



# Module-C Unit-2

## JAIIB PAPER-3

### **Accounting & Financial Management for Bankers(AFM)**



## JAIIB Paper 3 AFM Module C Unit 2- Ratio Analysis

### Accounting Ratios

**Accounting ratio is the comparison of two or more financial data** which are used for analyzing the financial statements of companies. It is an effective tool used by the **shareholders, creditors and all kinds of stakeholders to understand the profitability, strength and financial status of companies.**

### Classification of Ratios

*Accounting ratios can be classified on the following basis:*

#### **Traditional Classification**

The traditional classification has been on the basis of the financial statements, to which the determinants of a ratio belong. On this basis, the ratios could be classified as:

- Profit and loss account ratios, i.e, ratios calculated on the basis of the profit and loss account only.
- Balance sheet ratios, i.e, ratios calculated on the basis of the figures of balance sheet only.
- Composite ratios or inter-statement ratios, i.e, ratios based on figures of profit and loss account as well as the balance sheet.

#### **Functional classification**

Traditional basis of classification, as given above, has been found to be too crude and unsuitable because, analysis of balance sheet and income statement cannot be done in isolation. They have to be studied together in order to determine the profitability and solvency of the business. According to the order that ratios serve as a tool for financial analysis, they are now classified as:

- Profitability ratios,
- Turnover or activity ratios, and
- Financial or solvency ratios

*Financial ratios two categories:*

- **Short term Solvency Ratios** are the ratios that disclose the financial position or solvency of the firm in the short period. Some accountants prefer to call them simply as 'Liquidity Ratios'.
- **Long term Solvency Ratios** are the ratios that disclose the financial position or solvency of the firm in the long period. Some accountants prefer to call them simply as 'Solvency Ratios'.

## Uses of Accounting Ratios

- **Simply financial Statements:** Ratios simplify the comprehension of financial statement. Ratios tell the whole story of changes in the financial condition of the business.
- **Facilitate inter-firm comparison:** Ratios provide data for inter-firm comparison. Ratios highlight the factors associated with successful and unsuccessful firms. They also reveal strong firms and weak firm, overvalued and under- valued firms.
- **Facilitate intra-firm Comparison:** Ratios also make possible comparison of the performance of the different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.
- **Help in planning:** Ratios help in planning and forecasting. Over a period of time, a firm or industry develops certain norms that may indicate future success or failure.

## Limitations of Accounting Ratios

- The firm can make some year-end changes to their financial statements, to improve their ratios. Then the ratios end up being nothing but window dressing.
- Ratios ignore the price level changes due to inflation. Many ratios are calculated using historical costs, and they overlook the changes in price level between the periods. This does not reflect the correct financial situation.
- Accounting ratios completely ignore the qualitative aspects of the firm. They only take into consideration the monetary aspects (quantitative)
- There are no standard definitions of the ratios. So firms may be using different formulas for the ratios. One such example is Current Ratio, where some firms take into consideration all current liabilities but others ignore bank overdrafts from current liabilities while calculating current ratio
- And finally, accounting ratios do not resolve any financial problems of the company. They are a means to the end, not the actual solution.

## Calculation and Interpretation of various Ratios

### Profitability Ratios

#### Overall Profitability Ratio

It is also called as the '**Return on Investment**'. It indicates the percentage of return on the total capital employed in the business. It is calculated on the basis of the **following formula:**

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

**Capital Employee:** Different meanings by different accountants.

- Sum total of all assets whether fixed or current.
- Sum total of fixed assets
- Sum total of long term funds employed in the business i.e, Share+ Capital + Reserves and Surplus + Long term loans –(Non business assets+ fictitious assets)

**Operating Profit:** Means profit before 'Interest and Tax'. The term 'Interest' means interest means 'Interest on long term borrowings. Interest on short- term borrowings will be deducted for computing operating profit.

### Earnings per share (EPS)

EPS tells about the earning per equity share. It can be computed as follows:

**Earning per share**=Net profit after tax and Pref. dividend/ Number of equity shares

### Price Earning (P/E) Ratio

The ratio indicates the number of times the earning per share is covered by its market price. This is calculated according to the following formula:

Market price per equity share/ Earning per share

### Gross Profit Ratios

The ratio expresses the relationship between the gross profit and the net sales.

$$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

### Net Profit Ratio

This ratio indicates net margin earned on a sale of Rs. 100. It is calculated as follows:

$$\frac{\text{Net Operating Profit}}{\text{Net Sales}} \times 100$$

### Solvency Ratios

A company is considered to be solvent or financially sound if it is in a position to carry on its business smoothly and meet all obligations, both long-term as well as short-term, without strain. The following are the important ratios for measuring the long-term solvency of a firm.

**Long -term Solvency Ratios:** In order to determine the long term solvency of a business, the following ratios will be useful:

**(i) Fixed Asset Ratio:** The ratio is expressed as follows:

Fixed assets/ Long-term funds

- **The ratio should not be more than 1. If it is less than 1,** it shows that a part of the working capital has been financed through long-term funds. This is desirable to some extent because a part of working capital, termed as 'Core Working capital' is more or less of a fixed nature. **The ideal ratio is 0.67.**
- **Fixed assets include 'net fixed assets'** (i.e, original cost- depreciation to date) and trade investments including share in subsidiaries. Long term funds include share capital, reserves and long term loans.

**(ii) Debt Equity Ratio:** The debt-equity ratio is calculated to ascertain the soundness of the long-term financial policies of the company. It is also known as the 'External-Internal' equity ratio. It may be calculated as follows:

**Debt-equity ratio**= External equities/ Internal equities

### Short term Solvency Ratios

*The following ratios will be useful for determining the short-term solvency of a business.*

- **Current Ratio:** This ratio is an indicator of the firm's commitment to meet its short-term liabilities.

Current Assets/ Current liabilities

- **Liquidity Ratio:** This ratio is also termed as 'acid test ratio' or 'quick ratio'. This ratio is ascertained by comparing the liquid assets (i.e, assets which are immediately convertible into cash without much loss) to current liabilities. Prepaid expenses and stock are not taken as liquid assets. The ratio may be expressed as:

Liquid assets/ Current liabilities

### Turnover Ratios

**Stock turnover Ratio:** This ratio indicates whether the investment in inventories is efficiently used or not. It, therefore, explains whether investment in inventories is within proper limits or not.

Cost of goods sold during the year/ Average inventory

**Debtors 'Turnover Ratio (Debtors Velocity):** Debtors are an important constituent of current assets and therefore, the quality of debtors, to a great extent, determines a firm's liquidity. Two ratios are used by financial analysis to judge this. They are:

(i) Debtors, turnover ratio, and

(ii) Debt collection period ratio.

**Debtor's turnover ratio is calculated as under:**

Credit sales/ Average accounts receivable

**Debt collection period Ratio:** The ratio indicates the extent to which the debts have been collected in the time. It gives the average debt collection period. The ratio is very helpful to the lenders because it explains to them whether their borrowers are collecting money within a reasonable time. An increase in the period will result in greater blockage of funds in debtors. The ratio may be calculated by any of the following methods:

(i) Months (or days) in a year/ Debtors turnover

(ii)

$$\frac{\text{Months (or days) in a year}}{\text{Credit sales for the year}} \times \text{Average accounts receivable}$$

(iii) Account receivable/ Average monthly or daily credit sales

### **Different Users and Their Use of Ratios**

#### **Accounting ratios used by a long-term creditor:**

- Fixed charges cover= Income before interest and tax/ Interest charges
- Debt service coverage ratio= Cash profit available for debt service/ Interest + Principal payment instalment

#### **Accounting ratios used by a bank granting a short-term loan:**

- Quick ratio= Quick assets/ Current liabilities
- Current ratio= Current assets/ Current liabilities

#### **Accounting ratios used by shareholders:**

- Earnings per share= Profit available for equity shareholders/ No. of equity shares
- Dividend yield ratio= Dividend per share/ Market price per share

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