

# Importance of financial ratios

Business



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Financial ratios are the mathematical expressions in terms of ratios that are used to measure the effectiveness of the firms operations. These are the calculations that are derived from the company's information regarding the financial statements. The historical trends and the level of the ratios are used as inferences to the firm's financial conditions, and its operations attractiveness to potential investors. There are various methods that are employed to analyze the financial statements between two items, which develops many ratios as possible (Financial Ratios, 2012).

But there are the most important ratios that have been developed and categorized into the following; Liquidity ratio this is the ratio that shows the firm is capable of paying its current obligation, as it is a relationship between the availability of cash and other assets which covers the accounts payable. This is the relation between the current assets and current liabilities.

Profitability or return to investment ratio provides information in regard to the operations and performance of the company. It is important to note that there are factors that influence the profitability ratios such the price change, volume and expenses (Ratios Analysis and its Interpretation). Thus when developing the profitability ratio it is important determine the changes. The profitability ratios measure the returns of the firm less the expenses.

Activity/efficiency ratio helps in determining the company's credit collection and the turn over of inventories over a give time period. Therefore, the term by which firms handles their credits and their efficiency in handling purchases and distribution of its inventories. This is important as it avoids the overstocking of inventories in the firm's warehouses. Debt/Leverage ratio is a ratio t hat determines the extent by which a firm depends on borrowed

finances for its operations. This is the ratio that is closely viewed by potential investors and banks.

The leverage ratio mostly is a comparison of the assets of the company or its net worth with its liabilities (Financial Ratio Analysis). Financial ratios are vital tools that are used to measure the progress of firms toward the achievement of its objectives coupled with competing with other firms effectively. Thus, the ratios provide information that is imperative in making decision of the firm effectively.