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Ratio Analysis A brief explanation for Inhouse Counsel & Lawyers

Why Use Ratio Analysis?

Investment analysts and others use ratio analysis to interpret the financial statements. Ratios on their own do not provide any useful information – it is only when a ratio is compared with either an industry benchmark or a ratio from the year before that it becomes meaningful.

Use of Ratio Analysis in a Merger or Acquisition Transaction

Usually in a transaction situation you will be part of a team. Obviously the finance members of the team and the CEO or other management who are instigating the transaction should have a thorough understanding of the key issues and areas of risk in the transaction. You as in-house counsel should be fully briefed on these issues. Even so, your own ratio analysis which can be done quite quickly will assist and may even highlight some areas that others on your team have not yet discovered.

Ratio analysis could help you better understand the reason(s) for the transaction and the motivation of the vendor and purchaser. By giving you more understanding of the key assets being acquired or sold you can better identify the areas of risk in the transaction and those of the greatest magnitude. Put simply, the biggest and ugliest issues can be identified more readily.

Information is the currency of every negotiation and this further information provided by ratio analysis is the start of the information trail. It can help you identify those areas on which to concentrate your due diligence.

Use of Ratios as a Benchmark

Ratios can also help you benchmark your in-house legal team's performance against industry averages. It gives you an objective basis for comparison.

Comment:

In the following, the word, "company" is used, but read this as firm, company or partnership, whichever is appropriate.

Types of Ratios

Ratios usually fall into one of the following five categories:

- Liquidity
- Business efficiency
- Leverage
- Profitability
- Share Market Data

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Liquidity ratios

Liquidity ratios measure the company's ability to pay its short term debts. A high value ratio means that the company has a large safety margin to cover its short term debts.

Liquidity ratios include:

- The Operating Cash Flow Ratio:

$$\text{Operating Cash Flow Ratio} = \frac{\text{Cash Flow from Operations}}{\text{Current Liabilities}}$$

If this ratio is greater than one then the company has sufficient cash flow to meet its current liabilities. If it is less than one then questions should be asked as to how current liabilities are going to be met. The answer may be raising more funds from banks or the share market or perhaps improving cash flow from operations.

- The Current Ratio:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

If this ratio is greater than one then the company has sufficient current assets to meet its current liabilities. This concept is also expressed by saying the company has sufficient "working capital" ie it can when called up, pay its suppliers out of money it has received from its customers and other cash it has in its bank account.

Business Efficiency Ratios

Business efficiency ratios provide a measure of how quickly it takes the company to turn its products or services into cash – i.e., these ratios measure how quickly the business cycle moves. The quicker a company can turn its goods and services into cash the more efficient it is, making the best use of its assets.

Business efficiency ratios include:

- The Inventory days ratio:

Shows how long the company takes on average to turn over its inventory i.e., how long does it sit on the shelf before being sold.

$$\text{Inventory days ratio} = \frac{365 \text{ days}}{\text{Average cost of goods sold divided by Average Inventory}}$$

Average Cost of Goods Sold = the average of cost of goods sold in the Income Statement for this year and the cost of goods sold in the Income Statement for last year. Note that cost of goods sold is also the "changes in inventories of finished goods and work in progress and raw materials used"

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Average inventory = the average of the inventory in this year's balance sheet and the inventory in last year's balance sheet

Comment for legal firms, the ratio is ...

- The Number of Days in Receivables:

Shows how long on average the company takes to collect its accounts receivable.

$$\text{Number of days in receivables} = \frac{365 \text{ days}}{\text{Revenue divided by Average Receivables}}$$

Average Receivables = the average of Receivables in the Balance Sheet this year and the Receivables in the Balance Sheet last year

Comment for legal firms, the ratio is ...

Leverage Ratios

Leverage ratios show how much leverage a company has, i.e., how much debt it has compared to its profit levels or compared to its equity. The more leveraged a company is the more risk it is taking.

Leverage ratios include:

- Interest Coverage Ratio

Shows how much cash flow the company has to cover interest payments.

$$\text{Interest Coverage Ratio} = \frac{\text{Cash flow from operations}}{\text{Interest Payments}}$$

Interest payments are listed in the Cash Flow Statement and are sometimes called "interest payments" or "borrowing costs paid" or "finance costs paid".

This ratio shows how many times over the company can cover its interest payments with its cash flow.

- Debt to equity ratio

Shows how much debt the company has compared to its equity. Debt is considered riskier than equity because there are deadlines from the lenders as to when it must be paid back and banking covenants that must not be broken. Also, interest must be paid on debt. In comparison, equity from shareholders doesn't need to be paid back at a certain date and shareholders will sometimes allow latitude to a company about the quantity and timing of dividends.

$$\text{Debt to equity ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

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A ratio of more than one requires some further questioning as to the nature of the liabilities i.e., interest rate, timing of repayment and covenants imposed by the lender.

Profitability Ratios

Profitability ratios are used to show how profitable a company is compared to its competitors or compared to its past performance. Therefore these ratios need to be compared against a benchmark, which can be an industry benchmark or simply the company's past performance.

Profitability ratios include:

- Profit Margin:

$$\text{Profit margin} = \frac{\text{Net Profit after income tax}}{\text{Total Revenue}}$$

- Return on assets (ROA):

$$\text{Return on assets} = \frac{\text{Net Profit after income tax}}{\text{Total Assets}}$$

Share Market Data

Publicly listed companies are traded every day on the Australian Stock Exchange. Since this share price information is readily available, ratios can be calculated that help investors and others better understand the company and the value its shares offer the investor.

Share market data ratios include:

- Earnings per share

This ratio is usually provided in a company's annual report and often is at the foot of the Profit & Loss or Income Statement, saving the investor/analyst the need to calculate the ratio themselves.

The formula is earnings (which is an interchangeable term for profits) divided by the average number of shares on issue. As the name suggests this ratio tells the investor how much profit the company is making for each share.

- Price to Earnings Ratio (PE Ratio)

This ratio tells the investor the multiple of profit/earnings the market is currently paying for these shares. For example, a PE ratio of 20 means that share market investors are paying a share price that is 20 times the annual profits/earnings per share of the company. Compare this to legal or accounting practices which sell for two or three times net profit and you can see that the ability to easily sell public holdings attracts a willingness to pay a higher PE ratio.

The PE ratio is

$$\text{PE ratio} = \frac{\text{Current share price}}{\text{Net Profit after tax}}$$