

Financial Ratios and Meanings

Liquidity Ratios

Current Ratio:

Formula: Current Assets / Current Liabilities

Meaning: Measures the ability to meet current obligations in a timely manner. A healthy current ratio is greater than 2.

Improve by: Increase current assets by increasing profit, selling additional capital stock, borrowing additional long term debt, or disposing of unproductive fixed assets and retaining proceeds. Reduce current liabilities by retaining a greater portion of allocated savings. Avoid financing non-current assets with current liabilities.

Working Capital to Sales:

Formula: Working Capital (Current Assets minus Current Liabilities) / Total Sales

Meaning: Measures the degree that working capital should meet daily obligations in relation to business volume

Improved by: Improve working capital or reduce unprofitable sales while maintaining working capital

Working Capital:

Formula: Current Assets - Current Liabilities

Meaning: Principal measure of liquidity; Target for working capital should be at least one-half of operating budget

Improved by: Increasing current assets (increase turnaround on accounts receivable), decrease current liabilities (reduce short term debt), increase net income to improve cash flow

Debt and Risk Ratios

Debt Service Coverage:

Formula: Income before income taxes + depreciation + amortization + interest / Repayment of debt this year + interest

Meaning: Measures the ability of the company to generate cash flow to cover long-term obligations

Improve by: Improve profit or reduce long-term debt

Total Debt to Assets:

Formula: Total Liabilities (Current Liabilities + Non Current Liabilities) / Total Assets

Meaning: A measure of the relative obligations of a company; Debt/Asset of greater than 0.5 indicates that equity position by owners is less than 50%

Improve by: Reducing a company's debt load, tighter control of purchases

Total Debt to Net Worth:

Formula: Total Liabilities (Current Liabilities + Non Current Liabilities) / Total Net Worth

Meaning: Measure of leverage

Improve by: Improve profit, selling additional capital stock, sell off unproductive assets

Profitability Ratios

Profit Margin:

Formula: Profit before tax / Total Sales

Meaning: Measures operating performance

Improve by: Increase margins, increase service fees, or reduce expenses

Gross Margin:

Formula: Gross Profit / Net Sales

Meaning: Measures margin performance strictly on cost of goods sold

Improve by: Increase margins, increase service fees, or reduce costs of goods sold

Return on Net Worth:

Formula: Pre Tax Profit / Total Net Worth

Meaning: Measures the relationship between profit and net worth. Indicates the amount of return the investors are receiving for their investment

Improve by: Improve profits or reduce debt load

Operating Efficiency Ratios**Operating Expenses to Sales:**

Formula: Operating Expenses / Total Sales

Meaning: Measures the contribution of operating expenses to the overall generation of income

Improve by: Reduce operating expenses or increase sales with no increase in the operating expenses

Total Assets to Sales:

Formula: Total Assets / Total Sales

Meaning: Measures the relationship between Total Assets and Total Sales

Improve by: Improve sales or reduce unproductive assets

Labor to Net Sales Ratio:

Formula: Total Personnel Expenses (salaries plus fringe benefits) / Net Sales

Meaning: Measures the contribution of labor to the generation of income

Improve by: Reduce labor expense by reducing hours, reducing employees or reducing salaries. Increase margins and other income with no increase in labor costs.

Labor to Gross Income Ratio:

Formula: Total Personnel Expenses (salaries plus fringe benefits) / Gross Income

Meaning: Measures the contribution of labor to the generation of income after cost of goods sold.

Improve by: Reduce labor expense by reducing hours, reducing employees or reducing salaries. Increase margins and other income with no increase in labor costs.