Important accounting ratios for small business financial analysis

Description

Funding is tough for small businesses and start-ups, making proper financial analysis imperative for their success. It’s important to understand where every morsel goes and to make sure you get the most from every revenue line.

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It also helps you understand how well you are using your assets and how you are financing your business. Accounting ratios compare different figures, revealing relationships between them.

These can even be figures from profit statements and balance sheets, comparing the business’s profitability and financial position.

When comparing figures from profit statements and the balance sheet, it’s important to average balance sheet figures. This is because the profit statement is for a period, while the balance sheet is at a particular date.

Because of this comparison, accounting ratios give your financial figures context. It is from this context that your financial analysis yields valuable insights.

In their totality, ratios can measure profitability, liquidity, management efficiency, leverage, and valuation & growth. Here we only want to look at the ratios important for the financial analysis of small businesses, and why they matter.

Asset Utilization Ratios

Total Asset Turnover = Net Sales ÷ Average Total Assets

Measures how well assets are utilised to generate net revenue. It gives the percentage gained in revenue for every dollar invested in assets.

Return on Assets = Net Income ÷ Average Total Assets

This ratio measures how well assets are utilised to generate a profit for the business. It gives the percentage gained in profit for every dollar invested in assets. The higher these two ratios are the better for the business.

The resulting financial analysis will help businesses understand how well they are applying assets to generate income. For small businesses, it might be important to include the cost of renting equipment.

This might not be strict accounting practice, but it’s important since small businesses rent equipment more than they purchase it. Excluding rented equipment might paint a prettier picture than is on the ground, compromising the insights from your financial analysis.

Small businesses tend to go overboard with asset acquisition, particularly if they get funding early. These ratios will help you understand if you have fallen into the same trap with your business. Conversely, if you are absolutely sure the level of asset acquisition is optimal, it could signal an underutilization of capacity.

Either way, filling this room for improvement will positively impact your business.

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Gross Profit and Net Profit Margin

Gross Profit Margin = Gross Profit ÷ Net Sales

This ratio measures the percentage of sales that the business enjoys as gross profit. This gives an understanding of just how much the business earns over costs directly associated with generating sales.

Net Profit Margin = Net Income ÷ Net Sales

This ratio measures the amount of income derived per dollar of sales. It gives an understanding of the profit you earn from your business after all expenses have been paid. Generally, the higher these ratios are the better.

Pricing is very complicated for new businesses. Many variables are at play and need to be considered for an optimal pricing strategy to be found and applied. Some of these may include;

1. Experimenting with different pricing to penetrate the market
2. Limited understanding of the full resources going into generating sales
3. Clients having bargaining power in the early stages

It's important to understand if your current prices are working.

With good financial analysis, this need not be a guess or estimate. Understanding profit margins will help you understand if pricing strategies are working. If margins are too low, then the pricing strategy needs to be revised, no matter what results it's bringing.

Even if you are building a good client base, in the long run, it will work against your business. Low margins make it tough to fulfil your obligations, and those clients will be lost anyway. This is even more common when you agree to poor payment terms.

Above all though, remember that enticing clients with low prices with the intention of renegotiating them is the worst strategy. Most clients will refuse to renegotiate, and you'll be stuck with a bad price or face a bad reputation.

Instead, prioritise ensuring that your prices give you margins that can sustain your business.

Should the ratios be significantly higher than targets, this could be an opportunity to entice clients with lower pricing. If you fear that reducing prices may be misread as a reduction in quality, then promotions will do.

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It's a good opportunity to bundle products and offer clients more for less, increasing your value to them.

Cash Ratio (Consider Acid Ratio & Net Working Capital)

Net Working Capital = Current Assets – Current Liabilities

Working capital measures the business's ability to cover short-term liabilities from its current assets. It's a lot less reliable for small businesses as non-cash current assets are tough to convert into cash.

Acid Test Ratio = Quick Assets ÷ Current Liabilities

This ratio attempts to give a better liquidity picture by removing tough-to-liquidate current assets i.e. inventory. It gives a better understanding but still doesn't paint a clear picture as assets such as debtors can still be relatively tough for small businesses to convert into cash.

Cash Ratio = Cash ÷ Current Liabilities

This is the most important liquidity ratio for small business financial analysis. It measures theavailability of assets that can be used to immediately cover liabilities that have fallen due. It can includenon-cash assets such as an overdraft facility and short-term liquid securities.

The high mortality rate of small businesses is more often caused by poor cash flows than by a lack of profitability. Poor cash flows are actually a challenge for any business, big or small, but they are particularly devastating for small businesses.

When large businesses face cash-flow challenges, a number of factors work in their favour, including;

1. A good reputation that stops creditors knocking on their doors
2. A wide range of financing options with good terms
3. A wider asset base that can be liquidated to tame the situation

Smaller businesses are not so lucky, not on any of those fronts. When cash-flow challenges arise, they can lead to shutting down, even when the business is at its most profitable.

When doing financial analysis, it’s important to analyse your ability to stay ahead of your debts. This will help you put contingencies to make sure your business survives when these challenges do arise.

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Also, negotiating for possible bailouts while things are still good works in your business’s favour. It’s important for assets to be greater than liabilities, by as much a margin as possible.

Just don’t go overboard with cash assets though. Holding too much cash is a missed opportunity for your business to earn from it as an asset.

Any easily liquidated investment will also do, but will obviously carry the advantage of earning interest.

Receivables Turn-Over (Debtor Days) & Cash to Credit Sales

Receivable Turnover = Net Credit Sales ÷ Average Accounts Receivable

This ratio measures how well a business collects open accounts. A high ratio implies efficient credit and collection process.

Debtor days = 360 Days ÷ Receivable Turnover

This ratio measures the number of days it takes for a business to collect on credit sales.

Cash to Credit Sales = Cash Sales ÷ Credit Sales

This ratio measures the efficiency of extending credit. Cash need not be sales paid for immediately. It could include any reasonable collected amounts, such as immediately after delivery or within a short

period.

Small businesses tend to be negotiated into unfair contract terms, particularly where they deal with larger firms. More often than not they will accept because of a need to gain clients and get revenue in. This is an unwise strategy though.

It can lead to all sorts of performance challenges and is the greatest source of cash-flow problems. While receivables constitute liquid assets for larger businesses, it’s often not the case with small businesses.

Clients take their time to settle accounts and impose all sorts of terms, making receivables very unreliable. No small business financial analysis would be complete without ensuring a healthy stream of payments from debtors.

The financial health of your business depends on making sure accounts are paid on time and in full. Clients who don’t understand this are not worth keeping because great businesses are built on mutual relationships.

Also, keep a good ratio of cash to credit sales. Maintaining good cash flows and profitability means balancing cash and credit sales. Failure to do this, your business may become riddled with bad debts, and that’s a definite cause of business failure. And every business is capable of bad debts, no matter how big.

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Times Interest Earned & Times Interest Covered

Times Interest Earned = EBIT ÷ Interest Expense

This ratio measures the extent to which profit earned in the business covers interest expenses. It uses profit before interest and tax since interest is a tax-deductible expense.

Times Interest Covered = Cash ÷ Interest Expense

This ratio measures the extent to which available cash can be used to pay for interest. It’s important to remember that even profitable businesses can face problems if cash flows dry up. In your financial analysis, this ratio is an indispensable companion of Times Interest Earned.

While failure to generate cash to pay immediate debts can derail even the most profitable businesses, few expenses are as dangerous as interest. Your financiers usually have access to your financial information and when interest payments delay, they can act on it.

Temporary setbacks can be blown out of proportion and liquidation can be initiated prematurely. It’s important to make sure interest obligations are met on time so you can continue running your business

your way.

Additionally, these are important ratios for internal decision-making. Businesses borrow money so they can grow it. So even if they have to pay it with interest, it’s fine, because they would have earned more.

If, however, profits are lower than interest payments, then the business may not be worth it after all. This is an important bit of financial analysis when considering winding down the business for financial reasons.

Debt Ratio

Debt Ratio = Total Liabilities ÷ Total Assets

This ratio measures the portion of a business’s assets that are financed by obligations to third parties. Subtracting this ratio from one gives the Equity ratio. This is the portion of business assets financed by the owners’ equity.

Debt-Equity Ratio = Total Liabilities ÷ Total Equity

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This ratio evaluates the capital structure of the company. It directly compares financing contributed by the owners as equity vs what they borrowed from third parties. If it’s greater than one, then the firm is highly leveraged. If the converse is true, less than one, then your approach to financing is fairly conservative.

Business financing is a fine balancing act. Both modes of finance, debt and equity, carry with them a different set of pros and cons. As an entrepreneur, you need to do some serious financial analysis to figure out which option to use.

This is an ongoing process. As the levels of each change and your business goals and circumstances alter, so will the desired mode of finance. Staying on top of these ratios will aid your decision-making when financing your growth.

When it comes to these ratios, there is no optimal level, it’s highly determined by your preferences. Equity gives away ownership of the business but carries less risk. Debt allows you to retain ownership, but as interest payments are an obligation, it can lead to liquidation.

So the optimal level has to balance your appetite for risk, and your willingness to give away part of your company.

Return on Equity

Return Equity = Net Income ÷ Equity

This ratio measures the amount of money the business generated in return for the investment by the entrepreneur. It's the percentage earned by the entrepreneur for every dollar invested in the business.

Very often, entrepreneurs neglect themselves in their businesses. They put themselves and their interests last, sacrificing for the better good. While there are many rewards on the entrepreneurial journey, financial rewards cannot be overlooked.

Achieving freedom and sharing your passion is what entrepreneurship is about, but you went into business to get paid while doing it. Since equity includes all your contribution to the business, including non-cash capital, this ratio is comprehensive.

Look at all comparative investment vehicles and see what they'd give you for your buck. If, say a simple savings account offers a better return than your business, then maybe it's time to reconsider.

Time is an important factor here also. You should give your business time to grow and start earning, but if it perennially earns below even the simplest investment vehicle, it's a sign to implement that contingency plan and cut losses.

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How to put it together

The important thing to remember when doing your ratio analysis, like with all analysis is to give the ratios context. An important first step would be setting benchmarks to compare performance with. Industry and past period benchmarks give a good idea of where you are.

More importantly, though, use ratios to understand how you are doing regards the goals you set for your businesses. Without S.M.A.R.T. goals, your analysis isn't likely to yield any insights at all.

After all, benchmarks are just that, a means for comparison, not the be-all and end-all. Own it all, relate it to your business and only then will it work for you.

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