Chapter 15

FINANCIAL PERFORMANCE MEASUREMENT

1. Introduction

Financial statements are prepared to assist users in making decisions. They therefore need interpreting, and the calculation of various ratios makes it easier to compare the state of a company with previous years and with other companies.

In this chapter we will look at the various ratios that you should learn for the examinations.

2. The main areas

When attempting to analyse the financial statements of a company, there are several main areas that should be looked at:

◉   **Profitability**

◉   **Liquidity**

◉   **Gearing**

The importance of each area depends on whose behalf that we are analysing the statements.

We will work through an example to illustrate the various ratios that you should learn under each heading.

3. Worked example

Example 1

Statements of Financial Position as at 31 December

	2007 $	$	2006 $	$
ASSETS				
Non-current assets				
Tangible assets		1,341		826
Current assets				
Inventory	1,006		871	
Trade receivables	948		708	
Cash	360		100	
		2,314		1,679
TOTAL ASSETS		3,655		2,505
LIABILITIES AND CAPITAL				
Capital and reserves				
$1 ordinary shares	1,200		720	
Retained profit	990		681	
		2,190		1,401
Non-current liabilities				
10% loan 2015		500		400
Current liabilities				
Trade payables	653		516	
Tax payable	228		140	
Dividends payable	84		48	
		965		704
TOTAL LIABILITIES AND CAPITAL		3,655		2,505

Income statement for the year ended 31 December

	2007 $	2006 $
Revenue	7,180	5,435
Cost of sales	5,385	4,212
Gross profit	1,795	1,223
Distribution costs	335	254
Administrative expenses	670	507
Profit from operations	790	462
Finance costs	50	52
Profit before taxation	740	410
Company tax expense	262	144
Profit after taxation	478	266
Dividends	169	95
Retained profit for the period	309	171

You are required to calculate the profitability, liquidity and gearing ratios.

Profitability

Net profit margin   = $\dfrac{\text{Profit before interest and tax}}{\text{Revenue}}$

Gross profit margin   = $\dfrac{\text{Gross profit}}{\text{Revenue}}$

Return on capital employed   = $\dfrac{\text{Profit before interest and tax}}{\text{Total long term capital}}$

(= capital + reserves + long-term liabilities)

Asset turnover   = $\dfrac{\text{Revenue}}{\text{Total long term capital}}$

NB: ROCE = asset turnover × net profit margin

Liquidity

Current ratio   = $\dfrac{\text{Current assets}}{\text{Current liabilities}}$

Quick ratio (or acid test)   = $\dfrac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$

Inventory days   = $\dfrac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$

Average collection period (receivables days)	=	$\dfrac{\text{Trade receivables}}{\text{Revenue}} \times 365 \text{ days}$
Average payment period (payables days)	=	$\dfrac{\text{Trade payables}}{\text{Purchases}} \times 365 \text{ days}$

Gearing

Gearing	=	$\dfrac{\text{Long term liabilities}}{\text{Shareholders' funds}} \%$

4. Limitations of ratio analysis

You must learn the various ratios, however, it is important that you are able to discuss briefly the relevance of the various ratios, and also their limitations.

Very few of the ratios mean much on their own – most are only useful when compared with the ratios for previous years or for similar companies.

Many of the ratios use figures from the Statement of Financial Position. These only represent the position at one point in time, which could be misleading. For example, the level of receivables could be unusually high at the year end, simply because a lot of invoicing was done just before the year end. Perhaps more sensible in that sort of case would be to use the average for the year. Normally in the examination you will be expected simply to use Statement of Financial Position figures at the end of the year, but do be prepared to state the problem if relevant.