

KEY BUSINESS RATIOS

Ratios are the comparison of two figures, and are used in business to evaluate performance

Current Ratio

This measures a company's ability to pay short-term obligations. It is calculated by dividing current assets by current liabilities. The higher the current ratio the more capable the company is at paying their obligations. A ratio under 1 suggests that the company is unable at that point to pay off their obligations if they came due. While this shows the company is not in good financial health, it does not necessarily mean it will go bankrupt as there are many ways to access financing but it is not a sign of financial health.

The current ratio can give an idea to the efficiency of a company's operating cycle or their ability to turn their product into cash. Companies that have trouble with getting paid on their receivables or have long inventory turnover can run into liquidity problems as they are unable to alleviate their obligations. Because business operations differ in each industry, it is more useful to compare companies within the same industry.

Debt to Equity Ratio

The relationship between long-term funds provided by creditors and funds provided by owners. A firm's debt-to-equity ratio is calculated by dividing long-term debt by owners' equity. Both items are shown on the balance sheet. A high debt-to-equity ratio, which indicates very aggressive financing or a history of large losses, results in very volatile earnings. A low debt-to-equity ratio, which indicates conservative financing and low risk, results in fewer possibilities of large losses or large gains in earnings.

Inventory Turnover Ratio

This ratio gives an approximation of the number of times per year that a firm sells the equivalent of a complete inventory. It is calculated by dividing sales by the dollar value of inventory on hand.

Quick Ratio

An indicator of a company's short-term liquidity. The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets. The higher the quick ratio, the better the position of the company.

The quick ratio is calculated as:

$$= \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

The quick ratio is more conservative than the current ratio, because it excludes inventory from current assets. Inventory is excluded because some companies have difficulty turning their inventory into cash. In the event that short-term obligations need to be paid off immediately, there are situations in which the current ratio would overestimate a company's short-term financial strength.

Return on Equity (ROE)

A measure of the net income that a business is able to earn as a percent of stockholders' investment. Many analysts consider ROE the single most important financial ratio applying to stockholders and the best measure of performance by a firm's management. Return on equity is calculated by dividing net income after taxes by owners' equity.

Return on Investment (ROI)

A measure of the net income a firm's management is able to earn with its total assets. Return on investment is calculated by dividing net profits after taxes by total assets.

Muskoka Enterprise Centre

Location: 35A Manitoba St., Bracebridge, ON
Mailing: 1000 Taylor Court, Bracebridge, ON P1L 1R6
Phone: 705-646-9021 Fax: 705-645-1262
e-mail: info@muskokaenterprise.com
Serving the District of Muskoka