

## Understanding Financial Ratios

Financial ratios are key tools in financial planning and analysis, providing valuable insights into a company's financial health and performance. These ratios help individuals to make informed decisions about their finances, investments, and overall financial strategy. Here are some commonly used financial ratios in financial planning:

### Liquidity Ratio:

The liquidity ratio, often referred to as the Emergency Fund Ratio in financial planning, is a measure designed to provide individuals with a financial safety net in the event of unexpected circumstances. **It aims to ensure that individuals can cover their essential expenses for 6 months without encountering financial difficulties.**

This ratio is computed by **dividing the total liquid assets by the fixed monthly expenses**. The reserved liquid funds serve as a safeguard, offering individuals the means to regain their financial stability and assistance in times of unforeseen emergencies.

Let's take the example of having Liquid Assets worth 10 Lakhs *\*without taxation\**

Liquid Investment	Monthly Expense	Ratio	Ratings
10,00,000	600000	0.6	<b>Bad</b> with this liquid investment and expenditure you can survive for 1-2 months max.
10,00,000	400000	0.4	<b>Moderate</b> with this liquid investment and expenditure you can survive for 3-4 months max.
10,00,000	200000	0.2	<b>Good</b> with this liquid investment and expenditure you can survive for 3-4 months max.

### Debt-coverage Ratio:

The debt-coverage ratio is another financial metric that focuses on assisting individuals with outstanding loans or EMIs and helps them understand the proportion of these payments to their gross income, which constitutes an essential part of their expenses.

This ratio offers insights into the extent to which one's earnings are allocated to loan repayments and EMIs, helping evaluate the overall financial health. It is computed by **dividing the total EMIs by the gross income**, the ideal ratio is <30% of gross income should go towards EMI.

Let us take the example of having 10 lakhs as gross income:

Gross Income PA	EMI PA	Net %	Ratings
10,00,000	400000	40%	<b>Bad</b> the EMI payed is more than 40% of their Gross income
10,00,000	300000	30%	<b>Moderate</b> the EMI payed is 30% of their Gross income
10,00,000	200000	20%	<b>Good</b> the EMI payed is 30% of their Gross income

### Savings Ratio:

Maintaining sound financial health involves a significant portion of your income being directed towards savings, which can lead to future wealth accumulation. Saving early is crucial, as those with a strong savings ratio tend to enjoy improved financial well-being in the long run.

This metric serves as a guide to determine the percentage of your income that is set aside for savings and investment purposes. It is calculated by **dividing the total annual savings by the annual gross income, the ideal ratio is 15-45% depending on one's age.**

Younger individuals typically allocate a larger portion of their income for spending, resulting in a lower savings ratio. Conversely, as individuals age, the savings ratio tends to increase, reflecting a greater emphasis on saving over discretionary spending.

### The Importance of Financial Ratios

Financial ratios play a crucial role in assessing an individual's financial health, and their importance cannot be overstated. Here are several reasons why financial ratios are essential:

- **Evaluation:** Financial ratios allow for the continuous evaluation of an individual income over time. Comparing ratios across different periods reveals how much the financial health of individuals has improved, from the point they started.
- **Risk Assessment:** Financial ratios assist in assessing an individual financial risk profile. High debt ratios, for instance, may indicate a higher level of financial risk, influencing the financial health of the individual and taking precautions to clear out debt beforehand.
- **Operational Efficiency:** Ratios can provide insights into how much percentage of income an individual is spending on their expenses, and whether it must be cut down on some of them to have good financial health.
- **Strategic Planning:** Financial ratios guide strategic planning by highlighting areas that need improvement. They help individuals set financial goals and develop strategies to achieve them.

### Conclusion.

Financial ratios are powerful tools for understanding an individual's financial well-being, performance, and prospects. Whether you are an investor, a lender, or a manager, these ratios offer a structured and standardized way to interpret financial data of your income and make informed decisions.

**Research Desk**

**Dilzer Consultants Pvt Ltd**

---