Small business management (find attachment)

Business

Small business management Working of ratios (Keown 116 Current Ratio:

Formula: Current Assets/Current Liabilities Working: Current Assets: $163, 500, Current Liabilities: $94, 000

Current Ratio: 163, 500/94, 000 = 1. 74

2. Liquid Ratio:

Formula: Liquid Assets/Current Liabilities;

Liquid Assets: Current Assets – (Inventories + Prepaid expenses)

Working: Inventories:$68, 000

Prepaid expenses:$8, 000

Current Assets:$163, 500

Liquid Assets: $87, 500

Current Liabilities: $94, 000

Liquid Ratio: 87, 500/94, 000 = 0. 93

3. Gross Profit Margin:

Formula: (Gross Profit/Sales)*100;

Gross Profit: Net sales – Cost of sales

Working: Sales:$885, 000

Less Cost of sales:$575, 000

Gross Profit:$310, 000

Gross Profit Margin: 310, 000/885, 000 = 35. 02%

4. Net Profit Margin:

Formula: (Net Profit/Sales)*100;

Working: Net Profit (after tax): $35, 500, Sales: $885, 000

Net Profit Margin: 35, 500/885, 000 = 4. 01%

5. Return on Assets (ROA):

Formula: Net Profit Margin x Assets Turnover

Assets Turnover: Revenues/Average Assets during the period

Assumption: Since we have balance sheet of only one year, we will assume that the total assets figure shown in it is the average held over the entire year.

Working: Net profit Margin: 0. 04 (as calculated above)

Revenues: $885, 000, Average Assets: $533, 500

Assets Turnover ratio: 885, 000/533, 500 = 1. 66

ROA = . 04 x 1. 66 = . 0664 or 6. 64%

6. Return on owner's Equity (ROE):

Formula: Net Income/Owner's Equity

Working: Net Income: $35, 500, Owner's Equity: $259, 500

ROE: 35, 500/259, 500 = 0. 1368 or 13. 68%

7. Asset Turnover:

Formula: Assets Turnover: Revenues/Average Assets during the period

Assumption: Since we have balance sheet of only one year, we will assume that the total assets figure shown in it is the average held over the entire year.

Working: Revenues: $885, 000, Average Assets: $533, 500

Assets Turnover ratio: 885, 000/533, 500 = 1. 66

8. Ownership ratio:

Formula: Owner's Equity/Total Assets

Working: Owner's Equity: $259, 500, Total Assets: $533, 500

Ownership Ratio: 259, 500/533, 500 = 0. 4864 or 48. 64%

Way of increasing the return on owner's Equity

According to the Du Pont model, return on equity is dependent on 3 main components – net profit margin, asset turnover and equity multiplier (Keown

118). The formula goes as:

ROE: (Net Profit Margin) (Asset Turnover) (Equity Multiplier)

As per our calculations:

Net Profit Margin: 0. 04 and Asset Turnover: 1. 66

Equity multiplier: Assets/Owner's Equity = 533, 500/259, 500 = 2. 06

Hence, ROE: 0. 04 x 1. 66 x 2. 06 = 0. 1368 = 13. 68

Equity multiplier highlights the portion of the ROE that is financed through debt. Thus, one of the ways of improving ROE would be by increasing leverage. As the Debt to Equity ratio at present is 1. 05, there is some scope of increasing debt after considering the fact that the company's current ratio is good and the likelihood of liquidity problems is low. Another way of increasing ROE would be by increasing sales revenues and margins. To achieve an ROE figure of 30% which is more than double, we will have to increase debt component by 32%, sales by 50% and Net profit also by 50% to achieving following figure for the 3 ROE components:

ROE: (Net Profit Margin) (Asset Turnover) (Equity Multiplier)

ROE: 0. 04 x 2. 49 x 3. 02 = 0. 3018 = 30. 18%

. However, increasing debt will adversely impact the interest payout and eventually the net margin. Hence, we need to increase short term liabilities like creditors or tax provisions to reduce interest expenses. Net profit can be increased by reducing the operating expenses. However, such high increase in sales may not be possible for a small business. Any increase in one component has an impact on the other. Hence each one needs to be changed so as to impact the other minimally.

References

Keown, Arthur J. “ Foundations of finance: the logic and practice of financial management”. Prentice Hall. 2003. Web.