Using Financial Ratios to Assess Your Financial Health

If you want to evaluate your personal financial position, you can use financial ratios to assess your financial health. They can show you a snapshot of your financial well-being using different values concerning your money. Knowing these formulas gives you a bigger financial picture and helps you make important decisions about utilizing your money properly.

First, we have the Emergency Fund Ratio. An emergency fund is the cash you keep on hand to pay for unexpected expenses. If you want to determine how much your emergency fund should be saved, simply multiply your monthly expenses by six. You will want to add up your essential monthly expenses, or, in other words, the minimum amount of money you need to live for one month. The goal is to have anywhere between three and six months of living expenses saved in your emergency fund.

Second, we have the Housing-to-Income Ratio. This ratio will tell you how much you can afford to spend on your home. You divide your monthly housing costs by your gross monthly income. Housing costs include monthly mortgage payments, property taxes, insurance, and utilities. The goal is for this ratio to be 28% or less. The lower this number, the more affordable your housing costs are and the more income you have for other financial goals.

Third, we have the Debt-to-Income Ratio. This is used to determine the percentage of income used to repay debts. You divide your monthly debt payments by your monthly gross income. You want to include credit cards, student loans, and other consumer debt to calculate your debt payments. Generally, you want this number to be 36% or less. This is a great tool because it will tell you about your financial health and help you rethink your situation.

Fourth, we have the Savings Ratio. Your savings rate is expressed as what percent of your gross income you put away for the future, including retirement and other short-term goals. You simply take your annual savings and divide it by your annual gross income. You will add annual savings to retirement accounts, including 401(k)s, traditional and Roth IRAs, and taxable accounts for retirement. Do not include your emergency fund or college savings accounts. You want to aim for 10% to 20% savings.

Last, we have the 50/30/20 Budget Ratio. This can help you manage your budget regardless of your income. Essential needs are the largest allocation at 50% of your monthly take-home income. These bills include mortgage or rent, utilities, health insurance, and groceries. Discretionary spending should be kept at no more than 30% of your monthly take-home income. These expenses include dining out, travel, clothing, and entertainment. The remaining 20% should be used for saving for future financial goals. This includes retirement savings, saving for a house, tuition, and saving to pay down debt.

The key takeaway is that personal financial rations give you a clear snapshot of your financial health in many different areas. Rather than making a best guess, these ratios can give you an edge in your analysis. These calculations help you discover if changes need to be made to improve your money management and future planning decisions.