

Steps to Effectively Using Financial Ratios

By Darrel Hulsey

Business owners are intently interested in how well their business is doing. The most likely way to determine the status of a business is by analyzing the financial data and that means crunching the numbers. How one “crunches” the numbers can lead to completely different conclusions about the performance of a company. The basics of financial analysis usually mean calculating different financial ratios and then coming to conclusions about the how the company is financially performing. Whether calculated manually or automatically by using financial analysis software, there are certain things that must be considered before too many conclusions are drawn.

1. **Understand what comprises financial ratios.** The first step in effectively analyzing a company’s financial data is to understand what comprises different financial ratios. All financial ratios use numbers derived from two financial statements, the balance sheet and the income (or profit and loss) statement. Balance sheets represent a reflection for a particular point in time. Income statements present a cumulative time summary of performance. For example, year-end financial statements should include a balance sheet that presents how various company accounts look on that particular day at the end of the year, whereas the income statement shows how a company has performed over the entire year.

2. **Evaluate influencing factors.** As with all companies, the financial statements can be influenced by various factors such as management/owner decisions and discretionary spending, seasonal effects, legal structure choice, type of industry, customer mix, or a number of other issues. These factors can influence the financial statements and will, in turn, influence the financial ratios.
3. **Look at internal trends.** The next point to always keep in mind is that one ratio alone tells one very little. A clear picture starts developing when one looks at ratios over different time increments. By comparing financial results against prior performance one gets a better idea of what is occurring within the company. Trends will start to develop and can give insight into areas that may need corrective attention or to areas that may need to be reinforced. Internal trend analysis is most likely most beneficial because one is comparing similar business situations over various periods of time.
4. **Compare results to the industry.** Comparing your business performance to other similar businesses is a common way to judge how well the business is doing. Even though this is very common, there are limitations to doing so. First realize these comparative ratios represent an average. Averages are simply that and most likely your business will vary somewhat. Next be sure you are comparing your business to other businesses similar in asset size and sales volume. In some cases there may be no suitable comparisons. Try to

insure you are comparing “apples to apples.” There are several sources to get comparative financial data including private companies such as Risk Management Association (RMA) and trade associations that collect data from



their members. Knowing what is the average for your industry is important. The averages can serve as a general benchmark for your business. Additionally, these averages are often times used to compare your business performance when you are seeking capital from outside sources such as a bank. Being different may not be a deal killer, but not being able to explain why you are different may indeed be a deal killer.

Knowing the financial ratios of your business is crucial. Knowing what these ratios mean and being aware of trends can aid the entrepreneur in better managing a business.

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