

Exercise walk-through

Analysis of published accounts ■ 10.2

eXercise

You must be able to

- calculate profitability, liquidity and gearing ratios
- explain what each ratio shows
- analyse and evaluate a firm's performance and the limits of ratios

Method — Key ratios

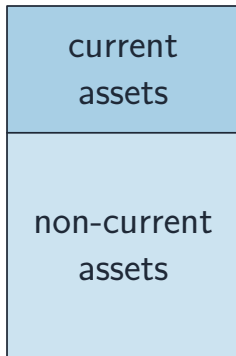
$$\text{ROCE} = \frac{\text{operating profit}}{\text{capital employed}} \times 100\% \qquad \text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

- **Worked ROCE:** operating profit \$80,000, capital employed \$400,000 → $\frac{80000}{400000} \times 100 = 20\%$.
- **Worked current ratio:** current assets \$60,000, current liabilities \$30,000 → $\frac{60000}{30000} = 2.0$ (about 1.5–2 is safe).
- **Gearing** = non-current liabilities ÷ capital employed × 100; high gearing is risky if interest rates rise.

Answer shapes: AO1 + AO2 + AO3 (reasoning chain) + AO4 (a supported judgement *in context*).

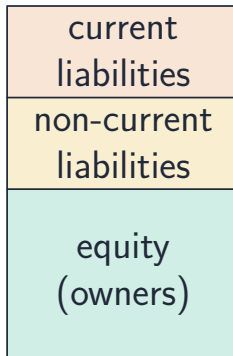
Method — Key ratios

what it owns



=

funded by



Financial statements and ratios let stakeholders judge a firm's performance

Practice 2.1 ■ 2 marks

State what the **current ratio** measures.

Solution 2.1

Method: Key ratios

Worked steps

how easily a firm can pay its short-term debts from its current assets (2 for a clear idea; 1 for a partial idea).

Practice 2.2 ■ 2 marks

A firm has operating profit of \$50,000 and capital employed of \$250,000. Calculate its ROCE.

Solution 2.2

Method: Key ratios

Worked steps

$\frac{50,000}{250,000} \times 100\% = 20\%$ (2; award 1 for a correct method with the wrong figure).

Practice 2.3 ■ 2 marks

State one limitation of ratio analysis.

Solution 2.3

Worked steps

any one of: uses past data; ignores non-money factors (brand, staff); needs a similar firm/industry to compare fairly (2 for a developed point; 1 for a basic one).

Exam-style 3.1 ■ 3 marks

Explain one reason why a business calculates its **gross profit margin**.

Solution 3.1

Method: Key ratios

Worked steps

[3] **AO1** 1 — give a reason (to see profit kept per sale; to compare with last year or rivals). **AO2** up to 2 — develop it, e.g. comparing the gross margin with last year shows whether costs of sales are rising → managers can act to control them → protecting profit (2 developed / 1 limited).

Exam-style 3.2 ■ 2 marks

A firm has current assets of \$80,000 (including \$30,000 of inventory) and current liabilities of \$40,000.

- (a) Calculate the current ratio.
- (b) Calculate the acid-test ratio.
- (c) Analyse what these two ratios suggest about the firm's liquidity.

Solution 3.2

Method: Key ratios

Worked steps

(a) current ratio = $\frac{80,000}{40,000} = 2.0$ (2). (b) acid-test = $\frac{80,000 - 30,000}{40,000} = 1.25$ (2; allow follow-through). (c) [4] AO2 1–2 + AO3 up to 2 — the current ratio of 2.0 looks safe, but removing inventory gives 1.25, still above 1, so the firm can meet short-term debts even without selling stock → liquidity is adequate but not excessive.

Exam-style 3.3 ■ 12 marks

Evaluate the usefulness of ratio analysis for judging a business's performance.

Solution 3.3

Method: Key ratios

Worked steps

[12] **AO1** 2 / **AO2** 2 / **AO3** 2 / **AO4** up to 6. **Useful:** ratios turn raw figures into comparable measures of profitability, liquidity and gearing, and reveal trends over time. **Limited:** they use past data, ignore non-money factors, can be distorted by accounting choices, and need similar firms to compare fairly. **Judgement:** ratios are valuable when compared over time and against similar firms, but they must be read with non-financial information — their usefulness depends on the quality of the comparison.