**Financial Ratios**

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# **Preface**

Financial ratios are referenced in the Income Statement and Cash Flow Statement standards. Ratios provided below are some of the more common ratios and are not a comprehensive list. This document will be updated, as needed, so refer back periodically for future additional ratios to be included.

# **Introduction**

Financial ratios, also known as accounting ratios, are part of the financial statement analysis and will often relate one financial statement amount to another financial statement amount. They are used to perform quantitative analysis and assess an entity’s liquidity, leverage, growth, margins, profitability and more. Analysis of financial ratios serves two main purposes:

1. Track financial performance - comparing ratios in recent periods and tracking the changes in their values over time to spot trends to determine if there is improvement or decline
2. Make comparative judgments – comparing ratios against the same information reported by competitors to determine financial performance against industry averages

Ratios are used by both internal (management) and external (creditors, competitors) parties and are a useful tool in measuring the efficiency and profitability of an entity.

# **Types of Ratios**

## **Leverage Ratios**

Measure the amount of capital that comes from debt. Common leverage ratios include:

|  |  |  |
| --- | --- | --- |
| **Ratio** | **Description** | **Calculation** |
| **Debt Ratio** | Measures the portion of assets financed by debt | Total liabilities ÷ Total assets |
| **Debt to Equity Ratio** | Calculates the weight of total debt and financial liabilities against equity (fund balance) | Total liabilities ÷ Fund Balance |  |

## **Liquidity Ratios**

Measure the ability to meet short term debt obligations with short term assets. Common liquidity ratios include:

|  |  |  |
| --- | --- | --- |
| **Ratio** | **Description** | **Calculation** |
| **Current Ratio** | Measures the ability to pay off short-term liabilities with current assets | Current assets ÷ Current liabilities |
| **Quick Ratio** | Measures the ability to pay short-term obligations using more liquid types of current (quick) assets | (Cash + Marketable securities + Accounts receivable) ÷ Current liabilities |

## **Profitability Ratios**

Measures the ability to generate income. Common profitability ratios include:

|  |  |  |
| --- | --- | --- |
| **Ratio** | **Description** | **Calculation** |
| **Gross Margin Ratio** | Evaluates how much gross profit is generated from sales | Gross profit ÷ Net sales |
| **Contribution Margin Ratio** | Measures percent of revenue available to cover fixed costs and net income | (Sales - Variable expenses) ÷ Sales |
| **Return on Sales Ratio** | Measures percent of income derived from sales | Net Income ÷ Net Sales |

## **Efficiency Ratios**

Measures the ability to use assets and liabilities to generate sales. Common efficiency ratios include:

|  |  |  |
| --- | --- | --- |
| **Ratio** | **Description** | **Calculation** |
| **Accounts Receivable Turnover Ratio** | Measures the average number of times in a year a company collects its open accounts | Net credit sales ÷ Average  accounts receivable |
| **Days' sales in receivables (avg. collection period)** | Provides average number of days it takes to collect a receivable | 365 days ÷ receivables turnover ratio |
| **Inventory Turnover Ratio** | Measures the number of times inventory is sold and replaced | Cost of goods sold ÷ Average inventory |
| **Day's sales in inventory (days to sell)** | Calculates average number of days inventory sits before selling | 365 days ÷ Inventory turnover ratio |