

THE STAPPAS PERSPECTIVE

Paul G STAPPAS/ 908-369-6843

RATIOS TO HELP BUSINESS OWNERS SUCCEED part 3

In this, the last issue discussing ratios, we will focus on the ratios that will help a business owner determine the TRUE financial strength of his or her business. These ratios are also based on the balance sheet of the firm's financial statements. These are the ratios that determine if the business is truly financially successful or not and, really, if the business owner is a good manager.

CURRENT RATIO: The current ratio gauges how capable a business is in paying current liabilities by using current assets only. Current ratio is also called the working capital ratio. A general rule of thumb for the current ratio is 2 to 1 (or 2:1 or 2/1). Depending on the industry, this ratio could be lower or higher. This is a primary ratio used by banks to help determine the credit worthiness of a business since it affects the firm's ability to meet its debt obligations. For example, a current ratio of .5 to 1 indicates that the firm's liabilities exceed its current (liquid assets), which, in turn, indicates that the firm would likely be rejected for financing.

Note, current asset cash is or assets that can easily be converted into cash such as receivables and inventory. A current liability is a liability that must be paid within one year such as vendor invoices, the current year's loan principal, etc. **The formula for the current ratio is**

$$\frac{\text{Total current assets}}{\text{total current liabilities}}$$

QUICK RATIO: Quick ratio focuses on **immediate** liquidity (i.e., cash, accounts receivable, etc.) but specifically ignores inventory. Also called the acid test ratio, it indicates the extent to which you could pay current liabilities **without** relying on the sale of inventory. Quick assets are highly liquid and are immediately convertible to cash. A general rule of thumb states that the ratio should be 1 to 1 (or 1:1 or 1/1). **The formula for the quick ratio is**

$$\frac{\text{Cash} + \text{accounts receivables} + \text{any other quick assets (such as stocks etc)}}{\text{current liabilities}}$$

DEBT TO EQUITY: Debt to equity is also called debt to net worth. It quantifies the relationship between the **capital** invested by owners and investors and the funds provided by creditors. The higher the ratio, the greater the risk to a current or future creditor. A lower ratio means the firm is financially stable and is probably in a better position to borrow now and in the future. **The formula for debt to equity is**

$$\frac{\text{total liabilities (or debt)}}{\text{net worth (or total equity)}}$$

EARNINGS BEFORE INTEREST AND TAXES (EBIT): This assesses the company's ability to meet interest payments. It also evaluates

PG STAPPAS

760 Vanessa Lane
Neshanic Station,
NJ 08853
USA

PHONE:
908-369-6843

FAX:
908-364-9449

E-MAIL:
pgstappas@
comcast.net

Visit our web site
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the capacity to take on more debt. The higher the ratio, the greater the company's ability to make its interest payments or perhaps take on more debt. **The formula for EBIT is**
$$\text{earnings before interest \& taxes/interest charges}$$

NET WORTH: This ratio is an important determinant of the **value** of a company, since it is composed primarily of all the money that has been invested since its inception, as well as the retained earnings for the duration of its operation. Net worth is used to determine **creditworthiness** because it gives a snapshot of the company's history. Also called owner's equity, shareholders' equity, or net assets. As a general rule, a firm can expect to be able to borrow up to six times its net worth. **The formula for EBIT is**
$$\text{total assets} - \text{total liabilities}$$

RETURN ON EQUITY (ROE): One of the most important ratios since it reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. This ratio shows the business owner how effectively the **capital** is being reinvested and serves as gauge of management's fiscal adeptness than the annual earnings. Firms with a higher percentage are usually much better managed companies. **The formula for ROE is:**
$$\text{net profit/net equity}$$

RETURN ON INVESTMENT (ROI): This ratio measures a firm's profitability and management's ability to generate profits from the **funds invested** into the firm. **The formula for ROI**
$$\text{net investment/total investment (total debt plus total equity) x100}$$

SUMMARY: Managing a firm for financial success is not an easy task. The formulas presented in this and the prior two STAPPAS PERSPECTIVES are tools that can help business better manage their firms for success.

PREPARE FOR SUCCESS

To be successful every firm MUST show a "good" net profit and must ALWAYS have adequate "liquidity" and MUST develop a STRONG balance sheet,

REMEMBER -- COMPANY'S DO NOT PLAN TO FAIL, THEY JUST FAIL TO PLAN

About Our Organization...

We provide complete and total STRATEGIC PLANNING consulting services to individuals that own and operate their own business as well as our exclusive BMA service that provides complete bookkeeping (saves an average of \$18,000 per year) and complete payroll (saves up to 70%). We help our clients succeed. Please contact us for more information. Call us or visit our web site for additional information.