St. Lawrence High School

A Jesuit Christian Minority Institution

Study Material 6

Sub: ACCOUNTANCY Class 12

Chapter: Unit 5: Analysis of Financial Statements Date: 01/02/2021

Topic: Accounting Ratios 2

Classification of Ratio

Ratio

Liquidity Ratio	Solvency Ratio	Activity Ratio	Profitability Ratio
1. Current Ratio 2. Quick or Liquid Ratio	1. Debt-Equity Ratio 2. Total Assets to Debt Ratio 3. Proprietary Ratio 4. Interest Coverage Ratio	1. Inventory Turnover Ratio 2. Trade Receivable /Debtor Turnover Ratio 3. Trade Payable/ Creditor Turnover Ratio 4. Working Capital Turnover Ratio	1. Gross Profit ratio 2. Net Profit Ratio 3. Operating Ratio 4. Operating Profit Ratio

<u>LIQUIDITY RATIO</u>

1. **Current Ratio:** It is the relationship between current assets and current liabilities. It can be expressed as follows.

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

Ideal Ratio is 2:1

2. **Quick Ratio:** It is the relationship between quick assets and quick liabilities. It can be expressed as follows

Quick Ratio = $\frac{Quick\ Assets}{Quick\ Liabilities} = \frac{Current\ Assets - Inventory - Prepaid\ Expenses}{Current\ Liabilities}$

Ideal Ratio is 1:1

<u>SOLVENCY RATIO</u>

It reflects the ability of a company to repay its long term debts. Under solvency ratio the following ratios are required to ascertain:

Debt Equity Ratio:

Debt Equity Ratio = $\frac{Long\ Term\ Debts}{Shareholders\ Funds}$

Here Long Term Debt = Long Term Loans and Debentures

Shareholders Fund = Equity share capital + Reserve & Surplus – Fictitious Assets

Total Assets to Debt Ratio:

It is the relationship between total assets and long term debt. It can be expressed as follows:

Total Assets to Debt Ratio = $\frac{Total\ Assets}{Long\ Term\ Debt}$

Proprietary Ratio

It is the ratio between shareholders fund and total assets. This ratio shows the proportion of total assets of a business financed by shareholders fund.

Proprietary Ratio = $\frac{Shareholders\ Fund}{Total\ Assets}$

Important point: If the ratio is high means more use of shareholders fund for acquiring total assets. If the ratio is low means maximum assets are financed out of debt capital.

Interest Coverage Ratio

It is the relationship between EBIT (Earning Before Interest & Tax) and amount of interest payable.

Interest Coverage Ratio = $\frac{EBIT}{Interest\ Payable}$

Important point: If the ratio is high means the ability of the firm is more regarding payment of interest and rate of solvency is very high.

<u>ACTIVITY RATIOS</u>

Inventory Turnover Ratio

It is the relationship between average inventory and cost of goods sold. It can be written as follows:

Inventory Turnover Ratio= $\frac{Cost\ of\ Goods\ Sold\ or\ Cost\ of\ Revenue\ from\ operation}{Average\ Inventory}$

Here, Cost of Goods Sold or Cost of Revenue from operation = Opening Stock + Purchases- Closing Stock

Or

= Sales – Gross Profit

Average Inventory = $\frac{Opening\ Inventory + Closing\ Inventory}{2}$

Important point: If the ratio is high means rotation of stock is more and as a result of that profit is high.

Trade Receivable Turnover Ratio / Debtors Turnover Ratio

It is the ratio between credit sales and average trade receivable. It can be written as follows:

Trade Receivable Turnover Ratio = $\frac{Credit\ Sales\ or\ Credit\ Revenue\ from\ operation}{Average\ Trade\ Receivable}$

Here, Average Trade Receivable = $\frac{Opening\ Trade\ Receivable + Closing\ Trade\ Receivable}{2}$

Trade Receivable = Debtors + Bills Receivable

Important point: If this ratio is high means poor management of debtors by the company.

Trade Payable Turnover Ratio / Creditors Turnover Ratio

It is the ratio in between credit purchases and average trade payable. It can be expressed as follows:

Trade Payable Turnover Ratio = $\frac{Net\ Credit\ Purchases}{Average\ Tarde\ Payable}$

Here, Net Credit Purchases = Credit Purchases – Purchase Return

Average Trade Payable = $\frac{Opening\ Trade\ Payable + Closing\ Trade\ Payable}{2}$

Trade Payable = Creditors + Bills Payable

Important Point: If this ratio is high means strict credit terms granted by the supplier. If this ratio is low means credit terms granted by the supplier is liberal.

Working Capital Turnover Ratio

It is the relationship between sales and working capital.

Working Capital Turnover Ratio = $\frac{Revenue\ from\ Operation}{Working\ Capital}$

Here, Working capital = Current Assets – Current Liabilities

PROFITABILITY RATIOS

Gross Profit Ratio

It is the relationship between gross profit and revenue from operation i.

Gross Profit Ratio = $\frac{Gross\ Profit}{Revenue\ from\ operation}$ x 100

Net Profit Ratio

It is the relationship between Net Profit and Revenue from operation.

Net Profit Ratio = $\frac{Net\ Profit}{Revenue\ from\ operation}$ x 100

Operating Ratio

It is the relationship between cost of revenue from operation, operating expenses and revenue from operation.

Operating Ratio = $\frac{Cost\ of\ Revenue\ from\ Oparation + Oparating\ expenses}{Revenue\ from\ Oparation}$ x 100

Operating Profit Ratio

It is the relationship between operating profit and revenue from operation.

Operating Profit Ratio = $\frac{Operating\ Profit}{Revenue\ from\ Operation}$ x 100

Here, Operating Profit = Net Profit after Tax + Non-Operating Expenses – Non-Operating Incomes

Or,

Gross Profit – Operating Expenses + Operating Incomes

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