**CBSE Quick Revision Notes and Chapter Summary**
**Class-12 Accountancy**
**Part – B – Accounting Ratios**

## Introduction

The main purpose of Financial Statements is to provide the accounting information to its users. Financial Statements are used for analysis, comparison and interpretation purpose. Accounting ratios are used to analyse the financial statements for assessing the profitability, solvency, efficiency and liquidity of the business. Accounting ratios are an important tool of financial statements analysis. Accounting ratios help in presenting the data in summarized form and in an effective manner.

## Classification or types of ratios

Ratios are classified into 4 categories

1. Liquidity Ratios also called as short term solvency ratios.
2. Solvency Ratios
3. Activity ratios also known as Turnover ratios or Performance ratios
4. Profitability ratios

### Liquidity Ratios

(1) Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Current Assets = Current Investments + Inventories (Excluding Spare Parts and Loose Tools) + Trade Receivables + Cash and Cash Equivalents + Short Term Loans and Advances + Other Current Assets

Current Liabilities = Short-Term Borrowings + Trade Payables + Other Current Liabilities + Short-term Provisions

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

Liquid Asset = Current Assets – Inventories – Prepaid expenses.

Current Liabilities = Short-Term Borrowings + Trade Payables + Other Current Liabilities + Short-term Provisions

### Solvency Ratios

(1) Debt Equity Ratio = $\frac{\text{Debt}}{\text{Equity}}$

Debt =Long Term Borrowings + Long Term Provisions

Equity / Shareholder's Funds = Share Capital + Reserves and Surplus

OR

Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Trade Investments + Long-Term Loans & Advances) + Working Capital – Non-Current Liabilities (Long-Term Borrowings + Long-Term Provisions)

Where Working Capital = Current Assets – Current Liabilities

(2) Total Assets to Debt Ratio = $\frac{\text{Total Assets}}{\text{Debt}}$

Total Assets = Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Investments + Long-Term Loans & Advances)

+

Current Assets (Current Investments + Inventories including Spare Parts & Lose Tools + Trade Receivables + Cash & Cash Equivalent + Short-Term Loans & Advances + Other Current Assets).

Debt =Long Term Borrowings + Long Term Provisions

(3) Proprietary Ratio = $\frac{\text{Proprietors Funds}}{\text{Total Assets}}$

**Proprietors Funds** = Share Capital + Reserves and Surplus

OR

Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Trade Investments + Long-Term Loans & Advances) + Working Capital – Non-Current Liabilities (Long-Term Borrowings + Long-Term Provisions)

Total Assets = Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Investments + Long-Term Loans & Advances)

+

Current Assets (Current Investments + Inventories excluding Spare Parts & Lose Tools + Trade Receivables + Cash & Cash Equivalent + Short-Term Loans & Advances + Other Current Assets).

(4) Interest Coverage Ratio = $\frac{\text{Profit before interest and tax}}{\text{Interest on Long term debt}}$

**Significance/Objectives/Importance**

- This ratio indicates that a firm can pay interest due on long term debts or not.
- Higher ratio indicates that firm can pay interest on long term debts without any hurdle.
- Low ratio indicates that firm may face problem in paying the interest due on long term debts.

## Activity Turnover Ratio

**(1) Inventory Turnover Ratio =** $\frac{\text{Cost of Revenue from operations}}{\text{Average Inventory}}$

Cost of Revenue from Operation = Revenue from Operation – Gross Profit

OR

Opening Inventory + Net Purchases + Direct Expenses (Assume to be given) – Closing Inventories

OR

Cost of materials consumed + purchase of stock-in-trade + change in Inventory (Finished Goods; Work in Progress & Stock-in-trade) + Direct Expenses (Assume to be given)

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

(2) **Trade Receivable Turnover Ratio** = $\frac{\text{Credit Sales (Net)}}{\text{Average Trade Receivable}}$

Net Credit Sales = Total Sales - Cash Sales

OR

Credit Revenue from Operation =

Revenue from Operation – Cash Revenue from Operation

Average Trade Receivables = $\frac{\text{Opening Trade Receivable + Closing trade Receivable}}{2}$

Trade Receivable = Debtors + Bills Receivables

(3) **Trade payable Turnover Ratio** = $\frac{\text{Net Credit Purchase}}{\text{Average Trade Payable}}$

Net Credit Purchase = Total Purchases – Cash Purchases

Average Trade Payables = $\frac{\text{Opening Trade Payables + Closing trade Payables}}{2}$

Trade Payables = Creditors + Bills Payable

(4) Working Capital Turnover Ratio = $\frac{\text{Revenue from Operations}}{\text{Working Capital}}$

Working Capital = Current Assets – Current Liabilities

Current Asset = Current Investments + Inventories (Excluding Spare Parts and Loose Tools) + trade Receivables + Cash and Cash Equivalents + Short Term Loans and Advances + Other Current Assets

Current Liabilities = Short-Term Borrowings + Trade Payables + Other Current Liabilities + Short-term Provisions

**Profitability Ratios**

**(1) Gross Profit Ratio =** $\frac{\text{Gross profit}}{\text{Revenue from Operations}} \times 100$

Gross Profit = Revenue from Operation – Cost of Revenue from Operations

Cost of Revenue from Operation = Opening Inventory (excluding Spare Parts and Loose Tools) + Net Purchases + Direct Expenses – Closing Inventory (excluding Spare Parts and Loose Tools)

OR

Revenue from Operation – Gross Profit

(2) **Operating Ratio** = $\frac{\text{Cost of Revenue from operation + Operating cost}}{\text{Revenue from operations}} \times 100$

Cost of Revenue from Operation = Opening Inventory (excluding Spare Parts and Loose Tools) + Net Purchases + Direct Expenses – Closing Inventory (excluding Spare Parts and Loose Tools)

OR

Revenue from Operation – Gross Profit

Operating Expenses = Office, Administrative, Selling and Distribution Expenses, Employees Benefit expenses, Depreciation & Amortisation

(3) **Operating Profit Ratio** = $\frac{\text{Operating Profit}}{\text{Revenue from operations}} \times 100$

Operating Profit = Net Profit (After Tax) + Non Operating Expenses / Losses – Non Operating Incomes

OR

Gross Profit + Operating Income – Operating Expenses

Non Operating Expenses = Interest on Long Term Borrowing + Loss on sale of Fixed or Non Current Assets

Non Operating Income = Interest received on investments + Profit of sale of Fixed Assets or Non-Current Assets

(4) **Net Profit Ratio** = $\frac{\text{Net Profit}}{\text{Revenue from operations}} \times 100$

Net Profit before Interest & Tax = Gross Profit + Other Incomes – Indirect Expenses

(5) Return on Investment (ROI) = $\frac{\text{N/P before interest, tax \& dividend}}{\text{Capital Employed}} \times 100$

Return on Capital Employed

Net Profit before Interest,
Tax and Dividend = Gross Profit + other Income – Indirect Expenses

**Formula of Capital Employed**

| Liabilities side approach | Assets Side Approach |
|---|---|
| Shareholder's Fund ( Share Capital + Reserves & surpluses) + Non-Current liabilities ( Long term-borrowing + long term Provisions, | Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current investment + Long-term Loans & Advances) + Working Capital<br><br>Working Capital = Current Assets - Current Liabilities<br>(It is Assumed that all Non-Current Investments are Trade Investments only)<br><br>(Interest on Non-Trade Investments should be Deducted from Profit before Interest, Tax and Dividend. Therefore it can not be a part of Non-Current Investments). |

**Ratio Analysis** : A tool used by individuals to conduct a quantitative analysis of infomation in a company's financial statements.

**Expression of ratios : Ratios are expressed in :**

1. Pure form like 2:1 al current ratios are expressed in pure form.
2. Percentage e.g. 15% al profitability ratios are presented in percentage form
3. Times like 4 times al turnonver ratios are presented in no. of times
4. Fraction like 3/4 or .75 al solvency ratios are presented in fractions except Interest Coverage Ratio which is presented in Number of times.