OCR
RECOGNISING ACHIEVEMENT

# Guidance on Accounting Elements

## OCR GCE in Business Studies

**August 2012**

The following guidance has been prepared in order to assist centres in the preparation of their candidates for the accounting elements with OCR GCE Business Studies units F292 – Business Functions and F297 – Strategic Management. The material not only makes reference to the traditional UK accounting standards and format, but also, as appropriate, to the newer international accounting standards. Although OCR will continue to provide accounting information in the traditional UK formats and terminology for the lifetime of the current specification, this will no longer be the case as and when the qualification is re-developed. However, responses which do utilise the international accounting standards and formats are just as acceptable as those which continue to use the traditional UK standards and formats.

Centres do need to be aware, however, that although this guidance is quite comprehensive, it is not necessarily exhaustive and OCR reserves the right to consider other appropriate aspects of accounting within units F292 and F297 (although any such material would be indicated within the pre-release case study material).

Centres entering candidates for unit F294 – Accounting should not consider this guidance to be exhaustive in the context of a specialist accounting unit.

**Profit and Loss Account for the year ended 31 May 2012**
**(or Statement of Comprehensive Income/Income Statement**
**for the year ended 31 May 2012)**

| | | |
|---|---|---|
| | **£000s** | **£000s** |
| Turnover (or Revenue) | | 750 |
| Cost of sales | | 490 |
| **Gross Profit** | | **260** |
| Expenses | | 150 |
| **Operating Profit** | | **110** |
| Depreciation | 20 | |
| Interest | 20 | 40 |
| **Profit before tax** | | **70** |
| Tax | | 18 |
| **Net Profit** | | **52** |
| Dividends | | 40 |
| **Retained Profit** | | **12** |

**Balance Sheet as at 31 May 2012**
**(or Statement of Financial position as at 31 May 2012)**

| | £000s | £000s |
|---|---|---|
| **Fixed Assets** (or Non-Current Assets) | | |
| Land and buildings | 290 | |
| Equipment | 310 | |
| **Total Fixed Assets** | | 600 |
| | | |
| **Current Assets** | | |
| Stock | 100 | |
| Debtors | 150 | |
| Cash | 50 | |
| **Total Current Assets** | | 300 |
| | | |
| **Current Liabilities** (or Creditors due within twelve months) | | |
| Trade Creditors | 60 | |
| Overdraft | 15 | |
| **Total Current Liabilities** | | 75 |
| | | |
| **Net Current Assets** | | 225 |
| | | |
| **Long Term Liabilities** (or Non-Current Liabilities or Creditors due after twelve months) | | |
| Loan | | 330 |
| | | |
| **Net Assets Employed** | | **495** |
| | | |
| **Equity** | | |
| Share Capital | | 200 |
| Profit and Loss Account | | 295 |
| | | |
| **Equity Shareholders' Funds** | | **495** |

Additional information

200 000 £1 ordinary shares
Current share price = £5.00

| Ratio | Formula | Data | Outcome | Interpretation |
|---|---|---|---|---|
| **SOLVENCY** | | | | |
| **Gearing** | Long term liabilities x 100<br>Capital employed | 330 x 100<br>330 + 495 | 40.0% | This shows the extent to which the business relies on debt (external) funding in its long term capital structure. High gearing has the effect of magnifying the EPS and P/E ratios (see below). |
| **Interest cover ratio** | Profit before interest and tax<br>Interest expense | 90<br>20 | 4.5 times | This shows how many times the business is able to pay its interest commitment from the year's profits. The larger the value the less risk. A value less than 1.0 means that the business is unable to pay its interest and this may lead to loan foreclosure. |
| **LIQUIDITY** | | | | |
| **Current ratio** | Current assets<br>Current liabilities | 300<br>75 | 4.00 | This is a broad test of liquidity. Any value above 1 indicates that the firm can pay its short term obligations from its current assets. |
| **Acid Test** | Current assets – stock<br>Current liabilities | 300 -100<br>75 | 2.67 | This is a more stringent test of liquidity in that it recognises that stock may not be immediately convertible to cash at full book value. |
| **ACTIVITY/EFFICIENCY** | | | | |
| **Stock turnover (days stock)** | Cost of sales<br>Stock<br>OR<br>Stock x 365<br>Cost of sales | 490<br>100<br><br>100 x 365<br>490 | 4.9 times<br><br><br>74.5 days | On average the company turns stock into sales 4.9 times per year. The larger the number the more active is the business. On average, the entire stock turns over every 75 days. Technically, this figure should be based on average stock, rather than just the closing stock figure. Average stock is calculated as: Opening stock + closing stock/2. |

| | | | | |
|---|---|---|---|---|
| **Debtor turnover (debtor days)** | Revenue<br>Debtors<br>OR<br>Debtors x 365<br>Revenue | 750<br>150<br><br>150 x 365<br>750 | 5.0 times<br><br><br>73.0 days | On average the company collects payment from its customers 5 times per year, i.e. debtors have an overage collection period of 73 days. A business would want a short debtor collection period. Technically, the debtor turnover/collection period should be based on just credit sales and not on revenue. |
| **Creditor turnover (creditor days)** | Cost of sales<br>Trade creditors<br>OR<br>Trade creditors x 365<br>Cost of sales<br><br>In this instance the cost of sales figure is used in lieu of (credit) purchases | 490<br>60<br><br>60 x 365<br>490 | 8.2 times<br><br><br>44.7 days | On average the company pays its creditors 8.2 times per year, i.e. it takes 44.7 days to settle its invoices. A business would want a long creditor payment period. Technically, the creditor turnover/collection period should be based on just credit purchases and not on all purchases. |
| **Fixed asset turnover** | Revenue<br>Fixed assets | 750<br>600 | 1.25 | This measures the relationship between fixed assets and sales/turnover/revenue. For every £1 invested in fixed assets this business generates £1.25 of sales. The higher the value the more productive are the assets. |

| | | | | |
|---|---|---|---|---|
| **PROFITABILITY** | | | | |
| **Gross profit margin (gpm)** | $\frac{\text{Gross profit}}{\text{Revenue}} \times 100$ | $\frac{260}{750} \times 100$ | 34.67% | Measures how much of each £1 of sales becomes gross profit. The larger the percentage the better and may indicate both the amount of value the business is able to add and the nature of competition in its market. |
| **Net profit margin (npm)** | $\frac{\text{Profit before interest and tax}}{\text{Revenue}} \times 100$ | $\frac{90}{750} \times 100$ | 12.00% | Measures how much of each £1 of sales becomes net profit. The larger the percentage the better.<br>By taking profit before interest and tax it is possible to measure the aspects over which the business has control. If profit was after interest and tax, then a rise in interest or taxation rates would depress npm and so make the business look less profitable, whereas managers are not able to control these factors.<br>If the detail in the P&L account does not include PBIT, then it is acceptable to use net profit, with a note to explain that this is an approximation. |
| **Return on Capital Employed (ROCE)** | $\frac{\text{Profit before interest and tax}}{\text{Capital employed}} \times 100$ | $\frac{90}{330 + 495} \times 100$ | 10.91% | The most fundamental measure of business financial performance and efficiency, in that it measures what comes out, profit, to what goes in, capital. The higher the percentage the better and the more efficient the business is in turning capital into profit. |
| **Return on Equity (ROE)** | $\frac{\text{Net profit}}{\text{Equity shareholders' funds}} \times 100$ | $\frac{52}{495} \times 100$ | 10.51% | Measures the amount the shareholders are getting back for every £1 of equity investment. Given that shareholders are likely to have a financial objective, the percentage the better. |

| SHAREHOLDERS | | | | |
|---|---|---|---|---|
| **Earnings per share (EPS)** | Net profit<br>Number of ordinary shares in issue | 52<br>200 | £0.26 | The larger the number the greater the reward for shareholders. It shows how the profit attributable to shareholders is split between each. However, EPS does not actually measure what is paid to shareholders. |
| **Dividends per share (DPS)** | Dividend<br>Number of shares in issue | 40<br>200 | £0.20 | Unless dividends exceed net profit, i.e. dividends are paid out of previous years earnings, DPS must be less than EPS. It shows the actual cash reward to each share. |
| **Dividend yield** | DPS x 100<br>Share price | 0.20 x 100<br>5.00 | 4.0% | Compares the reward from dividends to the opportunity cost of having the share. The larger the percentage the better. |
| **Price/Earnings ratio (P/E)** | Share price<br>EPS | 5.00<br>0.26 | 19.2 times | A measure of market confidence in that the market values the business at a 19.2 times multiple, hence the larger the value the more confident the market is that the business will continue to generate reward for its shareholders. |

**NB:** For all ratios, the key is that, regardless of whether comparisons are year on year or company to company, the same approach is always used.