MGT 300 Ratios

LIQUIDITY

Liquidity ratios assist in determining the business financial strength. Compare liquidity to the industry norms and note trends positive or negative.

Current Ratio – The Current Ratio is the most commonly used measure of the liquidity of a company. It is simply a common sense measure. The numerator is the value of assets that should be converted into cash within the next year. The denominator is the amount of bills coming due within the next year.

\[
\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}
\]

Quick Ratio (or Acid Test Ratio) -- The quick ratio is a more restrictive measure than the current ratio. The numerator consists of the most liquid current assets. It assumes a worst-case scenario in which inventory cannot be sold.

The average for all manufacturing companies is about one (1.0). This average also varies a great deal from one industry to another.

A commonly used variation of the ratio is:

\[
\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}
\]

DEBT (OR LEVERAGE)

Debt ratios assists in understanding to the solvency of a company and measures what portion of a firm’s assets are provided by the owner’s versus others. Too much long-term debt increases risk and one should note if a company has more debt than equity.

Debt-to-Equity -- A variation of the debt ratio. Measures the money invested by creditors relative to the money invested by the owners.

\[
\text{Debt-To-Equity Ratio} = \frac{\text{Total Debt (or liabilities)}}{\text{Total Equity}}
\]

This is just another way of measuring the degree of financial leverage. Notice that if the debt ratio is 40%, this means that every $1.00 of total assets is financed with $0.40 in debt and $0.60 in equity.

PROFITABILITY

Since a major goal of the company is to attain a high level of profitability, we would like to see a high value for these ratios. We can relate the company’s profits to almost any item on the balance sheet or income statement (e.g., net income to total assets, net income to common equity, net income to sales, etc.)

\[
\text{Return on Assets} = \frac{\text{Earnings After Taxes}}{\text{Total Assets}}
\]
Note: You will see a lot of variations in the numerator for this ratio: some analysts use earnings before taxes (EBT), others will use earnings before interest and taxes (EBIT). The most common, however, is earnings after taxes (EAT). Just make sure that, if you are comparing a company’s return on assets ratio to an industry average, you are calculating the ratio in the same manner as your source for the industry average.

Return on Equity – This ratio looks at the company’s profits from the standpoint of the company’s owners. It measures the profitability per dollar of investment in the firm by the owners.

\[
\text{Return on Equity} = \frac{\text{Earnings After Taxes}}{\text{Total Equity}}
\]

Note: As with the previous ratio, you will see a lot of variations in the numerator for this ratio. Again, just make sure that, if you are comparing a company’s return on equity ratio to an industry average, you are calculating the ratio in the same manner as your source for the industry average.