



## Key Financial Ratios

### Liquidity Ratios:

#### **Current Ratio**

$$= \text{Current Assets} / \text{Current Liabilities}$$

Measures the ability of an organization to pay current liabilities with current assets. Calculate this ratio by simply dividing current assets by current liabilities. A current ratio of 1 indicates that current assets exactly cover current liabilities, while a current ratio less than 1 indicates a deficiency of current assets and anything greater than 1 indicates a surplus of current assets.

#### **Quick Ratio**

$$= (\text{Cash and Cash Equivalents}) / \text{Current Liabilities}$$

Measures the ability of an organization to pay current liabilities with *only the most liquid current assets*: cash and cash equivalents (investments). This is a more sensitive, more narrowly defined, liquidity test than the *current ratio*. For instance, an agency might have current assets of cash, investments, accounts receivable, and inventory, but the latter two assets, respectively, are uncollectable and tied up; in this instance, an organization would want to know how easily it could cover those bills coming due within the year with only cash and investments, given that the other two categories are, at least temporarily, illiquid.

#### **Months of Cash**

$$= (\text{Cash and Cash Equivalents}) / [(\text{Expenses-Depreciation}) / 12]$$

Measures how many months of expenses the agency could pay with the cash that it has on hand. Calculate this ratio by dividing the agency's cash, plus cash equivalents, by one twelfth of the agency's annual expenses, minus depreciation (a non-cash expense); the result of this calculation will be expressed in months. A good rule of thumb requires an agency to have three months of cash to cover an average month of expense. However, fewer months of cash should only be considered a cause for concern if the agency lacks other liquidable current assets to pay its current liabilities.



## **Financial Leverage Ratios**

### ***Net Asset Ratio***

$$= \text{Net Assets} / \text{Total Assets}$$

Calculates the percent of total assets that the agency owns outright, or free and clear from debt obligations. In general, an agency should have a large enough net asset base to cover future fluctuations in net income.

### ***Long-term Debt to Net Assets***

$$= \text{Total Long-term Debt} / \text{Total Net Assets}$$

Calculates the proportion of long-term debt obligations to the amount of total net assets; or, in other words, it measures the level of indebtedness, or leverage, of an agency. The long-term debt to net asset (or equity) ratio measures how much money an organization should safely be able to borrow over long periods of time. This ratio should also be reviewed in the context of an agency's liquidity health and consistency of cash flow production. For example, an agency with healthy liquidity, which produces regular, positive cash flow, would be better positioned to meet monthly principal and interest payments, and therefore take on greater amounts of debt.

### ***Debt Service Coverage Ratio (DSCR)***

$$= (\text{Surplus} + \text{Interest} + \text{Depreciation}) / \text{Annual Principal and Interest Payments}$$

The debt service coverage ratio (DSCR), is the ratio of cash available for debt servicing to interest, principal and lease payments. It is a popular [benchmark](#) used in the measurement of an entity's (person or corporation) ability to produce enough cash to cover its debt (including lease) payments. The higher this ratio is, the easier it is to obtain a loan. The phrase is also used in commercial banking and may be expressed as a minimum ratio that is acceptable to a lender; it may be a loan condition or covenant. Breaching a DSCR covenant can, in some circumstances, be an act of [default](#).



## **Asset Turnover Ratios:**

### ***Days Receivable***

$$= \text{Accounts Receivable Outstanding} / (\text{Annual Revenue} / 360)$$

This ratio tells the analyst how many days it takes the agency to convert receivables into cash—it measures, in other words, the average collection period. Calculate this ratio by dividing the amount of receivables outstanding by average daily revenue. Be sure to view this ratio in light of the agency's average collection period, so any significant deviations can, if necessary, be reacted to in a timely manner.

### ***A/R Turnover***

$$= 360 / (\text{Days Receivable})$$

This ratio simply takes the *Days Receivable* and asks: given that it takes X days to convert receivables into cash, how many times per year does this cash conversation happen? For example, if *Days Receivable* is 60, then *A/R Turnover* is equal to 6: 360 days/60 days = 6. In other words, if, on average, it takes an agency 60 days to turn receivables into cash, receivables are converted, or “turned over,” into cash 6 times per year.

### ***Days Payable***

$$= \text{Accounts Payable Outstanding} / (\text{Annual Expense} / 360)$$

Measures the average amount of time it takes an agency to pay bills. To find this number, simply do the same thing you did for accounts receivable; that is, divide the amount of payables outstanding by average daily expense. As with the *Days Receivable* ratio, be sure to look at this ratio in a historical context to uncover possible payment problems.

### ***A/P Turnover***

$$= 360 / (\text{Days Payable})$$

Similar to the calculation for receivables, this ratio simply takes the *Days Payable* number and asks how many times per year, does the agency pay off average amounts payable? For example, if *Days Payable* is 30, then *A/P Turnover* is equal to 12: 360 days/30 days = 12.

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