

Financial Ratio Analysis

Put something in the numerator of a quotient and something else in the denominator and we have another key figure. A ratio. A relationship of one thing to the other and the question is what does such a relationship represent? Which quantity? With what dimension? What exactly is in the numerator and what is in the denominator?

Examples:

- Gross margin = Total result / Turnover
- Turnover rate total capital = Turnover / TC
- Asset balance index = Net profit / Working capital
- Return on total resources = Net profit / Working assets

and so on.

'Gross margin' times 'turnover rate total capital' gives YTC. Vice versa: YTC can be decomposed into 'gross margin' and 'turnover rate total capital', if one continues to decompose, thus creating the Du Pont de Nemours chart, which hinges on the accuracy of the profit and equity figures. That famous Du Pont chart is fundamentally under discussion. Also everything that is based on this, for example FPA (Financial Performance Assessment) developed by Goalfix Europe.

The profitability or yield is a key figure, with in the numerator the PROFIT (achieved during a period; a current quantity) and in the denominator the CAPITAL (a state variable).

Total Capital (TC) is divided into Equity Capital (EC) and Loan Capital (LC). It can be all three in the denominator. Per the moment of the opening balance or of the closing balance or of some average of several snapshots. And the numerator can be recognized income before interest related to LC and before tax, the TC displays YTC (the Return on TC). The gross profit (the total result minus interest on LC) related to the EC is YEC gross (the gross Return on EC). The net profit, after settlement with the tax authorities, related to the EC is net YEC (the net Return on EC).

Is it a meaningful yield index? Literature and practice abound with these kinds of key figures. Something of profit in the numerator and something of capital in the denominator with all kinds of names, such as NOPAT, Capital charge, spread, EVA, RONA, RONAE, and so on, by which some understand this and the other something else. Anyone can enter any number.

Absolute amounts are frightening, are not popular en masse people cling to so-called certainties and hide behind ratios whereby the numerator often moves separately from the denominator so that nothing is certain anymore.

One thing expressed as a percentage of something else and who knows after many conversions what it represents?

Obviously afraid of reality, many economists deny its existence and then create their own false realities. Economy is full of it. It is not good – no matter how practically learned about it is done – because it does not solve anything.

About numbers, there is almost always a certain accuracy, a lower and an upper limit value, in between for example a real value of something is situated.

Numbers are commonly afflicted with a certain degree of inaccuracy. Furthermore, it is not uncommon for an unreliability to be specified and, moreover, all kinds of presuppositions often apply. Be on your guard when it comes to numbers. Watch out.

As long as we don't know the PROFIT nor the CAPITAL, the YIELD is in the air. Many of the officially presented yield figures are of no use. The same applies mutatis mutandis also to derivative key figures.

Financial ratio analysis often lacks evidence.