Financial statements – ratio analysis

Introduction

A number of different ratios can be calculated from a company's financial statements to help them to interpret performance. Ratios can help organisations to compare their performance to previous years, to budgets, to industry averages, and to their competitors.

As there are a number of different users of the accounts, we must keep them in mind when carrying out ratio analysis as they will use different ratios to carry out the analysis which will help them with their decision making.

Let's look at a question to see how an organisation could use different ratios to complete their analysis.

Example

Kath Parker is the Managing Director of Noca PLC, and is concerned that the company is not managing its working capital efficiently. She has sent you an email asking for your assistance in identifying any problem areas and your suggestions as to how these can be remedied.

You have calculated the following ratios for Noca PLC for the year 2011, and have also obtained the industry average for each of these for comparative purposes.

Accounting ratios

	Noca PLC	Industry average
Current ratio	8.2:1	3.1:1
Inventory holding period	46 days	29 days
Trade receivables collection period	70 days	54 days
Trade payables payment period	55 days	64 days

Prepare a reply to Kath that includes:

a) Comments on whether Noca have performed better or worse in respect of the above ratios compared to the industry averages.

b) Three suggestions as to how the working capital of Noca PLC could be more effectively managed.

Answer

To prepare a reply to Kath we need to consider how the ratios are calculated which will then enable us to carry out the analysis.

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

	Noca PLC	Industry average
Current ratio	8.2:1	3.1:1

$$\text{Inventory holding period} = \frac{\text{Inventories}}{\text{Cost of sales}} \text{ X 365 days}$$

	Noca PLC	Industry average
Inventory holding period	46 days	29 days

$$\text{Trade receivables collection period} = \frac{\text{Trade receivables}}{\text{Revenue}} \text{ X 365 days}$$

	Noca PLC	Industry average
Trade receivables collection period	70 days	54 days

$$\text{Trade Payables Payment Period} = \frac{\text{Trade payables}}{\text{Cost of Sales}} \text{ X 365 days}$$

	Noca PLC	Industry average
Trade payables payment period	55 days	64 days

b) Three suggestions as to how the working capital of Noca PLC could be more effectively managed

1.

2.

3.