Financial Ratio Analysis

A single number in a financial report tells us little on its own. A profit of one hundred thousand dollars may be excellent for a small shop and weak for a large company. Financial ratio analysis compares numbers from the income statement and the balance sheet, so that we can judge a business quickly and fairly. Following common definitions, such as those used by the CFA Institute, we look at four groups: liquidity, profitability, efficiency and leverage.

1. Liquidity Ratios

Liquidity ratios show whether a business can pay its bills in the coming months. The current ratio divides current assets, such as cash, money owed by customers and stock, by current liabilities, which are the debts due within a year. The quick ratio is stricter, because it leaves out stock, which may take time to sell. A ratio below one can be a warning that cash may run short.

Example: A family has three thousand dollars in its account and two thousand dollars of bills due this month. Its liquidity ratio is one and a half, so the bills can be paid.

At work: Adel, a financial analyst at a chain of electronics stores, checks the liquidity ratios. The current ratio is two, but most current assets are phones in stock, so the quick ratio is only zero point eight, and he plans to keep more cash.

2. Profitability Ratios

Profitability ratios show how well a business turns sales and capital into profit. The net profit margin divides net profit by revenue, so it shows how many cents of each dollar of sales are kept as profit. Return on equity divides net profit by the owners' equity, so it shows what the owners earn on their money. Margins differ a lot between industries, so we compare them with similar businesses.

Example: A lemonade stand sells two hundred dollars of drinks and keeps forty dollars as profit. Its net profit margin is twenty percent, so it keeps twenty cents of every dollar.

At work: Adel finds a net profit margin of four percent, while last year it was six percent. This profitability ratio leads him to study prices and discounts more closely.

3. Efficiency Ratios

Efficiency ratios, also called activity ratios, show how well a business uses its assets in daily work. Inventory turnover divides the cost of goods sold by the average stock, so it shows how

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many times the stock is sold and replaced in a year. Receivable days show how long customers take, on average, to pay. Faster turnover and fewer receivable days usually mean that less cash is tied up.

Example: A bakery sells and replaces its flour stock every week, so its inventory turnover is about fifty-two times a year. Its money is rarely tied up in old flour.

At work: Adel calculates the efficiency ratios and finds that inventory turnover has fallen from eight to five times a year. Old laptop models are waiting in the stores, so the company runs a sale to free the cash.

4. Leverage Ratios

Leverage ratios, also called solvency ratios, show how much a business depends on borrowed money. The debt-to-equity ratio divides total debt by the owners' equity. The interest coverage ratio divides operating profit by interest costs, so it shows how easily interest can be paid. Some debt can help a business grow, but high leverage makes it more fragile when sales fall.

Example: A family owes forty thousand dollars on a house worth two hundred thousand, so its own share, or equity, is one hundred and sixty thousand. Its debt-to-equity ratio is one quarter, so its leverage is low.

At work: Adel checks the leverage ratios before a new store is opened. Operating profit covers interest costs six times, so a small new loan looks manageable.

Conclusion

In summary, financial ratio analysis looks at four groups: liquidity, profitability, efficiency and leverage. Each ratio answers one question, and together they give a clear picture of the health of a business. Ratios are most useful when we compare them over several years and with similar businesses. They do not give final answers, but they show us exactly where to ask the next question.

Sources

- CFA Institute: Financial Analysis Techniques (refresher reading: activity, liquidity, solvency and profitability ratios) – https://www.cfainstitute.org/insights/professional-learning/refresher-readings/2026/financial-analysis-techniques
- Corporate Finance Institute: Financial Ratios – https://corporatefinanceinstitute.com/resources/accounting/financial-ratios/

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