Financial ratios—what do they mean?

Financial ratios are one of many tools stock analysts and investors use when analyzing a company or industry. No one consistently predicts stock price movements; however, ratios often highlight a company's strengths and/or potential problems. Financial ratios can also give mixed signals about a company's financial health, and can vary significantly among companies, industries, and over time. Consequently, investors should consider a company's products, management, competitors, and vision for the future, as well as financial ratios.

Price Earnings Ratio—There are over 100 different ratios and models used today to analyze companies. The most common is the price earnings (P/E) ratio. It is published daily with the composite transactions of the New York Stock Exchange, American Stock Exchange, and NASDAQ National Market Issues. The P/E ratio (sometimes called the earnings multiplier) measures the degree of optimism investors have with regard to a particular stock. As the name indicates, the ratio is calculated by dividing the current price of a security by the stock's current earnings per share.

A high P/E ratio (compared to the industry) can mean (1) investors are paying more for a company because they expect good future earnings and growth in stock value, or (2) the stock is overpriced and may be heading for a decline. A low P/E ratio (compared to the industry) could mean (1) the stock is undervalued and is likely to increase in value, or (2) the company is in some financial trouble and is not expected to recover in the near future.

Other Common Ratios—Following is a partial list of ratios that are useful when analyzing a company's balance sheet and income statement. These ratios fall into 4 general categories—liquidity, profitability, turnover, and leverage ratios.

Category	Example Ratio	Formula
Liquidity Ratios	Current Ratio	Current Assets/Current Liabilities
	Quick Ratio	Current Assets–Inventory/Current Liabilities
Profitability Ratios	Return on Assets	Net Profits/Total Assets
	Return on Equity	Net Profits/Net Worth (Equity)
	Return on Sales	Net Profits/Annual Net Sales
Turnover Ratios	Accounts Receivable Turnover	Net Yearly Sales/Average Accounts Receivable
	Inventory Turnover	Cost of Goods Sold/Average Inventory
	Interest Coverage	Pretax Income + Interest Expense/Total Debt
Leverage Ratio	Debt to Equity	Total Debt/Total Equity

Liquidity Ratios—These ratios focus on a company's ability to pay bills when due. If liquidity ratios remain relatively high for a prolonged period, too much capital may be invested in liquid assets (e.g., cash, short-term investments, accounts receivable, inventory) and too little devoted to increasing shareholder value.

The current ratio measures a company's ability to meet short-term obligations if sales cease. Depending on the industry, a current ratio of 2 or greater is preferable. If the ratio is less than 1, a company could have trouble meeting current obligations if sales decline.

The quick ratio is similar to the current ratio; however, inventories are excluded from current assets in the quick ratio calculation because inventories can become overvalued within a short time frame. This is particularly true in the retail industry where inventory values can drop significantly if merchandise remains on the store's shelves. Depending on the industry, a quick ratio of 1 or greater is preferable. If the ratio is less than 1, it could be difficult for a company to pay short-term obligations if sales drop.

Profitability Ratios—These ratios vary from industry to industry, and should be compared to a company's ratios for prior years/periods. The return on assets ratio measures how well a company is using its assets to generate net profit. The return on equity ratio measures a company's return on investors' money, while the return on sales ratio considers profit as a percentage of sales. A low return on sales ratio can mean sales prices are too low and/or operating costs are too high.

Turnover Ratios—Efficiency or turnover ratios measure activity or changes in certain assets. Poor turnover generally indicates resources are invested in nonincome producing assets.

The accounts receivable (A/R) turnover ratio measures how quickly a company collects on sales. For example, an A/R turnover ratio of 6 means receivables are paid every 2 months. A low A/R turnover ratio could indicate a company has uncollectible receivables.

The inventory turnover ratio measures how quickly inventory is sold and replaced each year. An inventory turnover of 12 means inventory is sold (turned over) once each month. A low inventory turnover ratio could mean there is a lack of demand for a business's products and/or inventories may be (become) overvalued.

The interest coverage ratio measures a company's ability to make interest payments on debt. If the ratio does not exceed the interest rate on current debt, the business may not be making enough to pay interest expense.

Leverage Ratios—These ratios consider a company's use of borrowed funds (rather than stockholders' equity or investments) to expand its business. The goal is to borrow funds at a low interest rate and invest in a business activity that produces a rate of return exceeding the target rate of return for investments.

The debt to equity ratio measures the long-term solvency of a company by comparing debt to net worth. A company with a high debt to equity ratio could have trouble meeting fixed interest/debt payments if business falters or does not grow as planned.

These are some thoughts to consider when analyzing financial statements. Your Deloitte & Touche financial advisor can provide additional information and should be consulted before any action is taken.

The Thought

No one can make you feel inferior without your consent.

—Eleanor Roosevelt

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