Accounting and Financial Analysis

Hi-Tech Lubricants Limited (HTL)

[Date] [Course title]

Table of Contents

Introduction:
Growth and expansion of entities is highly dependent upon their sources of finance. This is due to the cost of finance source. There are two broad categories of financing, which are credit and equity financing. Both modes of financing are different from each other based on their multiple features. Some of them are discussed below:

Cost of source:

Credit finance carry interest on it while dividend is given on equity finance to shareholders. Credit financing carry higher cost then equity. Interestingly, Cost of credit financing can be taken as expanse in income statement while cost of equity financing cannot be taken as expense. This create difference of profits of company and tax expense of company because interest expense is considered as admissible expense for tax purpose.

Period of financing:

Credit is considered as reliable source of finance for short term funding and investing requirements. Equity is a reliable source of financing for long term projects. This is due to risk profiling of entity. Risk profiling is directly linked with the ability of entity to repay the dues. However, in case of equity, there is no such a risk profiling explicit, but it exists implicitly by the profits and liquidity of company.

Availability of Funds:

Sometime companies do not have availabilities of funds whether internally or their external borrowing power is completely utilized. Unavailability of one or both options enforces organization to use other option although other one is costly.

Explanation:

About Hi-Tech:

Hi-Teach Limited operates in oil and gas marketing sector. It was incorporated back in 1997 as Association of persons (AOP). During its early days, it imports oil and sell in Pakistan as distributing agent. Later, passing through expansions and multiple structural changes, it is registered as Public Interest company in 2012.

Major competitors of Hi-Tech includes PSO, Shell Pakistan and Attock Petroleum. Sources of finance are analyzed by using ratio analysis. Most common ratio is debt ratio. Debt ratio is a comparison of total debt of company and total equity of company.

Debt to Equity:

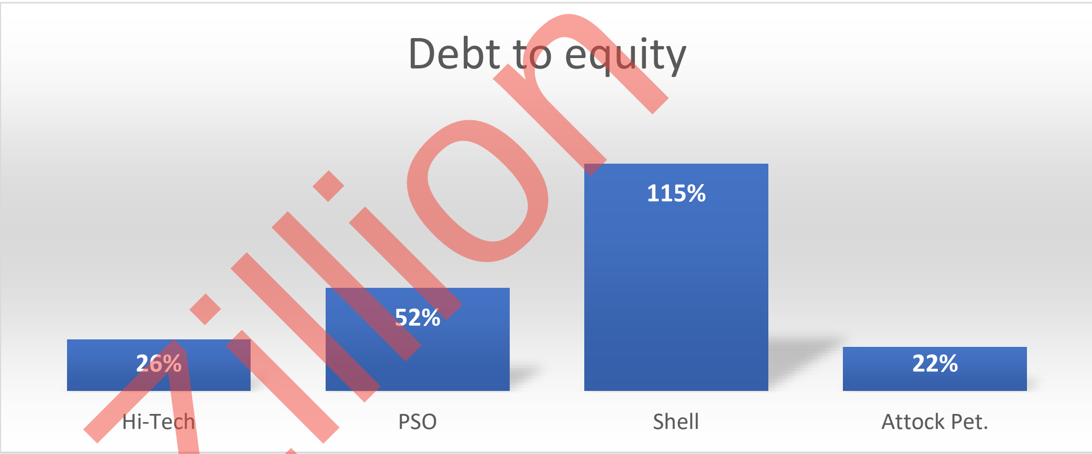
Debt to equity ratio of Hi-Tech is 0.0256. It is considered as well enough for liquidity and solvency of company. Hi-Teac uses both sources of finance for financing its projects. Debt ratio up to 0.5 is considered good.

Total borrowing of company are Rs 808.53 million. While equity of company is Rs 3,1577.66 million. Total borrowings of Hi-Teach consist of two components. These components are long term and short-term borrowings. Long term borrowing is amounting to Rs 43 million while short term borrowings are Rs 766 million almost respectively.

Biggest competitor of Hi-tech is Pakistan state oil. PSO has debt amounting Rs 62.33 billion, while its total equity is Rs 118.26 billion. Debt to equity ratio of PSO is 0.52, which is almost double of the debt to equity ratio of Hi-Tech. However, this percentage is not taken as bad because this gave more opportunities to expend and grow its business without effecting liquidity and solvency of company.

Shell Pakistan is also one of the biggest rivals of Hi-Tech. Debt to equity ratio of shell Pakistan is more then 1, which means its credits are higher than its equity financing. Debt to equity ratio higher then 1 is considered as bad because it requires higher liquid assets to meet with the need of short-term liabilities.

Attock Petroleum has been emerged as strong new entrant over the Past few years. Debt to equity position of Attock Petroleum is bit similar with Hi-Tech. Total debt of Attock Petroleum is Rs 4.41 billion while its equity injection is Rs 19.93 billion. This mean debt to equity ratio of Attock Petroleum is 0.22, Which is even less then Hi-Tech.



Industry average of financing the capital from debt in comparison to equity is almost more then 0.5. This mean Hi-Tech is not effectively utilizing its availability of debt capital to facilitate its operation, which will contribute toward success and growth of company in future.

Ratio Analysis:

Ratio analysis has been used to measure the performance of company. It is a comparison of values calculated using different set of formulas It has few broad categories however it has been divided into three major categories. These categories are profitability analysis, Liquidity analysis and Solvency Analysis. Mostly ratios are analyzed while making comparison with the performance of last years and industry. One Year is taken as base year. Further classification of ratios into sub categories has been given below:

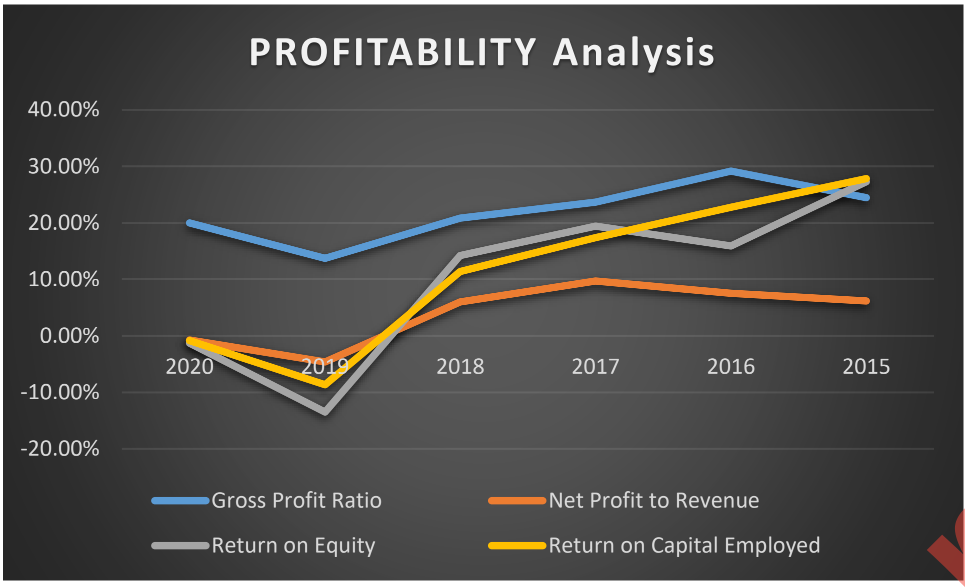
Profitability Analysis
- Gross Profit Ratio
- Net Profit Ratio
- Return on Equity

Liquidity Analysis
- Current Ratio
- Quick Ratio
- Working Capital Cycle

Solvency Analysis
- Debt to equity Ratio
- Gearing ratio
- Equity Multiplier

Profitability Analysis:

Profitability analysis is performed to check the growth of entity in term of profits. It is future divided into four major ratios. Profits of entity are compared with different line items of financial statements to calculate the ratios. After that ratios are compared with the past performance of entity. Last 5 years ratios are considered as relevant because ratio analysis of more than 5 years did not reflect only performance of entity. It incorporates change of economy, management, standard procedures and company policies. Although these all are incorporated in 5 years period but their effect in this case is not much prominent on financials of company. Profitability trends of Hi-Tech of past 5 years are presented below in graphical in form:



Gross Profit ratio is a comparison of net sales with gross profits of entity. Hi- Tech has shown highest Gross Profit ratio in 2017, Which is followed by a down turn in form of constant decrease. It has shown lowest gross profit ratio in 2018, which is followed by the recovery phase in 2019 and 2020. Its gross profit ratio remains at 20% in 2020. Gross Profit ratio has shown that the performance of entity passes through the multiple phases in last five years but now it is back on boom phase.

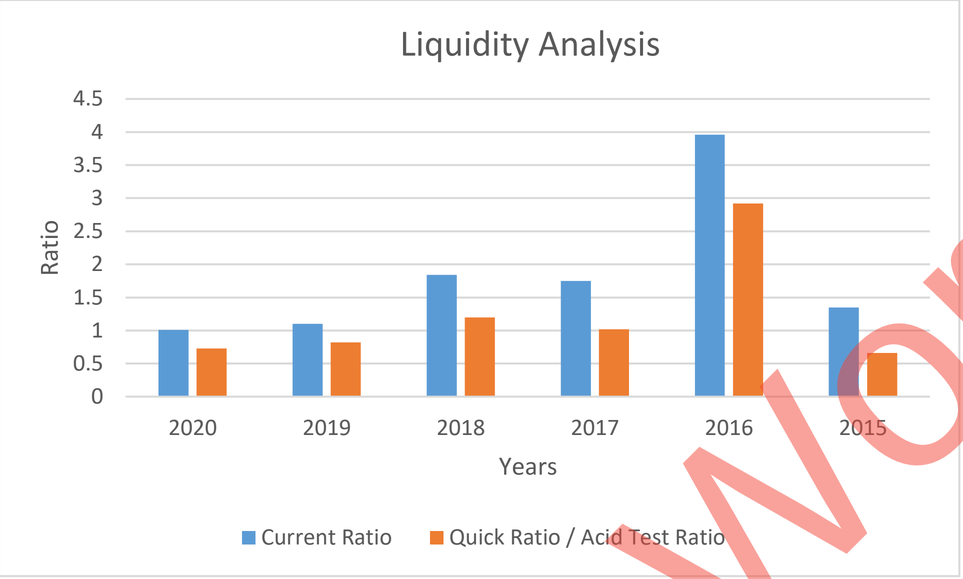
Net Profit Ratio is a comparison of Net sales with the net profits of entity. Hi Tech, has earned highest net profit ratio in 2017 @ 9.71%. Net Profit ratio shows increasing trends from 2015 to 2017 while it is followed by constant down turn even it is negative in 2019 and 2020. Net Profit ratio of entity did not recover itself from recession phase. This show that even increase of operational profits are not reflected in net profits of entity. Which mean Non-production expenses of entity are higher than its operational profits.

Return on equity is a comparison of net profits earned with the equity of company. Hi tech has shown highest return on equity in 2015 at 27.2%. This is followed by decrease in 2016 while it recovers back in 2017 due to highest earnings ratios. However, its recession phase starts from 2018 and continued to 2020 even ratios are negative. Hi -Tech has issued share in 2016 at premium on par value. This gave increase in equity of company but after that Hi-Tech shown 20 % return on equity in 2017. This mean increase of equity is reflected in revenue of company but after that return on equity start decreasing.

Return on Capital Employed (ROCE) is a comparison of net profit earned with the total capital employed. Total capital employed include debt and equity both. ROCE has shown almost same trends as shown by return on equity. Return on capital employed was highest in 2015 at 27.83%. This is followed by constant decrease up to 2020 even higher profits of 2017 did not change the decreasing ROCE of company. This is an indicator of ineffective utilization of capital employed. Debt side of company is about 30 % of total capital of company.

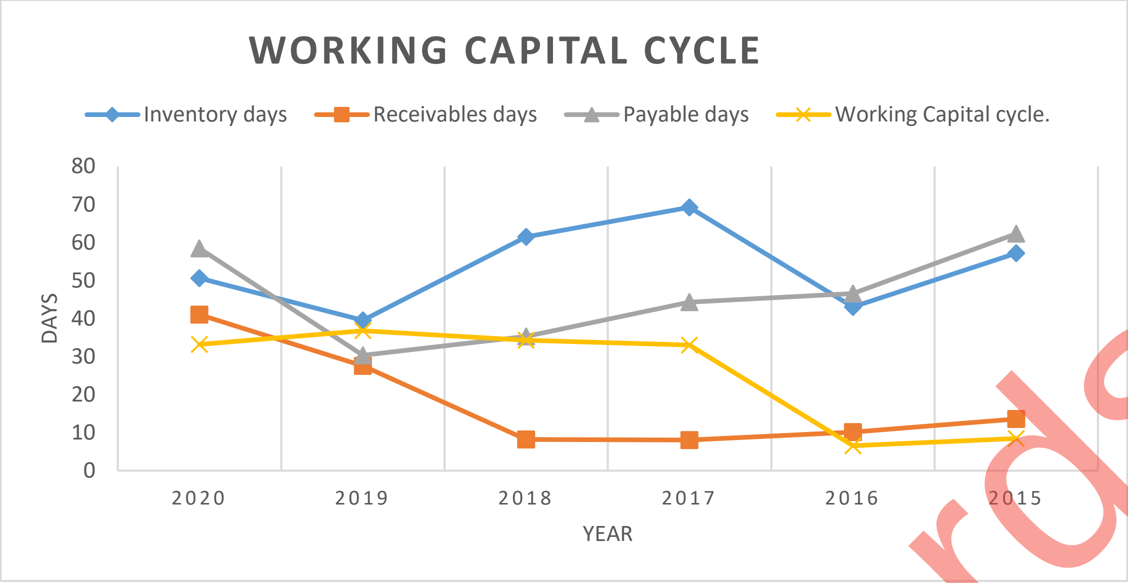
Liquidity Analysis:

Liquidity analysis of company is performed to check the ability of company to pay off short term liabilities. Liquidity ratios are considered by the creditors and lenders because unfavorable liquidity ratios increase the risk of loss of credits and it also decrease the capability of company to pay cost of credits. Graphical presentation of liquidity Ratios are given below:



Current Ratio is a comparison of current assets with current liabilities. Hi- Tech has shown good current ratios all the time. It has highest current ratio of 3.96:1 in 2016. Current ratio of more than 1 is considered as good while current ratio between 1 and 1.5 is a positive indicator of its performance. Lowest current ratio of Hi-tech is 1:1 in 2020. Current ratios have shown two phases in past five years. Current ratio keeps on increasing from 2015 to 2016 while after that it is decreasing. In this way it reached 1in 2020 from 3.96 in 2016. This mean current assets are decreasing and current liabilities are increasing in relative term. If this trend remains continued, then it would be difficult for Hi-Tech to pay its liabilities.

Quick Ratio is a comparison of current liabilities with current assets of company except inventory. Inventory is considered as fewer liquid assets, so it is subtracted from total currents assets of entity. This ratio compares liquid assets of company with current liabilities. Hi-Tech has shown same trends in quick ratio also as in current ratio. Quick ratio of Hi-Tech was highest in 2016 at 2.92, which is followed by decrease and it is 0.73 in 2020. 0.73 quick ratio means all liquid assets of HTL can only pay off 73% short term liabilities. Remaining liabilities would be paid from the revenue earned from operation. Quick ratio between 0.5 and 1 is considered as satisfactory while more then 1 is considered as best for the operational efficiency of the company. Quick ratio of HTL is good but it needs improvement to maintain its credit ratings and worthiness.



Working Capital cycle is a measure of number of days taken by purchases to convert into collection of cash from sales. It is sub divided into three time periods.

Inventory days is a measure of number of days taken by purchases to convert into sales. Lower the number of days higher would be turn overs of inventory. This is an indicator of operational efficiency of company. Hi-Tech had minimum 39 days in 2019. Maximum inventory days were 70 in 2017. Inventory days has shown crests and troughs in its trend analysis of its last five years performance. Inventory days decreases in 2016 while increases in 2017. After that it also decreases in 2018 and 2019.During this time it reached its lowest stand and then it is followed by increase in 2020. This trend shows that the resources of HTL can perform but they require effective management.

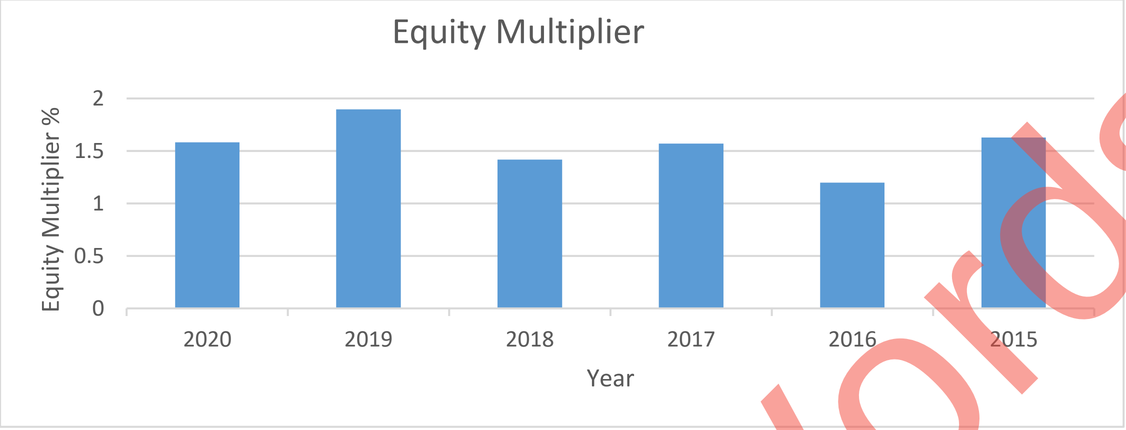
Receivable days is a measure of number of days taken by sales to convert into cash proceeds. Receivable days are considered as indicator of performance of recovery department. Receivable days almost remain constant from 2015 to 2018 While after that they start climbing. Increase of receivable days show that HTL has change its credit policies or lay off the experienced individuals. Which result into increase of receivable days. Entities try to keep their receivable days minimum to facilitate their operation and avoid from bad debts.

Payable days is a measure of number days taken by entity to pay its payables, which arises due to purchase of inventory. Payable days of HTL in 2020 are almost equal to its payable days in 2015. In between both extremes, payable days first keep on decreasing till 2019 after that it increases in 2020. It means HTL usually pay its debts early but now due to decrease in profits, it is using the financing of creditors to run operations as entity is suffering from loss.

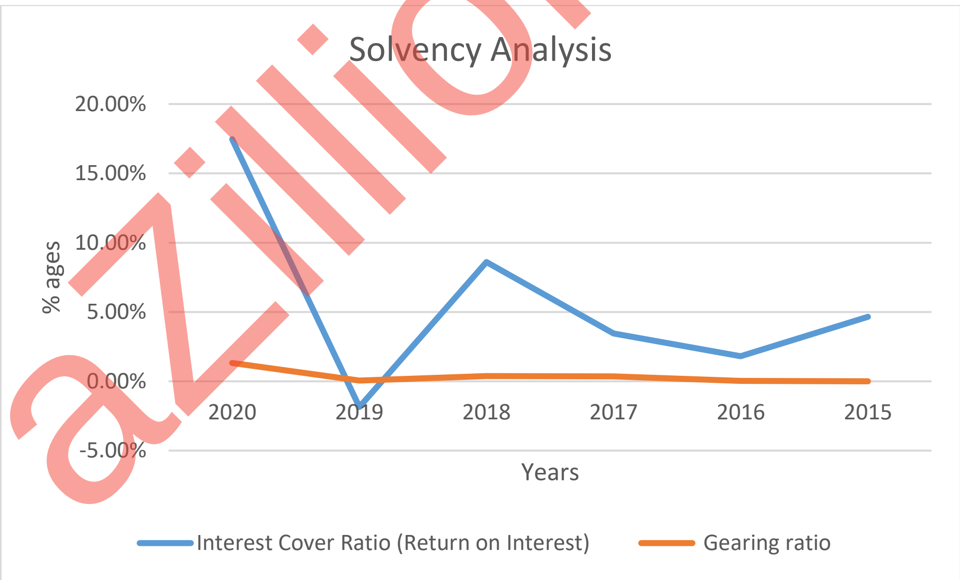
These all reveals that the HTL need serious efforts to increase its inventory turnover and decrease its receivable days. These will help operation and entity both to earn higher profits and maintain better liquidity.

Solvency Analysis:

Solvency Analysis is measure of debt to equity financing of equity to check the l=the long-term sustainable growth of entity. Solvency analysis is classified into few sub ratios. Let us discuss them into detail.



Equity Multiplier is a comparison of total assets with the total equity of company. This is used to measure to check the increase in assets of company due to operations. HTL has shown highest equity multiplier of 1.9 in 2019. Trend analysis of equity multiplier show that the it decreases from 2015 to 2016, which is followed by increase in 2017. After that it also decreases in 2018 while it showed increase during 2019. Which is also followed by decrease in 2020. This trend analysis is linked with profitability and liquidity of company. Higher profitability and liquidity in 2017 driven the equity multiplier toward increase but losses of 2020 drive it toward decrease. Equity multiplier between 1 and 1.5 is considered as satisfactory.



Gearing ratio is a comparison of long-term debt to long term capital employed. It is measured to check the long-term liquidity and going concern of entity in foreseeable future. HTL has shown consistency in gearing of company. Gearing remains almost constant over the last 5 years. However, it shows small increase in 2020, which is due to increase in long term borrowings.

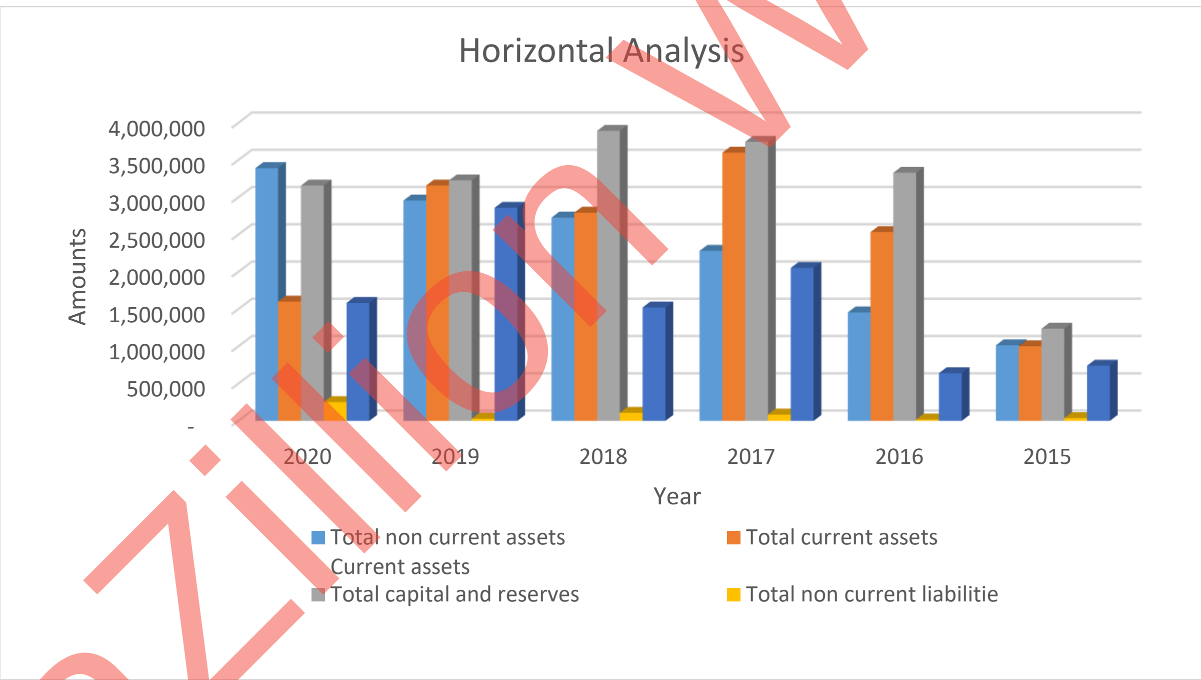
Interest Coverage is a comparison of finance cost with earnings before interest and tax. Interest coverage is calculated to check the effect of finance cost on profitability of company. Interest coverage has shown many diversions in last five years. Interest coverage is highest in 2020 at 17%. While it was minimum as negative in 2019 due to losses. Profits converted into losses due to interest cost. Interest cover show that although long term debts are not high but short-term cost of long term and short-term borrowings is high.

Horizontal Analysis

Horizontal Analysis is a one off the simplified approach to evaluate the performance of company. In this analysis, major line items ae analyzed by comparing them with their past values. Change in one item is checked against change in other. So, figures will make sense.

Four major components of balance sheet are identified to perform the horizontal analysis of HTL. Let us discuss each of them one by one.

Total Non-Current Assets are major component of smoothing running of business. Non-Current Assets increases over the year constantly. Non-Current assets were RS 1 million in 2015, which are RS 3.4 million in 2020. Overall, they have shown an increase of more than 330%.

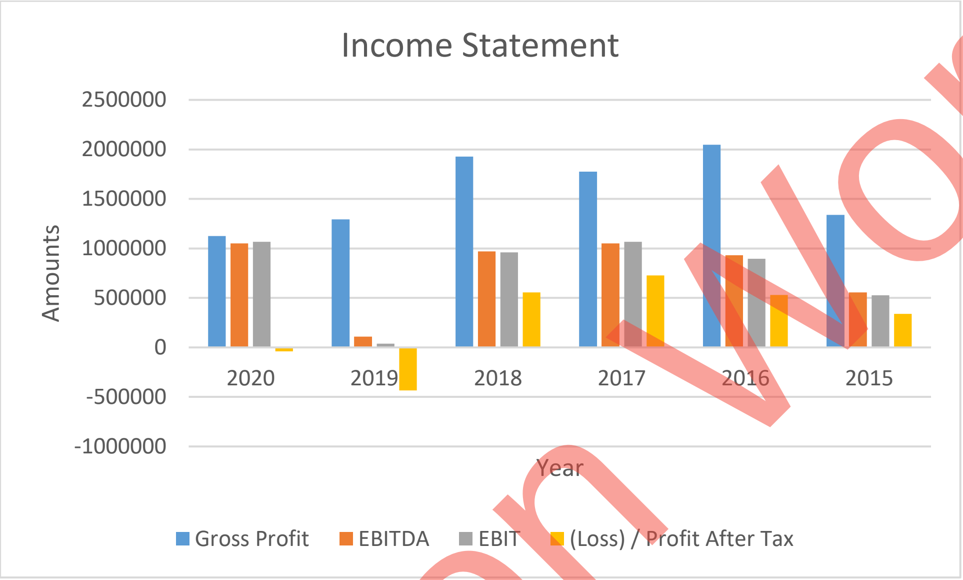


Total Current Assets of HTL increases overall from 2015 to 2020. HTL had current assets of Rs 1 million in 2015, which are Rs 1.6 in 2020.However these were highest in 2017 due to highest profits. Current assets increase from 2015 to 2017. These were decreases in 2018 but followed by high increases in 2019. Highly changing amounts of current assets are indicator of short-term policies and poor management of resources to capitalize all the resources to enhance growth of company.

Assets have increase to an overall 500% from 2015 to 2020. Which is highly positive sign for entity in term of profitability of company. However, this all increase is not solely due to accumulated profits of entity. It increases also due to new capital injunction in form of both debt and equity.

Total capital reserves are the total equity capital of company. This is also known as net assets of entity. Net assets of HTL also increases in relation to 2015 in 2020. Overall increase in capital reserves of company is almost 250%. This is positive sign for the growth, development and expansion of business.

Total Non-current liabilities mostly consist of log term borrowings. They also increase from 2015 to 2020 by 214%. Non-current liabilities were highest in 2019 at Rs 2.8 million. This increase was due to short term maturity of long-term borrowings. HTL has utilized credit facilities to grow its business but losses during 2019 has changed net profit to net loss. Still many liabilities are maturing in next 12 months, which will hit the income of company.



Gross Profit of HTL increases from 2015 to 2016, after that decreases in 2017. During 2018, GP increases but it is followed by constant decrease. On the other side **Net Profit** of HTL was highest in 2017. which is followed by constant decrease, but it recovers from losses during 2020. EBIT is highest in 2020. It means finance cost is affecting the net profits badly. EBITDA is showing operational revenue. Operational revenue start increasing from 2015 and remain almost constant till 2018. 2019 proves as worst year for the life of company and it badly affected the overall position of entity.

Vertical Analysis:

Vertical analysis is also one of continent way to analyze performance of entity over the years. In this method, major components of financial statements are accessed for their performance vertically in financials of company. Results of this evaluation is accessed, and better decisions are suggested to improve effectiveness, growth and sustainability of organization

Income Statement:

	2020	2019	2018	2017	2016	2015
Net Revenue	100%	100%	100%	100%	100%	100%
Cost of Sales	80%	86%	79%	76%	71%	76%
Gross Profit	20%	14%	21%	24%	29%	24%
Administrative Expenses	6%	4%	4%	4%	4%	3%
Distribution Cost	11%	8%	7%	6%	12%	11%
EBITDA	19%	1%	10%	14%	13%	10%
Depreciation and Amortization	3%	1%	1%	1%	1%	1%
Other Expenses	0%	1%	1%	1%	1%	1%
Other Income	2%	1%	1%	1%	1%	1%
EBIT	19%	0%	10%	14%	13%	10%
Finance Cost	3%	2%	1%	0%	0%	0%
(Loss) / Profit Before Tax	-1%	-2%	9%	14%	13%	9%
Taxation	0%	3%	3%	4%	5%	3%
(Loss) / Profit After Tax	-1%	-5%	6%	10%	8%	6%

Vertical Analysis of income statement is given above in tabular form. Cost of sales are quite high as they cover 80% of the revenue, while these were 86% in last year. Other major components are admin cost and distribution expenses. During last year, Cost of goods sold (CGS) was 86% but distribution and admin costs were less. during 2017, Entity earn highest profits when CGS was76%. The operational cost of HTL is higher which is leading toward losses.

Balance Sheet Analysis:

	2020	2019	2018	2017	2016	2015
Non-current assets						
Fixed assets	34%	26%	25%	16%	8%	10%
Investment in subsidiary company	26%	21%	24%	22%	28%	39%
Total non-current assets	68%	48%	49%	39%	37%	50%
Stock-in-trade	9%	13%	17%	26%	17%	25%
Short term investment	15%	14%	17%	18%	37%	0%
Cash and bank balances	3%	3%	9%	1%	5%	4%
Total current assets	32%	52%	51%	61%	64%	50%
Issued, subscribed and paid up capital	23%	19%	21%	20%	29%	43%
Share premium	29%	24%	26%	25%	36%	0%
Accumulated profit / (loss)	11%	10%	23%	19%	18%	18%
Total capital and reserves	63%	53%	71%	64%	84%	61%
Total non-current liabilities	5%	1%	2%	1%	1%	2%
Trade and other payables	14%	12%	11%	14%	15%	34%
Short term borrowing	15%	32%	13%	19%	0%	0%
Total current liabilities	32%	47%	28%	35%	16%	37%

Fixed Assets of HTL are now major parts of the assets of company in 2020, which were only 20% in 2015. Investment in subsidiaries is also covering major portion of total assets. Non-Current assets are 68% of total assets while short term investments are 15% of total assets. On Other side of balance sheet capital and reserves are 63%.

While current short-term borrowings are 15%. This mean these are required to settle in next accounting period. Current liabilities are 32% of total equity and liabilities. Current assets decrease from 52% to 32%, while non-current assets increase from 48% to 68% from 2019 to 2020. Short term investments increase from 0 to 15%. During 2019-2020,

current assets are realized, and fixed assets are bought. While During 2017-2918, current assets were also used to purchase noncurrent assets.

Credit side of balance sheet changes due to issue of equity and debt securities. But increase of liabilities lead toward eventually decrease of capital reserves. Decrease of capital reserves decreases the equity of company.

Conclusion:

Debt to equity ratio of HTL is less than all the debt equity ratio of all other competitors of HTL. However, competitors' size of business is much higher than the size of HTL. Moreover, they are also earning higher profits. HTL size of business is low and it is passing through losses from last two years. Cost of production of HTL business is high. Industry credit risk is high because oil prices changes frequently and even at fast pace.

This will change the perception of investors about HTL's risk profiling as industry risk is high and company is facing high losses. HTL's almost 15% of total liabilities and equity are short term liabilities. These all make HTL high risk entity and it would be difficult for HTL to finance its activities through credit. Credit providers would not provide it the credit in present circumstances. HTL should put serious efforts on its operating profits first and then raise finance through credit.

Profitability ratios are suggesting that GP ratio should be improved as CGS were 76% in 2017 when it produced highest profits of last six years. Operational profits can be improved by decreasing inventory days and receivable days. HTL sis using the capital of suppliers in financing its operation by paying them late. This is raising the current liabilities of HTL. HTL need to change payable periods also so that working capital turnover increases, and it would lead toward increase in gross profit of entity.

Admin and distribution expenses should be managed in an order so that their variance should be decreased. HTL is maintaining higher amount of assets in liquid form but taking loans to finance its activities. HTL should take loans for long term not for short term. It should invest its current assets in risk free business and investments should be made in multiple entities to diversify their business.

Accounting Risk Analysis:

Accounting risk is a risk which deals with the misstatement of financial information given through accounts and disclosures. Information has some inherent limitations due to multiple factors which contribute toward the errors or fraud. It is based upon some assessments. Some of them are given below:

Institutional context is a context of territory/ institutions where company operates. It relates with the quality of external environment. HTL is a listed entity. It is reportable to securities and exchange commission of Pakistan (SECP). SECP has been globally recognized as 7th most effective regulator of world in past. This show that the regulatory environment is strong. Auditors are completely independent in Pakistan. One off top 7 firm of Pakistan is auditing HTL.

Law and courts actively investigate cases. Companies cases are heard in company courts at special company bunches. This show that the institutional context is strong enough to cater with the risk of misstatement and accounting risk.

Opportunity is a potential of misstatement available to company. It deals with the principle line of business of entity and economics of company. HTL operates in oil and gas marketing sector but its economics doubts the creditability of accounting information because company after hearing higher profits passes through the down turn.

Incentives deals with the behavior of management. It relates with the top tear management of company and their style of management. Financials of HTL show that the cost of sales increasing systematically and after profits of 10% in 2017 management attempts to misstate the profits to save the tax expense.

Behavior relate with the human behavior of management of company like Whether they want to report higher profits, or they want to save taxes by buying non- current assets, misreporting the profits and increasing expenses etc. HTL's management always attempted to reduce their profits. This show that the behavior of management is to hide the facts of company.

Cash Flow from operations is almost equal to the profits earned from operation. Restatement of figures rarely exist. Company follow IAS and IFRS for accounting and reporting along with the company act regulations. Accounting risk is lower because of strong regulator and auditor but cannot be zero.

Let us discuss some specific issues of accounting risk analysis.

Revenue amounting to Rs 5.6 million has been recognized as key Audit matter in auditor report. Revenue is most significant item of income statement. Risk of material mis statement is higher in it. Auditor checked the sample f transactions and found it according to the ins and IFRS.

Stock in trade amounting to Rs 447 million has been considered as overvalued because of sales of inventory just before the yearend at sales price of lower then valued amount. Auditor perform recalculation and reperformance audit procedures to check its valuation but found that the percentage write down applied to older stock is made on historic stock-in-trade write down.

Shares amounting to 827,775 are held by SK lubricant an co. SK is also a major supply of the HTL. It means decreases in payable period is due to related party transactions with supplier in past few years. It had affected the credit terms and credit worthiness of the HTL. Such a related party would affect the business of the company.

Short term finance arranged by company amounting to Rs 760 million are take at variable rate between 9 and 16% almost in 2020. Which is quite high, and risk involves in it is as finance cost would be reported at lower rates to show to profits while expenses are paid at higher rate.

Competition commission of Pakistan has initiated the proceedings against the brand name of company i.e. ZIC for spreading false information and using deceptive market practices but HTL did not recognized any provision against this. Worth of proceedings are penalty of 7.5 million. Company would might have understated its liabilities and this would might be settle at some penalties. Risk I valve in this provisioning is high and it seemed that company has understated its liabilities.

No provision is Made against super tax notice issued by DCIR amounting to RS 21 million. This is also alarming for secure future of company. Risk involved in it is that consequences of decision would not relate to future period but would be charge to that period.

Company follow IAS and IFRS as accounting policy any change in them is taken as mandatory for the business.

Bibliography:

1) Mitrovic, A., Keevil, S., & Pelinkovac, M. (2015). RATIO ANALYSIS SPECIFICS OF THE FAMILY DAIRIES'FINANCIAL STATEMENTS. *Economics of Agriculture*, *62*(4), 1061-1078.

2) Drake, P. P., & Abbozzi, F. J. (2012). *Analysis of financial statements* (Vol. 204). John Wiley & Sons.

3) Lavada, M. N., Lapian, S. J., & Tumiwa, J. R. (2017). ANALYZING THE FINANCIAL STATEMENT USING HORIZONTAL–VERTICAL ANALYSIS TO EVALUATING THE COMPANY FINANCIAL PERFORMANCE PERIOD 2012-2016 (Case Study at PT. Unilever IndonesiaTbk). *Jurnal EMBA: Jurnal Riset Ekonomi, Manajemen, Bisnis dan Akuntansi*, *5*(3).

4) Saer, I. M., & Deman, N. (2012). Financial ratios as an evaluation instrument of business quality in small and medium-sized enterprises. *International Journal of Management Cases*, *14*(4), 373-385.s

5) Gombola, M., & Marciukaityte, D. (2007). Managerial overoptimism and the choice between debt and equity financing. *Journal of Behavioral Finance*, *8*(4), 225-235.

6) Mande, V., Park, Y. K., & Son, M. (2012). Equity or debt financing: does good corporate governance matter?. *Corporate Governance: An International Review*, *20*(2), 195-211.

7) Coleman, S., Cotei, C., & Farhat, J. (2016). The debt-equity financing decisions of US startup firms. *Journal of Economics and Finance*, *40*(1), 105-126.

8) Goh, B. W., Lim, C. Y., Lobo, G. J., & Tong, Y. H. (2017). Conditional conservatism and debt versus equity financing. *Contemporary Accounting Research*, *34*(1), 216-251.

9) Van Binsbergen, J. H., Graham, J. R., & Yang, J. (2010). The cost of debt. *The Journal of Finance*, *65*(6), 2089-2136.

10) Elgers, P. T. (1980). Accounting-based risk predictions: a re-examination. *Accounting Review*, 389-408.