CURRENT ASPECTS OF UNSECURED LENDING
WHAT DO FINANCIAL RATIOS REALLY ACHIEVE?

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Before analysing a company's financial situation and its ability to repay a loan, it is important to have a clear understanding of the type of borrowing required. No matter what type of financing is being considered, a lender must make certain that all requirements are considered.

Good credit judgment usually follows naturally from the development of complete information and the thorough analysis of the information. This information is obtained from a wide variety of sources, including newspapers, business periodicals, conversations with business people, seminars and so forth.

After attaining a thorough understanding of the company, the industry in which it operates, its management and its requirements, the analyst or lender can then proceed to analyse the financial statements with greater confidence. Ideally a complete history of half yearly and annual financial information should be available for analysis.

As one begins to analyse the financial statements it should be remembered that one is simply seeking the story behind the numbers. The financial statements reflect the results of business activity, and there is really nothing mysterious about them. If the analyst understands the business, it should be natural to develop an understanding of the numbers.

Obviously in any lending proposal, whether it is unsecured or otherwise a good analyst begins his process by reviewing the income statement. As mentioned, the profitability of a company is of primary importance. After a broad review of the company's profitability, looking particularly at gross margins, operating margins and net margins, the analyst should then consider the accounting policies.

A review of the significant accounting policies including the methods of accounting for bad debts, inventory valuation procedures, methods for depreciation of fixed assets, and other accounting policies related to various other balance sheet and income statement items assists in determining the impact of those significant accounting policies on net income.

Now having developed the basic considerations lets turn to my topic - "What do financial ratios really achieve?"

Ratio analysis is a powerful tool to gain a more complete understanding of the business activity. However, all too often, ratios are calculated without sufficient understanding, and this lack of understanding can lead to confusion and erroneous conclusions. The difficulties seem to be primarily related to the multitude of ratios and the wide variety in methods of calculation.

I believe that only a few ratios need to be used in assisting to interpret financial data and the method I follow in converting financial date into ratios serves two principal purposes:

- Comparison to historical company standards.

- Comparison to other companies or industry average.

Ratios may be grouped into five principal categories:

- Liquidity

- Coverage

- Leverage

- Operating

- Expense items to sales.

As mentioned the number of possible ratios is quite large and will depend on such factors as industry size, selling methods, and financing methods. What I present below are the standard ratios within each category and their use. If a particular entity has unusual transactions, and I instance the differences between, Industrial Companies, Finance Companies and Merchant Banks, then special ratios are used in the analysis.

LIQUIDITY RATIOS

Liquidity is a measure of the entity's ability to meet current obligations as they come due. Within this category are the two most common ratios in accounting; the current ratio and the quick ratio (also known as the acid test). Because these two ratios are so well known we will skip them and go onto other liquidity ratios that are not as well known.

Receivables Turnover - Computed by dividing the year end total of accounts and notes receivable (trade) into annual sales. The result shows the number of times trade accounts and notes receivable turn over during the year. The higher the ratio the shorter the collection time. As noted above, whether or not a ratio is favourable depends on historic trends and comparisons

with other similar entities and industry averages. One problem with this ratio is that it does not take account of seasonal fluctuations in receivables. It would also be misleading if there are significant cash sales.

Days' Sales in Receivables - Computed by dividing the turnover ratio into 365. It shows the number of days on average that receivables are outstanding. For example if sales were $6M and receivables $1M the turnover ratio would be 6. Dividing 76 into 365 gives a result of 61 days average outstanding. If the terms are 30 days or more, the collections are quite slow and require management action.

Inventory Turnover - Computed by dividing cost of sales by average inventory (usually the average of the opening and closing inventory amounts). As with receivables, a high ratio is favourable because it means that less inventory is required for a particular level of sales. If the turnover ratio is divided into 365 you arrive at the number of days on average that inventory remains on hand. The lower the figure the more favourable for liquidity.

Sales to Working Capital - Computed by dividing net sales by year end net working capital. This ratio measures how efficiently working capital is used in relation to sales. A low ratio may indicate an efficient use of working capital and a high ratio may show a vulnerable position for creditors. The company's historic trend and industry averages are important in interpreting this ratio.

COVERAGE RATIOS

These ratios measure a firm's ability to maintain debt service.

Interest Coverage - Income before interest expense and income taxes divided by interest expense. This ratio shows the number of times that earnings cover the annual interest requirement. Creditors want to see a high ratio for protection.

Cash Flow over Current Maturities - Cash flow from operations (net income plus non cash expenses) divided by the current portion of long term debt. This ratio shows the coverage of current maturities by cash flow from operations. It is valid measure of the ability to service the company's debt and is an indicator of the ability to take on more debt.

LEVERAGE RATIOS

These ratios measure a firm's vulnerability to business downturns, but the danger points may vary greatly among industries.

Debt to Net Worth - Total liabilities divided by tangible net worth. This ratio shows the relationship between the owners and

the creditors. The higher the ratio, the greater the risk for the creditors. Of course if things go well, a highly leveraged entity will show a higher return on equity than a low ratio enterprise. This ratio could also be based on just long term debt.

Fixed Assets to Net Worth - Fixed assets (net of depreciation) divided by tangible net worth. A low ratio is favourable for creditors. A ratio of less than one means that the owners have provided all the funds for the fixed assets and there is a cushion for creditors.

OPERATING RATIOS

There are many operating ratios that are used to evaluate management performance. It is particularly important in determining whether an operating ratio is favourable or unfavourable to compare with industry averages and company historic trends. Three of the more important operating ratios are listed below and are expressed as a percentage.

Pre-Tax Income to Net Worth - Income before taxes divided by tangible net worth. For example if the ratio is .2, it would be expressed as a 20% return on equity. A high return is favourable but it may indicate a highly leveraged situation. Some people are net income rather than pre-tax income for this ratio.

Pre-Tax Income to Total Assets - Pre-tax income divided by total assets. This ratio measures the pre-tax return on total assets as a measure of management effectiveness in employing available resources. A high ratio is obviously favourable but special situations can distort this ratio.

Net Margin - Pre-tax income divided by net sales. This ratio measures management's overall performance. It is particularly good for a high volume/low margin business such as a supermarket. A small change in the net margin can be very significant.

EXPENSE ITEMS TO SALES

In this category there can be as many ratios as there are expense items on the income statement and most management reports with the exception of publicly listed companies are presented that way with the percentage of each item to sales being expressed on the income statement. Here again the individual percentages are significant only in relation to company historic trends and industry averages. The ratio is always expressed as a percentage and is computed by dividing sales into the expense item.

SUMMARY

Management can more easily understand the financial statements through ratios because they can be used for comparison with companies, industry average and an entity's historic trends

without the confusion that can result from differences in the size of the underlying amounts. The numbers are easier to understand and relationships are clearer with ratios. One note of warning, however; make sure every ratio used has a meaning for the particular entity being analysed.

From a lenders point of view, good credit decisions whether they are secured or unsecured, result from a thorough analysis of an enterprise, its management, the industry in which it operates, and the markets it serves. The company analysis includes a review of the results of its operations and financial condition and an assessment of expected future demands on the company's cash related to its ability to generate cash. The real key is to get behind the numbers and understand the underlying business activity. It takes time, hard work and sufficient level of humility.