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NEED/IMPORTANCE OF THE STUDY

STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESES

RESEARCH METHODOLOGY

RESULTS & DISCUSSION

FINDINGS

RECOMMENDATIONS/SUGGESTIONS

CONCLUSIONS

SCOPE FOR FURTHER RESEARCH

ACKNOWLEDGMENTS

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FINANCIAL DIAGNOSIS: A CASE STUDY OF LANKA ALUMINIUM INDUSTRIES PLC IN SRI LANKA

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ABSTRACT

An attempt was to enquire into the entire gamut of the Lanka Aluminium Industries Plc (LALU) affairs by diagnosing the financial health, particularly, aspects of liquidity, assets management, debt-financing and profitability, applying the techniques of ratio analysis on accounting information for a period five years (i.e., 2006-2010). The result reveals that the LALU shows inefficient financial performance during the period of the study and needs immediate action and care of concerned authorities for its mere existence event.

KEYWORDS

Accounting System; Financial Diagnosis; Income Statement and Balance Sheet.

1. INTRODUCTION

inancial Statements are derived from a historical cost- based accrual accounting system employing generally accepted accounting principles. The two primary statements are the income statement and the balance sheet (Pinches, 1984). A firm's income statement reports operations over a period; the balance sheet reports its assets, equity and liabilities at a point in time. For the investors, careful analysis of these statements can provide some clues about the firm's future cash flows. For management, careful analysis can help it plan for and anticipate the future. Thus, the point of financial analysis is to diagnose trends that are indicative of the magnitude, timing or riskiness of the firm's future cash flows (Pinches, 1984). The financial statements, if utilized and interpret carefully, can provide 'symptoms' of the condition of the firm. That is, just as a physician uses symptoms for diagnosis, a financial analyst of manager help to utilize his/her experience to interpret the 'symptoms' revealed by the financial economic and managerial conditions of the firm (Mathur, 1979).

2. THEORETICAL BACKGROUND

The analysis and interpretations of financial statements are generally aimed at determining the financial position of a firm. Ratio analysis is a part of the total analysis of the financial statements. Financial ratio is used as an analytical technique for assessing the performance of the concern (Kaveri, 1980). Any attempt to find out the relationship between two items or groups of items of the financial statement establishes a ratio. (Kaveri, 1980). The analysis of financial ratio involves two types of comparisons (i) time-series analysis and (ii) cross-sectional analysis.

Times series analysis is done when a financial analyst measures a firm's performance overtime. Comparison of current to past performance utilising ratio analysis allows the firm to determine whether it is progressive as planned. Cross-sectional analysis involves the comparison of different firms' financial ratios at the same point in time. Another popular type of cross-sectional comparison is a comparison of the firm's ratios to industry averages (Gittman, 1982).

Ratio analysis becomes complete if the actual ratios of a firm are compared with the average ratios or standard ratios of the industry. It is important not to rely on single ratio for getting a complete idea about the soundness or weakness of the business firm because each ratio tells its own story and each ratio in conjunction with the others then tells a supplementary story (Kaveri, 1980). Ratio analysis may not be a precise technique for ascertaining liquidity, solvency, profitability, etc., of the firm because the financial statements are prepared on the basis of certain for the industry owing to the dissimilarities of the firms in the industry in several respects like business policy, accounting procedures, local conditions, management policy and the knowledge of persons preparing such statements, etc. In that case, an accurate measure. The ratio technique is also used for forecasting the business position on the basis of past ratios, but it does not cover uncertainty of the future and other economic spite of certain limitations the ratios if discriminatingly calculated and wisely interpreted can be a useful tool of financial analysis (Hunt, 1971). Financial ratios can be grouped into four basic categories, as follows:

- 1. Liquidity Ratio;
- 2. Asset Management ratios;
- 3. Debt Management ratios; and
- 4. Profitability ratios.

LIQUIDITY RATIOS

Liquidity ratios focus on current assets and liabilities and are often of lesser importance when considering the long run viability and profitability of the firm. (Pinches, 1984).

ASSETS MANAGEMENT RATIOS

Asset management ratios are indicators of managerial capabilities in effectively utilising the firm's assets. It captures the firm's managerial efforts in managing inventories of raw and finished goods, its production processes, its credit and asset management policies, and the effectiveness of its marketing and sales force (Mathur, 1979).

DEBT MANAGEMENT RATIOS

The extent, to which a firm uses debt financing or financial leverage, has three important implications. (i) By raising funds through debt, the owner can maintain control of the firm with a limited investment; (ii) Creditors look to the equity, or owner-supplied funds to provide a margin of safety; if the firm earns more on investments financed with borrowed funds than it pays in interest, then the return on the owner's capital is magnified or 'leveraged'

PROFITABILITY RATIOS

Profitability is the net result of a large number of polices and decisions (Weston & Brigham, 1990) Managerial perceptions of the economic environment, competition, the firm's product markets and decisions with respect to assets and capital structure, all have an impact on the firm's profit. Therefore, profitability ratios may be considered to be the key ratios that are strong measures of the firm's overall performance (Mathur, 1979).

3. OBJECTIVES

The study has the following objectives

- 1. To evaluate the financial performance of the Lanka Aluminium Industries PIc respect of liquidity, assets utilization, debt management and attaining planned goal of profits;
- 2. To identify causes of such poor management of liquidity, asset utilization, debt-financing and profitability of the Lanka Aluminium Industries Plc; and
- 3. To make some suggestions and recommendations for over coming the crises in order to get better operational result in future.

4. MATERIAL AND METHODS

This section is divided into five sub-sections. The first sub-section presents the scope. The sub-second section discusses the period of the study. In the sub-third section, data sources are discussed. The sub-fourth section illustrates the reliability and validity whereas the last sub-section highlights mode of analysis. **4.1 SCOPE**

The scope of the study is Lanka Aluminium Industries Plc in Sri Lanka. Only one company is selected for the study purpose.

4.2 PERIOD OF THE STUDY

The period of the study was five years from 2009 to 2010 financial year.

4.3 DATA SOURCES

In order to meet the objectives and hypotheses of the study, data were collected from secondary sources mainly from financial report of the selected companies, which were published by CSE.

4.4 RELIABILITY AND VALIDITY

Secondary data for the study were drawn from audited accounts (i.e., income statement and balance sheet) of the concerned companies as fairly accurate and reliable. Therefore, these data may be considered reliable for the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence, researcher satisfied content validity. **4.5 MODE OF ANALYSIS**

The following ratios are taken to measure the financial diagnosis of the industry which is given table-1.

TABLE-1: CALCULATIONS OF RATIOS

Liquidity Ratios					
Current Ratio	= Current Assets / Current Liabilities				
Quick Ratio/ Acid Ratio	= Current Assets- Inventory/ Current Liabilities				
	= Current Assets–Inventory/ Current Liabilities – Bank overdraft				
Cash Ratio = Cash + Short Term Market Securities / Current Liabilities					
Assets Management Ratios					
Average Collection Period	= Accounts Receivables/ Credit Sales X365				
Inventory Turnover	= Cost of Goods Sold/ Average Inventory				
Fixed Asset Turnover	= Sales/ Fixed Assets				
Total Asset Turnover	= Sales/ Total Assets				
Debt Management Ratios					
The Debt Ratio	= Total Debts/ Total Assets				
The Debt-Equity Ratio	= Long term debts/ Owners' equity				
Time Interest Earned Ratio	= Earnings before interest & taxes (EBIT) or operating income/ Interest expense				
Profitability Ratio					
Gross Profit Ratio	= Gross Profit/ Net Sales X100 or Sales – Cost of Goods Sold/ Sales				
Net Profit Ratio	= Net Profit Before Tax/ Net Sales X100				
Operating Profit Ratio	= Profit from Operating Activities / Net SalesX100				
Return on Capital Employed	= Profit after Interest and Taxes/ Capital Employed X100				
Return on Investment	= Net Profit after Interest and Tax / Total AssetsX100				

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5. ANALYSIS

This section presents the findings of the study. The following table-2 shows that summary of financial ratio.

TABLE-2: SUMMARY	OF FINANCIAL RATIOS
TADLE-2. JUNIMANT	OF THINKING AL INATIO

Years										
Ratios	2006	2007	2008	2009	2010					
Liquidity Ratios										
Working Capital (in Sri Lankan Rupees.)	78,084,000	115,630,000	142,632,000	1,491,840,000	191,830,000					
Current Ratio (proportion)	1.83:1	2.21:1	1.77:1	1.51:1	1.56:1					
Quick Ratio/ Acid Ratio(proportion)	1.41:1	2.09:1	1.05:1	1.11:1	1.31:1					
Cash Ratio(proportion)	0.49:1	0.46:1	0.74:1	0.77:1	0.68:1					
Assets Management Ratios										
Average Collection Period (In days)	34.32	52.86	51.61	59.80	55.53					
Inventory Turnover (In times)	16.37	8.32	7.72	7.27	9.78					
Fixed Asset Turnover (In times)	4.30	4.75	7.41	9.97	8.83					
Total Asset Turnover(In times)	2.22	2.11	2.25	2.37	2.66					
Debt Management Ratios										
The Debt Ratio(In times)	0.27	0.25	0.39	0.50	0.45					
The Debt-Equity Ratio(In times)	0.08	0.07	0.12	0.14	0.10					
Time Interest Earned Ratio(In times)	4.16	4.58	3.06	2.23	3.02					
Profitability Ratios										
Gross Profit Ratio (%)	13.55	12.88	10.82	8.99	9.72					
Net Profit Ratio (%)	3.52	3.46	1.57	1.17	2.40					
Operating Profit Ratio (%)	6.23	5.54	5.40	4.34	5.57					
Return on Capital Employed (%)	15.64	13.04	15.17	13.00	19.64					
Return on Investment (%)	10.50	9.15	8.17	5.69	9.91					

Source: Calculated from the figures available in the income statements and balance sheets of the companies concerned. From the above table-2, research findings discuss the following subheads.

5.1 LIQUIDITY RATIOS

From the table-2, it was oberserved that the position of net working capital of the Lanka Aluminium Industries Plc is very much efficient in the sense that in all of the five years starting from 2006-2010. The current, quick and cash ratio are also reasonable position. Current ratio indicates that the industry is fully unable to pay its short-term obligations, because its current liabilities, in some of the cases are two or three times greater than its current assets. The quick ratio and cash ratio also give us similar impression as we have in case of current ratio. This situation needs some short of corrective measures to overcome the serious shortage of working capital. This can be done by introducing fresh working capital by raising equity finance.

5.2 ASSETS MANAGEMENT RATIOS

Table-2 illustrates that average collection period in all the years excepting the year 2006, is quite normal. Inventory turnover ratio, gradually decreases besides the years of 2006 to 2009. In 2010 it reaches the pick and in 2009. If we look into the fixed asset turnover ratio and total asset turnover ratio, we get a very good picture in respect of Industry performance in asset utilization. The position of both ratios, in all of the years excepting the year 2007 (i.e., only for total assets turn over), is an upward trend. Finally, we can say that the performance of the industry particularly in respect of asset utilization is satisfactory.

5.3 DEBT-MANAGEMENT RATIOS

We found that from the table-2 that all of the ratios related to debt management, show a miserable situation of the industry in managing funds. From the debt ratio, we observed that it shows a decreasing trend up to the year 2007 and thereafter, an increasing trend.

The debt-equity ratio expresses that the burden of debt in almost all the years shows an upward trend and causes to increase the degree of financial risk to the capital structure of Lanka Aluminium Industries Plc. Time interest earned ratio shows increasing trend up to the year 2007 and thereafter, a decreasing trend. In fine, we can say that the debt management system of the industry is very much and is not conducive to attract more funds from outside in case of emergency. Lanka Aluminium's management contends that the shortfall of cash flow is the main reason for such occurrence.

5.4 PROFITABILITY RATIOS

Profitability is the net result of a number of policies and decisions. This ratio enables us to judge how successful the entity has been at trading. The higher the gross profit ratio, the better profitability. Hence, the companies with higher gross profit ratio may be said to be better ones. It states that all the years' show decreasing trend of gross profit. Similarly, Net profit ratio, operating profit ratio, return on capital employed and return on investment shows that all the years' show decreasing trend.

In fine, after studying all of the profitability ratios of the industry, we find that the industry shows a dismay picture of its profit performance. Therefore, management of this industry should take necessary measures to improve profitability.

6. SUGGESTIONS

From the study so far made by financial ratios, the following remedial measures can be suggested for achieving a better financial performance of the industry.

- 1. Budgetary control and standard costing systems have to be introduced so that person can be identified with responsibility for the work done improperly and wrongly.
- 2. Equity capital is to be raised up to the extent of present accumulated operating loss. Dependence on borrowed funds is to be reduced gradually.
- 3. Working capital of permanent nature and fixed assets, are to be financed from long-term sources and working capital of variable nature is to be financed from short-term sources, as per ideal concept of financing.
- 4. Working capital crisis has to be removed for better and smooth running of production. For this purpose, line of credit arrangements can be established with commercial banks.
- 5. Improved accounting system aiming at better functioning of accounting information systems (AIS) and management information systems (MIS) as well.

7. CONCLUDING REMARKS

From the above analysis and discussion, we may conclude Lanka Aluminium Industries PIc shows inefficient performance during the period of the study and calls for keen attention of this industry' management solving the problems as highlighted in this paper.

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