

- **Activity ratios answer the question, "How efficiently is the organization using its assets to produce revenues?"**
- **Capital structure ratios answer the questions, "How are the organization's assets financed?" and "How able is the organization to take on new debt?"**

The remainder of this chapter uses ratio analysis to analyze the statement of operations and the balance sheet for Newport Clinic (see Exhibit 4-1). The analysis is presented by category, using two years for comparison. Before working with these ratios, it is important to understand the points made in Exhibit 4-5.

Exhibit 4-5 • Key Points to Consider When Using and Interpreting Ratios

1. **No one ratio is necessarily better than any other ratio.** It is often useful to use more than one ratio to help answer a question.
2. **Each ratio's terms offer clues about how to fix a problem.** For example, if the current ratio (current assets/current liabilities) is too low, it can be improved by increasing the numerator (current assets), decreasing the denominator (current liabilities), or both. However, changing the conditions to improve one ratio may affect other ratios as well.
3. **Most ratios are interpreted as follows: "There are N dollars in the numerator for every dollar in the denominator."** Thus, a current ratio of 2 indicates that there are \$2 in current assets for every \$1 in current liabilities.
4. **A ratio can best be interpreted relative to a standard.** The standard may be the organization's past performance, a goal set by the organization, a comparison group (such as similar organizations), or some combination thereof. For example, a current ratio of 2.00 probably would be interpreted favorably if the industry standard were 1.75; however, it probably would be interpreted unfavorably if the industry standard were 2.50. There are several problems with using standards for comparison in the health care industry. Two of the most prominent are the availability and reliability of the data.
 - **Finding appropriate data.** Not all segments of the health care industry have data available that can be used for standards. For example, there are no complete, national-level ratio data on health departments or mental health centers. On the other hand, certain segments of the industry have excellent data. The Center for Healthcare Industry Performance Studies (CHIPS) in Columbus and Health Care Investment Analysts (HCIA) in Baltimore both provide excellent ratio information on hospitals on both a national and regional basis. In addition, many cooperatives, such as Premier, provide benchmarking standards to their members. Alternatively, individual providers may join together to develop their own standards.
 - **Even if data are available, it is important to compare an organization to similar organizations.** It might be highly inappropriate for a small rural hospital in North Dakota to use the ratios of large academic medical centers in Boston for comparison. Services such as CHIPS can provide data by size and location. The data are presented by both median and percentile, which means that an organization can set its own standards relative to how well it wants to look compared to its peers.
 - **The reliability of the data.** The same ratio may be calculated differently by different organizations. For example, in calculating the days in accounts receivable, one organization may use the ending balance in accounts receivable, whereas another organization may use the average daily balance. **Therefore, when comparing organizations against one another or to standards, it is necessary to make sure the same formula is being used (see Perspective 4-4).**
 - There may be differences in practices and procedures among organizations that may not be immediately apparent to those using the information. For example, hospitals may use different depreciation or inventory valuation methods. This could have a profound effect on certain ratios.
 - **In general, a ratio should be neither too high nor too low relative to the standard.** For instance, the acid test ratio [(cash + marketable securities)/current liabilities] looks at an organization's ability to meet its short-term debt obligations. Though an organization would like to have this ratio above the standard, at some point it may indicate too much cash on hand, which likely could be better invested elsewhere. Thus it would not want this ratio to be too high.
6. **Not only should a ratio be compared to a standard, but also the trend of the ratio can help interpret how well an organization is doing.** For instance, an organization would feel differently if a ratio were at the standard and declining versus being at the standard and rising over the last five years. However, in using longitudinal data, it is important to know when major changes took place in the environment or in the organization. For example, if an organization borrowed a considerable amount of money in one year, then it would expect its long-term debt to net assets (equity) ratio to change.
7. **Since ratios are usually relatively small, relatively small differences may indicate large percentage deviations from the standard.** For example, if the organization's current ratio were 1.5 and the industry standard 2.0, while this is only a 0.5 difference, the organization would be 25 percent below standard.