**Current liabilities**

- A current ratio of 2:1 is normally recommended

## 2) The quick ratio/Acid test ratio

- As it normally takes longer to change inventory into cash, it is useful to measure the ability of the business to pay off short-term obligations without relying on the sale of inventories.
- The **Quick ratio/acid test ratio** is calculated with the following formulae

$$\text{Quick Ratio} = \frac{\text{Current assets - Inventory}}{\text{Current liabilities}}$$

- A quick ratio of at least 1:1 is the norm
- Although the quick ratio is always less than the current ratio, a quick ratio that is too low relative to the current ratio may indicate that inventories are higher that they should be.



## Asset Management ratios

- **Asset management ratios** are designed to measure how effectively the assets of the businesses are being used to create sales
- The asset management ratios are discussed below and they include the inventory turnover, the average collection period and the total asset turnover

## 1) Inventory turnover

- The **inventory turnover** measures how well inventory is being managed.
- The higher the turnover the better, because the more times inventory can be turned over in an operating cycle, the greater the profit.
- The formulae is

$$\text{Inventory Turnover} = \frac{\text{Cost of Sales}}{\text{Inventory}}$$

$$\textbf{Profit Margin} = \frac{\textbf{Profit after Taxes and interest}}{\textbf{Sales}}$$

- It is measured as a percentage.
- To increase the profit margin, management of a company would have to increase revenue or decrease expenses.

## 3) The return on total assets (ROA)

- The **Return on total assets** (ROA) measures the profitability of the business as a whole in relation to its total assets used.
- The ratio is calculated by dividing the profits after tax by total assets.

$$\textbf{Return on total assets} = \frac{\textbf{Profit after tax}}{\textbf{Total assets}}$$

- It is measured as a percentage
- A low ratio in comparison with averages indicates a use of business assets that is not efficient.



## 4) Return on equity (ROE)

- The **Return on equity** (ROE) measures the profitability of own capital and is influenced largely by how much borrowed capital the business uses.
- A guideline to finding the profitability of own capital is to compare the return on equity to the return on alternative investments.

$$\textbf{Return on Equity} = \frac{\textbf{Profit after Taxes}}{\textbf{Owners' equity}}$$

- It is measured as a percentage
- If the ROE is less than the rate of return on an alternative risk-free investment, it would not be worthwhile for the owners to continue investing their capital in the business.

- Financial leases are normally used to finance vehicles and equipment and they give the lessee the chance to own the asset at the end of the lease.
- As the entire lease payment is tax-deductible (can be taken off income tax), it is an attractive form of financing from a tax point of view.

## The cash Budget

- A **cash budget** is a statement of estimated future cash receipts and payments, showing the forecast cash balance of the business at certain intervals.
- A properly prepared cash budget will show how cash flows in and out of the business, as well as the business's future ability to pay its debts and expenses.
- Banks are more likely to grant a business loan under favourable terms if the loan request is supported by a methodical cash budget.
- Once a cash budget has been carefully mapped out, a financial manager will be able to compare it to the actual cash inflows and outflows of the business.
- A monthly cash budget helps to show estimated cash balances at the end of each month, which may show up likely short-term cash shortfalls or reveal if large sums of excess cash are lying idle and could be invested to earn a return in the short term



## Preparing a cash budget

- There are 3 separate parts to the cash budget, namely estimated cash receipts, estimated cash payments and the balance.
- Cash receipts are income items such as cash sales, payments from trade receivables and others.
- Cash payments include cash purchases, payments to creditors, rent, wages and salaries, tax paid, interest paid, lease payments, loan repayments and assets purchases for cash.
- Depreciation (decrease in value over time) is not included in the cash budget because it is only a book write-off.
- The difference between the monthly cash receipts and cash payments if the cash flow for the month.
- This is added to the beginning cash balance to calculate the ending cash balance for the month.

**(TOTAL CASH RECEIPTS – TOTAL CASH PAYMENTS) + BEGINNING CASH = ENDING CASH BALANCE**

**TOTAL CASH RECEIPTS – TOTAL CASH PAYMENTS = NET CASH FLOW**