CONCEPT: INTRODUCTION TO RATIOS

● *Ratios* are a significant part of financial analysis. Companies and investors use ratios to make informed decisions.

□ Ratios fall into one of five broad categories:

1. *Liquidity (Solvency) Ratios* – ability to pay _____ obligations

2. *Financial Leverage Ratios* – ability to pay _____ obligations

3. *Efficiency (Turnover) Ratios* – measures how efficiently company's use their _____

4. *Profitability Ratios* – measures how _____ the company is

5. *Market Value Ratios* – relate financial information to the actual _____ on the open market

□ A ratio is always going to divide one number by another number

- It is important to be able to calculate the ratio, but also important to be able to analyze the results

- The general rule for ratio interpretation:

$$Ratio = \frac{A}{B}$$

The calculation will result in a decimal (i.e. 1.54): this means that for each one unit of "B" there are 1.54 units of "A"

□ When we study each ratio, we will discuss the calculation and the analysis

- Some ratios have *thresholds* that must be maintained, otherwise it indicates a problem

- We can also analyze ratios by using *benchmarks*, comparing to similar companies or industry averages

- Finally, we can compare ratios to *prior periods* for the same company to note changes and trends

EXAMPLE: Julie, a fruit enthusiast, eats both apples and oranges. This month, Julie ate 50 oranges and 20 apples. Express Julie's fruit eating habits as a ratio of oranges eaten to apples eaten. Other fruit enthusiasts have an Orange/Apple ratio of 1.50.