Ratio analysis essay

I am going to illustrate the financial state of Chester Private Hire Cars by explaining the accounting ratios and how are those used in order to monitor the financial position of the business. The first area I am going to look at in order to compare two-year period financial state of the business is profitability.

This area is all about the money which goes into the business. There are three calculations: Gross Profit, Net Profit, and ROCE. Gross profit it is amount of money the business has before the expenditure is taken away. The calculation shows how the business is managing its purchases of stock. Calculation for gross profit (YEAR 2006): GROSS PROFIT 250X 100 = X 100 = 35.

71% (36%)SALES 700Calculation for gross profit (YEAR 2007): GROSS PROFIT 200X 100 = X 100 = 25%SALES 800This shows that for every £1 made in sales, 36p (2006)/25p (2007) is left as gross profit after the cost of goods sold has been deducted. The gross profit has fall over the year period of time by 10. 71%. This means that the amount of money that goes in the business has been decreased. As a business they should reduce the cost of its purchases, they might find a cheaper supplier which would not affect the quality of the service that they are providing. This would increase the rate of the gross profit without forcing the business to increase the cost of goods sold.

Net profit it is amount of money the business has left over after all expenses are taken away. This calculation shows how well the business manages its other expenses. Calculation for net profit (YEAR 2006): NET PROFIT 120X 100

= X 100 = 17. 14% (17%)SALES 700Calculation for net profit (YEAR 2007): NET PROFIT 60X 100 = X 100 = 7.

5% (8%)SALES 800The net profit has fall over the year period of time by 9. 64%. This means that the amount of money that the business had left over after deducting expenditure has decreased. So, for every £1 the business has 17p left (2006)/8p left (2007) after deducting all of its expenses. The owners should think about moving into cheaper premises in order to increase the rate of the net profit. ROCE (Return on Capital Employed) is the last calculation I am going to use in order to judge profitability of the business.

This calculation shows the amount of money an investor has received back on their capital. Calculation for ROCE (YEAR 2006): NET PROFIT 120X 100 = X 100 = 77. 41% (77%)CAPITAL EMPLOYED 155Calculation for ROCE (YEAR 2007): NET PROFIT 60X 100 = X 100 = 50%CAPITAL EMPLOYED 120ROCE was quite high in 2006 however it has fall over the year period of time by 27. 41%. This means that the amount of money an investor has received back on their capital has decreased.

This measurement is often used to compare with interest rates in order to see the efficiency of an investment/generating a return. Overall, the profitability needs to be improved in order to expand the business. The business seems to have a higher level of gross profit comparing it to the net profit; this shows that the business operational costs are too high. The percentage of the net profit should be similar to the gross profit percentage and this would show that the amount of money spend on expenses is reduced and that it stays at good level. The owners of Chester Private Hire

Cars should consider cutting the operational costs which would make the business more profitable.

The second area I am going to explain is solvency. By working out solvency we are able to see how easily the business is able to pay its creditors. Solvency divides into two ratios: Current Ratio, and Acid Test Ratio. Current ratio allows the business to see how well they are able to meet their liabilities. Calculation for current ratio (YEAR 2006): CURRENT ASSETS 185: 1 = : 1 = 2. 05 : 1CURRENT LIABILITIES 90Calculation for current ratio (YEAR 2007): CURRENT ASSETS 175: 1 = : 1 = 1.

59 : 1CURRENT LIABILITIES 110Current ratio has fall over the year period of time by 0. 46. A good practice is only considered if the current ratio has a figure between 1. 5 and 2 – this shows that the business is easily paying its liabilities. If the figure is over 2 it means that the money should be put elsewhere in order to make more money (for example: investment, bank saving account etc.

) and it would improve the business finances. If the figure is below 1. 5 it makes the business hardly profitable as they are not able to pay its liabilities. So, if the current ratio has fallen to 1. 59 it can be considered as a good practice. However, the business is in dangerous position, this is because if the bank demanded repaying the money borrowed using the overdraft, the company would not be able to cover these demands from current assets.

Acid test ratio shows the assets which are compared to liabilities, so it shows how well a business can meet its liabilities without selling the stock. This does not include the stock, and these assets are considered to be the hardest current assets to turn into cash quickly. Calculation for acid test ratio (YEAR 2006): CURRENT ASSETS – STOCK 185 – 120 65: 1 = : 1 = : 1 = 0. 72 : 1CURRENT LIABILITIES 90 90Calculation for acid test ratio (YEAR 2007): CURRENT ASSETS – STOCK 175 – 125 50: 1 = : 1 = : 1 = 0. 45 : 1CURRENT LIABILITIES 110 110This shows that the business is in not good enough position to expand it. The number of stock sold is not always the same so the margin of profit will vary as well.

Basically, the owners will not be sure if they are going to be able to pay all the liabilities at all of the times. However, if the stock is sold the business is in a good position of solvency. The final area I am going to look at is performance. Determining performance shows us the level of the business efficiency and how quickly the business has sold its stock. I am going to calculate asset turnover, stock turnover, debtors' days, creditors' ratio and debt/equity ratio.

Asset turnover shows how well the business uses their assets. By working out the asset turnover we are able to know how many pounds the business earns for every pound invested in the assets. Calculation for asset turnover (YEAR 2006): SALES 700= = 3. 41 (3)ASSETS 205Calculation for asset turnover (YEAR 2007): SALES 800= = 4. 44 (4)ASSETS 180Asset turnover has risen by 1.

03 and this means that the business has made an improvement of the assets usage. Stock turnover shows how effective the stock control system is. This is very dependent upon the nature of a company – for example a product

may go out of date so even if the stock turnover seems to appear high it does not mean that the business is making a lot of successful sales. Calculation for stock turnover (YEAR 2006): COST OF SALES 450= = 3. 75 (4)AVERAGE STOCK 120Calculation for stock turnover (YEAR 2007): COST OF SALES 600= = 4.

8 (5)AVERAGE STOCK 125Stock turnover has risen by 1. 05 which means that the speed at which the stock is sold has been improved. Debtors’ days shows us how many days it will take the debtor to give back the money for purchasing goods on credit. Calculation for debtors’ days (YEAR 2006): DEBTORS 45X 365 (YEAR) = X 365 = 23. 46 (24 days)SALES 700Calculation for debtors’ days (YEAR 2007): DEBTORS 50X 365 (YEAR) = X 365 = 30. 41 (31 days)SALES 600The number of the days is low therefore the business has a good level of credit control.

It collects the owed money quickly, however the number of days has increased over the year period of time by 7 days so the owners should try to improve and keep the number of the days as low as possible. Creditors’ ratio shows us how many days the business is going to pay the debts for. Calculation for creditors’ ratio (YEAR 2006): CREDITORS 90X 365 (YEAR) = X 365 = 73 daysPURCHASES 450Calculation for creditors’ ratio (YEAR 2007): CREDITORS 100X 365 (YEAR) = X 365 = 60. 83 (61 days)PURCHASES 600The creditors’ ratio has fall over the year period of time by 12 days.

The number of the days has been decreased therefore the business has a better financial situation as it takes less days to pay off the creditors. As a business they should always try to reduce its debtor’s payment period. If the business has cash flows problems, they should try to lengthen its creditor's payment period. Debt/equity ratio shows us if the business is able to pay all of its debts. Calculation for debt/equity ratio (YEAR 2006): LOANS 50: 1 = : 1 = 0. 32 : 1CAPITAL EMPLOYED 155Calculation for debt/equity ratio (YEAR 2007): LOANS 60: 1 = : 1 = 0.

50 : 1CAPITAL EMPLOYED 120The debt/equity ratio has been increased by 1. 8. If the ratio is greater than 1 it means that majority of the business assets are funded through the debts, if the ratio is lower it means that the business is not struggling with the debts. This ratio should be kept as low as possible and there might be some consequences if the business debt/equity ratio is still increasing. In conclusion, Chester Private Hire Cars seems to be falling and it is definitely not ready to expand. Overall, the business performance, profitability, and solvency are not that good.

There are too many risks and dangers in order to expand. The business performance is getting worse and at this stage the business should set some special arrangements or a strategic plan in order to survive. This business will fall into the bankruptcy if there are not going to take any actions; owners should maintain the business more efficiency. The profitability should be improved in order to put the business in a strong position and the level of solvency needs to be improved as well – if this is not going to happen then the business is going to be struggling to pay all the liabilities. I would suggest that Chester Private Hire Cars makes sure that the business is ready to expand; considering all of those aspects the business is not yet ready to expand and the owners should take some actions and wait until the performance, profitability and solvency is improved.