

Lesson 1 : Financial Ratio

Financial Ratio Analysis : Definition

Ratio analysis is a method of examining a company's balance sheet and income statement to learn about its liquidity, operational efficiency, and profitability. It doesn't involve one single metric; instead, it is a way of analyzing a variety of financial data about a company. Ratio analysis is a cornerstone of fundamental equity analysis.

There are many different ratios that investors and other business experts can analyze to make predictions about a company's financial stability and potential future growth. These can be used to evaluate either how a company's performance has changed over time or how it compares to other businesses in its industry. Financial ratios are basic calculations using quantitative data from a company's financial statements. They are used to get insights and important information on the company's performance, profitability, and financial health. Common financial ratios come from a company's balance sheet, income statement, and cash flow statement. Businesses use financial ratios to determine liquidity, debt concentration, growth, profitability, and market value.

Key Takeaways

- Ratio analysis compares line-item data from a company's financial statements to evaluate its profitability, liquidity, efficiency, and solvency.
- Ratio analysis can track how a company is performing over time or how it compares to another business in the same industry or sector.
- Ratio analysis may also be required by external parties that set benchmarks often tied to risk, such as lenders.
- While ratios offer useful insight into a company, they should be paired with other metrics to obtain a broader picture of a company's financial health.

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- Examples of ratio analysis include the current ratio, gross profit margin ratio, and inventory turnover ratio.

2/ The role of Financial ratios

Financial ratios play a vital role in the analysis of a company's financial statements. They provide insights into the company's financial performance and help investors, management, and shareholders make informed decisions. Here are some of the key reasons why financial ratios are important:

1. Financial ratios help assess the financial health of a company by analysing its financial statements. This can help investors and analysts make informed investment decisions.
2. Ratios help companies understand how they are performing compared to their peers in the industry. This can help companies identify areas where they need to improve.
3. Financial ratios can be used to monitor a company's performance over time. This can help companies identify trends and make adjustments to their business strategy.
4. Financial ratios can help companies identify areas where they are overperforming or under-performing. This can help them make more informed decisions about where to allocate resources.

Also The ratios of these different financial metrics from a company can be used to:

- Evaluate a company's performance over time
- Estimate likely future performance
- Compare a company's financial standing with industry averages
- Measuring how a company stacks up against others within the same sector

Ratios are comparison points for companies and are not generally used in isolation. Instead, they are compared either to past ratios for the same company or to the same ratio from other companies.

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