Financial Statement Analysis: The Case of Sunlight Industrial and Distribution Company (SIDCO)

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1. Background of the company

Sunlight Industrial and Distribution Company (SIDCO) was established in 1975 E.C, with the objectives of:

- developing small- scale industries in Ethiopia;
- setting up efficient distribution outlet for marketing imported as well as locally produced industrial and agricultural commodities; and
- representing local enterprises and foreign firms.

With rich and time-tested experience as well as activities in business today, widening its scope of services it offers, SIDCO is firmly engaged in Manufacturing, Import, Export, Agency, Marketing and Distribution.

2. Statement of the problem

If proper financial analysis is not done and decisions are not made on the basis of analysis, this result the following problems which prevail in the organization under consideration.

- The longer period that might be taken for credit sales collection has an impact of tying up the production capital from being re-used for purchases of raw materials for the next round production. If this trend continues, it will reduce the net income of the company for the year.
- The fact that management is not considering fixed assets turn over ratio as the means of evaluating the performance of the firm has blocked the firm from observing the unused production capacity potential.

- The company does not make a write-off entry for damaged inventories, hence; the inventory balance is showing overstatement and unrealistic balance.
- The net working capital and over all capital is limited. Currently, the factory has a working capital and investment shortage because it doesn't have a policy of raising additional capital through any means. Because the capital of the company is limited, it might have a direct bearing on the liquidity position of the company.

3. Research Questions

In light of the above problem statement, the research will try to give answers to the following research questions.

- Does the company has the ability to meet its current and long-term obligations in due time?
- What does the trend in the efficiency of Asset utilization of the firm look like over the periods under consideration?
- Does the company make adequate use of the financial analysis tools to monitor its performance, condition and future prospects from financial perspective?

4. Objectives of the Study

The objectives of the study are divided in to two.

4.1 General objective

The general objective of the study is to analyze the financial statements of SIDCO Share Company and come up with reliable information regarding weaknesses and strengths of the firm regarding financial performance and position of the firm.

4.2 Specific objectives

From the above general objective the following specific objectives can be derived

- To evaluate the financial strengths, weaknesses and performance of the company over the five years period under consideration;
- To assess the effectiveness of the company with regard to its asset management in generating sales;

- ❖ To assess the liquidity, leverage management, profitability ratios and market based ratios;
- ❖ To clearly show the trend of changes in the ratio: the direction of changes and reasons for changes.

4.3 Research Methodology

In order to conduct the study, researchers employed descriptive research method. Both primary and secondary data were collected and used. To get the necessary information for the analysis, the researchers used the five year income statements and balance sheet (from 2002 to 2006) G.C. Thus, document analysis is used as a method gathering relevant data for the research. The data contained in the basic financial statements, i.e., Balance sheets and income statements of SIDCO Company for the five years are analyzed using financial ratios. Also, and vertical and horizontal analysis were used. After the items being exactly known from the financial statements logical relationship are established between the items using Financial Ratio formula. Then description of the implications of the ratios followed.

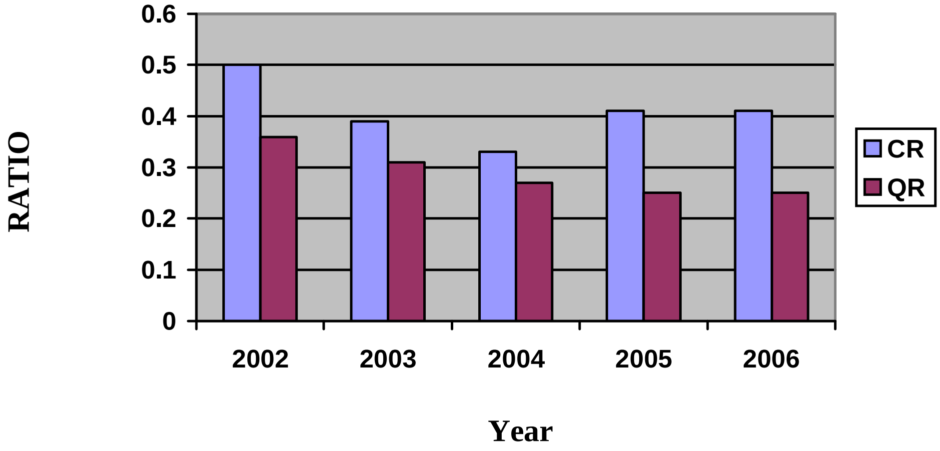
5. Summary of Findings

The major findings are summarized and presented hereunder.

5.1 Liquidity ratios

Current ratio of SIDCO ranges from the minimum ratio of 0.33 in the year 2004 to the maximum of 0.50 in 2002. The mean current ratio over the range of five under study is 0.41.The minimum and maximum Quick ratio of SIDCO was recorded 0.25, in the year 2005 & 2006 and 0.36 in the year 2002 respectively. The average quick ratio of SIDCO over the period of 2002-2006 was 0.29.

Figure 1: Liquidity Ratio

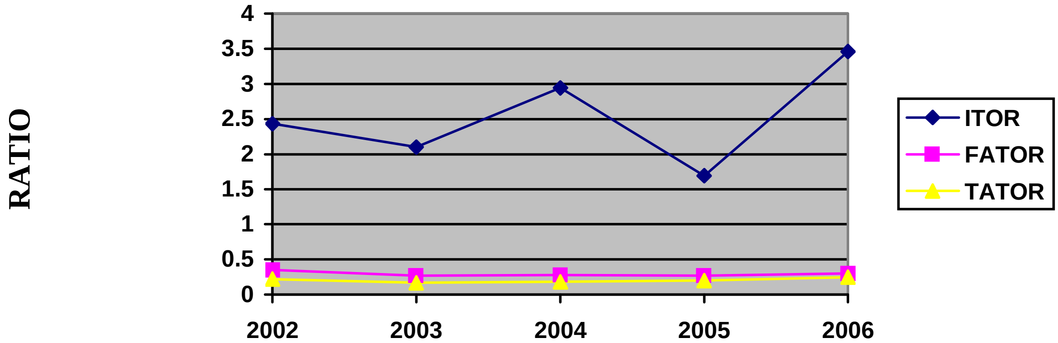


Source: Financial statement of the company (2002 to 2006)

5.2 Asset Management ratio

The maximum ITOR of SIDCO is 3.46 and the minimum is 1.69 recorded in the years 2006 and 2005 respectively. The average ITOR was 2.52 over five years. FATO ratio of SIDCO ranges from 0.35 in 2002 and 0.27 in 2003 and 2005. The average FATOR within the five years was 0.29.In the year 2003 the TATOR of SIDCO was at minimum point 0.17 and in the year 2006 it was at maximum point, 0.25. The average TATOR of SIDCO was 0.20.

Figure 2: Asset Management Ratio

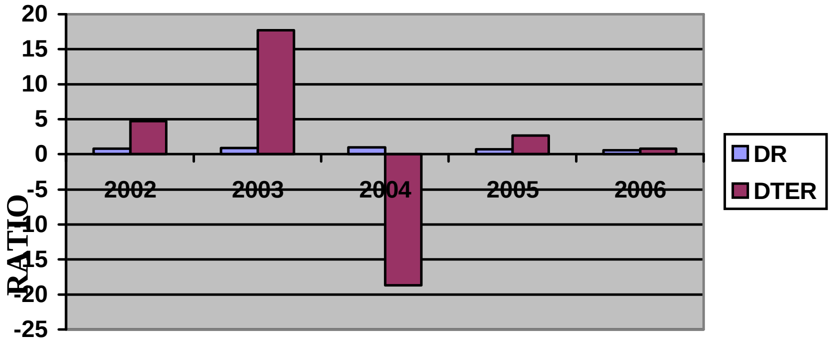


Source: Financial statement of the company (2002 to 2006)

5.3 Debt Management Ratio

Debt ratio of SIDCO shows maximum 1.05 in the year 2004 and minimum 0.52 in the year 2006. The mean debt ratio value over the entire period amounts to 0.81. The debt equity ratio of SIDCO shows maximum value of 17.73 in the year 2003 and minimum value of -18.74 in the year 2004

Figure 3: Debt Ratio



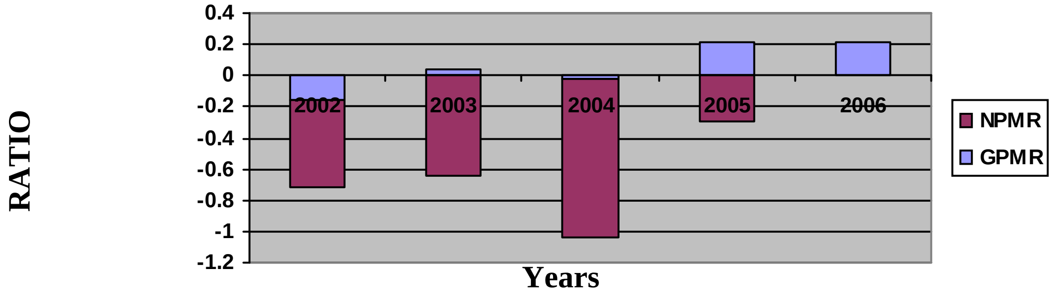
Years

Source: Financial statement of the company (2002 to 2006)

5.4 Profitability Ratio

The minimum gross profit margin ratio of SIDCO -0.16 in the year 2002 and the maximum is 0.22 in the year 2005. The net profit margin ratio of SIDCO ranges between 0.00916 obtained in 2006 to -1.02 obtained in 2004

Figure 4: Profitability Ratio



Source: Financial statement of the company (2002 to 2006)

6. Conclusion

On the basis of the major findings, the following conclusions were drawn.

- ✓ The liquidity condition of SIDCO is not satisfactory. Literatures generally suggest current and quick ratios to be 2:1 and 1:1 ratio respectively. However, SIDCO's current ratios are far below these amounts.

- ✓ When the debt management of the company is assessed, over the five consecutive years, on average, 81 percent of assets were coming from debt; the remaining 19 percent are financed by owners. From this, one can conclude that the management was using more debt financing than equity.
- ✓ While assessing how the company has been managing its assets, the research groups found our that the assets turn over for the year 2005 was slightly higher, as the result of increasing specially inventory level other wise the data analysis indicated that company has a better handling of its inventory turnover, fixed asset turnover as well as total asset turnover for the remaining budget years.
- ✓ The study group examined the profitability ratio of SIDCO for the last four years and found out that it was decreasing, however, the year 2006 showed a profit and in order to earn more, strict follow up of the management is necessary in all areas with special emphasis in the production and sells part of the company.
- ✓ In general, the four types of ratios within the five years indicted that SIDCO performance is low and the ability to survive in the long run is questionable.
- ✓ The common size and common-base year comparisons financial statements shows most of the Balance sheet and Income statement items are increased year to year when it was divided by Total Assets, Sales and the base year. This shows the performance of the company is increased.

7. Recommendations

Based on the findings and conclusions the researchers forward the following recommendations:

- It is found that the company liquidity position for the last five years was less than satisfactory due to higher amounts of liabilities. The researchers, therefore, recommend that, to increase the ability of the firm to meet its current obligation the company should increase its current assets through investing cash in short time investment.
- The company needs to improve its profitability ratio by reducing the cost of good sold and operating expenses. It can be, therefore, suggested that the company should reduce the cost of goods sold by efficient utilization of direct

material, direct labor and factory over head costs. The operating expense can also be lowered or slashed by reducing expenses that do not generate reasonable revenue.

- The administrative expense of the company particularly the repairing cost of plant asset for the last five consecutive years has improved. This is encouraging; however there are still some rooms for more improvement. The group has noted that there are old plants consuming huge maintenance costs. The group thus recommends that the company has to dispose these old plant assets that are not worthy, and give up incurring high maintenance costs.
- As observed, even if the ratios are prepared, the management was not making use of all financial ratios for evaluating the company's performance. So, the student researchers recommend that the company should use these ratios to assess its financial condition and make prompt action to rectify problems.

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