TSSM™
Creating VCE Success

Accounting
Teach Yourself Series
Topic 11: Analysing Business Performance

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Contents

Analysing Business Performance 3
Initial terminology 3
As it appears in Units 1-4 3
Profitability 4
As it appears in Units 1-4 4
Return on Owner's Investment 4
Return on Assets 4
Net Profit Margin 4
Gross Profit Margin 5
Review Questions 5
Liquidity .... **Error! Bookmark not defined.**
As it appears in Units 1-4 .... **Error! Bookmark not defined.**
Working Capital Ratio .... **Error! Bookmark not defined.**
Quick Asset Ratio .... **Error! Bookmark not defined.**
Cash Flow Cover .... **Error! Bookmark not defined.**
Review Questions .... **Error! Bookmark not defined.**
Efficiency .... **Error! Bookmark not defined.**
As it appears in Units 1 - 4 .... **Error! Bookmark not defined.**
Accounts receivable' Turnover .... **Error! Bookmark not defined.**
Inventory Turnover .... **Error! Bookmark not defined.**
Accounts Payable' Turnover .... **Error! Bookmark not defined.**
Asset Turnover .... **Error! Bookmark not defined.**
Review Questions .... **Error! Bookmark not defined.**
Stability .... **Error! Bookmark not defined.**
As it appears in Units 1-4 .... **Error! Bookmark not defined.**
Debt Ratio .... **Error! Bookmark not defined.**
Review Questions .... **Error! Bookmark not defined.**
Understanding Ratios .... **Error! Bookmark not defined.**
As it appears in Units 1-4 .... **Error! Bookmark not defined.**
Review Questions .... **Error! Bookmark not defined.**
Other Evaluation Measures .... **Error! Bookmark not defined.**
As it appears in Units 1-4 .... **Error! Bookmark not defined.**
Review Questions .... **Error! Bookmark not defined.**
Strategies for improvement .... **Error! Bookmark not defined.**
As it appears in Units 1-4 .... **Error! Bookmark not defined.**
Solutions to Review Questions .... **Error! Bookmark not defined.**

Analysing Business Performance

As we have seen already, businesses commence operations with a view to making a profit for the owner. On occasions a business may not make a profit or may make a smaller profit than expected. It is therefore important for a business to analyse their financial reports in an effort to understand why they performed the way they have and to provide strategies for improvement in the future.

Initial terminology

As it appears in Units 1-4

Analysing the performance of a business is more than looking at the final bank figure or the $ amount of Profit (or Loss) made by the business.

A ‘raw’ number does not mean a lot unless we can use that number for analysis or comparison.
In Units 2 & 4, financial reports are analysed using a number of performance indicators or financial ratios.

Assessing the performance of a business occurs after financial reports have been prepared for a reporting period. There are three areas where performance can be measured and evaluated.

These areas of performance measurement are:

- Profitability
- Liquidity
- Efficiency
- Stability

It is also important to look at other factors to help evaluate the performance of a business as well as provide clues and suggestions for strategies to improve performance.

Profitability

As it appears in Units 1-4

Profitability is a measure of how the business has performed in terms of returning a profit measured by comparing its profit against a base like sales, assets or owner's investment. There are four financial ratios associated with Profitability.

Return on Owner's Investment (ROI)	Return on Assets (ROA)
Net Profit Margin	Gross Profit Margin

Return on Owner's Investment

Measured using the following ratio: $\dfrac{\text{Net Profit}}{\text{Average Capital}} \times \dfrac{100}{1}$

Return on Owner's Investment measures the 'return' or 'money back' the owner has received on his/her investment in the business. In the real world a person has many alternative investments available to them – invest in shares, deposit their money in a high interest account, purchase property. All of these investments provide a return – dividend, interest or rent. Each investment has its own rewards and risks. An owner of a business hopes to be rewarded for their investment of time (working hours), money (capital), expertise and what they have given up to operate the business (previous job, safer investment, savings).

Return on Assets

Measured as: $\dfrac{\text{Net Profit}}{\text{Average Total Assets}} \times \dfrac{100}{1}$

Return on Assets is designed to measure how well the assets of the business are generating revenue and hence, profit. The Equipment, Inventory, Office Furniture, Vehicle, etc, all contribute to the business earning revenue.

As the assets age they become more inefficient, breakdown more and hence earn less revenue for the business. This ratio helps an owner determine if the assets of the business are getting to the point where they may need replacing.

Net Profit Margin

Measured by: $\dfrac{\text{Net Profit}}{\text{Net Sales}} \times \dfrac{100}{1}$

When an owner determines a selling price for their product they must consider a number of things:

* What did the product cost the business?
* What price are my competitors charging?
* Will my selling price allow me to make a profit?

This ratio determines how much (in % or in $ terms) profit is made for each $1 of Sales.

Gross Profit Margin

Measured by: $\frac{\text{Gross Profit}}{\text{Net Sales}} \times \frac{100}{1}$

In the same manner as Net Profit Margin, the Gross Profit Margin examines the profit made on just the buying and selling of Inventory – the mark up.

A business can use this ratio to determine if Inventory expenses – Freight, Insurance, Cartage, etc are costing the business too much and affecting the ability of the business to make an overall Net Profit.

Review Questions

1. Explain what is meant by the term 'profitability'.

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2. From financial reports the accountant was able to provide the following information:

	2023	**2024**	**2015 Budget**
Net Profit Margin			
$\frac{\text{Net Profit}}{\text{Net Sales}}$	9%	0.1%	11%
Gross Profit Margin			
$\frac{\text{Gross Profit}}{\text{Net Sales}}$	46%	39%	44%

Using the data provided above, **identify** the movement in

* Net Profit Margin

* Gross Profit Margin

* Profitability

Item	**Improved/Deteriorated/Remained unchanged/Unable to determine**
Net Profit Margin	
Gross Profit Margin	
Profitability	