



The next entry in the balance sheet is *working capital* (or *net current assets*). This is often defined as the finance available for the day-to-day running of the business. It is important that the business has sufficient current assets available to meet its commitments in terms of current liabilities. Working capital has been calculated as follows:

$$\begin{aligned}\text{Working capital} &= \text{current assets} - \text{current liabilities} \\ &= \text{£}296\,000 - \text{£}209\,000 \\ &= \text{£}87\,000\end{aligned}$$

This value has been added to the total fixed assets to provide a value of £405 000.

The business has one *long-term liability*, a bank loan. Long-term liabilities are the long-term debts. At the time the balance sheet was prepared £20 000 was still owed on the bank loan. The value of the outstanding debt has been deducted from the £405 000 to arrive at a value for *net assets* of £385 000. This value represents the difference between all the business's assets (fixed and current) and liabilities (current and long term).

The bottom part of the balance sheet is known as the *financed by* section and explains how the £385 000 has been accounted for. One of the basic principles of a balance sheet is that it must balance; everything owned by a business, or of value to it, will have been paid for in some way. In the case of Harrogate Quality Bathrooms Ltd the money introduced by the shareholders (the *share capital*) was £138 000. The business also has *reserves* valued at £212 000. This is the accumulated net profit that does not necessarily have to be held in the form of cash or bank deposits. The final source of finance is the profit that the business made for the year, £35 000. When added together these three sources of finance come to £385 000, exactly the same value as the net assets.

I hope this explanation has proved to be helpful. Should you require any further help or advice, please do not hesitate to contact either myself or my manager, Duncan Wells.

We look forward to your continued business.

Yours sincerely

Your business finance adviser

Task 2

Calculations for ratios (using 2008 final accounts*):

$$\begin{aligned}\text{Gross profit margin} &= \text{gross profit} \div \text{sales} \times 100 \\ &= 692 \div 2265 \times 100 \\ &= 31\%\end{aligned}$$

$$\begin{aligned}\text{Net profit margin} &= \text{net profit} \div \text{sales} \times 100 \\ &= 35 \div 2265 \times 100 \\ &= 1.5\%\end{aligned}$$



Return on capital employed	= net profit ÷ capital employed × 100 = 35 ÷ 385 × 100 = 9%
Current ratio	= current assets ÷ current liabilities = 296 ÷ 209 = 1.4 (ratio is 1.4:1)
Acid test	= (current assets - stock) ÷ current liabilities = (296 - 176) ÷ 209 = 120 ÷ 209 = 0.6 (ratio is 0.6:1)
Debtor days	= debtors ÷ sales turnover × 365 = 72 ÷ 2265 × 365 = 12 days
Creditor days	= creditors ÷ purchases × 365 = 198 ÷ 1464 × 365 = 49 days
Stock turnover	= cost of goods sold ÷ average stock
Average stock	= (285 + 176) ÷ 2 = 231
Stock turnover	= 1573 ÷ 231 = 7 (times a year) or = 365 ÷ 7 = 52 days

*All figures from accounts are in £000s. Answers have been rounded up for simplicity.

Task 3

Cammish & Co. Chartered and Certified Accountants		
Performance Analysis for Harrogate Quality Bathrooms Ltd - Summary		Accounts date: 31 March 2008
Profitability		
Gross profit margin	31%	For every £100 of sales, £31 of gross profit has been generated. It shows that 31% of sales revenue in 2008 was gross profit.
Net profit margin	1.5%	For every £100 of sales, £1.50 of net profit has been generated. It shows that 1.5% of sales revenue was net profit.
Return on capital employed	9%	This shows that for every £100 of capital invested in the business £9 return has been generated. The ratio shows that the profit for 2008 was almost one tenth the size of business in terms of capital employed. A rate that is significantly in excess of the rate that could be earned on a bank deposit is desirable, as this rate is.



Liquidity		
Current ratio	1.4:1	For every £1 of short-term debt, the business has approximately £1.40 of current assets to pay them with. We often recommend that the value should be between 1.5 and 2. A value lower than 1.5 could mean that the firm is in danger of not being able to meet its current liabilities. A value higher than 2 could indicate that too much of the firm's finance is tied up in short-term assets, and may not be being used productively.
Acid test	0.6:1	For every £1 of short-term debt, the business has approximately 60p of liquid assets to pay them with. We often recommend that a value of 1 is preferred. Lower values could indicate a liquidity problem, such as an inability to meet short-term debt.
Efficiency		
Debtor days	12 days	Debtors have taken, on average, 12 days to pay. A 12-day delay has been typical between an invoice being issued and payment being received.
Creditor days	49 days	Creditors have been paid, on average, after 49 days. There has typically been a 49-day delay between suppliers issuing an invoice and payment being made. Debtors are paying faster than creditors are being paid.
Stock turnover	52 days	Stock is held, on average, for 52 days. This indicates the length of time that an item of stock is typically held by the business.

Task 4 (D2)

An example of a PowerPoint presentation is included in this Box (see *Harrogate Quality Bathrooms Ltd.ppt* file).

GRADING COMMENTS

The contents of both the profit and loss account and balance sheet need to be explained for coverage of P4. In order to cover P5 learners need to accurately carry out ratio calculations. Analysing the ratios provides evidence for coverage of M2. Using the results of the calculations and the other data provided to evaluate the financial performance of the business will provide evidence for coverage of D2.