

How well do you know your business?

Lessons in understanding financial ratios

Expert knowledge means success



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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

The significance of the movement in the figures in the balance sheet and profit and loss account of your business can often be highlighted by the use of ratios.

Below you will find the usual ratios used in the analysis of a business by bankers. An understanding of how they look at your business will help you understand your business better and hopefully improve your margins and operating efficiency and profitability.

Ratios

Gross Profit Margin

This is calculated by expressing the difference between the sales and cost of sales (your gross profit) as a percentage of your sales or turnover.

This ratio measures the performance of the business at its prime level of operations and is therefore of crucial importance. It indicates the contribution that your sales activity makes to the operating costs of the business. Sometimes a gross loss is suffered in which case the margin will be negative and it will contribute to your overall loss.

Trading Overheads

This ratio is arrived at by taking the totals of your trading and operating overheads and expressing them as a percentage of turnover.

This measures the percentage of turnover which is used up by operating costs which are more fixed than variable in nature. It is possible to arrive at a rough break-even level of sales by calculating the exact level of sales and the contribution from it which will exactly meet your operating expenses.

Profit Margin

This is calculated by taking your profit before tax and expressing it as a percentage of your sales or turnover.

This measures performance of the business before deduction of tax, (and sometimes depreciation and extraordinary items).

Current ratio

This ratio is determined by taking the total of the current assets of the business and dividing them by the total of the current liabilities, that is creditors of the business which fall due within 12 months of the balance sheet date. The ratio is often expressed against a measurement of 1 – e.g. 3:1.

This shows how many times your current liabilities are covered by your current assets and gives an indication of the ability to pay your current debts without having to liquidate fixed assets or raise longer-term funds.

Asset cover

This is arrived at by taking current and fixed assets and dividing them by all liabilities.

This shows how many times the total tangible assets of the business (intangible assets are ignored from the calculation) cover total external liabilities. The higher the figure then the greater the degree of safety to creditors and the providers of debt finance.

Where group and related company loans or directors' loans are viewed as quasi-capital, it may be appropriate to exclude these funds from liabilities because they may really be tantamount to the fixed capital of the business.

Acid Test

This is arrived at by dividing the liquid assets of the business (cash immediately disposable, investments, debtors and bills receivable) by the current liabilities.

This ratio shows how many times liquid assets cover current liabilities and indicates the ability to pay current debts from cash and "near cash" assets.

Stock Turn

This is arrived at by taking the total of the stock of raw materials, finished goods and work in progress and dividing them by the total of the cost of sales of the business and multiplying the answer by the number of trading days in the accounting period.

This ratio is expressed in number of days and indicates the speed of stock turnover expressed as the number of days' sales invested in stock and work in progress.

Credit Given

The total of the debtors and bills receivable of the business are divided by the turnover and multiplied by the number of days in the accounting period.

This represents the number of days' credit which is given to customers or clients of the business. Where the business trades substantially for cash, care should be exercised in interpreting the outcome but the trend is nevertheless important.

Credit Taken

This is arrived at by taking the creditors and bills payable of the business and dividing it by the cost of sales and multiplying that answer by the number of days in the accounting period. Alternatively the denominator can be the turnover or sales of the business.

This shows how quickly the business pays its creditors. In the event that the purchases figure is not available the alternative use of turnover or sales may provide a useful indication but it is a less technically accurate method of assessment and care should be exercised in interpreting the outcome. Where trade creditors as opposed to total creditors is separately identifiable from the accounts, that figure should be used rather than total creditors and bills payable.

Debt To Equity

This takes the loans and external finance of the business (as opposed to creditors) and divides the total by the net assets or total of capital reserves. The answer is expressed against the figure of 1 - e.g. 5:1.

This measures the gross level of debt finance against shareholders' equity. Depending upon their nature, it may be appropriate to ignore such items as hire purchase, intra-group loans, directors' loans etc. so as to reflect "outside" debt to equity. Equally there may be a case for including these "inside" debts with the net assets and shareholders' equity as they may be regarded as effectively the same.

Repayment Commitments

This is arrived at by taking the cost of interest and other finance charges which appear in the accounts and adding to it the capital repayments in an accounting period and dividing the total by the profit of the business before tax and depreciation and expressing the total as a percentage.

This measures the percentage of funds generated from ordinary activities before tax and depreciation, which are committed to servicing the interest on and repayment of debt: the lower the percentage then the greater degree of safety for the lender.

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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