

Current ratio / working capital ratio =

$$\frac{\text{current assets}}{\text{current liabilities}}$$

$$\frac{\$1,000,000}{\$800,000} = 1.25$$

## What is it?

Current ratio, sometimes called working capital ratio, **shows how many times a company can meet its short term liabilities in one year**. Generally speaking, current ratio between 1.5 to 3.0 indicates strong financial performance.

## Why measure it?

Current ratio can be an indication of a company's short term financial health and shows whether you are able to collect accounts in a timely manner.

Although it seems like higher the better, it is not always the case. High current ratio (i.e. 4) may suggest that the company is not efficiently using its current assets, is not securing financing well, or is not managing its working capital well.

Some industries may have a lot lower current ratio than others (i.e. retail industries usually is under 1 as they have really short receivable days and long payable days).

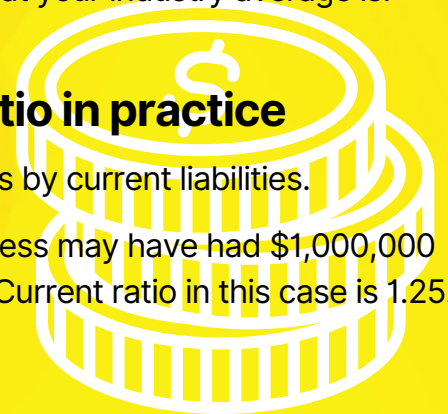
It is recommended to compare your current ratio to your industry average if your current ratio seems to be out of ordinary. Lenders usually look for current ratio over 2.

Contact us if you would like to know what your industry average is.

## Current ratio / working capital ratio in practice

Calculate current ratio by dividing current assets by current liabilities.

At the end of previous financial year, your business may have had \$1,000,000 current assets and \$800,000 current liabilities. Current ratio in this case is 1.25.



Debtor days / days sales outstanding =

$$\frac{\text{closing trade debtors}}{\text{average credit sales}}$$

$$= \frac{\text{closing trade debtors}}{\left( \frac{\text{total sales} - \text{cash sales}}{\text{number of days}} \right)}$$

$$\frac{\$300,000}{\left( \frac{\$600,000 - \$100,000}{28} \right)}$$

$$= \frac{\$300,000}{\$17,857.14} = 16.8 \text{ days}$$

## What is it?

Debtor days is the **average number of days taken for your business to receive payment from your customers for invoices issued to them.**

## Why measure it?

Many businesses track debtor days due to the high importance of cash in running a business. It is in a business's best interest to collect as much outstanding accounts receivable as quickly as possible, as there is time value of money.

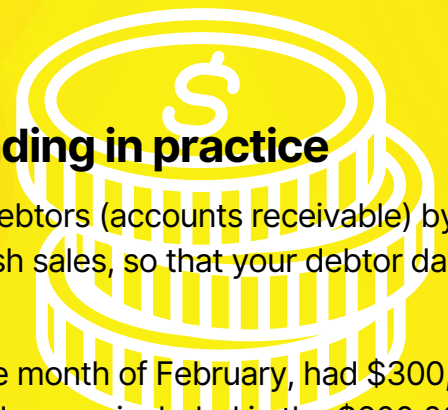
A high debtor days number can lead to cash flow problems as this suggests the business is taking too long between the time of a sale and the time the business receives payment.

Although debtor days is a great benchmark metric to compare with industry average and to assess cash flow, analysing trends can give a great insight. For example, if a trend is increasing, it may suggest that customer satisfaction is declining, customer's business is struggling, or your sales team is offering longer payment terms to drive higher sales.

## Debtor days / days sales outstanding in practice

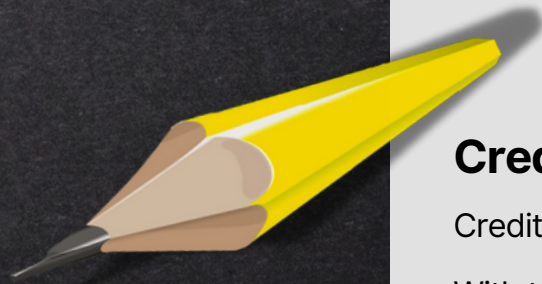
To calculate debtor days, divide closing trade debtors (accounts receivable) by average credit sales. Key here is to exclude cash sales, so that your debtor days reflect sales made in credit only.

For example, if you had \$600,000 of sales in the month of February, had \$300,000 in accounts receivable and \$100,000 of cash sales was included in the \$600,000 sales, your debtor days is 16.8 days.



Creditor days / days payable outstanding =

$$\frac{\text{closing trade creditors}}{\text{average credit purchases}}$$

$$= \frac{\text{closing trade creditors}}{\left( \frac{\text{total purchases} - \text{cash purchases}}{\text{number of days}} \right)}$$


$$\frac{\$2,000,000}{\left( \frac{\$4,000,000}{89} \right)}$$

$$= \frac{\$2,000,000}{\$44,943.82} = 44.5 \text{ days}$$

## What is it?

Creditor days is the **average number of days you take to settle debts with suppliers.**

## Why measure it?

Creditor days plays a key role in your cash flow.

From a cash flow perspective, longer creditor days is better. However, if your creditor days are higher than terms of trade with suppliers, you are risking jeopardizing suppliers' goodwill.

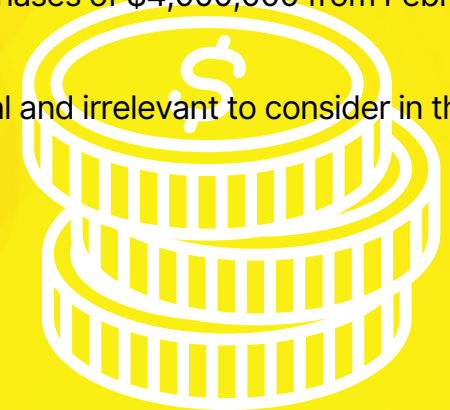
Ideally, creditor days should be the same as terms of trade to maximise cash flow.

## Creditor days / days payable outstanding in practice

Creditor days is calculated by dividing trade creditors by average credit purchases.

With trade creditors of \$2,000,000, credit purchases of \$4,000,000 from February to April, creditor days is 44.5.

In most businesses, cash purchases are minimal and irrelevant to consider in this calculation.



Inventory days / days sales in inventory =

$$\frac{\text{inventory}}{\text{average COGS}}$$

$$= \frac{\text{inventory}}{\left( \frac{\text{COGS}}{\text{number of days}} \right)}$$

$$\frac{\$800,000}{\left( \frac{\$5,000,000}{365} \right)}$$

= 58.4 days

## What is it?

Inventory days / days sales in inventory is the **average number of days it takes for all inventory on hand to sell.**

## Why measure it?

As a business owner, you make decisions on pricing, manufacturing, marketing, and purchasing new inventory every day. Knowing your inventory days will help you make better decisions.

Generally, **high** inventory days indicates overstocking, market/product deficiencies, or poorly managed inventory. However, it is important to note that sometimes a high inventory days is preferable (i.e. in a case when short supply is expected and you might want to stock up on those supplies, then later sell at a higher price).

This metric like every other metric, should be compared with similar industry, and if possible, similar business model competitors. This metric is also useful if it were done on a product by product basis to identify which products have **high** or **low** inventory days.

## Inventory days / days sales in inventory in practice

Inventory days can be calculated by dividing inventory by average cost of goods sold (COGS).

If your business had \$5 million in cost of goods sold and \$800,000 inventory for the year ended 30 June 2022, your inventory days for 2022 financial year is 58.4 days.

Interesting thing about inventory days is you can divide number of days by inventory days to achieve inventory turnover, which is a metric for how many times your inventory turns over in a given period. In the example above, inventory turnover for 365 days is  $365/58.4 = 6.25$  and inventory turnover per quarter is  $91/58.4 = 1.56$ .

Inventory turnover / stock turnover =

$$\frac{\text{COGS}}{\text{average inventory}}$$

$$= \frac{\text{COGS}}{\left( \frac{\text{OP inventory} + \text{CL inventory}}{2} \right)}$$

$$\frac{\$5,000,000}{\left( \frac{\$750,000 + \$850,000}{2} \right)}$$

$$= \frac{\$5,000,000}{\$800,000} = 6.25$$

## What is it?

Inventory turnover / stock turnover is the **average number of times that inventory sells in a given period**.

## Why measure it?

As a business owner, you make decisions on pricing, manufacturing, marketing, and purchasing new inventory every day. Knowing your inventory turnover will help you make better decisions.

Generally, **low** inventory turnover indicates overstocking, market/product deficiencies, or poorly managed inventory. It is important to note that sometimes low inventory turnover is preferable (i.e. in a case when short supply is expected and you might want to stock up on those supplies then later sell at a higher price).

This metric like every other metric, should be compared with similar industry, and if possible, similar business model competitors. This metric is also useful if it were done on a product by product basis to identify which products have high or low inventory turnover.

## Inventory turnover / stock turnover in practice

Inventory turnover can be calculated by dividing cost of goods sold (COGS) by the average inventory.

For example, if your business had \$5 million in cost of goods sold, \$750,000 opening inventory and \$850,000 closing inventory for the year ended 30 June 2022, your inventory turnover for 2022 financial year is 6.25 times.



Net working capital per revenue (NWCR) =

$$\frac{(\text{trade debtors} + \text{inventory} + \text{WIP}) - \text{trade creditors}}{\text{revenue}} \times 100$$

$$\frac{(\$750,000 + \$200,000) - \$600,000}{\$4,000,000} \times 100$$

= 8.75%

## What is it?

Net working capital per revenue (NWCR) **measures a business's operational liquidity efficiency**. It shows how much of the sales will need to go toward meeting operational expense obligations. The higher the value is, the more money is locked up in non-liquid cash assets.

## Why measure it?

As a business owner, collecting debtors, managing inventory/WIP, and paying off creditors are major headaches. NWCR is a metric that shows how well you are doing the above as a whole. Checking the trend will show how well your liquidity strategies are working.

Lenders usually check working capital and look for a negative trend that shows your liquidity is improving.

## Net working capital per revenue (NWCR) in practice

NWCR is calculated by adding short term debtors, inventory, work in progress less current creditors, then dividing that value by revenue and multiplying by 100 (to express as a %).

If your debtors are \$750,000, inventory is \$200,000, creditors are \$600,000, and gross sales are \$4,000,000, your NWCR is 8.75%.

