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Overview of Ratio Analysis

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the types of financial ratios. Specifically, this lesson will cover:

1. Classification

Financial statements are generally insufficient to provide information to investors on their own; the numbers contained in those documents need to be put into context so that investors can better understand different aspects of the company's operations. **Ratio analysis** is one of three methods an investor can use to gain that understanding.

In the framework of business analysis and profitability, financial ratio analysis allows an observer to put the data provided by a company in context. This allows the observer to gauge the strength of different aspects of the company's operations.

Financial statement analysis is the process of understanding the risk and profitability of a firm through analysis of reported financial information. Ratio analysis is a foundation for evaluating and pricing credit risk and for doing fundamental company valuation. A financial ratio, or accounting ratio, is derived from a company's financial statements and is a calculation showing the relative magnitude of selected numerical values taken from those financial statements.

TERM TO KNOW

Ratio Analysis
The use of quantitative techniques on values taken from an enterprise's financial statements.

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2. Types of Ratios

There are various types of financial ratios, grouped by their relevance to different aspects of a company's business as well as to their interest to different audiences. Financial ratios may be used internally by managers within a firm, by current and potential shareholders and creditors of a firm, and other audiences interested in understanding the strengths and weaknesses of a company, especially compared to the company over time or compared to other companies.

Most analysts think of financial ratios as consisting of five basic types.

Type of Financial Ratio	Description
Profitability ratios	Measures the firm's use of its assets and control of its expenses to generate an acceptable rate of return
Liquidity ratios	Measures the availability of cash to pay debt
Asset management ratios	Measures the effectiveness of a firm's use of resources, or assets (also called efficiency ratios)
Debt, or leverage, ratios	Measures the firm's ability to repay long-term debt
Market ratios	Measures the cost of issuing stock and the relationship between return and the value of an investment in a company's shares; concerned with shareholder audiences

SUMMARY

In this lesson, you learned that ratio analysis is **classified** as a tool that investors and managers use to better understand a company's operations. Ratio analysis uses the information provided on a company's financial statements. There are five basic **types of ratios**, including profitability, liquidity, asset management, debt, and market ratios.

Best of luck in your learning!

TERMS TO KNOW

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