



- b) The ratios you have calculated using the 2008 accounts
- c) Data that Duncan has provided you with of the 'industry average' ratios. This data was contained within a report that he had purchased, published in June 2008. The figures are shown below:

Ratio	Industry average
Gross profit margin	32%
Net profit margin	21%
Return on capital employed	25%
Current ratio	3.2:1
Acid test	1:1
Debtor days	24 days
Creditor days	35 days
Stock turnover	56 days

SAMPLE ANSWER

Task 1

Cammish & Co. Chartered and Certified Accountants

July 2008
Mrs S. Cutts
Harrogate Quality Bathrooms Ltd

Dear Mrs Cutts

Re: explanation of final accounts dated 31.03.08

Further to your recent request, am I writing to provide a full explanation of the contents of the most recent accounts for Harrogate Quality Bathrooms Ltd. Within this explanation I will define any key accounting terminology and provide a breakdown of the important calculations contained within the accounts.

I will first explain your *profit and loss account*. Your level of *sales revenue* for the year ending 31 March 2008 was £2 265 000. Your *opening stock* level on 1 April 2007 was £285 000. During the year the business has bought £1 464 000 worth of stock (these are known as *purchases*) and on 31 March 2008 the *closing stock* was valued at £176 000. These figures can be used to calculate the *cost of sales*; this is the value of all direct costs connected to the sales across the year. We have calculated the cost of sales in the following way:

$$\begin{aligned}
 \text{Cost of sales} &= \text{opening stock} + \text{purchases} - \text{closing stock} \\
 &= £285\,000 + £1\,464\,000 - £176\,000 \\
 &= £1\,573\,000
 \end{aligned}$$



We have then used this figure to calculate the *gross profit*; this is the sales revenue less the cost of sales. The gross profit has been calculated as follows:

$$\begin{aligned} \text{Gross profit} &= \text{sales revenue} - \text{cost of sales} \\ &= \text{£}2\,265\,000 - \text{£}1\,573\,000 \\ &= \text{£}692\,000 \end{aligned}$$

The *net profit* (or *operating profit* as it is sometimes known) has then been calculated by adding up all the *expenses* (or *overheads*) faced during the year and then deducting this total from the gross profit. Net profit has thus been calculated as follows:

$$\begin{aligned} \text{Net profit} &= \text{gross profit} - \text{expenses} \\ &= \text{£}692\,000 - \text{£}657\,000 \\ &= \text{£}35\,000 \end{aligned}$$

I will now explain your *balance sheet*. The balance sheet shows (as of 31.03.08) the *assets* and *liabilities* of Harrogate Quality Bathrooms Ltd. The balance sheet is a 'snapshot' of the business on that date; items contained within it will doubtless have changed shortly after production of the document.

The first part of the balance sheet shows the value of the *fixed assets* of the business. These are long-term items of value that are owned by Harrogate Quality Bathrooms Ltd. The original purchase cost of the equipment and vehicles are shown. A value has then been deducted for *depreciation* to date; this is the fall in value of the assets since they were bought. We have used *straight line depreciation* which means we have assumed that the assets decline in value by a fixed amount each year. The right hand column shows the *net book value*; this is a more realistic valuation of the fixed assets as the value reflects the amount by which they have depreciated in value:

$$\text{Net book value} = \text{purchase cost} - \text{accumulated depreciation}$$

For example, for equipment:

$$\begin{aligned} \text{Net book value} &= \text{£}262\,000 - \text{£}15\,000 \\ &= \text{£}247\,000 \end{aligned}$$

The total value of the fixed assets on 31 March 2008 was £318 000.

The values of the *current assets* of the business are then listed; these are the short term items of value owned by Harrogate Quality Bathrooms Ltd. The stock value of £176 000 is the closing stock valuation; this is the value of the stock on 31 March 2008. *Debtors* are also classified as a current asset; debtors (who are customers) owe the business money, so in this sense have value to the business. On 31 March 2008 £72 000 was owed to the business. £46 000 was held as cash or money on deposit in the bank and £2 000 was owed to the business by HM Revenue and Customs in the form of *Value Added Tax accruals*. Total current assets were valued at £296 000.

Current liabilities appear as the next set of items in the balance sheet. Current liabilities are the short term debts of the business; those that must be paid before the next balance sheet is published (on 31 March 2009). For Harrogate Quality Bathrooms Ltd its *creditors* are suppliers to whom the business owes money; on 31 March 2008 creditors were owed £198 000. On that date the business had no *overdraft*, but did owe HM Revenue and Customs £11 000 in VAT liabilities. Total current liabilities were valued at £209 000.



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:

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

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*):

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

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