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ACCOUNTING RATIOS

LIQUIDITY
short-term ability to pay debts and meet unexpected needs for cash

1 CURRENT RATIO/ WORKING CAPITAL RATIO
- indicates short-term debt-paying ability
- The *higher* the ratio, the better

2 QUICK RATIO/ACID-TEST RATIO
- indicates **immediate** short-term liquidity
- The *higher* the ratio, the better
- excludes inventory, prepaid assets which are LEAST current assets

3 CURRENT CASH DEBT COVERAGE
- Indicates short-term debt paying ability on a **cash basis**
- The *higher* the ratio, the better
- reflects the whole period and does not just use year end balances, it combines cash and accrual figures

4 RECEIVABLES TURNOVER
- Indicates the effectiveness of **credit collection policies** (how fast money is collected from debtors)
- measures the number of times **trade receivables are converted into cash** during the period
- The *higher*, the better

5 AVERAGE COLLECTION PERIOD
- indicates the liquidity of receivables and collection success
- the *shorter* the duration, the better

6 INVENTORY TURNOVER
- indicates the liquidity of inventory (effectiveness of inventory management)
- the *higher* the turnover, the better

7 AVERAGE DAYS IN INVENTORY
- indicates the liquidity of inventory and inventory management
- the *shorter* the duration, the better
- converts inventory turnover into a measure of day for inventory to be sold

SOLVENCY
entity's ability to survive over a long period of time

1 DEBT TO TOTAL ASSETS RATIO (Leverage)
- Indicates the degree of leverage (percentage of total assets funded through creditors)
- The *lower*, the better

2 TIMES INTEREST EARNED
- Indicates entity's ability to sustain debt by measuring its **ability to meet interest payments from operating profit** as they fall due
- The *higher*, the better

3 CASH DEBT COVERAGE
- Indicates entity's ability to repay liabilities from cash generated from operating activities without having liquidate assets used in operations
- The *higher*, the better

4 FREE CASH FLOW
- Indicates entity's ability to pay dividends or expand operations
- The *higher*, the better

PROFITABILITY
profit/operatin success of entity for a period of time

1 RETURN ON EQUITY RATIO
- Indicates profitability of ordinary shareholders' investment (earnings per dollar invested by the owners)
- The *higher*, the better

2 RETURN ON ASSETS
- Indicates overall profitability with respect to investment in assets
- The *higher*, the better

3 PROFIT MARGIN
- Indicates profit generated by each dollar of sales
- It depends on the volume of firms but generally, the *higher*, the better

4 ASSET TURNOVER
- Indicates how efficiently assets are used to generate sales
- The *higher*, the better

5 GROSS PROFIT RATE
- Indicates entity's ability to maintain an adequate selling price above its cost
- The *higher*, the better

6 OPERATING EXPENSES TO SALES RATIO
- Indicates the costs incurred to support each dollar of sales
- The *lower*, the better

7 CASH RETURN ON SALES RATIO
- Indicates the net cash flow generated by each dollar of sales
- The *higher*, the better

8 EARNINGS PER SHARE
- Indicates profit per ordinary share
- The *higher*, the better

9 PRICE EARNING RATIO
- Indicates relationship between market price per share and earnings per share

HOW TO ANSWER RATIO QUES ?
1. Explain what the ratio means (defn)
2. Give correct interpretation for the increase/decrease in the ratio. Is it good or bad? What does it mean?
3. Trend analysis from year to year - improving or worsening?
3.A) Comparison between 2 or 3 entities - which is better?

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