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Keeping Your Business on Track, Part III

Home-Based Business Fact Sheet Bulletin #3002

RATIO ANALYSIS

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What is Ratio Analysis?

Ratio analysis is a type of analysis that helps you better understand and guide the financial affairs of your business. A ratio is a mathematical expression and is computed using information from the balance sheet and/or income statement.

How You Can Use Ratio Analysis in Your Business?

You can see how your business is doing by checking your most recent ratios against previous ratios on a regular basis. This will help you improve the quality of business management decisions and the performance of your business. You can also check your ratios against ratios of other firms in your industry. This will tell you if your business is performing better or worse than other business firms in the industry. You can find information on the ratios typical to your business in publications such as Dunn and Bradstreet's *Industry Norms and Key Business Ratios.* This reference is available in many public libraries and university libraries. Also, industry trade associations often furnish important financial data, such as figures of differently sized businesses in terms of sales, expenses, capital requirements and profit percentages.

Ratio Analysis Formulas

There are many ratios you can use to analyze and gauge the financial health of your business. This fact sheet will discuss four key financial performance areas worth analyzing: liquidity, profitability, solvency and efficiency.

- **Liquidity** measures how easily you can turn assets into cash. Three common measures of liquidity include *working capital,* the *current ratio* and the *quick ratio.* Working capital measures a company's cash flow position. The current ratio measures the degree to which current assets can be used to pay current debt obligations. The quick ratio measures the degree to which very liquid current assets can be converted to cash to meet current debt obligations. Generally, the larger the ratio, the more liquid the business.

Working Capital	=	Total Current Assets – Total Current Liabilities
Current Ratio	=	Total Current Assets ÷ Total Current Liabilities
Quick Ratio	=	(Total Current Assets – Inventory) ÷ Total Current Liabilities

- **Profitability** measures the degree to which the business is profitable. Three common profitability ratios include *return on investment, return on total assets,* and *return on sales.* Return on investment measures the return on funds invested by the owners of the business. Return on total assets measures how efficiently profits are being generated from assets employed in the business. Return on sales or net profit margin is a measure of overall business success. Generally, the larger (more positive) the ratio, the more profitable the business.

Return on Investment = Net Profit (Loss) ÷ Net Worth

Return on Total Assets = Net Profit (Loss) ÷ Total Assets

Return on Sales = Net Profit (Loss) ÷ Net Sales

- **Solvency** measures the degree to which the business relies on debt financing. Two common solvency ratios are the *leverage ratio* and the *debt to assets ratio.* The leverage ratio measures the degree to which the business uses borrowed versus owner's money in the business. The debt to assets ratio measures the degree to which total assets are being financed by creditors. Generally, the larger the ratio, the less solvent the business.

Leverage Ratio = Total Liabilities ÷ Net Worth

Debt to Assets Ratio = Total Liabilities ÷ Total Assets

- **Efficiency** measures the degree to which the business is effectively utilizing its resources in generating sales and profits for the business. Two common efficiency ratios are the *asset turnover ratio* and the *inventory turnover ratio.* The *asset turnover ratio* measures the degree to which the total assets of the firm are being used to generate sales. The *inventory turnover ratio* measures how well the business's inventory is being managed. Generally, the larger the ratio, the more efficient the business.

Asset Turnover Ratio = Net Sales ÷ Total Assets

Inventory Turnover Ratio = Net Sales ÷ Average Inventory At Cost

Summary

Ratio analysis is an analytical tool that you can use to see how your business's financial affairs compare year to year and to other business firms in the same industry. The information and data gained from ratio analysis will help you make more informed business decisions and help keep your business economically viable.

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