

2 ANALYSIS AND COMMENTARY

A key question is how best to assess the pre-release information.

The simplest approach is to read through each section and ask yourself what this is telling you about the company, focussing on control issues and the effectiveness of its systems and processes.

Let us take each section in turn:

COMPANY BACKGROUND

Key aspects from this section are as follows:

- Ruby Dale Ltd ("Ruby Dale") designs, manufactures, distributes and retails luxury shoes and handbags. As such controls relating to quality are particularly important, whether the sourcing and purchase of raw materials or those linked to manufacturing processes.
- The company has expanded rapidly which, while encouraging as far as profit is concerned, raises many issues for control systems – are systems that worked when the company was smaller still effective now, is there a need for greater segregation of duties, do some controls need to be more formalised, are some functions too large for effective management without restructuring and/or is it now easier for frauds to get lost in the overall volume of business?
- The doubling of the workforce increases the risk of new recruits not being set up correctly on payroll, of controls over overtime and expenses being inadequate and staff being paid too much / too little.
- The rapid growth in e-commerce means that adequate IT and website controls are essential, whether to prevent hacking and loss of customer data, or to ensure that prices and stock availability are kept up to date so customer orders can be processed quickly and accurately.
- The recent decision to outsource some production to cope with capacity constraints raises two issues – firstly that the choice of supplier incorporated both financial (e.g. cost) and non-financial (e.g. quality, delivery times) factors, and, secondly that adequate controls are in place to manage and monitor those suppliers, particularly ensuring quality is not compromised.

SUSTAINABILITY

In the real assessment you may have to evaluate how well the company is doing in terms of operating in a sustainable manner. Using the environmental/social/economic categories we can see that Ruby Dale is making advances in all three areas:

- Environmental – Ruby Dale is trying to achieve savings in water, waste and energy but there is scope for further recommendations, such as using electric vehicles for distribution.
- Social – Ruby Dale's focus here is on training, apprenticeships and working with the local community. No mention is made of initiatives with respect to third party suppliers.
- Economic – Ruby Dale does seem to be investing for the future but must be wary of trying to grow too quickly and risk over-trading.

Furthermore, any threats to the company's sustainability credentials could have a damaging impact on its brand and reputation, so it is vital that suitable controls are in place and working effectively, such as screening potential suppliers before placing orders.

SWOT ANALYSIS

In practice a SWOT analysis is used to determine the strategic position of a firm and help formulate future strategy. Within PDSY the emphasis will need to be on control systems, so each item within the SWOT needs to be interpreted in terms of potential control issues:

| Category | Potential control issues |
|----------|--|
| S | <p>In terms of strengths, the main control issue relates to protecting the strengths. For example,</p> <ul style="list-style-type: none"> • Do we have adequate control systems regarding taking orders on the website to ensure that customers get sent the correct products, as failure to do so would erode customer confidence? |
| W | <p>All weaknesses can give rise to control problems:</p> <ul style="list-style-type: none"> • Operating at full capacity may only be possible if staff are working flat out (or even with overtime), making it more likely that mistakes will be made. • In addition, it is important that scarce resource are allocated correctly, perhaps using limiting factor analysis – e.g. contribution per labour hour to rank options. • Low staff motivation may result in higher staff turnover, emphasising controls relating to recruitment and termination of staff, making sure they are paid correctly, that fraudsters cannot enrol fake employees, etc. • The risk of overtrading makes it even more important that controls relating to receivables and inventory management are working effectively. |
| O | <p>Most opportunities emphasise the need to make good decisions, emphasising task 4 on brought forward MDCL topics. For example,</p> <ul style="list-style-type: none"> • Using the principles of relevant cash flows to decide whether new products or stores are viable |
| T | <p>As with weaknesses, all threats can give rise to control problems. For example,</p> <ul style="list-style-type: none"> • Purchasing controls (such as authorisation) are required to limit the damage of increases in the cost of materials. |

STAFF

A list of key staff help you see how the organisation is structured and also if there are obvious control issues relating to responsibilities – for example, having a separate Accounts Payable Clerk and Accounts Receivable Clerk should mean better segregation of duties.

RUBY DALE'S FINANCIAL STATEMENTS

You could calculate ratios to see if any key problems are highlighted:

| | (Working) | Ratio |
|--|--------------------------|---------|
| Gross margin (%) | 25,946/41,380 | 62.7% |
| Operating margin (%) | 7,358/41,380 | 17.8% |
| ROCE (%) | 7,358/(36,836 + 20,286) | 12.9% |
| Current ratio | 9,218/4,276 | 2.2:1 |
| Quick ratio | (676 + 4,762)/4,276 | 1.3:1 |
| Inventory days | (3,780/15,434) × 365 | 89 days |
| Receivables days | (4,762/41,380) × 365 | 42 days |
| Payables days | (3,150/15,434) × 365 | 74 days |
| Operating cycle | 89 + 42 – 74 | 57 days |
| Gearing (Debt/Equity) | 20,286/36,836 | 0.55:1 |
| Gearing (debt/total long term finance) | 20,286/(20,286 + 36,836) | 35.5% |

The effectiveness of such an exercise is limited by the fact that we only have one year of results and no industry averages, so have no basis of comparison to evaluate figures.

Furthermore it is likely that Ruby Dale's demand has a seasonal element with additional sales in the run up to Christmas. As a result a September year end could mean that the inventory and payables levels given are higher than average as the company builds up to meet the extra demand. However, receivables may be lower than is typical as the larger sales to retailers have not been made at that point.

Given all this, we can make the following comments:

- Gross margin is good, indicating that the combination of brand names and sales channels is working.
- However, the operating profit margin seem low, possibly indicating a need to review areas such as distribution costs and administration to see if there are cost inefficiencies or control issues.
- Overall, ROCE seems reasonable.
- It could be argued that there is no real concerns over short term liquidity risk as both current and quick ratios are greater than 1. However, this view is countered by the relatively long operating cycle. A long operating cycle will increase the risk of overtrading as more funds are tied up in working capital.
- Inventory days at 89 days are high and increase the risk of obsolescence as customer tastes and fashion change. The fact that the company has had stock-outs on popular lines means that perhaps they need to review how much inventory is held of which items.
- We are not told the split between cash sales (presumably most customers via the website) and credit sales (presumably to independent shops). However, the receivables days seems reasonable at an average of 42 days, although this figure could be lower than is typical, given the seasonality aspect mentioned above.

- Payables days also seem high, although this could be unrepresentative due to seasonal trade. However, is there a danger that we are at risk of upsetting suppliers, which could result in delays in delivery or poor quality, both of which could seriously compromise Ruby Dale's quality and ability to meet customer orders?
- Financial gearing is low, so there should be scope to raise debt finance for new projects if required.

WHAT NEXT?

You do not need to learn any of the above analysis – the aim is to help you feel comfortable with the company and what it does and to think about the assessment topics in an integrated way.

In some respects the main reason for looking at the pre-release material is to feel comfortable with the scenario and to know what is there so you can refer back to it if necessary.

- In sample assessment 1 all relevant information was given to you within the tasks, so there was little need to refer back to the pre-release material in order to answer them.
- However, in sample assessment 2 you needed to refer back to the financial statements in order to calculate ratios.