

WHERE IS YOUR BUSINESS GOING?

by Linda Carter

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email: LC@the-retail-advisor.com

Often you receive your financial statements and file them away for safekeeping until you are asked for them by your bank or another creditor requests them. But, within those financial statements are the indicators of success of the past year. This article and another to follow next month will explore these indicators and give you the ability to transform the numbers on your financial statements into meaningful indicators of where you and your business have been and keep you better informed as to where it is going.

The indicators of success are developed through calculating several industry standard financial ratios. Before these ratios can be calculated some attention should be given to the financial statements to assure that what is calculated is a true picture of the financial status.

Beginning in the assets section, remove any entries such as the Cash Value of Life Insurance and be certain inventory is recorded properly. The Cash Value of Life Insurance is not expected to mature or be cashed in within a twelve-month period. An overstatement of inventory due to including stale inventory with a low value will distort the information and improperly valuing at cost rather than at lower of cost or market as with the Retail Inventory Method will also distort the ratios calculated. Including aged receivables that are likely candidates for write-off will also distort the current assets value.

In Liabilities, review any loans from owners as to whether they are really loans or equity placed within the business. If there is no intention to repay or there is a below market or no interest applicable they are probably not true liabilities of the business.

To help you, we have included a sample summary set of financial statements below so you can follow along and do the calculations. The first two ratios have to do with the company's debt-paying ability.

1. Current Assets to Current Liabilities -

This is also called the Current Ratio and is calculated by dividing Current Assets by Current Liabilities. The current ratio is used to measure the short-term ability of the company to pay its debts. A current ratio of 2:1 is considered healthy and the retailer can expect to encounter credit problems with resources such as factors any time the current ratio falls below 1.5:1. On our example below the current ratio is (250,000 divided by 125,000) or 2 which is good.

2. Debt to Equity Ratio -

This ratio is computed by dividing Total Liabilities by Net Worth. This ratio indicates the relationship between capital invested by owners and borrowed funds. Should this ratio exceed 1:1, the investment of the creditors would exceed that of the owners. Creditor's look to a store's equity to provide a margin of safety. If owners have provided only a small proportion of the operation's total financing, too much of the risk of the business is born by the creditors. On our example below, the Debt to Equity Ratio is 1.59 (175,000 divided by 110,000) which is bad. This means that for every \$1.00 of equity, there is \$1.59 of debt.

The next series of ratios are the ratios of Return on Investment and are calculated using the value of Net Worth. Net Worth is the equity the owner or stockholders have in a business. Since you may have adjusted Assets and Liabilities above, to arrive at Net Worth subtract the adjusted Liabilities from the adjusted Assets.

Just as we adjusted Assets and Liabilities from the Balance Sheet, the Income Statement may need adjusting also. Sales should include only income from merchandise sold. Sales tax should be excluded from this figure since the sales tax collected is a liability. If your statements include sales tax in sales then it is also an expense in the Schedule of Expenses. It should be removed from both places. Lease Department Sales should not be included in Sales but rather should be a separate item of income on the Profit and Loss Statement. Freight is not an operating expense but should be in the Cost of Goods Sold section.

The list is quite lengthy of mistakes that are often made in the Income Statement. We went over them in last month's e-newsletter. Careful evaluation of the expenses to be certain each one is an operating expense for the business of selling goods is what is called for.

3. Return on Investment % -

From the income statement use the line titled "Income before Income Taxes" adjusting that entry as you may need to resulting from the adjustments we discussed above. Divide this figure by Net Worth. This percentage should be at least 15%. For our sample below this ratio is 20% (20,000 divided by 100,000) which is very good.

This ratio is important for investors who must decide whether they are likely to realize a satisfactory return on their investment in a company.

4. Net Sales to Net Worth -

Computed by dividing Net Sales by the average of the Beginning of Year (BOY) and end of year Net Worth. This ratio provides an indication of how productively management is deploying the store's equity. For example, if equity is invested in dormant inventory that is not generating sales, then invested capital is not being turned over to create profit and there will be little or no return on investment. A ratio of 3 is acceptable and 5 is very good. On our example below the ratio is 5 (500,000 divided by 100,000) which is very good.

5. Return on assets -

This ratio is computed by dividing Income before Income Taxes (as adjusted) by Total Assets (as adjusted). This ratio measures the productivity of the assets and is similar to Return on Investment except that it includes the return attributable to the financing provided by outside creditors. Therefore, Return on Assets measures the return on investment of both the store's owners and creditors. This ratio should be at least 10%. On our example below the ratio is just 7.02%, a little low.

All of the ratios discussed above will provide the owner or creditor of a retail store an indication of the status of his investment in that business. These are also the ratios a banker or other interested outside party would consider before making a loan to the store or investing in or purchasing the business. Next month's article will be of use to store management in identifying just where problems in the store's operation lie and where improvements can be made.

BALANCE SHEET

	ASSETS	
Current Assets		
Cash	100,000	
Inventory	150,000	BOY: 150,000
Total current assets	250,000	
Total Fixed Assets	35,000	
TOTAL ASSETS	285,000	

LIABILITIES		
Total Current Liabilities	125,000	
Total Long Term Liabilities	50,000	
TOTAL LIABILITIES	175,000	
OWNERS EQUITY		
Total Capital (Net Worth)	110,000	BOY: 90,000
Total Liabilities and Capital	285,000	

INCOME STATEMENT

Sales	500,000	Last Year: 475,000
Cost Of Goods Sold	240,000	
Gross Profit	260,000	
Operating Expenses	240,000	
Net Profit Before Taxes	20,000	
Total Square footage of store	1,200	

The additional seven ratios that we will define are best described as Operating Ratios. They are useful to store management in identifying where the problems lie and where improvements can be made to increase the profitability indicated by the ratios discussed last month.

6. Net Profit on Sales % -

This ratio is calculated by dividing Net Profit before Taxes dollars by Sales. This tells you your profit % and can be considered the bottom line of your operations. In our example this is 4% (20,000 divided by 500,000).

7. Sales per square foot -

This ratio is computed by dividing net sales by total square footage. If sales per square foot is strong relative to the industry's performance, it is likely that expenses as a percent of net sales are

in line and well-controlled. If sales per square foot are weak, just the opposite is likely. In our example, the sales per square foot is \$417 with is OK (500,000 divided by 1200).

By breaking this ratio down a little further, management can assemble a great amount of very useful information. A store manager can compare each of his department's sales per square foot by dividing each departments sales by the amount of square footage that the department occupies. Those departments with high sales per square foot are most likely to be a store's moneymakers and are carrying the departments with low sales per square foot. With departmental sales per square foot information, management can give consideration to increasing or decreasing department sizes or even eliminating a particularly unprofitable department; the end result is an increased overall store profit.

8. Stock Turn Rate –

This is calculated by dividing annual net sales by the average retail inventory for the same period. The stock turn rate represents the number of times that average inventory on hand has been sold and replaced. Ideally a fast stock turn rate prevents overstocking and means that inventory is fresh and current. However, too fast of a stock turn rate can mean a store is inadequately stocked and sales are being lost because of poor selection of merchandise available to customers. Since stock turn rate is directly influenced by the amount of inventory carried, one could speed up the stock turn rate by maintaining inventory levels which were too low. Therefore, in determining optimum profitability, stock turn rate needs to be considered in conjunction with sales per square foot. If sales per square feet is healthy or not declining, the retailer can be fairly confident a fast stock turn rate is not costing sales. **The more common problem is a stock turn rate that is too slow. This is usually the result of too much inventory due to overbuying and not following an Open-To-Buy.** The correct retail way to calculate Stock Turn Rate is to divided sales by the average of the last 12 month's beginning of month retail inventory amounts. When you are just working with a year end financial statement you can still get an approximate number by dividing the ending average inventory at cost (beginning of year + end of year, divided by 2) by the complement of the store's IMU%. In our example, assuming cost is 46% the inventory at retail is \$326,087 (150,000 divided by .46). Therefore, the stock turn rate is a poor 1.53 (\$500,000 divided by \$326,087).

9. Operating Expense Ratio –

This ratio is computed by dividing operating expenses (excluding interest) by net sales. It indicates the portion of each sales dollar spent for operating expenses. Operating expenses should be maintained at levels low enough to be profitable yet high enough to support the store's sales volume. For example, sales could be missed because of understaffing the store in an attempt to reduce sales payroll expense. For our example data this is 48% (240,000 divided by 500,000). The correct level for your store depends on the type of merchandise you carry and the Gross Profit you can achieve.

As with the sales per square foot ratio, management can obtain useful information regarding expenses by further breaking down this ratio. By dividing each individual expense making up operating expenses (such as payroll, rent, advertising, utilities, and so forth) by net sales, an individual ratio can be computed for each area of expense to give the retailer an indication of where expenses should be reduced without hurting the store's profitability.

10. Gross Profit Ratio –

To compute this ratio, divide gross profit by net sales. This ratio identifies the average gross profit realized on each sales dollar. Gross profit is directly influenced by markup, markdowns and shrinkage. If initial markup is unusually low or markdowns or shrinkage excessively high, gross profit will suffer. It is essential that gross profit is sufficient to cover the operating expenses and yield an adequate net profit. We like to see the gross profit ratio percentage at 50 or higher for apparel. A western wear store's Gross Profit would be perhaps 45%. For our example data this is 52% (260,000 divided by 500,000).

11. Cumulative Gross Margin (CGP) –

This ratio is not as the others I have discussed. However, we find it very useful when analyzing a client's merchandising status. It is calculated by multiplying the gross margin percentage by the stock turn rate. CGP ratio measures the effectiveness of the entire merchandising effort. It merges two previously discussed ratios and enables a retailer to analyze the combined strength of these financial measures. We use this ratio exclusively at the merchandise classification level; in other words, we compute a cumulative gross margin for each merchandise class carried in a store in order to compare them with regard to profitability. By using this

ratio, classifications can be compared in these two areas using a common denominator. A poor performance in either gross margin or stock turn can be offset by the relative strength of comparison ratio to yield an acceptable result. Those merchandise classes with the high cumulative gross margin are a store's best performers and should be considered as candidates for expanded assortments while the exact opposite is true of those classifications with the poorest cumulative gross margin. For this store, the Cumulative Gross Margin is 80 (52 times 1.53) which is very low (. We like to see a Cumulative Gross Margin in the 125-150 range for a men's wear store and 190-220 for a women's wear store.

12. Annual Sales Growth –

This ratio is calculated by subtracting last year's sales from this year's sales and dividing the result by last year's sales. As the name indicates, this measures the increase or decrease in sales volume from one fiscal year to the next. To determine real sales growth, a retailer needs to reduce the sales growth rate by the inflation rate for retail goods. This eliminates the portion of sales increase which was created by inflation. For this example store the Annual Sales Growth is 5.3%, before adjusting for inflation $(500,000 - 475,000) / 475,000$.

SUMMARY

Calculation of the twelve ratios discussed in these two articles is relatively simple and, I feel, well worth the time spent computing them. The management information provided by these ratios can be very valuable to those retailers intent upon making and keeping their stores profitable.

An additional step I recommend to retailers doing an analysis of this type is to keep a record of each year's financial ratios so that they can be compared from year to year. This lets the you see if a trend in one ratio is developing, i.e., either an increase each year or a decrease each year for several consecutive years. If an unfavorable trend is developing the you can see it and correct the situation early, before it adversely affects the store's profit.

So, when you receive the annual financial statements prepared by your accountant for your business, don't just glance at the profit figure and then file them away. Take time to analyze and understand the grades you received on this year's report card and use that information to improve next year's performance.

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510 Red Oak, Allen, TX 75002
Phone: 877-206-1299