

# Financial Ratios Analysis

This playbook provides a guide on how to calculate and interpret key financial ratios for effective business analysis. It outlines the steps necessary to understand different metrics that indicate the financial health of a business.

## Step 1: **Gather Data**

Collect the necessary financial documents such as the balance sheet, income statement, and cash flow statement. These statements contain the figures required to calculate financial ratios.

## Step 2: **Liquidity Ratios**

Calculate liquidity ratios to assess the company's ability to pay off its short-term debts.

- **Current Ratio:** Divide current assets by current liabilities.
- **Quick Ratio:** Subtract inventory from current assets, then divide by current liabilities.

## Step 3: **Solvency Ratios**

Compute solvency ratios to evaluate the company's ability to meet long-term obligations.

- **Debt to Equity Ratio:** Divide total liabilities by shareholder's equity.
- **Interest Coverage Ratio:** Divide earnings before interest and taxes (EBIT) by interest expenses.

## Step 4: **Profitability Ratios**

Analyze profitability ratios to understand the company's ability to generate profit.

- **Net Profit Margin:** Divide net income by revenue.
- **Return on Assets (ROA):** Divide net income by total assets.
- **Return on Equity (ROE):** Divide net income by shareholder's equity.

## Step 5: **Efficiency Ratios**

Measure efficiency ratios to determine how effectively the company uses its assets and liabilities.

- **Asset Turnover Ratio:** Divide revenue by total assets.
- **Inventory Turnover:** Divide cost of goods sold by average inventory.

## Step 6: **Market Value Ratios**

Assess market value ratios to gauge the company's stock valuation.

- **Price-Earnings (P/E) Ratio:** Divide market value per share by earnings per share (EPS).
- **Earnings Yield:** Divide EPS by market price per share.

## Step 7: **Interpret Results**

Review the calculated ratios and compare them with industry standards or historical data to interpret the company's performance. Look for trends or anomalies that could indicate financial health or concerns.

## Step 8: **Make Decisions**

Use the interpretation of the financial ratios to inform business decisions. Consider actions such as adjusting strategies, improving operations, or communicating financial health to stakeholders.

# **General Notes**

## **Industry Benchmarks**

It's important to compare financial ratios with industry benchmarks for a relevant analysis. Ratios can vary significantly across different industries.

## **Historical Context**

Analyzing ratios over time can provide insights into trends and long-term performance, rather than relying solely on a snapshot of current data.

## **Comprehensive Analysis**

A single ratio does not provide a complete picture. Always consider a range of ratios for a holistic view of the company's financial condition.