Interpreting the profit and loss account

The five profit and loss accounts below are adapted from the financial accounts of five different businesses. (Two of the accounts are for 6-month periods; the remaining three are for a full year.)

- **Ericsson** A manufacturer of mobile phones and related products. The selling price of the phones is relatively low compared to their direct costs because the market is so competitive. Marketing and R&D overheads are high. Some 'one-off' losses have arisen from restructuring, but overall the firm is growing, assisted by a policy of retaining approximately two-thirds of profit for further investment each year.
- **Boots plc** A retailer with town centre sites and a number of production plants for its pharmaceutical companies. The majority of its sales are through its retail outlets. Both production and retail activities are in reasonably competitive markets. Problems in 1999 were mainly due to the disposal, at a loss, of a subsidiary, although Boots tried to emphasise that profit quality was still sound by paying a significant dividend to shareholders. Some relatively unsuccessful takeovers have led to it consolidating rather than seeking to grow, leading to accusations of short-termism.
- **Alfred McAlpine** A construction firm that carries out most of its business by subcontracting work to other building firms. The pace of change in the construction industry has required reinvestment of profits, although this has been difficult to achieve in an industry that has been very competitive, forcing down profit margins. Overheads are high compared to most industries, but this also arises because gross margins are large, with high-value-added products or services.
- **Bloomsbury Press** A relatively small-scale publisher that subcontracts its actual printing to other firms. The firm has grown rapidly, but this has meant that printers are aware that Bloomsbury needs to use their services more than in previous years. Marketing expenses have been very high because of the growth in popularity of its 'Harry Potter' books. The benefits of much of this marketing are expected to occur in the following year, in the form of even higher sales and also much better profit figures, but accounting rules mean that the expenses are classified in the year in which they occur. Consequently, expenses have been unusually high in the 2 years shown.
- **Pearson** A communications company, originally a book publisher but now also the owner of the *Financial Times* and some television and broadcast businesses. Gross margins are good. A series of recent mergers and takeovers has led to rapid growth, with shrewd investments in businesses providing the firm with some exceptional increases in profit. These 'one-offs' have been retained in the firm to fund further takeovers, rather than given to shareholders. Dividend payments have varied in accordance with the firm's 'quality profit' rather than its net profit.

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(All figures are in £m)

Year ending:		Firm A 1998	Firm A 1999	Firm B 1998	Firm B 1999	Firm C 1999	Firm C 2000	Firm D 1999	Firm D 2000	Firm E 1999	Firm E 2000
	Sales	13,059	15,169	2,395	3,332	5,044	5,187	6.4	11.4	356	389
(–)	Cost of sales	7,482	8,863	1,127	1,414	2,802	2,816	3.2	6.9	120	133
=	Gross profit	5,577	6,306	1,268	1,918	2,242	2,371	3.2	4.5	236	256
(–)	Expenses	4,220	5,068	942	1,571	1,755	1,820	3.3	4.2	217	233
=	Operating profit	1,357	1,238	326	347	487	551	(0.1)	0.3	19	23
+/–	Exceptional items	(139)	(20)	303	133	(317)	10	0.0	0.0	(2)	(2)
=	Net profit before tax	1,218	1,218	629	480	170	561	(0.1)	0.3	17	21
(–)	Corporation tax	364	300	188	180	146	162	0.0	0.1	4	6
=	Net profit after tax	854	918	441	300	24	399	(0.1)	0.2	13	15
The appropriation account											
	Dividends	282	310	130	144	214	222	0.1	0.2	4	4
	Retained profit	572	608	311	156	(190)	177	(0.2)	0.0	9	11

Exercise 1 *5 marks*

Study the five profit and loss accounts for firms A, B, C, D and E. Match the profit and loss accounts to the five businesses described earlier.

Exercise 2 *25 marks*

Show your reasoning for each of the decisions taken in answer to Exercise 1.

Exercise 3 *7 marks*

(a) Identify a company whose 'profit quality' is less than that shown by its net profit. Justify your choice. *(4 marks)*

(b) Identify a company whose 'profit quality' is higher than the net profit implies. Explain your choice. *(3 marks)*

Exercise 4 *13 marks*

(a) Examine the ten sets of profit and loss accounts and identify the three that you consider show the most successful performances. Explain your reasoning. *(9 marks)*

(b) On what grounds could it be argued that Firm D is operating successfully? *(4 marks)*