

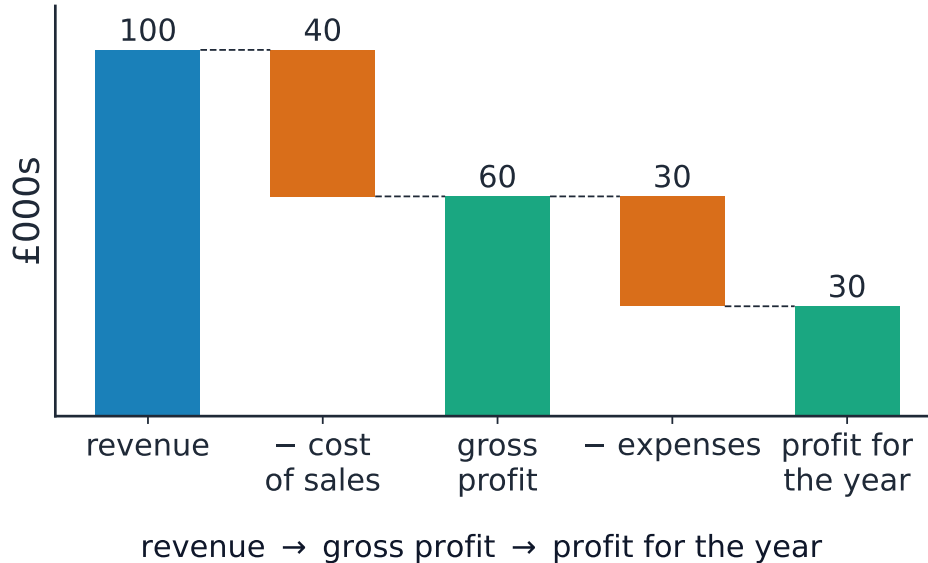
Exercise walk-through

5.5

Analysis of accounts

IGCSE Business Studies

The income statement



An **income statement** runs from **revenue** down to profit.

- revenue – cost of sales = **gross profit**
- – expenses = **net profit**

The balance sheet

what it owns

current assets
non-current assets

=

funded by

current liabilities
non-current liabilities
equity (owners)

The **statement of financial position** balances:

$$\text{assets} = \text{liabilities} + \text{equity}$$

It shows what the business
owns & **owes** .

Ratios

profitability

gross & net **profit margin** : profit
as a % of revenue

liquidity

current ratio =
current assets / current liabilities

The ratios, and who reads the accounts

gross profit margin

gross profit as a percentage of revenue – how much each sale contributes before overheads

net profit margin

the same after all costs – what is actually kept

ROCE

profit as a percentage of the **capital employed** on the money invested

– the return

current ratio

current assets $\div$ current liabilities – can the firm pay its short-term debts?

the acid test

the same with inventory removed, since stock may not sell quickly

cost of sales

the cost of making or buying the goods that were sold

Internal users (owners, managers) read the accounts to control and to plan; **external** users (banks, suppliers, government, investors) to decide whether to lend, supply or invest.

Reading a statement of financial position

Non-current assets

Non-current assets
vehicles.

are kept over a year – property, machinery,

Non-current liabilities

Non-current liabilities
long-term loan.

are owed beyond a year – a mortgage, a

Owners' equity

Owners' equity
bilities.

is what is left for the owners: assets minus lia-

Acid test ratio

The **acid test ratio**
liabilities – liquidity without

assuming the stock can be sold.

is current assets *less inventory*, over current

ROCE

Return on capital employed
over capital employed, as a percentage.

: **profit for the year**

Different **stakeholders** read different ratios: a supplier looks at liquidity, an owner at profitability, a lender at gearing.

Exercises 2.1-2.3

2.1 State what the **gross profit margin** measures.

[2]

2.2 A business has a profit of \$30,000 and capital employed of \$150,000. Calculate the ROCE.

[2]

2.3 State what the **current ratio** measures.

[2]

Exercises 2.1-2.3

2.1 State what the **gross profit margin** measures.

[2]

2.1

- **gross profit margin** is gross profit as a **percentage of revenue** (K)

2.2 A business has a profit of \$30,000 and capital employed of \$150,000. Calculate the ROCE.

[2]

2.2

$$\text{ROCE} = \frac{\$30\,000}{\$150\,000} \times 100\% = \mathbf{20\%}$$

(K)

2.3 State what the **current ratio** measures.

[2]

2.3

- the **current ratio** measures whether a business can pay **short-term debts** from current assets (K)

Exercise 3.1 (a)

3.1 A business has current assets of \$40,000 (including \$10,000 inventory) and current liabilities of \$20,000.

(a) Calculate the current ratio.

[2]

Exercise 3.1 (a)

3.1 A business has current assets of \$40,000 (including \$10,000 inventory) and current liabilities of \$20,000.

(a) Calculate the current ratio.

[2]

(a)

$$\text{current ratio} = \frac{\$40\,000}{\$20\,000} = \mathbf{2.0}$$

(K)

Exercise 3.1 (b)

3.1 A business has current assets of \$40,000 (including \$10,000 inventory) and current liabilities of \$20,000.

(b) Calculate the acid test ratio.

[2]

Exercise 3.1 (b)

3.1 A business has current assets of \$40,000 (including \$10,000 inventory) and current liabilities of \$20,000.

(b) Calculate the acid test ratio. [2]

(b)

$$\text{acid test} = \frac{\$40\,000 - \$10\,000}{\$20\,000} = \mathbf{1.5}$$

(K)

Exercises 3.2-3.3

3.2 Explain two reasons why a business calculates profitability ratios.

[6]

3.3 A business's profit margin has fallen this year. Do you think the owners should be worried? Justify your answer.

[6]

Exercises 3.2-3.3

3.2 Explain two reasons why a business calculates profitability ratios. [6]

3.2

- for **each** of two reasons: K + An, max 3 each
- e.g. **judge performance**: profit per \$1 of sales → owners see if the firm is doing well
- e.g. **compare**: with last year or rivals → managers spot a fall and act

3.3 A business's profit margin has fallen this year. Do you think the owners should be worried? Justify your answer. [6]

3.3

- **worried**: costs rising faster than sales, or prices cut → less profit
- **not always**: a one-off cost or a deliberate price cut to win share
- **judgement (Ev)**: a warning – a lasting fall is serious; a one-off or strategic fall may not be