**RATIO ANALYSIS**

Ratios are used to see how well the company is doing. They are used to compare the performance of a company over a period and or against other business in the same industry. There performances are compared in percentage terms instead of money. There are 3 main categories of ratios that yo need to know. They are

1. Profitability – These ratios look at how profitable the business is and looks at the relationship between Profit, Sales and capital employed
2. Liquidity – This measure the company’s ability to repay its short-term debts. Not being able to repay back debt is one of the reasons why business fail
3. Gearing – This looks at how much of the business capital comes from external source (Loans)

**USERS OF FINANCIAL INFORMATION**

**Stakeholders** **Def** These are the people who have an interest in a business. They are affected by the activities of the business and how well it is doing

The following are the main stakeholder sin a business

1. *Employees and Managers*

Employees and managers ill be interest in how well the business is doing because if the business is doing well, they will have a job but if the business ids trading poorly, they might lose their job. Ratios look at how solvent a business is. Also, if the business is trading profitability, they may be rewarded for their hard work

**Solvent Def** This means the business can pay all its debts. It is when the company’s Total assets are higher, they their External debt

**External Debt Def** This is also known as Liabilities. It refers to the whom the business owes money too

1. *Share holders*

Share holders are the owners of the business so they will look at the profitability ratios and will be looking for a dividend in return for their investment. The will also be looking at the return they get for their investment (Return of Investment)

**Dividend** **Def** This is money the shareholders receive for investing their money in a business. The dividend is usually paid out of the companies profit. This higher the profit the higher the dividend

1. *Lenders*

Lenders will be looking art the liquidity ratios and the company ability to repay its debts as they fall due. High level of debt will put pressure on the business to make repayment because they will have to pay interest as well as the loan

1. *Suppliers*

Suppliers will also look at the liquidity ratios of the business. Suppliers who provide goods on credit will have interest on this ratio because they don’t want to supply goods to customer who can pay fro them thus creating a Bad Debt

**Bad Debt** **Def** This is a customer who can’t p pay for the goods that they bought on credit from the company. This means that the company will have to foot the bill themselves thus having less of a profit

**Credit Def** This means buying for good now paying for them later. Usually 30 days

1. *Government*

The government will be interest in the companies ration t make sure that they are pay the correct tax. Compony ay the government Corporation tax, VAT, PRSI from the profit they make

**PROFITABILITY RATIOS**

You need to know the following ratios. This includes the formula, how to use the formula and how to comment on the ratio. The profitability ratio looks at how profitable the business is and looks at the relationship between Profit, Sales and capital employed

|  |  |  |
| --- | --- | --- |
| **Gross Margin** | **Net Profit** | **Return on Capital Employed** |
| *Formula*  Gross Profit X 100  Sales 1 | *Formula*  Net Profit X 100  Sales 1 | *Formula*  Net Profit X 100  Capital Employed 1 |
| *Explanation*  This show the amount of Gross Profit the company makes form sales. So, if the Gross Margin was 40% this means that the company make 40c for every €1 of sales | *Explanation*  This show the amount of Net Profit the company makes form sales. So, if the Net Margin was 20% this means that the company make 20c for every €1 of sales | *Explanation*  This show how well the company is using capital to generate profits. Investors compare the best return offer to invest their money. TI is also good to compare with risk free investment of 5% |

**Comment on the Profitability ratios**

To comment on the profitability ratios, answer the following questions

1. Say what the formula means
2. What was the ratio this year?
3. What was the ratio last year?
4. How much did it go up/down by? Is it a positive or negative trend?
5. Would the stakeholder be happy or not and why?
6. If it is a negative what does the company have to do to improve it?

NOTE See page 356-360 of text book for questions

**LIQUIDITY RATIOS**

You need to know the following ratios. This includes the formula, how to use the formula and how to comment on the ratio. This measure the company’s ability to repay its short-term debts. Not being able to repay back debt is one of the reasons why business fail

|  |  |
| --- | --- |
| **Working Capital Ratio** | **Acid test Ratio (Quick Ratio)** |
| *Formula*  Current Assets: Creditor falling due with 1yr  OR  Current Assets  Creditor falling due with 1yr | *Formula*  Current Assets – Less Closing Stock: Creditor falling due with 1yr  OR  Current Assets – Closing Stock  Creditor falling due with 1yr |
| *Explanation*  This shows if the business has enough short-term assets to generate cash to pay back short-term debts. The ideal ratio is 2:1. This means that for every €1 owed by the company they have €2 in assets for pay it back | *Explanation*  This ratio takes closing stock out because if can be hard to convert it into cash quickly. The ideal ration is 1:1. This means that for €1 they owe they have €1 to pay in assets. |

**Comment on the Liquidity ratios**

To comment on the Liquidity ratios, answer the following questions

1. Say what the formula means (what is the ideal)
2. What was the ratio this year?
3. What was the ratio last year?
4. How much did it go up/down by? Is it a positive or negative trend?
5. Would the stakeholder be happy or not and why?
6. If it is a negative what does the company have to do to improve it?

NOTE See page 360-362 of text book for questions

**SOLVENCY**

**Solvency** **Def** This looks at the company’s ability to pay its total debt

This looks at the total assets less the external liabilities. If a company has more assets than liabilities the it can repay its debts but if the liabilities are higher that the assets, then the company is Insolvent.

**Insolvent** **Def** This means that a company is not able to repay its debt as they fall due so may become bankrupted if they can’t find another solution

NOTE See page 362 of text book for questions

**GEARING**

Gearing looks at hoe much capital in the company is from Debt (Loans) compare to the capital that is provided by shareholders (Equity)

**Debt Capital** **Def** This is long term debts (Debentures, Mortgages long term loans)

**Equity Capital** **Def** This is money that is provided by shareholders (Share capital and

Reserves)

**Low Gearing** **Def** This is a company that doesn’t have a lot of fixed interest repayment so are a less risky business. Equity capital is higher that debts capital

**High Gearing** **Def** This is a company that has a lot of loans which means they have a lot of interest to repay. This means that they are a high-risk company. Debt capital is higher that equity capital

|  |
| --- |
| **Gearing** |
| *Formula*  Debt Capital: Equity Capital |
| *Explanation*  Business that are highly geared will find it hard to raise finance because lender will not get much of a return and the company is a high risk of not paying back its debts |

NOTE See page 364 of text book for questions