

Ratio Analysis

1. Gross Profit Percentage :

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

This ratio shows how effectively a business has controlled its 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. Current Ratio

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

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.

5. Acid test (quick) Ratio

$$\frac{\text{CURRENT ASSETS} - \text{STOCK}}{\text{CURRENT LIABILITIES}}$$

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.

Limitations of Ratios

1. Ratios are only relevant if they are compared with the ratios of other businesses that are of a similar type and size.
2. Ratios do not take external factors into account such as inflation, government taxes and what competitors might be planning to do such as launch a new better product.
3. Ratios do not take into account internal factors that affect the success of the company such as motivation.
4. To be useful, ratios must be accurate – some information may not be shown in the accounts of the business.

