

Analysis of published accounts A2

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What you need to know

By the end of this topic you should be able to:

1. **Liquidity.** Say what liquidity means and why it matters to a business.
2. Calculate and interpret the **current ratio** and the **acid test ratio**.
3. Explain **ways a business can improve its liquidity**.
4. **Profitability.** Say what profitability means and why it matters.
5. Calculate and interpret **return on capital employed (ROCE)**, the **gross profit margin** and the **profit margin** (exam questions also ask for the operating profit margin).
6. Explain **ways a business can improve its profitability**.
7. **Financial efficiency.** Say what it means and why it matters.
8. Calculate and interpret the **rate of inventory turnover**, **trade receivables turnover (days)** and **trade payables turnover (days)**.
9. Explain **ways a business can improve its financial efficiency**.
10. **Gearing.** Say what gearing means and why it matters; calculate and interpret the **gearing ratio**; explain **ways to change (improve) gearing**.
11. **Return to investors.** Say what it means and why it matters; calculate and interpret **dividend yield**, **dividend cover** and the **price/earnings (P/E) ratio**; explain **ways to improve the return to investors**.

You also need to be able to judge how far published accounts and ratio results can be trusted when someone uses them to make a decision.

Understand it

Published accounts and why ratios are needed

A bank deciding on a loan, a supplier deciding whether to give credit, or a saver thinking of buying shares cannot see inside a company. What they can see is the set of statements the company has to release each year: its **published accounts**. Limited companies are required by law to prepare a statement of profit or loss

and a statement of financial position (with notes and a directors' report) every year and send them to their shareholders; a public limited company's accounts can be read by anyone.

Raw figures on their own say little. A profit of 2 million dollars is excellent for a corner shop and a disaster for a car maker. A **ratio** compares two figures from the accounts, so that the result can be compared with the business's own past years, with its rivals, or with what it planned. The syllabus groups ratios into five families, each answering one question:

Family	The question it answers
Liquidity	Can the business pay the debts that fall due in the next year?
Profitability	How much profit does it make from its sales and its capital?
Financial efficiency	How quickly does it turn inventory into sales, and sales into cash?
Gearing	How much of its long-term finance is borrowed?
Investment	What return do shareholders get, and how much do they pay for it?

All the ratios below use one business. Kestrel Kayaks plc makes kayaks and sells them on credit to sports shops.

Kestrel Kayaks plc, year ended 31 December 2025	million dollars
Revenue (all on credit)	48.0
Cost of sales	(30.0)
Gross profit	18.0
Expenses	(13.2)
Operating profit	4.8
Interest	(0.8)
Tax	(1.0)
Profit for the year	3.0
Dividends paid	1.5

Kestrel Kayaks plc, at 31 December 2025	million dollars
Inventory (it was 6.6 a year earlier)	5.4
Trade receivables	4.8
Cash	1.8
Current assets	12.0
Trade payables	4.5
Bank overdraft	2.0
Tax owed	1.0

Kestrel Kayaks plc, at 31 December 2025**million dollars**

Current liabilities	7.5
Non-current liabilities (bank loans)	12.0
Issued share capital (20 million shares)	8.0
Reserves	20.0

Kestrel's share price at the year end was 1.80 dollars.

Liquidity

Liquidity is about timing: whether a business will have cash in hand when its short-term debts (wages, suppliers, an overdraft the bank wants back) fall due. A business can be profitable and still fail if the cash is tied up in unsold goods or unpaid invoices when a payment is due. Suppliers and banks look at liquidity before giving credit.

The **current ratio** compares everything that should turn into cash within a year with everything that must be paid within a year:

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}} = \frac{12.0}{7.5} = 1.6, \text{ written } 1.6 : 1$$

The **acid test ratio** is stricter. It leaves out inventory, because goods still have to be sold (and the buyer may then take weeks to pay) before they become cash:

$$\text{acid test ratio} = \frac{\text{current assets} - \text{inventory}}{\text{current liabilities}} = \frac{12.0 - 5.4}{7.5} = \frac{6.6}{7.5} = 0.88 : 1$$

Interpreting them. Kestrel has 1.60 dollars of current assets for every dollar it owes in the short term, but only 88 cents if it cannot sell any kayaks. A current ratio of about 1.5:1 to 2:1, and an acid test near 1:1, are often quoted as comfortable, but what is normal depends on the industry: a supermarket that is paid in cash at the till and pays its suppliers weeks later can run safely with low ratios. A ratio that is **too high** is not good news either: it can mean cash sitting idle or too much inventory, money that could have earned a return. A big gap between the two ratios shows that much of the business's liquidity depends on selling its inventory.

Ways to improve liquidity (each must raise liquid assets or cut current liabilities):

- **Collect from customers sooner**, by shorter credit terms, chasing late payers or discounts for paying early: trade receivables turn into cash. Customers may go to rivals that give longer credit.
- **Pay suppliers later**: cash stays in the business longer. Suppliers may refuse credit or withdraw discounts.
- **Hold less inventory** (for example with just-in-time ordering): less cash is spent on stock. A business can run out when demand rises.
- **Sell unused non-current assets**, or sell and lease them back: cash comes in. The business loses the asset, or pays rent for it.
- **Replace an overdraft with a long-term loan**: current liabilities fall. Interest is still paid, and gearing rises.
- **Cut or delay dividends**, or cut overheads: less cash goes out. Shareholders may be unhappy.

Selling inventory for cash raises the acid test (cash is counted, inventory is not), but it leaves the current ratio almost unchanged, because one current asset has turned into another.

Profitability

A profit figure alone does not show whether a business is doing well. **Profitability** compares that profit with something else: the capital that had to be invested to earn it (ROCE) or the revenue it came from (the margins). Shareholders want a return on their money, lenders want to be repaid from profit, and retained profit pays for growth.

Owners and lenders together have put long-term money into the business. **Return on capital employed (ROCE)** asks what that whole pool of money earned in a year, which is why analysts usually look at it first:

$$\text{ROCE} = \frac{\text{operating profit}}{\text{capital employed}} \times 100$$

$$\text{capital employed} = \text{issued share capital} + \text{reserves} + \text{non-current liabilities}$$

For Kestrel, capital employed = 8.0 + 20.0 + 12.0 = 40.0 million dollars, so ROCE = 4.8 ÷ 40.0 × 100 = 12%. Operating profit is used because it is the profit earned before any of it is paid out to the people who provided the capital: interest to lenders, dividends to shareholders.

Interpreting ROCE. Kestrel earns 12 cents a year for each dollar invested in it. Compare it with what that money could earn elsewhere: if a savings account paid 4%, investors are rewarded for the risk; Kestrel pays interest of 0.8 million dollars on 14 million dollars of borrowing (12 of loans plus a 2.0 overdraft), about 5.7%, so its borrowed money earns more than it costs, which adds to shareholders' returns. Compare it with past years and rivals to see if it is improving.

The **margins** show how much of each dollar of sales is left as profit at each stage:

$$\text{gross profit margin} = \frac{\text{gross profit}}{\text{revenue}} \times 100 = \frac{18.0}{48.0} \times 100 = 37.5\%$$

$$\text{operating profit margin} = \frac{\text{operating profit}}{\text{revenue}} \times 100 = \frac{4.8}{48.0} \times 100 = 10\%$$

$$\text{profit margin} = \frac{\text{profit for the year}}{\text{revenue}} \times 100 = \frac{3.0}{48.0} \times 100 = 6.25\%$$

Read the margins together. Kestrel keeps 37.5 cents of each sales dollar after paying for materials and production, but only 10 cents after its expenses. A high gross margin with a low operating margin points at **expenses** (rent, salaries, marketing); a falling gross margin points at **cost of sales or prices**.

Ways to improve profitability:

- **Raise prices** or add value (better design, branding): each sale earns more, but if demand is price elastic, sales volume may fall so far that profit falls.
- **Cut the cost of sales** with cheaper suppliers or materials, or less waste: quality and reputation may suffer.
- **Cut expenses**, for example fewer managers, cheaper premises or less advertising: staff morale and future sales may suffer.
- **Raise productivity** (training, better machinery, lean production): lower unit costs, but it costs money first.

- **Use capital better:** sell assets that earn nothing and repay debt with the money; capital employed falls, so ROCE rises even if profit is unchanged.

Financial efficiency

Financial efficiency is about speed: how fast inventory is sold, how fast credit customers pay, and how long the business itself takes to pay its suppliers. Together these decide how much cash is locked up in day-to-day trading. Cash tied up in stock or unpaid invoices cannot be used elsewhere, and slow-moving stock may go out of date.

The **rate of inventory turnover** is how many times a year the business sells and replaces its inventory:

$$\text{rate of inventory turnover} = \frac{\text{cost of sales}}{\text{average inventory}}, \quad \text{average inventory} = \frac{\text{opening} + \text{closing inventory}}{2}$$

Kestrel's average inventory is $(6.6 + 5.4) \div 2 = 6.0$, so inventory turnover = $30.0 \div 6.0 = 5$ times a year: on average a kayak waits $365 \div 5 = 73$ days before it is sold. If only one year's inventory is given, use it. The answer is a number of **times**, not dollars. A higher rate is usually better, but what is normal varies hugely: a baker sells its stock every day, a jeweller a few times a year.

Trade receivables turnover (days) is how long credit customers take, on average, to pay:

$$\text{trade receivables turnover} = \frac{\text{trade receivables}}{\text{credit sales}} \times 365 = \frac{4.8}{48.0} \times 365 = 36.5 \text{ days}$$

Trade payables turnover (days) is how long the business takes, on average, to pay its suppliers:

$$\text{trade payables turnover} = \frac{\text{trade payables}}{\text{credit purchases}} \times 365$$

Kestrel's credit purchases are not given, so use cost of sales: $4.5 \div 30.0 \times 365 = 54.75$, about 54.8 days.

Interpreting them. Kestrel is paid by the shops after about 37 days but pays its own suppliers after about 55: its suppliers are, in effect, financing its trade, which helps its cash flow. Receivables days much longer than the credit terms offered mean customers are paying late; payables days far beyond the agreed terms can damage relations with suppliers, and paying too fast may mean missing out on free credit.

Ways to improve financial efficiency: sell or clear slow-moving lines and order smaller, more frequent deliveries (inventory turns over faster); shorten credit terms, invoice promptly and chase late payers (receivables days fall); negotiate longer credit from suppliers (payables days rise, keeping cash longer). Each has a cost: running out of stock, losing customers, or upsetting suppliers.

Gearing

A business's long-term finance comes from two kinds of provider: its owners (share capital and retained profit) and its lenders (long-term loans). **Gearing** is the lenders' part of that total. Loans must be repaid and interest must be paid every year, whatever happens to profit; dividends to shareholders can be cut in a bad year. So the more highly geared a business is, the riskier it is for lenders and for shareholders.

$$\text{gearing ratio} = \frac{\text{non-current liabilities}}{\text{capital employed}} \times 100$$

For Kestrel, $12.0 \div 40.0 \times 100 = 30\%$.

Capital employed 40 (million dollars)		
8	20	12
Share capital	Reserves	Non-current liabilities
Equity 28 (owners' money)		Borrowed

$$\text{Gearing} = 12 \div 40 \times 100 = 30\%$$

$$\text{ROCE} = \text{operating profit } 4.8 \div 40 \times 100 = 12\%$$

Interpreting gearing. Above 50% is usually called **high gearing**: banks may refuse to lend more or charge higher interest, and a rise in interest rates or a fall in profit could leave little or nothing for shareholders. Kestrel's 30% is low to moderate, so it could probably borrow more. Gearing is not simply bad: when ROCE is well above the interest rate, borrowed money earns more than it costs and shareholders gain; owners who want to keep control may prefer loans to selling more shares.

Ways to change gearing. To **reduce** it: issue more shares and use the money to repay loans, retain more profit (reserves grow, so capital employed grows while debt does not), or sell assets to repay debt. To **raise** it, when borrowing is cheap and the business wants growth without giving up control: finance new projects with long-term loans rather than shares.

Investment ratios

Shareholders get a **return** in two ways: dividends paid out of profit, and a rise in the share price. Investment ratios help them judge whether the shares are a good buy, and help directors judge whether the company will attract the investors it needs, for example before a share issue.

Two figures come first:

$$\text{dividend per share} = \frac{\text{total dividends}}{\text{number of shares}} = \frac{1.5}{20} = 0.075 \text{ dollars}$$

$$\text{earnings per share (EPS)} = \frac{\text{profit for the year}}{\text{number of shares}} = \frac{3.0}{20} = 0.15 \text{ dollars}$$

Dividend yield is the cash return on the money a buyer would pay for a share today:

$$\text{dividend yield} = \frac{\text{dividend per share}}{\text{share price}} \times 100 = \frac{0.075}{1.80} \times 100 = 4.17\%$$

Dividend cover sets the year's profit against what was handed to shareholders; the bigger the result, the more profit was kept back:

$$\text{dividend cover} = \frac{\text{profit for the year}}{\text{total dividends}} = \frac{3.0}{1.5} = 2 \text{ times}$$

The **price/earnings ratio** is how many years of current earnings a buyer pays for in the share price:

$$\text{P/E ratio} = \frac{\text{share price}}{\text{earnings per share}} = \frac{1.80}{0.15} = 12$$

Interpreting them. Kestrel's yield of 4.17% can be compared with the interest on savings: a yield above it attracts investors who want income. A cover of 2 means half the profit was paid out and half retained; a high cover means the dividend is safe and could be raised, a cover near 1 (or below) means the company is paying out almost all (or more than) it earns, which cannot last. A high P/E means investors expect profits to grow, so they pay a lot for each dollar of today's earnings; a low P/E suggests little confidence, or a bargain.

Ways to improve the return to investors: raise profit (higher EPS, and usually a higher share price), pay out a larger share of profit as dividends (yield rises, but cover falls and less is retained for growth), and keep shareholders informed so confidence and the share price rise. A falling share price raises the yield on paper, which is not good news for existing shareholders.

Using ratios well, and their limits

A single ratio means little. It becomes useful when it is compared:

- **over time:** is Kestrel's ROCE rising or falling? Exam tables often put the most recent year in the **left** column, so read the headings first;
- **with other businesses** in the same industry;
- **with targets or forecasts**, or across the business (one product, one branch).

Ratio analysis and published accounts have limits that every evaluation should weigh:

- **They look backwards.** The figures describe last year; a new competitor, a recession or a new strategy can change everything.
- **One date only.** The statement of financial position shows a single day, and a business can arrange that day to look good (**window dressing**): collecting debts or delaying purchases just before the year end, or valuing inventory generously.
- **Comparisons can mislead.** Businesses value assets and inventory differently and have different year ends; inflation makes past figures look smaller.
- **No reasons.** A ratio shows what changed, never why. A falling margin might come from a price war or from a deliberate cut in prices to win market share.
- **No non-financial information:** staff skills and morale, brand, customer loyalty, the quality of products, environmental record.
- **Outsiders see a slimmed-down version.** Directors choose what to reveal beyond the legal requirements, and totals are grouped into a few broad lines, so a reader cannot see, for example, which product or branch made the profit; managers inside the business have far more detail.

Key facts and formulas

There is no formula list for this subject in the exam. "Learn it" means you must remember it.

Fact or formula	Status
Current ratio = current assets $\div$ current liabilities, written as $x : 1$	Learn it
Acid test ratio = (current assets – inventory) $\div$ current liabilities, written as $x : 1$	Learn it
Capital employed = issued share capital + reserves + non-current liabilities	Learn it
ROCE = operating profit $\div$ capital employed $\times 100$	Learn it
Gross profit margin = gross profit $\div$ revenue $\times 100$	Learn it
Operating profit margin = operating profit $\div$ revenue $\times 100$	Learn it
Profit margin = profit for the year $\div$ revenue $\times 100$	Learn it
Operating profit = revenue – cost of sales – expenses; profit for the year = operating profit – interest – tax	Learn it
Rate of inventory turnover = cost of sales $\div$ average inventory (times a year), where average inventory = (opening + closing inventory) $\div 2$	Learn it
Trade receivables turnover = trade receivables $\div$ credit sales $\times 365$ (days)	Learn it
Trade payables turnover = trade payables $\div$ credit purchases (or cost of sales) $\times 365$ (days)	Learn it
Gearing ratio = non-current liabilities $\div$ capital employed $\times 100$	Learn it
Dividend per share = total dividends $\div$ number of shares	Learn it
Earnings per share = profit for the year $\div$ number of shares	Learn it
Dividend yield = dividend per share $\div$ share price $\times 100$	Learn it
Dividend cover = profit for the year $\div$ total dividends (times)	Learn it

Fact or formula	Status
Price/earnings ratio = share price ÷ earnings per share	Learn it

How to do it

We have tagged 34 questions on this topic, from 2021 to 2026 (February/March 2026 included). 22 of them mix more than one type (usually a calculation followed by a 12-mark evaluation), so the counts add up to 73.

Question type	Questions
Calculate a profitability ratio	12
Evaluate the usefulness of ratios, published accounts or financial data	12
Use ratio results to evaluate or recommend a decision	11
Calculate the gearing ratio	9
Calculate an investment ratio	8
Calculate a liquidity ratio	7
Calculate a financial efficiency ratio	4
Explain or evaluate ways to improve liquidity, profitability or efficiency	4
Evaluate business performance from ratio trends	2
Explain limitations of published accounts	2
Define published accounts or explain why one ratio is useful	2

The written answers are marked for four skills: **K** (knowledge), **App** (application to the business in the case), **An** (analysis: chains of causes and consequences) and **Eval** (evaluation: a supported judgement). Below, (K), (App), (An) and (Eval) after a sentence show the mark it earns; (1) in a calculation is one mark.

How calculation marks work. The marks build up: the formula earns 1 if nothing else is right, then a correct step (capital employed, operating profit, profit for the year), then the figures put into the formula, then the answer. A correct answer with no working gets full marks, but a wrong answer with no working usually gets nothing, so always show each step. If a later part uses your earlier answer, you are marked on your own figure. Using the wrong year usually limits you to 1 mark out of 2, or 2 out of 3.

1. Calculate a profitability ratio (12 questions)

Paper 3, 1–4 marks: ROCE, the operating profit margin, or the profit margin, from a table of the business's figures.

1. **Write the formula** in words (1 mark if nothing else scores).

2. **ROCE**: first add up capital employed from the table: issued shares + reserves + non-current liabilities (1). If the table gives "shareholders' equity", that already contains shares and reserves.
 3. **Operating profit margin** when operating profit is not given: write operating profit = revenue — cost of sales — expenses (1), work it out (2), then put it into the margin formula (3).
 4. Substitute and give the answer **as a percentage** with the % sign, to 1 or 2 decimal places (last mark). Round correctly rather than cutting digits off: in November 2024 an operating margin truncated to 4.62% instead of 4.63% earned 3 of 4.
- Use **operating profit** for ROCE and the operating margin, and **profit for the year** for the profit margin. Using profit for the year in ROCE loses marks.
 - Leaving reserves or the loans out of capital employed loses the answer mark, but the formula and working still score.
 - A forecast question (next year's ROCE) works the same way with the forecast figures.

2. Evaluate the usefulness of ratios, published accounts or financial data (12 questions)

Paper 3, [12]: 2 K, 2 App, 2 An and 6 Eval, marked by level (the 2021–2022 papers used 2 K, 2 App, 4 An, 4 Eval). Paper 1 asks the same thing as a 12- or 20-mark essay without a case; Paper 4 as a 20-mark question. The case names a user (directors, a bank, people thinking of buying or selling shares) and a decision.

1. **K (2)**: what the ratios (or the accounts) measure, and what the user wants to know.
2. **App (2)**: quote the case's ratios or your own answers from the calculation parts **inside** a point. A figure that is only copied out earns nothing.
3. **An (2)**: one developed chain: what the figure shows → what it means for this user → how it points the decision one way.
4. **Eval (6)**: the other side, in context: what the figures cannot show (why things changed, the future, non-financial factors, competitors), only one or two years, no comparison with rivals, window dressing, forecasts that may be wrong. End with a judgement: how far the data helps, which figure matters most for this decision, and what else the user needs.

3. Use ratio results to evaluate or recommend a decision (11 questions)

Paper 3, [12], after the calculations (2 K, 2 App, 2 An, 6 Eval; the own-figure rule applies). The decisions asked so far: how to finance an expansion or takeover (loan or new shares), whether to become a plc, whether to raise dividends, whether to accept an offer or a joint venture, whether existing shareholders should invest more. Paper 4 ([20]: up to 3 K, 2 App, 8 An, 7 Eval) asks how ratio results steer the choice between strategies.

1. **K (2)**: the decision's key terms (a loan, a share issue, a plc, a dividend) and what the relevant ratio shows.
2. **App (2)**: use the ratios as evidence: gearing near or above 50%, dividend cover, liquidity, ROCE against the interest rate.
3. **An (2)**: follow the evidence through to **cost, risk and control**: more borrowing → higher gearing and interest → less profit for dividends; a share issue → no interest, but control shared with new owners.

4. **Eval (6)**: weigh the arguments, recommend clearly, and say what the decision depends on (the owners' attitude to control and risk, interest rates, how soon the money is needed, whether forecasts can be trusted).
- Work out a **forecast** ratio when it helps: add a new loan to non-current liabilities **and** to capital employed, then recalculate gearing.
 - In Paper 4, knowing a ratio's formula alone is limited knowledge: explain what the ratio is used for. Without a knowledge mark nothing else scores.

4. Calculate the gearing ratio (9 questions)

Paper 3, 2–4 marks.

1. Formula: $\text{non-current liabilities} \div \text{capital employed} \times 100$ (1).
 2. Capital employed = shares + reserves + non-current liabilities (or equity + non-current liabilities) (1).
 3. Substitute (next mark), answer as a % (last mark).
- **Forecast gearing** after new borrowing: the loan goes into both the top and the bottom of the fraction.
 - In June 2025 a gearing figure without its % sign lost a mark; always write it.

5. Calculate an investment ratio (8 questions)

Paper 3, 1–4 marks: dividend cover, dividend yield, the P/E ratio, or the change in one of them.

1. **Dividend cover**: if only operating profit is given, first find profit for the year = operating profit – interest – tax (1), state the formula (2), then divide by the total dividends. The answer is in **times**: adding a dollar sign, m or % costs a mark. Using operating profit instead of profit for the year scores only 2 of 4.
2. **Dividend yield**: if only total dividends are given, first find the dividend per share; then $\div \text{share price} \times 100$, as a %.
3. **P/E**: $\text{share price} \div \text{earnings per share}$ (EPS may need working out first). One-mark questions want only the answer.
4. **Change between years**: work out each year's ratio, then subtract. A change in a percentage is given in **percentage points** (a yield falling from 6% to 4.5% is a fall of 1.5 percentage points).

6. Calculate a liquidity ratio (7 questions)

Paper 3 (1–2 marks) and Paper 2 (3–4 marks).

1. Add up current assets and current liabilities if the table lists the items separately.
2. **Acid test**: take inventory out of current assets first. If the table already gives "liquid assets", use that figure directly.
3. Give the answer **as a ratio**, $x : 1$ (for example 1.25:1). On a one-mark current ratio, adding a dollar sign or "m" scored nothing.

- A one-mark current ratio has no method mark: the answer is right or wrong.
- Paper 2 can follow up by asking how the acid test helps a manager [2]: one use, such as testing whether the business could still settle everything it owes within the year if its stock proved hard to sell (K), then linked to the case's own figures, for example how its result sits against a benchmark the case gives for similar firms (App).

7. Calculate a financial efficiency ratio (4 questions)

Paper 3, 2–3 marks.

1. **Inventory turnover**: $\text{cost of sales} \div \text{inventory}$, using the average of the opening and closing figures when both are given. Give the answer in **times** unless days are asked for (in March 2026 an answer in days earned only 1 of 2).
2. **Trade receivables turnover**: $\text{trade receivables} \div \text{credit sales} \times 365$, in **days** (revenue if credit sales are not given).
3. Formula (1), substitution (next mark), answer with the right unit (last mark). A dollar sign or % instead of days or times costs a mark.

8. Explain or evaluate ways to improve liquidity, profitability or efficiency (4 questions)

Paper 3, [12] (2 K, 2 App, 2 An, 6 Eval): ways to raise profitability or liquidity, or why financial efficiency matters to the business's plans. Paper 2, [3]: a single liquidity method, explained for the case's business.

1. **K**: what the ratio family measures, and two methods.
 2. **App**: tie each method to the case: its ratios, its products, its customers and suppliers.
 3. **An**: complete the chain from the method to the ratio: "chase late payers → cash comes in sooner → liquid assets rise → the acid test improves". Naming a method without saying how it raises cash or lowers current liabilities is incomplete.
 4. **Eval**: each method's drawback for this business (lost customers, upset suppliers, lower quality, morale, the firm's social aims), which method is best, and why.
- Paper 2 [3]: name a method (1), explain how it improves liquidity (2), in the context of the case (3).

9. Evaluate business performance from ratio trends (2 questions)

Paper 3 [12] (for example, judging a year's results from the shareholders' side) or Paper 4 [20] (several years of ratios tied to a strategy).

1. Read each trend: up or down, by how much, and over how long.
2. Analyse both sides: which ratios improved and why that matters to the stakeholder named, which got worse.
3. Judge: short term against long term, and what outside factors (inflation, wages, competition) might explain the figures.

10. Explain limitations of published accounts (2 questions)

Paper 1, 3–5 marks, no case. Explain **why** each limitation can mislead, not just name it: in the 5-mark version, describing only earns 1, an explanation 2–3, and an effective explanation 4–5; in the 3-mark version, two limitations each soundly explained earn all 3. Use the list under "Using ratios well, and their limits".

11. Define published accounts or explain why one ratio is useful (2 questions)

- **Define "published accounts" [2]:** two separate points, for example that they are financial statements (such as the statement of profit or loss), and that limited companies must produce them each year for their shareholders.
- **Why one ratio is useful [2]:** one use, then applied to the case (see type 6).

Worked examples

Example 1

Fernhill Furniture Ltd makes sofas and sells them to furniture stores, which are given 30 days to pay. Figures for the year ended 31 December 2025 (thousand dollars): revenue 3,650 (all on credit); cost of sales 2,190; inventory 380 at the start of the year and 350 at the end; trade receivables 480; cash 70; trade payables 300; bank overdraft 100; tax owed 100.

- Calculate Fernhill's current ratio. [1]
- Calculate Fernhill's acid test ratio. [2]
- Calculate Fernhill's trade receivables turnover (days). [2]
- Calculate Fernhill's rate of inventory turnover. [3]
- Using your answer to (c), explain how Fernhill could raise its cash balance. [3]

(a) Current assets = $350 + 480 + 70 = 900$; current liabilities = $300 + 100 + 100 = 500$. Current ratio = $900 \div 500 = 1.8 : 1$ (1).

(b) $(900 - 350) \div 500 = 550 \div 500$ (1) = 1.1 : 1 (2).

(c) $480 \div 3650 \times 365$ (1) = 48 days (2).

(d) Rate of inventory turnover = cost of sales $\div$ average inventory (1). Average inventory = $(380 + 350) \div 2 = 365$, so $2190 \div 365$ (2) = 6 times (3).

(e) Fernhill could chase the stores to pay within the 30 days it allows (1). Cash would come in sooner, so its cash balance would rise and its liquid assets would cover more of its short-term debts (2). Its stores take 48 days, not 30: if they paid on time, trade receivables would be $3650 \times 30 \div 365 = 300$ thousand dollars

instead of 480, bringing in 180 thousand dollars of cash, more than enough to clear its 100 thousand dollar overdraft (3).

Example 2

Ridgeway Cycles plc makes bicycles. Extracts from its accounts:

Year ended 31 March 2026	million dollars
Revenue	64.0
Cost of sales	38.4
Expenses	17.6
Interest	1.4
Tax	1.6
Total dividends paid	2.0

At 31 March 2026	million dollars
Issued share capital	8.0
Reserves	24.0
Non-current liabilities	18.0

(a) Calculate Ridgeway's operating profit margin for 2025–26. [4]

(b) Calculate Ridgeway's return on capital employed (ROCE). [3]

(c) Ridgeway plans to borrow a further 20 million dollars with a 10-year bank loan. Calculate its forecast gearing ratio if it does, assuming nothing else changes. [3]

(d) Calculate Ridgeway's dividend cover. [4]

(a) Operating profit = revenue – (cost of sales + expenses) (1) = $64.0 - 38.4 - 17.6 = 8.0$ million dollars (2). Operating profit margin = operating profit ÷ revenue × 100 (3) = $8.0 \div 64.0 \times 100 = 12.5\%$ (4).

(b) Capital employed = $8.0 + 24.0 + 18.0 = 50.0$ million dollars (1). ROCE = $8.0 \div 50.0 \times 100$ (2) = 16% (3).

(c) Non-current liabilities become $18.0 + 20.0 = 38.0$ and capital employed $50.0 + 20.0 = 70.0$ million dollars (1). Gearing = $38.0 \div 70.0 \times 100$ (2) = 54.3% (3). (Today it is $18.0 \div 50.0 \times 100 = 36\%$.)

(d) Profit for the year = operating profit – interest – tax = $8.0 - 1.4 - 1.6 = 5.0$ million dollars (1), and dividend cover = profit for the year ÷ total dividends (2). $5.0 \div 2.0$ (3) = 2.5 times (4).

Example 3

Use your answers to Example 2. Ridgeway wants to build a factory for electric bikes costing 20 million dollars. The finance director proposes the 10-year bank loan at 7% interest a year. The other option is a share issue at about 2.50 dollars a share. Ridgeway has 40 million shares, and the founding family owns 22 million of them and wants to keep control. Sales of electric bikes in Ridgeway's country are forecast to grow by 15% a year, but two rival makers are also building factories.

Evaluate the case for paying for the new factory with the loan rather than the share issue. **[12]**

The gearing ratio shows what share of a business's long-term finance is borrowed; above 50% a business is usually seen as highly geared and risky to lend to (K). A bank loan must be repaid with interest whatever the profit, while new shares never have to be repaid but share ownership and future dividends with the new shareholders (K).

The case against the loan. The loan would raise Ridgeway's gearing from 36% to 54.3% (App), taking it past the level at which lenders start to see it as high risk. Interest of 7% on 20 million dollars is 1.4 million dollars a year, doubling its interest bill to 2.8 million dollars (App). On this year's operating profit of 8.0 million dollars, profit before tax would fall from 6.6 to 5.2 million dollars before the factory earns anything, leaving less profit to cover the dividend and to retain for future growth; if the rivals' factories start a price war, the interest still has to be paid (An).

The case for the loan. The alternative is worse for the owners' control: at 2.50 dollars a share, 20 million dollars means 8 million new shares, and the family's 22 million would fall from 55% of 40 million to $22 \div 48 = 45.8\%$, losing its majority (Eval). The loan is also cheap compared with what Ridgeway earns: its ROCE is 16% while the loan costs 7%, so if the factory earns the same return on its 20 million dollars, about 3.2 million dollars a year, it would more than cover the 1.4 million dollars of interest, and the extra profit would all belong to the existing shareholders (Eval).

Judgement. Ridgeway should use the loan, because keeping the family's control matters to its owners and the factory should earn more than the loan costs (Eval). But this depends on the 15% growth forecast: with two rivals adding capacity at the same time, prices could fall and the new factory could earn well below 16% (Eval). Ridgeway could reduce the risk by borrowing less than the full 20 million dollars and paying part from its retained profit, which would keep gearing nearer 50%, or by negotiating a fixed interest rate so that a rise in rates cannot squeeze profit further (Eval).

The marks: 2 K for gearing and the two sources; 2 App for the forecast gearing and the extra interest, both used in the argument; 2 An for the developed chain from interest to profit and dividends; 6 Eval for the counter-argument on control, the ROCE comparison, and a judgement that depends on Ridgeway's own facts.

Example 4

Lumen Print Ltd prints labels and packaging for food producers. In 2025 it bought a new printing press with a five-year bank loan, and in the middle of 2025 its largest customer moved its orders to a rival printer. Lumen has asked its bank to raise its overdraft limit. The bank has calculated these ratios from Lumen's published accounts:

Ratio	2025	2024
Current ratio	1.2:1	1.6:1
Acid test ratio	0.55:1	0.95:1
Trade receivables turnover	52 days	38 days
Operating profit margin	7%	10%
ROCE	9.5%	11%
Gearing	41%	28%

Evaluate how far these ratios can guide the bank's decision on Lumen's overdraft. **[12]**

Ratio analysis compares figures from the accounts so that a business's liquidity, profitability and debts can be judged against earlier years (K). For a bank lending on overdraft the key question is liquidity: whether the business can pay its short-term debts from assets that are quickly turned into cash (K).

What the ratios tell the bank. Lumen's acid test fell from 0.95:1 to 0.55:1 in a year (App), so it now has only 55 cents of liquid assets for each dollar it owes in the short term. If its suppliers and the bank all asked to be paid at once, Lumen could not pay them without first selling inventory, so a bigger overdraft would be lent to a business already short of cash, and the bank's risk of not being repaid rises (An). Customers now take 52 days to pay instead of 38 (App), which tells the bank where part of the cash has gone: it is tied up in unpaid invoices, so the overdraft may be paying for slow collection rather than for growth (An).

What they cannot tell the bank. The ratios show that things got worse, not why or whether it will last. Losing its largest customer in mid-2025 probably explains much of the fall in margin and ROCE; if Lumen has since won new customers, the 2025 figures may overstate the problem (Eval). Gearing rose from 28% to 41% because of the loan for the new press, which looks riskier, but the press may cut printing costs and raise margins in future years, which no ratio from 2025 can show (Eval). The figures also come from a single year-end date and only two years, with no comparison with other printers, so the bank cannot tell whether an acid test of 0.55:1 is unusual for this kind of business (Eval).

Judgement. The ratios are very useful to the bank as warning signs: the fall in the acid test and the slower collection from customers are exactly what a lender of short-term money needs to see (Eval). But they are not enough to decide on their own. Before raising the limit the bank should ask for a cash-flow forecast, Lumen's plan for replacing its lost customer, and the list of customers who owe it money, to see whether the slow payers are likely to pay in the end (Eval). If Lumen can show new orders and faster collection, the bank could raise the limit for a short period and review it, rather than refusing because of figures that may describe a bad year that is already past (Eval).

The marks: 2 K for ratio analysis and liquidity; 2 App for the acid test and receivables figures used in the argument; 2 An for the developed chain from low liquidity to the bank's risk; 6 Eval for the limits of the figures, weighed in Lumen's context, and a judgement on how far they help and what else the bank needs.

Common mistakes

- **Leaving part of capital employed out.** Examiners reported this year after year (2021, 2022, 2023): reserves (retained earnings) were often missed, and when the case gave shares, reserves and loans as separate lines, many answers left one of them out of the total. Capital employed is shares **plus** reserves **plus** non-current liabilities.
- **Not knowing the formula.** On one June 2023 paper (Paper 31) most candidates could not write the ROCE formula; in November 2021 many used a wrong formula for dividend cover, and in November 2022 a significant minority turned the inventory turnover formula upside down. With no formula and a wrong answer, a calculation scores nothing.
- **Leaving a calculation blank.** In several papers between a tenth and a fifth of candidates skipped a ratio. Writing the formula alone usually earns a mark, and a correct capital employed earns another.
- **Answers without the right unit.** Margins, ROCE and gearing are percentages; liquidity ratios are written $x : 1$ (a fraction left unfinished is not a ratio); inventory turnover is in times; receivables and payables turnover are in days. Putting a dollar sign or "m" on a ratio usually loses a mark, or every mark for a one-mark answer.
- **Confusing the acid test with the current ratio.** Many candidates forgot to take inventory away. When a table gives the liquid assets figure directly, use it: subtracting it from current assets gives inventory, not the acid test numerator.
- **Using the wrong profit.** ROCE and the operating margin need operating profit; dividend cover and the profit margin need profit for the year (work it out from operating profit – interest – tax if needed).
- **Skipping the dividend per share.** In June 2022 the most common error in the dividend yield was not working out the dividend per share before dividing by the share price.
- **Reading a table the wrong way round.** Accounts often put the latest year first. In March 2023 some candidates read rises as falls; check the column headings.
- **Copying ratios without explaining them.** Lifting a figure from the table ("ROCE is 9%") and moving on earns nothing in a 12-mark answer unless you show what that ratio means for the decision: risk, interest, the chance of more borrowing.
- **Only one side.** Usefulness answers often list what the ratios show and stop. The evaluation marks come from what they cannot show and from a judgement in the case's context.
- **An unfinished method.** In a "ways to improve liquidity" answer, say how the method brings cash in or reduces current liabilities, and which ratio it moves.

How to get the marks

- **Command words.** *Calculate*: formula, working, answer with its unit. *Explain*: the point, how it works, and the case. *Evaluate*: both sides and a supported judgement for this business. *Recommend* or *Advise*: a clear choice for the person in the case, with reasons and what it depends on. *Discuss* (Paper 1): arguments for and against a view, then how far you agree.
- **Show every step** of a calculation, and keep your working even when you think it is wrong: later parts are marked on your own figure.

- **Round sensibly:** two decimal places for ratios, one or two for percentages, whole or one-decimal days. Use the year the question asks for.
- **Put the case's numbers to work.** An application mark is earned when a ratio supports an argument, not when it is copied out. In Paper 4, application in context only counts when it is linked to knowledge, analysis or evaluation.
- **Explain what each ratio means for the decision:** high gearing → harder or dearer to borrow; high dividend cover → room to raise the dividend; low acid test → may struggle to pay suppliers.
- **Balance and judge in context.** The top evaluation level needs judgements built on this business's own facts (its owners, plans, figures); a conclusion with no facts from the case is capped at the middle level. Say what the decision depends on, and which figure matters most.
- **Name the limits of the data** in every usefulness answer: historic, one date, few years, no industry comparison, window dressing, forecasts, non-financial factors.

Quick check

1. A company has 25 million shares, a share price of 4.50 dollars, profit for the year of 6 million dollars and total dividends of 2.5 million dollars. Calculate its earnings per share, P/E ratio, dividend yield and dividend cover.
2. Last year a company paid a dividend of 0.12 dollars a share when its share price was 3.00 dollars. This year it paid 0.10 dollars a share and the share price is 4.00 dollars. Calculate the change in the dividend yield.
3. A shop has current assets of 720,000 dollars (including inventory of 270,000 dollars) and current liabilities of 480,000 dollars. It uses 120,000 dollars of cash to pay off part of its overdraft. Calculate the current ratio and acid test ratio before and after, and say whether its liquidity has improved.
4. A business has operating profit of 2.7 million dollars and capital employed of 30 million dollars. It sells an unused warehouse for 3 million dollars and uses the money to repay part of a long-term loan; operating profit does not change. Calculate its ROCE before and after, and explain why it changed.
5. A supplier is deciding whether to give 60 days' credit to a new trade customer, using the customer's latest published accounts. Explain two reasons why those accounts might mislead the supplier. [3]

Answers

1. $\text{EPS} = 6 \div 25 = 0.24$ dollars. $\text{P/E} = 4.50 \div 0.24 = 18.75$. Dividend per share $= 2.5 \div 25 = 0.10$ dollars, so dividend yield $= 0.10 \div 4.50 \times 100 = 2.22\%$. Dividend cover $= 6 \div 2.5 = 2.4$ times.
2. Last year $0.12 \div 3.00 \times 100 = 4\%$; this year $0.10 \div 4.00 \times 100 = 2.5\%$. The yield fell by 1.5 percentage points (partly because the share price rose, which existing shareholders will welcome).
3. Before: current ratio $720 \div 480 = 1.5 : 1$; acid test $(720 - 270) \div 480 = 450 \div 480 = 0.94 : 1$. After: current assets $= 600$ and current liabilities $= 360$ (thousand dollars), so the current ratio is $600 \div 360 = 1.67 : 1$, but the acid test is $(600 - 270) \div 360 = 330 \div 360 = 0.92 : 1$. The current ratio looks better, yet the shop has less cash and the acid test is slightly worse: paying off debt with cash does not by itself improve liquidity.
4. Before: $2.7 \div 30 \times 100 = 9\%$. After: capital employed $= 30 - 3 = 27$ million dollars, so $\text{ROCE} = 2.7 \div 27 \times 100 = 10\%$. The same profit is now earned from less capital, because an asset that earned nothing has been turned into a smaller debt.
5. The accounts describe the past: they may be many months old by the time the supplier reads them, and if the customer has since lost sales or taken on new debts, its liquidity could be far worse than the figures suggest, so the supplier might give 60 days' credit to a business that cannot pay. They show one chosen date: the customer could make its year-end position look stronger, for example by delaying purchases until just after the year end so that its cash looks higher, so a healthy-looking acid test may not reflect the rest of the year. Two limitations, each explained with why it misleads this supplier, earn all 3 marks.

Past questions to try

- **9609/33/O/N/24 Q4**: the change in dividend yield between two years, then judging the year's financial results from the shareholders' side.
- **9609/31/M/J/23 Q4**: a forecast ROCE, then how far the figures can support a decision about launching a new range.
- **9609/32/O/N/24 Q4**: an operating profit margin that needs operating profit worked out first, then ways to raise profitability.
- **9609/12/O/N/22 Q3**: the ways published accounts can paint a false picture of how a business is doing.