Ratios Theory

Profitability

A measure of how well a business converts revenue earned into profit. Reported on in the Income Statement and based on revenues and expenses.

Ratios – Gross Profit, Profit, Expense

Liquidity

Liquidity is a measure of the cash in a business and how easily it can pay its short-term debts. It is also refers to how easily an asset can be converted to cash. It is based on assets, liabilities and equity and is reported on in the Balance Sheet.

Ratio – Current

Working capital

Working capital is the excess of current assets over current liabilities of a business at a point in time. It indicates a business' ability to pay its current liabilities as well as having the liquidity to pay for operating expenses.

Gearing

It is the relationship between debt (external equity) and Equity (internal equity). If a business is highly geared it relies heavily on borrowed funds to operate (creditors have greater equity in the business than the owners). Debt may provide funds for operation and expansion but it is also a drain on cash, as debt repayments must be met. Creditors may also want to be more involved in the running of the business if there are substantial debts.

Ratio – Debt to Equity

Limitations/Problems with using Ratios

1. Ratios do not explain why, they do not identify the causes of problems.
2. Ratios present limited information and must be viewed in the context of the business and compared to previous periods or industry benchmarks to be meaningful.
3. Comparison with other businesses may be flawed because of different accounting policies.
4. Figures are based on estimations eg. depreciation, doubtful debts.

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