Unit 4: Chapter 12

MONITORING A BUSINESS: RATIO ANALYSIS

Learning Outcomes from this chapter

On completion, you should be able to:

- Explain the main ratios used for assessing a company's financial performance
- Illustrate the main uses of the income statement and the statement of financial position for a business
- Calculate and interpret the main profitability, liquidity and debt and equity ratios
- Recommend how to improve profitability, liquidity and debt and equity ratios
- Understand the importance of accountancy and business data in the monitoring of the business enterprise
- Identify the main limitations of ratio analysis when interpreting a company's performance

The income statement

Income Statement for Sample Business Ltd 31/12/19			
	€	€	€
Sales			260,000
Purchases			110,000
Gross profit			150,000
Less expenses			
Carriage out		40,000	
Insurance		28,000	
Depreciation: motor vehicles		22,400	90,400
Net profit			59,600
Less dividends			36,000
Add reserves			12,000
Reserves/retained earnings			35,600

Gross profit	Sales – cost of sales, direct cost of manufacturing
Net profit	Gross profit – expenses
Reserves	Retained earnings, net profit – dividends + previous reserves
Uses	Shows level of expenses (manager), level of dividends (investors)

The statement of financial position

Statement of Financial Position of Sample Business Ltd on 31/12/19			
	€	€	€
Fixed assets	Value	Depreciation	Net Book Value
Premises	200,000	0	200,000
Motor Vehicles	80,000	22,400	57,600
Total fixed assets	280,000	22,400	257,600
Current assets			
Closing stock	13,500		
Debtors	58,300		
Cash on hand	1,700	73,500	
Less creditors falling due within 1 year			
Creditors	32,000		
Bank overdraft	28,000	60,000	
Working capital			13,500
Total net assets			271,100
Financed by	**Authorised**	**Issued**	
Ordinary shares	250,000	150,000	
15-year loan		85,500	
Reserves		35,600	271,100
Capital employed			271,100

Fixed assets	Value of long-term assets a business uses/owns
Current assets	Value of short-term assets (cash, debtors, closing stock)
Current liabilities	Value of short-term debts (trade creditors, overdraft)
Working capital	Short-term finance to run the company day-to-day (current assets **–** current liabilities)
Debt capital	Long-term borrowing (bank loans **>** 5 years **+** preference shares)
Equity capital	Long-term borrowing (issued share capital **+** reserves)
Capital employed	All long-term funding for the business (equity capital **+** debt capital)

Gross Profit Margin (GPM) – profitability ratio

Explanation	Percentage of sales a business keeps after deducting cost of sales
Formula	$\frac{Gross\ profit}{Sales} \times 100 = X.XX\%$
How to improve	Increase sales (advertising campaign) Reduce direct costs
Interested stakeholders	Employees (job security) Investor (measure against competitors) Manager (assess performance, earn bonuses)

Net Profit Margin (NPM) – profitability ratio

Explanation	Percentage of sales a business keeps after deducting all expenses
Formula	$\frac{Net\ profit}{Sales} \times 100 = X.XX\%$
How to improve	Increase sales (promotional campaign) Reduce expenses (change service provider)
Interested stakeholders	Employees (job security) Investor (measure against competitors)

Return on Investment (ROI) – profitability ratio

Explanation	Percentage of net profit from the long-term capital invested
Formula	$\frac{Net\ \ profit}{Capital\ employed} \times\ 100\ \ = X.XX\%$
How to improve	Increase net profit (reduce expenses/increase sales) Reduce long-term loans/debts
Interested stakeholders	Investors (shows their expected return) Employees (with shares)

Current ratio – liquidity ratio

Acid test ratio – liquidity ratio

Explanation	Compares value of current assets owned by the business with how much it owes in the short term. Removes closing stock from current ratio, as it can be slow to sell.
Formula	(Current assets – Closing stock): Current liabilities = X:1 (ideal = 1:1)
How to improve	Sell slow-moving stock at a discount
Interested stakeholders	Employees (shows if there is enough cash to pay staff on time) Suppliers (shows the risk of the business becoming a bad debt)

Debt/Equity ratio – gearing ratio

Explanation	Compares long-term funding of the business – % debt to % equity funding
Formula	Debt capital : Equity capital = X:1
How to improve	<1:1 low geared; 1:1 neutral gearing; >1:1 highly geared
Interested stakeholders	Shareholders (high debt means high interest/repayments)

Limitations of ratio analysis

Changes to staffing	The business may have lost key personnel over the year. The business might not be as strong going into the next year, but this would not be shown in the figures.
Valuation of assets	Assets may be under- or over-valued in order to affect ratios favourably for the business. This may not give a clear and fair representation of the current situation.
Changes in business environment	Predicting the future based on past performance does not factor in changes to the business environment.
Other economic variables	Ratios do not factor in changes in inflation rates. The prices at which the business buys stock could have increased. Sales revenue could have risen without the business actually selling more, if the business increased its prices.