

Using ratios to uncover the true financial position of the customer

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When assessing a customer's creditworthiness, things are not always as they seem. A business may have strong cash flow but still carry crippling debt, or it may have a poor payment history yet still maintain substantial reserves. Without closely evaluating financial statements, credit professionals risk making uninformed and potentially costly decisions. However, while financials may not tell the full story, the person reading them can reveal much more.

Why it matters: Ratios are an important part of financial statement analysis, helping credit professionals uncover a customer's true economic standing. The more familiar they become with them and what they signify, the more accurate their analysis becomes, allowing them to identify risk more efficiently.

Credit professionals use ratios to standardize, analyze and compare monetary data, expressed as mathematical relationships in the form of percentages or multiples. Although there isn't a definite set of key financial ratios and no single uniform definition for all ratios, there are over 30 calculations available for credit professionals to use. These are classified into five categories: liquidity ratios, activity ratios, leverage ratios, profitability ratios and market ratios.

The calculations used will vary by customer as each industry has different standards based on its specific needs, expectations and the time required to turn cash. "These seemingly simple numbers hold incredible power in revealing the financial health, efficiency and trajectory of the company you are reviewing," said George Schnupp, [CCE](#), instructor for NACM's Financial Statement Analysis 2: Credit and Risk Assessment course, which will be offered at this year's Credit Congress in St. Louis.

Liquidity ratios

Liquidity ratios measure a company's ability to meet cash needs as they arise. In other words, they indicate whether the customer has sufficient funds to fulfill their short-term obligations. "Since trade credit is typically expected to be paid in less than a year—often within 30 days—I focus heavily on assets that can be converted to cash quickly," said Kevin Stinner, [CCE](#), [CCRA](#), credit manager at J.R. Simplot Company (Boise, ID). Current ratios, for example, measure short-term liquidity, dividing current assets by liabilities. "If a customer's balance sheet shows \$2 million in equity against \$100 million in liabilities, that equity doesn't really mean much. I also use the quick or acid-test ratio, which is like the current ratio, except it eliminates inventory, which is usually the least liquid current asset."

Activity ratios

Activity ratios evaluate the liquidity of specific assets and the efficiency of

managing such assets. The accounts receivable turnover ratio indicates how many times receivables are collected during a year on average by dividing net sales by net accounts receivable. The inventory turnover ratio measures a company's efficiency in managing and selling inventory. This is done by dividing the cost of goods sold by inventories of a company. "In a commodity-based business, we want to make sure inventory isn't being held too long, as price fluctuations driven by global economic factors can quickly create risk," said Brendon Misik, [CCE](#), [CICP](#), senior manager, Ag credit at Nutrien (Hoffman Estates, IL).

Leverage ratios

Leverage ratios capture the extent of a company's financing with debt relative to equity and its ability to cover interest and other fixed charges. The debt-to-equity ratio involves that total liabilities be divided by the stockholders' equity to reveal debt relative to the equity base. "A company's equity position tells me that if they can't repay my debt, what is the likelihood that I'll still get paid if something were to happen," said Stinner.

Profitability ratios

Profitability ratios reflect the overall performance of a corporation and its efficiency in managing assets, liabilities and equity. Common profitability ratios include gross profit margin, which calculates the profit generated after consideration of the cost of products sold, and operating profit margin, which estimates profit generated after consideration of operating expenses. Another commonly used one is net profit margin, measuring profit generated after consideration of all expenses and revenues.

Market ratios

Market ratios measure returns to stockholders and the value the marketplace puts on a company's stock. For instance, the earnings per common share ratio reveals the return to common stock shareholders for each share owned. Price-to-earnings ratio expresses a multiple that the stock market places on a business's earnings.

The bottom line: Financial ratios are helpful in detecting areas of strength and weakness in a customer's business. Though valuable, they have their limitations and aren't able to predict future outcomes. With caution and good judgment, they can serve as strategic, analytical tools for credit professionals.