1 Liquidity Ratios

Liquidity ratios indicate the ease at which a business can turn current assets into cash in order to meet its current obligations.

1.1 Current Ratio

Compares the ratio between current assets and current liabilities to determine the liquidity of the business and the ability of the business to meet short-term obligations. It is the liquid reserve available to satisfy contingencies and uncertainties.

1.2 Quick Ratio

The quick ratio is similar to the current ratio, except it removes inventory from the asset equation and just considers cash, marketable securities and accounts receivable. This ratio must be used carefully though as some companies can turn inventory into cash more quickly than others can collect receivables. The result can also be impacted by the business’s industry.

1.3 Cash Ratio

The cash ratio indicates a conservative view of liquidity as it assumes that a business may have pledged its receivables and its inventory, or that its inventory and receivables are relatively illiquid.
Leverage Ratios

Leverage ratios measure the relative contribution of stockholders and creditors and indicate the extent to which the business is reliant on debt financing.

2.1 Debt to Assets Ratio

The Debt to Assets ratio shows the extent to which a company uses debt as a form of financing. It indicates the percentage of total assets that are financed by creditors, liabilities and debt. The higher the ratio of debt to assets, the greater the financial risk.

2.2 Debt to Equity Ratio

The Debt to Equity ratio highlights how much of the business is financed by debt compared to the amount financed by equity.

2.3 Interest Coverage Ratio

Like the Coverage Ratio, the Interest Coverage Ratio indicates how well the business may cover its future loan payments. It is a good indicator to consider when assessing a business for a loan as it indicates the degree to which interest expenses are covered with company’s earnings before tax.

2.4 Debt to Income Ratio

The Debt to Income ratio is similar to the Leverage Factor however it considers Debt to Total Income as opposed to Debt to EBITDA. Again, it should be measured in years and thus provides an indication of the time taken for a business to pay its liabilities under existing business terms and profits generated.

It can be useful to compare the Debt to Income Ratio against the Leverage Ratio to ensure that the impact of operating costs does not significantly destroy the business’s ability to repay debts.

For businesses in the construction industries, Absa takes into account both the Leverage Factor and the Debt to Turnover ratio.

2.5 Debt Service Coverage Ratio

The Debt Service Coverage Ratio (DSCR) measures the cash flow a business has available to pay its debt. In the calculation EBITDA (i.e. operating profit) is used as a proxy for cash flow.
3 Alternative Ratios

3.1 Altman Z

The Z-score model is a quantitative model developed in 1968 by Edward Altman to predict bankruptcy (financial distress) of a business, using a blend of the traditional financial ratios and a statistical method known as multiple discriminant analysis.

The Z-score is known to be about 90% accurate in forecasting business failure one year into the future and about 80% accurate in forecasting it two years into the future.

Using the following 8 variables from the Income Statement and Balance Sheet

- Earnings Before Interest & Taxes
- Total Assets
- Net Sales
- Market Value of Equity
- Total Liabilities
- Current Assets
- Current Liabilities
- Retained Earnings