UNIVERSITY OF THE PEOPLE

BUS 4404-01 PRINCIPLES OF FINANCE 2 - AY2024-T3

LEARNING JOURNAL UNIT 1

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Financial Ratio Analysis

The fundamental concept underpinning ratio analysis is comparing different figures from a company's financial statements to derive insightful calculated values. The ratios themselves hold little meaning in isolation. The true value comes from benchmarking these ratios against prior periods for the same company to assess financial trajectory or comparing them to ratios for peer companies in the same industry to evaluate relative financial health (Bloomenthal, 2023). For instance, the current ratio which divides current assets by current liabilities quantifies a company's ability to cover short-term obligations. While a value of 1.5 could be considered good, that assessment has far more weight if the ratio is higher than the industry average of 1.0 or the company's own ratio last year of 1.0, signaling strengthening liquidity. This relative comparison allows ratio analysis to become a powerful tool for evaluating financial performance.

Liquidity Ratios

The ***current ratio*** and ***quick ratio*** (also called the acid test ratio) are two important measures of a company's liquidity or its ability to pay off short-term debts and expenses. The current ratio tells us the number of times a company can pay off current liabilities with current assets. A higher number indicates good short-term financial health. Similarly, the quick ratio more strictly measures a company’s capacity to pay debts using quick assets that can rapidly convert into cash. These ratios help assess whether the business has sufficient liquidity.

Leverage Ratio

The ***debt-to-total assets ratio*** tells us how much of the total assets of the business are financed through debt vs through shareholders' equity. A higher number indicates the company is more heavily reliant on debt financing which leads to higher interest costs and financial risk. Investors use this measure to determine how leveraged or risky the company's financing structure is.

Profitability Ratio

Earnings per share (EPS) shows the total company profit earned in a period divided by the number of outstanding shares. It is one of the most widely used metrics to gauge profitability. A higher EPS generally indicates greater value generation and is preferred by investors. However, EPS does not account for share dilution from stock options.

Valuation Metric

Finally, ***market capitalization*** measures the total market value of a company’s outstanding shares. It equals the share price multiplied by total shares outstanding. This gives investors a sense of the public’s valuation of the company and size of the business. Higher generally means investors see greater growth potential. Comparing market cap over time or to competitors signals over/under valuation.

Reference:

Bloomenthal, A. (2023, March 17). *Financial Ratio Analysis: Definition, types, examples, and how to use*. Investopedia. https://www.investopedia.com/terms/r/ratioanalysis.asp

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