

# ANALYSIS & INTERPRETATION OF FINANCIAL STATEMENTS

# Obj.9      Analysing Profit Results

- The Trading, Profit & Loss a/c should be examine to make meaningful deductions concerning the business.
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- The following ratios can be used -:
  - Stock turn [rate of stock turnover]
  - Gross profit percentage
  - Net profit percentage

# Stock turn

- The stock turn ratio tells us how many times during the year stocks had to be replenished.

*Using the formula*

**cost of sales / average stock**

Where average stock is -:

- $(\text{opening stock} + \text{closing stock}) / 2$       and
- $\text{cost of sales} = \text{cost of goods sold}$
  
- $365 / \text{stock turn} = \text{number of days stock was held before it was sold.}$

# Gross/Net profit percentages

- Gross/Net profit percentages tell us what portion of the sales for the period resulted in a profit.
- Increased sales does not always mean an increase in profits.

- Gross profit percentage (**GPP**)

$$\frac{\text{gross profit}}{\text{sales}} \times 100$$

- Net profit percentage (**NPP**)

$$\frac{\text{net profit}}{\text{sales}} \times 100$$

# Obj.12    Analysing the Balance Sheet

- The Balance Sheet should be examined to make meaningful deductions about the business' financial status as at a given point in time.
- The following ratios can be used -:
  - **Current ratio**
  - **Acid test ratio**
  - **Return on investment**

# The Current Ratio

- The current ratio is a measure of liquidity (how quickly cash can be obtained to settle debts or pay expenses)
- The current ratio seeks to **match** those assets that can be easily converted to cash **with** those debts which have to be paid with the next 12 months.
- The current ratio formula is -:  
$$\frac{\text{current assets}}{\text{current liabilities}}$$
- An acceptable current ratio should be 1.5:1 or better

# The Acid Test Ratio

- The acid test ratio is a measure of liquidity (how quickly cash can be obtained to settle debts or pay expenses)
- The acid test ratio seeks to **match** those *cash or near cash assets* **with** those debts which have to be paid with the next 12 months. [**current assets less stock**]
- The acid test ratio formula is -:  
$$\frac{\text{current assets} - \text{stock}}{\text{current liabilities}}$$
- An acceptable acid test ratio should be 1:1 or better

# The Rate of Return On Investment

- The rate of return on investment is a measure of the profit (returns) the owner gained from putting his capital into the business.
- The rate of return on investment identifies the percentage of profits gained from the capital which had to be used during that year.
- The rate of return on investment formula is -:  
$$\frac{\text{net profits}}{\text{capital employed}} \times 100$$
- An acceptable rate of return should be 20% or better



# Obj.10 & 11

# Working Capital

- Working capital is the amount of resources used to keep the business operational (on a day to day basis).
- Working capital is like a current asset – since its value changes continually (from day to day).
- Working capital is a quick reference to the level of liquidity in a business.
- Working capital can be calculated as -:
- **current assets – current liabilities**
- Where current liabilities are debts due within 1 year

# Mark-up & Margin

- Mark-up is
  - The profit described as a percentage/fraction of the cost price.
  - =  $\frac{\text{profit}}{\text{Cost price}}$
- Margin is
  - The profit described as a percentage/fraction of the selling price.
  - =  $\frac{\text{profit}}{\text{selling price}}$
- **Note:** if  $a/b$  is the mark-up then  $a/b+a$  is the margin
- **Also:** cost price + profit = selling price