

TIPS *from* LauberCFOs

Ratio Analysis... A Valuable Tool When Properly Used.

Business ratios can be good tools to gauge the financial health of your company. They also can be misleading or meaningless figures if used without the proper context.

That context primarily involves a standard or benchmark to compare to. The first set of ratios you develop for your business can be a benchmark to compare future ratios against. Those comparisons are where the value lies, indicating whether the company is moving in the right direction from a financial standpoint.

Your industry will have ratio norms, but be careful not to compare your ratios against those of companies in other lines of business. What is considered a good ratio in one industry might be a sign of serious trouble in another. Further, within your industry, a specific business may have factors that will affect its ratios and make comparisons invalid.

Numerous ratios can be determined, based on business financials and on business activity. Among the most common and useful are liquidity and financial leverage ratios and those that portray profitability and efficient use of assets.

Those include:

- **Current ratio = current assets divided by current liabilities.** This ratio can show a company's ability to meet financial obligations. Short-term creditors view a higher current ratio as an indicator of less risk. But a high current ratio also can indicate less money is going back into the business to protect its long-term viability.
- **Debt-to-equity = total debt divided by total equity.** This ratio offers a picture of how long-

term debt is being used and, like other financial leverage ratios, is a long-term indicator. It provides a snapshot of how much of the money in the business is the owner's (equity) vs. how much is from outsiders (debt). This ratio can be affected by how a company classifies long-term leases and other items.

- **Interest coverage = EBIT (Earnings Before Interest and Taxes) divided by interest expense.** This indicates how much of a company's earnings are needed to cover the cost of its debt.

Other ratios give a picture of how efficiently a company is using its assets. The most common ratios in this category are receivables turnover and inventory turnover.

- **Receivables turnover = annual credit sales divided by accounts receivable.** This simply shows how long it takes to collect receivables.
- **Inventory turnover = cost of goods sold divided by average inventory.** This activity ratio is another indicator of how efficiently assets are used during a specific time period.

Two common indicators of operating efficiency are gross profit margin and revenue per employee.

- **Gross profit margin = sales (minus cost of goods sold) divided by total sales.** This ratio indicates how well a business is using materials and labor in production. A higher margin can indicate greater efficiency. Gross profit margin also is an indicator of how well a company is maintaining its selling prices as compared to its cost of labor and material. Since different companies will include different expenses in the

calculation of cost of sales (for example, commissions or overhead items), it is important to understand the underlying numbers when comparing gross profit margin between businesses.

- **Revenue per employee = Total revenue divided by the total number of employees.** Tracking this ratio has taken on more significance as the cost per employee has skyrocketed and businesses have placed a greater focus on increasing productivity and becoming more “lean.”

As we mentioned, individual ratios in a vacuum should not be used as meaningful indicators. Once you have determined a set of ratios, you can then use those numbers to monitor trends. Where a ratio is today is less meaningful than the direction it is heading.

Those trends should always be coupled with other indicators to determine how well your business is doing. As part of an executive or management team, a business financial expert can help develop meaningful indicators and strategies to ensure those indicators are healthy and moving in a positive direction.

We'll describe some of those other business indicators, which may be a better measure of business health than ratios, in coming issues of the CFO Advantage. If you'd like to personally discuss meaningful business indicators for your company, call us at 414-273-8060 or, outside of Milwaukee, at 800-358-8060. You can also send me an e-mail at John.Lauber@LauberCFOs.com. One of our LauberCFOs would be happy to confidentially work with you.

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