Know the Basics of Key Ratio Analysis

Key ratio analysis in credit centers are using statistics and metrics to drive decisions on whether or not to grant terms to customers. It helps creditors summarize why these customers do or don't deserve the terms and whether their numbers provide enough need-to-know information about their financial health. It short, when done properly, key ratio analysis lets creditors know "can customers play their bills," says NACM speaker David Osburn, CCRA, of Osburn & Associates LLC.

Analyzing key ratios is an important tool but does not eliminate other fundamental duties of credit professions. As many credit managers and collectors have discovered over the years, just because someone *can* pay doesn't mean he or she *will* pay.

During the 120th Credit Congress & Expo in Las Vegas, Osburn laid out the following five key, basic key ratios:

Cash Flow. This is the most important of the five. Simplified, it is cash-in versus cash-out and. The "lifeblood" of the business, it holds so much critical information because, according to Osburn, the adage that "cash is king" is false—he estimates a more accurate statement would be: "cash *flow* is king." **Some Ratios to Remember for Calculating This Factor:** Traditional Cash Flow = EBITDA (earnings before interest, taxes, depreciation and amortization) – debt service x debt coverage ratio (DCR)—most lenders require DCR of at least 120%; EBITDA = net profit + interest expense + taxes + depreciation + amortization.

Liquidity. Liquidity is the closest business element to cash itself and, in many circles, is considered the second most important factor when looking at short-term creditworthiness. It essentially reflects a company's ability to service its short-term obligations. **Ratio to Remember:** working capital = current assets - current liabilities; current ratio = current assets/current liabilities; quick test/acid test ratio = current assets - inventory/current

Activity. These are the turn factors or swing factors of a business, the cash-conversion cycle at work. **Ratios to Remember:** Accounts Receivable Turnover = A/R / sales x days in period; Accounts Payable Turnover = A/P / COGS x days in period; Inventory Turnover = inventory / COGS x days in period

Leverage. This is the company's ability to service its long-term obligations (anything exceeding 12 months). **Ratio to Remember:** Debt ratio = debt/net worth (equity)

Operating performance. This is the profitability of the business or lack thereof**.** In long-term, this is the second most important factor because the business in question will die if it cannot demonstrate ongoing profitability. **Ratio to Remember:** Net profit = net sales - cost of goods sold – general and administrative expense.