Financial ratio’s

Business, Company

A financial ratio is an expression of the relationship between two items selected from the income statement or the balance sheet of a company. Ratio analysis helps you evaluate the weak and strong points in your financial and managerial performance. However, ratios have limitations. Since the information used to derive ratios is itself based on accounting rules and personal judgments, as well as facts, the ratios cannot be considered absolute indicators of a firm's financial position.

Ratios are only one means of assessing the performance of the firm and must be considered in perspective with many other measures. They should be used as a point of departure for further analysis and not as an end in themselves. It is very important to comprehend and analyze the companies' annual report and therefore their financial situation especially from the shareholders, investors and employees point of view. To achieve this aim there is a financial technique called ratio. Financial ratios provide a quick and relatively simple means of examining the financialhealthof a business.

A ratio simply relates one figure appearing in the financial statements to some other figure appearing in the financial statement1. Ratios can be divided in different group and each group can, at the same time, be sub-divided. The main categories are profitability, liquidity, capital gearing, investor and efficiency & effectiveness ratios. When analyzing the financial health of TESCO from the perspective of an employee, there are four different groups of ratios that the have to be consider:

Profitability: this kind of ratio provides a greater insight of the financial performance in a company, in other words, it determines if the company is

making a good profit and return on its asset and investment. These ratios can also tell us how well the company is managed compared to the industry average. Under this category we can find four sub-divisions: Return on capital employed: it is the percentage obtained from the net profit before interest and taxation divided by the capital employed which reveals the business performance, taking into account the long-term capital invest and the profit generated by it.

In TESCO return on capital employed is a relative profit measurement that not only incorporates the funds shareholders have invested, but also funds invested by banks and other lenders, and therefore shows the productivity of the assets of the company. Return on equity or return on ordinary shareholder's funds: it express on percentage the profits for the shareholders according to their stake in business. Gross profit margin: percentage obtained from the division of the gross profit (difference between sales and the cost of sales) of a company and the sales which gives us the profitability before other expenses are taken into account.

Net profit margin: it is the result of the net profit before interest and taxation which represents the profit before any expenses of servicing long-termfinanceare subtracted divided by sales and then multiplied by 100 to get the percentage. Liquidity Ratios: It is essential for a company the measuring of the cash flows over the time to be aware of the liquid resources available to afford the obligations. The most used liquidity ratios are: current ratio and acid test ratio.

These would examine the relationship between liquid resources held and creditors due for payment in the near future2. Current ratio: this kind of ratio shows the size of the relationship between current assets (cash and assets which would become cash in a short time) and current liabilities (creditors falling due within one year), enhancing the comparability between firms. The result of the division expresses the times that the current assets would cover the current liabilities.

Acid Test ratio: It is another reflection of the liquidity of a business It tells you if the business could meet its current obligations with quickly convertible assets. To calculate it, we have to take the current assets, subtract the stock or inventory and divided the result by the current liabilities. Capital Gearing Ratios: This would shows the relationship between the amount finance by the owners of the company and the amount financed by outsiders. Gearing ratio: it is the percentage given as a result of the long-term liabilities divided by the capital employed.

To analyze if a gearing ratio has an acceptable level it has to be consider the growth of profits and cash flows. Times interest covered or interest cover ratio: this kind of ratio measures the amount of profit available to cover interest payable. The lower the level of profit coverage the greater the risk to lenders that interest payments will not be met. Investor Ratios: the investors ratios' sub-division explaining next are a fundamental tool for the investors who hold share in a company to assess the returns on their investment.

Earnings per share: to calculate we have to divide the earnings available to ordinary shareholders by the number of ordinary share in issue. This would

show the measure of share performance and it would help asses the investment potential of a company's share. Price earning ratio: this type of ratio is very relevant for investors. Basically, it gives us an indication of the confidence that investors have in the future prosperity of the business. The price earning (P/E) is a company's price-per-share divided by its earnings-per-share.

Dividend yield: the dividend is the payment companies make to shareholders out of their excess earnings. The dividend yield is the comparison of companies' dividends, in other words, it relates the cash return from a share on their investment in the company. That's the dividend amount divided by the stock price. Dividend cover: this is the combination of the earning per share and dividends per share figure and it would tell us how easily a business could pay its dividend from profits. To calculate it we just need to divide the earnings per share by dividends per share.