Financial ratios made easy

Mark Oborn skips over the scary aspects of financial ratios and cuts to the chase as to how you can apply them easily to benefit your business

Is that a yawn I hear? Well, this is a short article, mainly because I know how boring finance can often be! But this is an important area of our business and should not be overlooked. I may be teaching my granny to suck eggs here, but until I studied basic finance I had never come across these ratios; no-one ever bothered to show me. So if you are a finance whiz-kid, please excuse this article, but if you are like I was and a bit hazy about ratios, read on.

Debtor and creditor days

This has probably been one of the best ratios I have learnt to manipulate in my business, yielding the best results once I got them sorted. These ratios simply say how long you are taking to pay your suppliers (creditors) and how long you are taking to be paid by your customers (debtors). If your creditor days are longer than your debtor days, you will have a cash surplus; if it is the other way around, you will need to borrow money from somewhere for the difference in the days. I think that is a crucial ratio to understand.

Simple calculations

Look at your last set of accounts, go to the balance sheet and take the amount owed to the creditors, probably in the 'liabilities' section. Now look at your profit and loss account and divide those creditors by the purchases for the year and multiply by 100. This now gives a percentage of creditors you owed at the time of the balance sheet. Assuming your accounts are made up for the year, multiply this percentage by 365 days; this will now tell you how many days credit you have taken with your creditors.

Example
Total creditors owed on balance sheet: £10,000
Total purchases for the year from profit and loss: £100,000
10,000/100,000 x 100 = 10%
10% of 365 days = 36.5 days credit taken
To work out your debtor days, look at your balance sheet, divide your total debtors (probably in the net current assets) by the sales figure for the year in your profit and loss account. Multiply this by 100 to give a percentage, then multiply the percentage by the total number of days the accounts represent – probably 365.

Example
Total debtors from balance sheet: £60,000
Total sales for the period from profit and loss: £800,000
60,000/800,000x100 = 7.5%
7.5% of 365 days = 27.3 days credit given
In this example we are giving 27 days credit and taking 36.5 days credit; this means we have the use of the money for nine days. But imagine if this was the other way round. If you take less credit than you give, you may need to borrow money, either in the form of an ovedraft or in the form of having less money in your account, which could be invested elsewhere and earning interest.

When Amazon launched its online bookstore, it used this to a fantastic advantage. Amazon took the order and the money from the customer online, then ordered the book from its supplier and agreed extended credit terms. Amazon had the money from the customer for over a month before it needed to pay the supplier. This money was used to fund Amazon's rapid growth. A whole business model was based on the fundamental principle of manipulating creditor and debtor days.

In practice

I am not suggesting we don't pay our suppliers at all, please don't get me wrong. What I am suggesting is that you could agree credit terms with your suppliers while adjusting your own policies, and possibly incorporate incentives, to affect your debtor days to your advantage.

When these ratios first came to my attention, I realised I was having to borrow money for nearly 20 days a month... ouch! Now I have reversed this by offering early payment incentives to customers and agreeing slightly extended terms with selected suppliers. The difference now is almost zero, but occasionally swings in my favour – a great result.

Look out for more fun ratios in future articles.

Mark Oborn is a director of SBO Dental Laboratory in London. He has had many articles published on aesthetics and CAD/CAM dentistry, and has had lectured world-wide on both subjects. Mark's latest venture is the launch of his dental business blog (www.markoborn.blogspot.com).

Additional resources

Business Balls Financial Glossary www.businessballs.com/finance.htm

Business Knowledge Centre www.netmba.com/finance/financial/ratios/

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