

Reading materials
Class XII Accountancy
Ratio Analysis

Types of accounting ratios

There are different types of ratios analysis that have been calculated by every company to evaluate business performance. Simply we may divide it as below:

Type #1– Liquidity Ratios

These ratios represent whether the company has enough liquidity to meet its short term obligations or not.

- **Current Ratio:** It represents the liquidity of the company in order to meet its obligations in the next 12 months. Higher the current ratio, stronger the company to pay its current liabilities.
- **Quick Ratio:** It represents how cash rich is the company to pay off its immediate liabilities in the short term.

Type #2 – Solvency Ratios

These ratio analysis types suggest whether the company is solvent & is able to pay off the debts of the lenders or not.

- **Debt-Equity Ratio:** This ratio represents the ratio of own fund to loan fund. A low debt/equity ratio means that the company has a lesser amount of debt on its books and is more equity diluted. A 2:1 is an ideal debt-equity ratio to be maintained by any company.
- **Interest Coverage Ratio:** It represents how many times the company's profits are capable of covering its total interest payments.
- **Proprietary Ratio:** It establishes the relation between the owner's funds and total assets. This ratio shows to the extent to which the shareholders own the business.

Type #3 – Profitability Ratios

This type of ratio analysis suggests the returns that are generated from the Business with the Capital Invested.

- **Gross Profit Ratio:** It represents the initial profit of the company after adjusting the cost of the goods that are been sold.
- **Net Profit Ratio:** It represents the overall profitability of the company after deducting all the cash & no cash expenses.
- **Operating Profit Ratio:** It represents the soundness of the company and the ability to pay off its debt obligations.
- **Return on Capital Employed:** Return On Capital Employed represents the profitability of the company with the capital invested in the business.

Type #4 – Turnover Ratios

These ratios signifies how efficiently the assets and liabilities of the company are been used to generate revenue.

- **Inventory Turnover Ratio:** Inventory Turnover Ratio represents how fast the company is able to convert its inventory into sales.
- **Trade Receivable Turnover Ratio:** Receivables Turnover Ratio reflects the efficiency of the company to collect its receivables. It signifies how many times the receivables are been converted to cash.
- **Trade Payable Turnover Ratio:** It shows the relationship between net credit purchases and average trade payables.

Ready Aid to Different Formulae

- A. **Liquidity Ratio:** These are divided into:
 - a. **Current Ratio** = Current Assets / Current Liabilities
 - b. **Quick ratio or Acid test ratio** = (All current assets less inventories less prepaid expenses) / Current Liabilities
- B. **Solvency Ratio:** These are divided into:
 - a. **Debt to Equity Ratio:** Long term debt / Shareholders Fund
 - b. **Proprietary Ratio:** Shareholders Fund / Total Assets
 - c. **Debt to asset Ratio:** Total Debts / Total Assets
 - d. **Interest Coverage Ratio:** Net Profit before Interest and Tax / Total Interest Payments
- C. **Activity Ratio:** These are further divided into:
 - a. **Trade receivable Turnover Ratio:** Credit Revenue from operations / average trade receivables.
 - b. **Trade payable Turnover Ratio:** Net credit purchases / average trade payables

- c. Working capital Turnover Ratio:** $\text{Cost of revenue from operations} / \text{Working capital}$
- d. Inventory Turnover Ratio:** $\text{Cost of revenue from operation} / \text{Average inventory}$

D. **Profitability Ratio:** These are divided into:

- a. Gross Profit Ratio:** $(\text{Gross profit} / \text{revenue from operations}) * 100$
- b. Net Profit Ratio:** $(\text{Net profit} / \text{revenue from operation}) * 100$
- c. Operating Ratio:** $\{(\text{Cost of Revenue from operation} + \text{operating expenses}) / \text{Revenue from operation}\} * 100$
- d. Operating Profit Ratio:** $(\text{Net operating profit} / \text{Revenue from operations}) * 100$
- e. Return on Investment:** $(\text{Net profit before interest and tax} / \text{capital employed}) * 100$

Note:

- a.** While calculating current assets we exclude loose tools and spare parts.
- b.** Shareholders Fund = Share Capital + Reserves and surplus
- c.** Shareholders Fund can also be calculated as Non-current assets + working capital - non-current liabilities
- d.** $\text{Average trade receivables} = (\text{Opening trade receivables} + \text{closing trade receivables}) / 2$
- e.** $\text{Average trade payables} = (\text{Opening trade payables} + \text{closing trade payables}) / 2$
- f.** Working capital = Current assets – current liabilities
- g.** $\text{Average Inventory} = (\text{Opening inventory} + \text{closing inventory}) / 2$