ANALYSIS OF ACCOUNTS

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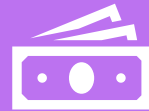
ANALYSIS OF PUBLISHED ACCOUNTS

Analysis of accounts means using data contained in accounts to make useful observations about the performance and financial strength of the business.

Without analysis of accounts, it is often impossible to tell whether a business is performing better this year than last year or if it is performing better than other businesses.

ANALYSIS OF ACCOUNTS

There are five most commonly used ratios that are used to measure and compare profitability (or performance) and liquidity of a business.



Liquidity is the ability of a business to pay back its short-term debts.

Profitability is the measurement of the profit made relative to either the value of sales achieved or the capital invested in the business.

THE CONCEPT AND IMPORTANCE OF PROFITABILITY

- Profitability is different to profit, although it is related.
- It is measured in percentage form. It is therefore a measure of efficiency and can be used to compare the business's performance over a number of years and also to compare its performance with that of other businesses.
- It is important to investors when deciding which business to invest in.
- It is important to directors and managers of the business to asses if the business is becoming more or less successful overtime.

PROFITABILITY RATIOS

- Return on capital employed (ROCE): (Net profit/Capital employed)*100
- The higher this result, the more successful managers are in earning profit from capital used in the business.
- If this percentage increases, it means that managers are running the business more efficiently-making higher profits from each dollar invested in the business.
- This result should be compared with other years and other companies to see if managers are running business more efficiently or not.

30/90*100=3
33.3%

PROFITABILITY RATIOS

- Gross profit margin(%)=(Gross profit/revenue)*100
- If gross profit margin is 20%, it would mean that for every $1, company made 0.2 cents gross profit. However, this is not the final profit of the company.
- This result needs to be compared with other years and other companies.
- If this percentage increases next year, it would suggest that prices have been increased by more than the cost of sales has risen. It would also suggest that cost of sales has been reduced.

PROFITABILITY RATIOS

- Net profit margin (also known as profit margin) (%)= (net profit/ revenue)*100
- If a net profit margin is 20%, it means that company made 20 cents net profit on each $1 worth of sales.
- The higher the result, the more successful the managers are in making net profit from sales.
- This should be compared with other years and other companies.

PROFITABILITY RATIOS-WHAT DO THEY TELL US

Ratio results	Observation	Analysis
Gross profit margin: 2017-20% 2018-24%	This means that the gross profit on each $1 of sales has increased.	The business is more successful at converting sales into profit. Either the price of the goods has increased (by more than costs) or the costs of sales has fallen (but price has not reduced at all or not by as much)

PROFITABILITY RATIOS-WHAT DO THEY TELL US

Ratio results	Observation	Analysis
Net profit margin: 2017-14% 2018-12%	This means that net profit on each $1 of the sales has fallen- even though gross profit margin has increased.	The business is less successful at converting sales into net profit. The overheads/ fixed costs of the business must have increased significantly during the year-reducing the company's net profit compared to revenue.

PROFITABILITY RATIOS-WHAT DO THEY TELL US

Ratio results	Observation	Analysis
Return on capital employed: 2017-10% 2018-6%	The profit made for each $1 invested in business has fallen.	This must be because either net profit has fallen or capital employed has increased. If capital employed has increased, this could mean that managers of the business have invested more, hoping to make higher profit in future.

THE CONCEPT AND IMPORTANCE OF LIQUIDITY

- Liquidity is the ability of a business to pay back its short-term debts
- If a business cannot pay its suppliers for materials that are important to production or if the business cannot repay overdraft when required to, it is said to be illiquid.

LIQUIDITY RATIONS

- Current ratio=(current assets/ current liabilities)*100
- If current assets are $125 million and current assets are $100 million, the current ration will be 1.25.
- This means that business could only just pay off all of its short-term debts from current assets.
- A safe current ratio would be between 1.5 and 2. If its less than 1, business could have real cashflow problems and if it is very high, it could mean that too much working capital is tied up in the business.

LIQUIDITY RATIOS

- Acid test ration= ((current assets-inventories)/(current liabilities))*100
- 1 would mean that the company could pay off its short-term debts from its most liquid assets and is an acceptable acid test result.
- If its less than 1, this might be worrying for management and steps must be taken to improve liquidity of the business like by selling inventories for cash.

LIQUIDITY RATIOS

Ratio results	Observation	Analysis
Current ratio 1.0-2018 Current ration 1.5-2017	The current ratio has fallen between 2017 and 2018	It could be because a business bought many supplies and did not pay for them or business used cash to pay for fixed assets. The business has low liquidity.
Current ratio 1.75-2018 Acid test ratio 0.5-2018	The current ratio is acceptable and much higher than the acid test ratio in 2018	The acid test ratio might be too low and the business might be at a risk of not being able to pay its short-term debts from its liquid assets. The great difference between the two results is because of relatively high levels of inventory.

WHY AND HOW THE ACCOUNTS ARE USED

- Managers: They will use accounts to help them keep control over the performance of each product or division of the business. Accounting information will help in decision making. They will also calculate ratios to compare company to compare the company's profit performance and liquidity with other years and other businesses.
- Shareholders: The higher the profitability ratio results are, the more likely shareholders will invest. They want the business to worth more at the end of the year than it was at beginning. They will also access the liquidity of the business.
- Creditors: Liquidity ratios, especially when compared with the previous year, will indicate the ability of the company to pay back all of its creditors on time.

WHY AND HOW THE ACCOUNTS ARE USED

- Bank: If the business seems to be at a risk of becoming illiquid, it is unlikely that the business will be willing to lend more.
- Government: The government and the tax office will want to check on the profit tax paid by the company . If company is making a loss, this might be a bad new for government.
- Workers and trade unions: Workers and trade unions will want to access whether the future of the company is secure or not and how much profit is it making.
- Other businesses: The managers of other companies may be considering a bid to take over the company. Businesses will compare their performance and profitability with others in the same industry.

LIMITATIONS OF USING ACCOUNTS AND RATIO ANALYSIS

- Managers will have access to all accounts data.
- Ratios are based on past accounting data.
- Accounting data over time will be affected by inflation (rising prices), and comparisons between years can be misleading.
- Different companies may use slightly different accounting methods which can make comparisons difficult.