Beckfoot

A Level Business	Interpretation of financial statements	3.5.1

enjoy learn succeed

Financial Statements

Key Idea	Companies are required by law to produce financial statements at the end of the financial year.
Statement of Financial Position	Otherwise known as the Balance Sheet
Statement of Comprehensive Income	Otherwise known as the Profit and Loss Account

Statement of Comprehensive Income (Profit and Loss Account)

Key Idea	Also known as the profit and loss account. This shows the profit or loss for the year and then shows other items of comprehensive incomes, such as gains made on currency transactions
Key Idea	Sole Traders and Partnerships also produce financial statements. They are less complicated that those required by a Ltd, or a PLC
Key Information	The Statement of Comprehensive Income contains: 1. Revenue 2. Cost of Sales 3. Gross Profit 4. Selling expenses 5. Admin Expenses 6. Operating profit 7. Finance costs 8. Profit for the year (net profit) 9. Profit for the year (net profit) after tax
Key Idea	Standard practice is to make comparisons over time, so to complete 2 or more years data.
Stakeholder Interest	This is very important to evaluate the performance of a business, and will be of interest to a range of stakeholders: Shareholders Managers and Directors Employees Suppliers The Government

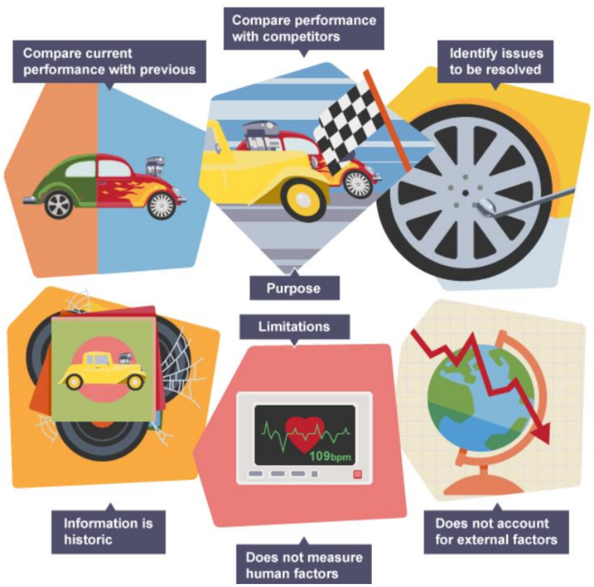
Statement of Financial Position (Balance Sheet)

Key Idea	Also known as the Balance Sheet. This shows a summary of a firms assets, liabilities and capital
Key Idea	It is only valid at one particular point in time – 1 day
Assets	The resources that a business owns and uses. Assets are usually divided into current assets and non-current assets
Current Assets	These are used up in production such as stock of raw materials. They can also be money owed to the business by debtors. Examples are: Stock Debtors Cash
Non-current assets	These are the long term investments such as machinery, land, buildings, vehicles and IT equipment that are used again and again over a period of time.
Depreciation	This is an estimate of the fall in value of a fixed asset over time
Current Liabilities	This is the amounts that are owed by the business and which are due to be paid in the next 12 months. Examples are: Trade and other payables (creditors) Short term borrowing (overdraft) Current tax liabilities Provisions such as dividends
Non-current liabilities	These are debts that need to be paid over a year, for example a bank loan
Working Capital	This is the amount of money available for the day to day running of the business. It is worked out as follows: Current assets – current liabilities
Fact	New Assets Employed = Capital Employed This is always the case because the capital employed is the amont of long term money put into the business and the net assets employed how it is used
Capital Employed	Long term liabilities + share capital + profit and loss reserves

Ratio Analysis

Key Idea	It is often necessary to compare a firm's performance or different organisations' performance over a number of years. Ratio analysis can be used to compare the year to year profitability, liquidity and efficiency of a business or similar businesses.
Key Idea	Ratio analysis covers 2 areas: • Profitability • Liquidity

Purpose and limitations of Ratio Analysis



Purpose of Ratio Analysis

Key Idea	1. ratios help compare current performance with previous records 2. ratios help compare a firm's performance with similar competitors 3. ratios help monitor and identify issues that can be highlighted and resolved 4. ratios help with future decision making

Profitability Ratios

Key Idea	There are 3 main ratios 1. Gross Profit Margin (Gross Profit / Sales Revenue) x 100 2. Operating profit margin (Operating Profit / Sales Revenue) x 100 3. ROCE

Return on Capital Employed (ROCE)

Key Idea	ROCE is sometimes referred to as the "primary ratio". It tells us what returns (profits) the business has made on the resources available to it.
Formula	(Operating Profit / Capital Employed) x 100
Key Idea	With ROCE, the higher the percentage figure, the better. The figure needs to be compared with the ROCE from previous years to see if there is a trend of ROCE rising or falling.
Key Idea	The higher this number is the better
To improve ROCE	1. Increase operating profit 2. Maintain operating profit but reduce the value of capital employed

Limitations of Ratio Analysis

Key Idea	1. ratio analysis information is historic – it is not current 2. ratio analysis does not take into account external factors such as a worldwide **recession** 3. ratio analysis does not measure the human element of a firm 4. ratio analysis can only be used for comparison with other firms of the same size and type 5. it may be difficult to compare with other businesses as they may not be willing to share the information

Liquidity Ratios

Key Idea	Liquidity ratios calculate the organisation's ability to turn **assets** into cash in order to pay debts.
Key Idea	There are 3 main ways to calculate liquidity in a business 1. Current Ratio 2. Acid Test Ratio 3. Gearing Ratio

Gearing Ratio

Key Idea	Gearing measures the proportion of assets invested in a business that are financed by long-term borrowing
Key Idea	The gearing ratio is also concerned with liquidity
Key Idea	the higher the level of borrowing (gearing) the higher are the risks to a business, since the payment of interest and repayment of debts are not "optional" in the same way as dividends
Formula	(Long term liabilities / Captial employed) x 100
Why it is useful – Interpreting the ratio	1. A business with a gearing ratio of more than 50% is traditionally said to be "highly geared". 2. A business with gearing of less than 25% is traditionally described as having "low gearing" 3. Something between 25% - 50% would be considered normal for a well-established business which is happy to finance its activities using debt.

Current Ratios

Key Idea	Current ratio or the **working capital ratio** demonstrates the firms ability to meet its short-term **creditors**.
Key Idea	An ideal ratio of **2:1** is generally agreed. If the ratio is higher, **4:1** it could mean that the firm is inefficient and has too much money tied up in stock. On the other hand, a lower ratio value of **1:1** would mean that it may not be able to meet its debts quickly.
Formula	**current assets / current liabilities**
Ways of improving this	1. increase current assets 2. if ratio is too high you can sell non-current assets 3. decrease current liabilities for example, reducing trade credit terms

Acid Test Ratio

Key Idea	Acid test ratio is a more severe test of a firm's capabilities to meet its debts.
Formula	The formula is the same as the **current ratio** but with the added problem of writing off all stock. This is because it assumes that stock: • may be perishable • may go out of date • may go out of fashion or become obsolete In other words, the firm may be left with stock it cannot sell. An ideal value of **1:1** is generally accepted.
Formula	**(current assets – closing inventory) / current liabilities**

Labour Productivity

Productivity	**Production** is the total amount made by a business in a given time period. **Productivity** measures how much each employee makes over a period of time
Formula	Total Output (per period of time) / Average number of employees (per period of time)
Efficiency	**Efficiency** is about making the best possible use of resources. Efficient firms maximise **outputs** from given inputs, and so minimise their costs. By improving efficiency a business can reduce its costs and improve its competitiveness.
Key Idea	Staff productivity depends on: 1. skills 2. quality of machines available 3. effective management
Key Idea	Productivity can be improved through: 1. training 2. investment in equipment 3. better management of staff
Key Idea	As well as improving productivity, a business can cut costs by: **Reducing overheads** such as administration, eg making some support staff redundant. Customer service may suffer as a result of this. **Relocation** to countries where staff with appropriate skills can be hired at lower wages. **Improving management** so staff are motivated to work harder, or are better used. **Redesigning the product** so an item is easier and cheaper to make.
Kay Idea	**Lean production** is a set of measures that aim to reduce waste during production. Waste reduction methods, such as **just in time ordering of stock**, will increase efficiency.

Labour Retention

Key Idea	Labour retention and labour turnover is related. This is because turnover looks at the rate at which employees leave a business, while labour retention looks at the rate at which they stay with the business. Therefore labour retention is the opposite of labour turnover
Formula	Number of staff (over a period of time) / Average number of staff in post (over a period of time) x 100

Labour Turnover

Key Idea	Labour or staff turnover is another measure of personnel effectiveness. Labour turnover is the proportion of staff leaving a business over a period of time.
Formula	(Number of staff leaving over a period of time / Average number of staff in post during the period of time) x 100
Key Idea	High Labour turnover is caused by a number of factors: • Relatively low pay • Relatively few training and promotion opportunities • Poor working conditions • Low job satisfaction • Bully and harassment • The wrong person was recruited to the job in the first place
Key Idea	High Labour turnover is seen as a problem for the following reasons: • Recruiting staff is expensive • Training staff is timely and costs money • Induction programmes are costly
Key Idea	Occasionally labour turnover is a good thing: • New staff bring in new ideas • More efficient staff can be recruited • Can help cut costs

Absenteeism

Key Idea	Absenteeism is a problem for all business for a number of reasons. • Staff who are absent often claim to be ill. The business then in most cases has to pay sick pay. • Temp staff increase costs. • Increased overtime will also increase costs • Output can suffer • If production drops then customers complain • Demotivation of staff
Formula	Number of staff absence on a day / total number of staff employed x 100
Key Idea	Differences in rates of absenteeism occur for a number of reasons: Small businesses tend to have lower rates of absenteeism because there is generally more commitment and feeling of being part of a team in a small business. In a big business staff can feel more like 'a number' than a part of a team.

Strategies to increase productivity, retention, reduce turnover and absenteeism

Key Idea	**If a business can raise productivity and retention rate, and reduce staff turnover and absenteeism, the benefits will be significant. Eg,** • **If productivity rises output per worker will be hight and then the business can sell more products. This will increase revenue and profit.** • **If turnover can be reduced money will be saved on recruitment, selection and training, This cuts costs.**
Financial Rewards	An increase in financial rewards eg more products made, more the worker will be paid. This means that hard working, productive workers get paid more than lazy slow workers.
Employees share ownership	**Some businesses offer shares to a wide range of employees. The idea behind this is that employees will be paid a share in the form of a lump sum based on the profits made by the business. The payout of shares is normally only done if the business meets Key Performance Indicators**
Consultation strategies	Employees are more likely to be better moticiate and more productive if they are involved in decision making., Employees often complain when changes are made and they are not consulted.
Empowerment strategies	This involves use of knowledge, experience and talent of employees. If is achieved by granting employees more authority in the workplace. Empowering staff creates a happier, motivated workplace.
Training	This is closely related with empowerment strategies. Staff can be more empowered if they are trained properly to have the skills to complete more advanced jobs. The business needs to identify ‘skills gap’ and then train staff to fill this shortage.