

Financial statements A2

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Read first: **Business finance**, **Costs**

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What you need to know

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

1. **Statement of profit or loss.** Say what it is and why a business prepares it.
2. Know the lines it contains, in order: **revenue**, **cost of sales**, **gross profit**, **expenses**, **profit from operations** (operating profit), **taxation**, **profit for the year**, **dividends** and **retained earnings**.
3. **Amend a statement of profit or loss** when a figure is wrong or missing, and work out every line below it again.
4. **Explain the impact of a change** (a price rise, a higher cost, an extra expense) on the lines of the statement of profit or loss.
5. **Statement of financial position.** Say what it is and why a business prepares it.
6. Know what it contains: **non-current assets**, **current assets**, **current liabilities**, **net current assets**, **net assets**, **non-current liabilities**, **reserves** and **equity**.
7. **Amend a statement of financial position** when something changes, keeping it in balance.
8. **Link the two statements:** show how items in the statement of profit or loss (retained earnings, depreciation, closing inventory, tax) also appear in the statement of financial position.
9. **Explain why inventory is difficult to value.**
10. **Use the net realisable value (NRV) method** to value inventory.
11. **Explain the role of depreciation** in the accounts.
12. **Work out straight-line depreciation** and explain its effect on both statements. Only the straight-line method is needed.

The exam evidence is thin: this topic has been tagged in only two questions, a Paper 3 question in **2021** (inventory valuation) and a Paper 4 question in **2026** (how useful financial statements are when planning a strategy). Expect any of the points above, including calculations on the two statements and depreciation, which have not been asked yet.

Understand it

Why businesses produce financial statements

Owners, lenders, suppliers, employees and the tax authorities all want to know two things about a business: **did it make money this year**, and **what is it worth right now**? Financial statements answer these questions in a standard format, so that one business can be compared with its own past years and with other businesses. Limited companies are required by law to prepare them, and their figures are the starting point for ratio analysis (the next topic).

The two main statements answer different questions:

- the **statement of profit or loss** is like a video: it adds up everything that happened in the business's trading from the first day of its financial year to the last;
- the **statement of financial position** describes **one moment** (the last day of that year): it is like a photograph.

The statement of profit or loss

The statement of profit or loss starts with everything the business earned from selling its goods or services, and then takes away its costs in stages. Each stage gives a different measure of profit, and the final lines show where that profit went.

Pinecone Joinery Ltd makes kitchen cabinets. Its statement of profit or loss:

Pinecone Joinery Ltd, year ended 31 March 2026	dollars
Revenue	600,000
Cost of sales	(240,000)
Gross profit	360,000
Expenses (including depreciation of 20,000 on its machine)	(290,000)
Profit from operations (operating profit)	70,000
Interest on its bank loan	(6,000)
Profit before tax	64,000
Taxation (25%)	(16,000)
Profit for the year	48,000
Dividends paid to shareholders	(18,000)
Retained earnings for the year	30,000

Brackets mean the figure is taken away. Line by line:

- **Revenue** (sales turnover) is the value of everything sold in the year: price $\times$ quantity sold. It counts sales made on credit too, even if customers have not paid yet.
- **Cost of sales** is the cost of the goods that were actually sold, such as materials and the wages of the people who make the product. It is not simply what the business bought in the year, because some of what it bought is still unsold at the end of the year:

$$\text{cost of sales} = \text{opening inventory} + \text{purchases} - \text{closing inventory}$$

For Pinecone, $30000 + 250000 - 40000 = 240000$.

- **Gross profit** = revenue – cost of sales. It shows how much the business makes from trading before its running costs.
- **Expenses** (overheads) are the costs of running the business that are not part of making the product: rent, salaries of office staff, marketing, insurance, and depreciation.
- **Profit from operations** (operating profit) = gross profit – expenses. It shows how well the core business is managed, before any tax and interest. A business with loans pays interest on them, which is taken off next.
- **Taxation** is the tax on profit owed to the government. What remains is the **profit for the year**, which belongs to the owners.
- **Dividends** are the part of the profit for the year that a company pays out to its shareholders. The rest is the **retained earnings** for the year: profit kept in the business to pay for growth, to repay debts, or as a cushion against a bad year.

The statement of financial position

The statement of financial position lists, at the close of one day, the things of value that the business controls (**assets**), what it still has to pay to others (**liabilities**), and the part that is left for its owners (**equity**).

Pinecone's, at the same year end:

Pinecone Joinery Ltd, at 31 March 2026	dollars
Non-current assets (land and its machine)	310,000
Inventory	40,000
Trade receivables	35,000
Cash	15,000
Current assets	90,000
Trade payables	29,000
Tax owed	16,000
Current liabilities	45,000
Net current assets (current assets – current liabilities)	45,000
Non-current liabilities (bank loan repayable in 2032)	(120,000)

Pinecone Joinery Ltd, at 31 March 2026	dollars
Net assets	235,000
Share capital	150,000
Reserves (retained earnings)	85,000
Total equity	235,000

- **Non-current assets** are kept and used for more than a year to run the business: land, buildings, machinery, vehicles. They are not bought to be sold.
- **Current assets** are expected to turn into cash within a year: **inventory** (materials, partly finished goods and finished goods), **trade receivables** (customers who bought on credit and still owe money) and **cash**.
- **Current liabilities** must be paid within a year: **trade payables** (suppliers who have not yet been paid), a bank overdraft, and tax owed.
- **Net current assets** = current assets – current liabilities. This is the business's **working capital**: whether its short-term assets can cover its short-term debts. Pinecone has $90000 - 45000 = 45000$ dollars.
- **Non-current liabilities** are debts due after more than a year, such as long-term bank loans.
- **Net assets** = non-current assets + net current assets – non-current liabilities. For Pinecone, $310000 + 45000 - 120000 = 235000$ dollars. It is the same as total assets minus total liabilities: $400000 - 165000 = 235000$.
- **Equity** is the owners' claim on the business: **share capital** (the money shareholders put in) plus **reserves**, mainly the profits retained over all the years since the business started.

The statement **balances**: net assets always equal total equity, because whatever the business holds (after paying everyone it owes) belongs to its owners. If your two totals differ, an item is missing or in the wrong place.

How the two statements are linked

The two statements are prepared from the same records, so several figures move between them:

In the statement of profit or loss	In the statement of financial position
Retained earnings for the year (30,000)	Added to reserves: last year's 55,000 becomes $55000 + 30000 = 85000$
Closing inventory (subtracted in cost of sales)	Inventory, a current asset (40,000)
Depreciation, an expense (20,000)	Takes the same amount off the non-current assets
Taxation not yet paid (16,000)	Tax owed, a current liability
Revenue from credit sales not yet paid for	Trade receivables, a current asset
Interest on a loan	The loan itself is a non-current liability

This is why a change in one statement nearly always changes the other. If Pinecone had made 10,000 dollars more operating profit, retained earnings, reserves and therefore equity would all be higher, and so would net assets (through more cash or receivables).

Amending a statement, and the impact of a change

To **amend** a statement, change the figure that was wrong, then work down every line below it: one change in an early line moves every later total. A change usually affects some lines and not others:

Change	Gross profit	Operating profit	Profit for the year
Selling price rises (same quantity sold)	Up	Up	Up
Materials become more expensive	Down	Down	Down
Rent or advertising rises	No change	Down	Down
Extra depreciation charged	No change	Down	Down
Closing inventory valued lower	Down	Down	Down
Higher dividend paid	No change	No change	No change (retained earnings fall)

On the statement of financial position, a change must keep it balanced: every change affects **at least two** items. Buying a machine with cash raises non-current assets and lowers current assets by the same amount, so net assets do not change. Buying it with a long-term loan raises non-current assets and non-current liabilities. Total equity changes only through reserves (a profit raises them; a loss or a dividend paid to shareholders lowers them) or when new share capital is issued.

Valuing inventory

Inventory has to be given a value in the statement of financial position, and that value also sets cost of sales and so gross profit. The usual rule is to value inventory at **the lower of what it cost and its net realisable value**. Accountants are cautious (prudent): goods should never be shown as worth more than the business can actually get for them.

Net realisable value (NRV) is what the business would really end up with from selling the goods: the price it expects to get, after deducting any costs it still has to pay to make the sale, such as repairs, repackaging, delivery or a sales agent's commission.

$$\text{NRV} = \text{expected selling price} - \text{costs of selling}$$

Suppose 12 of Pinecone's finished cabinets cost 900 dollars each to make, but they have a scratch and will now sell for only 820 dollars each after 70 dollars of refinishing. $\text{NRV} = 820 - 70 = 750$ dollars, below the cost of 900, so each is valued at 750. The inventory is $12 \times 750 = 9000$ dollars instead of $12 \times 900 = 10800$ dollars. The 1,800 dollar fall reduces current assets, raises cost of sales, and so cuts gross profit and every profit line below it. If goods cannot be sold at all, or would cost more to sell than they would fetch, they are valued at nothing.

Why inventory is difficult to value:

- **The selling price is a guess.** NRV depends on the price the goods will fetch in future, which can change with fashion, new technology, competitors' prices or the economy.
- **Goods lose value over time.** Food goes off, fashion goes out of style, electronics are replaced by newer models; the same item is worth less each month it stays unsold.
- **Costs of selling are hard to estimate**, for example how much repair or discounting it will take to clear old items.
- **Counting and condition.** Thousands of items have to be counted and checked; some may be damaged, stolen or missing.
- **It is a judgement**, so managers can be tempted to value inventory high to make profit and assets look better (window dressing), for example before asking a bank for a loan. A higher closing inventory means a lower cost of sales and a higher profit.
- **Timing of the stock-take.** Inventory is counted on the last day of the year. A business whose stock builds up before a busy season, or runs down after it, will report a very different figure depending on when its year ends.

Depreciation

Pinecone bought its machine on 1 April 2025 for 110,000 dollars, and will use it for years. Charging its whole cost as an expense in the year it was bought would make that year's profit look very poor and later years' look too good. **Depreciation** spreads the cost of a non-current asset over the years it helps to earn revenue, as it wears out or goes out of date.

Its **role** in the accounts:

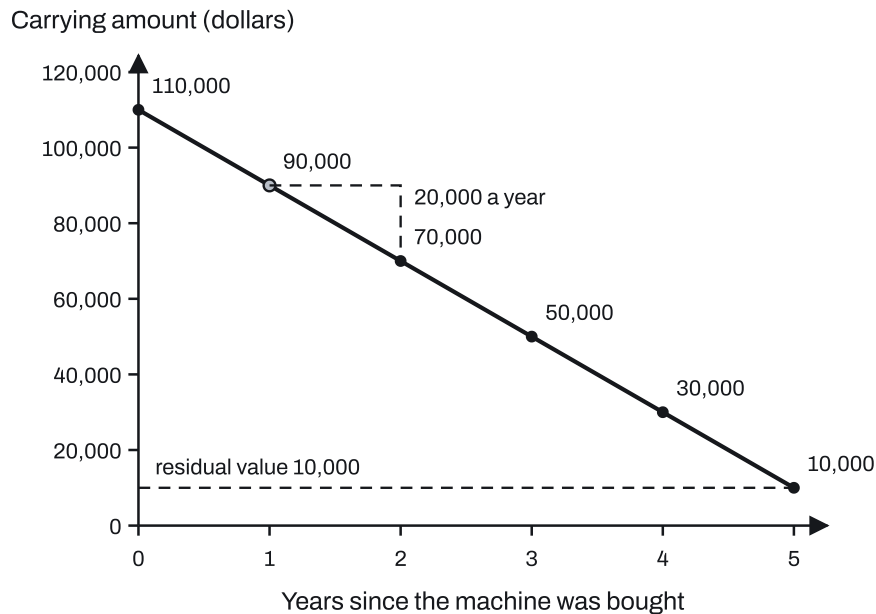
- each year's profit carries a fair share of the cost of the assets used to earn it;
- non-current assets are shown at a more realistic value as they get older;
- it is a cost that involves **no cash** leaving the business that year (the cash left when the asset was bought).

The **straight-line method** charges the same amount every year:

$$\text{annual depreciation} = \frac{\text{cost} - \text{residual value}}{\text{useful life in years}}$$

The **residual value** is what the asset is expected to be sold for at the end of its useful life.

Pinecone's machine cost 110,000 dollars, is expected to last 5 years and then sell for 10,000 dollars: annual depreciation = $(110000 - 10000) \div 5 = 20000$ dollars.



The impact on the two statements each year:

- **Statement of profit or loss:** 20,000 dollars is included in **expenses**, so operating profit (and profit for the year) are 20,000 dollars lower than without it.
- **Statement of financial position:** the machine is shown at its **carrying amount** (net book value), cost minus all the depreciation charged so far: $110\,000 - 20\,000 = 90\,000$ after one year, $70\,000$ after two. Non-current assets, net assets and (through lower retained earnings) equity are all lower.

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
Gross profit = revenue – cost of sales	Learn it
Cost of sales = opening inventory + purchases – closing inventory	Learn it
Profit from operations (operating profit) = gross profit – expenses	Learn it
Profit for the year = operating profit – interest (if any) – taxation	Learn it
Retained earnings for the year = profit for the year – dividends	Learn it
Net current assets = current assets – current liabilities	Learn it

Fact or formula	Status
Net assets = non-current assets + net current assets – non-current liabilities = total assets – total liabilities	Learn it
Total equity = share capital + reserves, and total equity = net assets	Learn it
Net realisable value = expected selling price – costs of selling	Learn it
Inventory is valued at the lower of its cost and its net realisable value	Learn it
Straight-line depreciation per year = (cost – residual value) ÷ useful life in years	Learn it
Carrying amount (net book value) = cost – total depreciation charged so far	Learn it

How to do it

We have tagged only 2 questions on this topic, so the exam evidence is thin: a Paper 3 case study question in **May/June 2021** and a Paper 4 essay in **February/March 2026**. The 2021 question has parts of two types, so the counts add up to 3.

Question type	Questions
Advise on how useful financial statements are for a strategy	1
Calculate an inventory value with net realisable value	1
Evaluate the difficulties of valuing inventory	1

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.

1. Advise on how useful financial statements are for a strategy (1 question)

Paper 4, **[20]**: up to 3 K, 2 App, 8 An and 7 Eval, each marked by level. The case gives a business planning its next strategy (in 2026, for growth) and some of its accounting data, there as ratios.

- 1. K (up to 3)**: explain what the statements are and what each shows. One statement explained in depth (what it is, what it shows, what it can be used for) earns all 3, and so do two statements each partly explained. **Without a K mark nothing else scores**. Knowing ratios alone earns only 1 K, so explain the statements themselves.

2. **App (2)**: use the case: its figures (profit margins, borrowing, revenue growth), its growth options, its stakeholders. A figure copied from the case earns nothing unless you use it in a point of analysis or evaluation.
3. **An (8)**: for each statement, a chain showing **how** it helps the strategy: the profit or loss statement shows whether profit is rising or falling and where costs are high → whether there is retained profit to invest → which option can be afforded. The financial position statement shows the assets, debts and equity → how much more the business can borrow → whether growth must be financed by shares or retained profit. Then the **other side** for each: the figures are historic and the strategy is about the future; one year means little without comparisons; the figures can be window-dressed; they leave out non-financial factors (staff, brand, competitors, customer demand). Level 3 needs developed analysis **and** a counter-argument; two such balanced points reach the top of the analysis marks.
4. **Eval (7)**: a judgement on **how useful** the statements are for this decision: which statement (or which figure) is most useful, what else the business needs (market research, forecasts, the external environment), and what the answer depends on. Keep the judgement on the statements' usefulness; don't turn it into advice on which strategy to choose.

2. Calculate an inventory value with net realisable value (1 question)

Paper 3, [4] then [2]. A table lists batches of inventory with quantities, selling prices and the costs of selling them; you value the batches the question names, then express the total as a percentage of a figure in the case.

1. **Start from the formula**: $NRV = \text{expected selling price} - \text{costs of selling}$. The marks build up through the calculation; the formula on its own earns 1 mark only when nothing else in your answer scores.
2. **Work out each batch**: quantity $\times$ selling price, minus its cost of selling (1 for each batch). Check the units in the table (tonnes, thousands of dollars).
3. **A batch that cannot be sold** has a value of 0: it still counts as a correct step.
4. **Add the batches** for the final answer: the right total earns all 4 marks. Include only the inventory the question names: if it asks about finished goods, leave out raw materials.
5. **Percentage of current assets** [2]: value $\div$ current assets $\times 100$ (1), and the answer (2). If your first answer was wrong, using it correctly here still earns both marks.

If the table also gives the cost of each batch, value each one at the **lower** of cost and NRV.

3. Evaluate the difficulties of valuing inventory (1 question)

Paper 3, [12]: 2 K, 2 App, up to 4 An and 4 Eval, marked by level. It usually follows the NRV calculation, and your own figure can be used.

1. **K (2)**: two relevant points: what inventory is (materials, work in progress, finished goods; a current asset), how it is valued (lower of cost and NRV), why it matters (it sets cost of sales and profit).
2. **App (2)**: two points tied to **this** business's goods: how quickly they lose value, how far their price moves, how orders vary, what the case says about its managers or the accounts.

3. **An (up to 4)**: two or three difficulties, each as a chain that **interprets** the case: what happens to the goods → why that makes their value uncertain → what a wrong value does to profit or the statement of financial position.
4. **Eval (up to 4)**: rank the difficulties: which is the **most** serious for this business, and why. Say what it depends on (how fast the goods lose value, how often inventory is counted and valued) and what the business could do about it.

Not yet asked: building, amending and depreciation

These syllabus points have no tagged question yet, but a case can include a statement to complete or change.

- **Complete a statement of profit or loss**: work down the lines in order (revenue, gross profit, operating profit, profit for the year, retained earnings), showing each subtraction.
- **Complete a statement of financial position**: sort each item into non-current assets, current assets, current liabilities or non-current liabilities, then net current assets, net assets, and check that net assets equal total equity.
- **Amend after a change**: change the item, then recalculate every total below it, in both statements if the change affects profit. Say which totals stay the same.
- **Depreciation**: annual charge with the straight-line formula; carrying amount = cost – depreciation so far; then say what happens to operating profit and to non-current assets.

Worked examples

Example 1

Kowhai Kitchens Ltd makes chilled ready meals for supermarkets. For the year ended 31 December 2025: revenue 840,000 dollars, cost of sales 504,000 dollars, expenses 196,000 dollars. It has no loans. Tax is 20% of profit from operations and had not been paid by the year end, and dividends of 45,000 dollars were paid.

- (a) Calculate Kowhai's profit for the year and its retained earnings for the year. **[4]**
- (b) The accountant then finds two errors. The year's depreciation of 12,000 dollars on a new delivery van was left out of expenses, and closing inventory was overvalued by 9,000 dollars because some meals were past their use-by date. Amend the profit for the year and the retained earnings. **[4]**
- (c) Explain the effect of these amendments on Kowhai's statement of financial position. **[3]**

(a) Gross profit = $840000 - 504000 = 336000$ dollars (1).

Profit from operations = $336000 - 196000 = 140000$ dollars (1).

Tax = $0.2 \times 140000 = 28000$, so profit for the year = $140000 - 28000 = 112000$ dollars (1).

Retained earnings = $112000 - 45000 = 67000$ dollars (1).

(b) A lower closing inventory means a higher cost of sales: $504000 + 9000 = 513000$, so gross profit = $840000 - 513000 = 327000$ dollars (1).

Expenses = $196000 + 12000 = 208000$, so profit from operations = $327000 - 208000 = 119000$ dollars (1).

Tax = $0.2 \times 119000 = 23800$, so profit for the year = $119000 - 23800 = 95200$ dollars (1).

Retained earnings = $95200 - 45000 = 50200$ dollars, 16,800 dollars less than before (1).

(c) The van's carrying amount falls by the 12,000 dollars of depreciation, so non-current assets are 12,000 dollars lower (1). Inventory, a current asset, is 9,000 dollars lower, while tax owed (a current liability) falls by $28000 - 23800 = 4200$ dollars (1). Net assets fall by $12000 + 9000 - 4200 = 16800$ dollars, matching the 16,800 dollar fall in retained earnings, so reserves and total equity are lower by the same amount and the statement still balances (1).

Example 2

Marlin Bike Hire Ltd rents out bicycles to tourists. It bought its fleet of e-bikes on 1 July 2024 for 132,000 dollars. The e-bikes are expected to last 4 years and then be sold for 12,000 dollars. Marlin uses the straight-line method.

(a) Calculate the annual depreciation on the e-bikes and their carrying amount at 30 June 2026. [3]

(b) At 30 June 2026 Marlin's other items were: vans and workshop equipment 113,000; inventory of spare parts 6,000; trade receivables 4,000; cash 21,000; trade payables 9,000; tax owed 7,000; bank loan repayable in 2031, 60,000; share capital 100,000 (all in dollars). Calculate Marlin's net current assets, net assets and retained earnings at that date. [4]

(c) On 1 July 2026 Marlin buys 10 more e-bikes for 25,000 dollars, paying 5,000 dollars in cash and adding 20,000 dollars to its bank loan. Explain the effect on Marlin's net current assets and net assets. [3]

(a) Annual depreciation = $(132000 - 12000) \div 4 = 30000$ dollars (1).

After two years, total depreciation = $2 \times 30000 = 60000$ dollars (1), so the carrying amount = $132000 - 60000 = 72000$ dollars (1). Each year's 30,000 dollars is also an expense in the statement of profit or loss, reducing operating profit, even though no cash is paid out for it.

(b) Non-current assets = $72000 + 113000 = 185000$ dollars. Current assets = $6000 + 4000 + 21000 = 31000$; current liabilities = $9000 + 7000 = 16000$ (1).

Net current assets = $31000 - 16000 = 15000$ dollars (1).

Net assets = $185000 + 15000 - 60000 = 140000$ dollars (1).

Total equity must equal net assets, so retained earnings = $140000 - 100000 = 40000$ dollars (1).

(c) Non-current assets rise by 25,000 to 210,000 dollars, cash falls by 5,000 to 16,000, and the bank loan rises by 20,000 to 80,000 dollars (1). Current assets become $31000 - 5000 = 26000$, so net current assets fall to $26000 - 16000 = 10000$ dollars (1). Net assets = $210000 + 10000 - 80000 = 140000$ dollars, unchanged: Marlin has swapped cash and new borrowing for e-bikes of the same value, and no profit or new share capital is involved, so equity does not change either (1).

Example 3

Glowstone sells phone accessories online. Phone makers launch new models every year, and accessories made for an older model quickly become hard to sell. Glowstone changes its prices every week to match rival online sellers; after rivals cut their charger prices, Glowstone now expects to sell its chargers for less than they cost. Its owner plans to apply for a bank loan next month and will show the bank Glowstone's statement of financial position. Glowstone values inventory at the lower of cost and net realisable value. Its inventory on 31 December 2025:

Product	Units	Cost per unit (dollars)	Expected selling price per unit (dollars)	Cost of selling per unit (dollars)
Phone cases	2,000	4.00	9.00	0.50
Chargers	600	6.00	5.00	1.00
Earphones for a discontinued phone	300	10.00	3.00	3.00

Total current assets on that date, with inventory correctly valued, were 52,000 dollars.

(a) Calculate the value of Glowstone's inventory on 31 December 2025. [4]

(b) Calculate the inventory as a percentage of current assets. [2]

(c) Evaluate the difficulties for Glowstone of valuing its inventory correctly. [12]

(a) Each product is valued at the lower of cost and NRV, where $NRV = \text{selling price} - \text{cost of selling}$.

- Phone cases: $NRV = 9.00 - 0.50 = 8.50$, above the cost of 4.00, so value at cost: $2000 \times 4 = 8000$ dollars (1).
- Chargers: $NRV = 5.00 - 1.00 = 4.00$, below the cost of 6.00, so value at NRV: $600 \times 4 = 2400$ dollars (1).
- Earphones: $NRV = 3.00 - 3.00 = 0$, so they are valued at nothing (1).

Total inventory = $8000 + 2400 + 0 = 10400$ dollars (1). (At cost it would have been 14,600 dollars, 4,200 dollars more.)

(b) $10400 \div 52000 \times 100$ (1) = 20% (1).

(c) Inventory is a current asset made up of the goods a business holds for sale or for making its products (K). It is valued at the lower of what it cost and its net realisable value, the price it should sell for less the costs of selling it, so that it is never shown at more than it can earn (K).

The goods go out of date quickly. New phone models arrive every year, and Glowstone's earphones for a discontinued phone have already fallen to an NRV of zero (App). An accessory's value depends on how many people still own the phone it fits, and that can fall sharply as soon as a new model is launched, so a value that is right in December may be far too high a few months later (An). If old stock is not written down in time, inventory and profit are overstated: valuing everything at cost would have added 4,200 dollars to an inventory that is really worth 10,400 (An).

Selling prices keep moving. Glowstone resets its prices weekly to match rivals (App). NRV needs an expected selling price, but if rivals cut their prices next week Glowstone must follow, and the phone cases' NRV of 8.50 could fall (An). For the chargers, already valued below cost, any further price cut lowers their value again, so the inventory figure is only as good as the owner's guess about future prices (An).

The temptation to value it high. The owner wants a bank loan and will show the bank the statement of financial position (App). A higher inventory value makes current assets and profit look stronger, so there is pressure to be optimistic about NRV, for example by leaving the earphones at their cost of 3,000 dollars instead of nothing (Eval). That would mislead the bank, and if the loan were granted on overstated figures Glowstone could struggle to repay it from sales that never happen (Eval).

Judgement. The most serious difficulty for Glowstone is how fast its products become obsolete, because it can cut the value of a whole product line to nothing within months, as the earphones show: their value fell from a cost of 10.00 to nothing, while the chargers, hit by rivals' price cuts, fell only from 6.00 to 4.00 (Eval). How much this matters depends on how often Glowstone values its inventory: checking it monthly rather than once a year, and writing down any accessory for a phone that is no longer sold, would keep the figure close to reality and give the bank a figure it can trust (Eval).

The marks: 2 K and 2 App (both difficulties tied to Glowstone's products and prices), 4 An for developed chains that interpret the case, and 4 Eval for ranking the difficulties with a supported judgement that says what it depends on.

Example 4

Summit Solar Ltd installs solar panels on homes in country S. Some figures from its financial statements:

	2023	2025
Revenue (million dollars)	4.0	5.2
Profit from operations (million dollars)	0.48	0.42
Inventory of panels (million dollars)	0.3	0.9

At the end of 2025 Summit Solar had long-term bank loans of 2.1 million dollars and total equity of 1.4 million dollars. The government's subsidy for home solar panels ends in 2027. The directors are choosing between two ways to grow: installing panels on factories and offices in country S, or opening a branch in a neighbouring country.

Advise the directors on the usefulness of financial statements when developing Summit Solar's strategy for growth. [20]

What the statements show. The statement of profit or loss records a business's revenue and costs over a year and the profit left at each stage (K). Comparing years shows whether the business is earning more from each sale and whether it is generating profit it can reinvest (K). The statement of financial position is a picture of the business's resources and debts taken on the last day of its year, and it reveals how much of its finance comes from loans rather than from its owners (K).

The statement of profit or loss. Revenue rose by 30%, from 4.0 to 5.2 million dollars, but profit from operations fell from 0.48 to 0.42 million dollars, a margin of 12% falling to about 8.1% (App). This tells the directors that growth so far has added sales but not profit: costs have risen faster than revenue (An). Before choosing a strategy that adds even more sales, they should find out where the profit is being lost, or the new branch or factory work could repeat the problem on a larger scale and leave less retained profit to finance future growth (An). However, the statement only shows **that** costs rose, not **why**, and it covers years when the home subsidy was still paid; once it ends in 2027, the past figures will say little about future home sales (An).

The statement of financial position. Summit Solar's loans of 2.1 million dollars are 1.5 times its equity of 1.4 million dollars (App). Entering either new market will need finance, and with so much borrowing already, banks may refuse further loans or charge higher interest, which would cut profit further (An). So the statement points the directors towards financing growth with new shares or towards the cheaper option (An). Inventory tripled to 0.9 million dollars, which suggests money is tied up in unsold panels; the directors can see this cash is not available for expansion (An). On the other hand, the statement is a snapshot of one day: inventory may be high at the year end only because panels were bought for jobs starting in January (An).

What the statements cannot show. Neither statement shows whether businesses in country S want solar panels, how strong competitors are in the neighbouring country, or whether Summit Solar's installers have the skills for large commercial roofs (Eval). These matter more than past profit for choosing **between** the two options, because both options are new markets for which the statements hold no figures at all (Eval).

Judgement. The financial statements are very useful to Summit Solar, but for setting the limits of a strategy rather than for choosing it (Eval). The statement of financial position is the more useful of the two here, because the heavy borrowing decides how much growth can be financed and how, while the falling margin in the statement of profit or loss is a warning that should be fixed before growing further (Eval). To choose between the options the directors also need market research in both markets, cost forecasts for each option and a plan for the end of the subsidy (Eval). How useful the statements are therefore depends on comparing several years and similar businesses, and on whether the figures for 2025 are typical; used alone they describe a past in which the subsidy was paid, not the future the strategy is for (Eval).

The marks: 3 K for explaining both statements and what each shows; 2 App for using Summit Solar's figures inside the analysis; 8 An for two developed chains that are each balanced by a limitation; 7 Eval for a judgement on which statement is most useful, what else is needed and what the answer depends on.

Common mistakes

- **Forgetting the costs of selling in NRV.** In June 2021 many candidates could work out what the inventory would sell for, but only the strongest then subtracted the cost of selling it; leaving it out loses a mark. NRV is always selling price **minus** selling costs.

- **Including inventory the question did not ask about.** If the question asks for the value of finished goods, raw materials stay out of the total; adding them loses a mark.
- **Leaving a calculation blank.** In June 2021 more than one candidate in ten left the percentage part blank, many of them after answering the calculation before it. Write the formula and use whatever figure you have: a wrong first answer used correctly still earns full marks.
- **Repeating the case without interpreting it.** Copying facts about the business into an evaluate answer earns little. Each fact must lead somewhere: why it makes the value uncertain, and what that does to profit or assets.
- **Answering about ratios instead of the statements.** In March 2026 many candidates wrote about ratios rather than explaining what the statements are and what they show. Ratios alone earn only 1 knowledge mark, and nothing else scores until the knowledge mark is earned.
- **Answering a different question.** In March 2026 many candidates advised on how the business should grow, or discussed other factors such as marketing, instead of judging how **useful the financial statements** are. Keep every paragraph on the statements.
- **One-sided analysis.** In March 2026 the analysis was often one-sided. Only explaining why the statements help limits the analysis marks: also say what they cannot show (they look backwards, cover one date, can be window-dressed, leave out non-financial factors).
- **Mixing up gross and operating profit.** Gross profit takes off only cost of sales; operating profit also takes off expenses such as rent, salaries and depreciation.
- **Calling cash spent on a machine an expense.** Buying a non-current asset is not an expense for that year; its cost reaches the statement of profit or loss gradually, as depreciation.
- **Forgetting that the statement of financial position balances.** After any change, check that net assets still equal total equity.

How to get the marks

- **Command words.** *Calculate*: formula, figures, answer with units ("dollars", "%"). *Explain*: a point, how it works, and the case. *Evaluate*: both sides, then a supported judgement for this business. *Advise*: a recommendation for the person in the case, with reasons and what it depends on.
- **Show every step of a calculation.** On the NRV question the marks build up: each correctly valued batch earns 1, and the right total earns all 4. The formula alone earns 1 only if there is no relevant calculation. Later parts are marked on your own earlier answer.
- **Lay out statements line by line**, with the name of each profit (gross profit, profit from operations, profit for the year, retained earnings). A missing step makes it hard to give method marks.
- **Explain both statements** in a usefulness question: what each one shows and what it can be used for. One statement explained fully, or two explained partly, gets all the knowledge marks.
- **Use the case's numbers inside your argument.** A ratio or figure from the case earns an application mark only when it supports a point of analysis or evaluation.
- **Balance every argument.** The top analysis level needs developed points that are counter-balanced, such as "the statement shows high borrowing, so further loans are unlikely, but it is a snapshot and the loans may be repaid soon".

- **Judge as you go, and finish with a clear judgement:** which statement or difficulty matters most, what else is needed, and what it depends on.

Quick check

1. A business has revenue of 250,000 dollars, gross profit of 95,000 dollars and expenses of 60,000 dollars. Tax is 25% of profit from operations, and it pays dividends of 10,000 dollars. Calculate its cost of sales, profit from operations, profit for the year and retained earnings for the year.
2. A bakery buys an oven for 18,500 dollars. It expects to use it for 8 years and then sell it for 2,500 dollars. Using the straight-line method, calculate the annual depreciation and the oven's carrying amount after 3 years.
3. A clothes shop has 50 winter jackets that cost 60 dollars each. It expects to sell them for 70 dollars each, but each needs 15 dollars of alterations first. Calculate the value of the jackets in the statement of financial position.
4. A business pays 4,000 dollars in cash for an advertising campaign. State the effect on (a) gross profit, (b) profit from operations and (c) net current assets.
5. Explain one reason why a statement of financial position may not show what a business is really worth. **[3]**

Answers

1. Cost of sales = $250000 - 95000 = 155000$ dollars. Profit from operations = $95000 - 60000 = 35000$ dollars. Tax = $0.25 \times 35000 = 8750$, so profit for the year = $35000 - 8750 = 26250$ dollars. Retained earnings = $26250 - 10000 = 16250$ dollars.
2. Annual depreciation = $(18500 - 2500) \div 8 = 2000$ dollars. After 3 years the carrying amount is $18500 - 3 \times 2000 = 12500$ dollars.
3. $NRV = 70 - 15 = 55$ dollars, which is below the cost of 60, so each jacket is valued at 55: $50 \times 55 = 2750$ dollars (250 dollars less than their cost of 3,000).
4. (a) No change: advertising is an expense, not part of cost of sales. (b) Falls by 4,000 dollars. (c) Falls by 4,000 dollars, because cash, a current asset, falls.
5. Non-current assets are shown at what they cost less the depreciation charged so far (K), not at what they could be sold for today (1). A business that bought its land many years ago may show it far below its current market price, so its net assets, and the value of the business they suggest, can be well below what a buyer would pay (1).

Past questions to try

- **9609/31/M/J/21 Q2**: valuing batches of inventory with net realisable value, then evaluating why it is hard to value correctly.
- **9609/42/F/M/26 Q2**: advising on how useful financial statements are when planning growth, using ratios from the case.