BUSINESS PERFORMANCE ADVANTAGE

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CFO Plus LLC
Partners In Growth

Our mission is to provide information and strategies to business owners and managers for improvement in the effectiveness of its business management so that key objectives can be realized.

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Understanding Financial Ratios

Even the most business-savvy person is tempted to ask, "What does this mean?" when faced with rows of numbers stacked into pages of columns on financial statements. Fortunately, some quick ways exist to analyze financial statements and get an understanding of this data. Known as finan-cial ratios, these rules of thumb can help you:

- Benchmark operational standards against industry averages and your competitors;
- Analyze overall financial and operational health; and
- Predict the results of future operations.

You can also use financial ratios to measure:

- Liquidity (ability to pay current bills);
- Activity (rates of inventory turnover and accounts receivable collection);
- Leverage (ability to borrow money and pay off debt); and
- Profitability (performance and efficiency at turning a profit).

In your analysis, you can choose from a vari-ety of financial ratios. Here are some of the most common.

Current Ratio
Equation: current assets ÷ current liabilities
What you can learn: *How well a company is able to pay its bills — short-term solvency.* It indicates the extent to which the claims of short-term creditors are covered by assets expected to be converted into cash in the near future.

Quick Ratio
Equation: (current assets – inventory) ÷ cur-rent liabilities
What you can learn: *What percentage of assets can be quickly turned into cash.* Inventories are typically the least liquid of a company's current assets, and that makes them the assets on which losses are most likely to occur in the event of liquidation. Therefore, the quick ratio is a measure of the firm's ability to pay off short-term obligations without relying on the sale of inventories.

Inventory Turnover
Equation: cost of goods sold ÷ average inventory
What you can learn: *Frequency with which inventory is sold.* The ratio depends on the industry and in some cases, even the time of year. Faster turnovers are generally viewed as a positive trend because they increase cash flow and reduce warehousing expense.

Debt to Equity
Equation: total liabilities ÷ net worth
What you can learn: *Relationship of dollars creditors contribute (debt) to capital invested by owners (equity).* This ratio indicates the degree of financial leverage that you are using to enhance your return. A rising ratio could mean that new debt should be restrained. Most investors feel safer investing in a well-capitalized company than in a highly leveraged business. A company is generally considered well-capitalized if the owners generally have a significant amount of their own funds at stake.

Return on Equity
Equation: net profit ÷ net worth
What you can learn: *How well owner-supplied funds are being used to generate profits.* The higher this number, the better. It shows what you have earned on your investment. The higher the ratio, the better the funds are being used to generate a good return on investment for shareholders and the greater the profit.

Understanding Financial Ratios (cont.)

One Caveat

While benchmarking against other companies can be valuable, it also presents pitfalls. Comparing apples with oranges can distort results. Look out for differences such as:

- Accounting methods (for example, using the first-in, first-out instead of last-in, first-out inventory method leads to dif-ferent inventory and cost-of-sales figures on the income statement).
- Fiscal year-ends (especially important for seasonal companies).
- Methods of computing financial ratios (for example, before-tax basis vs. after-tax basis).

Who Else Uses Financial Ratios?

Business owners and managers aren't the only ones who can benefit from looking at financial ratios. So can:

- **Investors,** to make informed and intelli-gent investment decisions.
- **Corporate financiers,** to spot potential takeover targets.
- **Creditors,** to evaluate business loan risks.
- **Investment advisors and banks,** to find prosperous companies that might need their services.

Take Advantage of Financial Ratios

In addition to using ratios to evaluate the per-formance of your own company and bench-mark it against the competition, you can use them when considering the financial health of potential business partners and the viability of investment options. Keep in mind, though, that financial statements often provide only one part of the big picture (see our article, *Building a Better Dashboard*, in the January-February 2002 **Business Performance Advantage**) – true performance management relies on other means of measurement. Give us a call so we can answer any questions you may have about calculating or interpreting financial ratios or improving performance measures. We can help you use all of these valuable tools to enhance your business's future.