

What is Financial Ratio Analysis?

Worksheet

Financial ratio analysis calculates key metrics (e.g., $ROE = \text{Net Income} / \text{Equity}$, $\text{Debt-to-Equity} = \text{Total Debt} / \text{Equity}$) from balance sheets and income statements. Ratios are grouped into profitability, liquidity, leverage, and efficiency categories to assess company health.

$$ROE = \text{Net Income} / \text{Shareholder Equity}$$

Questions

1. If net income is 40k and equity is 400k, ROE is
 - A) 4%
 - B) 10%
 - C) 40%
 - D) 400%
2. A high debt-to-equity ratio indicates
 - A) low profitability
 - B) high financial leverage and risk
 - C) strong liquidity
 - D) good inventory management
3. $\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$. A ratio of 1.5 means
 - A) 1.50 of current liabilities per asset
 - B) 1.50 of current assets per 1 liability
 - C) 50% more debt
 - D) 50% profit margin
4. Gross profit margin vs. net profit margin?
 - A) Gross ignores operating costs; net includes all expenses
 - B) Net is always higher
 - C) Gross = net
 - D) Net ignores taxes
5. Company A has net income 50k and shareholder equity 500k. Calculate ROE.
6. A company has total debt 200k and equity 800k. What is the debt-to-equity ratio?
7. Gross profit is 100k, sales are 250k. What is the gross profit margin?
8. Define: What is ROE?
9. Define: What does debt-to-equity ratio measure?
10. Define: Difference: ROE and ROA?

Answer Key

1. B) 10% - $ROE = 40k / 400k = 0.10 = 10\%$.
2. B) high financial leverage and risk - High D/E means more debt relative to equity, higher financial risk, and greater leverage.
3. B) 1.50 of current assets per 1 liability - Ratio of 1.5 means the company has 1.50 in current assets for every 1 of current liabilities.
4. A) Gross ignores operating costs; net includes all expenses - Gross margin = sales minus COGS. Net margin = all revenue minus all expenses (COGS, operating, taxes).
5. $ROE = \text{Net Income} / \text{Shareholder Equity}$ $ROE = 50,000 / 500,000 = 0.10 = 10\%$
6. $D/E = \text{Total Debt} / \text{Equity}$ $D/E = 200,000 / 800,000 = 0.25$ or 25%
7. $\text{Gross Profit Margin} = \text{Gross Profit} / \text{Sales}$ $GPM = 100,000 / 250,000 = 0.40 = 40\%$
8. Return on Equity (ROE) = Net Income / Shareholder Equity. Measures how efficiently the company generates profit from shareholder capital.
9. The proportion of debt and equity financing. $D/E = \text{Total Debt} / \text{Equity}$. Higher ratio = more leverage, higher financial risk.
10. ROE measures return on shareholder equity. ROA measures return on all assets (debt + equity).

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