# NOTES

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## Ratio Analysis

### I. Liquidity Ratios

→ check the capability of company to pay current liability
→ short term solvency

(A) Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$
(shows short term financial)

Current Assets = except for loose tools take all assets
Current liabilities = All current liabilities

Ideal Ratio = 2:1 (High → Good)

(B) Quick Ratio = $\frac{\text{Quick Assets}}{\text{Current liability}}$
(measures liquidity)

Quick Assets → except Inventories & Prepaid expense
Current liab → all

★ Quick Assets → Quickly converted into cash
★ Inventories are excluded → (can't be converted into cash easily
★ Prepaid expense excluded → Paid in advance & service not yet received (can't Be converted into cash)

Ideal Ratio = 1:1 (High good)

Other Imp Terms

1. Current liab = Current Assets − Capital Employed
2. Current Assets = CE + CL − Fixed Assets
3. Working capital = CA − CL

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# II Solvency Ratios

→ long term solvency Ratios

(A) Debt-Equity Ratio $= \frac{\text{Debt}}{\text{Equity}}$
(measure funds & shareholder fund invested in company)

{ Equity / shareholder fund / Proprietor fund }

Debt = long term Borrowings + long term Provisions
Equity = share capital + Reserve & surplus
ESC    PSC

Ideal Ratio 2:1

{ Low Ratio means → depend more on Borrowing than SF
High Ratio means → depend more on SF than Borrowing }

(B) Total Assets to Debt Ratio $= \frac{\text{Total Assets}}{\text{Debt}}$
(debt covered by Assets)

Total Assets = NCA + CA
Debt = long term Borrowing + long term Provisions.

Ideal Ratio = 2:1 (High good)

(C) Proprietary Ratio $= \frac{\text{Equity}}{\text{Total Assets}}$ (High good)
(Assets financed by Proprit)

Equity = Share capital + Reserve & surplus
Total Assets = NCA + CA.
(Expressed in fraction)

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(D) Interest Coverage Ratio = $\frac{\text{Profit Before Int \& Tax}}{\text{Int on long term debt}}$
(How many times Int are covered By profits)

[Ratio Expressed in Times. High good]

Profit Before Int / Tax
− Interest
Profit Before Tax
− Tax
Profit after Tax

# III TURNOVER / ACTIVITY RATIOS

→ enterprises uses it available Resource
→ expressed in Times
→ High good.

(A) Inventory Turnover Ratios = $\frac{\text{COGS / CRFO}}{\text{AV Inventory}}$ (High good)
(Times stock converted into Sales)

- Cost of goods sold / cost of Revenue from operations
  = Opening Inventory + Purchases + Direct Expense − closing stock

OR

COGS = Sales − Gross Profit

- Average Inventory = $\frac{\text{Op Invt + Cl. Invt}}{2}$

(B) Trade Receivable Turnover Ratio = $\frac{\text{Net credit Sales / RFO}}{\text{Avg TR}}$
(amount due from TR)

- Trade Receivable = debtors + B/R
- Net credit sales = Total sales − Sales Return − cash Sale
- Debtor collection Period = $\frac{365/12}{\text{TRTR}}$
- AV TR = $\frac{\text{OPTR + Cl. TR}}{2}$

(C) Trade Payable Turnover Ratio = $\frac{\text{Net credit purchases}}{\text{AV. Trade Payable}}$

- Trade Payable = ~~debtors~~ creditors + B/P
- Net credit Purchase = Total Purchase − Purchase Return − Cash Pur.
- AV. TP = $\frac{\text{OPTP + Cl TP}}{2}$
- Creditors Payment Prd = $\frac{365/12}{\text{TPTR}}$

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(4) working capital Turnover Ratios = $\frac{\text{Revenue from operations}}{\text{working capital}}$
(sales of company)

RFO = Net Sales
WC = CA − CL

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## IV Profitability Ratios

→ measures financial performance | Efficiency
→ expressed in percentage

(A) Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$

• Gross Profit = RFO − COGS

(B) Operating cost Ratio = $\frac{\text{Operating cost}}{\text{Net sales}} \times 100$

• operating cost = COGS + Admin & office Exp + selling exp

(C) Operating Profit Ratio = $\frac{\text{operating profit}}{\text{Net sales}} \times 100$

→ Operating cost Ratio + operating Profit Ratio = 100%

(D) Net Profit Ratio = $\frac{\text{Net Profit}}{\text{Net Sales}} \times 100$

[Net Profit → Profit After Tax]

(E) Return on Investment / Return on capital Employed
= $\frac{\text{Profit Before Int \& Tax}}{\text{Capital Employed}} \times 100$

• capital employed = debt + equity

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# Profitability Ratios

| | |
|---|---|
| Sales | xxx |
| – cost of goods sold | xxx |
| (A) Gross Profit | □□□ |
| – Admin & office Expense | xxx |
| – selling & dist Expense | xxx |
| (B) operating Profit | □□□ |
| – Non operating Exp | xxx |
| + Non operating Income | xxx |
| (C) Net Profit Before Tax | □□□ |
| – Tax | xxx |
| (D) Profit after Tax | □□□ |
| – Preference dividend | xxx |
| Profit available to Equity | □□□ |