

Financial Ratio Analysis

A GUIDE TO USEFUL RATIOS FOR UNDERSTANDING YOUR
SOCIAL ENTERPRISE'S FINANCIAL PERFORMANCE

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Introduction

A sustainable business and mission requires effective planning and financial management. Ratio analysis is a useful management tool that will improve your understanding of financial results and trends over time, and provide key indicators of organizational performance. Managers will use ratio analysis to pinpoint strengths and weaknesses from which strategies and initiatives can be formed. Funders may use ratio analysis to measure your results against other organizations or make judgments concerning management effectiveness and mission impact

For ratios to be useful and meaningful, they must be:

- Calculated using reliable, accurate financial information (does your financial information reflect your true cost picture?)
- Calculated consistently from period to period
- Used in comparison to internal benchmarks and goals
- Used in comparison to other companies in your industry
- Viewed both at a single point in time and as an indication of broad trends and issues over time
- Carefully interpreted in the proper context, considering there are many other important factors and indicators involved in assessing performance.

Ratios can be divided into four major categories:

- Profitability Sustainability
- Operational Efficiency
- Liquidity
- Leverage (Funding – Debt, Equity, Grants)

The ratios presented below represent some of the standard ratios used in business practice and are provided as guidelines. Not all these ratios will provide the information you need to support your particular decisions and strategies. You can also develop your own ratios and indicators based on what you consider important and meaningful to your organization and stakeholders.

The Ratios

Profitability Sustainability Ratios

How well is our business performing over a specific period, will your social enterprise have the financial resources to continue serving its constituents tomorrow as well as today?

Ratio	What does it tell you?
<p>Sales Growth =</p> $\frac{\text{Current Period} - \text{Previous Period Sales}}{\text{Previous Period Sales}}$	<p>Percentage increase (decrease) in sales between two time periods.</p> <p>If overall costs and inflation are increasing, then you should see a corresponding increase in sales. If not, then may need to adjust pricing policy to keep up with costs.</p>
<p>Reliance on Revenue Source =</p> $\frac{\text{Revenue Source}}{\text{Total Revenue}}$	<p>Measures the composition of an organization's revenue sources (examples are sales, contributions, grants).</p> <p>The nature and risk of each revenue source should be analyzed. Is it recurring, is your market share growing, is there a long term relationship or contract, is there a risk that certain grants or contracts will not be renewed, is there adequate diversity of revenue sources?</p> <p>Organizations can use this indicator to determine long and short-term trends in line with strategic funding goals (for example, move towards self-sufficiency and decreasing reliance on external funding).</p>

Profitability Sustainability Ratios continued

<p>Operating Self-Sufficiency =</p> $\frac{\text{Business Revenue}}{\text{Total Expenses}}$	<p>Measures the degree to which the organization's expenses are covered by its core business and is able to function independent of grant support.</p> <p>For the purpose of this calculation, business revenue should exclude any non-operating revenues or contributions. Total expenses should include all expenses (operating and non-operating) including social costs.</p> <p>A ratio of 1 means you do not depend on grant revenue or other funding.</p>
<p>Gross Profit Margin =</p> $\frac{\text{Gross Profit}}{\text{Total Sales}}$	<p>How much profit is earned on your products without considering indirect costs.</p> <p>Is your gross profit margin improving? Small changes in gross margin can significantly affect profitability. Is there enough gross profit to cover your indirect costs. Is there a positive gross margin on all products?</p>
<p>Net Profit Margin =</p> $\frac{\text{Net Profit}}{\text{Sales}}$	<p>How much money are you making per every \$ of sales. This ratio measures your ability to cover all operating costs including indirect costs</p>
<p>SGA to Sales =</p> $\frac{\text{Indirect Costs (sales, general, admin)}}{\text{Sales}}$	<p>Percentage of indirect costs to sales.</p> <p>Look for a steady or decreasing ratio which means you are controlling overhead</p>

Profitability Sustainability Ratios continued

<p>Return on Assets =</p> $\frac{\text{Net Profit}}{\text{Average Total Assets}}$	<p>Measures your ability to turn assets into profit. This is a very useful measure of comparison within an industry.</p> <p>A low ratio compared to industry may mean that your competitors have found a way to operate more efficiently. After tax interest expense can be added back to numerator since ROA measures profitability on all assets whether or not they are financed by equity or debt</p>
<p>Return on Equity =</p> $\frac{\text{Net Profit}}{\text{Average Shareholder Equity}}$	<p>Rate of return on investment by shareholders.</p> <p>This is one of the most important ratios to investors. Are you making enough profit to compensate for the risk of being in business?</p> <p>How does this return compare to less risky investments like bonds?</p>

Operational Efficiency Ratios

How efficiently are you utilizing your assets and managing your liabilities? These ratios are used to compare performance over multiple periods.

Ratio	What does it tell you
<p>Operating Expense Ratio =</p> $\frac{\text{Operating Expenses}}{\text{Total Revenue}}$	<p>Compares expenses to revenue.</p> <p>A decreasing ratio is considered desirable since it generally indicates increased efficiency.</p>
<p>Accounts Receivable Turnover =</p> $\frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$ <p>Days in Accounts Receivable =</p> $\frac{\text{Average Accounts Receivable}}{\text{Sales} \times 365}$	<p>Number of times trade receivables turnover during the year.</p> <p>The higher the turnover, the shorter the time between sales and collecting cash.</p> <p>What are your customer payment habits compared to your payment terms. You may need to step up your collection practices or tighten your credit policies.</p> <p>These ratios are only useful if majority of sales are credit (not cash) sales.</p>
<p>Inventory Turnover =</p> $\frac{\text{Cost of Sales}}{\text{Average Inventory}}$ <p>Days in Inventory =</p> $\frac{\text{Average Inventory}}{\text{Cost of Sales} \times 365}$	<p>The number of times you turn inventory over into sales during the year or how many days it takes to sell inventory.</p> <p>This is a good indication of production and purchasing efficiency. A high ratio indicates inventory is selling quickly and that little unused inventory is being stored (or could also mean inventory shortage). If the ratio is low, it suggests overstocking, obsolete inventory or selling issues.</p>

Operational Efficiency Ratios Continued

<p>Accounts Payable Turnover =</p> $\frac{\text{Cost of Sales}}{\text{Average Accounts Payable}}$ <p>Days in Accounts Payable =</p> $\frac{\text{Average Accounts Payable}}{\text{Cost of Sales} \times 365}$	<p>The number of times trade payables turn over during the year.</p> <p>The higher the turnover, the shorter the period between purchases and payment. A high turnover may indicate unfavourable supplier repayment terms. A low turnover may be a sign of cash flow problems.</p> <p>Compare your days in accounts payable to supplier terms of repayment.</p>
<p>Total Asset Turnover =</p> $\frac{\text{Revenue}}{\text{Average Total Assets}}$ <p>Fixed Asset Turnover =</p> $\frac{\text{Revenue}}{\text{Average Fixed Assets}}$	<p>How efficiently your business generates sales on each dollar of assets.</p> <p>An increasing ratio indicates you are using your assets more productively.</p>

Liquidity Ratios

Does your enterprise have enough cash on an ongoing basis to meet its operational obligations? This is an important indication of financial health.

Ratio	What does it tell you?
<p>Current Ratio =</p> $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ <p>(also known as Working Capital Ratio)</p>	<p>Measures your ability to meet short term obligations with short term assets., a useful indicator of cash flow in the near future.</p> <p>A social enterprise needs to ensure that it can pay its salaries, bills and expenses on time. Failure to pay loans on time may limit your future access to credit and therefore your ability to leverage operations and growth.</p> <p>A ratio less than 1 may indicate liquidity issues. A very high current ratio may mean there is excess cash that should possibly be invested elsewhere in the business or that there is too much inventory. Most believe that a ratio between 1.2 and 2.0 is sufficient.</p> <p>The one problem with the current ratio is that it does not take into account the timing of cash flows. For example, you may have to pay most of your short term obligations in the next week though inventory on hand will not be sold for another three weeks or account receivable collections are slow.</p>

Liquidity Ratios Continued

<p>Quick Ratio =</p> $\frac{\text{Cash} + \text{AR} + \text{Marketable Securities}}{\text{Current Liabilities}}$	<p>A more stringent liquidity test that indicates if a firm has enough short-term assets (without selling inventory) to cover its immediate liabilities.</p> <p>This is often referred to as the “acid test” because it only looks at the company’s most liquid assets only (excludes inventory) that can be quickly converted to cash).</p> <p>A ratio of 1:1 means that a social enterprise can pay its bills without having to sell inventory.</p>
<p>Working Capital =</p> $\text{Current Assets} - \text{Current Liabilities}$	<p>WC is a measure of cash flow and should always be a positive number. It measures the amount of capital invested in resources that are subject to quick turnover. Lenders often use this number to evaluate your ability to weather hard times. Many lenders will require that a certain level of WC be maintained.</p>
<p>Adequacy of Resources =</p> $\frac{\text{Cash} + \text{Marketable Securities} + \text{Accounts Receivable}}{\text{Monthly Expenses}}$	<p>Determines the number of months you could operate without further funds received (burn rate)</p>

Leverage Ratios

To what degree does an enterprise utilize borrowed money and what is its level of risk? Lenders often use this information to determine a business's ability to repay debt.

Ratio	What does it tell you?
<p>Debt to Equity =</p> $\frac{\text{Short Term Debt} + \text{Long Term Debt}}{\text{Total Equity (including grants)}}$	<p>Compares capital invested by owners/funders (including grants) and funds provided by lenders.</p> <p>Lenders have priority over equity investors on an enterprise's assets. Lenders want to see that there is some cushion to draw upon in case of financial difficulty. The more equity there is, the more likely a lender will be repaid. Most lenders impose limits on the debt/equity ratio, commonly 2:1 for small business loans.</p> <p>Too much debt can put your business at risk, but too little debt may limit your potential. Owners want to get some leverage on their investment to boost profits. This has to be balanced with the ability to service debt.</p>
<p>Interest Coverage =</p> $\frac{\text{EBITDA}}{\text{Interest Expense}}$	<p>Measures your ability to meet interest payment obligations with business income. Ratios close to 1 indicates company having difficulty generating enough cash flow to pay interest on its debt. Ideally, a ratio should be over 1.5</p>

Other Ratios

You may want to develop your own customized ratios to communicate results that are specific and important to your organization. Here are some examples.

Operating Self-Sufficiency =

Sales Revenue

Total Costs (Operating and Social Costs)

% Staffing Costs spent on Target Group =

Target Staff Costs

Total Staffing Costs

Social Costs per Employee =

Total Social Costs

Number of Target Employees

% Social Costs covered by Grants =

Grant Income

Total Social Costs