VANCOUVER COMMUNITY COLLEGE

Ratio Analysis

An important skill for management is the ability to determine what a change or trend in a particular ratio may mean for a business operation in terms of its ability to do things like efficiently collect on accounts, successfully apply for loans, find future investors, or keep stockholders satisfied with the operation's profitability.

To determine how well a company is performing, its current financial ratios need to be compared to previous years' ratios or industry ratios. Ratios fall into four categories:

(1) Liquidity: *working capital, current ratio,* and *quick ratio*—measures a business's ability to pay off short-term debt. A current ratio of 1.50 and a quick ratio of 0.90–1.00 are standard. Any less is cause for concern in most industries.

(2) Turnover (cash conversion): *inventory turnover, A/R turnover, CC/R turnover, A/P turnover,* and *collection periods.* This category is particularly important to any retail, wholesale, or manufacturing operation. In general, the higher the turnover the better—more cash flowing into the business.

(3) Ability to pay all debts (leverage, solvency): *debt ratio (total liabilities/total assets or total liabilities/owners' equity)* and *times-interest earned ratio.* A company with a low debt ratio will find it much easier to obtain loans. A high times-interest earned ratio means that the business easily pays off its interest expenses.

(4) Profitability: *profit margin, return on owners' equity (ROE), return on assets, earnings per share (EPS), asset turnover* – the fundamental goal of a business is to earn a profit so these ratios are the most commonly reported. A higher ROE (how much income is earned for every $1 invested) is more desirable for shareholders.

Remember that for any financial ratio involving an average (like inventory turnover, A/R ratio, etc.) you will need to take the average of a certain account over two time periods, before you can calculate the desired ratio.

Financial leverage refers to the use of **debt financing,** or taking on loans, to increase the return on ownership equity.

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