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OCR
Oxford Cambridge and RSA

A LEVEL
Financial Accounting Guide

BUSINESS

H431
For first teaching in 2015

A guide to the financial accounting area of study

Version 1

Introduction

A LEVEL BUSINESS

The following guidance has been prepared in order to assist centres in the preparation of their candidates for the financial accounting element with OCR GCE Business. The material makes use of the international accounting standards.

Centres do need to be aware that although this guidance is quite comprehensive, it is not necessarily exhaustive and OCR reserves the right to consider other appropriate aspects of accounting. It is designed as a guide only and does not replace the specifications which are the definitive documents for OCR AS and A Level Business. The income statement and statements of financial position examples provide outlines of acceptable format. They do not provide an exhaustive list of items that may be included in the documents.

Example:

Income statement for the year ended 31 January 2016

	£000s
Revenue	750
Cost of sales	490
Gross profit	**260**
Expenses	150
Operating profit	**110**
Depreciation	20
Profit before interest and tax (PBIT)	**90**
Finance costs	20
Profit before tax	**70**
Tax	18
Profit for the year	**52**
Dividends	40
Retained profit	**12**

Statement of financial position as at 31 January 2016			
	£000s	£000s	£000s
Non-current assets			
Intangible assets	50		
Property, plant & equipment	540		
Investments	10		
		600	
Current assets			
Inventories	100		
Trade and other receivables	150		
Cash and cash equivalents	50	**300**	
TOTAL ASSETS			**900**
Current liabilities			
Trade and other payables	60		
Overdraft	15	**75**	
Non-current liabilities			
Loan		**330**	
Capital & Reserves attributable to equity holders			
Share capital	200		
Retained earnings	295	**495**	
TOTAL EQUITY & LIABILITIES			**900**

Statement of financial position as at 31 January 2016			
	£000s	£000s	£000s
Non-current assets			
Intangible assets	50		
Property, plant & equipment	540		
Investments	10		
			600
Current assets			
Inventories	100		
Trade and other receivables	150		
Cash and cash equivalents	50	**300**	
Current liabilities			
Trade and other payables	60		
Overdraft	15	**75**	
Net current assets			**225**
Non-current liabilities			
Loan			**330**
Net assets			**495**
Capital & Reserves attributable to equity holders			
Share capital	200		
Retained earnings	295		
TOTAL EQUITY			**495**

Note: both of the above formats are acceptable and the number of columns used in each statement can vary.

Additional information: 200 000 £1 ordinary shares Current share price = £5.00

Ratio	Formula	Data	Outcome	Interpretation
Liquidity ratios				
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{300}{75}$	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	$\frac{\text{Current assets – inventories (stock)}}{\text{Current liabilities}}$	$\frac{300 - 100}{75}$	2.67	This is a more stringent test of liquidity in that it recognises that inventory may not be immediately convertible to cash at full book value.
Profitability ratios				
Gross profit margin	$\frac{\text{Gross profit x 100}}{\text{Revenue}}$	$\frac{260 \text{ x } 100}{750}$	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	$\frac{\text{Profit before interest and tax x 100}}{\text{Revenue}}$	$\frac{90 \text{ x } 100}{750}$	12.00%	Measures how much of each £1 of sales becomes net profit. It is acceptable to use operating profit instead of PBIT in the calculation. The larger the percentage the better. 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 and tax rates would depress npm and so make the business look less profitable, whereas managers are not able to control these factors. If the detail in the income statement does not include PBIT, then it is acceptable to use profit for the year, with a note to explain that this is an approximation.
Return on capital employed (ROCE)	$\frac{\text{Operating profit x 100}}{\text{Capital employed}}$ (Total equity + non-current liabilities)	$\frac{110 \text{ x } 100}{330 + 495}$	13.33%	The most fundamental measure of business financial performance and efficiency, in that it measures what comes out, profit, to what goes in, capital employed. The higher the percentage the better and the more efficient the business is in turning capital into profit.
Return on equity	$\frac{\text{Profit for the year x 100}}{\text{Total equity}}$	$\frac{52 \text{ x } 100}{495}$	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 higher the percentage the better.
The following ratios are ONLY examined at A Level				
Solvency ratios				
Gearing	$\frac{\text{Non-current liabilities}}{\text{Capital employed (Total shareholders' equity + non-current liabilities)}}$ x 100	$\frac{330}{495 + 330}$ x 100	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.
Interest cover	$\frac{\text{Profit before interest and tax (PBIT)}}{\text{Finance costs (Interest payable)}}$	$\frac{90}{20}$	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 the risk. A value less than 1.0 means that the business is unable to pay its interest and this may lead to loan foreclosure.

Efficiency ratios				
Creditor turnover (Creditor/ trade payables payment period)	Cost of sales* / Trade payables (creditors) Trade payables (creditors) x 365 / Cost of sales* *where purchases on credit are known they should be used instead of cost of sales.	490 / 60 60 x 365 / 490	8.2 times 44.7 days	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.
Debtors/receivables turnover (Debtor collection period)	Revenue* / Trade receivables (debtors) Trade receivables (debtors) x 365 / Revenue* *where credit sales are known they should be used instead of revenue.	750 / 150 150 x 365 / 750	5.0 times 73.0 days	On average the company collects payment from its customers 5 times per year, i.e. debtors have an average 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 revenue.
Non-current assets turnover	Revenue / Non-current assets	750 / 600	1.25	This measures the relationship between non-current assets and revenue. For every £1 invested in non-current assets this business generates £1.25 of sales. The higher the value the more productive are the assets.
Stock (inventory) turnover	Cost of sales / Inventories (stock) Inventories (stock) x 365 / Cost of sales	490 / 100 100 x 365 / 490	4.9 times 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.
Shareholder ratios				
Dividend per share (DPS)	Dividend / Number of shares in issue	40 / 200	£0.20	Unless dividends exceed profit for the year 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 / Share price	0.20 x 100 / £5.00	4.0%	Compares the reward from dividends to the opportunity cost of having the share. The larger the percentage the better for shareholders.
Earnings per share (EPS)	Profit for the year / Number of ordinary shares in issue	52 / 200	£0.26	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.
Price/earnings ratio	Share price / EPS	5.00 / 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.

N.B. 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.

The small print

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