



Financial Ratios Analysis

The Balance Sheet and the Statement of Income are essential, but they are only the starting point for successful financial management. Apply Ratio Analysis to Financial Statements to analyze the success, failure, and progress of your business.

Ratio Analysis enables the business owner/manager 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 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 Ratio

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:

$$\text{Current Ratio} = \text{Total Current Assets} / \text{Total Current Liabilities}$$

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?" A generally acceptable current ratio is 2 to 1. But whether or not a specific ratio is satisfactory depends on the nature of the business and the characteristics of its current assets and liabilities.

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The minimum acceptable current ratio is obviously 1:1, but that relationship is usually playing it too close for comfort.

If you feel your business's current ratio is too low, here are some ways in which it may be raised:

- Paying some debts
- Increasing your current assets from loans or other borrowings with a maturity of more than one (1) 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 it is one of the best measures of liquidity. It is figured as shown below:

$$\text{Quick Ratio} = \text{Cash} + \text{Government Securities} + \text{Receivables} / \text{Total Current Liabilities.}$$

The Quick Ratio is a much more exacting measure than the Current Ratio. By excluding inventories, it concentrates instead on the really liquid assets, with value that is fairly certain. It helps answer the current 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. The formula goes as shown:

$$\text{Working Capital} = \text{Total Current Assets} - \text{Total Current Liabilities}$$

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.

Leverage Ratio



This Debt/Worth or Leverage Ratio indicates the extent to which the business is reliant on debt financing (creditor money versus owner's equity):

$$\text{Debt/Worth} = \text{Total Liabilities/Net Worth}$$

Generally, the higher this ratio, the more risky a creditor will perceive its exposure in your business, making it correspondingly harder to obtain credit.

Income Statement Ratio Analysis

The following important State of Income Ratios measure profitability:

Gross Margin Ratio

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

Comparison of your business ratios to those of similar businesses will reveal the relative strengths or weaknesses in your business. The Gross Margin Ratio is calculated as follows:

$$\text{Gross Margin Ratio} = \text{Gross Profit/Net Sales}$$

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 one company to another for a wide variety of reason. This makes comparisons after taxes much more difficult. The Net Profit Margin Ratio is calculated as follows:

$$\text{Net Profit Margin} = \text{Net Profit Before Tax/Net Sales}$$

Management Ratios

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

Inventory Turnover Ratio



This ratio reveals how well inventory is being managed. It is important because the more times inventory can be turned in a given operating cycle, the greater the profit. The Inventory Turnover Ratio can be figured as follows:

$$\text{Inventory Turnover Ratio} = \text{Net Sales}/\text{Average Inventory at Cost}$$

Accounts Receivable Turnover Ratio (A.R.T)

This ratio indicates how well accounts receivable are being collected. If receivables are not collected reasonably in accordance with their terms, management should rethink its collection policy. If receivables are excessively slow in being converted to cash, liquidity could be severely impaired. Getting the Accounts Receivable Turnover Ratio is a two-step process and is calculated as follows:

$$\text{Daily Credit Sales} = \text{Net Credit Sales Per Year}/365 \text{ (Days)}$$

$$\text{A. R. T. (in days)} = \text{Accounts Receivable}/\text{Daily Credit Sales}$$

Return on Assets Ratio

This measures how efficiently profits are being generated from the assets employed in the business when compared with the ratios of firms in a similar business. A low ratio in comparison with industry averages indicates an inefficient use of business assets. The Return on Assets Ratio is calculated as follows:

$$\text{Return on Assets} = \text{Net Profit Before Tax}/\text{Total Assets}$$

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 shown:

$$\text{Return on Investment} = \text{Net Profit before Taxes}/\text{Net Worth}$$

These Liquidity, Leverage, Profitability, and Management Ratios allow the business owner to identify trends in a business and to compare its progress with the performance of others through data published by various sources. The owner may thus determine the business's relative strengths and weaknesses.