Ratio Analysis

1. *Gross Profit Percentage* :

$$\frac{\text{GROSS PROFIT}}{\text{SALES}} \times 100$$

This ratio shows how effectively a business has controlled it's cost of goods.

The Gross Profit ratio will change if:
a) the selling price of goods changes
b) the cost price of goods change

2. *Net Profit Percentage*

$$\frac{\text{NET PROFIT}}{\text{SALES}} \times 100$$

This ratio shows how effectively the expenses of the business are controlled

The Net Profit ratio will change if :
a) the gross profit ratio changes
b) expenses change

3. *Return on Capital Employed:*

$$\frac{\text{NET PROFIT}}{\text{CAPITAL EMPLOYED}} \times 100$$

This ratio shows the net profit made for each $100 invested by the owner into the business. The higher this percentage the better.

IMPORTANT – often, examiners will take capital employed to mean Average Capital. This means adding the open and closing balance of capital and divide by 2 to get the average. If you are only given the closing Capital, then use this figure.

4. *Rate of Stock Turnover*

$$\frac{\textbf{Cost of Sales}}{\textbf{Average stock}}$$

Average Stock is: $\frac{\text{Open stock + Closing stock}}{2}$

This ratio shows how quickly a business sells it's stock. The higher this ratio the better.

5. *Current Ratio*

$$\frac{\textbf{CURRENT ASSETS}}{\textbf{CURRENT LIABILITIES}}$$

This ratio compares the ability to use current assets to pay the current liabilities.

An ideal ratio is 2:1. A ratio too high means that the business has more current assets than it needs.

6. *Acid test (quick) Ratio*

$$\frac{\textbf{CURRENT ASSETS – STOCK}}{\textbf{CURRENT LIABILITIES}}$$

This ratio shows if there is enough cash assets to pay current liabilities. Stock is the least cash – like current asset and so it is subtracted.

An ideal ratio is 1:1.

7. *Debtors to Sales Ratio*

$$\frac{\textbf{DEBTORS}}{\textbf{CREDIT SALES}} \textbf{ x 365 days(or 12 months)}$$

This ratio shows how long a business takes to collect money in from it's Debtors. The higher the ratio, the worse the business is at getting debtors to pay on time and the more likely it is to have a high level of bad debts and cash problems.

8. *Creditors to Purchases Ratio*

$$\frac{\text{CREDITORS}}{\text{CREDIT PURCHASES}} \times 365 \text{ DAYS (or 12 months)}$$

This ratio shows how long a business takes to pay it's creditors. Taking too long to pay creditors is not a good thing as discounts for early payment are lost or suppliers could refuse to supply goods to the business on credit.

Limitations of Ratios

1. Results do not explain the results but merely show which areas of the business need further investigation

2. Ratios do not take seasonal factors into account.

3. For ratios to be accurate, the information must be timely to be of use – information may not be available for a long time after the end of the financial year.

4. To be useful, ratios must be accurate – some information may not be shown in the accounts of the business.