

Financial ratios

Financial ratios are tools that are used to make sense of your financial statements by trying to work out the health of your business. Ratios allow comparisons to be easily made between periods of operation and they can also be compared to statistics and other industry benchmarks that are generally made known by government or other marketing type organisations.

The ratios will show whether things are improving or deteriorating and can quickly point out the areas of need for immediate improvements. A ratio is merely a means of relating one number to another. In financial analysis, ratios may be expressed as the ratio, or the rate, or the percentage depending on your own preference.

To provide useful meaning, financial ratios should always be compared with, for example:

- The trend of your results over the past year or so.
- The results by other competitors (if these are available).
- Budgeted results.
- The effect of economic conditions or other competitors.

The following table provides a quick summary of key financial ratios, what they indicate and their method of calculation:

| Ratio | Indicator of | Method |
|--|--|--|
| Gross Profit Margin | % of Gross Profit on Sales | Gross Profit x 100/Sales |
| Net Profit Margin | % of Net Profit on Sales | Net Profit before tax x 100/ Sales |
| Material:Sales | % of Sales dollars used in materials | Direct Materials x 100/ Sales |
| Labour:Sales | % of Sales dollars used in labour | Direct Labour x 100/Sales |
| Overhead Expense:Sales | % of Sales dollars used in overhead expenses | Overhead Expense x 100/ Sales |
| Stock Turnover | Number of times stock turns over | Cost of Goods Sold/ $\frac{1}{2}$ x (Opening and Closing Stock) |
| Debtors Turnover | Average time to collect debts | Debtors x days in period/ Credit Sales |
| Working Capital | Liquidity of business | Current Assets/ Current Liabilities |
| Liquidity (also known as Quick Assets ratio) | Solvency of business | Current Assets – (Stock & other non-cash assets)/ Current Liabilities – (Liabilities not payable in the short term) |
| Net Worth | % of business assets owned by proprietors | Net Worth x 100/ Total Assets |
| Return on Total Resources | Efficiency of use of business assets | (Operating Profit + Interest) x 100/Total Assets |
| Return on Net Worth | Effectiveness of use of owner's funds | Net Profit x 100/ Net Worth |



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Other important ratios and analysis

There are other key management ratios from which useful information can be ascertained.

1. Leverage ratio

This debt to net worth or leverage ratio indicates the extent to which the business is reliant on debt financing (i.e. creditors money vs owners equity in the business).

The formula is:

$$\text{Debt to worth ratio} = \frac{\text{Total liabilities}}{\text{Net worth}}$$

Obviously, the lower this ratio is the better. If it is high, it will be risky for a creditor, who will perceive his exposure in your business as a risk. It will also make it harder to obtain credit.

2. Break-even analysis

Break-even is the level at which the sales will equal the total of all the costs. It is the point at which there is neither a profit nor a loss but the business breaks even.

In other words, the break-even point for any business is the point at which all its variable costs and all its fixed costs are met but no profit is achieved. This means that anything over and above that point will be profit. Make sure you understand clearly the relationship between sales and costs, and how these relate to profit because this will assist you to manage your business better.

Further information

The following fact sheets provide further information on these issues:

- Balance sheet ratios
- Break-even point
- Cash flow
- Financial analysis overview
- Profit and loss ratios