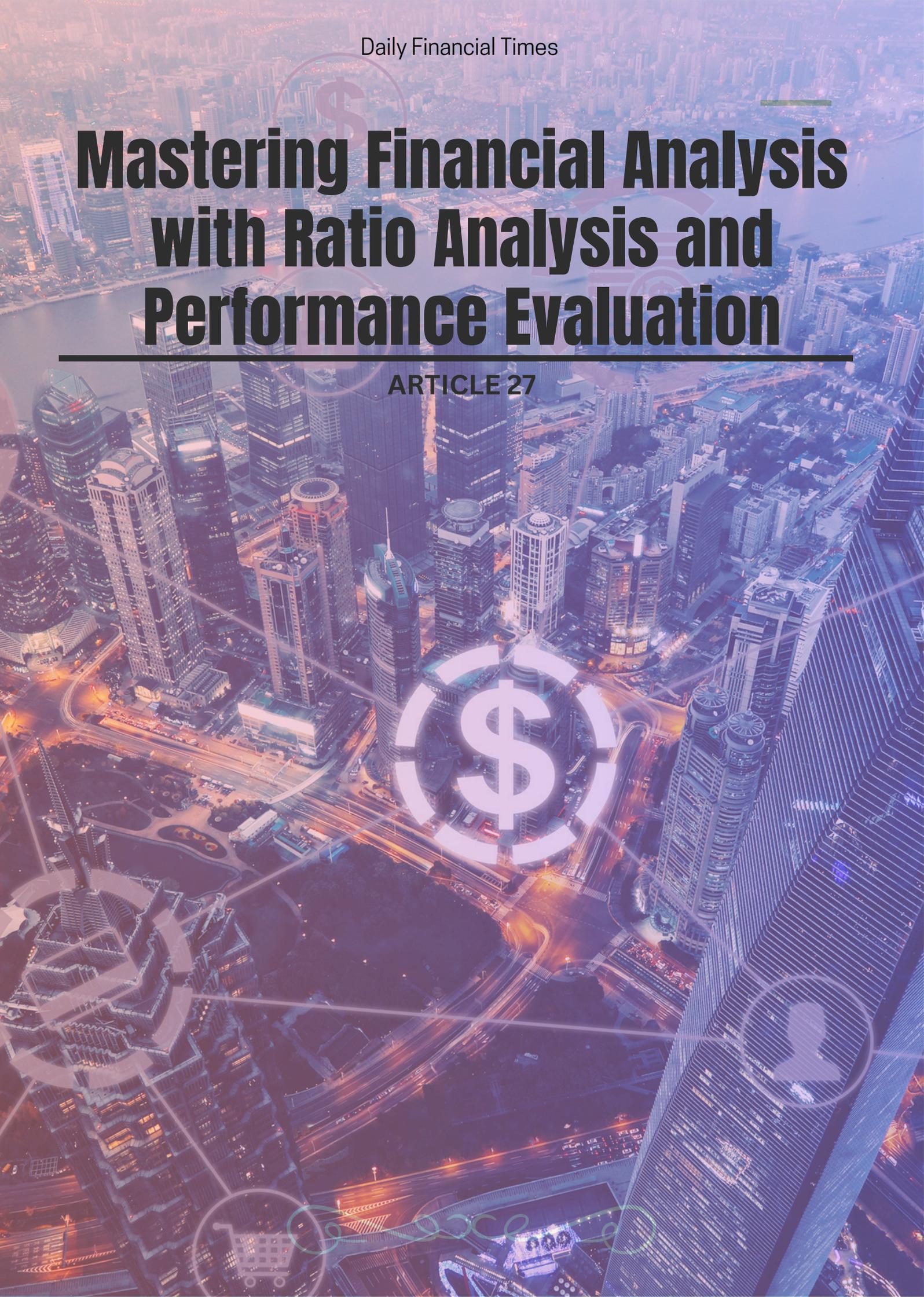


Daily Financial Times

# Mastering Financial Analysis with Ratio Analysis and Performance Evaluation

ARTICLE 27



# What Is Ratio Analysis?

Ratio analysis involves using numbers from financial statements (such as the income statement and balance sheet) to create meaningful relationships. These ratios help you assess a company's performance, efficiency, and overall financial health.

## Why Use Ratios?

1. **Comparability:** Ratios allow you to compare companies of different sizes.
2. **Trend Analysis:** Track changes in a company's performance over time.
3. **Decision-Making:** Provides a quick understanding for investors, managers, and stakeholders.

## Types of Ratios

Here are the most common types of ratios and what they tell us:

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### 1. Liquidity Ratios

- Measure a company's ability to meet short-term obligations.
- Examples:
  - $\text{Current Ratio} = \text{Current Assets} \div \text{Current Liabilities}$
  - (A ratio  $> 1$  means the company can cover its short-term debts.)
  - $\text{Quick Ratio} = (\text{Current Assets} - \text{Inventory}) \div \text{Current Liabilities}$
  - (This removes inventory, which might not be liquid.)

### 2. Profitability Ratios

Indicate how well a company generates profit.

- Examples:
  - $\text{Net Profit Margin} = \text{Net Income} \div \text{Revenue}$
  - (Shows how much profit is made for every dollar of revenue.)
  - $\text{Return on Assets (ROA)} = \text{Net Income} \div \text{Total Assets}$
  - (Measures how effectively the company uses its assets.)

### 3. Efficiency Ratios

Assess how effectively a company utilizes its resources.

- Example:
  - $\text{Inventory Turnover} = \text{Cost of Goods Sold} \div \text{Average Inventory}$
  - (Shows how many times inventory is sold and replaced over a period.)

### 4. Leverage Ratios

Evaluate a company's debt levels.

- Example:
  - $\text{Debt-to-Equity Ratio} = \text{Total Liabilities} \div \text{Shareholders' Equity}$
  - (Higher ratios indicate more reliance on debt.)



# Performance Evaluation: How to Use Ratios

Once you calculate ratios, the next step is performance evaluation, where you interpret what the numbers mean. Let's break this process into steps:

## 1. Compare Against Benchmarks

- **Industry Standards:** Look at ratios common in the industry. For example, a retail company's inventory turnover will differ from that of a tech company.
- **Competitors:** How does the company compare to similar businesses?

## 2. Analyze Trends

- Review ratios over several years to spot trends. Is profitability improving? Is the company managing debt better over time?

### 3. Identify Strengths and Weaknesses

- Strengths: High net profit margin or strong liquidity may indicate a healthy company.
- Weaknesses: Low efficiency ratios might signal poor resource management.

### 4. Make Informed Decisions

- Investors: Use ratios to decide whether a company is worth investing in.
- Managers: Identify areas for improvement, such as cost control or increasing asset efficiency.

## Practical Example: Applying Financial Analysis

Let's analyze a fictional company, ABC Electronics.

#### Step 1: Calculate Key Ratios

- Current Ratio =  $\$50,000 \div \$25,000 = 2.0$
- Net Profit Margin =  $\$10,000 \div \$100,000 = 10\%$
- Debt-to-Equity Ratio =  $\$30,000 \div \$40,000 = 0.75$

#### Step 2: Evaluate Performance

- A current ratio of 2.0 shows strong liquidity.
- A net profit margin of 10% indicates decent profitability for the electronics industry.
- A debt-to-equity ratio of 0.75 reflects moderate use of debt, which is manageable.

#### Step 3: Compare Trends

Over three years, ABC Electronics improved its net profit margin from 7% to 10%, showing better cost control and profitability.

# Key Takeaways

- **Understand the Ratios:** Liquidity, profitability, efficiency, and leverage ratios offer unique insights into a company's performance.
- **Evaluate Trends and Benchmarks:** Use these metrics over time and compare them to industry standards for a clearer picture.
- **Use Data to Improve:** Whether you're an investor, manager, or student, financial analysis helps in making data-driven decisions.

## Activities for Practice

- Pick a publicly listed company and calculate its key financial ratios using its latest financial statements.
- Compare these ratios to industry benchmarks and evaluate the company's strengths and weaknesses.

By mastering ratio analysis and performance evaluation, you're developing critical skills for business success. Keep practicing and enjoy the journey of learning finance!



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# Thank you!

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