6 Basic Financial Ratios and What They Reveal

Trade for
Good.

Ratios **track company performance**.

They can **rate and compare one company against another** that you might be considering investing in.

Ratios can help make you a **more informed investor** when they're properly understood and applied.

KEY TAKEAWAYS

- There are six basic ratios that are often **used to pick stocks for investment portfolios**

KEY TAKEAWAYS cont.

- Ratios include the
  working capital ratio,
  the **quick ratio**,
  earnings per share (EPS),
  price-earnings (P/E),
  debt-to-equity, and
  return on equity (ROE)
- Most ratios are **best used in combination** with others rather than singly to accomplish a comprehensive picture of a company's financial health

Trade for
Good.

1. Working Capital Ratio

The Working Capital ratio is helpful to **measure liquidity**. Liquidity refers to how easily a company can turn assets into cash.

current assets - current liabilities = working capital

The working capital ratio, like working capital, **compares current assets to current liabilities** and is a metric used to measure liquidity.

Working Capital Ratio cont.

A working capital **ratio of 1** can imply that a company **may have liquidity troubles** and not be able to pay its short-term liabilities.

A **ratio of 2** or higher can **indicate healthy liquidity** and the ability to pay short-term liabilities, but it could also point to a company that has too much in short-term assets such as cash.

Trade for **Good.**

2. Quick Ratio

It's another **measure of liquidity**.
It represents a company's **ability to pay current liabilities** with assets that can be converted to cash quickly.

current assets - inventory prepaid expenses / current liabilities
(current assets minus inventory minus prepaid expenses divided by current liabilities).

The formula removes inventory because it can take time to sell and convert inventory into liquid assets.

Quick Ratio cont.

A quick **ratio of less than 1** can **indicate that there aren't enough liquid assets** to pay short-term liabilities.

The company may have to raise capital or take other actions. On the other hand, it may be a temporary situation.

3. Earnings Per Share

Earnings per share (EPS) is a **measure of the profitability** of a company. Investors use it to gain an **understanding of company value**.

The company's analysts calculate EPS by dividing net income by the weighted average number of common shares outstanding during the year:

net income / weighted average = earnings per share

Trade for Good.

Earnings Per Share cont.

Earnings per share will also be zero or negative if a company has zero earnings or negative earnings representing a loss.

A higher EPS indicates greater value.

Trade for **Good.**

4. Price-Earnings Ratio (P/E)

The P/E ratio is used by investors to **determine a stock's potential for growth**. It reflects how much they would pay to receive $1 of earnings.

To calculate the P/E ratio, divide a company's current stock price by its earnings-per-share to calculate the P/E ratio:

current stock price / earning- per-share = price-earnings ratio

Trade for **Good.**

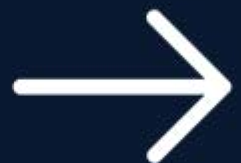
Price-Earnings Ratio (P/E) cont.

It's often **used to compare the potential value of a selection of stocks**.

Investors have been willing to pay more than 20 times the EPS for certain stocks when they've felt that a future growth in earnings would give them adequate returns on their investments.

The P/E ratio will no longer make sense if a company has zero or negative earnings. It will appear as N/A for "not applicable."

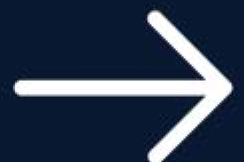
Trade for Good.



5. Debt-to-Equity Ratio

The debt-to-equity (D/E) ratio **measures how much a company is funding its operations using borrowed money**. It can indicate whether shareholder equity can cover all debts, if necessary.

Investors often **use it to compare the leverage used by different companies** in the same industry. This can help them to determine which might be a lower-risk investment.



Debt-to-Equity Ratio cont.

Divide total liabilities by total shareholders' equity to calculate the debt-to-equity ratio:

total liabilities / total shareholders' equity = debt-to-equity ratio

But like all other ratios, the metric must be analysed in terms of industry norms and company-specific requirements.

6. Return on Equity (ROE)

Return on equity (ROE) **measures profitability** and how effectively a company uses shareholder money to make a profit. ROE is expressed as a percentage of common stock.

It's calculated by taking net income (*income less expenses and taxes*) figured before paying common and preferred share dividends.

A **good ROE** to be one that **increases steadily over time**.

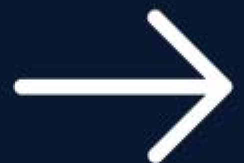
Trade for **Good.**

Return on Equity (ROE) cont.

Divide the result by total shareholders' equity:

net income (expenses and taxes before paying common share dividends and after paying preferred share dividends) / total shareholders' equity = return on equity

This could indicate that a company does a good job using shareholder funds to increase profits. That can in turn increase shareholder value.



The Bottom Line

Financial ratios can help you pick the best stocks for your portfolio and build your wealth.

Dozens of financial ratios are used in fundamental analysis. The six highlighted are the most common and the easiest to calculate.

A company cannot be properly evaluated using just one ratio in isolation. Use a variety of ratios for more confident investment decision-making.

Trade for
Good.