Monitoring the Business: Ratios

Help Sheet

There are 6 ratios students will need to know, they must be learned off by heart and applied to this topic.

Profitability x 3- Want a high as possible- all answers as a percentage

Gross Profit Margin (Gross Profit Percentage)

Gross Profit X 100 = %

Sales 1

To get Gross Profit- Net Profit +Expenses = Gross Profit/ Sales- Cost of Sales = Gross Profit

•Gross Profit Margin shows the percentage of profit on all items sold before expenses are taken into account- it is the profit percentage from all trading (buying and selling). The higher the percentage the better, as the business will have more money to cover its expenses

•For example, if Gross Profit Margin was 30%, this would mean that for every €100 of sales, the business made €30 Gross Profit, which can be used to cover expenses

**Advice if problem: Sell more products to increase sales, charge a higher selling price to increase gross profit**

Net Profit Margin (Net Profit Percentage)

Net Profit X 100 = %

Sales 1

*To get Net Profit- Gross Profit- Expenses = Net Profit*

•Net Profit Margin shows the overall percentage profit for the business after covering all costs, including expenses. As the business aims to make a profit, the higher the net profit the better

•For example, if the net profit is 10%, this means that for every €100 of sales, the business makes €10

**Advice if problem: Reduce expenses- e.g. shop around for cheaper supplier of gas/electricity/increase selling price to make more profit**

Return on Investment/Return on Capital Employed (always compare to banks risk free interest rates)

Net Profit X 100 = %

Capital Employed 1

**\*Capital Employed is made up of all three Gearing numbers- Issued/Ordinary Share Capital + Retained Earnings/Reserves + Long Term Loan**

**Advice if high/increased based on previous year: Makes it easier to attract new investors, potential to get more capital for expansion, potential wage demands from employees due to performance**

**Advice if low/decreased based on previous years: Harder to attract shareholders due to uncertainty, harder to acquire finance for expansion, job security issues for employees due to performance**

Liquidity Ratios- Ability for a business to pay short term debts as they fall due- all answers as Ratios

Current/ Working Capital Ratio

Current Assets: Current Liabilities =: (Ideal is 2:1)

If figure is close to 2 then the firm is liquid, able to pay debts as they fall due. If it below 2:1, they may need to solve this problem by sourcing cheaper suppliers or stop selling on credit.

Acid Test/ Quick Ratio

Current Assets- Closing Stock: Current Liabilities =: (Ideal is 1:1)

If acid test is close to 1:1, the firm is liquid. They should be able to pay short term debts as they fall due. If acid test is worsening from last year than the trend indicates that the firm’s liquidity position is worsening, corrective action must be taken such as selling excess stock at a discount.

Gearing Ratio- Examines the types of long term finance or capital being used- A firm would want this to be as low as possible- Answer is a Ratio

Debt Capital: Equity Capital=: (want below 1:1)

(Loans: Retained Earnings/Reserves + Ordinary/Issued Share Capital) (Note- NEVER USE AUTHORISED SHARE CAPITAL)

Examines how much long term debt the business is in. Higher than 1:1- business is highly geared- it has a lot of debt.

**Too much debt is bad- High Gearing Position:**

•A lot of interest to repay on loans

•Will reduce its ability to get more loans- seen as a risk by the bank

•Greater chance of going bankrupt- this money has to be repaid if a business fails

•May not be able to pay high return (dividend) to shareholders- they may not be attracted to your business or go elsewhere

•May need to use collateral to get loans