FINANCE NEW MEXICO

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Quick Ratios Help Businesses Take Their Financial Pulse

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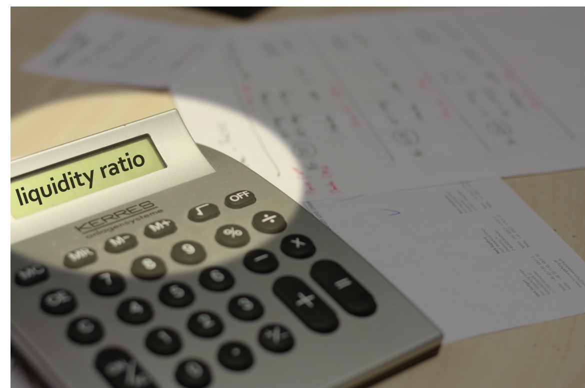
Operating a successful business requires attention to numbers — especially to basic financial ratios derived from the business's financial statements.



The current and quick ratios calculate a company's liquidity, while the debt ratio evaluates its long-term solvency. The gross profit margin shows if sales revenue covers the expenses incurred in making those sales.

Lenders and investors use business health assessments like these to determine if a company qualifies for a loan or is a good candidate for venture capital. Business owners should use them to regularly evaluate their business's financial standing.

Liquidity ratios divulge whether a company has enough liquid assets to meet its short-term obligations.

To get the current ratio, the owner divides available assets (such as cash, inventory and accounts receivables) by immediate liabilities (such as accounts payables or bills owed). Current assets are a balance sheet category representing cash and assets the business expects to convert into cash within a year. Current liabilities represent financial obligations that should be settled within a year.

The quick ratio is derived using the same formula but subtracting inventory from the current asset total. It acknowledges that many inventory items can't be quickly turned into cash.

A ratio of 1.5 to 1, for example, means the company has $1.50 in assets for every dollar in current liabilities. The higher the ratio, the easier it is for the company to meet its immediate financial commitments.

Creditors tend to see less risk in a company with a higher ratio, while shareholders see a lower ratio as evidence the company is putting more of its assets to work building wealth. If the ratio seems excessively high, though, the company might have too many assets in inventory or too many outstanding accounts receivable.

The debt ratio shows how much debt a company has relative to its assets, and this reveals whether the company might not be able to pay off its loans.

A business owner calculates the debt ratio by dividing total debt by total assets.

If the number is one, debt and assets are in balance. If the ratio is 1.2 to 1, though, the company has $1.20 in debt for every dollar in assets. Ideally, the debt ratio should be less than 1.

Investors and lenders scrutinize a business's debt ratio, and they also look at gross profit margin to measure a business's profitability. This number — also used by owners — shows whether sales revenue covers the cost of materials used in sales.

To calculate the gross profit margin, net income — total sales revenue minus the cost of goods sold — is divided by total sales revenue. The margin is expressed as a percentage that represents the total sales revenue a business keeps after paying sales-related costs.

The higher the percentage, the better, as a bigger profit margin leaves the company more money to cover other obligations or to invest.

These three ratios aren't the only ones used to evaluate a business's financial stability, but they do give business owners a basic understanding of where things stand.

Century Bank uses these tools and more when analyzing business financial records. To learn more about Century Bank, visit www.centurynetbank.com.

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