitability. A basic definition of the term is how quickly a company can raise cash in order to settles its debt. This can be measured in terms of the Current ratio and Quick ratio. For a quick reference liquid funds can be referred to as cash, short term investment and trade debtors. Based on the above calculation current ratio has fallen from 4.3 to 2.6, which can be considered to be quite significant, a fall of 1.7 can be seen. The basic idea behind this ratio is that a company should have enough current assets which give promise cash, in relation to its current liabilities. A ratio of 1 is expected, which has been the case for PQR, for three years. It is rather worrying over the time the company's gross profit has increased; its current asset ratio has fallen. Which indicates the company is using more and more of its current assets to pay off its current liabilities.

An additional liquidity ratio has also and has been calculated. The Quick ratio which is exactly the same as current ratio, however stock is not taken into account. It has been argued in some companies' stock turns over rather slowly in comparison to all the other current assets. However this is not the case for PQR, as stock has fallen from 1,000,000 to 800,000. Nevertheless with that in mind the calculated figures for the quick ratio have fluctuated. This basically indicates in some years stock turnover was slow and in other years it was high. Stock in 2004 turned over the slowest in comparison to the other two years.

Both these ratios give the company the indication of its liquidity; however in theory a Current ratio of 1.5 and Quick ratio of 0.8 is acceptable. Using this as a yard stick PQR's ratios are some what way off. Due to the size of the ratio's it can be argued the company is over investing in its working capital. It is tying up more funds then necessary, suggesting poor management.

EFFICIENCY

Debtor days are a rough measure of the average length of time it takes for a company's debtors to pay what they owe. Figures from the calculated ratio shows it has fallen quite significantly. As can be seen from, it started off from 61 days in 2002 and end up at 47 days in 2004. The company seems to have improved its credit control department whereby it may have introduced new internal controls. However in comparison to the amount of purchases it's making it could be argued it is reasonable. Reference must be made to the usual terms of credit, which are estimated to be about 30 days. As it started of at 61 days it could be stated it was in a very bad situation where it was unable to obtain payment for at least two months. It could be assumed it was a fairly new company. Its initial planning of obtaining money for its sales was way out. This may represent poor management of funds. Then again if the company was just starting off it may want to allow generous credit terms.
Creditor day's ratio often helps a company to assess its liquidity. The ratio calculated above has fluctuated, starting off at 33 days then increasing to 48 and then falling to 44 days. The increase from 2002 to 2003 shows that the company did not account for any long term finance in terms of current assets. However PQR made improvement from 2003 to 2004, has the credit days ratio fell, only slightly. Nevertheless it is a positive sign in relation to its credit control department.

Stock days started off at 136 days then falling considerably to 81 days in 2004. The company may well be turning over its stock very slowly; improvements were made in the latter years, as it was able to sell stock more quickly. As the table indicates the ratio fell by 55 days. It could be assumed the PQR was making better investment in stock in 2004 then in 2002. Further assumption can not be made as sufficient information is not available, however data on the actual size of the company and sector could be useful.
Further analysis can be made in relation to the efficiency ratios, as stock days can be added together with debtor days. This will indicate how quickly the company is able to turn stock into cash. Based on this thinking calculation can be made, where by in 2002 the company took 197 days (61 + 136) to obtain cash. This figure improved considerably as in 2004 PQR took 128 days (47 + 81). Again reflection can be made to the company's internal controls, which must have improved.

CONCLUSION

Ratios are used to assess financial performance of a company by comparing the calculated figures between pervious years. Such an approach for analysis of company's accounts will have its benefits and drawbacks. The major advantage is it enables meaningful information to be identified within financial statements. It allows the company to view whether aspects of the business are improving or declining. Ratio analysis covers a wide range of areas from profitability to investment. However like any other approach it does have its drawbacks. Probably the most important aspect of using ratios is that they do not give the answers to the assessment of how well the company has performed, they only raise questions. Ratio analysis allows managers to change figures, making users think a favourable position has arisen. Another drawback is there are various definitions to accounting ratios, different components can be applied. Therefore its reliability can be questioned.

In the end there is no right or wrong answer to the analysis of ratios, various calculations can be carried out. On its own it cannot be considered to be enough in terms of interpreting a company's financial statements. An overall picture of the company is okay, improvements have been made especially with the efficiency ratios. Profitability and liquidity ratios seem quite stable.