

Financial Ratios

The use of financial figures to gain significant information about a company

A free best practices guide for essential ratios in comprehensive financial analysis and business decision-making.

[Download](#)

Written by [CFI Team](#)

What are Financial Ratios?

Financial ratios are created with the use of numerical values taken from [financial statements](#) to gain meaningful information about a company. The numbers found on a company's financial statements – [balance sheet](#), [income statement](#), and [cash flow statement](#) – are used to perform [quantitative analysis](#) and assess a company's liquidity, leverage, growth, margins, profitability, rates of return, valuation, and more.

Financial ratios are grouped into the following categories:

Liquidity ratios

Leverage ratios

Efficiency ratios

Profitability ratios

Market value ratios

Uses and Users of Financial Ratio Analysis

Analysis of financial ratios serves two main purposes:

1. Track company performance

Determining individual financial ratios per period and tracking the change in their values over time is done to spot trends that may be developing in a company. For example, an increasing debt-to-asset ratio may indicate that a company is overburdened with debt and may eventually be facing default risk.

2. Make comparative judgments regarding company performance

Comparing financial ratios with that of major competitors is done to identify whether a company is performing better or worse than the industry average. For example, comparing the return on assets between

companies helps an analyst or investor to determine which company is making the most efficient use of its assets.

Users of financial ratios include parties external and internal to the company:

External users: Financial analysts, retail investors, creditors, competitors, tax authorities, regulatory authorities, and industry observers

Internal users: Management team, employees, and owners

Liquidity Ratios

Liquidity ratios are financial ratios that measure a company's ability to repay both short- and long-term obligations. Common liquidity ratios include the following:

The **current ratio** measures a company's ability to pay off short-term liabilities with current assets:

$$\text{Current ratio} = \text{Current assets} / \text{Current liabilities}$$

The **acid-test ratio** measures a company's ability to pay off short-term liabilities with quick assets:

$$\text{Acid-test ratio} = \text{Current assets} - \text{Inventories} / \text{Current liabilities}$$

The **cash ratio** measures a company's ability to pay off short-term liabilities with cash and cash equivalents:

$$\text{Cash ratio} = \text{Cash and Cash equivalents} / \text{Current Liabilities}$$

The **operating cash flow ratio** is a measure of the number of times a company can pay off current liabilities with the cash generated in a given period:

$$\text{Operating cash flow ratio} = \text{Operating cash flow} / \text{Current liabilities}$$

Leverage Financial Ratios

Leverage ratios measure the amount of capital that comes from debt. In other words, leverage financial ratios are used to evaluate a company's debt levels. Common leverage ratios include the following:

The [debt ratio](#) measures the relative amount of a company's assets that are provided from debt:

$$\text{Debt ratio} = \text{Total liabilities} / \text{Total assets}$$

The [debt to equity ratio](#) calculates the weight of total debt and financial liabilities against shareholders' equity:

$$\text{Debt to equity ratio} = \text{Total liabilities} / \text{Shareholder's equity}$$

The [interest coverage ratio](#) shows how easily a company can pay its interest expenses:

$$\text{Interest coverage ratio} = \text{Operating income} / \text{Interest expenses}$$

The debt service coverage ratio reveals how easily a company can pay its debt obligations:

$$\text{Debt service coverage ratio} = \text{Operating income} / \text{Total debt service}$$

Efficiency Ratios

Efficiency ratios, also known as activity financial ratios, are used to measure how well a company is utilizing its assets and resources. Common efficiency ratios include:

The [asset turnover ratio](#) measures a company's ability to generate sales from assets:

$$\text{Asset turnover ratio} = \text{Net sales} / \text{Average total assets}$$

The [inventory turnover ratio](#) measures how many times a company's inventory is sold and replaced over a given period:

$$\text{Inventory turnover ratio} = \text{Cost of goods sold} / \text{Average inventory}$$

The accounts receivable turnover ratio measures how many times a company can turn receivables into cash over a given period:

Receivables turnover ratio = Net credit sales / Average accounts receivable

The [days sales in inventory ratio](#) measures the average number of days that a company holds on to inventory before selling it to customers:

Days sales in inventory ratio = 365 days / Inventory turnover ratio

Profitability Ratios

[Profitability ratios](#) measure a company's ability to generate income relative to revenue, balance sheet assets, operating costs, and equity. Common profitability financial ratios include the following:

The [gross margin ratio](#) compares the gross profit of a company to its net sales to show how much profit a company makes after paying its cost of goods sold:

Gross margin ratio = Gross profit / Net sales

The [operating margin ratio](#), sometimes known as the return on sales ratio, compares the operating income of a company to its net sales to determine operating efficiency:

Operating margin ratio = Operating income / Net sales

The [return on assets ratio](#) measures how efficiently a company is using its assets to generate profit:

Return on assets ratio = Net income / Total assets

The [return on equity ratio](#) measures how efficiently a company is using its equity to generate profit:

Return on equity ratio = Net income / Shareholder's equity

Learn more about the different profitability ratios in the following video:

Market Value Ratios

Market value ratios are used to evaluate the share price of a company's stock. Common market value ratios include the following:

The book value per share ratio calculates the per-share value of a company based on the equity available to shareholders:

$$\text{Book value per share ratio} = (\text{Shareholder's equity} - \text{Preferred equity}) / \text{Total common shares outstanding}$$

The dividend yield ratio measures the amount of dividends attributed to shareholders relative to the market value per share:

$$\text{Dividend yield ratio} = \text{Dividend per share} / \text{Share price}$$

The earnings per share ratio measures the amount of net income earned for each share outstanding:

$$\text{Earnings per share ratio} = \text{Net earnings} / \text{Total shares outstanding}$$

The [price-earnings ratio](#) compares a company's share price to its earnings per share:

$$\text{Price-earnings ratio} = \text{Share price} / \text{Earnings per share}$$

Related Readings

Thank you for reading CFI's guide to financial ratios. To help you advance your career in the financial services industry, check out the following additional CFI resources:

Activity Ratios

Comparable Company Analysis

Enterprise Value-to-Sales (EV/Sales)

Solvency Ratio

Types of Financial Models

See all accounting resources

See all capital markets resources

Free Accounting Courses

Learn accounting fundamentals and how to read financial statements with CFI's [free online accounting classes](#).

These courses will give the confidence you need to perform world-class financial analyst work. Start now!

Building confidence in your accounting skills is easy with CFI courses! [Enroll now for FREE](#) to start advancing your career!

Share this article

Get Certified for Commercial Banking (CBCA®)

Stand out and gain a competitive edge as a commercial banker, loan officer or credit analyst with advanced knowledge, real-world analysis skills, and career confidence.

[Learn More](#)

We're hiring!

Company

Certifications

Courses

Support

Resources



© 2015 to 2023 CFI Education Inc.

[Privacy Policy](#) | [Terms of Use](#) | [Terms of Service](#) | [Legal](#)