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Manufacturing trading profit and loss account format

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The two principle statements which form a set of accounts are:- a) The profit and loss account defined as a summary of a business's transactions for a given period. b) The balance sheet defined as a statement of the financial position of the business at a given date (usually the end of that period). Other less important statements are the manufacturing account and the trading account. It is absolutely essential to any marketer to understand what the profit and loss statement and balance sheet mean. Both documents are vital, not only to show the corporate health of the organisation, but also as an indication to various shareholders of how well or badly the organisation is performing, as proof to potential investors or lenders for the raising of capital and as a statutory record for taxation and other purposes.
Chapter objectives
This chapter is intended to provide: - An introduction to the basic principles of the accounting equation - An introduction to, and the construction of, manufacturing, trading and profit and loss accounts and their use - An understanding of the principles and construction of a balance sheet and its interpretation - A detailed explanation of the interpretation of company accounts using ratio analyses and the uses of these.
Structure of the chapter
This chapter is structured in a logical way, building up from the basic tenets of financial analysis - the dual effect and the accounting equation. From this, the chapter looks at the construction of manufacturing, trading and profit and loss accounts and the drawing up of a balance sheet. Ratio analysis is a particularly powerful technique aimed at helping marketers to compare sets of figures over time and between companies. This is dealt with in considerable detail. The basic principles
All aspects of accounts are governed by these two principles. a) First principle: Dual effect
Every transaction has two effects, not one, e.g. if a Cerial Marketing Board (C.M.B.) purchases grain it has: - more stock - less cash. If the Dairyboard Company of Zimbabwe sells milk to a retailer, it has: - less stock - an amount owed by the customer if he does not pay immediately. b) Second principle: The accounting equation
The second principle stems from the first. Every transaction has two effects; these two are equal and balance each other. Thus, at any given moment the net assets of a business are equal to the funds which the owner or proprietor has invested in the business. Net Assets = Proprietor's funds is the ultimate accounting equation. An explanation of the terms is as follows: - Net assets are defined as a business's total assets less total liabilities. - An asset is defined as something owned by a business, available for use in the business. - A liability is defined as the amount owed by the business, i.e. an obligation to pay money at a future date. - Proprietor's funds represents the total amount which the business owes to its owner or proprietor. This consists of: Capital: (amount proprietor invested in the business) plus Profits: (funds generated by the business) minus Losses: (funds lost by the business) minus Drawings: (amounts taken out of the business). Use of the accounting equation to find profit
We normally arrive at a business's profit or loss by means of a profit and loss account, but where information about income and expenditure is lacking, the accounting equation can be a useful way of finding profit. If: Net assets = Proprietor's funds then an increase in net assets = an increase in a proprietor's funds. Considering what causes an increase in the proprietor's funds, we can say that INCREASE IN NET ASSETS (from the beginning of a period to the end) is equal to: New capital introduced + Profit - Drawings during the same period. If three of these four amounts are known, the fourth can be calculated. Manufacturing account
There are many firms, whether parastatal, sole trader, partnership or limited company, which manufacture the final product to be sold from raw materials, e.g. a fertiliser company uses phosphates, ammonia and so on to produce finished fertiliser pellets. In this instance, a manufacturing account is required in order to arrive at the final cost of manufacture. The manufacturing organisation will still need a trading and profit and loss account. The only major difference is that, in the trading account, the entry for purchases is replaced by the cost of manufacture. The cost of manufacture is calculated using a manufacturing account. Two important factors need to be taken into account: a) Different types of cost
The costs needed to prepare a manufacturing account can be broken down into two main categories known as direct and indirect costs. The main or direct costs are those of raw materials and labour which together are known as the prime cost, although any expense which can be traced directly to any unit of production is also a direct cost. The indirect costs are those associated with production but cannot be traced directly to a particular production unit. These costs will include the general factory overheads such as light, heat and power, rent, rates, insurance, depreciation of production machinery, etc. Certain labour costs, such as supervision by foremen or factory managers, will also be indirect costs because they are not directly traceable to a production unit but are absorbed as a general overhead. b) The effect of stocks
One complication in constructing the manufacturing account is to remember that there may be opening and closing stocks of raw materials and opening and closing wages to attach to partly completed items (work in progress). Figure 2.1 Pro forma manufacturing account
YEAR ENDED 19X7
Opening stock of raw materials x Production cost of completed goods carried down to trading account Purchases x xxx xxx Less closing stock of raw materials x Cost of raw materials consumed x Direct manufacturing wages x Prime cost xx Factory overheads: Rent and rates, x light, heat and power x Indirect wages x Depreciation of Prod. machinery x xx xx Opening work in progress x xxx Less closing work in progress x xxx xxx Now attempt exercise 2.1 and 2.2. These adjustments can be seen in the pro forma manufacturing account which follows. (see figure 2.1.)
Exercise 2.1 A simple manufacturing account
The following are details of production costs of Aroma Pvt Ltd for the year ended 31 December 19X5. \$ 1 January 19X5, stock of raw materials 1,300 31 December 19X5, stock of raw materials 1,800 Purchase of raw materials 10,000 Manufacturing (direct) wages 17,000 Royalties 600 Indirect wages 9,000 Rent of factory (excluding administration and selling and distribution departments) 2,080 Factory rates 640 General indirect expenses 680 Depreciation of work machinery 1,050 Prepare a manufacturing account for the year ended 31 December 19X5. Exercise 2.2 A manufacturing account with an adjustment of work-in-progress.
\$ January 19X4 stock of raw materials 1,500 31 December 19X4 stock of raw materials 2,750 1 January 19X4 work in progress 860 31 December 19X4 work in progress 940 For the year ended 31 December 19X4 Wages: direct 6,450 indirect 4,060 Raw materials purchased 15,700 Power fuel 1,020 Direct expenses 660 Carriage inwards on raw materials 1,050 Depreciation of factory machinery 720 Insurance of factory buildings 340 General factory expenses 700 Trading account
The purpose of the trading account is to show the gross profit on the sale of goods. Gross profit is the difference between the sale proceeds of goods and what those goods cost the seller to buy, or cost of sales. The cost of sales for this purpose includes the amount which has been debited for them to the purchases account plus the cost of getting them to the place of sale, which is usually the seller's premises, i.e. the carriage inwards of those goods. Preparing a trading account
The trading account is calculated by using a sequence of steps. It is essential that these steps are carried out in the order indicated. a) The first step is to transfer the balance on the sales account to the trading account: Dr: Sales A/c Cr: Trading A/c b) Next, debit the trading account with the cost of goods sold, starting with the opening stock: Dr: Trading A/c Cr: Stock A/c. The opening stock is obviously the same as the closing stock of the previous period; in the first year of trading, of course, there will be no opening stock. c) The balance on the purchases account is then transferred to the trading account and added to the opening stock figure: Dr: Trading A/c Cr: Purchases A/c. d) Transfer any balance on the carriage inwards account to the trading account: Dr: Trading A/c Cr: Carriage Inwards A/c. Add the carriage to the total arrived at in c) above. This gives the total cost of goods available for sale. e) Deduct the value of closing stock from the cost of goods available for sale. Any item deducted from the debit side of an account is, in effect, credited to the account. Deducting closing stock from the debit side of the trading account is therefore crediting it to that account. The corresponding double entry will therefore be to the debit of stock account: Dr: Stock A/c Cr: Trading A/c (by deduction from the debit side). We have now arrived at the cost of sales. f) The balance on the trading account will be the difference between sales and cost of sales, i.e. gross profit, which is carried down to the profit and loss account. Point to Note: The debit to stock account for closing stock is the value of the current asset of closing stock which will be included in the balance sheet, as we shall see later. When the opening stock is credited to the stock account in the next period, it will balance off the stock account. Net sales (turnover) and net purchases: Goods which have been returned by customers are represented by a debit balance on the sales return account. This must be transferred to the trading account, otherwise the sales and gross profit in that account will both be overstated. Following the same reasoning that allows us to deduct closing stock on the debit side of the trading account, we may deduct the debit balance on the sales returns account from the sales credited in the trading account. In this way, we show the net sales for the year. Net sales are known as turnover. Similarly, we show the credit balance on the purchases returns account as a deduction from purchases in the trading account to show the net cost of purchases. Goods which have been returned to suppliers must not be included in the cost of sales. Point to Note: The order of items is most important. Sales returns must be deducted from sales; purchases returns must be deducted from purchases; carriage inwards, if any, must be debited in the account before closing stock is deducted. Figure 2.2 shows a pro forma trading account. Figure 2.2 Pro forma trading account
Opening stock of finished goods x Sales xxx Production cost of completed goods b/d (from manufacturing account) x Closing stock of finished goods xx Cost of sales xx Gross profit d/d xx xx xxx Gross profit B/d xxx N.B. A trading account is prepared very much like a manufacturing account but substituting the production cost of completed goods for the usual purchasing figure (see exercise 2.3: Preparation of trading account) Appendix I shows a sample trading account for the Cerial Marketing Board, Zimbabwe. Now attempt exercise 2.3. Exercise 2.3 Preparation of trading account
Prepare a trading account from the following balances included in the trial balance of K. Smith at 31 December 19X8. Dr. Cr. \$ Sales 25,000 Purchases 16,000 Sales returns 3,000 Stock at 1.1.19X8 3,000 Carriage inwards 1,000 Stock at 31/12/19X8 5,000 The profit and loss account introduction: The remaining nominal accounts in the ledger represent non-trading income, gains and profits of the business in the case of credit balances, e.g. rent, discount and interest receivable. Debit balances represent expenses and losses of the business and are known as overheads, e.g. salaries and wages, rent and rates payable, lighting, heating, cleaning and sundry office expenses. These must now be transferred to the profit and loss account so that we can calculate the net profit of the business from all its activities. The profit and loss (income) statement presents a summary of the revenues and costs for an organisation over a specific period of time. Such a statement is generally developed on a monthly, quarterly and yearly basis. The profit and loss statement enables a marketer to examine overall and specific revenues and costs over similar time periods and analyses the organisation's profitability. Monthly and quarterly statements enable the firm to monitor progress towards goals and revise performance standards if necessary. When examining a profit and loss statement, it is important to recognise one difference between manufacturers and retailers. For manufacturers the cost of goods sold involves the cost of manufacturing products (raw materials, labour and overheads). For retailers, the cost of goods sold involves the cost of merchandise purchased for resale (purchase price plus freight charges). The balance sheet shows that the profit for an accounting period increases proprietor's funds. The trading and profit and loss account shows, in detail, how that profit or loss has arisen. The profit and loss statement consists of these major components:- Gross sales - the total resources generated by the firm's products and services - Net sales - the revenues received by the firm after subtracting returns and discounts (such as trade, quantity, cash) - Cost of goods sold - the cost of merchandise sold by the manufacturer or retailer. - Gross margin (profit) - the difference between sales and the cost of goods sold; consists of operating expenses plus net profits - Operating expenses - the costs of running a business, including marketing - Net profit before taxes - the profit earned after all costs have been deducted. Figure 2.3 shows a pro forma trading and profit and loss account. Figure 2.3 Trading, profit and loss a/c for the year ended 31 Dec 19X0 \$ \$ \$ Sales x Less: cost of goods sold stock, at a cost on 1 January ('opening stock') x Add: purchases of goods x Less: stock, at a cost on 31 Dec ('closing stock') (x) x Gross profit xx Sundry income: Discounts received x Commission received x Rent received x x xx Less: administration expenses Rent x Rates x Lighting and heating x Telephone x Postage x Insurance x Stationery x Office salaries x Depreciation x Accounting and audit fees x Bank charges and interest x Doubtful debts x Distribution costs: x Delivery costs x Van running expenses x Advertising x Discount allowed x x (x) NET PROFIT xxx Explanations It is essential that the difference between a trading and profit and loss account is clearly understood. The following provides an explanation. - The trading account shows the gross profit generated by the business. This is done by comparing sales to the costs which generated those sales. A retailer, for example, will purchase various items from various suppliers, and add a profit margin. This will give him the selling price of the goods and this, minus the cost of goods sold, will be the gross profit. Cost of goods sold is calculated by: Opening Stock + Opening Purchases (for year or period) - Closing Stock (cost of goods unsold at the end of the same period). This gives the cost of goods which were sold. Sales and cost of goods sold should relate to the same number of units. - The profit and loss account shows items of income or expenditure which although earned or expended by the business are incidental to it and not part of the actual manufacturing, buying or selling of goods. - In a complicated manufacturing industry and in service industries, different definitions of "goods", "net profit" and "cost of sales" may exist. Capital and revenue expenditure
Only revenue expenditure (e.g. heating bills) is charged to the profit and loss account; capital expenditure (e.g. the purchase of a new plant) is not. a) Revenue expenditure is expended on: - acquiring assets for conversion into cash (resale goods) manufacturing, selling and distribution of goods and day-to-day administration of the business; maintenance of fixed assets (e.g. repairs); It is well to note that "cash" need not be paid or received to be accounted for. The amount of revenue expenditure charged against the profits for the year or period is the amount incurred whether cash has or has not been paid. This applies with sales as well. Even if cash for sales has not been received in the year or period under review, sales will be included in the trading account. This is the "accruals" concept. b) Capital expenditure is expended on: - start up of the business; acquisition of fixed assets (not for resale); alterations or improvements of assets to improve their revenue earning capacity. Capital expenditure is not charged to the profit and loss account as the benefits are spread over a considerable period of time. Now attempt exercise 2.4. Exercise 2.4 Trading and profit and loss account
Nigel Munyai and his friends opened a small scale horticultural "co-operative" in Concession, growing and retailing. The business started on 1 August 19X6. The following is a summary of the transactions for the first year: \$ Capital introduced on 1 August 19X6 - cash 20,000 - stocks 12,000 Cash paid to suppliers 28,000 Amounts owed to suppliers at 3 July 19X7 14,000 Received from customers in respect of sales 50,000 Amounts owed by customers at 31 July 19X7 10,000 Stock of goods at the end of the year 11,000 Rent 2,500 Rates 800 Water and light 500 Salesmen's salaries 4,000 Salesmen's commissions, not yet paid 600 Bank charges 120 Office wages 400 Telephone and postal charges 150 Advertising 1,000 Drawings during the year 4,000 You are required to prepare a trading and profit and loss account for the year ended 31 July 19X7. The balance sheet introduction: The balance sheet is a statement of the financial position of a business at a given date. It is, therefore, only a "snapshot" in time. When comparing business performance, therefore, a number of years and time periods may be more suitable. The balance sheet is the accounting equation but set out in a vertical form in order to be more readily understood i.e. the accounting equation. Assets - Liabilities = Capital + Profit - Drawings expressed in the form of a balance sheet is as follows:- \$ Assets X Less: liabilities X Net assets X Representing: Capital X Profit for the year X X Less: drawings X Proprietor's funds X This is a simplified form: in reality the assets and liabilities will be further sub-divided and analysed to give more detailed information. Figure 2.4 shows a pro forma balance sheet. Figure 2.4 Pro forma balance sheet
Balance Sheet at 31 December 19X0 C Cost D Depreciation Net value (C-D) \$ \$ \$ A Fixed assets Freehold factory x x x Machinery x x x Motor vehicles x x x x x B) Current assets Stocks and work in progress x Debtors and prepayments x Cash at bank x Cash in hand x C) Current liabilities Trade creditors (x) Accrued charges (x) (x) D) Net current assets xx E) 15% loan (x) xxx F) Representing: Capital at 1 January x Profit for the year x x Less: drawings (x) G) Proprietor's fund xxx Explanations A with trading and profit and loss accounts, the balance sheet has its own nomenclature. These are fixed accounts, current accounts, current liabilities and funds: A) Fixed assets: assets acquired up with the business with a view to earning profits, but not for resale. They are normally valued at cost less accumulated depreciation. B) Current assets: assets acquired for conversion into cash in the ordinary course of business; they should not be valued at a figure greater than their net realisable value. C) Current liabilities: amounts owed by the business, payable within one year. D) Net current assets: funds of the business available for day-to-day transactions. This can also be called working capital. E) Loans: funds provided for the business on a medium to long term basis by an individual or organisation other than the proprietor. F) This total is the total of the business's net assets. G) This total is the total of proprietor's funds, i.e. the extent of his investment in the business. Within these main headings the following items should be noted: - Fixed assets Depreciation is an amount charged in the accounts to write off the cost of an asset over its useful life. - Current assets Debtors are people who owe amounts to the business. Prepayments are items paid before the balance sheet date but relating to a subsequent period. - Current liabilities Trade creditors are those suppliers to whom the business owes money. Accrued charges are amounts owed by the business, but not yet paid, for other expenses at the date of the balance sheet. Note-Working capital. This is a term given to net current assets, or total current assets less total current liabilities, e.g. \$ Current assets 7,600 Less current liabilities 1,800 Working capital 5,800 Working capital is important because it is the fund of ready resources that a business has in excess of the amount required to pay its current liabilities as they fall due. Working capital is important: lack of it leads to business failure. Appendix i shows a sample balance sheet and a full set of accounts for the Cerial Marketing Board of Zimbabwe. Now attempt exercise 2.5. Exercise 2.5 Balance sheet
Prepare a balance sheet for year ended 31 July 19X7 for Nigel Munyai's horticultural co-operative. \$ Capital introduced on 1 August 19X6 - cash 20,000 - stocks 12,000 Cash paid to supplier 28,000 Amounts owed to suppliers at 31 July 19X7 14,000 Received from customers in respect of sales 50,000 Amounts owed by customers at 31 July 19X7 10,000 Stock of goods at the end of the year 11,000 Rent 2,500 Rates 800 Water and lights 500 Salesmen's salaries 4,000 Salesmen's commissions, not yet paid 600 Bank charges 120 Office wages 400 Telephone and postal charges 150 Advertising 1,000 Drawings during the year 4,000 Stocks and work-in-progress Accounting for stocks: Almost every company carries stocks of some sort. In an agricultural business, these may be fertilisers, chemicals, produce, etc. Accounting for stocks presents a problem, because stocks in hand at the end of the financial year are regarded as current assets, whereas stocks used during the year form part of the company's costs. Hence, stocks (assets) appear in the balance sheet, and stocks (used) must be accounted for in the trading and profit and loss account. Valuation of stocks: Valuing closing stocks has always been a problem and a source of disagreement. There are many methods of establishing the value of stocks. Three common alternatives are average cost, first in first out (Fifo) and last in first out (Lifo). i) Average cost
Cost is calculated by taking the average price computed by dividing the total costs of production by the total number of units produced. This average price may be derived by means of a continuous update, a periodic calculation, or a moving period calculation. This method is often used to calculate the cost of low value items, e.g. in the manufacture of nails. ii) First in first out (Fifo)
The calculation of the cost of stocks and work-in-progress is on the basis that the stocks in hand at the year end represent the latest purchases or production, as the items going into stock at the earliest date are assumed to leave first, e.g. a greengrocer will obviously wish to sell the oldest stocks first. iii) Last in first out (Lifo)
The calculation of the cost of stocks and work-in-progress is on the basis that the stocks in hand represent the earliest purchases or production, as it is assumed that the latest stocks into store are the first to be taken out, e.g. a 'bin' system, where purchases are added to the top and sales will be removed from the top. Consider the following example comparing the effect of valuing stock of 240 units: FIFO trading account \$ \$ Sales (March) \$360 @ \$3.00 1,080 Purchases (01 February) \$200 @ \$2.00 (10 February) \$200 @ \$2.25 (15 February) \$200 @ \$2.50 1,350 Less: Closing stock (bought 15 Feb) \$200 @ \$2.00 (bought 10 Feb) 590 \$ 40 @ \$2.25 760 320 LIFO trading account \$ \$ Sales (March) \$360 @ \$3.00 1,080 Purchases (01 February) \$200 @ \$2.00 (10 February) \$200 @ \$2.25 (15 February) \$200 @ \$2.50 1,350 Less: Closing stock (bought 15 Feb) \$200 @ \$2.00 (bought 10 Feb) 490 \$ 40 @ \$2.25 860 220 Note: In both cases, there are 240 items in stock. Valuing stocks using the latest prices, the gross profit is \$320, whereas using the earliest prices the figure is \$220. The lower of cost and net realisable value: The most fundamental accounting concept with regards to the valuation of stocks and work-in-progress is that they need to be stated at cost, or if lower, at net realisable value. Net realisable value is the amount at which it is expected that items of stock and work-in-progress could be sold after allowing for the costs of completion and disposal. If net realisable value is higher than cost, then cost is taken, as valuing stocks at a higher value would not be prudent, i.e. profit would have been taken into account before it is actually earned. It is important to check against the net realisable value to ensure that the current asset, stock, is not stated at a figure above that for which it could be realised at the balance sheet date. Stock provision: If it is decided to reduce the value of certain items of stock from cost to net realisable value, e.g. obsolete, slow moving or unsaleable stocks, this is done by means of a provision. Stock is reduced in value, and a charge is made against profits. The full amount is deducted from stock in the balance sheet, but only the decrease between the beginning and end of a period is shown in that period's trading and profit and loss account. Now attempt exercise 2.6. Exercise 2.6 Valuation of stocks
Kubi Dwili began business as a small scale peanut importer in July 19X6. Purchases of peanuts were made as follows: 19X6 Tons Price per ton \$ 01 July 60 20.00 1,200 15 August 40 24.00 960 30 September 45 26.00 1,170 12 October 30 35.00 1,050 29 November 25 38.00 950 11 December 30 50.00 1,500 230 6.830 On 10 October, 100 tons of peanuts were sold and on 31 December 70 tons were sold. The total proceeds of the sale were \$8,500. You are required to calculate the value of closing stock and to prepare the trading account on the following bases: a) first in first out (b) last in first out (c) average cost. The interpretation of company accounts
ratio analysis
Why ratios: Ratios are the means of presenting information, in the form of a ratio or percentage, which enables a comparison to be made between one significant figure and another. Often the same ratios of like firms are used to compare the performance of one firm with another. A "one off" ratio is often useless - trends need to be established by company ratios over a number of years. - The great volume of statistics made available in the annual accounts of companies must be simplified in some way. Present and potential investors can therefore quickly assess whether the company is a good investment or not. - Financial ratio analysis is helpful in assessing an organisation's internal strengths and weaknesses. Potential suppliers will, for example, want to judge credit worthiness. - Ratios by themselves provide no information; they simply indicate by exceptions where further study may improve company performance. Management can compare current performance with previous periods and competing companies. Which areas are used for analysis
Four key areas are generally used for analysis: - profitability - liquidity - leverage (capital structure) - activity or management effectiveness (efficiency). a) Profitability
In most organisations profits are limited by the cost of production and by the marketability of the product. Therefore, "profit maximisation" entails the most efficient allocation of resources by management, and "profitability ratios" when compared to others in the industry will indicate how well management has performed this task. Key questions to be identified in profitability analysis include: - Does the company make a profit? - Is the profit reasonable in relation to the capital employed in the business? - Are the profits adequate to meet the returns required by the providers of capital, for the maintenance of the business and to provide for growth? - How are sales and trading profit split among the major activities? - To what extent are changes due to price change? - To what extent does volume change? - Does inter-company transfer pricing policy distort the analysis? - Has the appropriate proportion of profit been taken in tax charged? - What deferred taxation policy is being followed? - Has the share of profit (or loss) attributable to minority interests in subsidiaries changed? If so, is it clear why? - Are profits and losses on sales of fixed assets: -treated as adjustments of depreciation charges?-disclosed separately "above the line" in the profit and loss account?-treated as "below the line" items in the profit and loss account?-transferred directly to reserves? - What has been included in Extraordinary Items? - Should any of these items be regarded as part of the ordinary business of the company? - Do any items tend to recur year after year? - Is it clear which items have been transferred directly to reserves without going through the profit and loss account? - Is such treatment appropriate in each case? b) Liquidity
"Liquidity measures" are based on the notion that a business cannot operate if it is unable to pay its bills. A sufficient amount of cash and other short-term assets must be available when needed. On the other hand, because most short term assets do not produce any return, a strong liquidity position will be damaging to profits. Therefore, management must try to keep the firm's liquidity as low as possible whilst ensuring that short term obligations will be met. This means that industries with stable and predictable conditions will generally require smaller current ratios than will more volatile industries. Key questions to be identified in liquidity analysis include: - Has the business sufficient liquid resources to meet immediate demands from creditors? - Has the business sufficient resources to meet the requirements of creditors due for payment in the next 12 months i.e. creditors payable within one year? - Has the business sufficient resources to meet the demands of its fixed asset replacement programme and its commitments to providers of long-term capital falling due for repayment in say, the next five years? c) Leverage
"Leverage ratios" show how a company's operations are financed. Too much equity in a firm often means the management is not taking advantage of the leverage available with long-term debt. On the other hand, outside financing will become more expensive as the debt-to-equity ratio increases. Thus, the leverage of a business has to be considered with respect both to its profitability and the volatility of the industry. Key questions to be identified in leverage analysis include: - What sort of capital has the company issued? Who owns the capital? What is the cost of capital in terms of interest or dividend? What proportions of the capital have a financed return (gearing or leverage)? Is the mix of capital optimum for the company? Is further capital available if required? Is total capital employed analysed among different classes of business? If so, can return on capital be calculated for each class? Has issued Ordinary share capital increased during the period? If so, why? e.g. Rights issue? Bonus (scrip) issue? Acquisition? Are "per share" figures calculated using appropriately weighted number of shares? Are prior years' figures comparable? What individual items have caused significant movements on Reserves? Do any of them really belong in the profit and loss account? Is any long term debt convertible into ordinary shares? On what terms? Calculate appropriate measures on "fully diluted" basis - Is any long term debt repayable within a short period? If so, should it be treated as a current liability? Are there significant borrowings in foreign currencies? Are they matched by foreign assets? Are exchange losses and gains thereon treated? Is there any preference capital? Is short term borrowing included in capital employed? Should it be? Is the treatment of pensions appropriate? Is information revealed? Would capitalising leases significantly affect long term debt and gearing ratios? d) Activity
"Activity ratios" are used to measure the productivity and efficiency of a firm. When compared to the industry average, the fixed-asset turnover ratio, for example, will show how well the company is using its productive capacity. Similarly, the inventory turnover ratio will indicate whether the company used too much inventory in generating sales and whether the company may be carrying obsolete inventory. Key questions to be identified in activity analysis are: - Does management control the costs of the business well? - Which costs, if any, have changed significantly, thus reducing or improving apparent profitability? - Does management control the investment in assets well? - Are fixed assets sufficient for the current level of activity? Are they replaced on a regular basis and adequately maintained? - Are the stock levels adequate for the level of activity, or excessive? - Are debts collected promptly? - Are creditors paid within a reasonable period of time? - Are surplus cash resources invested to increase overall returns? - How vulnerable are the profits before interest and tax? - How many times can the interest be paid from the available profit? - How many times can the existing dividend be paid from the available profit? e) Other
Other questions can be asked in interpreting final accounts. These may relate to long-term trends in the business or to fixed assets, e.g. i) Long-term trends in the business - Are profits increasing or decreasing? - Is the size of the business growing faster or slower than inflation? - How has past growth been financed? - Are the levels of stocks, debtors and creditors consistent with the long-term growth of the business? - Are dividends increasing? - Have any radical changes occurred in the past, giving rise to major changes in the business? ii) Fixed assets - Where fixed assets are shown "at historical cost": - How old are they? What is their estimated current value?-How would revaluation affect the depreciation charge? - Where fixed assets are shown "at valuation": -When was the valuation made, and on what basis?-How have values changed since that date?-Might the assets be more valuable if used for other purposes? - What method of depreciation is used for valuation? - What asset lives are used? Are different lives used for Current Cost Accounting? Has adequate provision been made for technological obsolescence? Are any assets leased? What is their value? How much are the annual rentals? How long is the commitment? - Is goodwill: -Shown as an asset?-Written off against reserves?-Being amortised by charges against profit? - How does the book value of goodwill compare with the estimated surplus of the current value of fixed assets over their net book value? - Has the status of any investments changed during the period? Subsidiaries? Associated companies? Trade investments? Non-consolidated subsidiaries? Are investments in associated companies shown by the "cost" method or by the "equity" method? - What is the difference between cost and market value of quoted investments? Is market value used if it is lower than cost? Are there any long-term debtors? How have they been treated in the balance sheet? Methods used to evaluate organisational performance
To evaluate the performance of a company with respect to these ratios, three methods are used, namely industry comparisons, time series analysis and absolute standards. a) Industry comparisons
Data are used, such as that provided by commercial firms like Dun and Bradstreet and Profit Impact of Marketing Strategies (PIMS), are used for comparing the company with others of about the same size, that serve the same market and have similar products. The danger is that when industry averages include companies with different products or markets, averages can be misleading. b) Time series analysis
Ratios for several periods are used to determine whether significant changes have occurred. These time series can also be used to project the future financial performance of the company. c) Absolute standards
Most organisations have some minimum requirements for corporate performance regulations of the particular industry, e.g. the long-term debt-to-equity ratio should not exceed one. A thorough financial analysis usually is a condition of these three approaches. Figure 2.5 shows an example of how a time series analysis can be used to back financial and business objectives. Figure 2.5 Framework for linking financial business objectives
The main types of ratio 1) Profitability a) Gross profit margin or profit margin on sales or b) Net profit margin: c) Return on assets: d) Return on equity Note that: NAV = Net asset value/e. Net asset turnover X profit margin = return on assets 2) Liquidity a) Current ratio b) Quick (liquidity or acid test ratio): c) Defensive interval ratio: d) Inventory to net working capital: 3(i) Leverage (coverage ratios or gearing) - debt cover a) Conventional leverage: b) Murphy Prussman Gearing: c) U.S. measure of leverage: (ii) Leverage - interest cover d) Interest coverage: e) Cumulative interest coverage: 4) Activity (efficiency ratios) a) Debtors turnover: b) Creditors turnover: c) Inventory turnover: d) Wages turnover: e) Net asset turnover: f) Profits per employee: Other useful ratios 1) Stock market ratios a) Earnings per share: b) Price earnings ratio: c) Dividend yield (net): d) Dividend cover: Financial measures of business unit performance
If an organisation is made up of multiple divisions or Creditors Business Units (SBU's), then the following measures can be computed, provided that balance sheet and income statement data are available at the divisional or SBU level. These analyses enable corporate management to assess the performance of divisions, SBU's and/or their management. a) Return on sales (ROS) ROS is computed by dividing net income (NI), or profit (P) before or after interest and taxes, by total revenue: Some argue that interest expenses and tax should not be considered as they are outside the SBU manager's control. However, interest may be added to show managers that invested funds are not a free resource. This, however, understates the true cost of capital employed, because the interest is a charge for only the debt portion of capital. b) Return on investment (ROI), return on net assets (RONA) and return on equity (ROE) Note: NET ASSETS = TOTAL ASSETS - TOTAL LIABILITIES Note: Owner's equity = total assets - total liabilities In using any of these measures to assess an SBU manager's ability to use assets efficiently, account should be taken of whether cash is centrally controlled or headquarters determines both credit and payment policies. If the latter, then cash receivables or payables or both should be omitted from the investment base. c) Cash flow (CF) Cash flow is not the same as net income (NI) or profit (P). It differs in two ways: i) Cash flow includes depreciation, as this is a bookkeeping transaction, and tax, because tax is a cash cost. Thus, CF = NI (or P) after tax and depreciation ii) Cash flow is affected by balance sheet changes, e.g. increase in accounts receivable or additions to fixed assets (FA), e.g. plant and equipment and changes in working capital (WC). CF = Net Income (or Profit) after tax plus Depreciation minus changes in FA and minus changes in WC Note: If no tax is paid or if tax is deferred, use Net Income (or Profit) before tax. The changes in (D) are calculated by the company's balance sheet entries for two consecutive periods. Working Capital = D Cash plus or minusD Stock plus or minusD Accounts receivable plus or minusD Accounts payable (and other short-term liabilities) Example: Balance sheet 19X5/6 19X6/7 (\$000's) (\$000's) Profit 400 380 Plus Depreciation 120 125 Cash flow from operations 520 505 Less Increase in Working capital (380) (420) Increase in Fixed Assets (90) (105) Net cash generated or (Used) 50 (200) d) Sustainable growth rate (SGR) This is a measure of the ability of the business to grow within the constraints of its current financial policies. What is required is a balance sheet for the SBU which includes a justified assignment of the proportion of the total corporate short-run liabilities and long-run debt. Once accomplished, the maximum sustainable growth rate (a measure of the ability of the business to fund the new assets needed to support increased sales) is estimated by: where: p = profit margin after taxes d = dividend payout ratio (for a business unit this is computed from the corporate overhead charge plus any dividend paid to corporate) L = debt to equity ratio t = ratio of assets (physical plant and equipment plus working capital) to sales. The growth rate is expressed in nominal terms. Real SGR is reduced by 2.2% for every 5% of inflation for two reasons: i) Depreciation charges based on historical costs overstate taxable income because they fail to fully recover the economic value of depreciating assets. ii) Working capital increase solely due to inflation requires financing. If the actual growth rate exceeds SGR, then the organisation can consider a number of strategic actions which affect the "productivity" side of the quest for increased profits ("productivity" as opposed to "volume" strategies to increase profits). These are: i) reduce investment intensity (cut stocks and/or receivables)ii) reduce dividendsiii) obtain injections of "equity" from the corporate bodyiv) increase debt. Now attempt exercise 2.7. Exercise 2.7 Ratio analysis
Nigel Munyai's horticultural business continued to flourish. Six years later his condensed financial accounts for the last three years are summarised below (N.B. he introduced fresh capital into the business): Profit and Loss account for the year to 31 March 19X0 19X1 19X2 (\$000's) Sales (all on credit) 415 645 885 Less: Cost of goods sold: Opening stock 35 40 65 Purchases 340 565 805 375 605 870 Less: Closing stock 40 335 65 540 115 755 Gross profit 80 105 130 Less: Expenses 40 50 60 Loan interest - 40 - 50 10 Net Profit 40 55 60 Balance Sheet as at 31 March 19X0 19X1 19X2 (\$ 000's) Fixed assets 89 93 101 Current assets Stocks 40 65 115 Trade debtors 52 108 250 Cash at Bank 12 104 6 179 - 365 193 272 466 Financed by: Capital 100 120 146 Add. Net profit for the year 40 55 60 Less: Drawings 24 16 35 20 38 22 (all on 31 March) 116 140 168 Loan - - 110 Current liabilities Creditors 77 132 178 Bank overdraft - 77 - 132 108 174 272 466 Compute the following ratios for 19X0, 19X1 and 19X2. a) activity ratio on sales)b gross profit on cost of goods sold)c stock turnover)d return on capital employe)e) current ratio) f) liquidity) debt/correlation periodh) working capitali) ratio of current assets to total assetsj) ratio of cash to current liabilities Comment briefly on the results of the business over the last three years. Key terms
Trading accountAverage costBalance sheetCapital expenditureCost of goods soldCredit balancesCurrent liabilitiesDebit balancesDirect and indirect costsDual effectFirst-in-first-outFixed and current assetsGross marginGross salesLast-in-first-outLeverageLiquidity ratioLoansManufacturing accountNet profitNet salesNet sales and net purchasesOpening and closing stockOverheadsProfitProfitability ratiosProfit and loss accountRatio analysisRevenue expenditureTrading accountThe accounting equationWorking capitalWork-in-progress

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