Key financial ratios: how to assess the true performance of your business

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Are you getting the right financial advice to run a prosperous business?

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There has been a recent spate of businesses turning over more than $10 million that have gone broke. This begs the question how can a business with a supposedly healthy turnover fail?

There are only three reasons why a business may find itself going into administration:

- They are getting poor financial advice;
- They are getting good advice but are not implementing it; or
- They are not seeking the advice in the first place

My experience is it is almost always the latter!

<u>It's not rocket science. Invariably, a business in administration has run out of cash flow!</u>

Business owners are often so busy building their business that they don't read the warning signs and get help early enough.

In many cases this is because they don't know what they don't know and they are looking at profit and turnover as the sole gauge of their success. However you can have a profitable business and still run out of cash.

Key indicators

Here are the financial ratios and measurements you need to watch to determine how your business is really performing.

Free cash flow
No matter how profitable your business, you can still have negative free cash flow. This means that even though you are making a profit, your business is growing at such a rate that the profit is not sufficient to fund the growth. You have to borrow more and more from the bank until there's a hiccup and the bank says no more!

To assess your free cash flow look at how much cash is 'available for use' in your business.

Asset turnover
Asset turnover looks at how many sales you can generate for the capital employed in the business. For instance if you have $10 million of capital employed in your business and that can generate $10 million in sales your ratio is 1. Depending on your industry, you should generally have above 3 unless you have very high profitability.

$$\frac{\text{Sales}}{\text{Capital employed in business}} = \text{Asset turnover}$$

Rate on capital employed
If your money wasn't invested in your business you could invest it elsewhere, for instance the stock market. This ratio measures how efficiently your company can generate profits from its capital employed. How does this compare against other investment opportunities?

$$\frac{\text{Sales}}{\text{Earnings before interest \& tax}} \times \frac{\text{Total net assets}}{\text{Sales}} = \text{ROCE}$$

Key indicators

Here are the financial ratios you need to watch to determine if you are running a prosperous business.

Sustainable growth rate
Your sustainable growth rate is how much the business can afford to grow without requiring disproportionate debt. Growth funded entirely on debt is dangerous debt. This is a more complicated calculation but your accounts team should be able to tell you this.

Return on equity x (1 - dividend payout ratio) = sustainable growth rate

Working capital absorption ratio
This is a simple ratio that you need to know in a high growth business. In other words, how much additional working capital is needed to fund a given increase in turnover.

$$\frac{\text{Working capital*}}{\text{Revenue}} = \text{working capital absorption rate}$$

* Working capital is the combination of your work in progress and Debtors balances less Creditors

Revenue and profit
It goes without saying that you need to keep a close eye on profit and venue.

$$\frac{\text{Profit before Interest and Tax}}{\text{Revenue}} = \text{Profitability \%}$$

If you don’t know the answer to any of these you are not getting the right financial advice to run a prosperous business.

Get the right financial advice

Speak to MGI today about how to improve financial insights in your business.

Book your free appointment