

Balance sheet ratios

The important ratios that arise from the Balance Sheet include working capital, liquidity, net worth, debtors turnover, return on assets and return on investment.

Working capital ratio

This ratio is also known as "the current ratio", and is one of the best-known measures of financial strength. 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 stock shrinking or uncollectable debtors?"*

A generally acceptable current ratio is 2:1; 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. The minimum acceptable current ratio is obviously 1:1 but that relationship is usually playing it too close for comfort.

Because there is a time lag between paying for materials and labour used to produce your goods and the receipt of the cash for those goods, the business needs money to fund its day-to-day operations. This money is referred to as working capital and is represented by the difference between current assets and current liabilities.

The formula for working out your working capital ratio is as follows:

$$\text{Current Assets (\$120,000)} / \text{Current Liabilities (\$80,000)} = 1.5 : 1.0$$

In this case it means that there is \$1.50 available in current assets to meet every \$1 of current liability.

This ratio is used by lenders as a guide to the soundness of a business because the greater the excess of current assets over current liabilities the better the position that the business is in to meet its commitments at least in the short term.

Here are some of the things that you could do if you feel that your current ratio is too low:

- Pay off some debts.
- Increase your current assets by borrowing for periods of more than one year.
- Convert non-current assets into current assets.
- Increase your current assets from taking in new equity contributions.
- Put profits back into your business, rather than drawing them out by way of salaries etc.

Liquidity ratio

This ratio is also called "the quick ratio", and is known as the "acid test ratio" because it is one of the best measures of liquidity. This ratio is used to determine the solvency of your business or its ability to meet its immediate commitments. The liquid ratio is a much more exacting measure than the current ratio. By leaving out stocks and other non-cash assets, it concentrates clearly on assets that are liquid with a value that is fairly certain. It will answer the question of: *"If all sales revenue should disappear, could my business meet its current obligations with the funds on hand or that can be easily accessed?"*

A ratio of 1:1 is considered satisfactory unless the majority of your quick assets are in debtors and there is a pattern of debtors lagging behind rather than paying their accounts on time.

It is often referred to as the acid test. In calculating this ratio it is important to bring in only those current assets that are in cash or can be converted readily into cash. Similarly current liabilities brought in must only be those that need to be met quickly.

The formula for this ratio is:

$$\begin{aligned}
 & \frac{\text{Current Assets} - (\text{Stock \& other non-cash assets})}{\text{Current Liabilities} - (\text{Liabilities not payable in the short-term})} \\
 &= \frac{\$120,000 - (\$16,000 + \$10,000)}{\$80,000 - \$3,000} \\
 &= \frac{\$94,000}{\$77,000} \\
 &= 1.22 : 1.00
 \end{aligned}$$

This means that there is \$1.22 in cash or near cash assets to meet every \$1.00 of immediate commitment.

Net worth ratio

This ratio measures the adequacy of the owner's funds as it indicates the proportion of the total asset of the business that is owned by him or her. Net worth is calculated by subtracting all liabilities from total assets to arrive at the balance, which are the owner's fund.

The formula for this ratio is:

$$\begin{aligned}
 & \frac{\text{Net Worth}}{\text{Total Assets}} \times \frac{100}{1} \\
 &= \frac{\$120,000}{\$360,000} \times \frac{100}{1} \\
 &= 33.33\%
 \end{aligned}$$

In this case the owners have funded 33.33% of the business assets.

Debtors turnover ratio

This ratio indicates how well debtors are being collected. If debtors are not collected reasonably in accordance with their terms, you should rethink your collection policy. If debtors are excessively slow in being converted to cash, liquidity will be severely affected.

The debtors' turnover ratio is calculated as follows:

$$\frac{\text{Net credit sales}}{365 \text{ days}} = \text{daily credit sales}$$

$$\text{Debtors turnover (in days)} = \frac{\text{Debtors}}{\text{Daily credit sales}}$$

Return on assets ratio

This measures how efficiently profits are being generated from the assets employed in the business, when compared with the ratio of firms in a similar business. A low ratio in comparison with the averages in the industry indicates inefficient use of the business assets.

The return on assets ratio is calculated as follows:

$$\text{Return on assets} = \frac{\text{Net profit before tax}}{\text{Total Assets}}$$

Return on investment ratio (ROI)

The ROI is, perhaps, the most important ratio of all. It is the percentage of return of funds on the funds invested in the business by you, its owners. This ratio tells you whether or not all the effort and time 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 or other secure bank investments, then you may be wiser to sell the business and put the money into that investment. You may find that this will avoid all the heartache and struggles of running a business.

Unless the return from the business is greater than the ROI, then you have to ask the question: "What's the point of being in business?"

The ROI is calculated as follows:

$$\text{Return on Investment} = \frac{\text{Net profit before tax}}{\text{Net worth}}$$

These liquidity, leverage, profitability and management ratios allow you to identify trends in your business and to compare its progress with the performance of others in the industry. You will then be able to determine the relative strengths and weakness of the business, as compared to others. Where there are weaknesses, strategies for improvement can be put into place. In the case of the ROI ratio, if it appears that it would be much better to put the funds into a secure investment which provides a return without you being involved, then it may be time to make changes, such as selling the business.



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Further information

The following fact sheets provide further information on these issues:

- Accounting records you should keep
- Break-even point
- Financial analysis overview
- Financial ratios
- Profit and loss ratios