Task 1

Depreciation

Depreciation is the term used when describing the decline in value of something. It also represents the ownership and consumption of something useful life. In accounting terms, this is limited to the value of a fixed asset during its useful life. Examples of fixed assets are fixtures & fittings, vehicles and equipment.
The reasons for depreciation are:

- New models – in today's modern world, there is new technology that compliment the new generation. This makes things more efficient.
- Wear and Tear – equipment eventually gets worn out to an extent that it is no longer worth fixing and needs to be replaced (upgraded) in order to not be labelled as 'old fashioned'.

Fixed assets are shown in the balance sheet and are valued as part of the business. To produce accurate accounts, a business must show that the value of fixed assets goes down over time.

The purpose of depreciation is to match the cost of a fixed asset that has a life of more than a year to the revenues earned from using the ass et. The reason why depreciation is used is to spread the initial price of the asset over its useful life.

There are several methods that can be used when calculating depreciation. The calculations are normally based on either the amount of time passed or the amount of use of the asset. The first method is:
Straight-line depreciation – this is the most simple and frequently used method in businesses. This is calculated by taking the purchase price of an asset and subtracting it from an estimated scrap value . The result is then divided by the business' estimate of the number of productive years the asset can be expected to benefit the company. The answer will give you the Net Book Value, which shows the annual depreciation amount (how much it will be worth every year.

METHOD

Straight line depreciation = $\dfrac{\textbf{Purchase price of asset – scrap value}}{\textbf{Estimated useful life of assets}}$

A business buys new machinery for the business costing £5000. They estimate a scrap value of £200. The business then estim ates a useful life of three years for the computers. Using that information, I put it into the formula:

$$\frac{\text{£5,000 purchase price - £200 scrap value}}{\text{3 years estimated useful life}}$$

The answer, £1,600, is the depreciation charges the business would take annually if they use the straight line method.

Reducing balance depreciation – this method is slightly more complicated than the straight line method. This method assumes that an asset loses more value at an early stage in its lifetime. This means that a set depreciation rate is used, e.g. 20%, which therefore results in less value lost every year.

METHOD

Reducing balance depreciation

Original cost of machinery - £50000
Year 1 depreciation (£50000 x 15%) = £7500
Value at end of year 1 (£50000 - £7500) = £42500

Year 2 depreciation (£42500 x 15%) = £6375
Value at end of year 2 (£42500 - £6375) = £36125

Year 3 depreciation (£36125 x 15%) = £5418.75
Value at end of year 3 (£36125 - £5418.75) = £30706.25

Task 2

Arsenal Football Club

Arsenal Football Club is an English professional football club, who most recently moved from Highbury & Islington and are now located in Holloway, North London. The club is run under its parent company, Arsenal Holdings PLC. They play in the Premier League and are the third most successful club in England, behind Liverpool and Manchester U nited respectively. Arsenal was founded in 1886 and started dominating English football in the 30s. After a barren period in the post-war years, they have become one of the most successful clubs in the country over the past twenty years – during this time, Arsenal have won the league on six occasions. Their most notable Premier League season was in 2003/2004, where they went the whole season unbeaten. They also became the first London club to the reach the Champions League final, which was in the 2005/2006 season. The club's colours have always been red and white. Arsenal FC are one of the richest clubs in English football, worth over £600m and are also one of the top 10 richest football clubs in the world. The club recently left Highbury (capacity 38,419), their home from September 1913 – May 2006 and moved into the Emirates Stadium, a bigger stadium with a capacity of 60,432, which is located in Ashburton Grove, Holloway. They are also part of an exclusive organisation of European football clubs, the G -14 group.

Arsenal has a range of products and services to satisfy their customers. They have an official sports shop, Arsenal World of Sport, located in Finsbury Park, where replica kits, hats, footballs and much more merchandise can be purchased. They have also set up 'The Arsenal Membership' for supporters of the club. Under the membership scheme, 'The Arsenal', the club provides a lot of benefits as well as opportunities to new members. The scheme is seen as crucial to the growth and development of the club. All season ticket holders are classed as Gold members. If you are a new member or a supporter renewing their membership (Red Membership & Silver Membership respectively), they have the option to receive a membership pack. This contains an official Acces s-All-Areas DVD, Building for Success magazine, an Arsenal bottle opener and a 2007/2008 Club Yearbook. Other benefits from the membership include:

- Having the opportunity to attend Members Day at Emirates Stadium.
- Access to Membership website and Monthly Newsletter - this includes an online ticket facility, all of the latest membership news and a members community message board. The newsletter features Arsenal highlights of the month and competitions.

- Membership Magazine - each full member receives a limited edition Arsenal magazine at the end of every season. The magazine contains membership news, features and exclusive player interviews.
- Access to match tickets - tickets go on sale to silver members approximately 8 weeks prior to a league fixture. If any tickets remain after being offered to silver members they are then made available to red members approximately 4 weeks prior to the fixture.
- The 'online box office' allows members to purchase tickets, has a state of the art seat locator and a live ticket availability indicator.
- At Emirates Stadium, membership cards double up as stadium access cards for gold, silver and red level members (where match tickets have been purchased).

Arsenal Football Club also runs its own community scheme, Arsenal in the Community. It has been running since 1985 and focuses on innovative sports development in the local community and the Arsenal community worldwide. The Community Department offer a range of sporting, social inclusion, educational and charitable projects. They have achieved unbridled success and have touched the lives of all Arsenal fans on a local, regional and global scale. Arsenal have recently launched their own TV channel, Arsenal TV Online, which is accessible on the Internet. You can subscribe to it through BT Total Broadband and can tune into eight channels that can show you:

- **The Best Of** - The latest highlights, news and interviews packaged in a live continuous video stream.
- **Match Video** - Highlights of EVERY Arsenal first team and reserve match.
- **Match Centre** - LIVE text and audio commentary of EVERY competitive first-team game.
- **Talk** - Exclusive interviews and every pre- and post-match press conference.
- **Gold** - Enjoy classic Gunners moments and matches from the past.
- **The Club** - Go behind the scenes at the club - enjoy footage from the training ground and more.
- **Live** - A channel dedicated to live events — pre-season games, webcams, webchats etc.
- **Free Video** - Watch free videos to get a taste of the content on offer.

Stakeholders are very important in today's modern society, as they can hold the key to the company's success. They have an interest in the financial issues and decisions made by and for the club. Arsenal Football Club's stakeholders are the people who are affected by the actions of the business. Their stakeholders are, first and foremost, their shareholders. Their shareholders are the most important because they are the ones that pump money into the business and keep the business moving financially. Another of their stakeholders are their players. The players are the people that play for the club and market the club to the fans by achieving success on the football pitch. Another stakeholder in Arsenal FC are their fans. The fans are the people that buy tickets and watch TV to view their team play and support them, so they have a say in the football club as well. The managers and directors are also stakeholders in Arsenal FC because they run the club on a

day-to-day basis and make decisions on behalf of the shareholders and must have their best interests at heart. The Club's sponsors are also very important stakeholders because they are giving money to the club to market their business on the front of their shirts as well as sponsor them for other projects.

Accounting for limited companies is a very cru cial function of businesses. It can assess how well the business is performing. This is important for a business internally as well as externally. Internally, managers want to see how much they are selling, the level of their costs and the level of profit they are making. From that information, they can set budgets and performance targets to plan for the next year. Accounting also shows managers where financial problems might be happening within the business. Externally, every business is legally required to keep records of their finances. A firm has to make its accounts available HM Revenue & Customs. Limited companies also have to publish their annual report and final accounts for the year, as they have a separate legal identity. Also, potential investors will want to know if a company is worth investing their money in and potential creditors will want to know if the business is capable of paying back any loans they may give to them.

Arsenal Holdings PLC does not have a trading account, as they do not tra de. They only sell goods and services.

A profit & loss account takes the gross profit of a firm and deducts all the expenses to find the final profit for the year, which results in the net profit.

Components of Profit & Loss Account

Profit & Loss Account – the profit & loss account shows the true profit of the business and takes all general expenses into account. The account comprises of:

Expenses – amount that the business has to pay out such as wages, advertising etc.

Depreciation – a business' assets do not retain value over time. Machinery loses each year. Businesses must show their reduction in depreciation when they finalise their accounts, otherwise the value of the business will be overstated. Depreciation is classed as an expense to the firm, ther efore, appears on the profit & loss account.

Components of Appropriation Account

Appropriation account – the appropriation account is the statement of how net profit is distributed to various shareholders and partners. This type of account is only for partnerships and limited companies and is not done for sole traders, as the profits made are solely available to the owner. The account comprises of:

Corporation tax – this is tax charged on business profits and is the first thing that is accounted for in th e appropriation account.

Interim dividends – these are dividends that are paid part -way through the company's financial year before final profits are then calculated.

Proposed dividends – these are dividends that are paid at the end of the financial year, after all profits have been calculated.

Reserves – this is what is retained in some limited companies. They decide to keep some of the profits made instead of distributing it to shareholders.

Reserves may be kept for different purposes, for example, to pay for the replacing of machinery in the future.
Retained profit – this is any profit left over after reserves are taken and kept for use for another time.

A balance sheet is a statement that shows the comparison between its assets and liabilities and how the business is funded.
<u>Components of Balance Sheet</u>
The balance sheet is last in the set of final accounts drawn up and gives an overview of the company's financial state on a certain date. The balance sheet comprises of:
Fixed assets – this is the first section on the balance sheet. It shows the items of value that the firm has bought and will use for a long time e.g. machinery, vehicles, equipment, buildings etc. These are known as tangible fixed assets. Fixed assets shown on the balance sheet will show the original prices paid for the assets, their depreciation value and the net current value for each asset.
Intangible fixed assets are items of value that cannot be touched but comes about when a new owner pays the previous owner the book value of the business to compensate for the good reputation of the business.
Current assets – this is second section and displays assets that are promptly available to the business when paying debts and can be converted into cash. This includes stock, debtors, cash in the bank and cash at hand.
Current liabilities – this section shows amounts owed to the suppliers and lenders of the business and need to be paid back as soon as possible. This section normally includes creditors, bank overdrafts, VAT, loans, corporation tax and dividends.
Long-term liabilities – the fourth section shows debts that need to be paid back over a long period of time, for example, a mortgage, debentures and a long-term bank loan.
Financed by – the last section in the balance sheet shows where the money came from to run the business. It also shows the amount taken away from the business for the owner's use (drawings). This last part will also determine whether the final accounts balance. This is done by checking that the net assets amount is the same as the final amount in this section. If it is not the same, the accounts need to be checked again until it balances.

Components of Arsenal's Profit & Loss Account

Arsenal's profit and loss account comprises of:

Turnover of the group including its share of joint ventures – this shows the annual sales made by Arsenal Holdings PLC before the share of turnover of joint venture is added.

Group turnover – the group turnover represents the total annual sales by Arsenal Holdings PLC after the share of turnover of joint venture is added. In Arsenal's case, its group turnover comprises of broadcasting, retail, commercial, property development, player trading and gate & other match day revenues. This is also known as gross profit.

Operating expenses – this shows the costs of operating all of Arsenal's companies on a day-to-day basis. In Arsenal's case, its expenses comprise of amortisation of player registrations, depreciation, staff costs, cost of property sales and other operating charges such a s audit fees and lease payments.

Operating profit/loss – this shows the income or loss generated by Arsenal's operations before interest and taxation are taken into account. This is described as net profit.

Profit on ordinary activities before finance charges – this shows the income from Arsenal's operations before they are charged. Some of the charges include bank loans and overdrafts & fixed/floating rate bonds.

Profit on ordinary activities before taxation – this shows the income from Arsenal's operations before they are taxed. This includes all profits from any source, trading, interest or property, and represents the total results for the financial year.

Profit after taxation retained for the financial year – this shows the income from Arsenal's operations after tax. This includes corporation tax.

Earnings per share – this is the total earnings made by Arsenal and is then divided by the total shares outstanding. Earnings per share are based on the weighted average number of ordinary shares of Arsenal in the reporting year. The calculation of earnings per share (basic and diluted) is based on earnings attributable to equity shareholders added to the adjustment to exclude exceptional charges net of tax relief.

Components of Arsenal's Balance Sheet

Arsenal's balance sheet comprises of:

Fixed Assets – this is the valued items owned by the business use for a long period of time. Fixed assets comprise of tangible fixed assets, intangible fixed assets and investments. In Arsenal's case, tangible fixed assets a re players, their stadium etc. Their intangible fixed assets are the cost & amortisation of player registrations and the net book value. Arsenal's investments include their investment in joint ventures and in subsidiary undertakings. Some of their investments include share holding, property development, retail operations, financing, stadium operations and property holding as well as the football club itself.

Current assets – this is assets that are available to the business and can be converted into cash in a short period of time. Current assets comprise of stock, debtors and cash in hand & at the bank. In Arsenal's case, its stock is in the form of development properties and retail merchandise. Its debtors come in the form of trade debtors and other debtors.

Creditors: amounts falling due within one year – this is the amount that is owed to other parties within a short period of time. This is known as current liabilities. In Arsenal's case, its creditors include secured fixed rate bonds, secured floating rate bonds, secured bank loans and overdrafts, trade creditors, amounts due to group undertakings, corporation tax, accruals & deferred income, social security and other tax.
Net Current assets/liabilities – this is the result of the difference between the current assets and creditors.
Total assets less current liabilities – this is the result of the fixed and current assets combined (total assets) minus current liabilities. The result is known as working capital. In Arsenal's case, its current liabilities are shown as creditors falling due within one year.
Creditors: amounts falling due after more than one year – this is the amount that is owed over a long period of time, ideally more than one year's time. This is known as long-term liabilities. In Arsenal's case, its creditors include secured fixed rate bonds, secured floating rate bonds, secured bank loans, debenture loans, grants, deferred income and other creditors.
Provisions for liabilities and charges – this is for when accounts are being prepared and an amount needs to be set aside for liabilities which are known to exist, but cannot be measured accurately. In Arsenal's case, its liabilities and charges include transfers, deferred taxation, pensions provision and share of losses of joint venture.
Net Assets – this is the result of total assets taken away from its total liabilities. In Arsenal's case, it is total assets less current liabilities minus provision for liabilities and charges.
Equity capital and reserves – this is the name given to shares. Equity capital means share capital. This is given to equity shareholders. Equity is the money that is used to run the business and can be described as all shareholders' funds. In Arsenal's case, its equity capital and reserves come in the form of called up share capital, share premium, merger reserve and the profit & loss account.
Equity shareholders' funds – this is the money generated by the business through investment. This must be the same as the net assets in order for the business to balance.

An appropriation account is an account that shows what a firm has done with its after-tax profits (its earnings). It shows the division of total funds between tax payments, real investment, making external loans or purchasing securities, retention of cash balances, and distribution to shareholders. Part may be paid to ordinary shareholders, as dividends, part to preference shareholders, and the remainder may be retained for investment. The part of the account that is retained adds to the balance sheet reserves. The appropriation account is the last part of the profit & loss account. The appropriation account contains corporation tax, interim dividends, proposed dividends, reserves and retained profit. In Arsenal's case, the appropriation account comprises of:

Taxation – this is the tax that the business is imposed to pay to the government by law. Companies like Arsenal are charged at 30%. Arsenal pays corporation tax through deferred taxation. It is the profits of Arsenal that are taxed and has to be paid.

Profit after taxation retained for the financial year – this shows the income from Arsenal's operations after tax. This is the net profit taken away from corporation tax.

Earnings per share – this is profit for the financial year divided by the average number of shares in issue during the period. It is the amount that could be paid out on each share if the company decided to distribute all its profits as dividends instead of retaining some for future expansion. Earnings per share are divided into basic and diluted shares. Basic shares are shares that are calculated without taking into account stock, warrants and debt whereas diluted shares provides a better measurement of the earnings allocated to each share of stock and includes stock, warrants and debt.

Reserves – this is money that is retained for the benefit of the business rather than distribute it to the shareholders. Reserves may be put aside for different purposes, such as replacing capital assets.

Corporation tax hinders the profitability of Arsenal because 30% of the profit is taken away as a result of this. This will definitely reduce the shareholders' share of the profit available to them as well as the overall profitability of Arsenal. Depreciation also hinders the profitability of the business because, for example, if players are bought at a high price and are sold after 5 years later, it may be at a lower price. Money that is paid to the shareholders is also a hindrance to Arsenal's profitability because if shareholders are paid so that they can be kept happy after the end of the year, there will be limited or no funds existing within the company, therefore, bringing plans to use these funds for improvement to a halt.

The appropriation account is important to all businesses because it allows shareholders to see how the business is doing financially over a period of time, whether quarterly or yearly. It also allows shareholders to see how much dividends are owed to them from the shares they have invested in the company. The appropriation account helps shareholders to know whether it is worth investing in a company of their interest.

Analysis of Arsenal's Balance Sheet

The balance sheet for Arsenal tells us that their financial state has improved over the last year. Arsenal Holdin gs PLC, the company in which Arsenal is run, had a fixed assets total of £520m in 2007, which signifies an improvement on last year's total of £518m. This shows that there was an increase of close to £2m. The fixed assets consist of tangible & intangible fixed assets and investments. The tangible fixed assets for 2007 were £455.3m, a considerable rise from £451.5m in the previous year. However, Arsenal's intangible fixed fell from £66.5m in 2006 to £64.7m in 2007. There was no investment in 2006 but there w as in 2007, which amounted up to £76m. This shows that Arsenal invested heavily this year in players, development property stocks and joint investment ventures.

Arsenal Holdings PLC had a current assets total of £211.2m in 2007, a massive improvement compared to 2006, with a total of £129.5m. This indicates a huge increase of £81.7m. The current assets consist of stock, debtors and cash. The overall stock for 2007 was £101.2m, which was more than double than in 2006, which was £44.9m. Though there was hig her stock, there were fewer debtors in 2007. It fell from £48.9m in 2006 to £36m in 2007. On a good note, the cash available to Arsenal more than doubled to £73.8m in 2007 than the £35.6m available in 2006. This shows that Arsenal had money coming in through properties that can be resold and debtors for player transfers.

Arsenal Holdings PLC owed creditors £150m in 2007, a slight improvement on the massive £167.7m owed in the previous year. This also shows an improvement of £17.7m in debts owed. However, they had a massive increase in money owed to its long -term creditors. In 2007, they owed long-term debts of £416m compared to £321m in 2006, an alarming increase of debts to £94.8m. This shows that Arsenal owed money from bonds, bank loans & overdrafts, so cial security, corporation tax, trade creditors, accruals, deferred income and other creditors, therefore, losing a lot of money in the process.

There was also a vast improvement in Arsenal's net current assets/liabilities, as they had net current assets of £61m in 2007, a significant change to 2006's current net assets of -£38m. This shows a massive difference of £99,397 between the two years. Arsenal's working capital also improved from £479.8m in 2006 to £581m in 2007, an increase of £101m. This shows that Arsenal Holdings had money available to them in order to operate.

Arsenal's provisions for liabilities and charges increased in 2007 to -£31m from -£28m in 2006, an increase of £3.6m in debt. This shows that money was not set aside for Arsenal to u se to pay debts or charges.

Arsenal's net assets increased in 2007 to £133.3m from £130.5m the previous year. This shows that there was an increase of almost £3m in net assets.

Arsenal's equity capital and reserves improved slightly as well. Equity capital and reserves consist of called up share capital, share premium, merger reserve and profit and loss account. The called up share capital, share premium and merger reserve remained the same from 2006, with amounts of £62,000, £29.9m and £26.6m in 2006 and 2007 respectively. The profit and

loss account increased from £73.8m in 2006 to £76.6m in 2007. This shows an improvement of £2.8m.

Arsenal's equity shareholders' funds increased in 2007 to £133.3m from £130.5m the previous year. This shows that there wa s an increase of almost £3m in Arsenal through investment.

Task 3

Fixed capital is money that is permanently invested in the business by its owners. In limited companies, money may come from different sources, as there may be many shareholders. Owners can obtain fixed capital from reserve funds, loans, debentures issued and shares sold. Fixed capital may go up in value if profit is retained and can also be raised through share issues. Fixed capital mainly comes from shareholders. Limited companies' form of fixed capital is share capital. In the case of limited companies, there are different types of share capital that may be held. They are:

Ordinary shares – this is the most common form of shares. It is usually known as equity capital. Anyone that holds ordinary shares become part owners of the company and enables them to vote at general meetings within the firm. Ordinary shares entitle its holder to a dividend, if any, after the payment of the fixed dividend in respect of preference shares. Ordinary shares carry the residual economic value of a company. They carry rights to distribution of profits through dividends and to the surplus assets of a company. Shares are, however, unsecured. This means that shareholders are last in the queue if a company goes bust and has to sell off its assets. If the amount realised is enough to pay off all creditors, the shareholders may salvage something. If it isn't, the shares will be worthless. Profits vary from year to year; therefore, dividends from shares may rise or fall.

Preference shares – these are shares in a company which give their holders an entitlement to a fixed dividend, usually expressed as a percentage return, but which do not carry voting rights. The fixed dividend received does not change even if the company makes very high profits. Preference shares may be issued with the right of conversion into ordinary shares. These are called convertibles.

The important difference between preference and ordinary shares are:

1. The dividend on ordinary shares is uncertain and variable (high when the company does well, poor or non-existent when it does badly). Preference shareholders get a fixed dividend which, if not paid, usually accrues until it can be
2. Each ordinary share usually carries a vote. Preference shares do not usually carry a vote unless dividends fall into arrears.
3. In the event of a winding up, preference shares are usually repayable at par value, and rank above the claims of ordinary shareholders (but behind bank and trade creditors).

Deferred shares – this is similar to ordinary shares, as they only receive dividends in certain circumstances such as specific levels or profit being earned or a particular date being reached. This type of share does not have any rights to the assets of a company undergoing bankruptcy until all common and preferred shareholders are paid. The value of these shares fluctuates with the market and cannot be accessed by the beneficiary for the purpose of liquidation until they are no longer employees of the company. Deferred shares are generally issued to company founders that restrict their receipt of dividends until dividends have been distributed to all other classes of shareholders.

Partnership/sole trader capital – Sole traders and partnerships do not have fixed capital within their business because they do not issue shares. Alternatively, the 'Financed by' or 'Capital and reserve' section of the balance

sheet for a sole trader will have an entry showing the amount of money they put into the business, either at present or later on during the life of the company. This is normally shown as 'Capital' or 'Capital introduced'.
Partnerships are similar to sole traders, except that a separate capital account is required for each of the partners in the balance sheet, which will be shown. The accounts are fixed and will alter only if the partners add extra capital to the business or take some out. The account changes annually as shares in the company profits and interest on the partners' capital are added and each partner's drawings are deduced.
Retained profit – this is the remaining profit retained by the company after all deductions have been made. It is used in two ways. Part of it is allocated to dividends and the rest stays within the company a s retained profits. Even though the retained profit is the owed to the ordinary shareholders of the company, it is retained in the business for future use.
Retained profit becomes a very important part of the balance sheet for a limited company over the ye ars. These profits, however, will eventually be used by the company to buy new fixed assets for the company.
The balance between paying dividends and retaining profit in the company has to be maintained effectively. Paying dividends might keep the shareholders happy at first but it could hinder the growth of the company in the long term, therefore, reducing the value of the shares on the stock markets. With this, the shareholders might see the value of their shares fall. Therefore, paying the shareholders g ood dividends and retaining sufficient profit for expansion are important for the benefit of the company.
Dividends – this is profit given to investors that buys shares from a company. Investors expect something back for their investment in the company. Dividends are what shareholders receive, which is a share of the company's profit over the last six months or year. Dividends will only be paid if the company makes a profit, though, the company may draw on reserves from the past profits to pay dividends. Di vidends will not appear on the balance sheet, as it is an expense to the business and will only appear in the profit and loss account. The dividend given by Arsenal Holdings PLC to its shareholders for this past year was £45.26 per share, a major decrease from last year's share dividend of £127.01 per share.

Working capital measures a business' efficiency as well as short -term financial health and is found at the heart of the balance sheet. It is also the day-to day finance used for operating a business. This is used to pay bills, funds the credit for debtors when making a sale, buys stock and repays loans as well as pay for running costs. Working capital also gives investors an idea of the company's underlying operational efficiency. Arsenal may struggle to finance for certain things if there is minimal working capital available, therefore, stretching its liquidity. However, if Arsenal has excess capital tied up in the short term, it may be able to afford the things needed that could boost efficiency. So, if a company is not operating in the most efficient manner (slow collection), it will show up as an increase in the working capital. This can be seen by comparing the working capital from one period to another. Slow collection may signal an underlying problem in the company's operations.
The formula for working capital is:

current assets – current liabilities = working capital

Current assets
Current assets are anything owned by a business that can be converted quickly into cash before the next balance sheet is drawn up, usually within a year. Current assets usually include stock, debtors, bank and cash. This is where business gains their working capital for the essential running of the business.

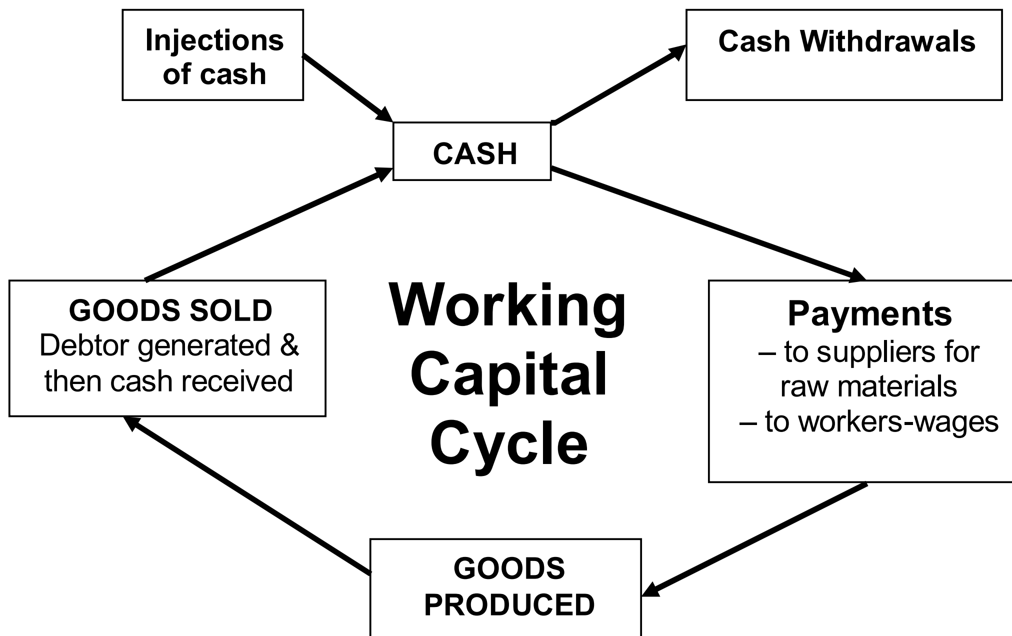
- ♠ Stock – this is the total value of goods for sales, partly manufactured items, and also items that have been completed, made or brought in by the firm and are available for sales to customers. In Arsenal's case, its stock is development properties and retail merchandise.
- ♠ Debtors – the total of all monies owed to the company, which consists of customers who have received goods ordered but have not yet paid for them. In Arsenal's case, they have trade debtors owing them money.
- ♠ Bank – this is the total amount of money held in the company's bank account or accounts
- ♠ Cash – the total amount of cash readily available to the company, which is usually held on the company's premises.

Current liabilities
Current liabilities are anything that the business owes to another company, which is advisable to be paid before the next balance sheet is drawn up, usually within a year. Current liabilities usually include creditors, bank overdrafts, dividends and unpaid tax.

- ♠ Creditors – this is the total of amount of money owed to suppliers that have offered the company credit. Credit terms are usually offered when a business has a good relationship with its suppliers. Therefore, the business may buy stock but are given the opportunity to pay for them at a later date. This makes the supplier a creditor of the firm, as it is owed money that needs to be repaid as soon as possible.

- Bank overdraft – this is when the company has drawn out more than what it has available in its bank account. This is usually repaid with interest and therefore makes it a liability to the business.
- Dividends per Share - The cash payment made by the company to its shareholders. This payment consists of each share that each shareholder owns in the company. Payment is usually made quarterly or annually.
- Unpaid tax – this is the tax put on the business b y the government that should be paid but has not been paid as yet.

Managing working capital using the working capital cycle
The working capital cycle monitors the movement of the cash within the company. Managing working capital is important to a business so that its working capital position can improve. They have to have funds readily available to pay for their day-to-day expenses as well as bills, wages, salaries etc. This is particularly true where there is a substantial time lag between making the product and receiving the money for it. In general terms, the firm's cash becomes tied up once stocks are purchased and it only becomes available again once it is sold. Reducing the period between these two events can relieve the business of any working capita l problems. They must therefore ensure they have enough cash to do this. A typical working capital cycle for a may look like this:



You can calculate a business' working capital cycle using the following formula:
Stock turnover (the number of days goods are held in stock) **+** *debtor collection period (the number of days it takes debtors to pay)* **–** *creditor payment period number of days' credit from suppliers)*

If the figure is high, it means that the cash is tied up for longer in the business. In order to improve its working capital position, it is advisable for the business to reduce the figure.

Managing working capital using stock control

Improving stock control and reducing stock turnover helps to improve a business' working capital position. They can do this by keeping costs at a minimum, therefore, buying the minimum stock needed to function. Another way of managing working capital is by reviewing stock over a period of time. By doing this, they can place orders for the stock needed to bring stock levels back up to maximum level. They can also review whether it is possible to reduce the level used and increase the regularity of the reviews. They can also use the just-in-time method (JIT) to manage working capital. This method helps keep stock at a mere level and orders new stock automatically when it is about to run out using computerised stock control systems. The timing for this is crucial, as the new stock needs to arrive just time before old stock finishes. If this is done right, it reduces stock to help working capital.

Managing working capital by managing debtors

Businesses need to actively manage its debtors or else they will be doomed to failure, especially when the expected money does not arrive quickly enough. Businesses can manage debtors effectively by insisting on cash every time you sell. By doing this, you have no worries about prompt payment. Another way of managing debtors is by checking creditworthiness of customers to see if a business is selling to someone who has been a good payer in the past with other businesses. Another way of managing debtors is by giving customers a small credit limit to start off with. By doing this, it gives customers a chance to prove that they are good payers. Businesses can manage debtors by sending out invoices promptly. By doing this, customers are less likely to forget to pay you and debts are chased up and referred to debt collection when in doubt. They can also manage debtors by making sure further orders are not processed until original debts from customers are cleared. Penalising late payers can manage debtors. Adding interest to overdue payments can do this. By doing this, customers will want to pay as soon as possible. Another unique way of managing debtors is by offering incentives to customers for prompt payment. When doing this, it encourages debtors to pay quickly in order to receive those benefits. Finally, another way of managing debtors is threatening to take legal action if there is no response from the debtor.

There are many differences between fixed capital for a sole trader/partnership and fixed capital for a limited company. Limited companies have share capital but sole traders and partnership do not. Another difference between fixed capitals for sole traders/partnership and limited companies are that limited companies have a variety of shares for people to be held, as investors have the option of holding ordinary, preference or deferred shares. Sole traders and partnerships do not issue shares and have only one form of finance available to them. Another difference is that fixed capital for a sole trader is not shared, while fixed capital in limited companies is given out to each shareholder.

Maintaining working capital within a business is very important for the future of the business. If a business does not have enough working capital, they could end up:

Not being able to pay debts – if a business cannot pay debts of the business, it will go bust. Therefore, the business will not be able to pay for other things such as stock and wages. This will lead to staff becoming frustrated, leaving the business, with no staff available.

Suffering a fall in productivity – if there is no staff available, then no work will be done and minimal or no productivity will come into play.

Losing sales/profits – if no money is coming in or available to the business, they will not make any sales, therefore, not being able to go through the working capital cycle.

Losing reputation – if a business cannot pay its debts, then people like suppliers will give them a bad name, therefore, making the company look unreliable to other people.

Suffering a fall in shares – potential investors will be put off from putting their money into the business because they believe the business is unreliable and has a bad reputation.

Arsenal Holdings PLC might encounter problems in managing its working capital because they might not do credit checks on their customers or they may not chase up their customers when they do not pay on time, which causes Arsenal to lose money. A business may encounter problems in managing working capital because of many reasons. This could be through:

- Excessive borrowing – borrowing is easy but repayments with interest are hard. If a business borrows too much money and are not ab le to pay back, they will have major difficulties.
- Offering too much credit – offering too much credit can mean that cash does not flow into the business quickly enough, making the business starved for cash. If a business offers longer credit terms than t heir suppliers, they will be paying their bills too early and no cash will come in from sales.
- Seasonal businesses – some businesses are successful during a certain season, when cash flows in rapidly at one point in the year and then very slowly in the oth er e.g. ice cream businesses do well during the summer and then poor during the winter.
- Excessive stock – a business may tend to buy large amounts of sock and then find it hard to generate income, raising cash flow concerns.

Arsenal can improve their wo rking capital by increasing their prices in shares as well as merchandise that they sell. If their suppliers have increased the price of their raw materials by 10%, they should also increase their prices to shift the costs to their customers. By doing this , they will not be losing money and it may enable them to either break -even or make a profit. Arsenal can also manage its working capital by not spending too much of its available capital on players. This will enable them to nurture their younger players f rom their academy and save money. Arsenal could also find a cheaper manufacturer. By doing this, they will be able to keep their costs lower. Another way of Arsenal improving its working capital position would be to spread its costs i.e. its electricity an d gas costs. Instead of paying large

amounts at once, they could spread the costs across the year. By doing this, they will reduce their costs.

Managing working capital is very important in a business. A business will be able to invest as well as attract investments, pay for its costs and make profit as result of managing their working capital efficiently.

Task 4

Ratio analysis is the calculation and comparison of ratios that are derived from the information in a company's financial statements. The level and historical trends of these ratios can be used to make accurate inferences about a company's financial performance and condition, its operations and attractiveness as an investment. The stakeholders of a bus iness implore ratio analysis, such as:
Owners – used to inform them when decisions are being made about the future or plans of the firm.
Investors – used to check how well the capital they invested is doing and checking that they are getting a fair return on their money
Suppliers – used to find out how soon they will be receiving the money that they are owed. They can also use the accounts of the business to decide on whether they are worthy of purchasing on credit.
Employees – used to check the firm's accounts to monitor how profitable the business is and request for pay rises or improved working conditions.
Customers – used to check that the business is likely to stay in business, therefore, being able to keep supplying them.
Tax authorities – used to check that the firm is paying the right amounts of tax owed.
Creditors – used to check that the firm is still in a position to make repayments on loans.

Ratio analysis is used to interpret the accounts of a business and consists of:

- Profitability – how well has the business done?
- Productivity – what is its financial state of health?
- Solvency – how well does the business operate?

Profitability ratios

Profitability ratios are the financial statement ratios that focus on how well a business is performing in terms of profit as well as a measure of overall performance. These ratios look at the profits made by the business for the year and compare these figures with the size of the business and the assets used by the business or its level of sales. Profitabil ity ratios can also be used to examine how well the business is operating or how well its current performance compares to past records or to other competitors. The key probability ratios that are used are:

Return on Capital Employed (ROCE)

ROCE is the % return on the capital invested in the business by its shareholder. It is perhaps the most important ratio in measuring profitability because it tells you how effectively the business has used the funds invested in it. It is especially useful to existing or p otential shareholders who wish to have an idea of what sort of return they will get on their investment. For a sole trader like Jane Simpson, ROCE is calculated using the following formula:

$$\frac{\textbf{Net Profit}}{\textbf{Capital employed}} \times 100 = \%\ \text{return}$$

$$\frac{3530}{21030} \times 100 = \mathbf{16.78\%}$$

Ratio	2005	2006
Return on capital employed (ROCE)	45%	**16.78%**

The ratios above for the return on capital employed for Jane Simpson has fallen from 45% in 2005 to 16.78% in 2006, a massive 28.22% decrease. This shows that the interest received from investment was minimal over the year, meaning that Jane Simpson made a loss instead of profit. It is good for the ratio to be high, as it will benefit the owner of the business. However, if the ratio is too high, other stakeholders, such as her employees, might be critical of the business because they may feel they are being underpaid and it is contributing to the business' high returns. They may also be critical because of the small investment put in for the long term.

Return on Net Assets

The return on net assets ratio is a measure of financial performance of a company that takes the use of its assets into account. A low return on assets ratio indicates that the earnings are low for the amount of assets. A low return on assets ratio compared to industry averages indicates inefficient use of business assets. This ratio is very similar to ROCE and used in the same way. It shows how much profit has been earned per pound of assets e.g. a return on net assets of 25% shows that 25p has been earned for every £1 worth of assets. Return on net assets is calculated using the following formula:

$$\frac{\textbf{Net Profit for the year}}{\textbf{Net Assets}} \times 100 = \text{\% return on net assets}$$

Gross Profit percentage

The gross profit percentage ratio gives an idea of the company's pricing, cost structure and production efficiency. It is profit made before indirect expenses are taken into account. The gross profit percentage ratio is a good ratio to benchmark against competitors. A low gross profit percentage could be the cause of an increase in cost of raw materials, discount on prices or loss of stock. The higher the gross percentage, the better. If it is rising, the business will receive more gross profit for every pound of sales. Gross profit percentage is calculated using the following formula:

$$\frac{\textbf{Gross profit for the year}}{\textbf{Sales for the year}} \times 100$$

$$\frac{30900}{39000} \times 100 = \mathbf{79.23\%}$$

Ratio	2005	2006
Gross profit %	33.33%	79.23%

The ratios above for the gross profit for Jane Simpson has risen from 33.33% in 2005 to 79.23% in 2006, a massive 45.9% increase, which i s more than double the previous year. This shows that over the year the company sales have increased and their cost have stayed low. In order to keep up this profit, they need to keep their cost low or and reduce any existing high costs as long as they quality of their product does not suffer. Alternatively, if the profit is too high, the company need to invest their money elsewhere. When figures are compared each year, the company can determine whether it is stable or not when trading.

Net Profit Percentage

The net profit percentage ratio shows all profit made by the business after all expenses are included. It shows what % of turnover is represented by net profit. A net profit percentage of 10% means 10p for each £1 of sales. It helps to compare the gross profit percentage with this ratio, as it shows how much of gross profit is being taken up by the expenses of the business. A fall in net profit percentage would indicate that expenses are increasing, therefore, increasing problems. An increase in net pro fit percentage means that the business is making higher net profit. Net profit percentage is calculated using the following formula:

$$\frac{\textbf{Net Profit for the year}}{\textbf{Sales for the year}} \times 100$$

$$\frac{3530}{39000} \times 100 = \mathbf{9.05\%}$$

Ratio	2005	2006
Net profit %	11.36%	9.05%

The net profit has decreased for 11.36% in 2005 to 9.05% in 2006. This shows the actual profit made by the company after all expenses are taken into account. Once again, the ratios above show that Jane Simpson is making a loss instead of a profit. Increasing gross profit can help improve this. Gross profit can be improved by an increase in sales turnover. The fixed expenses must be kept the same miscellaneous expenses should be kept low. Comparing the net profits from year to year helps to determine if expenses are increasing and what can be done to reduce that.

Gearing ratios

The gearing ratios show the amount of capital invested by the owners compared to borrowed funds e.g. a gearing ratio of 50% shows that the business has borrowed £1 for every £2 invested by the owners of the business. High gearing makes a business vulnerable to problems and

difficulties because they must continue to service its debt regardless of how bad sales are. Gearing ratios are calculated with the following formula:

$$\frac{\textbf{Preference share capital + Long-term loans and debentures}}{\textbf{Ordinary share capital + reserves}} \times 100$$

Productivity ratios

Productivity ratios are the financial statement ratios which measure the ability of a business to meet its short term financial obligations on time. Productivity ratios look at how efficiently a company is using its factors of production to produce products or services and make a profit. The key productivity ratios that are used are:

Stock Turnover

Stock turnover measures how well a company converts its stock into sales. It measures how well the company is making use of the part of its working capital that has been invested in stock. Stock turnover is the main component of asset turnover for companies that have little tied up in fixed assets but hold large amounts of stock, usually trading rather than manufacturing companies. The higher the stock turnover, the better, as the money is tied up for less time stock. The longer this is, obviously the worse this is for the business as the money is not available to be used elsewhere. The ratio is normally expressed as a number of days. Stock turnover is calculated using the following formula:

$$\frac{\textbf{Stock turnover}}{\textbf{Cost of goods sold}} \times 365 = \textbf{Stock turnover in days}$$

Ratio	2005	2006
Stock turnover	72 days	20 days

The ratios above show that the stock turnover has reduced dramatically from 72 days in 2005 to 20 days in 2006. This means that it took 20 days for the company to sell its stock this year, a massive improvement from 2005. This also shows that the business is proving to be efficient. Comparing stock turnover with other businesses in the same industry from year to year will help to determine whether they are selling their stock quicker than their competitors.

Asset Turnover

Asset turnover measures how effectively a business is using assets to generate sales. This measures how many pounds in sales is generated for each pound invested in assets. This ratio is useful to determine the amount of sales that are generated from each dollar of assets. As noted above, companies with low profit margins tend to have high asset turnover and those with high profit margins have low asset turnover, which will determine whether or not a business is working more efficiently. Asset turnover is calculated using the following formula:

$$\frac{\textbf{Sales}}{\textbf{Net Assets}} : 1$$

$$\frac{39000}{21030} = 1.85:1$$

Ratio	2005	2006
Asset turnover	£3.57:1	1.85:1

This ratio gives a company an idea of how well the assets are being used to generate sales for the company. The ratios above show that the asset turnover dramatically decreased from £3.57:1 in 2005 to £1.85:1 in 2006. This indicates that the company is not utilising its assets to build up money for the company effectively. Comparing asset turnover from year to year will help to determine whether or not they are taking too long to get rid of their stock.

Debtor Collection Period
Debtor collection period measures how long it takes a business to collect its debts from customers. A ratio of less than 1:1 (100%) indicates that debt is structured to be repaid quicker than the company has the ability to. The normal period for collecting debts will differ between industries. If the figure is stable, this suggests that the business' debt collection is under control. Debtor collection period is calculated using the following formula:

$$\frac{\textbf{Debtors}}{\textbf{Cost of sales}} \times 365 = \textbf{Debtor collection in days}$$

$$\frac{3400}{8100} \times 365 = 32 \text{ days}$$

Ratio	2005	2006
Debtor collection period	35 days	32 days

This ratio gives the company an idea of how long it takes its debtors to pay for goods through credit. The ratios above show that the company's debtor collection period has decreased from 35 days in 200 5 to 32 days in 2006. This signals that the company's debtors are paying quicker than the previous year, which indicates a slight improvement. Also, this improvement enables the company to pay off its creditors on time as well. Comparing the debtor collection period from year to year will help to determine whether they need to change their policy on payment structures or administer late charges for debtors that take too long to pay.

Creditor Payment Period
Creditor payment period measures the how long it takes a business to pay your creditors. This ratio may highlight difficulties in paying creditors and the loss of creditor discounts by not paying on time. It indicates the efficiency of a business. Efficiency and performance are linked, as efficient busi nesses are usually more profitable. This ratio gives you an insight into the business. If the period increases, it means that either the business is negotiating better with its suppliers or it is having problems paying off debts. If the creditor payment is greater than the debtor payment period, the company will have better credit terms when buying on credit, boosting cash flow in the process. If the debtor payment period is greater than the creditor payment period, it shows that the business is allowing lo ng periods for its costumers buying on credit that it is receiving from its suppliers. This will clearly hinder cash flow in the future. Creditor payment period is calculated using the following formula:

$$\frac{\textbf{Creditors}}{\textbf{Cost of sales}} \times 365 = \textbf{Credit payment in days}$$

$$\frac{4400}{8100} \times 365 = 41 \text{ days}$$

Ratio	2005	2006
Creditor payment period	30 days	41 days

This ratio gives the company an idea of how long it takes to pay back its creditors e.g. suppliers, lenders etc. The ratios above show that the creditor collection period has increased from 30 days in 2005 to 41 days in 2006, a massive 11 day increase. This proves that the company is taking longer to pay back its debts when due. This affects the company b ecause late payment contributes to a bad reputation. Comparing the creditor payment period from year to year will help to determine whether they need to negotiate a suitable payment structure with their creditors. They may also have to reduce their debtor collection period, even though it will mean less cash available, as bills will need to be paid first and foremost before the company can get cash.

<u>Solvency ratios</u>
Solvency ratios are the financial statement ratios that measure the ability of a business to meet its short-term financial obligations on time and how well it can satisfy its long-term debts. The solvency ratio measures the size of a company's after-tax income, excluding non-cash depreciation expenses, as compared to the firm's total debt oblig ations. Acceptable solvency ratios will vary from industry to industry. The lower the solvency ratio of a business, the greater the probability that the company will default on its debt obligations. The key solvency ratios that are used are:
Current Ratio
The current ratio is a test of liquidity which determines whether short -term assets cover short-term liabilities. It shows how many times current liabilities are covered by current assets. High current ratios are needed for companies

that have difficulty borrowing on short-term notice. The generally acceptable current ratio is 2:1. The minimum acceptable current ratio is 1:1. If the ratio is low, it means that there is a danger of insufficient funds to pay debts when it is due. If it is high, it means that there may be too much money invested in stock or sitting idle as cash or debtors and should be invested elsewhere. The current ratio is calculated using the following formula:

$$\frac{\textbf{Current Assets}}{\textbf{Current Liabilities}} : 1$$

$$\frac{16900}{4400} = \mathbf{3.84:1}$$

Ratio	2005	2006
Current ratio	2.2:1	3.84:1

The ratios above show that the current ratio has increased from 2.2:1 in 2005 to 3.84:1 in 2006, an increase of more than 1.5. In other words, the company had £2.20 for every £1 they owed in the previous year , now they have £3.84 for every £1 for 2006. This shows that the business can raise enough money through its assets to pay off long and short term debts, therefore, making them liquid. Comparing the current ratio from year to year will help to determine whether they need to buy new assets or retain their asset level.

Acid Test Ratio
The acid test ratio measures the immediate amount of cash immediately available to satisfy short-term debt. It is similar to the current ratio but it excludes stock, therefore, making it a tougher test of liquidity. The reason for this is that it is sometimes difficult to sell stock quickly and for the expected price if the money is needed as soon as possible, therefore, making it unrealistic to rely on stocks to pay the firm's debts when due. This ratio shows assets that are readily available to the company and could be relied on if a creditor insisted on immediate payment. The ideal ratio to have would be 1 to 1.5, as current assets less stock would cover current liabilities. If it falls below 1, it means that there are little or no liquid assets, therefore, causing problems within the business. The acid test ratio is calculated using the following formula:

$$\frac{\textbf{Current Assets – Stock}}{\textbf{Current Liabilities}} : 1$$

$$\frac{16900-400}{4400} = \mathbf{3.75:1}$$

Ratio	2005	2006
Acid test ratio	0.7:1	3.75:1

The ratios above show that the acid test ratio has increa sed from 0.7:1 in 2005 to 3.75:1 in 2006, an increase of more than 3. In other words, the company had 70p for every £1 available in the previous year, now they have £3.75 for every £1 for 2006. This shows that the company has enough money left over and readily available for use at any time. Comparing the acid test ratio from year to year will help to determine whether they can sell stock quickly and have money to hold within the business.

From the profitability ratios calculated for Jane Simpson, we see that she is not making any profit in her business. Her ROCE (return on capital employed) decreased from 45% in 2005 to 16.78% in 2006. This indicates that she made a massive 28.22% loss instead of profit. Before the expenses are taken into account, her company's gross profit was very healthy, as it increased to 79.23% which more than doubled from the previous year of 33.33%. Unfortunately, she did not generate profit from the capital that was invested in her company. Instead, she made a loss of 9.05%, a decrease of 2.31%. From the productivity ratios calculated for Jane Simpson, we see that she is converting her stock into sales quicker than expected. Her stock turnover decreased from 72 days to 20 days. This indicat es a major fall and a massive improvement. However, her company's asset turnover indicates that she is not generating sales through assets, with the ratios dropping from £3.57:1 in 2005 to £1.85:1 in 2006. From the solvency ratios calculated for Jane Simpson, we see that her company is able to pay off short and long -term debts. Her current ratio increased from £2.20:1 in 2005 to £3.84:1 in 2006 , therefore, making them solvent. Her acid test ratio also shows that she can pay off debts and still have money av ailable for use, with £0.70:1 in 2005 and rising dramatically to £3.75:1.

The limitations of using ratios are that they do not show a company spent its money or how it was earned and also does not show cash flow within the company. Another limitation is that ratios are only authentic when the data is proved also, therefore, if the data is not reliable, the ratios will not be necessarily correct. Another limitation can be that r atios do not think of qualitative factors such as the effect it will have on em ployee morale, relationships with customers & suppliers and many more. Another limitation is that ratios do not explain why a company is located where it is and why it is located there. This is information that could be essential to anybody. Another limitation is that it does not show what kind of customers the business has or how frequent they come in. it also does not specify the amount of money they spend within the company. Another limitations of using ratios is that it does not show staff turnover over the year. It does not show how many employees are recruited or how many have left. This could be vital information to some people, as they may want to know how much is spent on recruitment. Another limitation is that ratios do not show the customer servic e provided by the business. This information could be important to some people because they may want to know the quality of the customer service provided and may judge whether customers will come back again or not. If the costumer service is poor, the busi ness will lose their costumers, therefore, reducing sales within in a year. Another limitation is that ratios do now show the company's competitors. This could be vital information to people, as investors would be able to decide whether it is worth investi ng in or the business can find out what it has to do to steal a march on competitors. Another limitation is that t he ratios also do not tell us how long the company has been in existence, though it could show when the business was established and how long it's been in existence. These show that ratios are limited in the information they can give, even though they may be useful to some extend n as much as they help judge the performance of the business but it does not tell us everything that we need to know about the business.

The ratios prove that Jane Simpson's business is solvent because they have more time to pay off debts.