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Is the business still healthy?

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Written by Prof Tommy du Plessis

Any small business owner would like to know how "healthy" his or her business is. Just as a medical doctor consults the "thermometer," among other things, to determine if everything is well, a business owner can look at readings from the financial statements. Today, we are looking at the balance sheet.

The main function of a balance sheet is to reflect the financial position of the company at a specific moment. This statement is thus a snapshot, a picture, of the company at a specific point in time.

From a comparison perspective, it is important to determine how the financial position of the company has changed from one moment to another.

Perhaps the most important ratio from the balance sheet is the return on total assets (ROI), where net profit before interest and tax is expressed as a percentage of the total assets employed in the company.

This ratio provides an indication of the return realised on the total investment without considering who provided the money to acquire the assets. This ratio also tests the viability of the business.

At a minimum, the company must realize a return that at least considers the inflation rate, the tax rate, and a fair salary or dividend for the owner. This is in addition to the salary owners provide themselves as managers of the company.

A second important ratio is the return on equity (ROE) realized on the owner's interest or equity. It is calculated by expressing net profit before tax but after interest as a percentage of the owner's interest.

A benchmark for the ratio is difficult to determine, but business owners must constantly decide whether it might be better to sell all assets, pay off debt, and invest what remains, namely the owner's interest, in another investment or business.

Solvency refers to the extent to which total assets exceed total liabilities. If total liabilities or debt exceed total assets, the company is insolvent.

By calculating the debt as a ratio of total assets and comparing it with previous periods, owners can determine whether the capital structure of the company has improved or deteriorated.

The ability of a company to meet its obligations over the short term is commonly known as liquidity. The most important ratio that can be calculated in this regard is the working capital ratio, or the ratio of current assets to current liabilities.

In practice, it is assumed that when current assets are at least twice as large as current liabilities, it indicates healthy liquidity. Such a company should therefore not experience problems in dealing with unforeseen events affecting cash flow.

By expressing only those assets that can be quickly converted into cash in relation to current liabilities, the so-called acid test ratio is calculated. In such a case, inventory is excluded as a current asset because it is believed that it is not always possible to easily convert inventory into cash.

Ratio analysis is the use of the readings on the "thermometer" of the company to determine if everything is still well. However, no ratio should ever be evaluated in isolation, and if warning lights are flashing, management must quickly come up with an action plan.

**Prof Du Plessis was the Director of the NWU Business School from 2003 to 2017.*