

# The relationship of accounting ratios in balance sheets

Accounting Ratios are the ratios show the relationship between accounting data in a balance sheet, profit and loss account in a particular organization. The accounting ratios are used to measure the performance in an organization. There are five different categories for calculating five different aspects of the business performance, it is profitability of company, liquidity of company, asset management of company, debts management and capital gearing of company, and market value of investment to ordinary shareholders/common stockholders. First, profitability of company is measuring gross profit markup, gross profit margin, operating profit margin on sales, profit margin on sales, basic earning power (BEP), return on total assets (ROA), and return on common equity (ROE).

In calculating liquidity of company, there are using the current ratio and liquid ratio.

Asset management of company are using inventory turnover, fixed assets turnover, total assets turnover, debtor ratio, debtor payment period, days sales outstanding (DSO).

In debts management and capital gearing of company, debts ratio, capital gearing ratio, debts equity ratio, times interest earned, creditor ratio, and creditor payment period are apply.

In market value of investment to ordinary shareholders / common stockholders measured about earning per share, price or earnings ratio, dividend cover, earnings yield, dividend yield, price or cash flow ratio, and also market price or book value ratio.

There are three ways to compare the accounting ratio for the business performance measurement. First, inter-temporal comparison between two periods means that compare the accounting ratio with the past year financial statement. Second, inter-firms comparison between two companies is measure the accounting ratio between the two same industry companies. Third, comparison with industry averages. I choose the inter-firms comparison to measure the business performance in GamudaBerhad and WCT Berhad.

GamudaBerhad is a leader in turnkey and B.O.T. civil engineering infrastructure and township development, with projects and investments in South East and Far East Asia, Indochina, South Asia and the Middle East. In infrastructure concession, they expertise covers highways and expressways, bridges, dams and hydropower, tunnels, hydraulic engineering and water treatment, railways and mass-rapid transit systems, marine works and ports, and building, which are delivered through general contracting, design and build, turnkey, as well as Build-Operate-Transfer methods.

WCT Berhad is a company that hands-on, experienced and capable workforce in engineering & construction and property development and management. WCT Berhad also an ownership of one of the largest fleet of modern construction machineries in the Middle East and Malaysia.

From the income statements and balance sheets in the financial statement can measure the accounting ratio for the both companies. The business performance can exactly measure from there. I found the information of the both companies from the link below. <http://www.wct.com.my/CMS/Home/1/0.aspx>, <http://www.gamuda.com.my/>.

### Financial Statement Analysis

Below is an accounting ratio for two companies.

## 2.1 Profitability

Ratio

Ratio with Formula

Calculation for GamudaBerhad

Calculation for

WCT Berhad

Gross Profit Markup

Gross Profit Margin

Operating Profit Margin on Sales

Profit Margin on Sales

Basic Earning Power

Return on Total Assets

Return on Common Equity

## 2.2 Liquidity

Ratio

Ratio with Formula

Calculation for GamudaBerhad

Calculation for

WCT Berhad

Current Ratio

Acid-test Ratio

## 2.3 Asset Management

Ratio

Ratio with Formula

Calculation for GamudaBerhad

Calculation for

WCT berhad

Inventory Turnover

Total Assets Turnover

Debtor Ratio

Day Sales Outstanding

2.4 Debts Management

Ratio

Ratio with Formula

Calculation for GamudaBerhad

Calculation for

WCT Berhad

Debts Ratio

Debts Equity Ratio

Times Interest Earned or Interest Cover

2.5 Market Value of Investment to Stockholders

Ratio

Ratio with Formula

Calculation for GamudaBerhad

Calculation for

WCT Berhad

Earnings Per Share

Price Earnings Ratio

Earnings Yield

Market Price Per Book Value Ratio

Comparison between GamudaBerhad and WCT Berhad

Below is the ratios comparison between two companies for business performance measurement.

### 3.1 Profitability

Gross profit markup and gross profit margin:

Gamuda having the higher gross profit markup and gross profit margin compare to WCT. That means Gamuda indicate the higher gross profit earned by the company from the sales made. This showing GamudaBerhad is effective and efficient in controlling the purchase cost by making the purchase at a lower cost from the supplier. Besides, Gamuda also effective in controlling the production cost by using the material and labour to reduce the production cost.

Operating profit margin on sales:

In operating profit margin on sales, Gamuda applies the higher margin than WCT. This mean that Gamuda is the company best to look at the change in operating margin over to WCT. The higher margin is mean it is earning more per dollar of sales.

Profit margin on sales:

Gamuda shows the higher profit margin compare to WCT. Gamuda earned high profit from the sales and the firm is effective control on the expenditure and interest cost. Compare to WCT, the company indicates high operating expenses and high interest cost than Gamuda. WCT was earned lesser profit than Gamuda.

Basic earning power (BEP)/ Return on common equity (ROE):

WCT shows the higher profit in the BEP and ROE. This mean WCT company show the high profit in generated from the total assets used and the capital employed due to the effectiveness and efficiency of using the assets and capital in business activities.

Return on total assets (ROA):

In return on total assets different with the BEP and ROE. Gamuda shows the higher profit in ROA rather than WCT. Gamuda can effectiveness using the assets in the business activities to increase the production volume and sale volume at the lower cost to increase the profit earning than WCT.

### 3.2 Liquidity

Current ratio and Acid test ratio:

Both company having the higher ratio in the current ratio and acid test ratio. This means that both companies are having the large amount of current assets that can be used to finance their current liabilities. Their company financial is stable and able to finance its short term liabilities. However, Gamuda having the higher ratio than WCT which is mean that financial in Gamuda is more stable than WCT.

### 3.3 Asset Management

Inventory turnover:

In the measurement of inventory turnover that shows the WCT having the higher inventory turnover rates compare to Gamuda. This means that WCT having the fastest stock taken out for resale. The stock of WCT will not accumulate and the money will not tied up with the stocks.

Total asset turnover:

WCT shows the higher total asset turnover compare to Gamuda. WCT is more effectiveness and efficiency of using the assets in the business activities to increase the production volume and sales volume.

Debtor ratio and Days sales outstanding (DSO):

Gamuda having the higher debtor ratio and days sales outstanding compare to WCT. Gamuda has given the longer credit time to the debtor who owing money. The longer time to collect money from the debtors will cause financial in Gamuda facing the short term financial problems.

### 3.4 Debts Management and Capital Gearing

Debts ratio:

WCT having the higher debts ratio compare to Gamuda. WCT will having the heavy debts burden and the company will bearing the high interest cost. They will face the unstable financial pay back the debts and it could cause to sell the assets to pay back the debts.

Times interest earned/Interest cover:

WCT shows the high debts equity ratio compare to Gamuda. High debts equity ratio in WCT means that it is always accompanied with low time interest earned and it also

bearing the high interest charges. However, Gamuda having the low debts equity ratio and this means the company having a high time interest earned compare to WCT. The company is bearing the low interest charges.

### 3.5 Market Value of Investment to Ordinary Shareholders

Earning per share:

Earning per share is to measure the business growth of the company. WCT having the higher earnings per shares compare to Gamuda. This represents WCT having the high rate of growth compare to Gamuda. This can attract more common stockholders to invest in WCT.

Price earnings ratio:

Gamuda having the highest prices earning ratio compare to WCT. So, stockholders in Gamuda need to take more times and the longer period to recover back their share investment. Therefore, WCT will be more attractive to invest because the company will recover back the share investment faster than Gamuda.

Earnings yield:

WCT shows the highest percentage in earning yield compare to Gamuda. The WCT Berhad is having the high net income return and this is more attractive to the common stockholders.

Market price per book value:

Gamuda is indicating the highest share market price compare to WCT. Gamuda will not be attractive to common stockholders because the share market price rises high above the real asset value.

Conclusion

By measurement in accounting ratio of financial statement, two of the companies are showing the different business performance. Gamuda Berhad and WCT Berhad are the two companies which are in the same industry. In profitability of company, Gamuda is earning the higher profit compare to the WCT. In liquidity of company, Gamuda also shows the stable financial compare to WCT. In asset management of company, WCT operates in the fast stock turnover than Gamuda. Other than that, WCT also can collect the money from the debtor faster than Gamuda. This will make WCT more liquid in their financial. In market value of investment to ordinary shareholders, WCT will attract more shareholders to invest in their company because they can get the high net income return and having the shortest time to get the investment money compare to Gamuda.

There are many problems to get the information because the base of the information is always out of date. The historical cost information may not be the most appropriate information because if the inflation effect happens, this may not be applies in. Beside that, the information in published accounts is summarized information, we cannot get the detail information and the analysis of accounting information not the root of the problems.

On the other hand, there are many problems in the comparison inter-firm also. Different companies are having the different financial and business risk. The companies will also using the different accounting policies. There will having the impacts of the size of the business and its comparators on risk, and the impacts of different environments on results.

## 5.0 Financial Markets

Financial markets is a market who is having surplus fund or capital that lending out to the organization or people who are lacking capital or fund in their business. There are many different types of financial markets. Every different financial market serves different types of customers and operating in different country. Financial markets are deal with stocks or shares, notes, mortgages, bonds and so on. Financial market also operates as the spot market or future market. Spot market deals in being bought for on the spot delivery within a few days, however, future market deals in being bought for on the future delivery at some future date such like a few months or a year in the future. There are various types markets in the financial markets.

### Money markets

This is the short term financial market. Money market deals with the high liquid debt securities in which of the funds are borrowed for a short period of less than one year.

### Capital markets

This is the long term financial market. Capital market is a financial market that deals with the stocks or shares, intermediate in which funds are loaned for a long period of one year or more than one year.

### Mortgage markets

Mortgage market is a financial market that deals with loans on residential, commercial, industrial real estate and farmland.

### Consumer Credit Markets

Consumer credit market is dealing with loans on autos and appliances, like education loan, vacations and so on.

## Primary markets

This is the financial market in which corporations raise fund by issuing new securities or new shares.

## Secondary markets

Secondary market is a financial market which is existing and already outstanding securities or other financial assets are traded among investors after they have been issued by the corporations.

## Initial public offering (IPO) markets

This is for the new establisher who is first time offering securities or shares to the public.

## Private market

Private market means that a financial transaction is worked out privately and directly between two parties without going to the public.

## 6.0 Transfer of Capital between Savers and Borrowers

There are three types of ways to transfer the capital or funds between the savers and borrowers.

### 6.1 Direct transfer from savers to borrowers

This method applies to a company issues and sells the stocks or bonds directly to the savers without go through any financial institution. So, the borrower will be the corporation who direct delivers the securities to the savers. The savers who are in turn the money to corporation. This is show the capital or fund directly transferred from savers to corporation.

### Indirect transfer from savers to borrowers through investment banking house

This method indicates that the business corporation as a borrowers. The business corporations will issues the corporation's securities or shares to the investment banking house. The investment banking house will resells the corporation's shares to the savers or the money lender. The investment banking house will be the middle man and receive the fund from the money lender and give the money to the borrowers or the business corporation.

### 6.3 Indirect transfer from savers to borrowers through a financial intermediary

This method takes place when a financial intermediary as a bank or a mutual fund obtains fund from savers by issuing its own securities or certificate of deposit to savers. After that, the financial intermediary uses the fund that collected from the savers to purchase and hold the securities of other corporations as an investment. The capital or fund that transfer from the savers to the financial intermediary when savers pay money to financial intermediary in exchanging for receiving certificate of deposit or securities issued by the financial intermediary. The financial intermediary will further transfer the fund to other corporation by paying money out of the fund to purchase securities of other corporation. Most of the savers will prefer to hold the securities and the deposit of the financial intermediary because they are more safe and liquid compare to the mortgages and loans. So, financial intermediary is efficiency of money and capital markets.

### 7.0 Investment Banking House

Investment banking house is an organization that underwriting and distributes the new issue of corporation's securities to assist corporation obtain fund for financing.

#### 7.1 Financial Intermediary

Financial intermediary is a financial firm that are transfer the capital or funds from the savers to the borrowers. Normally, they will analyze the potential of the borrowers when they receive the application from the borrowers. They are helping the individual savers to diversify their fund investment, processing and collecting loans and pooling risk. There are several types of the financial intermediaries.

##### Commercial banks

Commercial bank is a financial institution that provides the service that accepting deposits and giving the business loans to the corporation. Commercial bank is different compare to the investment bank. Investment bank is assist the business corporation to raise the capital or fund from the savers but the commercial bank is providing loan or lent out the money to the borrowers.

##### Saving and loan associations

A savings and loan association is a financial institution that accepting saving deposits and making mortgage loans to the borrowers. Saving and loan association is similar to bank. They have served individual savers and residential and commercial mortgage borrowers where they collect funds from many small money savers and they lend out to the house buyers and the other types of borrowers. They create the liquidity in the capital market.

## Mutual savings fund

Mutual savings fund is almost similar with the savings and loan associations. They also accept savings from the individuals and then lend out the money for the long term basis to the home loaner and the consumers.

## Credit unions

Credit union normally will apply in a smaller operation. That is designed for the special group or membership of the people in a particular company or association. Credit unions are make loans for the individuals like auto purchase, house improvement and house mortgage.

## Pension funds

Pension fund is a retirement plans that provide by the corporation or government agencies. The pension fund is been invested for the long term growth, provides the pension for the employees when they reach the age of the retirement or the end of the working years.

## Life insurance companies

Life insurances company is sell insurance products to their existing customers. They collect the payment of insurance in the annual premiums and then they invest these funds in the stocks, shares, bonds, real estate and mortgage. But they also provide the insurance cover to the consumer when the payment periods.

## Mutual funds

Mutual fund is a financial intermediary that collects funds from the savers and then uses it to buy the stock, long term bonds and short term debt instruments issued by businesses or government units.