

## **Sample Operational and Financial Analysis Report**

## Financial Analysis and Assessment

### Sample Company

**Industry:** Contract Research Organization

**Periods:** One fiscal year against the previous fiscal year

### LIQUIDITY

*Generally, what is the company's ability to meet obligations as they come due?*

In this case, the company's liquidity position is **about average for the industry** in which it operates. Having average liquidity means that, generally, there are adequate liquid assets relative to short-term obligations. This does **not necessarily** mean that the firm will never have trouble paying the bills, but it indicates that as of this specific Balance Sheet date, the company is in a reasonable position.



However, it is always important to keep in mind that **liquidity is a volatile statistic** that can move from good to poor very quickly. For this reason, it is more important to watch trends than raw data in this area. As of these two discrete dates, the company's liquidity trend is downward, so managers will probably want to examine the reasons for this shift and make sure that liquid resources are being used in the best ways for the company. For example, does the company have an adequate line of credit set up? Remember that typically, increasing sales (as this company has done) demands cash resources.

Liquidity is the challenge that is never solved. Here are some additional ways the company **might** improve liquidity: 1) Bill customers as quickly as possible after service has been rendered. There are always ways to streamline this process. 2) Make sure to print and take action on accounts receivable reports **each month**. 3) Use as much trade credit (accounts payable) as possible. Accounts payable are a form of free credit, since they often do not carry interest charges. 4) If possible, the company might also use a monthly payroll schedule.

| Financial Indicator   | Current Period | Prior Period |
|---|----------------|--------------|
| Working Capital   | \$49,997.00    | \$63,557.00  |
| <i>Working Capital = Current Assets - Current Liabilities</i>   |                |              |
| <b>Explanation:</b> This is the capital that finances continuing operations of the company. It is normally used to manufacture, sell, and receive payment for products and services. Working Capital shows the available liquidity resources after current obligations are met. |                |              |
| Accounts Receivable Days  | 10.8 Days      | 8.1 Days     |
| <i>Accounts Receivable Days = (AR/Sales) * 365</i>  |                |              |

**Explanation:** This number reflects the average length of time between credit sales and payment receipts and is crucial to maintaining positive liquidity.

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|                       |           |          |
|-----------------------|-----------|----------|
| Accounts Payable Days | 15.8 Days | 8.1 Days |
|-----------------------|-----------|----------|

$$\text{Accounts Payable Days} = (\text{AP}/\text{COGS}) * 365$$

**Explanation:** This ratio shows the average number of days that lapse between the purchase of material and labor and payment for them. It indicates how timely a company is in meeting payment obligations.

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|                |          |          |
|----------------|----------|----------|
| Inventory Days | 3.3 Days | 6.4 Days |
|----------------|----------|----------|

$$\text{Inventory Days} = (\text{Inv}/\text{COGS}) * 365$$

**Explanation:** This measure shows how much inventory (in days) is on hand. It indicates how quickly a company can respond to market and/or product changes. Not all companies have inventory.

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|                     |              |              |
|---------------------|--------------|--------------|
| Operating Cash Flow | \$244,727.00 | \$211,258.00 |
|---------------------|--------------|--------------|

$$\text{Operating Cash Flow} = \text{EBITDA}$$

**Explanation:** Operating Cash Flow or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is a key indicator of a company's ability to generate cash to meet obligations. This indicates the positive cash flow that a company generates from continuing operations.

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|                 |           |           |
|-----------------|-----------|-----------|
| Operating Cycle | 14.1 Days | 14.4 Days |
|-----------------|-----------|-----------|

$$\text{Operating Cycle} = \text{AR Days} + \text{Inv Days}$$

**Explanation:** Operating Cycle represents the number of days between the time a product is added to inventory (if any) and the time when cash is actually received.

## **PROFITS & PROFIT MARGIN**

*Are profitability trends favorable in the company?*

There are two components the company may want to watch in this key management area: 1) The net profit margin did not rise this period, as might be expected. Since some costs are fixed (they do not change much while sales change), the net profit margin should generally rise when the company generates more sales and gross profit dollars than last period. Basically, expenses should be shrinking as a percentage of sales. Although this is not a large problem because net profits (in dollars) are higher than last period, it is a good goal to improve the net profit margin when increasing sales. 2) The gross profit margin has slipped. Gross margins are important because they are the "levers" to gross profits, which managers use to "fund" operating costs. Even though dollars of gross profit still increased because sales rose by so much, managers will want to at least note any slips in gross margin.



On the clearly positive side, even though the net profit margin has stayed relatively flat, it is still in line with what most other companies in the industry are earning. The company is fairly profitable, generally. If managers can continue to grow the business and contain the different cost elements, the company will be in good health. Ultimately, the goal will probably be to generate above average profits compared to other businesses in the industry.

However, there is one more point to consider as well. It should be determined whether management is deliberately trying to keep profits and margins at only "average" levels. Perhaps the company is investing in future growth - expenses that will push higher long-term profits and sales? If this is the case, it is **not necessarily** true that profits in the firm should be pushed higher at this time.

It is always crucial to establish a good budget for the business and put that budget right into the accounting system. This allows managers to pull reports each month that show how much they are spending in each area versus how much they had budgeted to spend. **General Industry Observation:** Is there a way that the company can use more temporary workers? Using temporary labor can be very profitable. Any money that this type of labor generates above direct costs will fall to the bottom line. Also, management can use more or less of this labor based upon shifting client demand. Simply, there is no long-run obligation to temporary employees.

| Financial Indicator  | Current Period | Prior Period |
|--|----------------|--------------|
| Operating Cash Flow Margin   | 7.80%          | 7.50%        |
| <i>Operating Cash Flow Margin = EBITDA/Sales</i>   |                |              |
| <b>Explanation:</b> This percentage indicates how much cash flow a company realizes from each dollar of sales. |                |              |
| Return on Equity (ROE)   | 236.20%        | 83.40%       |
| <i>Return on Equity (ROE) = Net Profit before Taxes/Total Equity</i>   |                |              |
| <b>Explanation:</b> This measure shows how much profit is being returned on the shareholders' equity.          |                |              |
| Labor Cost Ratio   | 36.30%         | 31.60%       |
| <i>Labor Cost Ratio = Salary Expense/Sales</i>   |                |              |
| <b>Explanation:</b> This measure shows what percentage of sales dollars are being spent on employees.          |                |              |

## SALES

### *Are sales growing and satisfactory?*

The company did good work in raising sales. Higher sales are certainly better than lower sales since the company relies on sales dollars to "fund" additional expenses. Management was also able to increase sales at the same time as assets were lowered. Typically, companies like to see lower asset levels and higher sales concurrently. This can sometimes imply that the assets eliminated were not contributing to sales. More importantly, it means that the company is "turning" fixed assets more effectively than last period, which is good.



On the other hand, it should be mentioned that the employee base rose faster than sales levels, which means that the company is driving fewer sales through each employee that is on the payroll. This is less favorable, particularly if it continues as a trend in the future. This situation could possibly indicate that the company needs to allow some time for new hires to have an effect on sales. Or, perhaps it means that the people hired are not an integral part of the sales process, but they will still help profitability.

| Financial Indicator | Current Period | Prior Period |
|---------------------|----------------|--------------|
| Sales Per Employee  | \$51,161.03    | \$59,958.04  |

*Sales Per Employee = Sales/Total Employees (FTE)*

**Explanation:** This measure shows the annualized sales being generated per employee.

|                      |        |        |
|----------------------|--------|--------|
| Fixed Asset Turnover | 27.9 x | 11.1 x |
|----------------------|--------|--------|

*Fixed Asset Turnover = Sales/Fixed Assets*

**Explanation:** This asset management ratio shows the multiple of annualized sales that each dollar of fixed assets is producing. This indicator measures how well fixed assets are "throwing off" sales and is very important to businesses that require significant investments in such assets.

## **BORROWING**

### *Is the company borrowing profitably?*

In this case, the results are rather mixed. Profitability improved from last period but total debt rose at a much faster rate. For the short term, it is pleasing to see that profitability improved. However, in the long run it is important to improve profitability at a comparable rate to the debt increases, or the company could end up with long-term problems, in the form of an excessive debt load for the profitability level. It would be prudent to watch this area carefully. This situation is easy to miss if managers are concentrating on just profitability.



| Financial Indicator  | Current Period | Prior Period |
|----------------------|----------------|--------------|
| Debt-to-Equity Ratio | 2.2 x          | 0.7 x        |

*Debt-to-Equity Ratio = Total Liabilities/Total Equity*

**Explanation:** The Balance Sheet leverage ratio indicates the composition of a company's total capitalization. The total capitalization indicates the balance between money or assets owed versus the money or assets owned. Generally, creditors prefer a lower ratio to decrease financial risk while investors prefer a higher ratio to realize the return benefits of financial leverage.

|                    |       |       |
|--------------------|-------|-------|
| Cash Flow Leverage | 0.8 x | 0.7 x |
|--------------------|-------|-------|

*Cash Flow Leverage = Total Liabilities/EBITDA*

**Explanation:** This ratio measures a company's ability to repay debt obligations from operating cash flow (EBITDA).

|                    |        |        |
|--------------------|--------|--------|
| Cash Flow Coverage | 15.5 x | 15.2 x |
|--------------------|--------|--------|

*Cash Flow Coverage = EBITDA/Interest Expense*

**Explanation:** This ratio measures a company's ability to service debt payments from operating cash flow (EBITDA). An increasing ratio is a good indicator of improving credit quality.

## **ASSETS**

### *Is the company using fixed assets effectively?*

Asset purchases represent large investments (often financed) that can lead to long-term profitability. In this case, some assets were eliminated, but profitability was still improved. This is a very good result, because it can help improve the return on assets



significantly over the long term. Additionally, lowering the asset load while improving profitability should help lead to long-run health. The company will want to carefully consider whether or not to purchase additional assets at this time. A superficial glance would indicate that the company may not need to purchase assets right now to continue improving profitability; however, it is important to carefully analyze this kind of decision while looking at the company as a whole unit.

| Financial Indicator  | Current Period | Prior Period |
|--|----------------|--------------|
| Return on Assets   | 73.30%         | 49.60%       |
| <i>Return on Assets = Net Profit before Taxes/Total Assets</i>   |                |              |
| Explanation: This calculation measures the company's ability to use its assets to create profits. Basically, ROA indicates how many cents of profit each dollar of asset is producing per year.  |                |              |
| Asset Composition  | 45.70%         | 27.00%       |
| <i>Asset Composition = Current Assets/Total Assets</i>   |                |              |
| Explanation: This ratio measures the proportion of current assets to total assets. A lower ratio would indicate that a company has significant investments in long-term assets and less flexibility in meeting short-term obligations. |                |              |

## **EMPLOYEES**

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### *Is the company hiring effectively?*

Net profitability has improved from last period, which is good. However, it is less positive to see that the employee base grew significantly faster than net profitability. Over the **long run**, this may cause problems (if the trend continues). Unless managers are using a deliberate strategy to hire people who will generate additional profitability in the long run (and the company can maintain its liquidity), it might be wise to watch this area closely -- all future hires should be evaluated for their contribution to net profitability.



"Make everything as simple as possible, but not simpler." - Albert Einstein

| Financial Indicator   | Current Period | Prior Period |
|---|----------------|--------------|
| Return on Labor   | 17.50%         | 19.40%       |
| <i>Return on Labor = Net Profit before Taxes/Salary Expense</i>   |                |              |
| Explanation: This indicator represents the percentage of profit generated from each dollar invested in employee compensation. |                |              |
| Profit per Employee   | \$3,245.93     | \$3,668.43   |
| <i>Profit per Employee = Net Profit before Taxes/Total Employees (FTE)</i>  |                |              |
| Explanation: This indicator represents the annualized amount of profit that each employee is generating.                      |                |              |

**RAW DATA**

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|                                 | <b>Current Period</b> | <b>Prior Period</b> |
|---------------------------------|-----------------------|---------------------|
| <b>Income Statement Data</b>    |                       |                     |
| Sales (Income)                  | \$3,120,823           | \$2,818,028         |
| Cost of Sales (COGS)            | \$1,572,043           | \$1,318,906         |
| Gross Profit                    | \$1,548,780           | \$1,499,122         |
| Gross Profit Margin             | 49.63%                | 53.20%              |
| Salary Expense                  | \$1,132,019           | \$890,079           |
| Depreciation and Amortization   | \$30,965              | \$24,967            |
| Interest Expense                | \$15,760              | \$13,875            |
| Net Profit before Taxes         | \$198,002             | \$172,416           |
| Net Profit Margin               | 6.34%                 | 6.12%               |
| Extraordinary Gain or Loss      | \$0                   | \$0                 |
| <b>Balance Sheet Data</b>       |                       |                     |
| Cash (Bank Funds)               | \$10,526              | \$8,409             |
| Accounts Receivable             | \$92,485              | \$62,388            |
| Inventory                       | \$14,345              | \$22,982            |
| Total Current Assets            | \$123,406             | \$93,843            |
| Fixed Assets                    | \$111,789             | \$253,800           |
| Total Assets                    | \$270,239             | \$347,643           |
| Accounts Payable                | \$67,907              | \$29,143            |
| Total Current Liabilities       | \$73,409              | \$30,286            |
| Total Liabilities (Total Debt)  | \$186,412             | \$140,821           |
| Employees and Contractors (FTE) | 61                    | 47                  |

**GRAPHS**

