CLASS - XII th COMMERCE

SUB - ACCOUNTANCY

Date - 05/07/2021 - 10/07/2021

Chapter - 5

Part - B (Accounting Ratios)

Part-B

5. Accounting Ratio

Ratio- Arithmetical expression of relationship between two interdependent items.

Ratio Analysis- Ratio analysis is a technique of Financial statement analysis. It is widely used tool to interpret quantitative relationship between two variable of Financial statement.

Accounting Ratios- Ratios, when calculated on the basis of accounting information. (accounting variables)

Objectives of Ratio analysis-

1) To locate the weak spots of business which need more attention.
2) To help in deep analysis of the liquidity, solvency, activity and profitability of the business.
3) To provide information for making cross-sectional analysis.
4) To provide information for making time-series analysis.

5) To provide useful information for making estimates and prepare plans for the future.

Advantages of Ratio Analysis

1) Useful in Analysis of Financial Statement.
2) Useful in Simplifying Accounting Data.
3) Useful in Assessing the operating Efficiency of Business.
4) Useful for Forecasting.
5) Useful in Locating the Weak Areas.

Limitations of Ratio Analysis -

1) False Result
2) Qualitative factors are ignored.
3) Lack of Standard Ratio.
4) May not be comparable.
5) Effect of Price level changes

Types of Ratios

- **Liquidity Ratios**
  - Current Ratio
  - Quick Ratio
- **Solvency Ratios**
  - Debt to Equity Ratio
  - Total asset to Debt Ratio
  - Proprietary Ratio
  - Interest coverage
- **Activity Ratio/ Turnover Ratio**
  - Inventor Turnover Ratio
  - Debtor Turnover Ratio
  - Creditor Turnover Ratio
  - Working Capital Turnover Ratio
- **Profitability Ratio**
  - Gross Profit Ratio
  - Operating Profit
  - Operating Profit Ratio
  - Net Profit Ratio
  - Return on Investment

1) Liquidity Ratios - Liquity is the ability of the firm to meet its current obligations as they fall due.

Include two ratio -

i) Current ratio

ii) Quick ratio

2) Solvency Ratios - These ratios are calculated to assess the ability of the firm to meet its long-term liabilities as and when they become due.

Important solvency ratio -

i) Debt Equity Ratio
ii) Total assets to Debt ratio
iii) Proprietary Ratio
iv) Interest Coverage Ratio.

3) Activity Ratios - These ratios are calculated on the basis of 'cost of revenue from operations' or 'revenue from operations' these ratio are called as activity ratio.

Important activity ratio -

i) Inventory Turnover Ratio
ii) Debtors Turnover Ratio
iii) Creditors or Payables Turnover Ratio
iv) Working Capital Turnover Ratio.

4) Profitability Ratios - The main object of all the business concerns is to earn Profit. Profit is the measurement of the efficiency of the business.

Important profitability ratio -

i) Gross Profit Ratio
ii) Operating Ratio
iii) Operating Profit Ratio
iv) Net Profit Ratio
v) Return on Investment

- Current Ratio -

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Illustration - 1

Calculate Current Ratio from the following information:

Particulars	Rs.
Inventories	50,000
Trade receivables	50,000
Advance tax	4,000
Cash & Cash equivalents	30,000
Trade payables	1,00,000
Short-term borrowings (bank overdraft)	4,000

Soln

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets = Inventories + Trade receivables + Advance tax + Cash and Cash equivalents

= Rs 50,000 + Rs 50,000 + Rs 4,000 + Rs 30,000

= Rs 1,34,000

Current Liabilities = Trade payables + Short-term borrowings

= Rs 1,00,000 + Rs 4,000

= Rs 1,04,000

$$\text{current Ratio} = \frac{\text{Rs } 1,34,000}{\text{Rs } 1,04,000}$$

= 1.29 : 1

- Quick Ratio -

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

Illustration 3 -

Calculate 'Liquid Ratio' from the following information:

Current Liabilities	= Rs 50,000
Current Assets	= Rs 80,000
Inventories	= Rs 20,000
Advance tax	= Rs 5,000
Prepaid expenses	= Rs 5,000

Soln -

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Liquid Assets = Current assets − (Inventories + Prepaid expenses + Advance tax)

= Rs 80,000 − (Rs 20,000 + Rs 5,000 + Rs 5000)

= Rs 50,000

$$\text{Liquid Ratio} = \frac{\text{Rs } 50,000}{\text{Rs } 50,000}$$

= 1 : 1.

- Debt - Equity Ratio -

$$\text{Debt - Equity Ratio} = \frac{\text{Long term Debts}}{\text{Shareholders Funds}}$$

where,

Shareholders Funds (Equity)

= Share Capital + Reserve and surplus + Money received against share warrants + Share application money pending allotment.

Share Capital = Equity Share capital + Preference share capital

or

Shareholders Funds (Equity)

= Non-current assets + Working Capital - Non-current Liabilities

Working Capital = Current Assets - Current Liabilities.

Illustration 7 -

From the following balance sheet of ABC Co. Ltd. as on March 31, 2015. Calculate debt equity ratio:

ABC. Co. Ltd.

Balance Sheet as at 31 March, 2017

Particulars	Note No.	Amt (Rs)
I. Equity and Liabilities		
1. Shareholders' funds		
a) Share Capital		12,00,000
b) Reserves and surplus		2,00,000
c) Money received against share warrants		1,00,000
2. Non-current Liabilities		
a) Long term borrowings		4,00,000
b) other long-term liabilities		40,000
c) Long-term provisions		60,000
3. Current Liabilities		
a) Short-term borrowings		2,00,000
b) Trade payables		1,00,000
c) Other current liabilities		50,000
d) Short-term provisions		1,50,000
		25,00,000

Particulars	Note No.	Amt (Rs)
II. Assets		
1. Non-Current Assets		
a) Fixed assets		15,00,000
b) Non-current investments		2,00,000
c) Long-term loans and advances		1,00,000
2. Current Assets		
a) Current investments		150,000
b) Inventories		1,50,000
c) Trade receivables		1,00,000
d) Cash and cash equivalents		2,50,000
e) Short-term loans and advances		50,000
		25,00,000

Soln-

$$\text{Debt-Equity Ratio} = \frac{\text{Debts}}{\text{Equity}}$$

Debt = Long-term borrowings + other long-term liabilities + Long-term provisions

= Rs 4,00,000 + Rs 40,000 + Rs 60,000

= Rs 5,00,000

Equity = Share Capital + Reserves and surplus + Money received against share warrants

= Rs 12,00,000 + Rs 2,00,000 + Rs 1,00,000

= Rs 15,00,000

Debt Equity Ratio = $\frac{50,00,00}{1,50,0000}$

$= 0.33 : 1$