Financial Ratios

Ultimately, to determine the intrinsic value of a firm, investors need to forecast how strongly and steadily a firm will generate cash return. Accomplishing this task means (either directly or indirectly) forecasting firms' financial statements.

And one of the most effective ways of forecasting future financial statements is with the calculation, analysis and interpretation of **financial ratios**.

Firms do not change their underlying business and their method of operation quickly or dramatically. Therefore, many accounts within a firm's financial statements stay constant relative to one another. Consequently, investors can forecast where they will be in the future by simply studying where they have been in the past.

Furthermore, when these relationships do change, the change is slight and simple (e.g. a slight trend up or a slight trend down); and it can be ascertained easily by studying past changes.

Lastly, the relationships we speak of our reasonable and logical. This makes financial ratio analysis not only effective, but also simple.

These facts mean that financial ratio analysis is a central component in forecasting future financial statements (and ultimately in determining a firm's intrinsic value). And it behooves all investors to understand these relationships and how to represent them by calculating standard financial ratios. If investors understand them well enough, they could even create their own ratios that yield insight available only to them.

For detailed guidance on how to calculate and interpret the most important and effective financial ratios, go to the **How-to-Invest-in-Stocks** page and access the reports in the "**Financial Ratio Analysis**" section.