

Lecture 11

Interpretation of Accounting Ratio

The objective of ratio analysis is to *assess the financial performance and position of a company. This serves:*

- 1] Year-to-year performance
- 2] Firm-to-firm performance (*of course, it is in same industry*).
- Broadly speaking, basic ratios can be grouped into **five categories**.

Profitability and return

1] ROCE (Return on Capital Employed)

Return on Capital Employed =

Profit Before Interest and Taxation (PBIT)

Shareholders' Equity + Long Term Liabilities

When analyzing ROCE, there are **2 factors that contribute** towards a return on capital employed in terms of why the ratio is high or low. They are:

- 1] **Profit Margin**: It measures how much profit based on operating activity can be earned from a sale of 1 dollar (*thus, the profit before interest and taxation is used*).
- 2] **Asset Turnover**: It measures how well the assets of a business are used to generate sales.

2] ROE (Return on Equity)

Return on Equity =

Profit After Tax and Preferred Dividend
Ordinary Share Capital and Other Equity

It is not a widely-used ratio.

Long-Term Solvency and Stability

1] Capital Gearing

Capital Gearing =

Total Long-Term Debt

Shareholders' Equity + Total Long-Term Liabilities

It measures the proportion of a company's capital that is from long-term debt or share capital. Total long-term debt includes preferred shares and debentures. In general, more than **50%** is said to be high-g geared. Highly-g geared company will face difficulty in finding new sources of finance.

Long-Term Solvency and Stability

2] Interest Cover

Interest Cover =

$$\frac{\text{Profit Before Interest and Tax}}{\text{Interest Charges}}$$

The interest cover shows whether a company is earning enough profits before interest and tax to pay its interest cost comfortably.

Short-Term Solvency and Liquidity



1] Current Ratio

Current Ratio =

Current Assets

Current Liabilities

The idea behind this is that a company should have enough current assets that give a promise of cash to meet its future commitments to pay off its current liabilities. Obviously, a ratio in excess of 1 should be expected.

2] Quick Ratio

Quick Ratio =

$$\frac{\text{Current Assets - Closing Inventory}}{\text{Current Liabilities}}$$

Not all companies are able to convert all their current assets into cash very quickly. For example, manufacturing companies might hold large quantities of raw material stocks. This ratio should be at least 1.

Efficiency

1] Account Receivable Collection Period

AR Collection Period =

$$\frac{\text{Trade Receivables}}{\text{Credit Sales}} \times 365 \text{ days}$$

It is a rough measure of the average length of time it takes for a company's customer to pay what they owe. The figure for sale should be taken as the credit sale in the income statement. The trade receivables are taken from only debtors in the balance sheet.

2] Inventory Turnover Period

Inventory Turnover Period =

$$\frac{\text{Inventory}}{\text{Cost of Sales}} \times 365 \text{ days}$$

A lengthening inventory turnover period from one year to the next indicates two things:

- a) A slowdown in trading
- b) Investment in inventories is becoming excessive.

3] Account Payable Payment Period

AP Payment Period =

$$\frac{\text{Trade Accounts Payable}}{\text{Purchases}} \times 365$$

An increase is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from suppliers, increased bank overdraft and so on

Stock Market Ratio

1] Earnings Per Share

According to FRS 3, earnings per share (EPS) is defined as

The profit *after tax and after deducting preference dividends divided by the number of ordinary shares.*

2] Price/ Earnings

$$\text{P/E Ratio} = \frac{\text{Market price per share}}{\text{EPS}}$$

P/E ratio reflects the market appraisal of the share's future prospect. If one company has a higher P/E ratio than another, it is because investors either expect its earnings to increase faster than the other or consider that it is a less risky company or in a more secure industry

3] Dividend Yield

Dividend Yield =

$$\frac{\text{Dividend on the share for the year}}{\text{Current market value of the share}} \times 100$$

It is the return a shareholder is currently expecting on the shares of a company.