

How Healthy is Your Business?

Is your business ILL? How will you know?

Use the company's financial statements to find the following ratios as this will give you a better picture of how your Company is doing.

1) Current Ratio

The current ratio is an excellent diagnostic tool as it measures whether or not your business has enough resources to pay its bills over the next 12 months. The formula is:

$$\text{Current ratio} = \text{Current assets} / \text{Current liabilities}$$

Recall that Current assets are a category of assets on the [balance sheet](#) that represent **cash and assets** that are expected to be **converted into cash within one year**.

Current liabilities are a category of liabilities on the balance sheet that represent financial obligations that **are expected to be settled within one year**.

- For instance, suppose a business has \$8,472 in current assets and \$7200 in current liabilities
- Then the current ratio is $\$8,472/\$7200 = 1.18:1$.

So for this business, the current ratio gives a clean bill of health, as **for every dollar in current liabilities, there is \$1.18 in current assets**.

A current ratio of over 1 is good news, generally, although if you are comparing your current ratio from year to year and it seems abnormally high, you may have problems with collecting [accounts receivable](#) or be carrying too much inventory.

A drop in the ratio may indicate trouble, such as using a demand line of credit to finance new capital equipment or other long-term assets. Another reason for deterioration in the current ratio would be recent decreases in operating cash flow to pay your trade suppliers and other current debts as promptly as in the past.

2) Total Debt Ratio

The name of this ratio says it all; this ratio shows how much your business is in debt, making it an excellent way to check your business's long-term solvency. **The formula is:**

$$\text{Total debt ratio} = \text{Total debt} / \text{Total assets}$$

Once again, you can take these numbers from your [balance sheet](#) and plug them in. For instance, a business with \$22,375 in **total assets** and \$25,000 in **total debt** would have a total debt ratio of $\$25,000/\$22,375 = 1.11:1$.

This business, then, has \$1.11 dollars in debt for every dollar of assets. So for this business, the total debt ratio tells us that this business is not in good health and may become really ill; **for good health, the total debt ratio should be 1 or less**.

The lower the debt ratio, the less total debt the business has in comparison to its asset base. On the other hand, businesses with high total debt ratios are in danger of becoming insolvent and/or going bankrupt. (*You can see why lenders take such an interest in this ratio.*)

Needless to say, **the more debt that you take on, the higher this ratio will become.** Taking on too much debt means less flexibility in making business decisions or taking on new projects.

This is because your lenders will have become your business partners, and that's not the reason you went into business in the first place, is it?

3) Profit margin

How much net profit are your business's sales producing? Calculating the profit margin will give you the answer. The formula is:

$$\text{Profit margin} = \text{Net income/Sales}$$

For instance, if a business's sales are \$180,980 while its net income is \$42,325, its profit margin is $\$42,325/\$180,980 = 23.4\%$.

So for every dollar in sales, this business is generating a little more than 23 cents net profit. How healthy is this? Other than the obvious generality that the higher the profit margin the better off the business, the profit margin is an extremely useful measure of how your business is performing over time.

At a glance, you can see whether your business's net profit has increased, stayed the same, or decreased over last year. And if it's decreased, you'll know to take steps to cure the problem, such as better controlling your expenses.

Doctor's Prescription...

Imagine all three of the ratios in the examples above belonging to a single business, and you can see how just calculating these three ratios can provide a **quick health check for your business.** The business in the example isn't at death's door yet but it is ailing. While the profit margin and current assets ratio are robust the total debt ratio shows that the business is carrying too much debt, which will interfere with cash flow if it hasn't already.

How healthy is your business? Calculate these three ratios regularly to see how it's faring.