

Evaluating Liquidity (cont'd)

- **Current ratio**
 - Measures short term debt-paying ability

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- **Quick ratio**
 - Also measures short-term debt-paying ability

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Receivables}}{\text{Current Liabilities}}$$

Evaluating Liquidity (cont'd)

- **Receivable turnover**
 - Measures relative size of receivables and effectiveness of credit policies

$$\text{Receivable Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

- **Average days' sales uncollected**
 - Measures average days taken to collect receivables

$$\text{Average Days' Sales Uncollected} = \frac{\text{Days in a Year}}{\text{Receivable Turnover}}$$

Evaluating Liquidity (cont'd)

- **Inventory turnover**

- Measures relative size of inventory

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

- **Average days' inventory on hand**

- Measures average days taken to sell inventory

$$\text{Average Days' Inventory on Hand} = \frac{\text{Days in a Year}}{\text{Inventory Turnover}}$$

Evaluating Profitability (cont'd)

- **Profit margin**

- Measures net income produced by each sales dollar

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

- **Asset turnover**

- Measures how efficiently assets are used to produce sales

$$\text{Asset Turnover} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

Evaluating Profitability (cont'd)

- **Return on assets**
 - Measures overall earning power

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

- **Return on equity**
 - Measures profitability of stockholders' investments

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

Evaluating Long-Term Solvency

... refers to a company's ability to survive for many years

- The aim of long-term solvency analysis is to detect early signs that a company is headed for financial difficulty
 - Declining profitability and liquidity ratios
 - Unfavorable debt to equity ratio
 - Unfavorable interest coverage ratio

Evaluating Long-Term Solvency (cont'd)

- **Interest coverage ratio**
 - Measure of creditors' protection from default on interest payments

$$\text{Interest Coverage Ratio} = \frac{\text{Income Before Income Taxes} + \text{Interest Expense}}{\text{Interest Expense}}$$

Evaluating Cash Flow Adequacy (cont'd)

- **Cash flow yield**
 - Measures overall ability to generate operating cash flows in relation to net income

$$\text{Cash Flow Yield} = \frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Income}}$$

- **Cash flows to sales**
 - Measures ability of sales to generate operating cash flows

$$\text{Cash Flows to Sales} = \frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Sales}}$$

Evaluating Cash Flow Adequacy (cont'd)

- **Cash flow to assets**

- Measures ability of assets to generate operating cash flows

$$\text{Cash Flows to Assets} = \frac{\text{Net Cash Flows from Operating Activities}}{\text{Average Total Assets}}$$

- **Free cash flow**

- Measures cash generated or cash deficiency after providing for commitments

$$\text{Free Cash Flow} = \text{Net Cash Flows from Operating Activities} \\ - \text{Dividends} - \text{Net Capital Expenditures}$$

Evaluating Market Strength (cont.)

- **Price/earnings ratio**

- Measures investor confidence in a company

$$\text{Price/Earnings Ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share}}$$

- **Dividends yield**

- Measures a stock's current return to an investor in the form of dividends

$$\text{Dividends Yield} = \frac{\text{Dividends per Share}}{\text{Market Price per Share}}$$

Discussion

Q. What is the difference between liquidity and solvency?

A. Liquidity is a firm's ability to meet its current obligations, whereas solvency is a firm's ability to meet all its maturing obligations as they come due, without losing the ability to continue operations

Time for Review

1. Describe and discuss financial performance evaluation by internal and external users.
2. Describe and discuss the standards for financial performance evaluation.
3. Identify the sources of information for financial performance evaluation.

... And Finally

4. Apply horizontal analysis, trend analysis, vertical analysis, and ratio analysis to financial statements.
5. Apply ratio analysis to financial statements in a comprehensive evaluation of a company's financial performance.