# Financial Ratios

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



## 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

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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:

**Current ratio = Current assets / Current liabilities**

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

**Acid-test ratio = Current assets – Inventories / Current liabilities**

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

**Cash ratio = Cash and Cash equivalents / 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:

**Operating cash flow ratio = Operating cash flow / Current liabilities**

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:

**Debt ratio = Total liabilities / Total assets**

The debt to equity ratio calculates the weight of total debt and financial liabilities against shareholders' equity:

**Debt to equity ratio = Total liabilities / Shareholder's equity**

The interest coverage ratio shows how easily a company can pay its interest expenses:

**Interest coverage ratio = Operating income / Interest expenses**

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

**Debt service coverage ratio = Operating income / 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:

**Asset turnover ratio = Net sales / Average total assets**

inventory is sold and replaced over a given period:

**Inventory turnover ratio = Cost of goods sold / 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 compares the operating income of a company to its net sales to determine operating efficiency:

**Operating margin ratio = Operating income / Net sales**

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**

## 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:

**Book value per share ratio = (Shareholder's equity – Preferred equity) / Total common shares outstanding**

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

**Dividend yield ratio = Dividend per share / Share price**

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

**Earnings per share ratio = Net earnings / Total shares outstanding**

The price-earnings ratio compares a company's share price to its

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- How the 3 Financial Statements are Linked
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