Ratio analysis - CIMA

Management accountants prepare both financial and non financial information to support the business. They combine the relevant expertise of a traditional professionally qualified accountant with an understanding of the drivers of cost, risk and value in a business. This enables them to provide analysis and insights which are used to improve future performance. Businesses generate a huge amount of data. Management accountants can use a number of the companyõs key accounting statements to extract greater meaning from this information. The income statement sets out the total sales revenue and subtracts the costs of generating that revenue to give operating profit. This is the surplus earned by the normal operations of the company and tells us most about underlying business performance. Prospect plc is expanding rapidly as it builds a commercial property portfolio consisting mainly of shops and offices. The company receives rents and also benefits from any profits when it sells property and sites.

	£m 2012	£m 2011	
Sales revenue	120	80	*From products/ services sold*
(less) Expenses	105	60	*E.g. costs, overheads*
(equals) Operating profit	15	20	

The balance sheet (or statement of financial position) shows the wealth of a company at a particular date. It lists the company's assets (what it owns) followed by its liabilities (what it owes) ï the difference being the net assets. Assets may be current, such as cash, or fixed, such as property or equipment. This value represents the shareholders' equity ï the value in the company that the shareholders actually own.

This looks as if Prospect plc has expanded very fast indeed ï but how strong is its performance?

	£m 2012	£m 2011
Fixed (non-current) assets	135	80
Current assets	75	45
Current liabilities	60	25
Net current assets (or working capital)	15	20
Total assets (current plus fixed) less current liabilities	150	100
Non-current liabilities	70	30
Net assets	80	70
Total shareholders' equity	80	70

Accounting ratios allow different pieces of financial data to be compared. Analysing some key ratios helps to explore behind the figures and offer strong clues for the business to steer towards its objectives (previous year data in brackets):

Current ratio

This is a measure of liquidity i.e. the ability of a firm to pay its short term debts.

= current assets/current liabilities
= 75/60 = 1.25 (1.8)

Gearing

The gearing ratio shows how much of a firm's capital is from long-term loans, which must be paid back regularly with interest. The more highly geared a firm is, the greater the risk it faces.

= non-current liabilities/(equity + non-current liabilities)
= 70/(80 + 70) = 46.6% (30.0%)

Return on Capital Employed (ROCE)

This is a measure of profitability. ROCE compares the level of profit made to the value of the capital invested in the business.

= operating profit/(equity + non-current liabilities)
= 15/(80 + 70) = 10% (20%)

Profit margin

Another profitability ratio, profit margin identifies what percentage of the revenue remains as profits after all costs have been paid.

= operating profit/sales
= 15/120 = 12.5% (25%)

The chart shows every sign of a firm that has expanded too quickly:

Åsales have increased by an impressive 50% in one year
Åhowever, profitability has halved
Åliquidity has weakened while gearing is more risky at nearly 50%.

The result is a danger signal! Management accountants investigate this sort of data in order to alert managers to worrying trends, as well as to possible opportunities.

Questions

1. What are financial ratios?

2. List the five main types of ratios used by organisations.

3. Explain why one set of ratios is unlikely to be very useful to management accountants.

4. Analyse the limitations of using financial ratios.

Task

Locate last year's final accounts for an organisation of your choice. You should be able to find the accounts of public limited companies on the internet. Now calculate the following financial ratios for the firm.

- Gross and net profit margins
- ROCE
- Acid test ratio
- Gearing

Now pair up with someone else and compare the sets of ratios for two different organisations. Write a report explaining which organisation you feel is in a better financial position and why.

What have you learned?

Draw a mind map showing the financial ratios.