There are many ways that a business can actually measures how it is doing and one of these ways is to measure how the business is doing through ratio analysis. Ratios can assist the business to see how it is doing at present and also allow it to see how it compares to last year and the year before and against other competitors. In order for these ratios to actually be useful Domestic Dogs should compare over time to see if there are any trends and also between organisations within the same market such as competitors.

A variety of ratios covers solvency, profitability and performance. In order to work out the ratios and any other financial work you actually require a specific statement such as the profit and loss account and the balance sheet which illustrate the following:-

- Sales
- Current assets
- Current liabilities
- Opening stock and closing stock
- Expenses
- Net assets etc.

Solvency

Domestic Dogs can basically use ratio to work out their solvency by using the current ratio and acid test ratio and these ratios allows Domestic Dogs and also potential investors to actually see how well the business of Domestic Dogs is doing and also how well they are able to meet their objectives and their liabilities.

Current ratio

The current ratio illustrates how many assets that Domestic Dogs has compared to liabilities. The current ratio also gives the company of Domestic Dogs a more idea on how simple it would be to pay its credit and expenses.

A firm needs liquid assets to meet day to day payments. Therefore, liquidity ratios highlight the ability of the firms to convert its assets into cash. If the ratios are low then it means that money is tied up in stocks and debtors. Thus, money is not available to make payments. This may cause considerable problems for firms in the short run. It is often thought that a value less than 1.5 implies that the company may run out of money as its cash is tied up in unproductive assets.

If the figure is above 2 then Domestic Dogs may perhaps be in a difficult position for payment because its current assets would be virtually equal to its liabilities. Every business would consider having a figure of between 1.5 and 2 to ensure that the business of Domestic Dogs can possibly pay its liabilities without difficulties. However Domestic Dogs should not get a figure that is higher than 2 because it will not be a good idea for the business since the business will place the money elsewhere to actually advance and improve the business of Domestic Dogs.

Current ratio - $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Current ratio - $\frac{£10,600}{£3,600} = 2.9444$

It is considered good practice to have a number between 1.5 and 2. However having a figure above 2 is not good for the business of Domestic dogs because as stated above a figure higher than 2 would not be good for a large business such as Domestic Dogs.

Trading, Profit and Loss Account for 12 months ending 31/12/2007

		£		£
	Sales			**64,000**
Less:	Cost of Sales	4,000		
	Opening Stock	32,000		
		36,000		
Less:	Closing Stock	5,000		
				31,000
				33,000
Less:	Expenses			**21,400**
				11,600

Balance Sheet as at 31/12/2007

		£		£
	Fixed Assets			**41,000**
	Current Assets			
	Stock	5,000		
	Debtors	1,500		
	Bank	4,100		
		10,600		

Less:	Current Liabilities			
	Creditors	3,600		
	Working Capital			**7,000**
	Net Assets			**48,000**
	Financed by:			
	Capital			**39,400**
	Add Net Profit			**11,600**
				51,000
Less:	Drawings			**3,000**
				48,000

Acid test ratio

The Acid Test ratio shows the assets compared to liabilities such as the current ratio and the only difference is by taking out the stock figure from the current assets. The acid test ratio also shows how well Domestic Dogs can meet its liabilities without having to sell stock because by selling stock the business can actually loose a variety of money since stocks are need in large orgnisation such as Domestic Dogs and stocks can be used in hard situations. Furthermore the answer should be between 1.5 and 2 as illustrated above.

The acid test ratio is similar to the current ratio as it highlights the liquidity of the company. A ratio of 1:1 (i.e. a value of approximately 1) is satisfactory. However, if the value is significantly less than 1 it implies that the company has a large amount of its cash tied up in unproductive assets, so the company may struggle to raise money in the short term.

$$\text{ACID TEST RATIO} = \frac{\text{Current assets - stock}}{\text{Current liabilities}}$$

$$\frac{£10{,}600 - £5{,}000}{£3600} = \frac{£5600}{£3600} = 1.55555$$

The answer is 1.55555 which is very good for the business of domestic dogs home since it is between 1.5 and .

The primary difference between the current ratio and the quick ratio is the quick ratio does not include inventory and prepaid expenses in the calculation. Consequently, a business's quick ratio will be lower than its current ratio. It is a stringent test of liquidity.

Profitability ratio

In addition ratio can also illustrate how profitable Domestic Dogs home really is either as a snap shot or even over time. There are three main ways of working out how profitable Domestic Dogs Home really is and they are as follows:-

- Gross profit percentage- this calculation shows gross profit as a percentage of the turnover which are sales and any other income that the business gains. Furthermore the gross profit percentage sometime called gross profit margin and the calculation shows how well the business is managing its purchases of stock. In addition a higher gross profit percentage shows the organisation is doing well because it is controlling the cost of its purchases.

  Gross profit
  Turnover x 100 = gross profit percentage

  21,400
  64,000 x 100 = 33.4%

- Net profit percentage – the calculation of net profit percentage takes the idea of profitability one stage further by actually considering the profit as a percentage of turnover after all the other expenses have been taken out. The net profit percentage illustrates the profit that Domestic Dogs has made before tax has been considered; the calculation in addition shows how well Domestic Dogs Home manages its other expenses especially when comparing it to the gross profit percentage. Furthermore, if Domestic Dogs home has a high gross profit percentage but a la net profit percentage then it are operating costs.

  Net profit
  Turnover * 100 = Net profit percentage

  11,600/ 64,000 = 0.18

  0.18 x 100= 18 %

Performance ratio

The last set of the ratios that Domestic Dogs home might want to use is performance which basically shows the stock turnover, debtor's collection period and also asset turnover. Accounting ratios can offer an invaluable insight into a business' performance. Ensure that the information used for comparison is accurate - otherwise the results will be misleading.

Stock turnover - average cost of sales divided by the average value of stock. This ratio indicates how long you hold stock before selling. A lowe r stock turnover may mean lower profits. There are two different ways to work out this ratio which shows how quickly Domestic Dogs has sold its stock. In addition this is a useful way of measuring efficiency as the faster the stock is turned over the more likely the business is to be efficient. The calculation for stock turnover can either be by percentage or even by days.

Stock turnover in number of times

<u>Cost of sales</u>

Average stock = stock turnover

<u>4,000</u>

18500 (opening stock add closing stock / 2) = 0.127 (stock turnover)

Stock turnover in days

<u>Average stock</u>

Cost of sales x 365 (days in a year) = stock turnover (days)

<u>18500</u>

4000 =4.625 x 365 (days)= 1688.125 days

<u>Debtor's collection period</u>

The debtor's collection period looks at the link betw een the numbers of debtors and how long on average it takes Domestic Dogs home to collect its depts. The fewer the days the better credit control Domestic Dogs has because it collects what is owed very quickly and can concentrate on other things in work.

<u>Debtors</u>

Credit sales x 365= total number of days it takes debtors to pay.

Another method= debtors /sales x 365

1,500/ 64,000 x 365 = 8.55 days

Asset turnover

The final ratio that can actually help to work out the performance of Domestic Dogs Home is assets turnover. This ratio looks at the sales as a percentage of the total assets that a business owns.

Sales

Total assets = asset turnover

64000/48000= 1.33

1:1