BCS SPECIAL REPORT

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Management by the Numbers:

Key Balance Sheet ratios

By George Scott

Your accountant just called to tell you that your current ratio is "looking good" ... and, that your inventory turns were "spot on". You said "Thanks" and hung up the phone feeling good that your accountant sounded happy – even though you weren't quite sure what the comments signified.

Your accountant was sharing with you some of your key financial statement ratios from your most recent accountant-prepared financial statements.

The complexity and size of your business determines which type of financial statement best fits your situation (See Special Report 201501).

For businesses that have survived being in business for at least five years, we recommend having reviewed financial statements, which consists of a Balance Sheet, a Profit and Loss Statement, a Cash Flow Statement, and accountant's notes.

NOTE: For the purposes of this and all other Financial Statements special reports, the analyses are from a privately held company perspective.

BALANCE SHEET

The three main components of a balance sheet are assets, liabilities, and shareholders' equity.

Assets

Regardless of industry, the usual listed assets are cash, accounts receivable, and inventory.

Manufacturing concerns are likely to include a current assets entry of "Work In Progress"– which represents products that are moving through the production process to completion.

Financial Soundness

The first set of analyses measures a firm's ability to pay its short term liabilities (a/k/a monthly bills).

Current Ratio

Often the first used indicator of financial soundness is the *current ratio* – reached by dividing current assets by current liabilities.

A ratio of 2/1 is generally accepted as the minimally accepted standard for a firm to be considered financially sound.

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

If the ratio is less than 2/1 and excessive accounts receivable amount exists, a change in the accounts receivable policy may be needed.

Quick Ratio

$$\frac{\text{Current assets – inventory}}{\text{Current liabilities}}$$

Also known as an acid-test ratio, inventory is not included in this calculation.

Since the focus is on easily liquidated assets, it is generally accepted that this ratio is a better indicator of a firm's ability to pay its bills.

Cash Ratio

The current assets components used in this calculation are limited to cash, cash equivalents, invested funds, and current liabilities.

$$\frac{\text{Cash, cash equivalents, + Invested funds}}{\text{Current liabilities}}$$

Inventory and accounts receivables are not included due to the lack of a speedy liquidation of them.

A wise business owner will use these ratios (in addition to others) to make the best possible management decisions.

Ratios that solely utilize the Income and Expense Statement, and ratios that collectively utilize the Balance Sheet and the Income and Expense Statement will be addressed in two subsequent Financial Statement *Special Reports*.

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