



Recap of Final Accounts

- There are 3 important documents that a business must produce:

**The Trading,
Profit & Loss
Account**

The “history” book



**The Balance
Sheet**

A “snapshot” of
the business



**The Cash Flow
Forecast**

A “prediction” of
the future





The Limitations Of T,P & L

- The trading, profit & loss account is a historical view of the business
- It does not tell us what will happen in the future – although it may help to identify trends
- Businesses may “manipulate” accounts in order to reduce their tax liabilities, or to deter a potential takeover





The Limitations Of The Balance Sheet

- As soon as it is produced it is out of date
- Fixed assets may be over-valued if they are depreciated incorrectly
- Businesses are not required to include “intangible assets” such as brand names. This can understate the value of the company
- Companies tend not to give a breakdown of the figures – they just quote totals





Using Final Accounts

- It is common for businesses to assess their accounts once they are produced
- Simple ratio analysis is often used for this
- This most commonly used ratios are:
 - Return on Capital Employed (ROCE)
 - Stock Turnover
 - The Acid Test Ratio





The Return on Capital Employed (ROCE)

- Calculated using the following formula:

$$\text{Return on Capital Employed (ROCE)} = \frac{\text{Net Profit Before Tax}}{\text{Capital Employed}} \times 100$$

From TPL
Account

- This compares net profit to the amount of money in the business
- The higher this figure is the better
- E.g. a ROCE of 12% means that for every £1 invested in the business, a firm makes 12 pence net profit
- This can be used to compare the performance of the business with the interest from a bank account

From
Balance
Sheet



Stock Turnover

- Calculated using the following formula:

$$\text{Stock Turnover} = \frac{\text{Stocks}}{\text{Cost Of Sales}} \times 365$$

From
Balance
Sheet

From
TPL
Account

- Measured in days
- This measures how quickly a business sells its stock
- The lower this figure is the better
- E.g. a Stock turnover of 35 days means that on average a piece of stock is held in the business for 35 days



The Acid Test Ratio

- Calculated using the following formula:

Both From
Balance Sheet

$$\text{Acid Test Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

From Balance
Sheet

- The answer is shown as a ratio
- E.g. an acid test ratio of 1.24 would mean that for every £1 a business owes it has £1.24 of assets that can be sold **very quickly** to pay it
- Stock is not included because it may not be a finished good ready for sale
- The ideal is believed to be 1