

## Financial ratio analysis

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Pamela Peterson Drake, Professor of Finance at James Madison University, is an expert on ratio analysis. She is the author or co-author of "Introduction to Finance", "The Basics of Finance" and "Analysis of Financial Statements" (all of which, surprisingly, are listed and well rated on website [www.goodreads.com](http://www.goodreads.com)).

This particular paper, "Financial ratio analysis", is written for her students so it's at a fairly introductory level – but it's nonetheless a good grounding in what is a critical area. Even if it is never your intention to recommend individual stocks, understanding financial analysis can enhance your ability to conduct equity fund analysis. Financial ratios form the basis of fundamental, or bottom up, stock research. Understanding how to calculate and interpret this information will help you not only understand stocks better, but will help you have more meaningful discussions with portfolio managers about their investment styles and their portfolio holdings.

The paper discusses financial analysis and the information sources an analyst needs to consider when undertaking stock analysis including company or financial statement data, economic data, market data and, the events surrounding a company that might affect the analysis

Drake uses Microsoft's 2004 accounts to take the reader through various ratios that represent some of the most important – including various liquidity ratios, profitability and activity ratios, financial leverage ratios and shareholder ratios – as well as what the ratios mean and how to interpret them. Drake also incorporates market and economic data in places and considers how this might affect ratio analysis.

All fundamental bottom-up fund managers conduct ratio analysis, and it will form an integral part of their investment process. Their processes generally differ on how they interpret and act on much of that information. Growth managers will emphasise the importance of ratios such as EPS growth, and will do more qualitative work on stocks that have those characteristics. Value managers will emphasise the importance of ratios such as PE ratios in company analysis.

This article is invaluable in either building your understanding of company analysis, or just refreshing some of that knowledge.

[Read "Financial ratio analysis"](#)