RATIO ANALYSIS: *Pontoon plc*

Pontoon plc is a small, recently listed, company which manufactures precision equipment, and, following a review of the firm's position, the directors have decided that finance of approximately €4 million is required to modernise its production facilities. They estimate that, at current sales levels, this investment will have the effect of reducing cost of sales by €2 million. The industry in which Pontoon is engaged is subject to wide-ranging fluctuations in sales and profits. The directors are uncertain about which method of finance would be most appropriate and are currently considering the following three options:

1. issue of additional shares
2. issue of loan stock at an interest rate of 12% per annum and redeemable in 20 years' time
3. obtaining a bank overdraft.

The following gives some information concerning the industry, together with a summary of the financial statements of the company for the two years ended March 31, 20X2.

Ratios for similar firms in the same industry for 20X2 are:

Operating profit before interest and tax to long term capital employed (ROCE)	15%
Operating profit before interest and tax to sales	10%
Asset utilisation (asset turnover) (sales/capital employed)	1.5 times
Gross profit to sales (gross profit margin)	35%
Current (working capital) ratio	2.2:1
Quick (acid test) ratio	1.1:1
Average age of trade receivables (collection period)	73 days
Average age of inventory (stockholding period)	206 days
Interest cover	3 times
Gearing ratio (long-term loan capital/(L-T loan capital+shareholders' funds))	50.0%
- this is the D/(D+E) version of gearing	

INCOME STATEMENTS – for the year ended March 31

	20X2		*20X1*	
	€,000	€,000	€,000	€,000
Sales – all on credit	47,000		41,000	
Cost of sales	32,000		28,000	
Gross profit		15,000		13,000
Distribution costs	4,000		3,800	
Administration costs	6,000		5,200	
		10,000		9,000
Operating profit		5,000		4,000
Interest payable		600		600
Profit before taxation		4,400		3,400
Taxation		2,200		1,700
Profit after taxation		**2,200**		**1,700**

BALANCE SHEETS – at March 31

	20X2		*20X1*	
	€,000	€,000	€,000	€,000
Non-current assets (no additions in 20X2)				
Property, plant and equipment		14,630		17,100
Current assets				
Inventories	10,200		6,400	
Trade receivables	5,800		3,800	
Prepayments	200		200	
Cash and bank balances	1,200		1,180	
Total current assets		17,400		11,580
Total assets		€**32,030**		€**28,680**
Equity				
Called up share capital – ordinary shares of £1				
Authorised, issued and fully paid		6,000		6,000
Retained earnings		12,830		11,880
Total equity		18,830		17,880
Liabilities				
Non-current liabilities				
10% loan stock (20Z1-20Z9)		6,000		6,000
Current liabilities				
Trade payables	4,600		2,760	
Current tax liabilities	2,600		2,040	
Total current liabilities		7,200		4,800
Total equity and liabilities		€**32,030**		€**28,680**

Inventories at March 31, 20X0 amounted to €5 million and trade receivables at the same date amounted to €3.4 million. The effective tax rate is 50%.

You are required to advise the directors of Pontoon:

- **on the performance and position of their company;**
- **whether you believe their investment proposal will improve the company's situation;**
- **on which, if any, of their proposed methods of finance is the most appropriate.**