

Glossary of Financial Terms and Ratios

Balance Sheet: a snapshot of a company's financial condition as of a given date.

Income Statement: a financial report that depicts how much a company has made or lost during a particular period by subtracting the cost of goods and expenses from revenue to arrive at a net result, which is either a profit or a loss.

Asset: anything a company owns that has a present or future cash value.

Current Assets: cash and other short term assets (short term investments, accounts receivable, inventory and prepaid expenses) that can be converted into cash within a one-year period.

Liability: a debt or obligation for which a company is legally responsible.

Current Liabilities: Debts or obligations of a company that must be repaid within one year.

Working Capital: $\text{Current Assets} - \text{Current Liabilities}$

Working capital is the difference between a company's current assets and current liabilities, expressed in a total dollar amount. While excess inventory and slow receivable collection can increase working capital without actually improving cash flow, it is generally held that a higher working capital position, along with favorable liquidity ratios, indicates a company is better able to pay its short term obligations within terms.

Example: ABC Company has total current assets of cash, accounts receivable, inventory and prepaid expenses of \$1,000,000. Total current liabilities consist of accounts payable, accrued expenses and borrowings on its short term bank line of credit of \$500,000. Its working capital is \$500,000.

RATIOS

Liquidity Ratios

Liquidity is a measure of the ability of current assets to meet current obligations as they come due. In other words, can a firm quickly convert its assets to cash—without a loss in value—in order to meet its immediate and short-term obligations? These ratios provide a level of comfort to lenders in case of liquidation.

Current Ratio: $\text{Current Assets} \div \text{Current Liabilities}$

Total current assets divided by total current liabilities is a measure of a company's ability to pay its short term obligations in the normal course of business. Those assets that are expected to be converted to cash, sold or consumed in the normal business cycle should be sufficient to liquidate liabilities due within the current fiscal year or the business' normal operating cycle. While a higher ratio can sometimes mean slow receivable collection or excess inventory, it is generally favorable to have a higher current ratio. A less than 1:1 ratio could call into question a company's ability to pay its short term obligations within terms.

Example: ABC Company has total current assets of \$1,000,000 and total current liabilities of \$500,000. Its current ratio is 2:1.

Quick Ratio: $(\text{Cash} + \text{Cash Equivalents} + \text{Accounts Receivable}) \div \text{Current Liabilities}$

Considered a more stringent test of a company's liquidity than the current ratio, this ratio considers only those assets readily convertible to cash to pay current obligations. Generally speaking, like the current ratio, the higher the ratio the better the chances the business will be able to pay its short term obligations within terms.

Example: ABC Company has current assets including cash of \$200,000, accounts receivable of \$200,000 and marketable securities (publicly traded stocks) valued at \$100,000. Current liabilities total \$500,000. The quick ratio is 1:1.

Days Receivable Outstanding: $(\text{Month-end Receivables} \div \text{Month's Sales}) \times 30$

This measures the average number of days that it takes for a company to collect its receivables. The higher the number, the more slowly receivables are collected. A high number suggests a company may be having difficulty collecting their receivables, reducing their liquidity, and possibly impairing their ability to pay their suppliers within terms.

Example: ABC Company has monthly sales of \$200,000 and average accounts receivable of \$200,000. Their Days Receivable Outstanding is 30, meaning their average sale is collected within 30 days and that their receivables turn over approximately 12 times a year.

Days Inventory Held: $(\text{Month-end Inventory} \div \text{Month's Cost of Goods Sold}) \times 30$

This ratio measures the average number of days of inventory that a company has on hand.

Quick inventory turnover can indicate greater liquidity or superior merchandising. Slow inventory turnover means lower liquidity and possible overstocking, or obsolescence.

Example: ABC Company has monthly cost of goods sold of \$50,000 and average inventory of \$100,000, meaning that their inventory turns over every 60 days or approximately 6 times a year.

Days Payable Outstanding: $(\text{Month-end Accts. Payable} \div \text{Month's Cost of Goods Sold}) \times 30$

Assuming that virtually all purchasing is done on a credit basis, the days payable outstanding estimates the average number of days it takes a company to pay its accounts payable. Some accounting treatments can cause discrepancies in this figure, so it is important to evaluate this information in conjunction with other financial statement ratios and the company's specific accounts payable history.

Example: ABC Company has accounts payable of \$75,000 and cost of goods sold for the month of \$60,000. Their days payable outstanding is 37.5 days.

Leverage Ratios

Leverage is a measure of the relationship between the amount of capital provided by creditors and the amount contributed by owners. It addresses the question of how much protection a company's assets provide for the debt held by its creditors. Highly leveraged firms are companies with heavy debt in relation to their net worth. These firms are more vulnerable to business downturns than those with lower debt-to-worth positions.

Debt to Equity: $\text{Total Liabilities} \div \text{Total Equity}$

The debt to equity ratio measures the total debt of the business in relation to the total equity (equity equals the difference between total assets and total debt). The higher the number, the more debt the business carries in relation to invested capital and retained earnings which are the components of equity. Higher debt reduces the possibility of a full payout to creditors in the event of a business liquidation and also has possible negative cash flow implications due to the cost of carrying and servicing the debt through principal and interest payments.

Example: ABC Company has total assets of \$3,000,000, total liabilities of \$2,000,000 and equity of \$1,000,000. The Debt/Equity ratio is 2:1.

Fixed Assets to Equity: $\text{Net Fixed Assets} \div \text{Total Equity}$

Fixed assets to equity reveals what portion of the total assets of a business is invested in property, buildings, equipment and the like, in relation to total equity. Some businesses by nature are more fixed asset intensive. Too high a percentage of fixed assets, depending on the type of business, could suggest a lack of liquid assets to pay short term obligations.

Example: ABC Company has fixed assets after depreciation of \$1,500,000 and total equity of \$1,000,000. Its fixed asset to equity ratio is 1.5:1.

Coverage Ratios

Coverage ratios measure a firm's ability to service its debt. In other words, how well do the company's operating results cover its short-term financial obligations? In contrast to liquidity ratios that focus on the possibility of liquidation, coverage ratios seek to provide lenders a comfort level based on the belief the firm will remain viable.

Debt Service Coverage:

$(\text{Net Income} + \text{Depreciation} + \text{Amortization}) \div \text{Current Maturities of Long Term Debt}$

One measure of a company's ability to pay the current portion of its long term debt (that which is due in the current fiscal year), is to add the net income after taxes and non-cash expenses such as depreciation of fixed assets and amortization, and divide that by the principal payments on long term liabilities due within that year. A ratio of less than 1:1 could indicate difficulty paying those obligations within terms. The higher the number, the greater the company's ability to handle its debt service requirements.

Example: ABC Company has \$100,000 due this year as part of its long term mortgage and other long term financing. Its net income after taxes for the fiscal year was \$75,000 with depreciation expense for the year of \$50,000. The Debt Service Coverage ratio is 1.25:1.

Operating Ratios

Operating ratios are measures to assist in the evaluation of management performance.

Cost of Goods Sold: the costs that go into creating the products that a company sells.

Gross Profit: $\text{Net Sales} - \text{Cost of Goods Sold}$

Gross (Profit) Margin: $\text{Gross Profit} \div \text{Net Sales}$

Gross Profit Margin is the Gross Profit represented as a percentage of Net Sales. This number represents the percentage of sales that a company retains after paying for the basic costs of production (raw materials, employee salaries, and equipment). The Gross Margin also demonstrates the percentage of sales that are left available to be spent on other costs such as marketing, administration, and research and development.

Net Operating Profit: $\text{Gross Profit} - \text{Operating Expenses}$

Net Profit Margin: $\text{Net Operating Profit} \div \text{Net Sales}$

Net Profit Margin tells how well a company converts revenue from core operations into actual profit—how well it controls its costs and what percentage of profit it gets from every dollar of sales.

Example: ABC Company has annual sales of \$2,400,000 with a Cost of Goods Sold of \$1,400,000 and Operating Expenses of \$400,000. Its Gross Profit is \$1,000,000 and its Gross Margin is 42%. Its Net Profit is \$600,000, and its Net Profit Margin is 25%.

Return on Equity (ROE): $\text{After-tax Profit} \div \text{Total Equity}$

This ratio expresses the percentage of return on the amount of capital owners have invested.

Example: ABC Company has annual After-tax Profit of \$100,000 and Total Equity of \$500,000. Its return on equity is 20%.

For more information, please contact:

Charlie@CSuiteAdvisors.org	Charles E. Silva, Jr
www.CSuiteAdvisors.org	C-Suite Advisors, LLC
800.346.9889	PO Box 98489
	Atlanta GA 30359