100 US GAAP Financial Ratios

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Author's preface

Dear readers,

Fundamental research and analysis is the key for a solid and successful investment. Understanding and analyzing ratios such as operating income (EBIT), operating cash flow or working capital helps to determine a company's performance.

The book not only addresses financial market professionals, but also banks, auditors, tax accountants and especially small and mid-size businesses for better assessing its own financial position.

For a better understanding we have added a sample calculation to each ratio's definition as well as the fields of application. A critical assessment of each financial ratio is explained by discussing both advantages and disadvantages. Please note that differences in the way of calculation may still exist, which you should be aware of.

When analyzing financial ratios, one should make sure to always compare the ratios relative to the peer-group and the industry standards, as otherwise an isolated number would have a very limited significance. Finally the key for successful research is to transfer comprehensive analysis of several indicators into a meaningful result. For this purpose the book delivers a strong added value.

Sincerely, your authors

E-mail your comments to: **USGAAP_Ratios@cometis.de**

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2.1 Operating income / EBIT

Formula	Sample calculation
Net sales	14,019
– Cost of sales	5,004
– Operating expenses	7,857
+ Other operating income	294
= **Operating income / EBIT**	= **1,452**

Explanation

Operating income respectively operating profit is also known as EBIT, which stands for "earnings before interest and taxes". It is generally used to assess the company's earnings position, in particular in international comparisons. However, EBIT is not only pure earnings before interest and taxes as it is referred to by many people, but in more precise terms it is the operating result before the financial and thus investment result, which may have a major impact on the pre-tax earnings depending on the respective company.

Advantages	Disadvantages
• Allows assumptions to be made about pure operating activities	• Only meaningful when considered together with other indicators (e.g., revenues)
• Industry-wide comparisons of operating income are possible, in particular when other ratios are also considered (e.g., revenues)	• Interest income, which may not be included in EBIT, can be part of operating income (income from financing activities, e.g., financing installments)
• Distortions from tax effects are not included	• Income which may not stem from the operating activities may also be included in this figure (rental income)
• Used internationally	

6.1 Equity ratio

Formula

$$\frac{\text{Total stockholder's equity}}{\text{Total liabilities and stockholder's equity}} \times 100\%$$

Sample calculation

$$\frac{5{,}457}{10{,}134} \times 100\% = \mathbf{53.85\%}$$

Explanation

The equity ratio describes the relationship between stockholder's equity and total capital, i.e. total liabilities and stockholder's equity. As a rule, the more equity a company has available the better its credit-worthiness, the higher its financial stability and the more independent the company is from lenders. However, as equity is more expensive than debt (see also WACC, page 131), a high equity ratio depresses the return on capital employed. When calculating the equity ratio, we can either use total capital or, as generally practiced by financial analysts in particular when calculating the costs of capital, only use the sum of total equity and interest-bearing debt.

Advantages	Disadvantages
• Shows the type and composition of capital	• Depends heavily on industry and valuations
• Easy to calculate	• Hidden assets reduce the actual value of equity
• Serves to calculate the debt level (leverage) and allows assumptions to be made about a company's stability	• Balance sheet figures are now often being replaced by frequently used market values (e.g., use of market capitalization instead of balance-sheet equity to calculate costs of capital)
• Helpful in same-industry comparisons as an indicator for a company's relative financial strength	