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Want to learn Fundamental Investing?

I am committing to teaching basic fundamental investing, which will include a balance sheet, cash flow statement, income statement and all ratios revolving around them.

I will add one ratio every day to this thread■■:

1) Quick Ratio:

As the name suggests, this ratio is used to analyse how quickly can a company generate cash during turbulence or need.

It represents assets of a company that can be converted to cash in less than 90 days against its liabilities.

$$\text{Quick Ratio} = \frac{\text{Cash + Cash Equivalents + Short Term Investments + Current Receivables}}{\text{Current Liabilities}}$$

A ratio of 2 denotes it has twice as much cash to pay off any short-term liabilities, while a ratio of less than 1 denotes it might struggle in the short-term in case there's a cash crunch or business failure.

2) Working Captial Ratio:

It's also called the current ratio, which is a liquidity ratio that measures a firm’s ability to pay off its current liabilities with current assets. It's important to creditors because it shows the liquidity of the company.

Here's how it's calculated:

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

Since the working capital ratio measures current assets as a percentage of current liabilities, it would only make sense that a a higher ratio is more favourable. A WCR of 1 indicates the current assets equal current liabilities.

A ratio of 1 is usually considered the middle ground. It's not risky, but it is also not very safe. This means that the firm would have to sell all of its current assets in order to pay off its current liabilities.

A ratio less than 1 is considered risky by creditors and investors because it shows the company isn't running efficiently and can't cover its current debt properly. A ratio less than 1 is always a bad thing and is often referred to as negative working capital.

3) Times Interest Earned Ratio:
The times interest earned ratio, sometimes called the interest coverage ratio, is a coverage ratio that measures the proportionate amount of income that can be used to cover interest expenses in the future.

In some respects the times interest ratio is considered a solvency ratio because it measures a firm's ability to make interest and debt service payments.

Since interest payments are usually made on long-term basis, they are often treated as an ongoing, fixed expense. As with most fixed expenses, if the company can't make the payments, it could go bankrupt and cease to exist. Thus, this ratio could be considered a solvency ratio.

Here's a quick visual on the same:

$$\text{Times Interest Earned Ratio} = \frac{\text{Income before Interst and Taxes or EBIT}}{\text{Interest Expense}}$$

Significance: The times interest ratio is stated in numbers as opposed to a percentage. The ratio indicates how many times a company could pay the interest with its before tax income, so obviously the larger ratios are considered more favorable than smaller ratios.

In other words, a ratio of 4 means that a company makes enough income to pay for its total interest expense 4 times over. Said another way, this company's income is 4 times higher than its interest expense for the year.

Next, we move on to Solvency Ratios.

Let's start with the most fundamental one, shall we?

1) Debt to Equity Ratio:

The debt to equity ratio is a financial, liquidity ratio that compares a company's total debt to total equity.

The debt to equity ratio shows the percentage of company financing that comes from creditors and investors. A higher debt to equity ratio indicates that more creditor financing (bank loans) is used than investor financing (shareholders).

Each industry has different debt to equity ratio benchmarks, as some industries tend to use more debt financing than others. A the debt ratio of .5 means that there are half as many liabilities than there is equity.

In other words, the assets of the company are funded 2-to-1 by investors to creditors. This means that investors own 66.6 cents of every dollar of company assets while creditors only own 33.3 cents on the dollar.

Debt to equity ratio of 1 would means that investors and creditors have an equal stake in the business assets.

Here's how it's calculated:

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Significance:
A lower debt to equity ratio usually implies a more financially stable business.
Companies with a higher debt to equity
ratio are considered riskier to creditors and investors than companies with a
lower ratio.

Unlike equity financing, debt
must be repaid to the lender. Since debt
financing also requires debt servicing or
regular interest payments, debt can be a
far more expensive form of financing than
equity financing. High leveraging
of debt might hurt companies
to make the payments

2) Equity Ratio:
The equity ratio is the investment leverage or solvency ratio that measures the number of assets that are financed by owners' investments by comparing the total equity in the company to the total assets.

The equity ratio highlights two important financial concepts of a solvent and sustainable business. The first component shows how much of the total company assets are owned outright by the investors.

The second component inversely shows how leveraged the company is with debt. The equity ratio measures how much of a firm's assets were financed by investors.
In other words, this is the investors' stake in the company. This is what they are on
the hook for.

Here's how it's calculated:

$$\text{Equity Ratio} = \frac{\text{Total Equity}}{\text{Total Assets}}$$

Significance: -Higher equity ratios are typically favourable for companies. Higher investment levels by shareholders shows potential shareholders that the company is worth investing in since so many investors are willing to finance the company.

A higher ratio also shows potential creditors that the company is more sustainable and less risky to lend future loans.

3) Debt Ratio:
The debt ratio is a solvency ratio that measures a firm's total liabilities as a percentage of its total assets. In a sense, the debt ratio shows a company's ability to pay off its liabilities with its assets.

This shows how many assets the company must sell in order to pay off all of its liabilities.
This ratio measures the financial leverage of a company. Companies with higher levels of liabilities compared with assets are considered highly leveraged and riskier for lenders.

Here's how to calculate it:

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

The debt ratio is shown in decimal format because it calculates total liabilities as a percentage of total assets. As with many solvency ratios, a lower ratio is more favourable than a higher ratio.

A lower debt ratio usually implies a more stable business with the potential of longevity because a company with a lower ratio also has lower overall debt. Each industry has its own benchmarks for debt.

A debt ratio of .5 is often considered to be less risky. This means that the company has twice as many assets as liabilities. Or said a different way, this company's liabilities are only 50 percent of its total assets.

Only its creditors own half of the company's assets and the shareholders own the remainder of it.
A ratio of 1 means that total liabilities equals total assets. The company would have to sell off all of its assets in order to pay off its liabilities. This is a high leverage firm.

Next, we move on to Efficiency Ratios:

1) Accounts Receivable Turnover:

What are accounts receivable?

It's an efficiency ratio or activity ratio that measures
how many times a business can turn its accounts receivable into cash during a period.

In other words, the accounts receivable turnover ratio measures how many times a business can collect its average accounts receivable during the year. A turn refers to each time a company collects its average receivables.

E.g- If a company had $20,000 of average receivables
during the year and collected $40,000 of receivables during the year, the company would have turned its accounts receivable twice because it collected twice the
amount of average receivables.

This ratio shows how efficient a company is at collecting its credit sales from customers. Some companies collect their receivables from customers in 90 days while others take up to 6 months to collect from customers.

Here's how it's calculated:

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

Significance:
Since the receivables turnover ratio measures a business' ability to efficiently collect its receivables, it only makes sense that a higher ratio would be more favourable.

Higher ratios mean that companies are collecting their receivables more frequently throughout the year. For instance, a ratio of 2 means that the company collected its average receivables twice during the year.

In other words, this company is collecting is money from customers every six months. Higher efficiency is favourable from a cashflow standpoint too. If a company can collect cash from customers sooner, it will
be able to use that cash to pay bills and other obligations sooner.

Accounts receivable turnover also is an indication of the quality of credit sales and receivables. A company with a higher ratio shows that credit sales are more likely to be collected than a company with a lower ratio. Most important here is the quality of recievables.

2) Asset Turnover Ratio:

The asset turnover ratio is an efficiency ratio that measures a company's ability to generate sales from its assets by comparing net sales with average total assets.

This ratio shows how efficiently a company can use its assets to generate sales.

The total asset turnover ratio calculates net sales as a percentage of assets to show how many sales are generated from each dollar of company assets. For instance, a ratio of .5 means that each dollar of assets
generates 50 cents of sales.

This ratio measures how efficiently a firm uses its assets to generate sales, so a higher ratio is always more favourable. Higher turnover ratios mean the company is using its assets more efficiently and vice-versa!

Here's how it's calculated:

$$\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{AverageTotal Assets}}$$

Significance: For instance, a ratio of 1 means that the
net sales of a company equal the average total assets for the year. In other words, the company is generating 1 dollar of sales for every dollar invested in assets.

Like with most ratios, the asset turnover ratio is based on industry standards. Some industries use assets more efficiently than others. To get a true sense of how well a
company's assets are being used, it must
be compared to other companies in its industry.

The total asset turnover ratio is a general efficiency ratio that measures how efficiently a company uses all of its assets. This gives investors and creditors an idea of how a company is managed and uses its assets to produce products and sales.