Chapter 18 Ratio analysis

Key terms

1. Fraud: the illegal act of cheating somebody to get money.
2. Gearing: the ratio of a company's loam capital to its share capital.
3. Gearing ratios: explore the capital structure of business by comparing the proportions of capital raised by debt and equity.
4. Performance indicator: a type of performance measurement that evaluates the success of an organization or of a particular activity.
5. Profitability or performance ratios: illustrate the profitability of a business compared to other business.
6. Ratio analysis: to investigate accounts by comparing two connected figures.
7. Return on capital employed(ROCE): the profit of a business as percentage of total amount of money used to generate it
8. Window dressing: the legal adjusting of accounts by a business to present a financial picture that is to its benefit.

1. Profitability ratio

1) **Gross profit margin :** gross profit made on sales turnover / revenue

$$\text{Gross profit margin} = \frac{\text{Revenue}}{\text{Gross Profit}} \times 100$$

2) Operating profit margin : operating profit profit made on sales revenue/turnover.

$$\text{Operating profit margin} = \frac{\text{Operating Profit}}{\text{Revenue}} \times 100$$

3) Profit for the year (Net profit) margin:

- Net profit takes into account all business costs, include financial costs, other non operating costs and exceptional items.

$$\begin{array}{c}\text{Profit for the year margin} \\ \text{(Net profit margin)}\end{array} = \frac{\text{Net profit before tax}}{\text{Revenue}} \times 100$$

2. Liquidity ratio

Measuring liquidity

1. $$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}\text{, should be > 1.5}$$

2. $$\text{Acid test ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$$

3. Gearing ratios; shows the long-term financial position of the business.

↳ It can show the relationship between loans on which interest is paid and shareholders' equity on which dividends might be paid.

$$\text{Gearing ratio} = \frac{\text{Non-current liabilities}}{\text{Capital employed}} \times 100$$

Capital employed (fund for longterm investment) = Total asset - current .liability) or NC liability + Equity

4. Return on capital employed (ROCE or primary ratio)

$$\text{ROCE} = \frac{\text{Operating profit or EBIT (Earning Before Interest and tax)}}{\text{Capital employed (A - CL or NC(L) + E)}}$$