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Financial Analysis

Purpose

The purpose of Tool 1 is to help you to determine the market value of your present printing operations - whether you are doing well and can invest in the future, whether you are just surviving or whether your firm needs help.

In conjunction with the other Diagnostic Tools, Tool 1 will help you find ways of generating improved value from your operations. It will help you determine what your firm's capacity is to pay the bills and invest in sustainable longer term growth.

How to utilise this Tool

Financial analysis forms an integral part of the business strategy process. It covers issues ranging from short-term operational analysis of managing working capital, to longer-term finance and asset planning and management. An overview of useful financial ratios to help you in this process is provided in Attachment C.

People involved

Members of your management team and any members of your organisation involved in finance management.

Background Reading

PRINT21 Action Agenda Background Paper 1

Useful input

- The outputs generated by preceding analyses and any company reports that deal with financial issues like fixed/variable costs and income.
- Your accountant or financial adviser will be able to help you complete and get greater value from this tool.

Important Ideas

You need to know where your costs and income are generated within your firm. If you do not have this data talk to your accountant or seek the help of a professional business analyst.

This Diagnostic Tool introduces you to the idea that the key determinant of healthy financial performance is the vital factor called free cash flow.

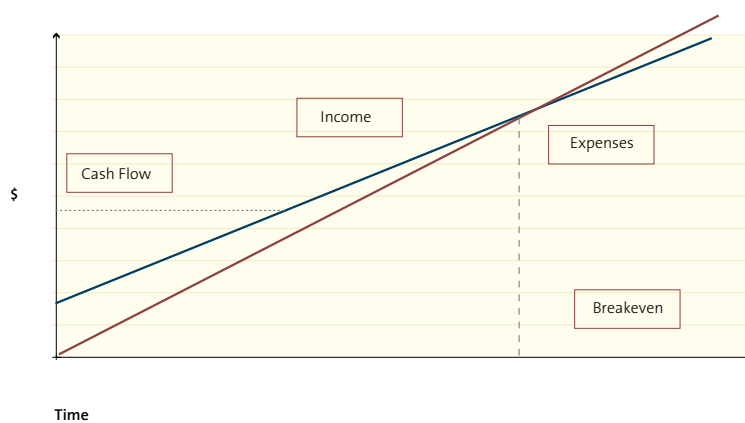
The key question for determining free cash flow is -

Does your firm generate or consume cash?

Consider the following situation - if you buy an asset today for \$100 000 and sell it in six months time for \$200 000 you would have made a profit of \$100 000 BUT what paid your bills in the intervening time period? It was - Cash flow!

So you need cash flow.

DIAGRAM 1.1



Consider Diagram 1.1. With any sort of investment it takes time for income to overtake expenses. During this early accumulation phase cash flow is needed to pay the bills. If the cash flow is insufficient to meet total current expenses, then the firm is likely to be bankrupt before income outpaces expenses. You therefore need to generate cash inflows that are greater than cash outflows.

Tool 1 helps you to review your firm's cash flow to determine whether it is positive, negative or could be improved.

If you want to know more about the concept of cash flow, see Attachment A.

Cash Flow Model for Investments

A number of firms use a very simple but effective method for determining when to purchase new equipment or to make an investment. The method is based on whether the purchase or investment pays for itself within a set period of time (usually three years), for equipment, six or more years. The income or sales from equipment is offset against the costs of running it (including lease or interest charges). In essence, the cash flowing from the purchase of a piece of equipment must pay for the equipment and give some years of uncommitted cash flow that can be viewed as profit, money to reinvest, or money to repay debt in other areas of the firm. This in turn increases the value of your firm to a prospective buyer.

DIAGRAM 1.2

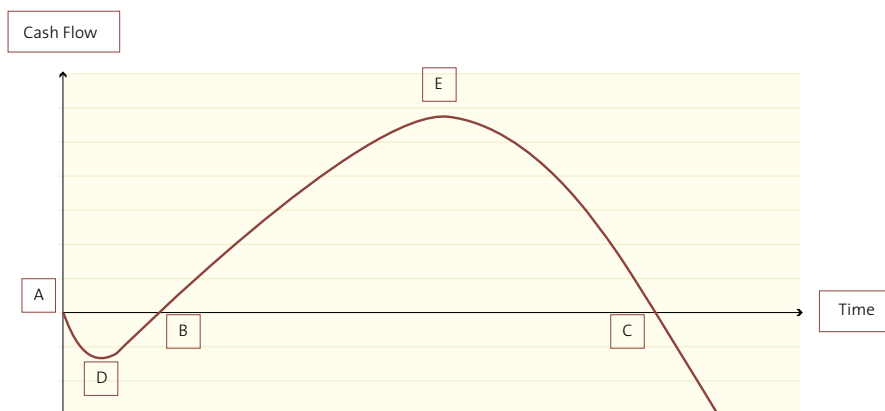


Diagram 1.2 is another way of looking at Diagram 1.1.

This is a classic situation. At point A, you make an investment and your cash flow goes negative (to D), before any income from that investment begins. As income increases, it should begin paying off the investment at B. Beyond B, your investment should keep generating positive cash flow, up to a maximum at point E, until such time as high running costs, repairs and competition from more recent technology, starts to affect your profit margins. At point C the investment is costing more than it is earning.

What you can not be sure (without researching your customers, your market, available technology, etc) are the values for the points B, C, D and E.

In an ideal world, at about point E you would initiate your next investment and hopefully progress beyond point B for the investment and not remain at point C and beyond for your first investment.

Knowledgeable prospective investors will be on the look out for asset planning of this nature.

Another way to value investments, is called Net Present Value (NPV) analysis. A description of this method is given at Attachment B. The NPV method is more sophisticated and is generally used by larger companies and investment houses. Nevertheless, the NPV method is worth knowing regardless of the size of your operations.

Valuing your business

With these basic ideas on valuation we can now consider the other important elements of the valuation process. These are

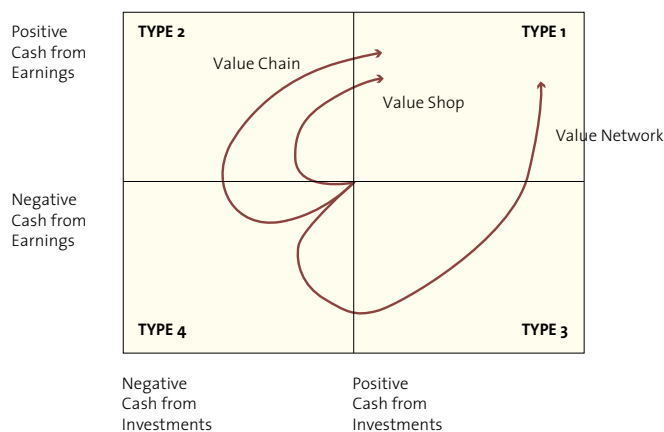
- the value creating path you consciously adopt as part of your business strategy.

From Tool 5, you will find that the expected commercial business behaviour of the firm is a function of the value-creating path you have chosen for your firm. The choices are:

- Value chain
- Value shop
- Value network

Diagram 1.3 below shows the three principal development value creating paths.

DIAGRAM 1.3



Your Company's Development Path - establishing the basis for commercial success

Lets start from the beginning. All companies commence commercial life as an idea. They have neither earnings nor investments.

Once implementation of the business idea has begun, companies undertake some investment and generate some revenue (positive or negative). If the company achieves success, it should generate more cash than it expends.

As Tool 5 explains:

- a typical traditional manufacturing company will tend to follow the value chain path
- a consulting or advising company will tend to follow the value shop path and an e-business market company will tend to follow the value network path
- traditional (ink-on-paper) printers will, in most cases, follow the value chain development. So let's focus on the company valuation issues associated with this path.

We will be looking out for two danger signals. The first is when -

Free cash flow goes from positive to negative over a longer period. This is an indication that the viability of the business is in question. This happens, for example, when large continuous investments are combined with decreasing earnings.

The second is when -

Market value falls below zero.

Market value of a firm is a function of free cash flow over time in both relative terms (relative to the industry) and absolute terms (risk and opportunity).

- Relative market valuation - expectations about the market performance associated with the various performance profiles adopted by firms - that is, how much profit you expect to make with your current business in the future.
- Absolute market valuation - risk/ return preferences operating for the industry. If the market is seen as tough your firm will be worth less to an investor than if it is a booming market.

Relative Market Valuation of your company = What will someone pay for your company = NPV

To work out the value of your company you need to step into the shoes of a potential investor. The investor of a company is primarily interested in return on investment. For example, a printing firm with \$2 million worth of equipment is not worth \$2 million; it is worth the free cash flow which that equipment can generate. Therefore, one way of working out the value of the firm, is by calculating the money that will be paid for the equipment and materials on the second hand market.

Another way to value a firm is to work out the value of its profits, not of the assets. Free cash flow and profits are the same over time. Future profits are not worth as much as the same profit today. So, the profits generated now are the most important thing on the buyer's mind. There are typically two ways the purchase decision is made.

- Using the payback period method. How long will it take to pay back my purchase costs? Typically, people want a payback in about three years. For the above firm, if there is a profit of \$100 000 per year, then a typical purchase price would be \$300 000.

- Using the Net Present Value (NPV) method. This converts expected future profits back to what they would be worth to you now. So \$100 000 in profits in five years is the same as \$40 000 in profits now if you use a discount rate of 20%. That is, you expect to gain 20% per year from your money, if you could invest it any way you wanted. That 20% includes an amount for the risk of the investment not working. A volatile market, which the printing industry is at the moment, will cause a higher discount rate to be used. For more detail on NPV see Attachment B.

Market Profiles

Potential investors are also likely to be interested in how you have positioned your business to compete in the market place. They will be interested in the market performance profiles you have adopted. Investors will be interested to know either how you have positioned your business to compete or how you expect it to compete relative to your competitors over the short and long-term? There are four market profiles to be considered. Which profile is the best fit for your firm?

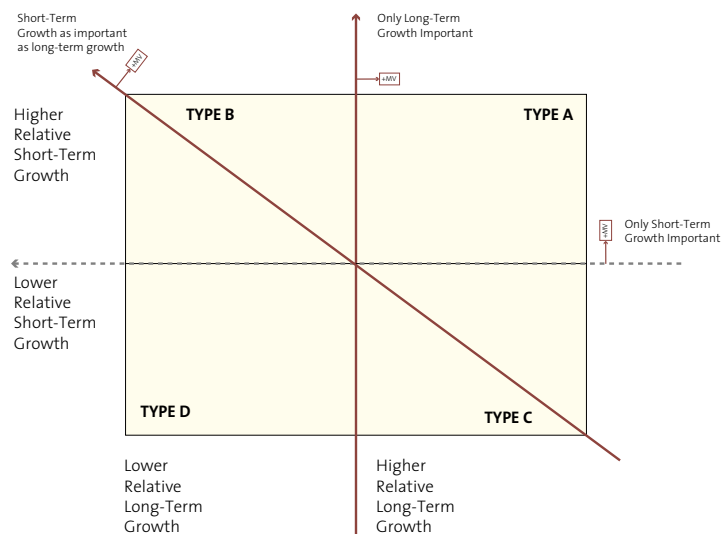
- **Type A:** Short-term and long-term growth both expected to be substantially higher than those of competitors.
 - These are companies that can sustain growth expectations at the same time as they deliver on them.
 - To maintain this position, they must craft and implement a superior strategy.
- **Type B:** Short-term growth is expected to be substantially higher and long-term growth is expected to be substantially lower than those of competitors.
 - These companies can deliver short-term improvements in results through growth or turn-around but these are seen as temporary events and not perceived to be sustainable.
 - To maintain this position, they must implement strategy successfully.
- **Type C:** Short-term growth is expected to be substantially lower and long-term growth is expected to be substantially higher than those of competitors.
 - These companies can sustain long-term growth expectations whilst delivering poor results in the short term.
 - To maintain this position, they must craft superior strategy.
- **Type D:** Short-term and long-term growth both expected to be substantially lower than those of competitors.
 - These are companies that must improve short-term business performance at the same time as they craft a new strategy that will generate long-term performance.
 - These are companies that presently do not have the ability to either craft or implement superior strategy (e.g. any company nearing bankruptcy).

Absolute Market Valuation

The market valuation of a firm is also a function of the importance the market places on its short-term versus long-term performance.

This weighting is partly industry-specific in that it is a function of the risk and opportunity profile for the industry. It is also in part a function of where the firm is in its development. Diagram 1.4 below illustrates the situation.

DIAGRAM 1.4



Commercial success hinges on having a market valuation above the average of the industry. Your firm must be on the +MV side of the diagonal line that is appropriate for the industry.

In the printing industry we can expect short-term performance expectations to make up 20-25% and long-term performance expectations to make up 70-75% of total performance expectations for a mature company.

Based on data presented in the PRINT21 Background Papers, a typical printing company profile would be as follows -

Average Turnover:	A\$2,000,000 increasing 5% per year
Profit Margin:	8% per year decreasing by 13% (not percentage units) per year.
Inflation	at 4% per year unchanged

This generates a free cash flow from earnings of A\$160,000 decreasing with 17% per year (more details are provided in the interactive version on CD).

Average asset base is: A\$3 200 000 with annual investments of approx A\$125 000 giving us a free cash flow from investments of negative A\$125 000.

As shown in Table 1.1, over a 20-year period, the market valuation of the firm then becomes negative.

TABLE 1.1

Free cash flow from Earnings	160,000
Free cash flow from Investments (-ve)	\$125,000
Net Free Cash Flow	\$35,000
Risk Rate	6%
NPV Short Term	5,208
NPV Long Term	-1,021,663
Weight NPV Short	0.25
Weight NPV Long	0.75
NPV	-764,945

Thus in the short term, over five years, a typical printer is worth only \$5,208! Yes, that's right only about the cost of a new computer!

Over twenty years, the market value of a typical print firm is a negative \$764,945. That means that if things keep on going as they are now, you will have to pay just to get the firm off your hands. Remember the value of a company is its future profits, not how much money is spent to keep it going.

Attachment A - Cash Flow, what is it?

Cash is consumed or generated from two different sources.

1. Cash earnings.

A company consumes or generates cash from its after-tax operating profit.

The starting term here is EBIT [Earnings before Interest and Tax]. To calculate cash earnings taxes are subtracted from the EBIT. Taxes are calculated as the amount the company would pay if it was entirely debt-financed and no interest was paid on the debt.

2. Cash investments.

A company can consume or generate cash by investing different amounts in its on- or off-balance sheet assets. This investment includes both changes in net working capital (such as accounts receivable, which serve as cash loans extended to finance customer purchase) and in fixed assets (such as investments in property, plant and equipment, and any investments in mergers and acquisitions).

Free cash flow is what remains of those cash flows that remain in a business after meeting all expenditure and investment outlays.

The sum of these two items (Equation 1) gives free cash flow for the period.

Equation 1

$$\text{Free Cash Flow} = \text{Cash from Earnings} + \text{Cash from Investment} = \text{Sales (Revenue) x Operating Margin (Margin) - Tax} + \text{Cash from (Changes in Working Capital + Capital Expenditure + Acquisitions or Divestitures)}$$

Equation 1 gives rise to four types of company profiles:

Type 1: Positive Cash from Earnings and Positive Cash from Investments

This type of company is profitable and in addition it reduces its working capital. In order to be sustainable the firm needs be paid by its customers before it has to pay its suppliers, and it needs to have continuous sales growth.

An example of this type of company would be a printing firm that has been in business for many years and operates with well established plant and equipment. The company has driven down its costs over time and has managed to retain healthy profit margins.

Type 2: Positive Cash from Earnings and Negative Cash from Investments

This type of company is profitable and supports its business with continuous investments. In order to be sustainable such a firm needs to have higher positive cash from earnings than negative cash from investments.

An example is a print company that has maintained healthy profits from operations but is continually investing in new technology.

Type 3: Negative Cash from Earnings and Positive Cash from Investments

This type of company is making a loss whilst having positive cash flow from investments. This can either be a turnaround company that frees up cash from its balance sheet or a company that generates cash from working capital as sales increase. In order to be sustainable, growth is a requirement and the firm needs to have higher positive cash from investment than negative cash from earnings.

An example is a print company that uses old equipment and operates from its own buildings. But the company has forced its prices down while not controlling costs.

Type 4: Negative Cash from Earnings and Negative Cash from Investments

This type of company is making a loss whilst investing in the business. This can either be a start-up company or a company heading for bankruptcy.

An example is a print company that has managed to secure growing volumes of business, but at greatly reduced margins whilst investing heavily in equipment.

Where does your company fit?

Using Equation 1, which of the above profiles best describes your company? A financially healthy company will be in a position to finance all expenditures because it will have a positive free cash flow.

A financially healthy company will be in a position to finance all expenditures because it will have a positive free cash flow.

Equation 2 describes the situation that will prevail for this firm.

Equation 2

Sales (Revenue) x Operating Margin (Margin) – Tax must be greater than
Changes in working capital + Capital Expenditures + Acquisition costs
OR -
There is an opportunity to achieve a positive free cash flow.

The financial viability of the firm is dependent on creating future positive free cash flow. To create a positive free cash flow the firm needs to make profits soon.

Attachment B- Net Present Value (See electronic tools for use)

Net Present Value (NPV) is equal to the difference between the present values of the net cash flows generated by a project and the initial cash outlay.

$$\text{NPV} = \text{sum of present value of net cash flows minus initial cash outlay}$$

Present value is the value of tomorrow's money today.

A basic principle of finance is the time value of money - that is a dollar today is worth more than a dollar tomorrow because the dollar today can be invested to start earning interest immediately.

Note that the sum of "cash earnings" and "cash investments" (Equation 1) provides free cash flow for the period.

The present value of a future payment may be found by multiplying the future payment by a discount factor, which is less than 1.

This discount factor (for discrete returns rather than compounding returns) is expressed as the reciprocal of 1 plus a rate of return:

$$\text{Discount Factor} = \frac{1}{(1+r)^t}$$

The rate of return "r" is the reward that investors demand for accepting delayed payment, "t" is the number of years.

The rate of return is often referred to as the discount rate, hurdle rate or opportunity cost of capital. It is called the opportunity cost because it is the return forgone by investing in the project rather than investing in securities.

Table 1.2 illustrates the present value of cash flows from different future times.

TABLE 1.2

AMOUNT	TIME FROM NOW	RATE OF RETURN (PA)	FORMULA	PRESENT VALUE
A\$110	1 year	10%	$\frac{1}{A\$110 * (1+0.1)^1}$	A\$100
A\$121	2 years	10%	$\frac{1}{A\$121 * (1+0.1)^2}$	A\$100
A\$100	1.5 years	10%	$\frac{1}{A\$100 * (1+0.1)^{1.5}}$	A\$86.68

² NPV analysis assumes all cash flows are made at the end of a period and discounted back to the beginning of the period.

The opportunity to generate future positive net free cash flow is dependent on whether the expected commercial behaviour of the firm will lead to short or long-term commercial success.

Determining future interest rates to use as a guide for the discount rate is difficult but the following table gives a guide. You need to add a premium to this interest rate based upon the size and riskiness of your firm.

TABLE 1.3

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Forecasted 90 Day Bank Bill Rate (%)*	6.33	6.92	7.05	6.67	5.69	4.86	4.81	5.20
Forecasted rate from 10 year Treasury Bond rate of July of the year (%)*	6.48	6.28	6.05	5.81	5.68	5.75	5.96	6.20
Your interest rate to use (note that you need to add a premium to the forecasted rates)								
Your Cash flow								
Deflator factor								
Cash flow x deflator								

* Source: The Growth Grid 2000, No 1 from EconTech

By using your interest rate in the discount factor formula you can develop a "deflator" factor. Alternatively from table 1.4 (following) you can determine a "Deflator" factor by using your interest rate and the number of years that you wish to discount the cash flow back. If you then multiply your cashflow by the deflator and sum those numbers you have a present value for your cash flow. To test the sensitivity of your cash flow to interest rate changes, different deflators can be used.

The net present value of a project is the sum of the cash flows times the deflator, less the cost of the initial investment. If the number is less than zero then it would be better financially not to proceed with the project.

³ If you want a more precise formula for r (sometimes known as the weighted average cost of capital) it would look like this.

$$r = r_D \times (1 - T_c) \times D/V + r_E \times E/V$$

- Where r_D = the firm's current borrowing rate
 T_c = the marginal corporate income tax rate
 r_E = the expected rate of return of the firm's stock (which depends on the firm's business risk and its debt ratio)
 D = the market value of current outstanding debt
 E = the market value of current outstanding equity
 V = $D + E$ = the total market value of the firm

Table 1.4

Years	Interest Rate																				
	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5	5.0	5.5	6.0	6.5	7.0	7.5	8.0	8.5	9.0	9.5	10.0	10.5
1	0.9950	0.9901	0.9852	0.9804	0.9756	0.9709	0.9662	0.9615	0.9569	0.9524	0.9479	0.9434	0.9390	0.9346	0.9302	0.9259	0.9217	0.9174	0.9132	0.9091	0.9050
2	0.9901	0.9803	0.9707	0.9612	0.9518	0.9426	0.9335	0.9246	0.9157	0.9070	0.8985	0.8900	0.8817	0.8734	0.8653	0.8573	0.8495	0.8417	0.8340	0.8264	0.8190
3	0.9851	0.9706	0.9563	0.9423	0.9286	0.9151	0.9019	0.8890	0.8763	0.8638	0.8516	0.8396	0.8278	0.8163	0.8050	0.7938	0.7829	0.7722	0.7617	0.7513	0.7412
4	0.9802	0.9610	0.9422	0.9238	0.9060	0.8885	0.8714	0.8548	0.8386	0.8227	0.8072	0.7921	0.7773	0.7629	0.7488	0.7350	0.7216	0.7084	0.6956	0.6830	0.6707
5	0.9754	0.9515	0.9283	0.9057	0.8839	0.8626	0.8420	0.8219	0.8025	0.7835	0.7651	0.7473	0.7299	0.7130	0.6966	0.6806	0.6650	0.6499	0.6352	0.6209	0.6070
6	0.9705	0.9420	0.9145	0.8880	0.8623	0.8375	0.8135	0.7903	0.7679	0.7462	0.7252	0.7050	0.6853	0.6663	0.6480	0.6302	0.6129	0.5963	0.5801	0.5645	0.5493
7	0.9657	0.9327	0.9010	0.8706	0.8413	0.8131	0.7860	0.7599	0.7348	0.7107	0.6874	0.6651	0.6435	0.6227	0.6028	0.5835	0.5649	0.5470	0.5298	0.5132	0.4971
8	0.9609	0.9235	0.8877	0.8535	0.8207	0.7894	0.7594	0.7307	0.7032	0.6768	0.6516	0.6274	0.6042	0.5820	0.5607	0.5403	0.5207	0.5019	0.4838	0.4665	0.4499
9	0.9561	0.9143	0.8746	0.8368	0.8007	0.7664	0.7337	0.7026	0.6729	0.6446	0.6176	0.5919	0.5674	0.5439	0.5216	0.5002	0.4799	0.4604	0.4418	0.4241	0.4071
10	0.9513	0.9053	0.8617	0.8203	0.7812	0.7441	0.7089	0.6756	0.6439	0.6139	0.5854	0.5584	0.5327	0.5083	0.4852	0.4632	0.4423	0.4224	0.4035	0.3855	0.3684

Years	Interest Rate																				
	11.0	11.5	12.0	12.5	13.0	13.5	14.0	14.5	15.0	15.5	16.0	16.5	17.0	17.5	18.0	18.5	19.0	19.5	20.0	20.5	21.0
1	0.9009	0.8969	0.8929	0.8889	0.8850	0.8811	0.8772	0.8734	0.8696	0.8658	0.8621	0.8584	0.8547	0.8511	0.8475	0.8439	0.8403	0.8368	0.8333	0.8299	0.8264
2	0.8116	0.8044	0.7972	0.7901	0.7831	0.7763	0.7695	0.7628	0.7561	0.7496	0.7432	0.7368	0.7305	0.7243	0.7182	0.7121	0.7062	0.7003	0.6944	0.6887	0.6830
3	0.7312	0.7214	0.7118	0.7023	0.6931	0.6839	0.6750	0.6662	0.6575	0.6490	0.6407	0.6324	0.6244	0.6164	0.6086	0.6010	0.5934	0.5860	0.5787	0.5715	0.5645
4	0.6587	0.6470	0.6355	0.6243	0.6133	0.6026	0.5921	0.5818	0.5718	0.5619	0.5523	0.5429	0.5337	0.5246	0.5158	0.5071	0.4987	0.4904	0.4823	0.4743	0.4665
5	0.5935	0.5803	0.5674	0.5549	0.5428	0.5309	0.5194	0.5081	0.4972	0.4865	0.4761	0.4660	0.4561	0.4465	0.4371	0.4280	0.4190	0.4104	0.4019	0.3936	0.3855
6	0.5346	0.5204	0.5066	0.4933	0.4803	0.4678	0.4556	0.4438	0.4323	0.4212	0.4104	0.4000	0.3898	0.3800	0.3704	0.3612	0.3521	0.3434	0.3349	0.3266	0.3186
7	0.4817	0.4667	0.4523	0.4385	0.4251	0.4121	0.3996	0.3876	0.3759	0.3647	0.3538	0.3433	0.3332	0.3234	0.3139	0.3048	0.2959	0.2874	0.2791	0.2711	0.2633
8	0.4339	0.4186	0.4039	0.3897	0.3762	0.3631	0.3506	0.3385	0.3269	0.3158	0.3050	0.2947	0.2848	0.2752	0.2660	0.2572	0.2487	0.2405	0.2326	0.2250	0.2176
9	0.3909	0.3754	0.3606	0.3464	0.3329	0.3199	0.3075	0.2956	0.2843	0.2734	0.2630	0.2530	0.2434	0.2342	0.2255	0.2170	0.2090	0.2012	0.1938	0.1867	0.1799
10	0.3522	0.3367	0.3220	0.3079	0.2946	0.2819	0.2697	0.2582	0.2472	0.2367	0.2267	0.2171	0.2080	0.1994	0.1911	0.1832	0.1756	0.1684	0.1615	0.1549	0.1486

Attachment C - Calculating Useful Financial Ratios

Ratios

PRINT21 Background Paper 1 Industry Analysis provides key statistics describing the financial performance of the Australian printing industry and provides useful background on the use of financial ratios.

The main conclusions that can be drawn from the background paper on the performance of the industry are that there are steady declines in key economic performance indicators, namely:

- Short term liquidity
- Debt to equity ratio
- Interest cover
- Industry value added
- Profitability
- Return on assets.

All in all, these are characteristics of an industry that is operating in a maturing or declining phase. In such a phase it is important to focus on the most important things from a financial perspective, which is generation of positive net cash flow and accumulation of cash whilst reducing debt. When a business moves from growth to maturity the return on assets (ROA) can be expected to decline by 10%; this will be reduced further when entering a declining phase.

The definitions for these ratios are generally taken from ABS 8140.0, 8225.0, *Analysing Company Accounts* by Martin Roth, Wrightbooks, 1995, and *Financial Accounting* by Carnegie, Jones, Norris, Wigg, and Williams, McGraw-Hill, 1999.

Financial ratios are indicators only. They do not present a complete picture of the business or industry. Other important factors may be determined by performance and not captured by financial ratios.

Comparison between companies can be difficult due to the adoption of different valuation methods. Ratios are interconnected and should not be treated in isolation.

By developing these ratios for each of the last few years you will have a better idea of where your firm is heading rather than where you think it is heading. At times it may be difficult to determine whether, in comparing ratios, the differences are due to the numerator or the denominator or both.

Firstly, ask how profitable (or operationally efficient) you are? This is not an absolute determinant but a guiding determinant. It is guided by the characteristics of your industry. Although a high profitability is desirable many firms do well with very low margins.

The Profit Margin ratio is an indicator of corporate efficiency. More explicitly, it reflects the return on sales from the operations of the organisation.

The ratio is given by: Profit Margin (%) = $\text{EBIT} / \text{Sales} \times 100$ EBIT = Earnings Before Interest and Tax

Return on Assets

This ratio is also known as return on investment. It measures the ability to generate profits from assets and is defined as operating profit before tax as a percentage of the total book value of assets. (ABS 8225.0)

The ratio is given by Return on assets (%) = $(\text{EBIT} / \text{Assets}) \times 100$

Financial Stability

Financial Stability ratios focus on assessing the amount of risk for an entity. They fall into two categories:

Measures of short-term liquidity:

Current Ratio

Measures of financial structure and long-term solvency:

Debt to Equity Ratio

Interest Cover

Current Ratio

Source: Analysing Company Accounts by Martin Roth, Wrightbooks, 1995 and ABS 8225.0.

Can the industry pay its bills? – It is useful to keep liquidity as low as possible while ensuring that short term obligations are met. The current ratio is the number of times current assets cover current liabilities, ie. the value of current assets divided by the value of current liabilities. This liquidity measure indicates ability to meet immediate financial obligations from current assets.

The convention usually adopted is that there should be a two-to-one difference between current assets and current liabilities.

The current ratio is given by: Current ratio = $\text{Current assets} / \text{Current liabilities}$

"A strong cash flow, with a high stock turnover rate and speedy collection of debts, may mean that a company can operate safely with a current ratio nearer to one or lower. a company's working capital - surplus of current assets over current liabilities- should be sufficient to pay bills and give credit as necessary."

It may be useful to consider the proportion of cash represented in current assets – the cash to liabilities ratio.

An enterprise should not be over-burdened with debt. Profits will not mean much if it is. But debt is also a path for growth, especially if interest rates are low and the economy is growing.

If industry is competing in a stable predictable environment then liquidity can be low.

Debt to equity ratio

This measures debt exposure. In general, the higher the ratio, the more likely it is that there may be difficulty paying debts, especially if interest rates rise.

There is no "safe" figure although the practice seems to be that if the ratio does not exceed 100%, there should be no difficulty.

Too much equity can mean that management is not taking advantage of the leverage associated with long term debt.

Outside financing will become more expensive as the debt to equity ratio increases. Therefore the degree of leverage has to be considered in the light of profitability and industry volatility.

The ratio is given by Debt to Equity ratio = Total Debt/ Equity*

* Shareholder's or Owner's Equity depending upon whether the company is public or private

Interest Cover

The ratio reflects the relationship between interest payments and profits to show if there is a good margin of profit to ensure against downturn or sharp interest rate rises. Interest cover is the number of times that a business can meet its interest expenses from its earnings before interest and tax.

The ratio is given by Interest Cover = EBIT/ Net interest payments

The rule of thumb is that enterprises should be able to cover interest payments at least three times.

Now that you have developed these ratios for the last few years, do you think that your current business strategies need to be modified?