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Financial Ratios Explained

The following list explains Financial Ratio Calculations and their meanings.

Forecast Sales

Calculation:	These figures represent monthly estimates of sales turnover. The budgeted figures are based on prior period actual sales and modified to include any anticipated variances and future growth.
What does it mean?	These figures are important in planning for the short-term and in determining cash flow budgets, profit analysis and pricing strategies.

Breakeven Sales

Calculation:	$\frac{\text{Other Direct Expenses}}{\text{Gross Profit}} \times \text{Total Turnover}$
What does it mean?	This formula determines the level of sales needed to produce a profit of zero, and to “break even”. It is useful in profit planning and pricing.

Sales Cover

Calculation:	$\frac{\text{Forecast Sales}}{\text{Breakeven Sales}}$
What does it mean?	This ratio shows the relationship between forecast sales and breakeven sales. The comparison illustrates whether the business is going to be in a profit or loss situation on a month by month basis. This can be determined quickly by a comparison of the percentage figures. The breakeven point is 100%, and as this increases so does the level of anticipated profit for the month. If the figure goes below 100%, then a loss situation is anticipated.

Gross Profit Margin

Calculation of ratio:	$\dfrac{\text{Gross Profit}}{\text{Sales}}$
What does it mean?	This ratio measures the profit margin on sales, and is a result of the “mark-up” on the cost of goods sold. This ratio is influenced by price changes with no cost change, or by cost changes without compensating changes in price. This ratio can be used as a control device to highlight excessive sales discounts or stock losses. The possible causes of a low ratio are poor pricing, poor buying, excessive shrinkage, high inventory causing mark down, and not taking discounts due to low cash.

Net Profit Margin

Calculation of ratio:	$\dfrac{\text{Net Profit (Before Tax)}}{\text{Sales}}$
What does it mean?	This ratio measures the amount of net profit produced for every dollar of sale. It measures the efficiency that operating costs are controlled and the level of management performance. The possible causes of a low ratio are low pricing, high costs or a combination of both.

Return on Capital

Calculation of ratio:	$\dfrac{\text{Net Profit (Before Tax)}}{\text{Total Assets}}$
What does it mean?	This ratio measures the efficiency of total assets (capital) in generating net profit. It measures the net profit produced for every dollar invested in total assets. This ratio is useful in providing an overview of profit management. The possible causes of a low ratio are low profitability or over-investment in assets, or both. Excessive amount of assets purchased in relation to sales produced usually cause low cash problems.

Return on Net Assets

Calculation of ratio: $\dfrac{\text{Net Profit (Before Tax)}}{\text{Net Worth}}$

What does it mean? This ratio measures the efficiency of net worth in producing net profit. Net worth represents assets less liabilities, or the amount of shareholders' funds in the balance sheet. It is a measure of the number of dollars in net profit produced for every dollar invested in Net Worth.

The possible causes of a high ratio are too much risk and debt financing. This can lead to problems when interest rates rise, margins shrink and the economy slows.

The possible causes of a low ratio are over-capitalisation and low risk taking. This can cause a reduction in cash flow and an increase in bad debts.

Current Ratio

Calculation of ratio: $\dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

What does it mean? This ratio measures solvency. It measures the capacity of the business to meet short-term financial commitments.

A high ratio may be caused by an imbalance in the investment in long-term assets, or an economic condition favouring high liquidity.

A low ratio may be caused by the financing of long-term assets with short-term money.

Liquid Ratio

Calculation of ratio: $\dfrac{\text{Cash \& Accounts Receivable}}{\text{Current Liabilities}}$

What does it mean? This ratio measures liquidity. It measures the ability of the business to meet its short-term liabilities using the most liquid of current assets. In this ratio stock is not included in current assets and the bank overdraft is not included in current liabilities.

The possible causes of a high ratio include an excess of cash. This may imply under-investment in inventory. The effect of this is reduced sales and profits.

The possible causes of a low ratio include shortage of cash and indicates over-investment in inventory.

Gross Gearing

Calculation of ratio:

$$\frac{\text{Total Liabilities}}{\text{Net Worth}}$$

What does it mean?

This ratio measures financial risk. It measures the number of dollars of debt owed for every dollar in net worth.

The possible causes of a high ratio include too much risk. If sales decrease and the economy slows interest expenses can absorb profits.

The possible causes of a low ratio include too little risk, which can lead to low returns.

Interest Cover

Calculation of ratio:

$$\frac{\text{Earnings Before Interest and Taxes}}{\text{Interest}}$$

What does it mean?

This ratio measures the ability of a business to meet interest payments. The lower the ratio the less likely a business will be able to meet interest payments.

Closing Bank

This figure is calculated on a monthly basis after the cash budget has been determined.

It is useful in demonstrating that sufficient cash will be available to meet creditors' claims and allows adequate time for any borrowings to be arranged in advance if any cash shortfalls are anticipated. It also facilitates the planned investment of surplus funds.