ANALYZING YOUR NUMBERS

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LEARNING OBJECTIVES

1. Understanding key ratios as they apply to small to medium businesses
2. Important ratios for financial institutions
3. Assessing your business' performance with ratios
4. The importance of a Business Performance Dashboard

INTRODUCTION TO THE BUSINESS PERFORMANCE DASHBOARD

Purpose:

- Evaluate the performance of a business
- Identify problems

How:

- Trend analysis
- Industry comparables

Ratio	Last Year (Historical)	Current (Actual)	Next Year (Projected)	Industry
Revenues	$623,313	$924,937	$1,000,000	N/A
Gross profit as a percentage of sales	60.5%	70.0%	65.0%	65.0%
Working capital ratio	0.60	0.70	0.80	1.20
Acid test ratio	0.15	1.10	0.50	1.00
Days of accounts receivable	40	35	30	30
Days of accounts payable	35	40	30	30

WORKING CAPITAL RATIO
= Current assets / Current liabilities

Purpose: Indicates if a company has enough short-term assets to cover its short-term debt

General Guideline:

- Working capital ratio < 1.0 = Potential issues paying creditors in the short-term
- Working capital ratio > 2.0 = Company is not investing excess assets
- Reasonable range of working capital ratio = 1.2 to 2.0
- Standard rule of thumb for financial institutions = 1.25

Current assets	$100,000	$200,000	$400,000
Current liabilities	$200,000	$200,000	$200,000
Working capital ratio	0.5	1.0	2.0

ACID TEST RATIO

$$= \frac{\text{Cash and equivalents + Accounts receivable}}{\text{Current liabilities}}$$

Purpose: Indicates if a company has enough short-term assets to cover its short-term debt **WITHOUT SELLING INVENTORY**

General Guideline:

- Acid test ratio < 1.0 = Company cannot pay its current liabilities and should be looked at with extreme caution
- Acid test ratio **MUCH <** Working capital ratio = Current assets are highly dependent on inventory (i.e. retail stores)

DAYS OF ACCOUNTS RECEIVABLE

$$= \frac{\text{Accounts receivable}}{\text{Sales}} \times \text{Number of days in year}$$

Purpose: Indicates the average number of days a company takes to collect revenue after a sale

General Guideline:

- Smaller number = a company takes fewer days to collect its accounts receivable
- Larger number =
  - A company selling a product on credit and financing its customers
  - Higher risk associated with bad debt
  - More cash is tied up in accounts receivable which may result in difficulties paying suppliers

DAYS OF ACCOUNTS PAYABLE

$$= \frac{\text{Accounts Payable}}{\text{Cost of Sales}} \times \text{Number of days in year}$$

Purpose: Indicates the average number of days a company takes to pay its input costs related to sales.

General Guideline:

- Smaller number = a company takes fewer days to pay its accounts payable
- Larger number =
  - A company is stretching supplier credit to finance its working capital requirements
  - May suggest problems with cash flows of business
  - Suppliers may cut off credit to the business or require cash up front for future purchases

TOTAL DEBT TO TANGIBLE NET WORTH
= Total adjusted liabilities / Tangible net worth

Purpose: Indicates how much of the business is financed by debt versus equity, also called "leverage".

Calculation:

- Adjusted Liabilities = Total Liabilities of the business
  excluding future taxes
  excluding debt assigned, subordinated and postponed to Lender
- Tangible Net Worth = Equity of Business
  plus any debt assigned, subordinated and postponed to Lender
  less intangible assets of the company, such as goodwill
  less advances to related parties, such as owners

TOTAL DEBT TO TANGIBLE NET WORTH
= Total Adjusted Liabilities / Tangible Net Worth

Purpose: Indicates how much of the business is financed by debt versus equity, also called "leverage".

General Guideline:

- Smaller number = Lower risk (< 2.00:1 indicates a well capitalized company)
  - A company is able to withstand more volatility in cash flow if it is financed with more equity and less debt
  - There is typically no requirement to make payments to the owner(s) of a company
  - Debt, such as trade payables, taxes and bank debt, carry expectation of repayment, regardless of performance of the business.
- Larger number = Higher risk (> 3.00:1 indicates a highly levered company)
  - As the ratio increases, the business is less able to deal with decreases in sales and the resulting drop in cash being generated by the business

DEBT SERVICE COVERAGE RATIO (DSCR)
= Cash Flow to Service Debt / Debt Obligations

Purpose: Shows the relationship between the cash generated by the business and the cash requirements the business has to those financing the business

Calculation:

- Cash Flow to Service Debt = Net After Tax Income
  plus interest expense
  plus non-cash expenses, such as amortization/depreciation and future taxes
- Debt Obligations = total of all principal and interest payments on loans, capital leases, and other required payments, including required dividends

DEBT SERVICE COVERAGE RATIO (DSCR)
= Cash Flow to Service Debt / Debt Obligations

Purpose: Shows the relationship between the cash generated by the business and the cash requirements the business has to those financing the business

General Guideline:

- Smaller number = Higher risk
  - A ratio of less than 1.00x indicates the business in unable to meet obligations from the cash generated by the business, and may have to rely on cash injections by the owners or the sale of assets.
- Larger number = Lower risk
  - Typically, a minimum 1.25x is required.
  - The additional 0.25x over 1.00x represents the additional cash that can be reinvested into the company to support growth and/or payments to the owners.

CREATE A BUSINESS PERFORMANCE DASHBOARD

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Questions