

does not change, its working capital ratios should not change either. A sudden move in the working capital ratios means that something in the company's structure has changed, and further questions should be asked as to why this is – for example, an increase in the current ratio may be generated by an increase in inventories, so one should ask: why have inventory levels risen? Has there been a sudden fall-off in demand for the company's products?

Another way of examining individual components of working capital is to compare the balance sheet value with the related annual sales figure (gross margin component). For example, for a retail company, the ratio of inventory on hand at the year-end to annual cost of sales will tell you how many days' business would be required to sell the inventory:

$$\text{Days inventory outstanding} = \frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ days}$$

*Similarly:*

$$\text{Credit given} = \frac{\text{Receivables}}{(\text{Credit}) \text{ Sales}} \times 365 \text{ days}$$

$$\text{Credit obtained} = \frac{\text{Trade payables}}{\text{Cost of sales}} \times 365 \text{ days}$$

'Credit given' tells you how many days' credit are given to customers (but note that you need to know either that all sales are on credit or that a substantial proportion of them is on credit). Where a company is buying goods for resale, the ratio of trade payables to cost of sales will show the days' credit obtained or taken from suppliers.

These ratios can also be useful even if you do not know that there is a high proportion of credit sales, or where most of the company's products are manufactured (so purchases from suppliers are only a small part of cost of sales), because while the absolute number of days is no longer a meaningful figure, a significant (say, more than 10 per cent) *shift* in the figure from one year to another will indicate a change in credit arrangements.

It is not uncommon for ratios including balance sheet figures to be calculated by using an average of the balance sheet element during the period. This is usually done by taking one half of the sum of the beginning and ending balance of the item, although it could be meaningful to take into account the timing of specific movements in the balance sheet items over the period. In the illustrations and examples in this book we will, however, use ending balance sheet amounts which can be more easily traced down to the figures on the face of the balance sheet.

## Analysing financial statements

It is very easy for people approaching ratios for the first time to go through a series of reactions, initially seeing the calculation of the ratios as an end in itself and then later asking what use the ratios are. Essentially analysis is about decoding the messages which are built into financial statements and using them to