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BUSINESS FINANCIAL RATIOS

Every month you should be producing accurate financial reports so you can see how your business is performing.
A lot of business owners don't understand these reports well enough to be able to extract and analyse the valuable information hidden in them.
The purpose of analysing your reports by using business financial ratios is so you can compare results from one period to another, to uncover trends and to highlight areas of your business that require further attention.

'Whatever you measure you can manage'

The key areas to examine are

Profitability
Performance
Liquidity
Leverage

PROFITABILITY

i) Gross Profit Margin – this is a key indicator for any business. It is a measure of the margin on the goods that you sell. The higher the margin the better.

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

ii) Net Profit Margin - measures the margin on sales after all your costs have been taken into account. The higher the margin the better.

$$\text{Net Profit Margin} = \frac{\text{Net Profit (Before Tax)}}{\text{Sales}} \times 100$$

iii) Return on Assets (ROA) – measures how well your business is using its assets to make a profit. A low ratio in comparison to the industry average indicates insufficient use.

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

iv) Return on Investment (ROI) – this key ratio tells you whether the effort you are putting into the business is worthwhile. If the ROI is less than the rate of return of an alternative investment eg term deposit, you may be wiser to consider selling the business.

$$\text{Return on Investment} = \frac{\text{Net Profit Before Tax}}{\text{Total Equity}}$$

PERFORMANCE

i) Accounts Receivable Collection – indicates how many days it takes for your business to collect its accounts receivable. If receivables are slow in being converted into cash your liquidity will be affected. This calculation is done in two steps:

$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

$$\text{Accounts Receivable Collection} = \frac{365}{\text{Accounts Receivable Turnover}}$$

This number is only ‘good’ or ‘bad’ in relation to the industry norms in which your business operates.

ii) Inventory Turnover – this reveals how well your inventory is being managed. The more times your inventory can be turned the greater your profit.

$$\text{Inventory Turnover} = \frac{\text{Sales}}{\text{Average Inventory}}$$

As with all ratios you have to judge your inventory turnover against the industry norm.

LIQUIDITY

i) Current Ratio – provides information on your current assets that are available for you to pay for your current liabilities. In most businesses a current ratio of 2:0 or better is considered good. It means that your company has twice the amount of current assets as current liabilities.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

ii) Quick Ratio – this ratio focuses on the ability of your company to meet its current debts with its most liquid assets ie cash & accounts receivable. While industry norms vary, a company with a quick ratio of 1:0 or better is usually well positioned to pay its current liabilities out of current assets.

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

LEVERAGE

i) Debt to Equity Ratio – measures the extent to which you are using debt ie accounts payable & loans rather than your own funds to finance your business.
Many analysts look for a ratio of 1:0 or less, this means that half of your total financing or less comes from debt.

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

ii) Debt Ratio – measures your total debts compared to your total assets. The higher your liabilities the more risky your company becomes. Generally the lower this number the better.

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

SUMMARY

No single ratio is a sign of the overall health or otherwise of a business.
A variety of ratios & reports need to be monitored regularly, changes for the worse should be analysed & steps taken to ensure long term correction is attained. Similarly changes for the better should also be analysed to ensure you continue taking similar action.
Comparisons should only be made with businesses in similar industries.