Achievable

ACCA FINANCIAL ACCOUNTING DUMP SHEET

# Ratio analysis

## Profitability ratios

| Ratio | Formula | Interpretation |
|---|---|---|
| Gross profit margin | Gross profit ÷ revenue × 100 | Higher = better cost control in production |
| Operating profit margin | PBIT ÷ revenue × 100 | Higher = better control of operating expenses |
| Net profit margin | Profit after tax ÷ revenue × 100 | Higher = more efficient after interest and tax |
| Return on capital employed (ROCE) | PBIT ÷ capital employed × 100, where capital employed = total equity + NCL (or total assets − current liabilities) | Higher = more efficient use of long-term capital |
| Return on equity (ROE) | (PAT − preference dividends) ÷ total equity (share capital + reserves) × 100 | Higher = better returns for equity shareholders |
| Asset turnover | Revenue ÷ capital employed (times) | Higher = more revenue generated per $ of capital |

Key relationship: $\text{ROCE} = \text{operating profit margin} \times \text{asset turnover}$

## Liquidity ratios

| Ratio | Formula | Benchmark and interpretation |
|---|---|---|
| Current ratio | Current assets ÷ current liabilities | ~2:1 generally expected; too high may mean excess idle assets |
| Quick ratio (acid test) | (Current assets − inventory) ÷ current liabilities | Rule of thumb ~1:1 (varies by industry); excludes inventory as less liquid; too low = liquidity risk |

If the current ratio rises more than the quick ratio, inventory is building up. If the quick ratio is close to the current ratio, little inventory is held

## Efficiency (activity) ratios

| Ratio | Formula | Interpretation |
|---|---|---|
| Inventory turnover | Cost of sales ÷ average inventory (times) | Higher = faster inventory turnover; lower may signal slow-moving inventories |
| Inventory days | (Average inventory ÷ cost of sales) × 365 | Fewer days = faster conversion to sales |
| Receivables collection period | (Trade receivables ÷ credit sales) × 365 | Fewer days = faster cash collection from customers |
| Payables payment period | (Trade payables ÷ credit purchases) × 365 | More days = longer credit taken; better for cash flow |

Cash operating cycle $= \text{inventory days} + \text{receivables days} - \text{payables days}$; lower = better working capital management

## Gearing (financial leverage) ratios

| Ratio | Formula | Interpretation |
|---|---|---|
| Capital gearing ratio | Long-term debt ÷ (equity + long-term debt) × 100 | > 50% = highly geared (more debt than equity); more financial risk |
| Debt to equity ratio | Long-term debt ÷ equity | Higher = more reliant on debt financing |
| Interest cover | PBIT (profit before financing and income taxes) ÷ finance costs (times) | Higher = more comfortable ability to service debt; rule of thumb: above 3× is usually considered safe |

- **High gearing** = higher financial risk (fixed interest payments), but potential tax benefits
- **Low gearing** = lower risk, more equity financed