

DO YOU KNOW THE RATIOS OF YOUR BUSINESS?

By Gary Haworth, CPA

For a small business owner, there are few things more important than the health of their business. The financial statements are the most important management tool for an owner to successfully run their business.

Most owners have a pretty good handle on the more traditional items on the reports like sales, expenses and net profit. But are you using the reports to determine some of the key ratios needed to truly understand and manage your business? Even if you feel some ratios may not be something you would use consistently or even are out of your control, it is important to know how other people may be using your ratios.

A banker looks at certain ratios when evaluating your business as to whether they will loan you money or renew your credit line. It can also affect the interest rate and other terms of your loan.

Potential buyers will definitely pay very close attention to your ratios when looking at what your business is worth to them. The better the ratios, the higher the potential sales price you will get.

Your creditors will run various ratios on your information to determine what they will offer you as credit terms.

Here are a few important key ratios and trend indicators. Please keep in mind that a change in one of the indicators from month to month or significant variances between your company and the industry average is what makes this so useful.

Breakeven Point

The breakeven point may be the single most important number for any business owner. It is the point when the revenue is exactly the same as the costs, thus there is no profit or loss. It generally is expressed in dollars. Once you pass the breakeven point, the gross profit on each additional dollar of sales should drop right to the bottom line as net income. An owner should be monitoring this number throughout the month to have a better picture of the business.

Debt-to-Equity Ratio

The bank and other creditors will pay special attention to this ratio. It is computed by dividing the total debt of the company by the total equity. Example: If total debt is \$300,000 and the total equity is \$200,000, your debt-to-equity ratio is 1.5. A ratio less than 2.0 is generally considered a healthy number.

Current Ratio

This ratio measures the ability of your company to pay off all of its current debts (due in one year or less) with the current assets. The current assets are cash and assets that can be turned into cash in a short time period. It is calculated by dividing the total current assets by total current debts. Having a ratio of at least 2 to 1 is the goal. A ratio of less than one means your company could have a hard time meeting its normal operating obligations like payroll and paying your vendor bills.

Quick Ratio

This is simply cash, collectible accounts receivables, and marketable securities divided by current liabilities. This means you would not need to sell inventory to meet your current obligations. A ratio of one or greater will generally allow your company to run smoothly.

Accounts Receivable Turnover

This is a ratio your banker will want to see when you request additional working capital funds. It is calculated by dividing the credit sales for the accounting period by the average of the outstanding accounts receivable at the beginning and the end of the accounting period. Comparing this number with your industry is very helpful in running your business. Just as important is looking at your accounts receivable aging (current, 30 day, 60 day and 90+ days). The older the account, the less likely you will collect it in full.

Inventory Turnover

This is the cost of goods sold divided by the average of the inventory at the beginning and end of the accounting period. Assuming your markup is consistent, the higher the inventory turnover ratio, the better for you.

Net Profit Margin

This is simply net income divided by sales. Obviously, every owner wants to see this go up! By comparing this with other similar businesses, you can better see where you stand and what potentially you can achieve.

Calculating and evaluating the various ratios and trend numbers may seem like a daunting task, but once you learn how and set up a couple easy formulas in a spreadsheet or in your software reports, it becomes very easy. Having and using these numbers should be key ingredient for an owner to evaluate and run a successful small business.

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