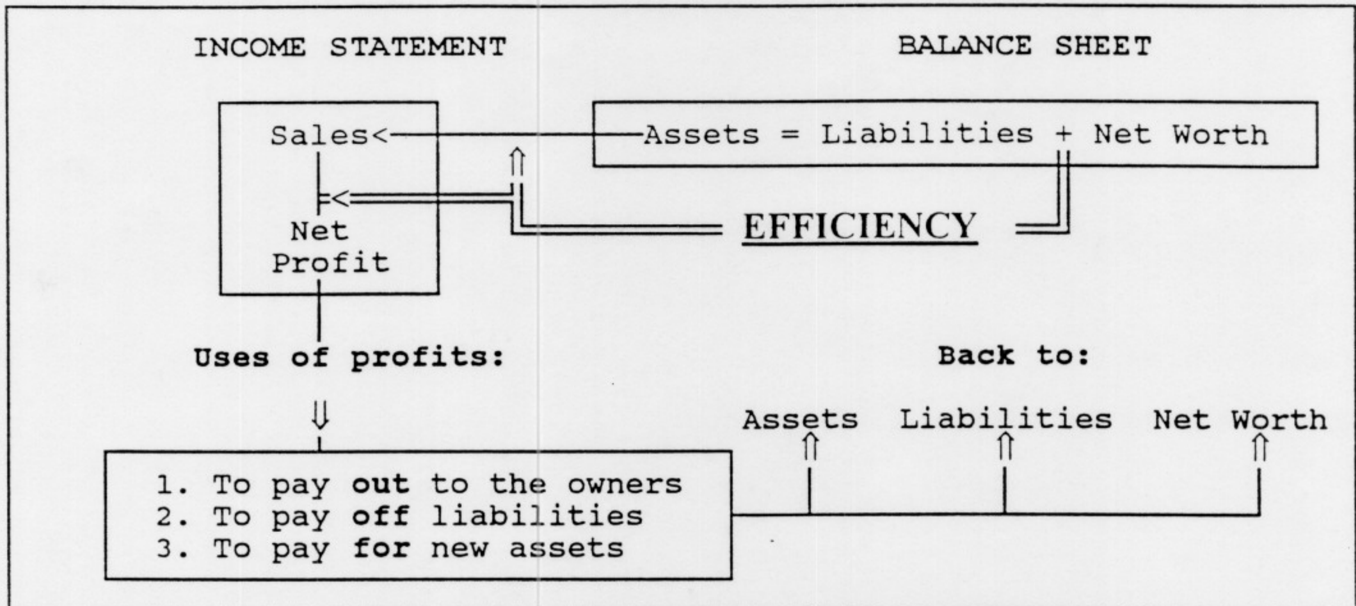
THE FINANCIAL OPERATING CYCLE



WHAT RATIOS MEAN AND HOW THEY ARE USED

Whenever talk turns to sports, fans usually go to statistics to argue about individual performance and "who was best." A baseball player's batting average or a quarterback's pass completion record are examples of ratios. They can help to measure performance in comparative terms; that is, they allow a comparison between two different values -- for example the number of hits in relation to the number of times at bat. Using ratios, players can be compared using a consistent standard.

Likewise, ratios allow you to focus on financial relationships in your business, rather than just on absolute numbers -- such as annual sales. Ratios let you compare your company's financial operating performance at different points of sales activity. Company and industry ratios can be used to accomplish three critical management tasks:

1. Comparing current company performance against past performance to determine trends and causes of internal strengths and weaknesses.

2. Comparing current and past company performance (trends) against industry performance to determine competitive strengths and weaknesses -- and their causes.

3. Using these two sets of comparisons to plan management actions to control the course of the company.

Key Influences On Balance Sheet Ratios

Most business owners are usually familiar with the profit and loss statement -- that's where the "bottom line" is. But the profit and loss statement only shows how well a business has performed during one season. As we mentioned earlier, the balance sheet show the cumulative results of a company's operations from the day it opened.

Like a ball player's lifetime batting average, the balance sheet shows strength (or weakness) over time. Anyone can have one good season, but it takes more -- more talent or more luck -- to keep repeating good performance year after year.

The majority of the assets of an "average" company is in accounts receivable and inventory -- and it makes sense to pay the most attention to the area where the heaviest investment is. The heavy investment in accounts receivable and inventory and relatively little cash puts management pressure on reprographic companies. Low cash can cause loss of discounts on payables, and may cause high borrowing. Both of these may cause profitability to decline.

Risk

As we noted earlier, the debt-to-net worth ratio measures the relationship of capital supplied by creditors to capital supplied by owner. To the extent that earnings are not sufficient to cover capital needs, then those needs will be met with increased debt. If more capital is supplied by creditors, the company becomes more leveraged. Increasing leverage, therefore, means increasing debt, and increasing debt means increasing risk. Leverage equates to financial risk because:

1. Debt (as reflected in the interest and principal that comes due on a regular basis) is a "fixed" cost -- it must be repaid, even if sales and/or profits slump.

2. Besides facing reduced total net profits in a down cycle, businesses frequently cut price to maintain market share -- thus cutting profit margins as well, and further reducing total profits.

3. When profits are reduced, the company may not have sufficient cash flow to be able to repay the debt-- and, obviously, the more debt a company has, the greater the problem will be. In the most severe situations, a company may be forced into bankruptcy.

4. In addition, most bank debt is tied to variable interest rates -- if rates rise in a period of decreased sales (as they did in the early 1980's), high leverage will pose additional threats to the company's existence.

As a whole, the reprographic companies responding to the survey appear to have a reasonably strong equity base. Such a base only implies that profits were generated at some time in the past -- not necessarily that they are currently being generated.

A strong balance sheet (with a high proportion of equity) implies that a company has "staying power." However, prolonged recession or mismanagement can erode even the strongest of companies. This threat is a continuing, long-term consideration. Often by the time management realized that profits are not sufficient to support continuing operations, it's too late. (For example, such a situation probably exists today in many parts of the agricultural sector.)

A Note of Caution . . .

Many managers have been trained to evaluate performance strictly in terms of Return on Investment. Care must be taken in evaluating R.O.I. (which is expressed as net profits divided by net worth.) A high R.O.I. figure can be produced by a combination of high profits or low net worth. But the latter case (low net worth) implies high liabilities, which, in turn, implies high risk.

Key Influences on Profit and Loss Statement Ratios

GROSS MARGIN

Pricing -- Common causes of over- or under-pricing are sales personnel making mistakes in calculating prices, and managers pricing without using (or knowing) actual costs as the basis for pricing.

Poor Buying -- Improper or inadequate management of the purchasing function generally results from inadequate negotiating skill, failure to check invoices or inordinate dependence upon a single supplier.

Lack of Discounts -- In situations where purchase discounts are offered, not taking them can result in significant increases in purchase costs. Usual reasons are inadequate cash flow and/or carelessness.

Shrinkage -- Caused by poor inventory control can dramatically affect gross margin. Obsolescence, internal pilfering (or outright employee theft), external theft, breakage and the like can all increase cost of goods sold (even though the goods weren't sold!) and decrease gross margin.

Low Productivity -- Special job requirements (or errors requiring that jobs be reworked) can increase labor costs in relation to the income the job brings in, thus decreasing gross margin.

> **Important**
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> One percent of gross margin may not seem like much -- one way or the other. But to evaluate the impact of a 1% change in margin, take 1% of your total sales. Is this number significant enough to want to put that amount in your pocket?

NET MARGIN

Between Gross Margin and Net Profit come Operating Expenses. Owners and managers need to focus on expense control plus several other vital areas affecting net profit margins.

Operating Expenses -- Expense control is fundamental management activity. While all expenses are important, particular attention should be devoted to payroll expense. As we noted earlier, interest expense can also become a major consideration for many businesses.

High Hidden Cost -- Hidden costs occur because the business is carrying too much inventory (or possibly too much in accounts receivable.) "Too much" is, of course, a relative amount, but here we mean in relation to the median company in the industry. (See the Inventory Turnover and Accounts Receivable Turnover Ratios.) Hidden cost include those caused by insurance paid on the excess inventory, borrowing (that is, interest that must be paid to support the excess), warehousing, and, in some states, inventory tax.

Low Sales -- Caused by a too-restrictive credit policy, insufficient inventory, marketing problems, or a regional recession will also decrease net profit -- because most of a shop's operating expenses are *fixed* (that is, they must be paid whether or not any sales are made.)

ASSET MANAGEMENT

Overall Efficiency/Profitability

The use of debt is a key determinant in the profit picture. Debt represents another approach to profitability -- as noted earlier, it's one way (but a potentially risky one) to achieve a high return on investment.

We want to examine the sources of a company's profitability: Since profit margin is a profit and loss statement ratio, a high profit margin indicates good cost and gross margin control, whereas a high asset turnover ratio demonstrates efficient use of the assets on the balance sheet.

Even though most asset turnover is usually secondary to profit margin in determining return on net worth, it should not be ignored. Quite the contrary, many companies have far too much money invested in assets, particularly in inventory and\or accounts receivable. This gives them ample room for improving asset turnover and producing a related improvement in return on the owners' investment.
A company should not look at the impact of any decisions on only one or two measures of performance. Instead, managers should look at the overall impact on return on net worth as well as the other ratios.

Specific Efficiency Ratios

The Working Capital Cycle represent the funds that are "tied up" in the cyclic process that runs from cash to inventory to accounts receivable back to cash.

The trick is to spin the working capital wheel as fast as possible -- in other words, make it work as efficiently as possible. Spinning the wheel faster can be accomplished in two ways:

1. While maintaining sales at their present level, reduce inventory and/or accounts receivable.

2. While increasing sales, maintain existing levels of inventory and/or accounts receivable.