Ratios: Formulas and Descriptions

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The Ratio module allows business owners and managers the ability to track the overall financial condition of their operations over a period of time. In this topic we have included a list of all the Ratios included in the module. The list also includes a description of each and details the formula used to prepare the ratio. Please refer to the *Using Ratios* document for step-by-step instructions on how to prepare a ratio for your business.

Business

Use the Business Ratios to analyze the financial health of your business. The ratios are most useful when compared to similar businesses to let you see how your business compares to industry averages. Because ratios are easier to use when you can see trends it may be useful to choose to look at a one-year trend (showing each of your reporting periods) or a five year trend (showing the last five year's annual totals).

- **Accounts Receivable Turnover:** This ratio measures the promptness of payment by customers. Higher numbers indicate effective collection policies and procedures. ***Total Revenue / ((Period End Net Accounts Receivable + Beginning Balance Net Accounts Receivable) /2)***.
- **Current Ratio:** This ratio gives you an indication of a company's short-term debt paying ability. Typically, this ratio will be from 2 to 3. To determine if your ratio is high or low, compare it with industry averages. The higher the ratio, the greater the liquidity.***Total Current Assets divided by Total Current Liabilities***.

- **Profitability -** measures the extent to which a producer generates a profit from the use of land, labor, management and capital.
  - **Equity to Asset:** Another measurement of financial position, this ratio measures the proportion of total assets financed by the owner's equity. A higher ratio indicates better protection to company creditors, since more capital has been supplied by the owners and less by the creditors. ***Total Equity divided by Total Assets***.
  - **Debt to Equity** This ratio measures the extent the company is financed with money borrowed from non-owners. The higher the value of the ratio, the more total capital has been supplied by the creditors and less by the owners.
  - **Gross Profit Margin:** This percentage measures profitability in terms of return per dollar of gross profit. ***Gross Profit divided by Total Revenue***.
  - **Inventory Turnover:** The inventory turnover ratio measures how quickly inventory is sold. A higher number generally indicates efficiency. However, companies must be careful of stock-outs in situations where too little inventory is kept on hand. ***Cost of Inventory Sold divided by ((Period End Inventory + Beginning Balance Inventory) divided by 2)***.
  - **Net Profit Margin:** This percentage measures profitability in terms of return per dollar of net profit. ***Net Income divided by Total Revenue***.

This documentation is for informational purposes only. For specific accounting guidance, please contact your accountant.

- **Quick Ratio:** This ratio is often used to evaluate a company's immediate liquidity position. A quick ratio that is too low would indicate greater risk for creditors and investors. Normally, this ratio should be greater than 1. ***(Cash + Marketable Securities + Net Receivables) / Current Liabilities***.
- **Return on Assets:** This percentage is often used as an overall index of profitability. The higher the value, the more profitable your business. ***Net Income / ((Period End Total Assets + Beginning Balance of Total Assets)/2)***.
- **Return on Equity:** This percentage measures the rate of return on money invested in the company by owners. The higher the value, the more profitable your business. ***Net Income / ((Period End Total Equity + Beginning Balance of Total Equity)/2)***.
- **Working Capital:** Because it is a dollar amount, this measurement is difficult to compare with other similar businesses, since you must also take into consideration the size of the business. However, it is a measure of the amount of funds available to purchase inputs and inventory items after the sale of current assets and payment of all current liabilities. ***Current Assets - Current Liabilities***.