Unit 4 financial ratios Module name profitability ratios
Outline- concept of profitability ratios types of profitability ratios
Learning outcomes- At the end of this module, students will be able to understand the concept of profitability ratios and list the types of profitability ratios.

Introduction
Ratio means the relationship between two or more things in financial analysis. Ratio is used as a benchmark for evaluating the financial position and performance of a firm. The relationship between two accounting figures expressed mathematically is known as financial ratio.

Now let's see the concept of profitability ratios.
Profitability Ratios are calculated to measure the operating efficiency of the company. Besides the management of the company, owners and creditors are also interested in the profitability of the firm.
A company should earn profit to survive and grow over a long period of time. Profit is the difference between revenue and expenses over a period of time usually one year. Owners want to get required rate of return on their investment while creditors want to get interest and repayment of principal amount regularly.

Now let's see the types of profitability ratios.

1. **Gross Profit Margin**

Gross profit is the difference between sales and the manufacturing cost of goods sold. It is calculated by dividing gross profit by sales.
Gross Profit Margin= Gross profit / Sales X 100
A high Gross Profit Margin is a sign of good management. It may increase due to

a) Higher sales price
b) Cost of goods sold remaining constant, etc.

If a firm has low Gross Profit Margin, then it may reflect higher cost of goods sold due to firm's inability to purchase raw materials at favourable terms, inefficient use of plant and machinery or over investment in plant and machinery leads to higher cost of production. Also, if the price of the product is low the Gross Profit Margin ratio will be low.

2. **Net Profit Margin**

It is obtained when operating expenses, interest and taxes are subtracted from the gross profit. It is calculated by dividing profit after tax by sales.
Net Profit Margin= Profit after tax / Sales X 100

3. **Operating Expense Ratio**

It explains the changes in the profit margin ratio. This ratio is calculated by dividing operating expenses i.e., cost of goods sold plus selling expenses and general and administrative expenses excluding interest by sales.
Operating Expense Ratio= Operating expenses / Sales X 100

4. **Return on Equity Ratio**

Ordinary shareholders are getting residual profits. The rate of dividend paid to equity shareholders is not fixed so the profit earnings may be distributed to the equity shareholders or retained in the business for expansion. Return on Equity is calculated by dividing profit after tax by the equity shareholders capital, reserves and surplus which is known as net worth.

Return on Equity Ratio= Profit after tax / Net worth

5. **Earnings Per Share Ratio**

It measures the profitability of each shareholder on each share. It is calculated by dividing profit after tax by the total number of shares outstanding.

Earnings Per Share Ratio= Profit after tax / Number of shares outstanding

6. **Return on Capital Employed**

It shows the percentage return to the company on the funds invested in the business by its owners. Higher the ratio, better will be the company. Capital employed includes equity share capital and other share capital, reserves and surplus, debentures and long-term loans.

Return on capital employed= Net Operating Profit / Capital Employed X 100

7. **Dividend Per Share**

The profit after tax belongs to shareholders but the company may not distribute entire amount to them. For example, Earnings Per Share is Rs. 6 and dividend paid on each share is Rs. 2. The remaining amount may be kept by the company as reserves. Dividend per share is the earnings distributed to ordinary shareholders divided by the number of ordinary shares outstanding.

Dividend Per Share= Amount distributed to shareholders / Number of ordinary shares outstanding

Conclusion

Profitability ratios are used by investors, bankers, financial institutions, creditors and other stakeholders for evaluating the financial performance of the company in regards of annual profitability.

These are the references which I have used for this module.

Thank you.