REVIEW QUESTIONS

Chapter 10: Ratios

1. Explain why a business owner might use ratio analysis, giving an example.

2. Define liquidity and profitability. Explain how a business can have both high profitability and low liquidity.

3. Over a long period of time what results are most likely to occur for a highly geared business?

4. The following information is for the business "Ball Sports", which sells basketball and football related goods to Western Australian sporting teams. This information was compiled by the business owner on the 30 June 2025.

BALANCE SHEET EXTRACT		INCOME STATEMENT EXTRACT	
Cash at bank	5 000	Cash sales	123 000
Debtors	22 000	Cost of sales	82 000
Inventory	38 000	Administrative expenses	1 000
Prepaid advertising	3 300	Selling expenses	6 000
Furniture and fittings	96 000	Marketing expenses	5 000
Delivery van	66 000	Financial expenses	7 000
Office equipment	83 000		
Accrued wages	8 900		
Overdraft	7 000		
Creditors	76 000		
Mortgage	129 000		
Total assets at 30 June 2024 = $313 300			

2024 ratio calculations:

Gross profit ratio	=	20%
Expense ratio	=	25%
Rate of return on assets	=	7.0%
Working capital	=	50%
Debt to equity	=	203%

(a) Calculate profitability, liquidity and leverage ratios for the 2025 financial year.

(b) Interpret the results of these calculations for the owner, in comparison to the 2024 information.

(c) Are selling and marketing expenses very different to each other? Which expense ratio is of most concern if these two categories are combined together as "advertising expenses"? Explain.

5. Consider the following comparative data for the business "Day Cafe", over 3 years.

YEAR	2015	2016	2017
Assets			
Prepaid rent	8 000	11 000	12 000
Prepaid advertising	2 000	2 000	3 000
Accounts receivable	43 000	25 000	28 000
Petty cash	400	600	100
Cash at bank	0	25 000	28 000
Stock	290 000	260 000	230 600
Café furniture	89 000	89 000	89 000
Computer equipment	11 000	5 000	5 000
Kitchen fittings	230 000	230 000	340 000
Accumulated depreciation	-100 000	-120 000	-140 000
Liabilities			
Loan - due 2030	320 000	300 000	290 000
Accrued wages	5 000	6 000	8 000
Overdraft	7000	0	0
Accounts payable	39 000	40 800	45 000
Owner's equity			
Capital	200 000	200 000	200 000
Add: Profit	2 400	(19 200)	52 700

(a) Calculate liquidity and gearing ratios for the business for the 2016 and 2017 financial years.

(b) Analyse each ratio.

(c) Advise the business owner on their best course of action to finance a renovation of the cafe.

1. *Review of past performance, e.g. Were profit goals met?*
   Planning for future financial goals, e.g. What changes are required so the business can reduce its gearing?
   Comparison with competitors, e.g. Has the industry average been bettered?
2. ***Liquidity:** ability to pay short term debt.*
   ***Profitability:** return on investment.*
   ***High profit:** could be due to non-cash items such as credit sales.*
   ***Low liquidity:** if sales cannot be quickly converted to cash the business may not be able to meet short term cash requirements.*
3. *High gearing, especially in time of high interest rates, can place pressure on the business to find cash to repay regular interest commitments – thus affecting overall profit.*
4.

(a) ***Gross profit ratio***

$$\frac{(123\,000 - 82\,000)}{123\,000} \times 100 = 33.3\%$$

$$\text{Profit ratio} = \frac{22\,000 \times 100}{123\,000} = 17.9\%$$

$$\text{Expense ratio} = \frac{19\,000}{123\,000} \times 100 = 15.4\%$$

Rate of return on assets

$$= \left(\frac{22\,000 \times 100}{\frac{323\,200 - 313\,300)}{2}}\right) \times 100$$

$$= \frac{22\,000}{318\,250} = 6.9\%$$

Working capital

$$= \frac{5\,000 + 22\,000 + 38\,000 + 3\,300}{8\,900 + 7\,000 + 76\,000} \times 100$$

$$= \frac{68\,300}{91\,900} = 74.3\%$$

$$\text{Quick asset ratio} = \frac{5\,000 + 22\,000}{8\,900 + 76\,000} \times 100$$

$$= \frac{27\,000}{84\,900} = 84\%$$

Debt to equity

$$= \frac{8\,900 + 7\,000 + 76\,000 + 129\,000}{(313\,300 - 220\,900)}$$

$$= \frac{220\,900}{92\,400} \times 100 \qquad = 239\%$$

(b) ***Profitability***

- *Has shown an improvement as the gross profit ratio has increased and the expense ratio decreased.*
- *Needs more investigation. Perhaps sales or sale price have increased, or cost of sales may have decreased.*
- *If expenses decreased, must find out which expenses were affected.*
- *Return on assets has remained the same, indicating assets are being used at the same level of efficiency.*

Liquidity

- This has improved, moving closer to the desired ratio of at least 100%.
- It is still at a concerning level, especially the quick asset ratio, as the business would not be able to quickly pay short term debt.

Gearing

- Very high and increasing.
- More than $2 liabilities for every $1 of owners equity.
- If interest rates are high, this is very concerning.

(c) Of the four possible expense ratios, Financial Expenses is currently the highest. If selling and meeting are combined, this would be the highest ratio, and by a large proportion. The business owner needs to be cautious in their interpretation of information, as the real effect of the combined Advertising Expenses is highest and they may miss this fact.

5. (a)

	2016	2017
Working capital	323 600 / 46 800	301 700 / 53 000
Quick asset	50 600 / 46 800	56 100 / 53 000
Gearing	346 800 / 180 800	343 000 / 252 700

(b)

Liquidity

- This has declined slightly, the working capital ratio is unusually high and not likely to be sustained.
- The business has large quantities of idle cash and stock which needs to be invested or on sold.
- A good improvement from the overdraft situation in 2015.

(c) Not recommended to further increase external financing through a loan, especially if interest rates are high. Consider additional owner investment, use of idle cash, improving movement of stock or other asset use.

Gearing

- The businesses reliance on external financing has decreased, lessening the risk
- This ratio is still above the ideal of 100% so the business should consider decreasing liabilities.

11: The Accounting Profession

1.

(a) **Integrity**

- Requires honesty.
- Need to be fair and truthful.
- Should not omit or obscure information.
- Should not provide misleading financial reports.

(b) **Objectivity**

- Need to not compromise.
- No bias or undue influence from others should be given in to.
- Don't allow professional judgement to be incorrectly influenced.

2. **Professional competence**

- Kai needs to maintain professional knowledge and skill.
- This needs to be at the level required by his accounting clients.
- He must keep up to date with technical standards in his area.
- He has to undertake continual professional development to keep a competent level of awareness of changes and updates to accounting.

3.

(a) **Confidentiality**

- Confidential details can only be revealed to others with a clients permission (unless legally required).
- The funds manager cannot allow someone to use this information to their advantage.
- The funds manager has a professional business relationship with the elderly couple.

(b) **Professional behaviour**

- Laws and regulations must be followed.
- The stockbroker must not do anything that would discredit their professional association.
- The stockbroker has to uphold the good reputation of the profession.