



6 RATIOS TO MANAGE YOUR BUSINESS

Your business' balance sheet and income statement are essential, but they are only the starting point for successful financial management.

Using ratio analysis on your financial statements you can analyse the success, failure, and progress of your business.

Ratio analysis enables the business operator to spot trends in a business and to compare its performance and condition with the average performance of similar businesses in the same industry. To do this, compare your ratios with the average of businesses similar to yours and compare your own ratios for several successive years, watching especially for any unfavorable trends that may be starting. Ratio analysis may provide the all-important early warning indications that allow you to solve your business problems before your business is destroyed by them.

Balance Sheet Ratio Analysis

Important balance sheet ratios measure liquidity and solvency (a business's ability to pay its bills as they come due) and leverage (the extent to which the business is dependent on creditors' funding). They include the following ratios:

Liquidity Ratios

These ratios indicate the ease of turning assets into cash. They include the current ratio, quick ratio, and working capital.

Current Ratio

The current ratio is one of the best known measures of financial strength. It is figured as shown below:

Current Ratio = Total Current Assets / Total Current Liabilities

The main question this ratio addresses is: "Does your business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible losses in current assets, such as inventory shrinkage or collectable accounts?"

If you feel your business's current ratio is too low, you may be able to raise it by:

- Paying some debts.
- Increasing your current assets from loans or other borrowings with a maturity of more than one year.
- Converting non-current assets into current assets.
- Increasing your current assets from new equity contributions.
- Putting profits back into the business.

Quick Ratios

The quick ratio is sometimes called the "acid-test" ratio and is one of the best measures of liquidity. It is figured as shown below:

Quick Ratio = Cash + Government Securities + Receivables / Total Current Liabilities

The quick ratio is a much more exacting measure than the current ratio. By excluding inventories, it concentrates on the really liquid assets, with value that is fairly certain. It helps answer the question: "If all sales revenues should disappear, could my business meet its current obligations with the readily convertible 'quick' funds on hand?"

An acid-test of 1:1 is considered satisfactory unless the majority of your "quick assets" are in accounts receivable, and the pattern of accounts receivable collection lags behind the schedule for paying current liabilities.

Working Capital

Working Capital is more a measure of cash flow than a ratio. The result of this calculation must be a positive number. It is calculated as shown below:

Working Capital = Total Current Assets - Total Current Liabilities

Bankers look at Net Working Capital over time to determine a company's ability to weather financial crises. Loans are often tied to minimum working capital requirements.

A general observation about these three liquidity ratios is that the higher they are the better, especially if you are relying to any significant extent on creditor money to finance assets.

Income Statement Ratio Analysis

Income statement ratios measure profitability. The key ratios include :

Gross Margin Ratio

This ratio is the percentage of sales dollars left after subtracting the cost of goods sold from net sales. It measures the percentage of sales dollars remaining (after purchasing or manufacturing the goods sold) available to pay the overhead expenses of the company.

The Gross Margin Ratio is calculated as follows:

Gross Margin Ratio = Gross Profit / Net Sales

Reminder: Gross Profit = Net Sales - Cost of Goods Sold

Net Profit Margin Ratio

This ratio is the percentage of sales dollars left after subtracting the Cost of Goods sold and all expenses, except income taxes. It provides a good opportunity to compare your company's "return on sales" with the performance of other companies in your industry. It is calculated before income tax because tax rates and tax liabilities vary from company to company for a wide variety of reasons, making comparisons after taxes much more difficult. The Net Profit Margin Ratio is calculated as follows:

Net Profit Margin Ratio = Net Profit Before Tax / Net Sales

Management Ratios

Other important ratios, often referred to as Management Ratios, are also derived from Balance Sheet and Statement of Income information. These include ;

Return on Investment (ROI) Ratio

The ROI is perhaps the most important ratio of all. It is the percentage of return on funds invested in the business by its owners. In short, this ratio tells the owner whether or not all the effort put into the business has been worthwhile. If the ROI is less than the rate of return on an alternative, risk-free investment such as a bank savings account, the owner may be wiser to sell the company, put the money in such a savings instrument, and avoid the daily struggles of small business management. The ROI is calculated as follows:

Return on Investment = Net Profit before Tax / Net Worth

Other management ratios include - inventory turnover ratio, accounts receivable turnover ratio, return on assets ratio.

These liquidity, leverage, profitability, and management ratios allow you to identify trends in a business and to compare its progress with the performance of others through data published by various sources.

Please contact this office if you would like us to assist you develop a set of management ratios for your business.

