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.