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B.COM. PART 1

CORE CONCEPT OF FINANCIAL ACCOUNTING

Ratio Analysis :- Ratio Analysis is a very important tool of financing analysis. It is the process of identifying the financial strengths and weakness of the organization by logically establishing relationship between the items of balance sheet or income statement or both interpreting the results there of in order to derive meaningful conclusions.

It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. As a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income and position statements. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.

Objective of Ratio Analysis

1. To know the areas of the business which need more attention
2. To know about the potential areas which can be improved with the effort in the desired direction.
3. To provide a deeper analysis of the profitability, liquidity, solvency and efficiency levels in the business;
4. To provide information for making cross-sectional analysis by comparing the performance with the best industry standards; and
5. To provide information derived from financial statements useful for making projections and estimates for the future.

Advantages of Ratio Analysis

1. Helps to understand efficacy of decisions
2. Simplify complex figures and establish relationships
3. Helpful in comparative analysis
4. Identification of problem areas
5. Enables SWOT analysis
6. Various comparisons

Limitations of Ratio Analysis

1. Limitations of Accounting Data
2. Ignores Price-level Changes
3. Ignore Qualitative or Non-monetary Aspects
4. Variations in Accounting Practices
5. Forecasting

Classification or Types of Ratio

1) **Liquidity Ratios**: To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as 'Liquidity Ratios'. These are essentially short-term in nature.

a) $\text{Current Ratio} = \dfrac{\text{Current Assets}}{\text{Current liabilities}}$

b) $\text{Quick Ratio} = \dfrac{\text{Quick Assets}}{\text{Current liabilities}}$

2) **Solvency Ratios**: Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as 'Solvency Ratios'. These are essentially long-term in nature.

a) $\text{Debt} - \text{Equity Ratio} = \dfrac{\text{Long} - \text{Term Debt}}{\text{Shareholder Funds}}$

b) $\text{Total Assets to debt Ratio} = \dfrac{\text{Total Assets}}{\text{Long} - \text{Term debt}}$

c) $\text{Proprietary Ratio} = \dfrac{\text{Equity}}{\text{Total Assets}} \text{ x } 100$

d) $\text{Interest Coverage Ratio} = \dfrac{\text{Net Profit before Interest } \& \, tax}{\text{Interest on long} - \text{term Debt}}$