# Analysis of Accountants

## Analysis of published account

- Published accounts of public limited accounts are made available to stakeholders
- Analysis of accounts means using the data contained in the accounts to make useful observations about the performance and financial strength of the business
- Analyzing accounts helps the business find out whether it is performing better in the current year than the previous year or even performing in comparison to other business

## Ratio analysis of accounts

- Capital employed is the shareholders' equity plus non-current liabilities and is the total long term and permanent capital invested in a business
- These ratios are used to measure and compare profitability (or performance) and liquidity of a business

## Profitability rations

1. Return on capital employed (ROCE)

   This is calculated by the formula:

$$\frac{Net\ Profit}{Capital\ employed} \times 100$$

   The higher this result, the more successful the managers are in earning profit from capital used in the business

2. Gross profit margin

   This is calculated by the formula:

$$Gross\ profit\ margin\ (\%) = \frac{Gross\ profit}{Sales\ revenue} \times 100$$

   This is before other expenses have been deducted and is not the final profit of the company

3. Net profit margin

   This is calculated by the formula:

$$Net\ profit\ margin\ (\%) = \frac{Net\ profit}{Sales\ revenue} \times 100$$

## The concept of liquidity

- Illiquid means that assets are not easily convertible into cash
- Liquidity is the ability of a business to pay back its short-term debts
- This measures a very important feature of business. If a business cannot pay its suppliers for materials that are important to production or if the business cannot repay an overdraft when required to, it is said to be illiquid

## Liquidity ratios

1. Current ration
   This is calculated by the formula:

$$Current\ ratio = \frac{Current\ assets}{Current\ liabilities}$$

   A really safe current ratio would be between 1.5 and 2.if the current ratio is less than 1, it would mean that the business could have real cash flow problems. If the current ratio is too high, it means too much working capital is tied up in unprofitable current assets.

2. Acid test ratio
   This is calculated by the formula:

$$Acid\ test\ ratio = \frac{Current\ assets - inventories}{Current\ liabilities}$$

   A result of 1 would mean that the company could just pay off its short term debts from its most liquid assets

## Uses and users of accounts

- Managers- have more detailed and frequent accounting information than any other groups. Used by managers to keep control over the performance if each product or division of the business. Managers will be able to identify which parts of the business are performing well or poorly. Accounting data will help in decision making.
- Shareholders and potential investors want to know from the income statement, how big a profit or loss the company made.
- Creditors are other businesses which have supplied goods to the company without receiving payment. The balance sheet will indicate to creditors the total value of debts that the company has to pay back and the cash position of the company. Liquidity rations will indicate the ability of the company to pay back all of its creditors on time.
- Banks may have lent money to the company on a short/long term basis. If the business seems to be at risk of becoming illiquid, it is unlikely that a bank will be willing to lend more
- Government and tax office will want to check in the profit tax paid by the company. If the company is making a loss this is an indicator to the government's control of the whole economy, especially if it means that workers' jobs may be lost
- Workers and trade unions will want to assess whether the future of the company is secure or not
- Other businesses (especially those in the same industry), managers of other companies may be considering a bid to take over the company or they may just wish to compare the performance and profitability of other businesses to that of their own.

## Limitations of using accounts and ratio analysis

- Managers will have access to all accounts but the external users will only be able to use the published accounts which only contain data required by law
- Ratios are based on past accounting data and may not indicate how a business will perform in the future
- Accounting data over time will be affected by inflation (rising prices), and comparisons between the years may be misleading
- Different companies may use slightly different accounting methods, these lead to different ratio results, making comparisons difficult.