Chapter 25 Analysis account

Key terms

1. Liquidity: the ability of a business to pay back its short-term debts
2. Capital employed: shareholders' equity plus non-current liabilities. It is the total long-term and permanent capital invested in a business.
3. Illiquid: that assets are not easily convertible into cash.

1. **<u>Ratio analysis of accounts</u>**

2. **<u>Profitability ratio</u>**: assess how well company generate profit

Profitability ratio	**Gross Profit (%)**	**Net profit(%)**	**Return on capital employed (ROCE) (%)**
Formular	(Gross profit / Sale revenue) x100	(Net profit / Sale revenue) x100	(Net profit / Capital employed) x 100
Analysis	• It shows how successful a business can convert sales into profit. • It shows the ability to control the cost of goods sold.	• It shows how successful a business can convert sales into net profit. • It shows the ability to control the overhead cost such as advertising and marketing.	• It shows how efficient a business can net profit from capital used in the business. • It shows the ability to generate net profit by the amount of investment.

2) Liquidity ratio: assess ability to pay its short-term debt.

Liquidity ratio	Current Ratio	Acid test ratio or Quick Ratio
Formular	(Current assets / Current liabilities) x 100	((Current assets - inventories) / Current liabilities) x100
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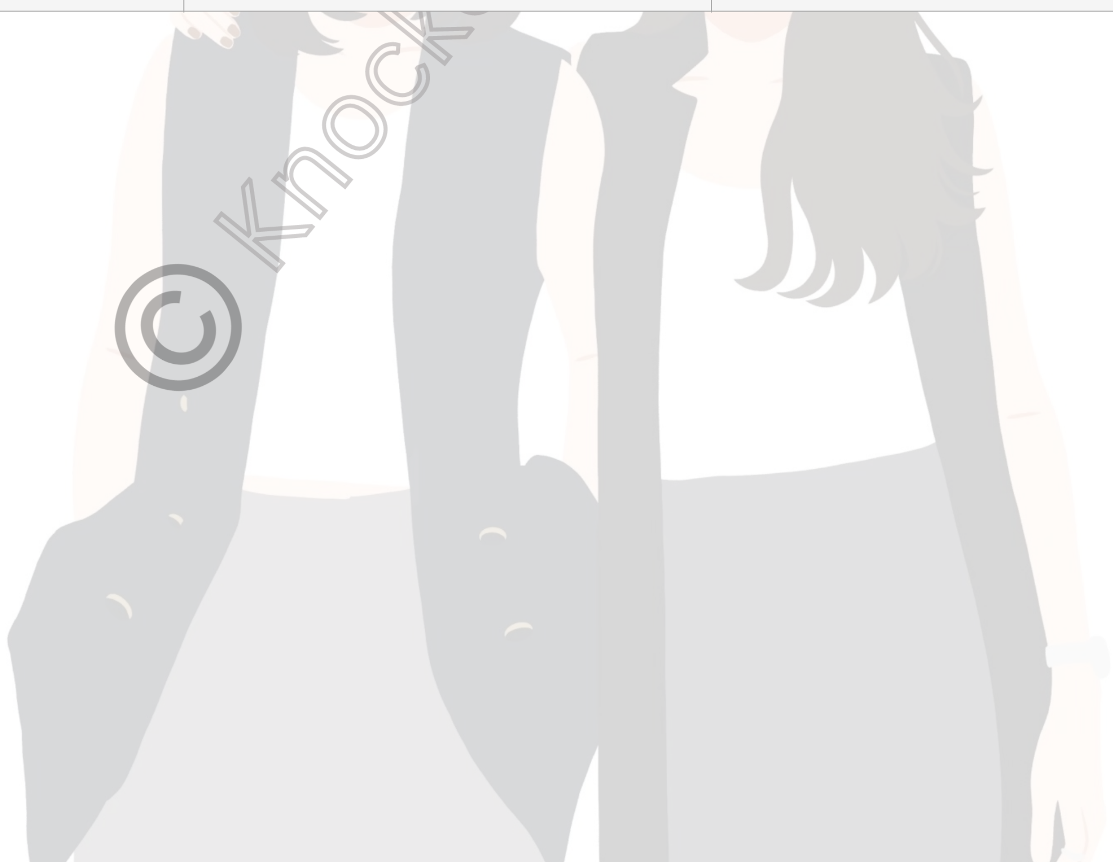
Analysis	• If current ratio < 1; it cannot pay off its short term debt from current assets. • If current ratio > 2 ; it has opportunity cost from holding too much liquid asset or working capital.	• If acid test ratio < 1; it cannot pay off its short term debt from its most liquid assets. It needs to reduce inventories and increase cash. • The great difference between current ratio and acid test ratio means the business holds a relatively high level of inventories.



2. Uses and users of accounts

Users of accounts	What they use the account for
1.Managers	• To control and assess the performance in controlling cost and generating profit
2.Shareholders	• To decide whether to invest in the business or not from profitability ratio
3.Creditors; suppliers that sell goods on credit to the business.	• To assess the liquidity problems and ability of the business to repay its creditor from liquidity ratio
4.Banks	• To decide whether to issue a loan to the business or not from liquidity ratio
5.Government	• To check the profit tax paid by the company
6.Workers and trade union	• To assess whether the future of the business is insecure or not.
7.Other businesses	• To decide whether to take over the business or not • To compare its business's performance with other rival businesses.

3. Limitations of using accounts and ratio analysis:

- External users can use only published accounts.
- Rations are based on historical data therefore they cannot predict future performance.
- Accounting data over time can be misleading by the reason for inflation.
- Different companies have different accounting policies so it is difficult to compare performance.