CA BUSINESS SCHOOL
EXECUTIVE DIPLOMA IN BUSINESS AND ACCOUNTING

SEMESTER 2: Interpretation of Financial Statements

Analysis of Accounting Ratios

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Ratio Analysis

A popular tool used to conduct a quantitative analysis of information pertaining to company's financial statements. Generally, accounting ratios are calculated from current year numbers and are then compared to previous years, other companies, the industry, or even the economy to judge the performance of the company.

Key Categories of ratios are as follows;

- Profitability.
- Efficiency.  
- Liquidity.  
- Gearing/Capital Structure. 
- Investors/Market Performance. *(Investors’ point of view.)*
Profitability Ratios

What does this **measure & indicate** to users/Stakeholders?

Profitability ratios

Primary

Secondary

**Primary**

1. **ROE. (Return On Equity)**
   - What?
   - How to calculate?
   - \[
     \text{ROE} = \frac{\text{NP. atri. O/SHS.}}{\text{Avg. Equity}} \times 100
   \]

2. **ROA. (Return On Assets)**
   - What?
   - How to calculate?
   - \[
     \text{ROA} = \frac{\text{EBIT}}{\text{Avg. Assets}} \times 100
   \]
Secondary

1. GP Margin. (Gross Profit)
   What?
   How to calculate?

   \[
   \text{GP Margin} = \frac{\text{GP}}{\text{Total Sales}} \times 100
   \]

2. OP Margin. (Operating Profit)
   What?
   How to calculate?

   \[
   \text{OP Margin} = \frac{\text{OP}}{\text{Total Sales}} \times 100
   \]

3. NP Margin. (Net Profit)
   What?
   How to calculate?

   \[
   \text{NP Margin} = \frac{\text{NP}}{\text{Total Sales}} \times 100
   \]
Efficiency Ratios

What does this measure & indicate to users/Stakeholders?

1. Asset Turnover Ratio

What?
How to calculate?

\[
\frac{\text{Total Sales}}{\text{Avg. total Assets}} \quad \text{(Times / x)}
\]

2. Inventory/Stock Turnover Ratio

What?
How to calculate?

\[
\frac{\text{Cost of Sales}}{\text{Avg. Stock}}
\]

3. Debtors Turnover Ratio

What?
How to calculate?

\[
\frac{\text{Total Credit Sales}}{\text{Avg. Drs.}}
\]
4. Stock Residency Period - Direct/Indirect

What?
Cost of Sales

How to calculate?
\[
\text{Avg. Stock} \times \frac{365}{50/12}
\]

5. Debtors Collection Period - Direct/Indirect

What?
Total Credit Sales

How to calculate?
\[
\text{Avg. Debtors} \times \frac{365}{50/12}
\]

6. Activity Cycle

What?

How to calculate?
\[
\text{SRP + DCP}
\]

• *If Figures are not available*, how to calculate?
Liquidity Ratios

What does this **measure & indicate** to users / stakeholders?

1. **Current Ratio.** \[ \frac{\text{CA}}{\text{CL}} \]  
   **What is best for the company??**
   
   What?  
   How to calculate?

2. **Quick Asset/Acid Test Ratio.** \[ \frac{(\text{CA} - \text{St.})}{\text{CL}} \]  
   **Traditional. Is this correct?**
   
   What?  
   How to calculate?

3. **Cash Flow Ratio.** \[ \frac{\text{NCF. OP. act}}{\text{CL}} \]  
   
   What?  
   How to calculate?
Gearing/Capital Structure Ratios

What does this measure & indicate to users / stakeholders?

1. Debt to equity Ratio/Gearing.

\[
\text{Debt to equity Ratio} = \left( \frac{\text{Total Liabilities}}{\text{Total Equity}} \right) \times 100
\]

What?
How to calculate?

Is high or low, good?

2. Debt Ratio.

\[
\text{Debt Ratio} = \left( \frac{\text{Total Liabilities}}{\text{Total Assets}} \right) \times 100
\]

What?
How to calculate?
3. Equity Ratio.

What?
How to calculate?

4. Interest Coverage Ratio.

What?
How to calculate?

5. Debt Coverage Ratio.

What?
How to calculate?

\[
\text{Equity Ratio} = \frac{\text{Total Equity}}{\text{Total Assets}} \times 100
\]

\[
\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{F/Cost}}
\]

\[
\text{Debt Coverage Ratio} = \frac{\text{NCL}}{\text{NCF.op.act}}
\]

Sometimes, efficiency.
Investors' / Market Performance Ratios

What does this **measure & indicate** to users / stakeholders?

1. **Net Tangible asset backing per share**
   
   \[
   \frac{(OS/HE-IA)}{O/SC}
   \]
   
   What?
   How to calculate?

2. **EPS**
   
   \[
   \frac{NP. atri.OSHs}{WA. O/Sc}
   \]
   
   What?
   How to calculate?

3. **Operating cash flow per share**
   
   \[
   \frac{(NCF. op. - Pr. Divi)}{WA. O/Sc}
   \]
   
   What?
   How to calculate?
4. Dividend per share

   What?
   How to calculate?

5. PE Ratio

   What?
   How to calculate?
**DuPont analysis**

A method of performance measurement that was started by the DuPont Corporation in the 1920s. With this method, assets are measured at their gross book value rather than at net book value in order to produce a higher return on equity (ROE).

It is also known as "DuPont identity".

DuPont analysis tells us that ROE is affected by three things:

- **Operating efficiency, which is measured by profit margin**
- **Asset use efficiency, which is measured by total asset turnover**
- **Financial leverage, which is measured by the equity multiplier**

\[ \text{ROE} = \text{Profit Margin} \times \text{Total Asset Turnover} \times \text{Equity Multiplier} \]

**Ratio Analysis Vs Other Techniques**

- Why Ratio Analysis **become more popular** than other techniques?
- **Is Ratio Analysis best** for AFI? Shortcomings of ratio analysis.