Rapid Revision: Ratio Analysis

1. Write out the formula for each of the following Ratios:

Ratio	Formula	Important to Note
Gross Profit Margin **(Profitability)**	$\frac{\text{Gross Profit}}{\text{Sales}} \times \frac{100}{1}$	**Expressed as percentage, you want to be as high as possible**
Net Profit Margin **(Profitability)**	$\frac{\text{Net Profit}}{\text{Sales}} \times \frac{100}{1}$	**Expressed as percentage, you want to be as high as possible**
Return on Investment/Return on Capital Employed **(Profitability)**	$\frac{\text{Net Profit}}{\text{Capital Employed}} \times \frac{100}{1}$ ($\frac{\text{Net Profit}}{\text{Long Term Loan + Issued Share Capital + Retained Earnings/Reserves}} \times \frac{100}{1}$	**Expressed as percentage, you want to be as high as possible**
Current/Working Capital Ratio **(Liquidity)**	Current Assets : Current Liabilities	**Ideal 2:1 or higher**
Acid Test/Quick Ratio **(Liquidity)**	Current Assets – Closing Stock : Current Liabilities	**Ideal 1:1 or higher**
Debt/Equity Ratio **(Gearing)**	Long Term Loan : Issued Share Capital + Retained Earnings/Reserves	**Ideal 1:1 or lower**

* Issued Share Capital can also be known as ordinary share capital

2. **Circle the correct option from the following information**

- A way to improve Net Profit Margin is to **increase/reduce** expenses such as staff wages or source cheaper suppliers
- Return on investment should always be compared with the risk-free investment offered by **shareholders/the bank**
- **Liquidity/Profitability** measures a business ability to pay **short/long term** debts as they fall due
- Making high interest payments and low dividends to shareholders is a result of being **highly/lowly geared**
- It is better for a business to have **more/less** debt capital than equity capital

3.

Stylish Tile & Bath Ltd provided the following financial information for 2020:

Net Profit	€72,000	Return on Investment
Issued Ordinary Share Capital	€450,000	2019 = 7%
Long Term Loan	€100,000	
Retained Earnings	€26,000	

(i) Calculate the **Return on Investment (ROI)** for the owners of Stylish Tile & Bath Ltd for 2020. Show your formula and your workings.

Workings: $\frac{\text{Net Profit}}{\text{Capital Employed}} \times \frac{100}{1} = \frac{NP}{ISC + LTL + RE} \times \frac{100}{1}$ $= \frac{72{,}000}{450{,}000 + 100{,}000 + 26{,}000} \times \frac{100}{1} = \frac{72{,}000}{576{,}000} \times \frac{100}{1} = 12.5\%$	**Return on Investment 2020:** 12.5%

(ii) Analyse the significance of the change in the Return on Investment for Stylish Tile & Bath Ltd.

It has increased from 7% to 12.5% - will make it easier to attract investors due to increase / employees may seek pay increase due to increase in return / more money available to fund strategic goals such as expansion

4.

(a) Using the figures below calculate the **Current Ratio** for 'Sentry Ltd'.

(Show your workings)

CA	— Debtors	€12,000
CL	— Bank Overdraft	€20,000
CA	— Cash	€15,000
CL	— Creditors	€50,000
CA	— Closing Stock	€ 8,000

Workings Current Assets : Current Liabilities

CA = 12,000 + 15,000 + 8,000 = 35,000

CL = 20,000 + 50,000 = 70,000

35,000 : 70,000

0.5 : 1

Answer: 0.5 : 1

(b) Comment on the liquidity position of Sentry Ltd:

0.5:1 well below Ideal 2:1. will have difficulty paying short term debts as they fall due. They only have 50 cent available to cover every €1 of liabilities. not a good position to be in.

5.

(a) Using the figures below, calculate the **Debt/Equity ratio (Gearing)** of Lalco Ltd. for 2015. **(Show your formula and workings.)**

Reserves	€130,000
Long-term Loan	€700,000
Ordinary Share Capital	€220,000

Formula: Long Term Loan : Ordinary Share Capital + Reserves

Workings:
700,000 : 220,000 + 130,000
700,000 : 350,000
2:1

Answer: 2:1

(b) Outline whether Lalco Ltd. is highly geared or lowly geared **and** the possible effect this result has on the business.

Highly geared :- Twice as much capital coming from debt than equity (2:1) - will have high interest payments, may impact on ability to borrow in future and low/no dividend payments.

6. Outline three limitations of using Ratio Analysis

1. • Business Climate and Staff relations with management not taken into account - eg. doesn't show if there were strikes/ or Covid that closed business down/Inflation

2. • Ratios based on past figures and not projected future ones
• Assets may not be shown to their true value

3. • Accounts may only be true for day they are written
• Different Accounting policies can be used from one year to the next.