

Financial Statement Ratios and Calculations

You've probably heard people banter around phrases like "P/E ratio," "current ratio" and "operating margin." But what do these terms mean and why don't they show up on financial statements? Listed below are just some of the many ratios that investors calculate from information on financial statements and then use to evaluate a company. As a general rule, desirable ratios vary by industry.

LIQUIDITY RATIOS

How "cash rich" is a company? Liquidity ratios show a company's ability to turn an asset into cash. The numbers are taken from the Balance Sheet.

1. Working Capital (uses absolute numbers)

Working capital shows if a company has enough cash to pay bills. It is the money leftover if a company paid its current liabilities (that is, its debts due within one-year of the date of the balance sheet) from its current assets.

Working Capital = Current Assets – Current Liabilities

This example (\$170,000 - \$150,000) shows an excess amount after paying all current liabilities. The answer must be positive. **Higher number is better.**

More money is needed to meet expenses if the answer is a negative number.

2. Current Ratio – Working Capital expressed as a ratio

This example ($\$170,000 \div \$150,000$) shows there is \$1.13 in cash and current assets available to pay every \$1 of current liabilities.

Higher number is better. Answer should be 2 or more

3. Quick or Acid Test

Inventory may become no longer useful. This ratio eliminates inventory from current assets and cash. It's called "quick" because it includes items that can be turned into cash. **Answer should be 1 or higher.**

This example ($\$85,000 \div \$150,000$) shows there is only \$0.50 in cash and current assets available to pay every \$1 of current liabilities.

ASSET MANAGEMENT RATIOS

How effectively are you managing your assets? These are also called turnover ratios or efficiency ratios. Asset management ratios are the key to analyzing how effectively and efficiency your small business is managing its assets to produce sales.

The numbers for these ratios are taken from both the Balance Sheet and Income Statement

1. Accounts Receivable Turnover

This shows how many days it takes to collect money owed to you. **Lower answer is better.**

It is also called the Average Collection Period or, Days' Sales Outstanding or Days' Sales in Receivables. It measures the number of days it takes a company to collect its credit accounts from its customers. A lower number is better because this means that the company gets its money more quickly.

Accounts Receivable Turnover = Accounts Receivable ÷ Sales x 365 days

This example $\$75,000 \div \$900,000 \times 365 = 30.42$ days

2. Inventory Turnover

It is also called the Days' sales in Inventory. This ratio shows how many days it takes you to turnover (or sell) your inventory. **Lower answer is better**, since it is better to have inventory sell quickly than to have it sit on your shelves.

Inventory Turnover = Inventory ÷ Sales x 365 days - $\$85,000 \div \$900,000 \times 365 = 34.47$ days

DEBT MANAGEMENT RATIOS

Shows how much money owners have invested in the business compared to lenders.

1. Debt to Equity Ratio

This is also called the Leverage Ratio. The numbers for this ratio are taken from the Balance Sheet.

Debt to Equity Ratio = Total Liabilities ÷ Shareholders' Equity $\$204,000 \div \$87,000 = 2.34$

The company is leveraged 2.34 times. For every \$1 owners have invested, lenders and creditors have invested \$2.34.

2. Accounts Payable Turnover

The numbers for this ratio are taken from the Balance Sheet and Income Statement

This ratio shows how quickly a company pays its suppliers.

Accounts Payable Turnover = Accounts Payable ÷ Purchases x 365 days

This example $\$41,000 \div \$350,000 \times 365 = 42.75$ days

Lower numbers (30 days or less) are better.

PROFITABILITY RATIOS

Shows company's ability to make a profit. The numbers are taken from the Income Statement. The higher the number the better.

1. Gross Profit Margin

The gross profit margin looks at cost of goods sold as a percentage of sales.

Gross Profit Margin = Gross Profit ÷ Sales

This example $\$360,000 \div \$900,000 = 0.40$ (40%) therefore Cost of Goods sold is 60%

2. Net Profit Margin

Net Profit Margin = Net Profit ÷ Sales

This example $\$53,000 \div \$900,000 = 0.058$ (5.8%)