Tool F

Description: Cadbury-Schweppes ensures effective supplier risk analysis by arming purchasing staff with a comprehensive guide to key financial ratios and quick interpretation tips.

User Tip: Enroll purchasing staff in corporate financial training modules to enhance analytical skills and improve the accuracy of supplier risk evaluations.

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Supplier Financial Analysis Guidelines

Financial Analysis for Suppliers

- Financial analysis of the company will provide a general idea of company's past performance and current stability.
- In addition, this data can be used to compare different companies in the same industry which allow us to make a better judgment.
- For the public companies, all information can be found in the annual or quarterly reports. This report will not only provide financials but also detailed information about changed accounting practices, management future plans for acquisitions, expansion, improvements, debt covenants, and disposal of operating units which will give a better overall picture of the stability of the company.
- In the United States, annual and quarterly reports of the publicly traded companies can be found in EDGAR (Securities and Exchange Commission database at www.sec.gov).
- For private companies, financial information must be obtained from the company. However this information will not be audited, and the numbers might not be as reliable as audited statements.

Additional Things to Look For

- It is important to look at cash flow the statement and balance sheet for cash. Firms generally fail due to lack of cash, not profit.
- The level of accounts payable and receivable; drastic changes in the account payables sheet can be a sign of trouble.
- It is important to eliminate the nonrecurring items when calculating the profit.
- Level of dividends can be a sign of financial healthiness. If the dividends are greater than the profits made for the year, the net value of the company has decreased.
- In addition to the above ratios, revenue and cost trends for the company must be analyzed and compared to competitors.

Bankruptcy Model (For Public and Manufacturing Firms) Using Market Value

Z score $Z = 1.2(X1) + 1.4(X2) + 3.3(X3) + 0.6(X4) + 1.0(X5)$

X1, Working Capital/Total Assets (WC/TA).
X2, Retained Earnings/Total Assets (RE/TA).
X3, Earnings Before Interest and Taxes/Total Assets (EBIT/TA).
X4, Market Value of Equity/Book Value of Total Liabilities (MVE/TL).
X5, Sales/Total Assets (S/TA).

Score	Conclusion
> 2.99	Good shape
1.81 to 2.99	Gray area
< 1.81	Possible likelihood of failure
Negative	Lost cause

Bankrupt companies—mean = 0.15, nonbankrupt companies—mean = 4.14

Bankruptcy Model (For Public and Manufacturing Firms) Using Book Value

Z score $Z = 0.717(X1) + 0.847(X2) + 3.107(X3) + 0.420(X4) + 0.998(X5)$

X1, Working Capital/Total Assets (WC/TA).
X2, Retained Earnings/Total Assets (RE/TA).
X3, Earnings Before Interest and Taxes/Total Assets (EBIT/TA).
X4, Book Value of Equity/Book Value of Total Liabilities (BVE/TL).
X5, Sales/Total Assets (S/TA).

Score
> 2.9
1.21 to 3
< 1.21
Negative

Bankrupt companies—mean = 0.15, nonbankrupt companies—mean = 4.14

Source: Cadbury-Schweppes plc; Procurement Strategy Council research.

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Supplier Financial Analysis Guidelines (Continued)

Key Financial Ratios	Description	Purpose
Liquidity Ratios		
Current Ratios (mrq)	Current Assets/Current Liabilities	The ability to meet short-term liabilities
Quick Ratio (mrq)	(Current Assets – Inventories)/Current Liabilities	The ability to meet ST liabilities (liquid assets do not count)
Capital Gearing (mrq)	Total Shareholders' Equity/Total Liability	Percentage of funds provided by investors
Net Working Capital Ratio (mrq)	(Total Current Assets – Total Current Liabilities) /Total Assets	The ability to meet obligations and expand by maintaining sufficient working capital
Profitability Ratios		
Return on Assets (ROA) (ttm)	Net Income/Average Total Assets	This ratio helps show how assets are being used to generate profits.
Return on Equity (ROE) (ttm)	Net Income/Average Stockholders Equity	Determines the rate of return on your investment in the business; as an owner or shareholder this is one of the most important ratios as it shows the hard fact about the business. Are you making enough of a profit to compensate you for the risk of being in business?
Profit Margin (ttm)	Net Income/Sales	Measures profitability
Gross Profit Margin (ttm)	(Sales – COGS)/Sales	Measures profitability before any overhead expenses
Earnings per Share (ttm)	Net Income/Weighted Average Number of Common Stock Outstanding	Measures profitability per-share basis
Activity Analysis Ratio		
Asset Turnover (ttm)	Sales/Average Total Assets	
Accounts Receivable Turnover (ttm)	Sales/Average Accounts Receivable	Measures how effectively a company is managing its receivables
Accounts Payable Turnover (ttm)	COGS/Average Account Payables	The number of times trade payables turn over during the year
Inventory Turnover	COGS/Average Inventories	The ability of supplier's inventory movement and ability to service product demands and turn current assets to cash
Capital Structure Analysis Ratio		
Interest Coverage Ratio (ttm)	EBIT/Interest Expense	Ability to pay interest payments with the current earnings
Total Debt to Equity (mrq)	Total Debt/Total Shareholders' Equity	Measures capital structure of the firm; only interest-bearing debt needs to be computed. You might take into consideration that some of the leases are not classified as debt in the balance sheet
Long-Term Debt to Equity (mrq)	Long Term Portion of Total Debt /Total Shareholders' Equity	Measures capital structure of the firm; only interest bearing debt needs to be computed. You might take into consideration that some of the leases are not classified as debt in the balance sheet

Source: Cadbury-Schweppes plc; Procurement Strategy Council research.

Supplier Financial Analysis Guidelines (Continued)

What to Look For
Higher liquidity ratios mean better payment ability. A general rule of thumb is to have a current ratio of two. Although this will vary by business and industry, a number above two may indicate a poor use of capital. A current ratio under two may indicate an inability to pay current financial obligations with a measure of safety. Higher liquidity ratios mean better payment ability. Quick Ratios below 0.5 indicate a risk of running out of working capital and a risk of not meeting your current obligations. While industries and businesses vary widely, 0.5 to 1 are generally considered acceptable quick ratios. This ratio give you an idea of the capital structure. Too much debt will cause low ratio. It is hard to determine what is ideal working capital for your business; however it must be positive.
One of the most common financial measures, it can be an effective tool to compare the profitability of two companies. If your return on assets is lower than a competitor, it may be an indication that they have found a more efficient means to operate through financing, technology, quality control, or inventory management. Higher is better; compare the return on equity to other investment alternatives, such as a savings account, stock, or bond. Compare your ratio to other businesses in the same or similar industry. Higher is better; often referred to as the bottom line, this ratio takes all expenses into account including interest. Compare to other businesses in the same industry to see if your business is operating as profitably as it should be. Look at the trend from month to month. Is it staying the same? Improving? Deteriorating? Are you generating enough sales to leave an acceptable profit? Trend from month to month can show how well you are managing your operating or overhead costs. Higher is better; a ratio less than one means you are selling your product for less than it costs to produce. If this ratio remains less than one, you will not achieve profitability regardless of your volume or the efficiency of the rest of your business. Compare to other businesses in the same industry to see if your business is operating as profitably as it should be. Look at the trend from month to month. Is it staying the same? Improving? Deteriorating? Is there enough gross profit in the business to cover your operating costs? Is there a positive gross margin on all your products? Higher is better.
The higher the number, the more efficient you are at collecting your accounts receivable. A ratio that is too high or one that is increasing over time may indicate an inefficient use of your working capital. It is important to compare this ratio to other businesses in your industry. The higher the turnover, the shorter the time between purchase and payment. A low turnover may indicate that there is a shortage of cash to pay your bills or some other reason for a delay in payment. Generally, the higher this ratio the better your use of inventory and the shorter the time between sales and collecting cash. Compare to industry standards. Low numbers indicate a large amount of capital tied up in inventory that may be more efficiently used elsewhere.
Higher is better; ideally, you want your coverage ratio to be over 1, as this indicates that your operating income is sufficient to cover your total debt service. A low number may indicate difficulty in paying interest. The higher the ratio, the greater the risk to a present or future creditor. Usually lower is better; however this depends on the optimal capital structure. Depending on the D/E ratio companies valuation will change. Best to compare industry averages. Usually lower is better; however this depends on the optimal capital structure. Depending on the D/E ratio companies valuation will change. Best to compare industry averages.

Source: Cadbury-Schweppes plc; Procurement Strategy Council research.

Interested in More on This Topic?

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