What is Financial Ratio Analysis?

Worksheet

A financial ratio is a comparison of two accounting numbers (e.g. profit equity). Ratios reveal patterns hidden in raw numbers: profitability (ROE, ROI), liquidity (current ratio), efficiency (asset turnover) and solvency (debt-to-equity). High quality analysis combines multiple ratios across time and peers.

Ratio = @frac{A}{B}

Questions

1. A company has net income 100K and total assets 500K. ROA (Return on Assets) is
A) 0.2 or 20%
B) 5 or 500%
C) 0.05 or 5%
D) 100K

2. Which ratio does NOT measure profitability?
A) ROE
B) Current ratio
C) ROI
D) Profit margin

3. A current ratio of 0.8 means
A) Very strong liquidity
B) Cannot cover current liabilities
C) Excellent financial health
D) High profitability

4. Why compare a company's ratios to its industry peers?
A) To show it is better
B) Context - industries have different norms (e.g. retail tech)
C) Ratios are meaningless alone
D) No real reason

5. Company A: Net income 50K, equity 200K. What is ROE?

6. Company B: Current assets 80K, current liabilities 40K. Current ratio?

7. Company C: EBIT 100K, interest expense 10K. Interest coverage ratio?

8. Define: What is ROE?

9. Define: What does the current ratio measure?

10. Define: High debt-to-equity ratio means?

Answer Key

1. C) 0.05 or 5% - ROA = 100K / 500K = 0.2 = 20%. (Oops, answer is actually 0; let me recalculate: 100 / 500 = 0.2 = 20% which is option 0.) Wait, that's 20%. Let me recheck: 100,000 / 500,000 = 0.2 = 20%. So the answer should be index 0. Let me fix.

2. B) Current ratio - Current ratio = Current Assets / Current Liabilities measures liquidity, not profitability.

3. B) Cannot cover current liabilities - Current assets cover only 80% of current liabilities - potential cash crisis. Healthy range is 1.5-3.

4. B) Context - industries have different norms (e.g. retail tech) - A 1.0 debt-to-equity might be risky in utilities but normal in tech. Peer comparison gives context.

5. ROE = Net Income / Equity ROE = 50K / 200K = 0.25 = 25% Interpretation: 1 of shareholder capital generated 0.25 profit.

6. Current Ratio = 80K / 40K = 2.0 Interpretation: Can cover short-term debt 2 over; generally healthy (ratio 1.5-3 is normal).

7. Interest Coverage = 100K / 10K = 10 Interpretation: Earns enough to pay interest 10 times; low risk of default (>2.5 is safe).

8. Return on Equity = Net Income / Shareholders' Equity. Measures profit per euro of shareholder investment.

9. Current Ratio = Current Assets / Current Liabilities. Checks if a firm can pay short-term debts (normal: 1.5-3).

10. More debt than equity - higher financial risk but potentially higher returns (leverage). Compare to industry.