

Four Steps to Evaluating Suppliers Before Signing a Contract

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Finding a new supplier is a task that should not be taken lightly. If the contract is high-value or if the deliverable is instrumental in your operations, your selection process should involve significant time and financial analysis to ensure that the right supplier is contracted. Although the supplier will principally be graded on the product or service it delivers, its financial health should be assessed to make sure that the supplier can continue to provide your business with the deliverable in the future. There are several steps a company should go through when analyzing a supplier's finances. The first three steps involve calculating specific [financial ratios](#) for the supplier, and the final step involves comparing those ratios to industry averages to understand how the supplier stacks up in its industry.

- 1. Calculate Profitability Ratios:** The profitability ratios are probably the most important set of metrics to analyze when selecting a supplier because if the supplier is not profitable, it will not operate for long. And if a supplier of yours closes business, it would strain your company as you try to find a replacement. Profitability ratios are used to assess a supplier's ability to generate earnings compared to its expenses. Ratios that should be used when evaluating a supplier are Return on Assets (calculated as $\text{Net Income} / \text{Total Assets}$), Return on Equity ($\text{Net Income} / \text{Stockholders' Equity}$), Profit Margin ($\text{Net Income} / \text{Sales}$), and Gross Profit Margin ($[\text{Sales} - \text{COGS}] / \text{Sales}$). These metrics will show you how the supplier is using assets to generate profit, the rate of return on investments in the business, and overall measures of profitability which contribute to sustainability.
- 2. Calculate Liquidity Ratios:** The liquidity ratios give you an inside look into the supplier's ability to meet short-term obligations, and while the supplier may not be paying you, liquidity also impacts its sustainability, which is your concern. Ratios that should be used when evaluating a supplier are Current Ratio ($\text{Current Assets} / \text{Current Liabilities}$), Quick Ratio ($[\text{Current Assets} - \text{Inventory}] / \text{Current Liabilities}$), and Net Working Capital Ratio ($[\text{Total Current Assets} - \text{Total Current Liabilities}] / \text{Total Assets}$). These three ratios will give you insight into the supplier's ability to meet short-term obligations and liabilities as well as its ability to expand by maintaining sufficient working capital.
- 3. Calculate Activity Ratios:** The activity ratios measure a supplier's ability to convert different balance sheet accounts into cash or revenue. Ratios that should be used when evaluating a supplier are [Accounts Receivable Turnover](#) ($\text{Sales} / \text{Average Accounts Receivable}$), Accounts Payable Turnover ($\text{COGS} / \text{Average Account Payables}$), and Inventory Turnover ($\text{COGS} / \text{Average Inventory}$). These metrics will show you how the potential supplier is managing receivables with its other clients, the number of times

payables turn over during the year (higher numbers are better), and its inventory management. All of these metrics will give you insight into the potential supplier's operations and will help you avoid potentially risky business partners.

- 4. Compare to Industry Averages:** The last piece of the puzzle is to compare all the ratios to an industry average, which will help you judge if the potential supplier is performing better than its peers. According to Rob Ripp, President of Fintelligent LLC, "Benchmarking financial ratios to industry norms helps ensure suppliers can deliver. Supplier failures can affect the entire supply chain, as products offered by upstream purchasers are compromised." If the potential supplier in question is a publicly traded company, then comparing its performance to industry peers should be easy; their financial data is available freely. However, if the potential supplier is a private company, the analysis is more difficult—even accessing their financials will require help from their accounting department. For benchmarking a private supplier, use public company data if there are comparable firms, or look for data on private firms from industry associations.

Relationships with suppliers can critically impact your business, so the process of selecting a supplier does merit attention. If done correctly you will have a supplier that will be in good financial health, which will lessen the risk for your business. These four steps are a great place to start, but depending on your industry and needs more analysis might be needed. If you are still unsure about a potential supplier, do not hesitate to ask for references.

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