Subject: Principles of Accounts

Topic: Accounting ratios and the interpretation of accounts

Level: S.4

This activity was produced by a teacher of S.T.F.A. Lee Shau Kee College
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Worksheet 2

Name:____________________ Class:____________ No.:_________________ Date:____________

Aunt Rose wants to invest in one of the following business, but she does not fully understand the financial statements. She asks her niece, who is an accountant, about this. R Ltd and T Ltd are same type of business in the same industry, the financial statements are as follows:

R Ltd		**T Ltd**	
Trading and profit and loss account		Trading and profit and loss account	
for the year ended 31 December 2005		for the year ended 31 December 2005	
	$'000		$'000
Sales	250,000	Sales	160,000
Less: cost of sales	190,000	Less: cost of sales	100,000
Gross Profit	60,000	Gross Profit	60,000
Expenses	25,000	Expenses	28,000
Net Profit	35,000	Net Profit	32,000

R Ltd		**T Ltd**	
Balance Sheet as at 30 December 2005		Balance Sheet as at 30 December 2005	
	$'000		$'000
Fixed assets	30,000	Fixed assets	16,000
Current assets:		Current assets:	
Stock	110,000	Stock	50,000
Debtors	62,500	Debtors	20,000
Bank	7,500	Bank	10,000
Less: current liabilities	(90,000)	Less: current liabilities	(16,000)
	120,000		80,000
Capital	120,000	Capital	80,000

After studying these financial statements, Aunt Rose has the following questions:

If I want to know which business's performance is better, can I just look at the profit figure?

The gross profit and net profit of R Ltd are higher than T Ltd, does this mean that R Ltd is more profitable than T Ltd.?

Task 1

You are Aunt Rose's niece, please write to her and answer her queries by explaining the accounts.

Task 2

 Work in pairs

Share with your partner about what you have written down. If your partner does not agree with you, discuss the point with him/her. Explain why you think you are right.

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Answers for Worksheet 1

<u>Task 1</u>

We can’t evaluate the performance of a business just by looking at the profit figure.

We can’t evaluate the performance by ratio analysis.

Ratio analysis is used to evaluate a company’s financial position and performance using three criteria: profitability, liquidity and management efficiency.

Profitability indicates how well the business generates profit.

Liquidity indicates how easily the business can meet its short term debts.

Management efficiency indicates how well the business manages its assets.

Instead of just looking at the gross profit figure and net profit figure, we have to work out the gross profit to sales ratio and net profit to sales ratio. The gross profit ratio shows how much gross profit has been made for every $100 of sales. The net profit ratio shows how much net profit has been made for $100 of sales.

The gross profit ratio of R Ltd was 24% in 2005. T Ltd had a gross profit ratio of 37.5%. The net profit ratio of R Ltd was 14% in 2005. T Ltd had a gross profit ratio of 20%.

The higher the ratio, the more profitable the firm is. This shows that the profitability of T Ltd was higher than that of R Ltd.