“What are ratios and why do they matter?” is the great question that I got asked by a SCORE Client at one of our business classes last week. She said, “Dean, you talk about knowing our business numbers and I understand good accounting and the reports that I can use and also the valuable forecasting tools, but now I just heard you suggest to another business CEO to look at their current ratio, please explain”.

Reports and forecasts are great but they don't tell you how well you are doing in relation to other businesses within your industry. For example, is it healthy or unhealthy if your automotive repair shop’s total debt equals your total assets? Since companies come in different shapes and sizes, the best way to make comparisons is by using ratios-comparisons of different elements from your balance sheet.

The challenge with ratios, is that there's got to be some standard. If you discover your tap water is all brown and you have your well tested, and they report that you have magnesium at 47 parts per million, you don't know what you've got unless you can measure it against a standard. The same is true for business ratios."

In the business world, we commonly use Robert Morris and Associates work that is known as "RMA Standards". This work lists standard ratios that are published in a document that includes most types of businesses that you can think of. These Ratios are commonly expressed as a percentage (usually x divided by y). I recommend looking at a few ratios to give a good comparison of how your business is doing and compare it to other businesses in your industry. All of the data for these calculations can be gotten from your current balance sheet.

**Current Ratio** (also known as “acid-test” ratio): This measures how well your business can pay off short-term debts (or as it is sometimes referred to, the size of your "buffer" or "cushion"). It's determined by dividing current assets by current liabilities. For example, if your current assets total $100,000 and your current liabilities total $50,000, the current ratio is expressed as a healthy 2 (or 2: 1) ratio. (That is, you have $2.00 in current assets for each $1.00 in current debt.) If the reverse was true and you had $50,000 in assets and $100,000 in debt, you would have a risky ratio of .5 (or 1 :2).
**Quick Ratio:** Like your current ratio, the quick ratio measures your company's ability to pay outstanding liabilities. The difference is that the quick ratio analyzes the amount of cash (or assets that can be quickly converted to cash) that can be used to payoff liabilities. For that reason you determine the quick ratio by subtracting inventory from current assets, then dividing the result by current liabilities. (You subtract the inventory because that cannot be quickly converted to cash.) Therefore if you had current assets of $100,000, current liabilities of $50,000, and inventory of $50,000, the quick ratio is expressed as a 'good' 1 (or 1 :1).

**Debt to Equity Ratio (DIE):** This ratio is calculated by dividing the total debt (liabilities) by the total shareholder equity in the company. This ratio measures risk to current or future creditors. In this case, the higher the ratio, the greater is the risk for the business (and for a lender). Ideally, your company's debts should not exceed the amount invested into it. For example, if your business's total debt is $110,000 and your shareholder equity is $95,000; your debt to worth ratio is 1.157. If that ratio were to rise dramatically (for example debt rose to $250,000 making the ratio 2.63), it's a signal that your company could be having a problem (or is headed for one) and should hold off on incurring more debt.

**PROFIT WORTH:** In addition to the example ratios above, another one which you may find helpful is your profit margin. This is the calculation that matters the most to many business owners because it makes clear how much of each dollar in sales ultimately becomes profit. It's a percentage calculated by dividing net income for any period by the net sales from that period. That is, it tells you how much of your profit is being eaten by your expenses. For example, if your appliance store netted $100,000 on sales of $1 million during the last twelve months, your profit margin is 10.

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Dean L. Swanson
Southeast Minnesota SCORE
c/o Rochester Area Chamber of Commerce
220 South Broadway, Suite 100
Rochester, MN 55904

*Dean is a volunteer SCORE Mentor and District Director of SCORE Minnesota*