

DO YOU KNOW THE RATIOS OF YOUR BUSINESS?

By Gary Haworth, CPA

Understanding your company's financial statements is critical to becoming a successful small business owner. Most owners have a pretty good handle on traditional line items such as sales, expenses and net profit. But are you correctly using the rest of the information to understand and manage your business in the best way possible? Even if you feel some of the items on your financial statement don't apply to your daily operations, it's important to know how these numbers affect your business.

A banker looks at these ratios when evaluating your business to determine 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 of your business will pay close attention to your ratios when looking at what your business is worth to them. The better the ratios, the higher the potential sale 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 is generally 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 you can potentially 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 a key ingredient for an owner to evaluate and run a successful small business.

Gary Haworth, CPA, is the owner of Haworth & Company, Ltd., and a member of the Small Business Resource Group, which helps small business owners with their accounting, marketing and payroll needs. He started his practice 20 years ago, growing from one person to now more than 30 employees and three locations. He can be reached at ghaworth@haworthco.com.