

Interpreting Financial Ratios

Luna Lighting, a retail firm, has experienced modest sales growth over the past three years but has had difficulty translating the expansion of sales into improved profitability. Using three years' financial statements, you have developed the following ratio calculations and industry comparisons. Based on this information, suggest possible reasons for Luna's profitability problems.

	Industry			
	2009	2008	2007	2009
Current	2.3X	2.3X	2.2X	2.1X
Average collection period	45 days	46 days	47 days	50 days
Inventory turnover	8.3X	8.2X	8.1X	8.3X
Fixed asset turnover	2.7X	3.0X	3.3X	3.5X
Total asset turnover	1.1X	1.2X	1.3X	1.5X
Debt ratio	50%	50%	50%	54%
Times interest earned	8.1X	8.2X	8.1X	7.2X
Fixed charge coverage	4.0X	4.5X	5.5X	5.1X
Gross profit margin	43%	43%	43%	40%
Operating profit margin	6.3%	7.2%	8.0%	7.5%
Net profit margin	3.5%	4.0%	4.3%	4.2%
Return on assets	3.7%	5.0%	5.7%	6.4%
Return on equity	7.4%	9.9%	11.4%	11.8%

Based on this information, some possible reasons for Luna's profitability problems are suggested as under:

- a) Net Profit margin of the company has degraded and this might be due to decrease in the net income of the company due to increase in expenses. This needs to be improved upon by cost control and cost reduction.
- b) Return on equity of the company has degraded further and this also indicates that there is a decrease in the net income of the company due to increase in expenses. This needs to be improved upon by cost control and cost reduction.

- c) Fixed charge coverage has fallen, which means that the debt payment along with interest might have increased and this will also lead to decrease in the net income of the company and thus degrading the profitability position of the company.
- d) Operating profit margin has dropped even though gross profit margin has remained constant. It means that the operating expenses are higher and need to be controlled to improve the profitability of the company.
- e) The fixed assets turnover and the return on assets have also degraded; this also indicates decrease in the net income of the company.