Income/Profit Ratios

For Example:

Gross Profits / Net Sales

Gross profitability:
-Measures how much money you're taking in
-Indicative of operational efficiency and great marketing

Net Income / Net Sales

Net profitability:
- Measures how much money is left after others take a bite (Creditors, Vendors, etc.)
- Weak Net Profit indicates excessive non-operating expenses that need to be dealt with

Net Income / Total Assets

Return on assets*:*
- Measures how productive you in producing products and services
- Low ROA indicates a problem in that customers aren't buying, sellers aren't selling, or you are over/under producing.

Net Income / Owner's Equity

Return on investment:
- Shows effectiveness of utilizing equity invested into the company
- Considered best indicator of Profitability as it shows how well management can turn a profit on investments given

Net Sales / Total Assets

Investment Turnover:
- Shows a company's ability to generate sales with assets available

Total Sales / # of Employees

Sales per employee*:*
- Shows how many sales your making compared to the amount of employees you have

Liquidity Ratios

For Example:

Current Assets / Current Liabilities

Current ratio:
- Represents your ability to pay your debts up to a year
- The general rule of thumb is that it should be at least 2:1; two dollars for every one you owe

Cash/Securities/Receivables / Current Liabilites

Quick ratio *(or "acid test"):*
- Represents your ability to pay now

- The general rule of thumb is that it should be at least 1:1; always have enough money on you to keep the loan sharks at bay

Sales to receivables (or turnover ratio):

$$\frac{\text{Net Sales}}{\text{Accounts Receivable}}$$

- Gauges the time between your sales and the collection of payment
- If you do the work, but have trouble collecting the cash, you might be working for free. And not meeting your liabilities as they come up.
- Divide 365 by this ratio to find the average time it takes to collect

Cash turnover:

$$\frac{\text{Net Sales}}{\text{Net Working Capital}}$$

- reflects your ability to finance your activities and its efficiency
- in general you need to five more coming in sales than you have in working capital as it has many cash leaks that may sink the ship

Working Capital Ratios

For Example:

Annual inventory turnover:

$$\frac{\text{COGS for the Year}}{\text{Average Inventory}}$$

- Represents the effectiveness of managing production, warehousing, and distribution for the year by how many times you sold all your inventory
- Avoid having too little inventory and not meeting demand, and keeping mountains of obsolete inventory slowly undermining your working capital
- Divide 365 by Annual Inventory Turnover and it will tell you long it takes you to produce and sell something

Inventory to assets ratio:

$$\frac{\text{Inventory}}{\text{Total Assets}}$$

- Shows how tied up your assets are in your inventory
- Because if you need new inventory, but you can't buy it until you sell your old inventory, then you have a mighty fine problem

Accounts receivable turnover:

$$\frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

- Allows you to see how quickly you turn your credit sales into cash
- Useful in knowing when you are going to get the money you need to keep working capital running
- Divide 365 by ratio to find the time it takes to collect on credits

Leverage Ratios

Examples:

Debt to equity ratio:

$$\frac{\text{Debt}}{\text{Owner's Equity}}$$

- Gives you the relative mix of supplied capital between creditors and owners
- In essence, investors want to see you succeed and make them more money. Creditors want to see you pay them what you owe, through success or failure.

Debt ratio:

$$\frac{\text{Debt}}{\text{Total Assets}}$$

- shows you the portion of your assets that you have through borrowing
- Never owe more than you own. On this situation you are technically bankrupt and one simple call from a creditor will bring you to your knees

Fixed to worth ratio:

$$\frac{\text{Net Fixed Assets}}{\text{Tangible Net Worth}}$$

- Indicates how much capital has been put into fixed assets
- Most don't like to see all their money trapped in fixed assets which are very illiquid. As they are hard to sell and hard to use for something else.

Interest coverage:

$$\frac{\text{Earnings before Interest and Taxes}}{\text{Interest Expenses}}$$

- alerts you on how comfortably you can handle interest payments
- **can't handle it** = can't take on more debt, can't grow, can't become more profitable; **can handle it** = can take on more debt, can grow, can become more profitable. Everyone's happy.