

Monitoring the Business – Ordinary Level

Gerard O'Mahony is an accountant with Allied Electronics. He is preparing a financial report for Ms. Jane Coughlan, Managing Director. Gerard prepared a P. & L. account and a Balance Sheet. He found the net profit percentage of the company was 14% and R.O.I. was 25%. The following is an extract from the Balance Sheet.

Balance Sheet (Extract)

	2001	2000
Current Assets	80,000	120,000
Current Liabilities	160,000	80,000
Closing Stock	40,000	20,000

(A) What do the letters 'ROI' and 'P. & L.' mean? (10m)

Marks: 2 marks each for correct identification of 'R' 'O' 'I' 'P' 'L'

(B) Calculate the working capital ratio for the years 2000 and 2001. (20 m)

Marks: Working Capital Ratio

- Correct formula: 2 marks x 2 = 4 marks]
- 2001 figures: 3 marks for each correct figure x 2 = 6 marks]
- 2001 answers: 2 marks for correct answer = 2 marks]
- 2000 figures and answers: same as above = 8 marks]

Correct answers, but no workings: maximum 5 marks x 2 = 10 marks

(C) Calculate the acid test ratio for the years 2000 and 2001. (20m)

Marks: Same marking scheme as for part (B)

(D) Draft the financial report outlining the profitability and liquidity position of the firm. (20m)

Marks:

- structure of the report: (To/From/Date/Body) 2 marks x 2 = 4 marks
- content of report: correct reference to Profitability and liquidity situations: 8 marks x 2 = 16 marks

A SAMPLE ANSWER:

FINANCIAL REPORT

To: Ms. Jane Coughlan, Managing Director

From: Mr. Gerard O'Mahoney

Date: 13th June 2001

Body of report:

1. Profitability (2001):

The firm is profitable in 2001, with a Net Profit percentage of 15% and ROI of 25%

2. Liquidity (2000 and 2001):

The Liquidity of the firm has disimproved:

- working capital ratio has fallen from _____ in 2002 to _____ in 2001

- acid test ratio has fallen from _____ in 2000 to _____ in 2001

(E) Distinguish between a debtor and a creditor.

(5m)

Marks: One at 3 marks, one at 2 marks

Monitoring the business – Higher Level

(A) Illustrate the benefits for the good financial management of the:

(i) Profit and Loss account

(ii) The Balance Sheet

(20m) (LCHL 2004)

Marks:

- P. & L. account: 2 points @ 5 marks each
[stating the point (3 marks) + some detail (2 marks)]
- Balance Sheet: 2 points @ 5 marks each
[stating the point (3 marks) + some detail (2 marks)]

A SAMPLE ANSWER:

(i) Profit and Loss account

The P. & L. shows the vital trading figures of a business for each year

Sales : the value of goods/services sold

Cost of sales : the cost of these goods/services

therefore Gross Profit : the Gross Profit earned on them,

Also Expenses : the expenses of running the business

therefore Net Profit : the net profit earned.

These figures are essential for the business (and its bankers) as they reveal how profitable (or not) the business is.

(ii) The Balance Sheet

The Balance Sheet shows how much the business owns (assets) and owes (liabilities) at the end of the year. From this the business (and its bankers) knows how much the business is worth.

The figures for working capital (current assets - current liabilities) and debt/equity ratio (total debt capital compared to total equity capital), which are drawn from the Balance Sheet, are vital indicators of the financial health and stability of the business.

Monitoring the business – Higher Level

- (B) (i) Using two ratios in each case, analyse the profitability and liquidity trend in Calty Construction Co. Ltd. from the following figures for 2002 and 2004.
(ii) Suggest how the trend might be improved.

	2002	2003
Current Assets	15,900	16,800
Net Profit	15,100	12,285
Equity Share Capital	100,000	105,000
Current Liabilities	8,100	7,400
Closing Stock	9,100	12,400
Gross Profit	45,150	40,950
Retained Earnings	169,500	157,500

(40m) (LCHL 2004)

Marks:

- 2 Profitability Ratios @ 10 marks each: 7 x 1 mark for correct formula, figures and answer for both years; 3 marks for how to improve trends.
- 2 Liquidity Ratios @ 10 marks each: 7x 1 mark for correct formulae, figures and answers for both years; 3 marks for how to improve trends.

A SAMPLE ANSWER:

(ii) Suggest how the trend might be improved.

- Gross Profit has declined but the gross profit margin has remained steady. The problem is that **Sales** have declined, so extra effort to improve sales is needed.
- Net Profit has declined along with Sales and Gross Profit as is to be expected. But **Net Profit Margin** has also declined, which means that expenses have arisen. These must be controlled better, by eliminating wasteful spending.
- Return on investment has declined. Net Profit is down though Capital Employed has actually increased. The business needs to get better profit from its capital by increasing sales and reducing expenses (as outlined above).
- Working Capital Ratio has risen because current assets are up while current liabilities are down. **Must find out which assets have increased and why.** Stock is up (while sales are down) so unsold stock is accumulating. **Better stock control is needed.**

Acid Test Ratio has disimproved because stock levels have increased substantially. Better stock control needed to prevent stock going off/out of date (and to reduce the costs of holding stock).