FINANCIAL STATEMENT ANALYSIS – ASSIGNMENT HELP

QUESTIONS

Scenario:

You are the manager of the high school athletic team division of Abel Athletics, a manufacturer of athletic equipment and apparel, which has recently gone through the initial public offering (IPO) process and has become a public company. Abel Athletics has annual sales revenue of approximately $50 million and makes seven unique and distinct products (which serve seven different markets). Each product is represented by its own division within the company and has its own group of sales, marketing, and manufacturing personnel. Some departments, including human resources and the finance division, support the entire organization. Operations consist of a single headquarters and production (manufacturing) center.

In your role as division manager you are responsible for compiling and reporting on budget / forecast data, for using financial information in decision making, and for assessing and valuing new business opportunities (which will ultimately be presented to upper management). You report directly to the Plant Manager; however, you work closely with the Chief Financial Officer (CFO) and the accounting department's staff accountants assist you with your budget / forecast responsibilities.

You have been informed by the CFO that Abel Athletics will be aggressively pursuing new business opportunities, which may include expansion through acquisition and the development and implementation of new products. As a publicly traded company, Abel Athletics is scrutinized by bankers and investors as never before. In fulfilling your responsibilities you must keep this in mind, and you must instill a new sense of financial discipline in the organization.

Abel Athletics is preparing to release its first Annual Stockholder Report since the company's recent initial public offering (IPO). The accounting department has already prepared and provided the financial statements and ratios (see below) for the most recent year. Now all the division managers are meeting to help create the written analysis portions for the annual report keeping in mind all the stakeholders who will be reading this information. (i.e.,shareholders, regulators, investors, security analysts, credit rating agencies, etc.) Using what you know about Abel Athletics from the scenario above, the financial documents, and details from your previous tasks, create Abel Athletics' first Annual Stockholder Report for its' stakeholders. Provide as much detailed analysis as possible to your shareholders for each of the following areas, keeping in mind how the users of this information are likely to use it:

1. Summarize the nature of the firm's business and its business strategy
2. Assess the internal and external risk factors for the firm
3. Provide an analysis of the financial condition for the firm
4. Evaluate the firm's credit worthiness
5. Discuss the competitive position of the firm
6. Summarize the financial and accounting control procedures in place to ensure compliance with applicable regulatory agencies

Phase 2 Task 1: Ratio Anlaysis
Key Financial Data for Abel Athletics

Stock Price (as of 12/21/06)	$6.25

Free Cash Flow/Share		$0.36
Dividend/Share (DPS): Dividends/shares outstanding		$0.24
Book Value/Share: Shareholders Equity/Shares Outstanding		$0.18
Strident Marks, Inc.		
Income Statement		
For the year ending December 31, 2006		
Revenue		
Net Sales		$8,994,000
COGS (not including depreciation)		$3,759,600
Gross Profit		$5,234,400
Expenses		
SG&A	$1,245,900	
Depreciation Expense	$350,000	
Total Operating Expenses		$1,595,900
Income Before Interest & Taxes		$3,638,500
Interest Expense		$250,000
Income Before Taxes		$3,388,500
Income Tax Expense		$1,016,550
Net Income		$2,371,950
Shares Outstanding		10,000,000
Earnings Per Share (EPS)		$0.24
Beginning RE		$1,500,000
Dividends		$2,400,000
Ending RE		$1,471,950
Strident Marks, Inc.		
Balance Sheet		
As of December 31, 2006		
ASSETS		
Cash		$1,336,950
Accounts Receivable		$900,000
Inventories		$7,500,000
Total Current Assets		$9,736,950
Property, Plant & Equipment		$625,000
less Accumulated Depreciation		$111,000
Net Property, Plant, and Equipment		$514,000
Total Assets		$10,250,950
LIABILITIES & SHAREHOLDER'S EQUITY		

Accounts Payable	$420,000
Accrued Liabilities	$484,000
Interest Payable	$2,500,000
Income Taxes Payable	$900,000
Dividends Payable	$2,400,000
Total Current Liabilities	$6,704,000
Long-term debt	$1,750,000
Total Liabilities	$8,454,000
Common Stock at Par	$425,000
Retained Earnings	$1,471,950
Treasury Stock - at cost	($100,000)
Total Shareholders equity	$1,796,950
Total Liabilities and shareholders equity	$10,250,950

Key Ratios:

		Industry Avg
* Liquidity Ratios		
Current Ratio: Curent Assets/Current Liabilities	1.45	1.25
Quick Ratio: (Current Assets-Inventory)/Current Liabilities	0.33	0.22
Net Working Capital Ratio: Net Working Capital/Total Assets	29.6%	25.2%
* Profitability Ratios		
Return on Assets: Earnings/Total Assets	23.1%	21.50%
Return on Equity: Earnings/Equity	132.0%	125%
Net Profit Margin: Earnings/Sales	26.4%	25%
Operating Profit Margin: Operating Profits/Sales	40.5%	35%
Gross Profit Margin: Sales-COGS/Sales	58.2%	55%
* Activity Analysis Ratios		
Asset Turnover Ratio: Sales/Total Assets	0.88	0.95
Fixed Asset Turnover Ratio: Sales/Net Fixed Assets	17.50	15.5
Equity Ratio (Proprietary Ratio): Shareholders Equity/Total Assets	0.18	0.15
Average Collection Period: AR/(Annual Sales/365)	36.52	40
Average Payment Period: AP/((70%*COGS/365))	58.25	25
Accounts Receivable Turnover Ratio: 365/Avg Collection Period	9.99	8.8
Inventory Turnover Ratio: COGS/Inventory	0.50	0.4
Average Age of Inventory	728.14	675.2
* Capital Structure and Debt Ratios		
Debt Ratio: Total Liabilities/Total Assets	82.5%	50%
Debt to Equity Ratio: Long Term Debt/Equity	97.4%	50%
Interest Coverage Ratio: EBIT/Interest	14.55	25.5

* Capital Market Ratios

Price / Earnings Ratio: Stock price/EPS	26.3	28.2
Market to Book Ratio: Stock Price/Book Value per Share	34.78	37.5
Dividend Yield: DPS/Stock Price	3.84%	2.50%
Dividend Payout Ratio: DPS/EPS	101.2%	25%

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ANSWERS

Answer 1

Abel Athletics operates in the athletics apparel and equipment industry. The company had seven divisions which serve seven different markets. The sporting goods and equipment industry's major segments are sports apparel, athletic footwear and sporting goods equipment. This industry includes those companies that design, manufacture, and/or market sporting and athletic gear, including apparel and equipment for fishing, hunting, hiking, golf, tennis, baseball, basketball, football, biking, rollerblading, snowboarding, skateboarding, surfing, skiing, and hockey, along with playground and play scape equipment. The demand of such kind of goods depends a lot on lifestyle changes in the market.

Abel Athletics plans to follow both inorganic and organic growth strategy. It wants to grow by adding newer product lines through a series of acquisitions. If we look at the way the organization is structures, it's a matrix structure. Every division acts as a profit center and has all the management activities like sales, marketing, and manufacturing specific to it. This kind of organization structure is in coherence with the inorganic growth strategy, because it is much easier to integrate the two companies. It also plans to implement newer products to further expand its product portfolio.

Over the past decade, apparel companies have shifted focus and now concentrate entirely on design and marketing while maintaining little or no manufacturing capability.

- Change has been expensive and transforming, but margins have failed to improve

  Despite operating leverage associated with apparel companies' shift away from manufacturing and design, margins are no better. With intense competition among manufacturers and among retailers, gains are passed on to consumers rather than retained by the companies.
- With change in operating model, value is concentrated increasingly in intangibles such as brand strength and customer relationships
- Increasing global sourcing subjects apparel companies to a new set of systemic risks

  Global sourcing, which has become a key component of the industry's current profile, can reduce risk by reducing capital intensity. Nonetheless, it increases an apparel company's sensitivity to foreign exchange fluctuations, potential supply disruptions, monitoring of quality standards, changes to fuel and transportation prices, and international trade policies.
- Consolidation among retailers has increased the retailers' power

  This results in fewer sale venues, which raises vendors' exposure to the financial health of key retailer. Apart from protecting their own margins, they are transferring some of their operating costs to vendors by, for example, requiring clothes to be delivered floor ready.
- Seasonality and Cyclicality

  Industry is subject to high cyclical volatility since consumers may defer non-essential replacement purchases where there is economic stress, or insufficient fashion incentive. Seasonality creates volatile cash flows as do unpredictable fashion and economic cycles.
- Diversity

  A company's diversity is a key element influencing its business profile and finally its rating. There are different angles to look at diversity and each of them needs to be assessed against the company specific background. Given the diversified nature of the rated universe covered by this methodology, four dimensions are used for the purpose of this rating methodology (Product Diversity, Regional Diversity, Customer Diversity, End market Diversity).
- Challenging raw material price environment

  Manufacturing companies have been challenged over the past few years by significant increases in the cost of energy and other raw materials due to increased global demand and rising oil prices. Cost savings generated by corporate restructuring, production relocation, and outsourcing has in many instances been largely or totally neutralized by higher costs of raw material, components, packaging and transportation. While rising prices are cushioned by a sound hedging mechanism, companies need to continuously reassess their business model and restructuring actions at shortening intervals to be able to withstand the pressures of this challenging environment.

Answer 2

Internal Risks

- Highly Levered Capital Structure
- Changes in inventory mix
- Inventory aging and out of season inventory
- Decrease in open sales orders

External Risks

- Increasing competition leading to global sourcing subjects apparel companies to a new set of systemic risks

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- Seasonality and Cyclicality

  Industry is subject to high cyclical volatility since consumers may defer non-essential replacement purchases where there is economic stress, or insufficient fashion incentive. Seasonality creates volatile cash flows as do unpredictable fashion and economic cycles.
- Volatility in Raw material prices and supply

  High risk in apparel industry comes from volatility in supply and prices of raw materials like cotton, etc.

Answer 3

The financial condition of the company will be analyzed under certain categories:

Activity

The activity ratios measure how efficiently a company performs day to day tasks, such as collection of receivables and management of inventory. Some common activity ratios include Inventory Turnover, Days of Inventory at Hand, Receivables Turnover, Days of Sales Outstanding, Payables Turnover, Number of Days Payable, Working Capital Turnover, Fixed Assets Turnover and Total Assets Turnover.

	Abel Athletics	Industry Avg.	Interpretations
Total Asset Turnover	0.88	0.95	Abel lacks in efficiency when it comes to managing total assets, indicates improper management of non fixed assets.
Fixed Asset Turnover	17.5	15.5	A higher Fixed Asset Turnover represents better and efficient use of Fixed assets to generate revenues
Average Collection Period	36.52	40	Lower Collection period indicates that Abel Athletic has better collection systems than the competition
Average Payment Period	58.25	25	Higher number of days to pay the suppliers indicated better leveraging power of Abel over the suppliers
Inventory Turnover	0.5	0.4	A high inventory turnover relative to industry norms indicates highly effective inventory management, or that the company runs on shortage of industry.
Accounts Receivables Turnover	9.99	8.8	Higher accounts receivables turnover means better and efficient credit management and collection

<u>Liquidity</u>

Liquidity analysis, which focuses on cash flows, measures a company's ability to meet its short term obligations.

	Abel Athletics	Industry Avg.	Interpretations
Current Ratio	1.45	1.25	Greater than 1 represents greater current assets than current liabilities. A number higher than industry average represents better liquidity condition of Abel Athletics
Quick Ratio	0.33	0.22	It gives a more conservative picture of liquidity. Although the number is small, it is still higher than the industry average, indicating that Abel is better equipped to handle its short term obligations than its peers.

Solvency

Solvency refers to company's ability to fulfill its long term obligations. The capital structure of the firm has an impact on these ratios.

	Abel Athletics	Industry Avg.	Interpretations
Debt Ratio	82.50%	50%	This means that 82.5% of Abel's assets are financed by debt. Higher than competitors indicate Abel to be a riskier investment than competitors
Debt Equity Ratio	97.40%	50%	This means that 97.4% of Abel's capital is constituted of debt. Higher number indicated higher financial risk and weaker solvency.
Interest Coverage Ratio	14.55	25.5	A lower interest coverage ratio than competitors indicates weaker solvency.

Answer 4

A number of factors go into determining a company's credit worthiness. These factors are both quantitative and qualitative in nature. We will analyze the credit worthiness of Abel Athletics based on these following criteria's:

1. Market Position
2. Business Volatility
3. Diversification
4. Financial Strength

Market Position

It is an indication of competitive strength of the company in the market it serves. This, in turn, translates into the likelihood of recurring sales, higher profitability and importance/relevance to retailer customers. Two important parameters, scale of operations and Brand Strength give a picture of position in the market.

Scale allows companies to leverage costs and obtain clout with suppliers and customers. It also enables investment in efficient technology, production, sourcing, marketing, and distribution.

Brand strength is a measure of consumer 'pull' for the brand, which is critical for success. Shift in fashion can cause a hot brand to turn cool in a short period of time. Stronger brands have greater consumer demand, resulting in higher likelihood of recurring sales, reducing volatility.

Under the criteria of market position, Abel Athletics might not be the largest of manufacturers of athletic apparel and equipments, but it is in a growth stage, looking for opportunities of expanding through acquisitions and addition of new product lines. It has Sales figures of $50 million which is quite a number.

Business Volatility

It is important to analyze company's vulnerability to cyclicality to determine its credit worthiness. Quarterly results should be analyzed for seasonal effects, which are very relevant for a company operating in this sector.

Abel Athletics has had consistency in this respect, and a look into the operating profits provides an important indicator of success of company's brand and cost effectiveness.

Diversification

Credit worthiness of a company is dependent not only the amount of cash and earnings the company generates but also on the volatility in those cash flows and earnings.

Abel Athletics is highly diversified with operations in 7 divisions which serve 7 different markets. It gives it a unique advantage over other competitors, where risks in one market get diversified by positive results in other division in other markets.

Financial Strength

Some important ratios that should be observed to measure the financial strength of a company when analyzing it for credit worthiness are:

Current Ratio

An indication of a company's ability to meet short-term debt obligations; the higher the ratio, the more liquid the company is. The Current Ratio for Abel Athletics is 1.45 which is much higher compared to industry average of 1.25. Hence we can say that Abel Athletics is better placed to meet its short term obligations, and is doing a much better job of managing its working capital.

Quick Ratio

Having a higher current ratio may also mean a lot of money invested into inventories. But Abel Athletics has a quick ratio of 0.33 which is much higher that the industry average of 0.22. Hence it also indicated stronger financial strength of Abel Athletics to meet is short term obligations.

Debt-Equity Ratio

In accordance with high growth strategy maintained by Abel Athletics, it is in constant need for funds to finance many new opportunities and projects. For this reason, Abel Athletics has a leverage of 97.4 % which is higher than the industry average. Keeping in consideration the fact that Abel Athletics had an

IPO just a last year, we can foresee a chain of events which will bring this leverage down in the near future.

Interest Coverage Ratio

Abel Athletics has a healthy interest rate coverage ratio of 14.55. This might seem a little low compared to the industry average of 25.5, but it is in coherence with the levered nature of capital structure of Abel Athletics. This ratio also stands to improve in the very short term because of the changing capital structure of the company.

Operating Profit Margin

Abel Athletics operates at an OPM of 40.5% compared to competitors at 35%, it clearly shows that operations at Abel Athletics are much more streamlined, and it operated at much higher efficiency than its competitors.

<u>Answer 5</u>

An analysis of the profitability ratios of a firms reflects it's competitive position in the industry, and by extension, the quality of its management. The commonly used measures of Profitability include Gross Profit Margin, Operating Profit Margin, Net Profit Margin, Return on Assets, and Return on Equity.

	Abel Athletics	Industry Avg.	Interpretations
Return on Assets	23.10%	21.50%	It shows that Abel generates more revenues than the competition for a given level of assets.
Return on Equity	132.00%	125%	Abel also generates more revenue for the given level of equity than its competitors
Net Profit Margin	26.40%	25%	Higher Net Profit Margin indicates better future profitability for Abelthan its competitors
Operating Profit Margin	40.50%	35%	Higher Operating Margins indicate efficient management of operating costs and operations by Abel.
Gross Profit Margin	58.20%	55%	Higher Gross Profit Margin indicates combination of higher product pricing and lower product costs. Higher GPM of Abel indicates that it has competitive advantage in the industry.

Thus we see that Abel Athletics outperforms competition in every measure of profitability and this indicates that Abel enjoys a certain level of competitive advantage in the industry.

Answer 6

Different regulatory authorities have different standards for reporting and compliance. These standards set the amount of disclosures and the types of information that must be provided to various stakeholders like the investors, creditors, etc. The following are the characteristics of effective reporting to ensure compliance with the regulatory bodies:

Transparency: The reporting of information should be carried out in the way that the user should be able to see the underlying economics of the business. Full disclosures and fair presentation creates the element of transparency.

Comprehensiveness: The information collecting and reporting framework should encompass the full spectrum of transactions. So the framework should be based on principles that are universal.

Consistency: Similar transactions should be measured and presented in a similar manner regardless of industry, company size, geography or other characteristics. Balanced against this need for consistency, however, is the need for sufficient flexibility to allow companies sufficient discretion in reporting.