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# Ratio analysis

2017-18

# FINANCIAL RATIOS

- ▶ *Gearing ratio*: long-term financial position
- ▶ *Profitability ratio*: shows how well business is doing
- ▶ *Return on capital employed (ROCE)*: measures profitability of business

# GEARING RATIOS

## DEFINITION

- ▶ Relationship between
  - ▶ loans on which interest is paid, and
  - ▶ shareholders' equity on which dividends might be paid
- ▶ Formula:

$$\text{gearing ratio} = \frac{\text{non-current liabilities}}{\text{capital employed}} \times 100\%$$

# GEARING RATIOS

## INTERPRETATION

- ▶ *highly geared*: loans are high relative to share capital
- ▶ as business gets *highly geared*:
  - creditors consider the business to be *more risky*
- ▶ if *gearing ratio*  $\approx 25\%$ 
  - business is not overburdened with long-term debt
- ▶ if *gearing ratio*  $> 50\%$ 
  - large proportion of business finance is borrowed
- ▶ if *gearing ratio* is low
  - more finance is provided by shareholders (owners)

# RETURN ON CAPITAL EMPLOYED (ROCE)

## DEFINITION

- ▶ Compares the profit made with the amount of money invested.
- ▶ "Profit" is defined as *operating profit* (also known as *earnings before interest and tax* EBIT)
- ▶ Formula:

$$\text{ROCE} = \frac{\text{operating profit}}{\text{capital employed}} \times 100\%$$

# RETURN ON CAPITAL EMPLOYED (ROCE)

## INTERPRETATION

- ▶ General rule: the higher the ratio the better
- ▶ Compare ROCE:
  - ▶ of the *same* company *over time*  
(e.g.,  $ROCE_{2013}$  and  $ROCE_{2014}$ )
  - ▶ of *different* companies *within* the same industry
- ▶ For investments to be worthwhile:  
→  $ROCE \gg$  return on safe investment

## LIMITATIONS OF RATIO ANALYSIS

- ▶ Basis for comparison
  - ▶ comparison over time (changing industries)
  - ▶ inter-firm comparison (comparable companies)
  - ▶ other differences (accounting standards/techniques, methods for calculation)
- ▶ Quality of final accounts (e.g., window dressing)
- ▶ Limitations of the balance sheet (snapshot of a point in year → representative?)
- ▶ Qualitative information is ignored
- ▶ Window dressing