

9.5: Key Ratios

Learning Objectives

- Use key ratios to inform decisions

Additional key ratios important in helping a retailer judge performance and financial well-being include inventory turnover, current ratio, quick ratio, and return on investment.

Inventory turnover is a measure of the productivity of inventory. The formula to calculate inventory turnover is $\text{inventory turnover} = \text{cost of goods sold} / \text{average inventory at cost}$.

Current ratio is a measure of financial strength, reflecting the firm's ability to pay short and long-term obligations. The formula considers the company's current total assets (both liquid and fixed) relative to its current total liabilities. The formula to calculate the current ratio is $\text{current ratio} = \text{current assets} / \text{current liabilities}$.

Quick ratio is another measure of financial strength. However, inventory is NOT counted among current assets because the quick ratio seeks to describe a firm's ability to pay short and long-term obligations, but does not regard inventory as sufficiently liquid. Instead, it considers only assets that can be converted to cash within 90 days like cash, cash equivalents, marketable securities like stocks and bonds and accounts receivable. The formula for the quick ratio is $\text{quick ratio} = (\text{current assets} - \text{inventory}) / \text{current liabilities}$.

Return on investment (ROI), also known as return on net worth (RONW), is a performance measure used to assess the efficiency of an investment—how well it generates profit compared to another investment. The formula for ROI is $\text{ROI} = \text{net profit} / \text{investment cost}$.

Although we've examined them previously, we include both gross margin percentage ($\text{gross margin} / \text{net sales}$) and net profit margin ($\text{net profit} / \text{net sales}$) here because they, like the others, are part of the strategic profit model.

Practice Questions

<https://assessments.lumenlearning.co...sessments/9241>

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