Financial management

Finance

Financial ratios express the financial health of a business by relating different components of the financial ments. They include debt equity ratio, return on equity, price earnings ratio and net profit margin amongst others.

Debt Equity Ratio

It measures the ratio of the Company total liabilities to shareholders equity. It generally measures the amount leverage used and the equity position of a given company. This ratio to investors indicates the risk involved in owning shares of a company. On the other hand, banks rely on it to assess the credit worthiness of the company, since low ratio signifies their debts will not be at risk.

Return on Equity

The Return on Equity, ROE, measures how much profit a company earned in comparison to the money shareholders have invested. Generally, the higher it is the more promising a company is. Potential investors rely on ROE when deciding whether or not to invest their money in a company. Furthermore, financial institutions use the ROE to assess capability of a company meeting its loan repayment obligations (Bull, p. 29).

Net Profit Margin

Net profit margin is the ratio of net profits to net sales of a company. This ratio reflects companys efficiency especially within its industry. Investors are attracted to stocks of companies with high net profit margin (Moyer, James and William, p. 70)

Price Earnings Ratio (P/E)

It is the ratio of company market share price to Earnings per share and is mostly used as a valuation of investments indicator. P/E reflects the premium paid for a share and thus growth investors look for higher P/E ratios in contrast to value investors. It reflects future earnings growth of a company and consequently implying it has no debt risk to banks. .

It is important for investors and financial institutions to note that financial ratios are subject to weakness in accounting methods. In addition, some ratios on their own are meaningless and thus need to be combined with others to draw a conclusive financial decision. Thus, in my opinion financial ratios should be used as indicators and not as complete evidence of company financial position (Beyer, p. 10).

Works Cited

Bull, Richard. Financial ratios: how to use financial ratios to maximise value and success for your business. Toronto: Elsevier, 2007.

Moyer, Charles, James McGuigan and William Kretlow. Contemporary Financial Management. Stamford CT: Cengage Learning, 2008.

Beyer, Swen. International Corporate Finance - Impact of Financial Ratios on Long Term Credit Ratings. Munich: GRIN Verlag, 2010.