USE ACCOUNTING RATIOS TO ASSESS BUSINESS PERFORMANCE

Ratio analysis is a good way to evaluate the financial results of your business in order to gauge its performance. Ratios allow you to compare your business against different standards using the figures on your balance sheet.

Accounting ratios can offer an invaluable insight into a business' performance. Ensure that the information used for comparison is accurate - otherwise the results will be misleading.

There are four main methods of ratio analysis - liquidity, solvency, efficiency and profitability.

Liquidity ratios

There are three types of liquidity ratio:

Current ratio - current assets divided by current liabilities. This assesses whether you have sufficient assets to cover your liabilities. A ratio of two shows you have twice as many current assets as current liabilities.

Quick or acid-test ratio - current assets (excluding stock) divided by current liabilities. A ratio of one shows liquidity levels are high - an indication of solid financial health.

Defensive interval - liquid assets divided by daily operating expenses. This measures how long your business could survive without cash coming in. This should be between 30 and 90 days.

Solvency ratios

Gearing is a sign of solvency. It is found by dividing loans and bank overdrafts by equity, long-term loans and bank overdrafts.

The higher the gearing, the more vulnerable the company is to increasing interest rates. Most lenders will refuse further finance where gearing exceeds 50 per cent.

Efficiency ratios

There are three types of efficiency ratio:

Debtors' turnover - average of credit sales divided by the average level of debtors. This shows how long it takes to collect payments. A low ratio may mean payment terms need tightening up.

Creditors' turnover - average cost of sales divided by the average amount of credit that is taken from suppliers. This shows how long your business takes to pay suppliers. Suppliers may withdraw credit if you regularly pay late.

Stock turnover - average cost of sales divided by the average value of stock. This ratio indicates how long you hold stock before selling. A lower stock turnover may mean lower profits.

Profitability ratios

Divide net profit before tax by the total value of capital employed to see how good your return on the capital used in your business is. This can then be compared with what the same amount of money (loans and shares) would have earned on deposit or in the stock market.

You could also use the net profit ratio to evaluate your profitability. Divide the net profit before tax by the total value of net sales (sales less returns) to see how good your net profit is. This can then be compared with the same ratio in other periods or with the ratio of competitors. Net profit ratio is one of the ratios used by analysts to determine whether a business is making progress.