Ratios for financial analysis pdf

5 minutes read What are Financial Ratios? Financial ratios help you interpret any company's finances' raw data to get actionable inputs on its overall performance. You can source the ratios from a company's financial statements to evaluate its valuation, rates of return, profitability, growth, margins, leverage, liquidity, and more. In simple words, a financial ratio involves taking one number from a company's financial statements and dividing it by another. The resulting answer gives you a metric that you can use to compare companies to evaluate investment opportunities. For example, just knowing that a company's share price is $20 doesn't offer any insight. But knowing that the company's price to earnings ratio (P/E) is 4.5 gives you some more context. It means that the price ($20), when divided by its earnings per share (EPS, in this case, 4.44), equals 4.5. You can now compare the P/E of 4.5 to that of other companies, competitors, or even to the company's historical P/E ratio to better understand the investment's overall attractiveness. Types of Financial Ratios Different financial ratios offer different aspects of a company's financial health, from how it can cover its debt to how it utilizes its assets. A single ratio may not cover the company's entire performance unless viewed as part of a whole. These ratios are time-sensitive as they assess data that changes over time. So you can use these ratios to your benefit by comparing them from different periods to get a general idea of a company's growth or regression over time. There are five broad categories of financial ratios. Let's look at them individually – 1. Liquidity Ratios Liquidity ratios tell a company's ability to pay its debt and other liabilities. By analyzing liquidity ratios, you can gauge if the company has assets to cover long-term obligations or the cash flow is enough to cover overall expenses. If the answers are positive, you may say the company has adequate liquidity, or else there may be problems. These liquidity ratios are notably more critical with small-cap and penny stocks. Newer and smaller companies often have difficulties covering their expenses before they stabilize. Some common liquidity ratios are Operating Cash Flow Margin = Cash from operating activities / Sales Revenue The operating cash flow margin indicates how efficiently a company generates cash flow from sales and indicates earnings quality. Cash Ratio = (Cash + Cash Equivalents) / Total Liabilities The cash ratio will give you the amount of cash a company has compared to its total assets. Quick Ratio = (Current Assets – Inventory) / Current Liabilities The quick ratio, aka acid-test ratio, will assess a company's marketable securities, receivables, and cash against its liabilities. This gives you an idea about the company's ability to pay for its current obligations. Current Ratio = Current Assets / Current Liabilities The current ratio will give you an idea about how well the company can meet its financial obligations in the coming 12 months. 2. Leverage Ratios Leverage or solvency ratios offer insight into a company's ability to clear its long-term debts. These ratios evaluate the company's dependence on debt for its regular operations and the possibility to repay the obligations. Some common leverage ratios are Debt Ratio = Total Debt / Total Assets The debt ratio compares a company's debt to its assets as a whole. Interest Coverage Ratio = Earnings Before Interest and Tax / Interest Expense The interest coverage ratio gives insights into a company's ability to handle the interest payments on its debts. Debt to Equity Ratios = Total Liabilities / Total Shareholders' Equity A debt-to-equity ratio compares a company's overall debt to its investor supplied capital. 3. Valuation Ratios Valuation ratios generally rely on a company's current share price and reveal whether the stock is an attractive investment option at the time. You can also call these ratios are market ratios as they examine a company's attractiveness in the stock market. Some common valuation ratios are: Price to Earnings Ratio (P/E) = Price per share / Earnings per share P/E is one of the most commonly used financial ratios among investors to determine whether the company is undervalued or overvalued. The ratio indicates what the market is willing to pay today for a stock based on its past or future earnings. Price/Cash Flow (P/CF) = Share Price / Operating Cash Flow per Share This ratio indicates a company's stock price relative to the cash flow the company is generating. The advantage of P/CF ratio is that it is tough to manipulate for a company. While companies can change revenue and earnings through accounting practices, cash flow is relatively immune from it. PEG Ratio = Price to Earnings / Growth Rate The PEG ratio is a valuation metric for determining the relative trade-off between the stock price, earnings per share, and a company's expected growth. It makes it easier to compare high growth companies that tend to have a high P/E ratio to mature companies that have a lower P/E. It is thus a better indicator of the stock's true value. Price to Sales Ratio (P/S) = Market Capitalization/Total Revenue A P/S ratio compares a company's market capitalization against its sales for the last 12 months. It is a measure of the value investors are receiving from the company's stock by indicating how much they are paying for shares per dollar of the company's overall sales. 4. Performance Ratios As the name indicates, performance ratios reveal a company's market performance (profit or loss). These ratios are also called profitability ratios. Some common profitability ratios are Return on Equity = Net Income / Shareholders' Equity ROE is also the return on net assets, as shareholders' equity is the total assets minus debt. Return on Assets = Net Income / Total Assets ROA measures the efficiency of a company in generating earnings from its assets. Gross Profit Margin = (Revenue – Cost of Goods Sold) / Revenue A gross profit margin ratio will tell you the relation between the company's gross sales and profits. Operating Profit Margin = Operating Profit / Revenue Operating profit margin indicates a company's profit margin before interest payments and taxes. Net Profit Margin = Net Profit / Revenue Net profit margin indicates a company's net margins. A high net profit margin is a good indication of an efficient business. 5. Activity Ratios Activity ratios demonstrate a company's efficiency in operations. In other words, you can see how well the company uses its resources, such as the assets available, to generate sales. Some commonly used activity ratios are: Inventory turnover = Net Sales / Average Inventory at Selling Price This ratio can indicate how efficient the company is at managing its inventory. A high ratio implies either strong sales or insufficient inventory. Receivables turnover = Net Sales / Average accounts receivable Receivables turnover indicates how quickly net sales are turned into cash. Payables turnover = Total supply purchase / Average Accounts Payable Accounts payable turnover ratio is a short-term liquidity measure that shows how many times a company pays off its accounts payable during a period, and indicates short term liquidity. Fixed asset turnover = Net Sales / Average Fixed Assets Fixed asset turnover measures how efficient a company is in generating sales from its fixed assets – property, plant, and equipment. Total asset turnover = Net Sales / Average Total Assets Fixed asset turnover measures how efficiently a company is using its assets to generate sales Financial Ratio Analysis Interpretation Ratio analysis can predict a company's future performance—for better or worse. Successful companies generally boast solid ratios in all areas, where any sudden hint of weakness in one area may spark a significant stock sell-off. While using these financial ratios, investors must be careful about each's nuances and use them in tandem for a comprehensive analysis of a stock. Financial ratios are mathematical comparisons of financial statement accounts or categories. These relationships between the financial statement accounts help investors, creditors, and internal company management understand how well a business is performing and of areas needing improvement. Financial ratios are the most common and widespread tools used to analyze a business' financial standing. Ratios are easy to understand and simple to compute. They can also be used to compare different companies in different industries. Since a ratio is simply a mathematically comparison based on proportions, big and small companies can be use ratios to compare their financial information. In a sense, financial ratios don't take into consideration the size of a company or the industry. Ratios are just a raw computation of financial position and performance. Ratios allow us to compare companies across industries, big and small, to identify their strengths and weaknesses. Financial ratios are often divided up into seven main categories: liquidity, solvency, efficiency, profitability, market prospect, investment leverage, and coverage.

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