

Cambridge IGCSE · Accounting 0452 · Notes

Limitations of accounting statements

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Read first: [Accounting principles](#), [Interpretation of accounting ratios](#), [Inter-firm comparison](#)

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What you need to know

By the end of this topic you should be able to recognise why financial statements, and the ratios worked out from them, don't tell the whole story about a business. The syllabus names three causes:

1. **Historic cost.** Assets are recorded at what they cost when they were bought, not at what they are worth now, and the statements describe a year that is already over.
2. **Difficulties of definition.** Figures such as profit, asset values and "capital employed" depend on choices and estimates (depreciation method, inventory valuation, what counts as a current liability), so two sets of statements can measure the same thing differently.
3. **Non-financial aspects.** Only things that can be measured in money are recorded, so the skills of the workforce, reputation, location, competitors and government decisions are missing, even though they affect the results.

The accounting principles behind these (historic cost, money measurement, consistency) are in the topic accounting principles; using ratios to compare years and businesses is in interpretation of accounting ratios and inter-firm comparison. This note only explains why the figures have limits.

Understand it

What the statements can and can't tell you

An income statement and a statement of financial position are a careful record of what **has happened**, measured in money. That makes them reliable, but it also sets limits. Before trusting a figure or a ratio, ask three questions:

- **Is the value up to date?** (historic cost, and the time gap)
- **Was it measured the same way as the figure I'm comparing it with?** (difficulties of definition)
- **What does the money figure leave out?** (non-financial aspects)

Historic cost: old values and old news

Under the historic cost principle, a non-current asset stays in the books at its cost (less depreciation), however much prices have changed since. Premises bought fifteen years ago may be shown at a fraction of what they would sell for today. So:

- the statement of financial position does **not** show what the business is worth;
- ratios built on asset values, such as return on capital employed (ROCE), can mislead.

Two shops each make a profit of \$15 000 a year from identical premises. Ama bought hers in 2008 for \$60 000; Ben bought his in 2024 for \$180 000. Each has other net assets of \$40 000.

	Ama	Ben
Capital employed	\$100 000	\$220 000
ROCE	15.00%	6.82%

Ama seems to use her capital more than twice as well, yet the two shops trade in exactly the same way. The difference comes only from **when** the premises were bought.

The statements are also **historic in time**. They describe a year that has ended, and they are usually finished weeks or months after the year-end. In that gap, sales, inventory, prices and costs keep changing. A trader who decides today using last year's figures may be acting on news that is out of date. And past results don't guarantee future ones.

Difficulties of definition: the same thing measured differently

Many figures in the statements are not simple facts; they depend on a method or an estimate:

- **Depreciation:** straight-line or reducing balance, the rate, the expected life and residual value are all choices.
- **Inventory:** valued at cost or net realisable value, and the cost itself can be worked out in more than one way.
- **Provision for doubtful debts:** the percentage is an estimate.
- **Terms in ratios:** "capital employed" or "current liabilities" can be defined differently from one business (or one textbook) to another, for example whether a loan due next year is included.

So two businesses with the same trading can report different profits. Take two traders, each with revenue of \$200 000, profit before depreciation of \$30 000 and equipment that cost \$40 000:

	Straight line, 10% a year	Reducing balance, 25% a year
Depreciation in the first year	\$4 000	\$10 000
Profit for the year	\$26 000	\$20 000
Profit margin	13.00%	10.00%

The first trader isn't better run; the methods differ. This is why a business must apply its methods **consistently** from year to year, and why comparing two businesses that use different accounting policies is unreliable.

Non-financial aspects: what money can't measure

The money measurement principle means only items with a money value are recorded. Plenty of things that decide how well a business does have no money value in the books:

Factor	How it affects the results
Skills, reliability and morale of the workforce	Better service, fewer mistakes, more sales
Reputation and customer loyalty (goodwill built up over time)	Customers return and recommend the business
Location	A busy street brings more customers than a back road
Actions of competitors	A new rival nearby can take sales
Government decisions	New taxes, regulations or grants change costs and demand
Working conditions, quality of goods, relations with suppliers	Affect staff turnover, returns and reliable supply

None of these appears in the statements, so the figures can't warn that a key worker is about to leave or that a large competitor is opening next door.

Why this matters for comparison

Inter-firm comparison and comparison over the years both suffer from these limits. The problems that really spoil a comparison are:

- **different accounting policies** (difficulties of definition);
- **a year that wasn't typical**, or figures that are out of date (historic in time);
- **things not recorded in money**, such as workforce skills (non-financial aspects);
- assets bought at different times at different prices (historic cost).

Differences in **selling prices**, **suppliers** or the **layout** of the ledger accounts are **not** limitations: ratios are percentages, not amounts, so they are built to show real differences in trading.

Key facts and formulas

There is no formula list in the IGCSE Accounting exam, so learn these.

Formula	Status
Historic cost: assets are shown at their original cost (less depreciation), not their current value, so the statement of financial position doesn't show what the business is worth	Learn it
Statements are historic in time: they report a past year and are prepared some time after its end	Learn it
Difficulties of definition: profit and asset values depend on methods and estimates (depreciation, inventory valuation, doubtful debts)	Learn it
Non-financial aspects: workforce skills, reputation, location, competitors and government decisions affect results but aren't recorded	Learn it
Not limitations of comparison: different selling prices, different suppliers, different layout of ledger accounts	Learn it

How to do it

We have 7 tagged questions for this topic from 2021 to 2025 (5 different, as some appear on two paper variants): 5 one-mark multiple-choice questions from Paper 1 and 2 parts of twenty-mark Paper 2 questions, each worth 2 marks.

Question type	Questions
Limitations of comparing businesses' ratios (multiple choice)	5
Non-financial factors (written)	1
How the time gap affects a decision (written)	1

1. Limitations of comparing businesses' ratios (multiple choice) (5 questions)

The question asks which statement **is** (or **is not**) a limitation of comparing the ratios of two businesses, or what would **prevent** a meaningful comparison.

- Sort each option** into one of two groups:
 - a real limitation: different accounting policies; the year may not be typical; figures out of date; accounting records **do not** include things like workforce skills;
 - not a limitation: different selling prices, different suppliers, different sizes, ledger accounts set out differently, businesses that use the **same** policies.
- Read the wording closely.** "Records **include** a value for workforce skills" is false, so it isn't a limitation. "Businesses **may have the same** accounting policies" helps comparison rather than spoiling it.
- For "**not** a limitation", pick the odd one out; it's usually a trading difference such as different selling prices.

2. Non-financial factors (written) (1 question)

"State two non-financial factors which may affect the trading results" (2 marks, 1 each).

1. Give two **different** factors from the table above, in a few words each: reputation, skills or morale of the workforce, competitors, government decisions, location.
2. Don't give financial factors such as selling prices, demand, costs or profit: they **are** in the statements.
3. Fit the business if you can, such as "a new supermarket opening nearby" for a shop.

3. How the time gap affects a decision (written) (1 question)

"Explain how the gap between the year-end and the preparation of the statements may influence a decision" (2 marks).

1. **Say what has happened since the year-end that the statements don't show**, linked to the decision: sales and profit made since then, the inventory held now, current prices or costs.
2. **Say that the owner should look at up-to-date figures** before deciding, for example "she needs to know how much inventory she holds today before cutting prices to clear it".

Each relevant point earns a mark; general statements such as "the figures are old" earn little unless they're tied to the decision.

Other angles you could meet, using the same ideas: why the statement of financial position doesn't show what a business is worth (historic cost); why two businesses' profits can't be compared directly (different depreciation or inventory methods); why past profit doesn't guarantee future profit.

Worked examples

Example 1

Which is a limitation of financial statements caused by the historic cost principle? **[1]**

A Non-current assets may be shown at values far below what they are worth today. B The skills of the workforce are not recorded. C Businesses may use different methods of depreciation. D Expenses are matched with the period in which they were incurred.

B is a non-financial aspect (money measurement), C is a difficulty of definition, and D is the accruals principle, not a limitation. **A (1)**

Example 2

Rosa wants to compare her gift shop's accounting ratios with those of a rival's gift shop. Which would **not** prevent a fair comparison? **[1]**

A The rival's financial year ends six months later than Rosa's. B The rival values its inventory by a different method. C The rival buys in larger quantities and receives more trade discount. D The rival's shop was closed for three months of the year for repairs.

A (a different time of year), B (a different policy) and D (a year that wasn't typical) all spoil the comparison. Buying more cheaply is a real difference in trading, which the gross margin will show. **C (1)**

Example 3

Leila owns a flower shop. Her statement of financial position at 30 June 2026 shows capital employed of \$90 000, which includes premises at their cost of \$50 000 in 2010. A valuer says the premises are now worth \$140 000. Her profit for the year (there is no interest) was \$18 000.

(a) Calculate Leila's return on capital employed (i) from her statement, (ii) if the premises were shown at their current value. **[3]**

(b) Explain why the figure in (a)(i) may mislead Leila. **[2]**

(c) State **two** non-financial factors which may affect the results of Leila's shop. **[2]**

(d) Leila's financial statements were completed on 30 September 2026. In October she is deciding whether to open a second shop. Explain how the gap between the year-end and the completion of the statements may influence her decision. **[2]**

(a) (i) $\frac{18\,000}{90\,000} \times 100$ **(1)** = 20.00% **(1)**.

(ii) Capital employed = 90 000 – 50 000 + 140 000 = 180 000; ROCE = $\frac{18\,000}{180\,000} \times 100$ = 10.00% **(1)**.

(b)

- Under historic cost the premises are shown at what they cost in 2010, far below their value now **(1)**.
- So capital employed is understated and ROCE looks twice as good as the return on the real value of the money tied up in the business; it may be better to sell or rent out the premises **(1)**.

(c) Any two **(1)** each: her reputation for fresh, good-quality flowers; the skill of her staff at arranging flowers; a new florist or supermarket opening nearby; the location of the shop.

(d)

- She needs to know the sales and profit made since 30 June, since trading may have improved or worsened in the last three months **(1)**.
- She should also check her current bank balance and costs, such as rents in the new area, before committing to a second shop **(1)**.

Common mistakes

- **Giving financial factors as non-financial ones.** Examiners found answers listing demand, selling prices or costs. These are measured in money; give reputation, workforce, competitors, government decisions or location.
- **Not seeing why the time gap matters.** Many candidates couldn't explain it. Name what may have changed since the year-end (sales, profit, inventory, prices) and link it to the decision in the question.
- **Calling different selling prices a limitation of comparison.** Ratios use percentages, not amounts, so price differences are what they are meant to show.
- **Missing a "not" or "include".** "Records include a value for staff skills" is false; read each option word for word.
- **Mixing up historic cost with other principles.** Historic cost means assets and expenses at their actual cost. It doesn't explain items left out of the books (that's money measurement).
- **Thinking the statement of financial position shows what the business is worth.** It shows assets at cost less depreciation, not their current value.

How to get the marks

- **"State":** a short point each, and two **different** points when asked for two. One word such as "reputation" or "competitors" is often enough.
- **"Explain":** give the point, then why it matters for **this** business and decision. Name the business and use its circumstances.
- **Calculations:** show the formula with the figures in; later parts are marked on your own answers.
- **Rounding:** give percentages to two decimal places when the question asks.
- **Multiple choice:** decide for each option whether it really makes figures unreliable or not comparable, then check whether the question asks for one that **is** or **is not** a limitation.

Quick check

1. State **three** non-financial factors that may affect the results of a café.
2. Two traders each have revenue of \$150 000 and profit before depreciation of \$24 000. Each bought a van for \$30 000 at the start of the year. One depreciates it by 20% a year on cost; the other by 40% a year on the reducing balance. Calculate each trader's profit margin and explain what this shows about comparing them.
3. Explain why a statement of financial position doesn't show how much a business could be sold for.
4. A trader made a profit of \$20 000 last year. Give **two** reasons why this doesn't mean she will make a similar profit this year.

Answers

1. Any three: skills or friendliness of the staff; reputation for good food; location (busy street or quiet road); a new café opening nearby; government decisions such as new food safety rules; working conditions and staff morale.
2. Depreciation: $20\% \times 30\,000 = 6\,000$ and $40\% \times 30\,000 = 12\,000$, that is \$6 000 and \$12 000. Profit: \$18 000 and \$12 000. Profit margins: $\frac{18\,000}{150\,000} \times 100 = \mathbf{12.00\%}$ and $\frac{12\,000}{150\,000} \times 100 = \mathbf{8.00\%}$. The trading is identical; only the depreciation method differs, so the profits can't be compared fairly (a difficulty of definition).
3. Assets are recorded at historic cost less depreciation, not at what they would sell for today; and things such as reputation, skilled staff and a good location have value but aren't recorded.
4. Any two: the statements describe a past year, and conditions change (prices, costs, demand); a competitor may open or close; government decisions may change taxes or rules; last year may not have been typical; key staff may leave.

Past questions to try

- 0452/12/M/J/25 Q32: which statement is a limitation of comparing two businesses' ratios.
- 0452/13/O/N/21 Q33: which option is not a limitation of inter-firm comparison.
- 0452/21/M/J/22 Q4: ratios for a trader, ending with two non-financial factors that affect her results.
- 0452/22/F/M/23 Q4: ratios and a pricing decision, ending with how the time gap after the year-end affects it.