3.5 Profitability and liquidity ratio analysis

The big picture

Imagine that a business earns a profit of 2 million HKD. With only this information, it is usually impossible to tell whether a business is doing well. Only by comparing financial figures to other data is it really possible to know the health of a business. Ratio analysis helps to do this. In simple terms, a ratio is one number expressed in terms of another number. For example, in a school with 40 male and 60 female teachers, the male to female ratio is 2:3.

Financial ratios are quantitative expressions of the relationships between variables in the final accounts that you learned about in Subtopic 3.4 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39045). Financial ratios give a better understanding of a business's performance because they put the business results into context through comparisons. Considered on their own, the profit and loss account and the balance sheet do not provide much insight into the financial health of a business. For example, a seemingly high profit figure for the year may not reveal much about the business's efficiency unless the profit figure is compared to the value of capital employed.

Figure 1. Financial figures on their own have little meaning; they need to be compared and put into context in order to be understood.

Credit: SEAN GLADWELL, Getty Images

Ratio analysis helps businesses to:

- understand the relative size of their profits
- identify trends in profitability, liquidity and efficiency over time
- control their costs
- make decisions about investments and growth
- make comparisons with competitors in the same industry

Concept

Change

Any changes in a business's external environment (Section 1.1.6 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/tool-business-plan-id-36505)) will cause changes in the financial ratios for the business as well. For example, a change in corporate tax rates or interest rates will cause changes to the net profit and will therefore affect the ratio analysis.

The COVID-19 pandemic caused major changes to businesses globally. Companies closed down, became bankrupt and experienced supply-chain problems. Unemployment and debt increased. Such changes had a major impact on the financial ratios of many businesses.

This subtopic will focus on the methods used to calculate profitability and liquidity ratios. It will also address the importance of these ratios for businesses and the strategies businesses can use to improve these ratios. This quantitative analysis is important to help guide business decision-making and to measure the performance of a business over time.