Monitoring the Business | H1 Notes

Financial Statements

Businesses use different financial statements. The two most important are the Profit and Loss Account and the Balance Sheet.

Ratios

Ratios are used to show the financial position of the business. There are three types – Profitability ratios, Liquidity ratios and Debt/Equity ratios. They allow us to make comparisons and observe trends in the business.

Profitability Ratios

Gross Margin

The ideal result is for it to be as high as possible. It is also called the Gross Profit Percentage.

$$\frac{\text{Gross Profit}}{\text{Sales}} \times \frac{100}{1}$$

Net Margin

The ideal result is for it to be as high as possible. It is also called the Net Profit Percentage.

$$\frac{\text{Net Profit}}{\text{Sales}} \times \frac{100}{1}$$

Return on Investment

The ideal result is for it to be as high as possible. It is also called the Return on Capital Employed.

$$\frac{\text{Net Profit}}{\text{Capital Employed}} \times \frac{100}{1}$$

Liquidity Ratios

Current Ratio

The ideal result is for it to be at least 1.5:1. It is also called the Working Capital Ratio.

Current Assets : Current Liabilities

Quick Ratio

The ideal result is for it to be at least 1:1. It is also called the Acid Test Ratio.

Current Assets – Stock : Current Liabilities

Gearing

Gearing

The ideal result is for it to be lower than 50%. It is also called the Leverage or Debt Ratio.

$$\frac{\text{Fixed Interest Capital}}{\text{Equity Capital}} \times \frac{100}{1}$$

Financial Problems

Low Profitability

Caused by forecasts that were not met, bad management or low sales. This can make it hard to attract new investors and persuade banks to give loans.

Liquidity

Liquidity refers to the business' ability to pay short term debts as they fall due. If there is not enough working capital in the business, it can have low liquidity and find it hard to repay its debts. This can cause a lack of cash to pay for stock, a damaged credit rating when creditors are not paid online and possible closure of the business.

High Gearing

This means that the business has more loans than equity capital. The business would then find it hard to pay other bills. They will also struggle to pay dividends, making the share price reduce and make the business less attractive to investors. They will find it difficult to get more loans and reduce their creditworthiness in the future.