Accounting Ratios

Goals

- A way of using the definitions you just learned again to make them more solid.
- Give us the U in EC314U by adding a topic of general interest.
- View ratios as a non-probabilistic expression of risk.
- Point out other uses of the ratios.

The Ratios

https://prezi.com/gz6nmvsbjrz7/accounting-ratios/

Summary of Use

There are multiple uses for each ratio. These are categorized by how we used them in class, not exclusive use.

- ▶ Loan Related
    - ▶ Debt Ratio: How likely will a lender be able to recover principal of a loan if borrower stops making payments.
    - ▶ TIER: How likely will the borrower make payments on time.
    - ▶ Subtleties on which to use when and how to combine depending on if the firm requires few or many assets to produce.

- ▶ Working Capital related
    - ▶ Current Ratio: Upper bound on working capital adequacy.
    - ▶ Quick Ratio: Lower bound on working capital adequacy.
    - ▶ Subtleties on which to use depending on if inventory is firm specific or can be sold for near purchase price.

Summary of Use (Con't)

- Meeting Increases in Sales
  - Inventory Turnover: Can you meet a temporary increase in sales?
  - Asset Turnover: Can you meet a permanent increase in sales?

Warnings/Reminders

Use:

- Real World use can be different and complex, recall the DuPont example
- "Good" depends on industry

Typical Exam Questions:

- A few interpretive questions, "Which firm would you rather lend to"
- Some require some algebra and require you to remember some accounting definitions and identities.