

ANALYSIS OF PUBLISHED ACCOUNTS (5.8)

(Chapter 35 - A level 5.8)

In a previous topic, we went over **profitability ratios**, which measure the overall performance of a business, and **liquidity ratios**, which shows the ability of a firm to pay its short term debts.

There are also other ratios used to measure more aspects of business activity. These are :

- ❖ **Financial efficiency ratios**
- ❖ **Gearing ratios** (measure risk)
- ❖ **Investor ratios** (used by shareholders)

Efficiency ratios

Financial efficiency ratios show a business how well they are using their resources. They are usually used when liquidity ratios have identified potential liquidity problems. Efficiency ratios help to narrow down the precise nature of the problem. The two efficiency ratios are :

- **Inventory turnover** - is the rate that inventory stock is sold, or used, and replaced. Ultimately, the inventory turnover ratio measures how well the company generates sales from its stock.
The higher the number, the more efficient the managers are in selling inventory rapidly. The result is not a percentage but the number of times inventory turns over in the time period – usually a year.

$$\text{Stock Turnover Ratio Formula} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

- **Days in sales receivables** - this ratio measures the number of days, on average, it takes the business to recover payment from customers who have bought goods on credit – the trade receivables.
There is no right or wrong result, it will vary from business to business. If it takes too many days (ratio is too high) then the management of credit collecting is poor, if it takes too little days (ratio too low) then customers may ask for more credit.
A business selling almost exclusively for cash will have a very low ratio result. The result will be in days.

$$\text{Debtor Days Formula} = \frac{\text{Average Accounts Receivable}}{\text{Annual Total Sales}} \times 365 \text{ Days}$$

Gearing ratios

Financial gearing is used to measure risk associated with financing the business. The two financial risk related ratios are :

- **Gearing ratio** - the ratio shows the extent of which the business is financed from long-term loans. The higher the ratio (+50%), the greater the risk of investing into the business - as they have a lot of unpaid loans.
A low ratio shows a safe business strategy, but also a potential lack of ambition to take loans to expand the business. (It has a lot of different formulas.)

$$\text{Gearing (\%)} = \frac{\text{Long-term liabilities}}{\text{Capital employed}} \times 100$$

- **Interest cover** - often used alongside the gearing ratio, it is a debt and profitability ratio used to determine how easily a company can pay interest on its outstanding debt. (lots of unpaid loans.)
The higher the ratio (%) the lower the risk to investors.

$$\text{Interest Coverage Ratio} = \frac{\text{Earnings before Interest and Taxes (EBIT)}}{\text{Interest Expense}}$$

Investor ratios

Investor ratios are usually used by potential investors to see whether or not they should invest in a business. Or potential investors who are deciding whether they want to stay invested in a business. The three investor ratios are :

- **Dividend yield** - this ratio helps compare a company's stock price with its dividends. It provides an idea of how well the company distributes its profit to its shareholders. Investors will compare this to other businesses dividend yields to see which investment is better.
A high dividend yield ratio indicates that the company is giving a good share of its profit to its shareholders.

$$\text{Dividend yield (\%)} = \frac{\text{dividend per share} \times 100}{\text{current share price}}$$

- **Dividend cover** - it indicates the number of times that a company can pay dividends to shareholders from its total income. A result above 1.5 is ideal. Not measured in %.

$$\text{Dividend cover ratio} = \frac{\text{profit for the year}}{\text{annual dividends}}$$

- **Price/earnings ratio** - tells investors how much a company is worth, this can be used to compare with other businesses. Not a %. The higher the number the better.

$$\text{Price/earnings ratio} = \frac{\text{current share price}}{\text{earnings per share}}$$