Aspects of Accounting for A Level Business Studies
Lesson Plan
Duncan Williamson at the OSL Reading Conference
11th December 2006

Introduction to the Lesson

two minutes

- This lesson is held in a tiered lecture hall with just a small white board as an AV resource.
- 20 students: male and female, mixed ability, a few of them also studying accounting at A level.
- The purpose of this **one hour lesson** is to review the basics of the interpretation of the profit and loss account and balance sheet. We will start by reviewing

  - the purposes of accounts
  - the users of accounts and what they are looking for

The main areas of concern are

- profitability
- liquidity and working capital management
- window dressing

To develop the ideas, we will look at some real and recent examples from the business world of where we can apply the theory of ratio analysis.

From the AQA Specification

This lesson aims to review the following aspects of the AQA Specification, taken from Unit 4 of the Business Studies module.

refer to this as necessary

Interpretation of profit and loss accounts and balance sheets	Users and purposes of company accounts; judgement of profit quality, profit utilisation, balance sheet strength and trends over time (eg growth in turnover); balance sheets will balance assets employed with capital employed; limitations of published accounts
Working capital	Stock and debtor control; liquidity; stock valuation conforms to the lower of cost and net realisable value; (LIFO and FIFO are not included).
Ratio Analysis	The emphasis should be on concepts rather than equations, although calculations are required.
Liquidity (acid test only)	Emphasis on the concept, with its implication of risk, but avoiding determinism (low liquidity implying imminent collapse); how can a firm improve its liquidity? What may be die pitfall?

Begin by saying that accounts should now really be called Financial Reports … possibly get the extra half or one mark for knowing and saying that!

Ask the group as a whole: what are the purposes of financial reports

five minutes

Put their answers on the board to ensure that everyone knows them all. Answers should include:

- stewardship
- monitoring/management information
- transparency to help to attract investment
- taxation
- reducing fraud

eight minutes

Ask: who are the **users of accounts** and what do they need to know

Put their answers on the board to ensure that everyone knows them all. See teacher's notes for full listing. I don't expect them to say all of these and I concentrate on, say, the most important five or six of them … time constraint.

Ratio Analysis

The teacher told me that the students were concerned that although it's called ratio analysis, some of the calculation are percentages, rates of change … I stressed to the students that in business studies we use the generic name of ratio analysis to cover the interpretation of accounting data and financial reports.

two minutes

Stress that the specification says that you are required to **understand ratio analysis** rather than spending hours and hours understanding the ratios and how they work. However, they are simple to learn and **you may be asked to carry out some calculations**.

Put on the board: a brilliant resource that you simply MUST use is the Ratio Analysis Section at www.bized.ac.uk that I wrote a couple of years ago.

You need to know these ratios … I always stress that they need to be able to **classify** such ratios under their **headings** of profitability, liquidity, efficiency … do this on the board one you have listed the ratios

eight minutes

- gross profit margin
- operating profit margin
- net profit margin … before and after tax

- return on capital employed

- current or working capital ratio … even though the specification doesn't name it … why not aim for the guaranteed A grade
- acid test ratio … quick ratio or liquid ratio

What follows now is what I would have liked to have done if I had had, say, two hours rather than just the one hour.

The Marks and Spencer data is real and up to date and relates to a retailer. This example introduces the idea of International Financial Reporting Standards. This will become important over the coming years as listed companies report under these standards rather than under UK Standards.

Vodafone is provided as an example of a very large company with serious corporate governance problems and significant profitability problems.

I didn't use these two companies in this lesson because of the time constraint.

Marks and Spencer and Vodafone

- **Explain** the difference between the Gross and Operating Margins and the ROCE
- How can you **explain** the values of the current and acid test ratios of M&S and Vodafone being so low? After all they are a long way away from the 'ideal' value of 2:1 and 2: 1
- **What is** stock turnover? **Contrast** M&S's stock turnover with that of Vodafone
- **What does** (stock turnover + debtors' turnover – creditors' turnover) **tell us**?

Marks and Spencer Results

	IFRS		UK GAAP	
Marks and Spencer: basic analysis	**2006**	**2005**	**2005**	**2004**
Operating Profit (%)	10.90%	7.98%	7.78%	9.92%
EBIT (%)	10.90%	7.98%	9.38%	9.42%
ROTA (EBIT)	16.32%	12.29%	17.39%	10.59%
Current Ratio	0.57	0.67	0.65	2.05
Working Capital	-874.9	-405.1	-451.8	1984.8
Gearing (NCL)	176.42%	299.24%	368.18%	102.67%
Stock turnover (days)	19.7	17.9	16.9	19.4
Depreciation as % of Total Gross Assets	7.0%	6.6%	7.6%	6.8%
Income Tax as % of EBT	30.2%	29.7%	21.2%	29.3%

Notes: IFRS = International Financial Reporting Standards, NCL = non current liabilities

Vodafone Results

Ratios	**2006 $m**	**2006**	**2005 £m**
Gross Profit Margin	41.84%	41.84%	40.78%
Operating Profit Margin	-47.99%	-47.99%	29.53%
Profit before Tax Margir	-50.61%	-50.61%	8.57%
Profit after Tax Margin	-58.72%	-58.72%	20.30%
ROCE	-17.29%	-17.29%	4.35%
Current Ratio	0.49	0.49	0.64
Acid Test Ratio	0.47	0.47	0.61
Stock turnover (days)	6.36	6.35	10.16
Debtors turnover (days)	55.18	55.19	70.65
Creditors turnover (days	331.70	331.69	337.67

Additional Aspects

a) M&S Accounting Policies: Turnover

We will discuss: this is largely teacher led since this is a business studies group rather than an accounting group. Marks and Spencer has a well know returns policy: customers are free to return items almost without let or hindrance … what are the accounting implications of this?

See the teacher's notes.

We did do the following:

b) What can Ratio Trends tell us?

The following two examples are used to explain that analysts need more than two years' worth of data to work on. Stress that exam problems typically give one or two years' worth of data for a company. For the bonus mark or two, tell the examiner that you know this … here's why:

three minutes

i) **Give the students one minute to** interpret the following results and summarise their findings on the board. I expect very little since there isn't much to talk about!

	2006	2005
Current Ratio	1.5: 1	1.5: 1
Acid Test Ratio	0.84: 1	0.60: 1

five minutes

ii) **Now give the students one minute to** Interpret the following results and contrast your analysis with your analysis of the results in part a). Again put there suggestions on the board.

	2006	2005	2004	2003	2002	2001
Current Ratio	2: 1	2: 1	2: 1	2: 1	2: 1	2: 1
Acid Test Ratio	0.75: 1	0.80: 1	0.85: 1	0.90: 1	0.95: 1	1: 1

Expect the discussion here to be much richer: **see the teacher's notes here**.

twelve minutes

c) No such thing as an Ideal Ratio: use the table of date on page 4 to help to illustrate that even though text books say that the ideal current ratio is 2: 1 very rarely do companies have a ratio of 2: 1. The same as with the acid text ratio being 1: 1.

Stress that Tesco is the UK's most successful retailer yet its current ratio is 0.43: 1and its acid test ratio is 0.23: 1.

Use this example to discuss how Tesco can survive with such supposedly poor liquidity results: ask the students how Tesco can have such a low current ratio value. Expect them to make the following points:

- cash rich
- very quick turnover of goods
- extended credit from suppliers

Put these ideas on the board to help to ensure all students know it and understand it.

twelve minutes

We did spend some time on the following section, window dressing.

Window Dressing: question from the AQA June 2004 (Wayside Restaurants Ltd) exam

*The company's accountant has suggested to the Chief Executive how the accounts (**Appendix C**) might be window dressed to make them appear more favourable to shareholders. The investors might be impressed by a better liquidity position and higher declared profits. Perhaps the depreciation rates currently being used could be adjusted?*

Appendix C	***2002***	***2003***
No of shares issued	*2 m*	*2 m*
Total dividends	*£1 m*	*£1 m*
Net profit	*£4 m*	*£2 m*
Cash	*£50,000*	*£20,000*
Fixed assets	*£30 m*	*£35 m*
Capital employed	*£32 m*	*£38 m*
Long term loans	*£16 m*	*£21 m*

*Consider whether the Chief Executive should allow the use of **window dressing** to make the accounts appear more favourable. (10 marks)* June 2004

Ask the students to answer these questions and work through them on the board:

a) what is window dressing?
b) discuss the examples of the use of window dressing given in the question
c) say why companies might use window dressing.

Discuss this powerful example of window dressing:

Influencing the Current Ratio	**Before**	**After**
Current assets	200	150
Current liabilities	100	50
Working Capital	**100**	**100**
Current Ratio	2: 1	3:1

Stress how simple it is but how effective it is!

Sale and Repurchase

Finance v Operating Lease

one minute

Summarise the main points and introduce the richness of studying M&S and Vodafone!

Devised and Prepared
by Duncan Williamson