

## ANNEXURE 2: FINANCIAL RATIOS

It is important for business owners and financiers to apply ratio analysis to actual and projected financial statements. These can provide valuable insight into the performance and progress of the business. Comparisons can be made against similar businesses and industry standards. These ratios can assist in decision making to enhance growth profitability and debt management in a business. These ratios can provide early warning indications to allow you to solve your business problems before the business can be completely destroyed. Financiers and creditors can use these ratios to provide them with valuable information on whether or not to fund or supply a business.

**Below are some useful ratios with explanations:**

### **Leverage:**

This is the debt/worth or leverage ratio which indicates the extent to which the business is reliant on debt financing (creditor money versus owner's equity). The higher the ratio the riskier the business becomes to financiers and creditors.

**Gross Margin** = Gross Profit/Sales.

Gross margin measures the profitability considering only variable costs and is a measure of the percentage of revenue that goes to fixed costs and profit.

**Net Profit Margin** = Net Income/Sales

**Total Asset Turnover** = defined as Sales/Total Assets

**Return on Assets (RAO)** = Net Income/Assets

ROA is a measure of the return on money provided by both owners and creditors, and is a measure of how efficiently all resources are managed.

**Return on Equity (ROE)** = defined as Net Income/Equity

Where the equity value is the shareholder's equity at the *end* of the period in which the income was earned. ROE is a measure of the return on money provided by the firm's owners.

ROE can be calculated indirectly as:

$$\text{ROE} = (\text{Net Income/Total Assets}) (\text{Total Assets/Equity})$$

ROE also can be calculated using the following method:

$$\text{ROE} = (\text{Net Income/Sales}) (\text{Sales/Total Assets}) (\text{Total Assets/Equity})$$

This states that ROE is determined by multiplication of three levers:

ROE = (net profit margin) (total asset turnover) (leverage)

These levers are readily viewed on the business's financial statements. While ROE's may be similar among businesses, the levers may differ significantly.

## **Liquidity**

The term *working capital* is used to describe the current items of the balance sheet. Working capital includes current assets such as cash, accounts receivable, and inventory, and current liabilities such as accounts payable and other short term liabilities. *Net working capital* is defined as non-cash current operating assets minus non-debt current operating liabilities. Cash, short-term debt, and current portion of long-term debt are excluded from the net working capital calculation because they are related to financing and not to operations.

Two commonly used **liquidity ratios** are the *current ratio* and the *quick ratio*.

**Current Ratio:** defined as Current Assets/Current Liabilities.

The current ratio is a measure of the business's ability to pay off current liabilities as they become due.

**Quick Ratio:** defined as Quick Assets/Current Liabilities.

The quick ratio also is known as the acid test. Quick assets are defined as cash, accounts receivable, and notes receivable – essentially current assets minus inventory.