JUST THE FACTS BUSINESS:
HELPING YOU TALK ABOUT MONEY

Financial Ratios

Financial ratios are formulas used to measure and evaluate a business's overall financial condition and performance compared to prior years and competitors.

They are used by internal managers, owners/shareholders (and potential owners/shareholders) and lenders to compare companies of similar size and scope, based on standard inputs and calculations.

There are four main categories of financial ratios.
They are all inter-related.

1. Operational ratios

Analyzing how efficiently a company is working – such as the time it takes to collect payments from sales and how quickly inventory is being sold.

2. Profitability ratios

Determining whether a company is making money, based on a variety of inputs, including:

- Gross profits margin (total sales minus the cost of sales).
- Net profit margins (after taxes, how much profit is generated for each dollar of sales).
- Return on shareholder equity (how much after-tax profit is generated for each dollar invested).
- Coverage ratio (capacity to repay loans and interest on debt).
- Return on total assets (how well assets are generating profit).

3. Liquidity ratios

Also known as working capital and current ratios, which indicate whether a business has sufficient cash flow to meet its short-term obligations and attract better credit terms with lenders.

4. Leverage ratios

Measuring how much debt a business is carrying compared to the amount invested by its owners/shareholders (known as debt-to-equity ratios), or the percentage of its assets financed by creditors (debt-to-assets ratios). High leverage ratios suggest a dependence on debt to run the company, which could be a sign of financial weakness.

For a list of the most common ratios and the equations used to calculate them, visit cpacanada.ca/JTFBusinessResources.

The younger a company the shorter its financial history, therefore the harder it is to calculate meaningful ratios. Over time, ratios indicate trends and whether a company is improving financially.

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