Read through the case study below, and then answer the following questions.

**TMA 03 Part 1 questions**

1. Briefly explain the general purpose of each of the three financial statements (the income statement, the balance sheet and the cash flow statement) and the usefulness of each of them for a business like Better Homes Ltd. *(20 marks)*
2. Analyse the financial statements that have been prepared by Better Homes Ltd’s financial director. In particular, comment on the following aspects of the company: *(50 marks)*
   * i.Areas of concern in financial performance, focussing mainly on information from the income statement
   * ii.Areas of concern in financial health, focussing on ratios dependent on the income statement and the balance sheet
   * iii.Areas of concern in cash flow management, focussing on information available from the cash flow statement.
3. Assess the value of Bill Rancini’s parents’ recent concern that ‘the company has not performed well in the past year’ (the year to 31 December 2017). What practical steps should Bill Rancini now undertake in order to improve the financial performance of the business? *(20 marks)*

Case study

**Better Homes Ltd**

Bill Rancini comes from a family that has bought, renovated and sold or rented houses as a side-line to their main forms of employment for a number of years. This family interest has proved to be a profitable small business. His father is an electrician by trade but has developed skills in other areas such as basic plumbing and carpentry. This has greatly reduced the cost of ‘doing up’ old properties. Bill’s mother works as a part-time bookkeeper so she has enough spare time to keep proper financial records for the business.

Bill’s favourite subject at school was Art. While still at school Bill discovered a knack for helping his parents to tastefully furnish renovated properties in preparation for their sale or rent. After school Bill studied interior design while helping run his parents’ business.

About 20 years ago Bill was left money by a grandparent. He used this to open her first Better Homes shop in an exclusive part of London. It sells high quality home furnishings and accessories to mainly wealthy customers who have limited time.

Bill’s luck, good taste and business acumen has proved very successful. The private company he formed nearly 18 years ago, Better Homes Ltd, has grown to comprise a chain of 25 stores in wealthy parts of London and the south-east of England. The retail outlets have been complemented by an effective and profitable website.

Bill is the majority shareholder while his parents own the remaining shares in the business. Bill has recently decided he wants to sell the business in about three years. He is conscious that his parents are growing old and he also wants to spend more time with his young family.

Bill’s parents have decided to retire from formal employment in the next few months. They will still run their property business. While they are essentially passive shareholders in Better Homes Ltd, Bill still relies on them for common sense advice he can trust.

Better Homes Ltd has been particularly profitable since the global financial crash beginning in 2007. It appears to Bill and the joint chief executive of the company that the luxury goods market has not been affected by cuts in government expenditure. Revenues have increased on average by 10% per annum in recent years. In the year ending 31 December 2016 the company achieved a record return on equity of 37%. This has generated some media interest in Better Homes Ltd as well as a number of serious offers to buy the company.

In the last year, Bill has relied mainly on advice of the new company joint chief executive to improve financial health ratios, to invest in new staff, and to improve back office and other business systems by means of technology. The joint chief executive has also concentrated on buying goods that can be sold with a higher profit margin. A more contentious strategic decision by the fellow director was to overhaul marketing and advertising expenses in order to reduce what he regarded as unnecessary expenditure. Bill’s parents have recently challenged the views of the joint chief executive and advised him that the company has not performed well in the past year.

Bill now needs to properly understand the implications of the latest financial statements below to see if the company is on the right track, and if his parents’ recent advice is justified.

**Better Homes Ltd Income Statement**

**For the years ended 31 Dec 2017 and 2016**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  |  |  |  |
|  |  |  |  |  |
|  | Year to 31 Dec 2017 | | Year to 31 Dec 2016 | |
|  | £k | £k | £k | £k |
| **Sales revenue** |  | **90,872** |  | **88,476** |
|  |  |  |  |  |
| Less: cost of goods sold: |  |  |  |  |
| Opening inventory | 5,246 |  | 5,168 |  |
| Purchases from wholesalers | 39,256 |  | 40,626 |  |
|  | 44,502 |  | 45,794 |  |
| Less closing inventory | 3,792 |  | 5,246 |  |
| **Cost of goods sold** |  | **40,710** |  | **40,548** |
| **Gross profit** |  | **50,162** |  | **47,928** |
|  |  |  |  |  |
| Less expenses: |  |  |  |  |
| Salaries and other costs | 18,562 |  | 16,154 |  |
| Rent and office services | 656 |  | 628 |  |
| Insurance | 99 |  | 94 |  |
| Distribution and postage costs | 323 |  | 310 |  |
| Marketing and advertising expenses | 748 |  | 864 |  |
| Office administration | 191 |  | 164 |  |
| Energy and other utilities | 272 |  | 264 |  |
| Depreciation | 724 |  | 682 |  |
| Audit, Accounting & Legal Costs | 46 |  | 43 |  |
| Interest on bank loan | 6 |  | 12 |  |
| Interest on bank overdraft | 0 |  | 0 |  |
| **Total Expenses** |  | **21,627** |  | **19,215** |
|  |  |  |  |  |
| Interest received |  | 1,350 |  | 1,290 |
|  |  |  |  |  |
| **Profit before taxation** |  | **29,885** |  | **30,003** |
|  |  |  |  |  |
| Corporation tax |  | 5,977 |  | 6,001 |
|  |  |  |  |  |
| **Profit after taxation** |  | **23,908** |  | **24,002** |

**Better Homes Ltd Balance sheets at 31st December 2017 and 2016**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  |  |  |  |
|  |  |  |  |  |
|  | Year to 31 Dec 2017 | | Year to 31 Dec 2016 | |
|  | £k | £k | £k | £k |
| **Non-current assets** |  |  |  |  |
| Property |  | 12,860 |  | 13,600 |
| Computers and equipment |  | 412 |  | 328 |
| Vehicles |  | 228 |  | 234 |
| Total non-current assets |  | 13,500 |  | 14,162 |
|  |  |  |  |  |
| **Current assets** |  |  |  |  |
| Inventory | 3,792 |  | 5,246 |  |
| Receivables | 951 |  | 1,612 |  |
| Other current assets | 48 |  | 46 |  |
| Cash at bank | 105,271 |  | 77,910 |  |
| Total current assets | 110,062 |  | 84,814 |  |
|  |  |  |  |  |
| **Current liabilities** |  |  |  |  |
| Payables | 11,124 |  | 10,398 |  |
| Corporation tax | 5,977 |  | 6,001 |  |
| Other tax liabilities | 349 |  | 273 |  |
| Bank overdraft | 0 |  | 0 |  |
| Total current liabilities | 17,450 |  | 16,672 |  |
|  |  |  |  |  |
| **Net current assets/working capital** |  | **92,612** |  | **768,142** |
|  |  |  |  |  |
| **Total assets less current liabilities** |  | **106,112** |  | **82,304** |
|  |  |  |  |  |
| **Long-term liabilities** |  |  |  |  |
| Bank loan |  | 300 |  | 400 |
|  |  |  |  |  |
| **Net Assets** |  | Total**105,812** |  | Total**81,904** |
|  |  |  |  |  |
| **Equity** |  |  |  |  |
| Share capital |  | 1,000 |  | 1,000 |
| Reserve: retained earnings |  | 104,812 |  | 80,904 |
|  |  |  |  |  |
| **Total Equity** |  | Total**105,812** |  | Total**81,904** |
|  |  |  |  |  |

**Better Homes Ltd Cash Flow Statements For the years ended 31 December 2017 and 2016**

|  |  |  |
| --- | --- | --- |
|  |  |  |
|  |  |  |
|  | **Year to 31 Dec 2017** | **Year to 31 Dec 2016** |
|  | £k | £k |
|  |  |  |
| **Operating activity:** |  |  |
| Operating profit | 28,541 | 28,725 |
| Interest paid on overdraft | 0 | 0 |
| Corporation tax paid | (6,001) | (6,485) |
| Add back non-cash expenses: |  |  |
| Depreciation | 724 | 682 |
| Loss/(Profit) on disposal of non-current assets | 0 | 0 |
|  |  |  |
| **Changes in cash invested in Working Capital:** |  |  |
| (Increase)/Decrease in Inventory | 1,454 | (78) |
| (Increase)/Decrease in Receivables | 661 | (472) |
| (Increase)/Decrease in Other current assets | (2) | 8 |
| Increase/(Decrease) in Payables | 726 | 1,854 |
| Increase/(Decrease) in Other tax liabilities | 76 | 94 |
|  |  |  |
| **Net cash inflow/(outflow) from operating activities** | **26,179** | **24,328** |
|  |  |  |
| **Investing activity:** |  |  |
| Purchase of non-current assets | (62) | (47) |
| Proceeds on disposal of non-current assets | 0 | 0 |
|  |  |  |
| **Net cash generated (consumed) by investing activity** | **(62)** | **(47)** |
|  |  |  |
| **Financing activity:** |  |  |
| Repayment of Bank Loan | (100) |  |
| New Bank Loan | 0 | 0 |
| Interest paid on bank loan | (6) | (12) |
| Interest received on bank deposit | 1,350 | 1,290 |
| **Net cash generated (consumed) by financing activity** | **1,244** | **1,278** |
|  |  |  |
| **Change in Cash Balances** | **27,361** | **25,559** |
|  |  |  |
| **Opening cash balance (overdraft) at 1st January** | **77,910** | **52,351** |
|  |  |  |
| **Closing cash balance (overdraft) at 31st December** | Total**105,271** | Total**77,910** |