

Analysing your club's financial health

> Ratios and benchmarks

Analysing the financial health of a club

Financial ratio analysis is not something undertaken by many smaller clubs, but it is the common method of analysing the financial health of a club with gross receipts above, say, \$100,000, of predicting the club's potential for success or failure, and of assessing its progress. Ratio analysis enables you to spot trends in the club and to compare its performance and condition with the average performance of similar clubs in the same industry.

Although there are many financial ratios you can use to assess the financial health of your club, we will discuss the main ones that you can use easily. The ratios are grouped together under each area the club should focus on for financial survival and prosperity.

Liquidity ratios

These ratios indicate the ease of turning assets into cash to assess your clubs' ability to pay its bills as they fall due. They include the current ratio, the quick ratio, and working capital. **In general, the higher the ratios in this category, the sounder are the club's activities and its ability to withstand tight cash flow periods.**

Current ratio = Total current assets / Total current liabilities

One of the most common measures of financial strength, this ratio enables you to see if the club has current assets sufficient to meet its due debts with a margin of safety.

A generally acceptable current ratio is 2 to 1. However, this will depend on the nature of the club and the form of its current assets and liabilities. For example, a club may have current assets made up predominantly of cash and would therefore survive with a lower ratio.

Quick ratio = Current assets – inventory / Current liabilities – overdraft

Sometimes called the 'acid test' ratio, this is one of the best measures of liquidity. By excluding inventory that could take some time to realise unless the price is 'knocked down,' it concentrates on real, liquid assets. It helps to answer the question, 'If the club does not receive income, will it be able to meet its current obligations with the readily convertible "quick" funds on hand'?



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Solvency Ratios

These ratios indicate the extent to which the club is able to meet all its debt obligations from sources other than cash flow and hence remain solvent and able to continue to operate. Commonly used solvency ratios are the leverage ratio, debt to assets and interest coverage.

Leverage ratio = Total liabilities / Equity

The leverage (or gearing) ratio indicates the extent to which the club is reliant on debt financing versus equity. Generally speaking, the higher the ratio, the more difficult it will be to borrow more money.

Debt to assets = Total liabilities / Total assets

This measures the percentage of assets being financed by liabilities. Generally speaking, it should be less than 1, indicating adequacy of total assets to finance all debt.

Interest coverage = Net profit / Total interest

This measures how many times your net profit covers your interest expense obligations. The higher the ratio, the more likely the club will be able to meet its interest expenses.

Profitability benchmarks

These are ratios that measure your club performance and ultimately indicate the level of success of your operations.

Gross margin benchmark = Gross profit / Net income

This ratio measures the percentage of sales dollars still remaining (after obtaining or manufacturing the goods sold) and available to pay the overhead expenses of the club. This ratio is only relevant to the trading segments of the club.

Net margin benchmark = Net profit / Net income

This measures the percentage of sales dollars left after all expenses (including stock), except income taxes. It provides a good opportunity to compare the club's 'return on income' with the performance of other clubs.

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Operational benchmarks

These are ratios that measure the performance of each distinct activity within the club. They enable management to see quickly how successful each activity is.

Activity expense benchmark = Activity expenses / Activity income

For example:

Fundraising ratio = Fundraising expenditure / Fundraising income

This ratio measures the cost of fundraising against the income derived from fundraising. It can be used for discrete activities within the club.

Activity expense to total expense benchmark = Activity expense / Total expense

This is the ratio of the cost of the activity to total expenditure. It allows management to see quickly which activities are the most expensive.

Activity expense to total income benchmark = Activity expense / Total income

For example:

Fundraising expense to net income = Fundraising expense / Net income

This shows fundraising expenses as a fraction of the total of all income derived from the activities of the club. Where this ratio is calculated for each discrete activity within the club, management can clearly see which fundraising activities are the most expensive.

Activity income to total income benchmark = Activity income / Total income

For example:

Fundraising income to net income ratio = Fundraising income / Net income

This is the ratio of the income from fundraising to the net income derived from all the activities of the club. Where this ratio is calculated for each discrete activity of the club, management can clearly see which activities generate the highest proportion of the club's net income.

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Management ratios

Management ratios monitor how effectively you are managing the key cash flow activities of the trading operations. These measures are referred to as 'working capital'.

$\text{Days' Inventory} = \text{Inventory} / \text{Cost of goods sold} \times 365$

$\text{Days' Debtors} = \text{Debtors} / \text{Net Income} \times 365$

$\text{Days' Creditors} = \text{Creditors} / \text{Cost of goods sold} \times 365$

Balance sheet ratios

These ratios indicate how efficiently your club is using assets and equity to make a profit.

$\text{Return on Assets} = \text{Net Profit before Tax} / \text{Total Assets} \times 100$

The return on assets indicates how efficiently profits are being generated from the assets employed in the club. The ratio will only have meaning when it is compared with the corresponding ratios of similar clubs. If the ratio of your club is low in comparison with those of similar clubs, it indicates that you are using your assets inefficiently.

$\text{Return on Investment} = \text{Net Profit before Tax} / \text{Equity} \times 100$

The ROI is perhaps the most important ratio of all as it tells you whether or not the club is achieving its objectives and making an appropriate return on the funds it raises and receives.

Financial management tip: *By comparing each of these ratios after each reporting period, you will be able to see the strengths and weakness of the club's operations.*

Net operating cash flow is less than profit after tax, which means the club is spending more than it is earning.

In a small club under, say, \$100,000 this would not be necessary.

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