



KEY BUSINESS RATIOS

The payoff for mastering key business ratios is immediate, and yet too often they are often shrouded in complexity and feared by many managers. It doesn't have to be this way.

Business analysts and investors claim that key ratios give a reliable indication of the competence of a manager or value of a business, especially when comparing the figures of previous periods or those of the competitors. They continue to use complex terminology and create a level of complexity that is of great concern to entrepreneurs and business start-ups.

There are literally hundreds and thousands of books published on business and they can be very complex and difficult to navigate. In many cases the terminology used causes readers to "give-up" and yet the topic can be exciting and more easily explained.

It is widely accepted in business that "what gets measured gets managed" and as business ratios are the guiding stars in any business it is important to measure the ratios that you really need to know about, including:

- ✓ The cash flow cycle
- ✓ Financial leverage
- ✓ Operating performance
- ✓ Financial strength
- ✓ Corporate valuation
- ✓ Investment ratios
- ✓ Performance drivers
- ✓ Shareholders value added
- ✓ Acquisition analysis

These are the critical numbers that drive your business success. These measures are derived from relationships that exist between various financial parameters in your business and whilst each measure is simple to calculate, comprehension lies in understanding what these results mean and how the results of different measures fit together to give an overall picture of the health of the company.

Financial Statements

It is important that you only use data that makes sense, the big issues in business are:

- Assets
- Profits
- Growth
- Cash flow

Each of these four variables have interconnecting links. There is a balance that can be maintained between them and from this balance comes corporate value.

To have a clear understanding of how business performs, you need to understand the component parts and the good news is... there are only three documents you need to obtain the raw data for analysis. These are:

- The balance sheet
- The profit and loss account
- The cash flow statement

The Balance Sheet.

The balance sheet is simply a "snapshot" of the assets used by the company and of the funds that are related to those assets. It's a static document relating to one point in time. Therefore we take repeated "snapshots" at fixed intervals - monthly, quarterly, annually, to see how assets and funds change with the passage of time.

The profit and loss (p/l) account

The profit and loss account measures the gains and losses over a period of time (both normal and abnormal operations) It measures the total income and deducts the total costs. These incomes and costs are subject to strict accounting rules.

The p/l quantifies and explains the gains and losses of the company over a period of time bounded by two balance sheets (current year and previous year) It derives some values from both balance sheets therefore it is not independent of them.

It is not possible to alter a value in the profit and loss account without some corresponding adjustment to the balance sheet. In this way the profit and loss account and the balance sheet support one another.

The cash flow statement

The cash flow statement is a very powerful document. Cash flows into the company when cheques or electronic money transfers are received and flows out of the company when cheques, salaries and electronic payments are issued. Understanding the factors that cause these flows is fundamental. The cash flow statement depends on the two balance sheets and the profit and loss account. It links together the significant elements of all three and is now regarded in some quarters as the most important.