**Chapter 11 Accounting and Performance Analysis**

The main reason an entrepreneur sets up a business is to make money. To calculate how much money (profit) an entrepreneur makes they must do up a set of accounts and financial statements. These accounts and financial statements must then be monitored, analysed and compared to previous years to get a through picture of how the business is performing.

**1. Trading, profit and Loss Account**

* The trading account shows the sales, purchases, cost of sales and gross profit of the firm.
* Sales – Cost of Sales = Gross profit

**Sales**: This is how much a business sold its products for (turnover)

**Cost of Sales:** This is the cost of buying and making the products.

* Opening Stock + Purchases – Closing Stock

**Gross Profit/Loss:** This is the difference between sales and cost of sales.

* It is the profit/loss made before any expenses are made.

**Income:** A business can make money from a range of activities other than buying and selling goods.

**eg.:** rent received, wages received, interest received, etc.

**Expenses:** These are bills that a business has to pay.

**eg.:** wages, light and heat, advertising, insurance, rent and rates, telephone, stationary and postage, depreciation, etc.

**Net Profit:** This is what’s left after adding income and paying your bills.

**Dividends:** The owners of the business (shareholders) receive a share of the profit called a dividend.

**Retained Profit:** This means that profits are saved to reinvest in the business in the future.

**Importance of the Trading, Profit & Loss Account**

1. A low gross profit tells managers that the price they are selling their products for may be too low.
2. A low gross profit tells the manager that they are paying too much for their raw materials.
3. A low net profit tells managers that their expenses are too high. The manager should make cut-backs.
4. The size of the net profit tells managers how much they should pay out in dividends or how much money will be left to put back into the business.

**2. The Balance Sheet**

This shows the business’s financial position (wealth) on a particular day. It shows everything a business owns or is owed (its assets) and all the money the business owes (its liabilities)

**Fixed Assets**

These are possessions which a business owns for a long period of time (greater than one year).

**eg.:** land, buildings, premises, motor vehicles, furniture and fittings, plant and machinery, equipment, etc.

The premises can be used as security (collateral) for any loans the firm has.

**Current Assets**

These are short term assets which we own for less than one year.

**eg.:** stock, bank, cash, debtors, amounts prepaid by the firm

An asset is something which we own or which is owed to us.

**Current Liabilities**

Liabilities are all debts that are owed by a business/person and which must be repaid in under one year.

**eg.:** creditors, bank overdraft, expenses which are due.

**Working Capital**

Current Asset – Current Liabilities

This measures the liquidity of a firm - the firm’s ability to its debts in the short term.

**Financed By**

This is the amount of money invested or put into a business

**Long term liabilities**: These are debts which will have to be repaid in the long term

**Share capital:** This is the money invested (put into) a business by its owners (shareholders)

**Retained earnings:** These are a firm’s profits which have been put aside and left to build up over the past number of years. These can be re-invested in the business in the future and used to help it expand.

**Importance of the Balance Sheet**

1. The value of fixed assets tells managers whether a business has enough security to offer a bank when applying for a loan.
2. The working capital figure tells a manager whether the business has enough cash available to pay its short term debts
3. The “Financed BY” section tells a manager whether or not they will be able to take out more loans. If the “Financed By” section is made up of a lot of loans already, then banks will be more unwilling to lend a business.

**Importance of Financial Statements**

1. Comparisons can be made with previous years.

2. It can help to obtain loans or other sources of finance

3. It allows owners/managers to plan ahead.

4. They can be used to evaluate the effectiveness of management, the business structure and the use of resources.

5. They draw attention to unprofitable areas of a business or unprofitable products and allow corrective action to be taken.

**Ratio Analysis**

Managers must analyse the performance of their business from 1 year to the next. This is split into 3 areas:

**1. Profitability Ratios**

These ratios examine whether the profits made are good or bad for the business but are only valuable when compared to previous years. They can also be compared to industry norms.

**A) Gross Margin (Gross Profit Percentage)**

**Gross Profit x 100**

**Sales**

This shows how much gross profit was made on each €1 of sales.

The businesses expenses still have to be paid out of these profits.

**Importance**

* A decreasing ratio between one year and the next means prices have fallen, costs have risen, or that there have been stock losses (damaged, stolen, or out of date)
* An increase in selling price or buying goods from cheaper supplier should correct this.

**B) Net Margin (Net Profit Percentage)**

**Net Profit x 100**

**Sales**

* This tells us what percentage of money taken in by the business can be kept as the businesses profits.

**Importance**

* A decreasing ratio between one year and the next usually means that expenses have risen
* Cutbacks in expenses are needed (such as ban overtime).

**C) Return on Investment (Return on Capital Employed)**

**Net Profit x 100**

**Capital Employed**

* This is a measure of a firm’s performance.
* It is the profit generated expressed as a percentage of the amount invested in the company.
* It should be compared with the return on risk free investments (3-4%).
* Favourable/unfavourable returns measure the efficiency (or lack) of in using resources to generate profits.

**Example**

If the R.O.C.E. is 10%, this tells a manger that for every €1 invested, the business makes 10 cent profit.

The Irish Government will give you 3-4% if you invest with it (Government Bonds). There is no risk of losing your money. Given the risk involved 10% is a good return.

**Importance**

A decreasing ratio between one year and the next means that managers are not using resources as well as they should to create profits.

**2. Liquidity Ratios**

* These measure the ability of a firm to pay its short term debts as they fall due. It sees if a business can survive into the future.

**A) Current Ratio/Working Capital Ratio**

**= Current Assets**

**Current Liabilities**

* This measures a firm’s ability to pay its current liabilities from its current assets.
* It compares assets which will become liquid inside a year with liabilities that will have to be paid within the same time span.
* It is the ability of a company to pay all its debts as they fall due.
* The desired ratio is 2:1 but many companies survive on ratios as low as 1.5:1.
* This means that for each €1 owed, €2 is available to pay it.

**Importance**

* If the ratio is less than 2:1 then a business will does not have enough cash to pay its debts as they fall due. The business may lose out on discounts from suppliers and incur interest charges on Bank Overdrafts.
* A very high current ratio is not a healthy sign as it may indicate high levels of stock-holding, inefficient use of resources and long credit periods allowed.

**B) Acid Test (Quick) Ratio – (similar to Current ratio except it takes closing stock out of the equation)**

=  **Current Assets – Closing Stock**

**Current Liabilities**

* This gives an indication of a company’s ability to pay its short term debts as they fall due (its employees, suppliers and other short term creditors).
* It uses liquid assets (debtors and cash), not stock (because stock cannot be turned to cash as quickly)
* A general rule of thumb is that a 1:1 ratio is satisfactory. If a company has a high stock turnover it can survive a ratio of less than 1:1.
* This means that for each €1 owed, €1 is available to pay it.
* A firm should be able to use its liquid assets to pay its debts and have stock available to continue producing.

**Importance**

* If the ratio is less than 1:1 then a business will does not have enough cash to pay its bills. The business will lose its credit rating and find it hard to get credit from suppliers.
* A very high current ratio is not a healthy sign as it may indicate high levels of stock-holding, inefficient use of resources and long credit periods allowed.
* If both ratios are good then the firm is liquid.
* If the figures are below recommended levels, then the firm may be experiencing liquidity problems. This can also be called overtrading.

*Solution to Overtrading*

1. Sell stocks at discount
2. Sell shares
3. Sell fixed assets
4. Improve stock controls
5. Restrict credit given to debtors

**3) Gearing Ratios**

Gearing compares fixed interest capital (debt) and the other capital of a company (equity). It compares the finance provided by lenders with the finance provided by owners. A company should borrow if the return on the borrowed money is greater than the interest payable on the loan.

**A) Debt/Equity Ratio**

**Debt Capital x 100**

**Equity Capital**

**Debt Capital** = long-term loans and preference shares

**Equity capital** = ordinary share capital and reserves/retained earnings (finance provided by owners)

* If the percentage is over 100% (or > 1:1) then the firm is said to be highly geared.
  + i.e. the business has borrowed more money than shareholders have invested.
* If the percentage is equal to 100% (or = 1:1) then the firm is said to be neutrally geared.
  + i.e. the business is financed equally by its owners and borrowing.
* If the percentage is less than 100% (or < 1:1), then the firm is said to be lowly geared.
  + i.e. the business has borrowed less money than shareholders have invested
* Low gearing is better however the original owners may lose control if they continue to sell shares in order to raise finance.
* High gearing is risky because the business is liable for all repayments and high interest payments. This will reduce profits and increase the possibility of bankruptcy.

**Analysis of the ratio:**

1. The debt/equity ratio lets the manager know whether or not the business will be able to take out more loans. A business that has borrowed a lot of money and has to repay a lot of interest will find it hard to get a new loan until the old one is paid back.
2. The debt/equity ratio lets the manager know how much interest they can expect to pay back. A highly geared company’s profits will be lower if it has a lot of interest to pay back.
3. The debt/equity ratio lets the manager know whether the business is in danger of going bankrupt. A business that has a lot of loans and interest to repay might not afford to be able to pay back what it owes.

**High gearing results in the following problems:**

1. Banks may be reluctant to lend more money. The business already has loans and interest to pay back to lenders, and might not be able to afford to have another loan.
2. Shareholders would be unwilling to invest in a firm that has high gearing, as the chances of getting good dividends are reduced (this is because profits go toward loan and interest repayments).
3. Firms with high levels of borrowings may be under financial pressure to make loan and interest payments. If a business cannot afford to pay back all its loans and interest it can go bankrupt.
4. A firm may be forced to sell the assets used as collateral if the interest and loan repayments are not made.