RESOURCE GUIDE · HERMIT BUSINESS SOLUTIONS

Understanding Ratio Analysis

*Turn the numbers already in your accounts into a handful of figures **that tell you how your business is really doing.***

Why ratio analysis matters

Two businesses can post the exact same profit and still be in very different financial health. Ratio analysis takes figures already sitting in your accounts and turns them into a small set of comparable numbers: how easily you can cover short-term bills, how efficiently you're using what you own and how much profit you're actually keeping. Once you know your ratios, you can track them year on year, compare them against others in your sector and spot problems long before they turn into a cash crisis.

The four main categories

- Liquidity ratios: can you cover short-term debts as they fall due
- Profitability ratios: how much of your revenue turns into actual profit
- Efficiency ratios: how well you're using assets like stock and debtors
- Gearing (leverage) ratios: how much of the business is funded by debt versus equity (your own money)

Worked examples

Using a simple set of year-end figures (revenue £250,000, gross profit £100,000, net profit £30,000, current assets £60,000, current liabilities £40,000, stock £15,000, total debt £80,000, total equity £120,000), here's how the main ratios are calculated.

Ratio	Formula	Example calculation	Result
Current ratio	Current assets ÷ Current liabilities	£60,000 ÷ £40,000	1.5:1
Quick ratio (acid test)	(Current assets minus stock) ÷ Current liabilities	(£60,000 minus £15,000) ÷ £40,000	1.13:1
Gross profit margin	Gross profit ÷ Revenue x 100	£100,000 ÷ £250,000 x 100	40%
Net profit margin	Net profit ÷ Revenue x 100	£30,000 ÷ £250,000 x 100	12%
Gearing ratio	Total debt ÷ Total equity x 100	£80,000 ÷ £120,000 x 100	66.7%

What your results show, and how to improve them

Here's what each result means in practice and one or two things that you could do to make things better.

Ratio	Result	What it means	How to improve it
Current ratio	1.5:1	Comfortable cover for short-term bills (£1.50 of current assets for every £1 owed)	Chase debtors faster, agree longer payment terms with suppliers or build up a cash buffer
Quick ratio	1.13:1	Still above 1:1 once stock is stripped out, so bills aren't dependent on stock sales	Trim slow-moving stock and keep a cash reserve that doesn't rely on stock value
Gross profit margin	40%	A healthy margin before overheads are taken out	Review supplier prices, cut waste or revisit your pricing
Net profit margin	12%	The gap below the 40% gross margin shows overheads are absorbing a fair chunk of it	Review overhead and staffing costs and compare them against sector norms
Gearing ratio	66.7%	Debt is a little over two thirds the size of equity, not alarming but worth watching	Pay down debt where you can and hold off further borrowing until it eases

KEY TAKEAWAYS

Ratios only mean something in context. A 1.5:1 current ratio might be healthy for one business and tight for another. it depends on the sector, the season and what's normal for a business your size. We always look at the trend and the comparison, not a single number in isolation.

What to do next

- Pull your current ratio and net profit margin from your last set of accounts
- Compare this year's figures against last year's to spot the trend, not just the snapshot
- Benchmark against others in your sector where you can
- Book a review with us if a ratio looks off and you're not sure why