Week 5 DQ 1 Financial Ratios

Financial Ratio Analysis Explained in 3 minutes. Sometimes it's not enough to simply say a company is in "good or bad" health... To make it easier to compare a company's health with other companies, we have to put numbers on this health, so that we can compare these numbers with the numbers of other companies... So now... how do we use numbers to assess company health? This is where Financial Ratios come in. Very common types of financial ratios are Liquidity Ratios, Profitability Ratios, and Leverage Ratios.

Liquidity Ratios can tell us how easily a company can pay its debts so that the company doesn't get eaten up by banks or other creditors. An example of this is the Current Ratio. This tells us how much of your company's stuff can be easily changed into cash within the next 12 months so that it can pay debts which need to be paid also within 12 months. The higher your current ratio is, the less risky a situation your company is in.

Now moving on. Profitability Ratios can tell us how good a company is at making money. An example of this is the Profit Margin Ratio. This tells us how much profit your company earns compared to your company's sales. Normally, a higher number is better because you want to earn more profit for every $1 of sales that you get.

And finally, what about Leverage Ratios? These can tell us how much debt the company is using to make the company run and stay alive. An example of this is the simple Debt Ratio. This tells us how much % of a company's assets are paid for by debt. Normally, a company is considered "safer" when the debt ratio is low. Note that this was just a very simple overview. There are a lot more financial ratios & many different ways of using them, plus a lot of problems and disadvantages in using them as well.