# Accountancy Notes PDF

# On

# Accounting Ratios

**Ratio**

Ratio is an arithmetical relationship between two interdependent or related items.

**Accounting Ratios**

It is a mathematical expression that shows the relationship between various items or groups of items shown in financial statements. When ratios are calculated on the basis of accounting information, they are called accounting ratios.

### Ratio Analysis

It is a technique which involves re-grouping of data by application of arithmetical relationship.

### Forms of expressing Ratios

There are several forms of expressing ratios as per the chapter on accounting ratios class 12. Let's have a look:

- Pure : Ratios are expressed as quotient
- Percentage: Ratios are expressed as percentage
- Times : Ratios are expressed in number of times
- Fraction : Ratios are expressed in fraction

**Ratio Analysis**

- It studies the various financial factors in a business.
- It analyses financial statements using accounting ratios.
- It helps determine and interpret relationships between items of financial statements and provides a meaningful understanding of the position and performance of an enterprise.

### Objectives of Ratio Analysis

- To know the areas of an enterprise which need more attention.
- To know about the potential areas which can be improved on.
- Helpful in comparative analysis of the performance.
- Helpful in budgeting and forecasting.
- To provide analysis of the liquidity, solvency, activity and profitability of an enterprise.
- To provide information useful for making estimates and preparing the plans for the future.

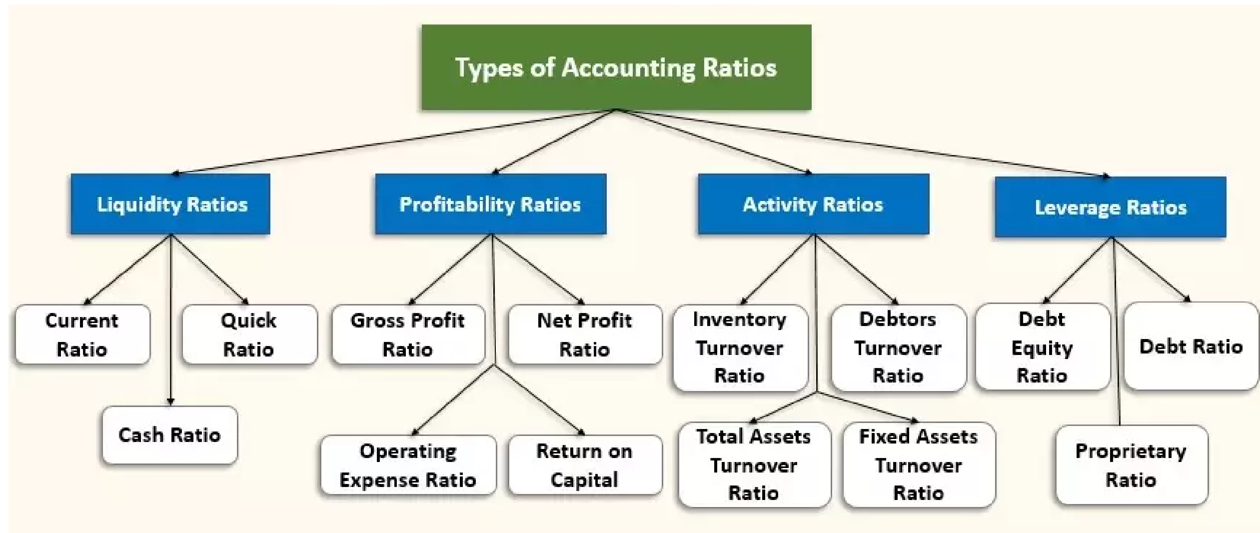
### Advantages of Ratio Analysis

- It is an essential tool for analysis of Financial Statements.
- It simplifies the information on the accounting data.
- It assists in business planning and forecasting
- It helps identify and interpret the favourable and unfavourable ratios which can be used to identify the weak areas in the enterprise.
- It facilitates Inter-firm and Intra-firm Comparison.

**Limitations of Ratio Analysis**

- Accounting ratios ignore qualitative factors.
- Absence of universally accepted terminology.
- Ratios are affected by window-dressing.
- Effects of inherent limitations of accounting.
- Misleading results in the absence of absolute data.
- Price level changes ignored.
- Affected by personal bias and ability of the analyst.

**Classification of Accounting Ratios**




**Items Included in Current Assets**

- Current investments
- Inventories (Excluding loose tools, stores and spares)
- Trade receivables (bills receivable and sundry debtors less provision for doubtful debts)
- Cash and cash equivalents (cash in hand, cash at bank, cheques/drafts in hand)
- Short-term loans and advances
- Other current assets (prepaid expenses, interest receivable, etc.)

**Items Included in Current Liabilities**

- Short-term borrowings
- Trade payables (bills payable and sundry creditors)
- Other current liabilities (current maturities of long-term debts, interest, accrued but not due on borrowings, interest accrued and due on borrowings, outstanding expenses, unclaimed dividend, calls-in-advance, etc)
- Short-term provisions

**Current Ratio**

It calculates the relationship between the current assets and current liabilities and measures the relationship between the current assets and current liabilities.

**Steps to be taken to determine the effect of a transaction on Current Ratio**

- **Step 1:** Amounts of Current Assets and Current Liabilities are to be assumed.
- **Step 2:** Consider the effects of a transaction and put it in the assumed amounts of Current Assets and Current Liabilities. After accommodating such effects in the assumed amounts, new amounts of Current Assets and Current Liabilities are to be calculated.
- **Step 3:** Using these new amounts, a new ratio is to be calculated. Such a new/revised ratio is to be compared with the old ratio to determine its effect on the Current Ratio, i.e., increase, decrease or no change in the ratio.

**Liquid or Quick or Acid Test Ratio**

It is a liquidity ratio that measures the enterprise's ability to meet its short-term financial obligations, i.e., Current Liabilities, and indicates the short-term debt-paying capacity of an enterprise and is, therefore, a better indicator of liquidity.

**Debt-to Equity Ratio**

- It is a relationship between long-term external equities, i.e., external debts (includes long-term borrowings and long-term provisions) and internal equities (Shareholders' Funds) of the enterprise.
- It measures the proportion of external funds and shareholders invested in the company.
- It assesses the enterprise's long-term financial soundness and indicates the extent to which the enterprise depends on borrowed funds for its business.
- It is expressed as a Pure Ratio.

**Total Assets to Debt Ratio**

- It is a relationship between total assets and long-term debts of the enterprise.
- It measures the extent to which debt (Long-term) is covered by the assets.
- It measures the 'Safety Margin' available to the lenders of the long-term debts.
- A higher ratio means higher safety for lenders and a lower ratio means lower safety for lenders.
- It is expressed as a Pure Ratio

**Proprietary Ratio**

- It is a relationship between the proprietor's fund and total assets.
- It shows the financial strength of the entity.
- It is used to find the proportion of total assets financed by Proprietors' Funds.
- It is an important ratio for the creditors. It helps them identify the portion of shareholders' funds in the total assets employed in the firm and the safety margin available to them.
- A very high ratio indicates an improper mix of proprietors' funds and loan funds that result in a lower return on investment. A higher ratio means adequate safety for creditors and lenders. On the other hand, a lower ratio means inadequate safety for creditors and lenders.
- It can be expressed either as 'Pure Ratio' or a 'Percentage Ratio'.

**Interest Coverage Ratio**

- It is a relationship between Net Profit before Interest and Tax and Interest on Long Term Debts.
- It is calculated to ascertain the amount of profit available to cover the interest on long term debts.
- A higher Interest Coverage Ratio is considered better for lenders as it signifies a higher margin to meet interest cost.

**Inventory Turnover Ratio**

- It is a relationship between Cost of Revenue from Operations, i.e., Cost of Goods Sold and average inventory carried during that period.
- It ascertains whether the stock investment is appropriate and that only the required amount is invested in the stock.
- It measures the number of times an enterprise sells and replaces its inventory. Therefore, it is an activity and efficiency ratio that measures the efficiency of inventory management.
- A high ratio shows that more sales are being produced by a rupee of investment in the inventories. A very high ratio indicates overtrading, which may result in a working capital shortage. Only an optimum Inventory Turnover Ratio ensures adequate working capital and helps firms earn a reasonable margin.

**Trade Receivables Turnover Ratio**

- The relationship between Credit Revenue from Operations (i.e., Net Credit Sales) and Average Trade Receivables (i.e., Average of debtors and bills receivable of the year).
- It indicates the number of times trade receivables are turned over in a year about credit sales.
- It identifies how quickly trade receivables are converted into Cash and Cash Equivalents and, therefore, indicates the efficiency in collecting amounts due against trade receivables.
- A higher ratio shows that debts are collected more promptly, and a lower ratio shows inefficiency in the collection or increased credit period or more investment in debtors.
- It should be computed that provision for doubtful debts is not deducted from trade receivables since the purpose is to calculate the number of days for which sales are tied up in trade receivables and not to ascertain the realizable value of debtors.

**Trade Payables Turnover Ratio**

- It is a relationship between the net credit purchases and total payables or average payables.
- It identifies the number of times the creditors are turned over in relation to credit purchases.
- A high ratio indicates that the enterprise is not availing a full credit period, which boosts up the credit worthiness of the enterprise.It is expressed in Times.

**Working Capital Turnover Ratio**

- It is a relationship between working capital and revenue from operations.
- It shows the number of times a unit of Rupee invested in working capital produces sales.
- It helps to ascertain whether or not working capital has been effectively used in generating revenue.
- A higher ratio is considered as an ideal ratio, whereas a very high ratio indicates overtrading.

**Gross Profit Ratio**

- It is a relationship between the Gross Profit and Revenue from Operations (i.e., Net Sales).
- A change either in Revenue from Operations (i.e., Net Sales) or Cost of Revenue from Operations (i.e., Cost of goods sold) or both will have an impact on this ratio.
- It shows the average margin on goods sold.
- It determines the efficiency with which production and/or purchase operations and selling operations are carried on.
- It is a reliable guide for fixing selling prices.
- It is useful in determining the efficiency of trading activities.
- It can be compared with the ratio of earlier years or with that of other firms to compare the efficiency and growth of the business.

**Operating Profit Ratio**

- It is the relationship between Operating Profit and Revenue from Operations i.e., Net Sales.
- It determines the operational efficiency of the business.
- An increase in the ratio shows improvement in the operational efficiency of the entity.

**Net Profit Ratio**

- It is a relationship between Net Profit and Revenue from Operations, i.e., Net Sales.
- It helps in determining the operational efficiency of the business.
- It indicates the business's actual status, as the higher the Net Profit Ratio, the better the business.
- An increase in the ratio over the past period shows improvement in operational efficiency.
- A decline in the ratio over the past period shows a fall in operational efficiency.
- It facilitates comparison of operation efficiency with that of industry standards.

**Return on Capital Employment and Investment**

- It shows the relationship between Net Profit/Earnings before interest and tax with capital employed.
- It measures how efficiently the resources of the business are being used.
- It is a fair measure of the profitability of any concern with the result that the performance of different industries can be compared.
- It indicates whether the company or business is giving satisfactory returns.
- It assesses the overall performance of the enterprise.