Ratio analysis

Ratio analysis is an accounting technique used to compare one figure with another figure. For example if the A business is twice as big as the B business we could represent the ratio of the sizes of the two business in the following way:

A : B = 2 : 1

Ratios help us to instantly check whether a business is sound, and also to compare ratios over a period in time. Ratios can be used for the following purposes:

1. Examining trends in results over a number of years.

2. Comparing the results of a business with results of other businesses.

3. Comparing the results of the business with the average results of all

businesses in that sector.
In business we also use the term ratio to apply to other measures such as calculations e.g. profit figures.

Here are some of the most important ratios used in business:

Profit margin ratios:

Gross profit % = (Gross profit / Sales) x 100%

Operating profit % = (Operating profit / Sales) x 100%

Gearing ratio:

Gearing ratio = (Preference share debt - cash at bank) / Equity

Management ratios:

Return on ordinary shareholders funds = (Net profit before tax / Average Equity) x 100%

Return on capital employed (ROCE) = (Operating profit / Average capital employed) x 100%

Investment ratios:

Earnings yield = (Earnings per share / Share Price) x 100%

Earnings per share = Net profit (after tax and preference divi) / Number of ordinary shares

Price/earnings ratio = Market price of share / Earnings per share

Dividend yield = (Dividend per share / Market price of share) x 100%

Dividend cover = Net profit / Dividends

Interest cover = Profit (before interest and tax) / Intrest payable for year

Solvency ratios:

Working capital (current ratio) = Current assets / Current Liabilities

Acid or quick test ratio = (Current assets - stock) / Current Liabilities

Debtor days and creditor days:

Debtor days = (Average trade debtors / Credit sales) x 365 days

Creditor days = (Average trade creditors / Credit Purchases) x 365 days