PART 6 : Advanced principles

Unit 6.1 : Financial relationships (ratio analysis)

1 Business B had the highest percentage of gross profit to revenue of 37.5%:

<table>
<thead>
<tr>
<th>From Income Statements for year ending 31 December:</th>
<th>Business A</th>
<th>Business B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (sales)</td>
<td>$1 000 000</td>
<td></td>
</tr>
<tr>
<td>less Cost of sales</td>
<td>$700 000</td>
<td>$500 000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$300 000</td>
<td></td>
</tr>
<tr>
<td>Gross profit/revenue (%)</td>
<td>30%</td>
<td>37.5%</td>
</tr>
<tr>
<td>Expenses</td>
<td>$220 000</td>
<td></td>
</tr>
<tr>
<td>Profit for the year</td>
<td>$80 000</td>
<td></td>
</tr>
<tr>
<td>Profit for the year/revenue (%)</td>
<td>8%</td>
<td>12.5%</td>
</tr>
</tbody>
</table>

2 Each business could try to increase its gross profit margin in sales by (any two from):
   ● reducing costs of sales, for example, by purchasing the goods from cheaper suppliers;
   ● increasing selling prices;
   ● reducing trade discounts offered to credit customers.

3 Business B had the higher percentage of profit for the year to revenue at 12.5%.

4 Business B achieved the best return on capital employed at 17.86%. Calculations are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Business A</th>
<th>Business B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit for the year</td>
<td>$80 000</td>
<td>$100 000</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>$700 000</td>
<td>$480 000</td>
</tr>
<tr>
<td>Current assets</td>
<td>$200 000</td>
<td>$160 000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$200 000</td>
<td>$80 000</td>
</tr>
<tr>
<td>Capital employed:</td>
<td>$700 000</td>
<td>$560 000</td>
</tr>
<tr>
<td>(total assets less current liabilities)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on capital employed (%)</td>
<td>11.43%</td>
<td>17.86%</td>
</tr>
</tbody>
</table>
5 The return on capital employed (ROCE) shows how successful a business has been at using its assets to generate profit. Business owners and investors will want to maximise this return, or invest in companies that do, to ensure they are getting the best return they can on the money they invest. They may compare their ROCE to the interest rate they could earn by saving the same amount of money in a bank account, without any risk.

6 Capital employed is equal to the amount of owner’s capital and non-current liabilities (loan capital) invested in the assets of the business. It is therefore equal to the value of the total assets of the business less its current liabilities.

7 (a) Liquidity refers to how quickly and easily a business can raise cash from its current assets to pay its immediate and short-term debts.

(b) Business B was the most liquid with £2 of current assets for every $1 of current liabilities. The liquidity ratios were calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Business A</th>
<th>Business B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$200 000</td>
<td>$160 000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$200 000</td>
<td>$80 000</td>
</tr>
<tr>
<td>Working capital ratio (current ratio): current assets : current liabilities</td>
<td>1:1</td>
<td>2:1</td>
</tr>
</tbody>
</table>

8 The working capital ratio (or current ratio) compares the value of current assets to current liabilities. The more a business has invested in current assets compared to its current liabilities, the more favourable is its liquidity position. The quick ratio (or acid test) compares the value of the current assets of the business excluding inventory, to the value of its current liabilities. Inventory is excluded because it is the least liquid current asset: it can sometimes take time to sell to raise cash and may lose value over time.

9 (i) The working capital (or net current assets) of a business is the amount of money the business has available to pay ongoing running expenses after all current liabilities have been met.

(ii) Working capital is calculated as current assets less current liabilities.

10 A business could try to increase its working capital by (any four from):

- securing more owners capital and/or long-term liabilities to pay down its current liabilities;
- increasing cash sales as a proportion of total sales;
- holding less inventory and managing inventory more efficiently;
- retaining more profit in the business and reducing owner’s drawings of cash and goods for own use from inventory;
- reducing expenses so more cash is kept in the business;
- delaying cash payments to trade payables until required;
- offering trade receivables more generous cash discounts to encourage early repayment.
11 The rate of inventory turnover in a business may fall due to:

- falling sales;
- increased selling process resulting in a fall in customer demand and sales;
- buying too many goods to hold in inventory.

12 (a) The average time it takes for trade receivables to be paid or collected is 25 days more than the period the business allows credit customers to settle their invoices or accounts. This means cash is not being collected from trade receivables as quickly as the business needs to pay its short-term debts and expenses. This may be due to the business selling goods on credit to too many customers with financial problems and poor repayment histories.

(b) The business could improve its average trade receivables collection period by (any three from):

- restricting credit sales only to the most financially secure and reliable customers;
- sending out regular statements and payment due reminders to its trade receivables;
- offering them more generous cash discounts for early payment;
- charging high rates of interest on late payments;
- refusing to supply any more items to a customer with a debt that was overdue until it been paid off in full;
- threatening a customer with legal action to recover an unpaid debt.

13 (a) The trade payables payment period =

\[
\text{Trade payables at end of year} \times \frac{365 \text{ days}}{\text{Credit purchases for the year}}
\]

(b) By delaying payment of balances on trade payables the business will hold on to its cash for longer. However, the business could end up paying more because it may lose cash discounts offered for early payment and may incur interest charges if payments are late. Suppliers may also refuse the business further sales on credit if it continues to fail to pay its debts on time.

14 Comparing the financial performance of different firms using accounting data and ratio analysis can be problematic because firms will differ in their size, capital requirements, production processes, the products they sell and many other attributes. Additionally, they may have different accounting years and policies, for example, methods used to depreciate non-current assets may differ, and accounting years. For example, some businesses may depreciate the value of their non-current assets using the straight line method while others may use the reducing balance method. This in turn will affect the values of their net assets used to calculate their returns on capital employed.

There are also many factors that affect the performance of different businesses which cannot be easily measured and will not appear in financial statements. For example, financial performance may depend on the age and condition of its non-current assets, level of customer loyalty and the quality and skills of management and employees.

**Unit 6.2 : Accounting principles**

1 (a) Consistency
   (b) Prudence
   (c) Accounting entity
   (d) Money measurement

2 (a) The accruals (matching) principle requires that the costs of the business are matched to the incomes they help to generate in the same accounting year. This means that the profit or loss of the business for a given accounting year should include only those incomes earned and expenses incurred in that year regardless of whether they have been paid or not. Any accrued income or expenses should therefore be included in the calculation of profit or loss for the year but any income and expenses that have been prepaid should be excluded and not charged to profit until the year in which they are finally earned or incurred through the provision and use of goods or services.

(b) The going concern principle assumes that the business is able to continue trading or providing a service to earn revenue well into the future and the financial statements are prepared on the basis that there is no intention to close and/or sell off the business. It means that the non-current assets of the business can be valued at their cost less accumulated depreciation as opposed to their realisable value on sale which may be much lower.

(c) The materiality principle advises that low value items that will not materially affect...
the profit or value of a business need not to be recorded separately. This is because they are not worth the time, cost or effort of recording separately. Only if items of expenditure are large or material enough to have an impact on the profit or value of the business should they be recorded separately in its accounts.

(d) The accounting year principle states that financial statements should be produced at regular intervals during the lifetime of a business. As a minimum they should be produced at least once each year at the end of each accounting year. Without regular annual statements it would be impossible to examine how the profitability and value of a business, and compared to other businesses, has changed over time and why.

3 The rule for valuing inventories at the lower of their cost or net realisable value, is a practical application of the prudence principle.

4 International accounting standards can improve the quality and usefulness of information presented in financial statements by:

- reducing areas of difference and variety of accounting practices, thereby improving the compatibility of accounting data from different businesses in different countries;
- improving the reliability of accounting information and ensuring it is free from significant errors or bias by insisting common standards are followed and maintained;
- increasing the understandability of accounting information, as the standards require it to be clear, well presented and to explain key issues.

5 It will be important to the clients of a practising accountant for the accountant to display professional ethics because they require the accountant to (any two from):

- be honest and trustworthy;
- not allow bias, personal interests or the views of others to exert unjustifiable influence on their judgment and business relationships;
- keep his or her knowledge and skills in accounting at a high level and up-to-date with the latest developments;
- meet all applicable technical and professional standards;
- respect the privacy of information provided by a client and should not disclose any such information to others without their agreement or unless there is a legal or professional reason to do so;
- comply with relevant laws and regulations and should avoid any action that discredits the accounting profession.

6 Unless there is good evidence to support the revaluation of non-current assets by 30% in a statement of financial position it will not be honest to do so and will fail the professional standard of integrity. If asked to do so by a client, an accountant should refuse.

7 (a) Only items with a definite monetary value should be included in the accounts of a business. Other aspects of business performance, such as a highly skilled and motivated workforce are difficult to measure and will therefore not have a definite monetary value. The money measurement principle therefore means a value of $35,000 for the increased skill of the workforce should not be recorded in the financial statements.

(b) The accounting principle of consistency should prevent the company from changing from one method of depreciating its non-current assets to another because it requires the same accounting treatment to be applied to similar items each accounting year. Changing from the straight line method of depreciation one year to the reducing balance method the next would make it very difficult for users of financial statements to understand what had caused the values of the assets of the business to change over time. For example, if its assets had increased in value was this due to the change in the valuation method or because the business had expanded and acquired more assets, or a combination of both factors?