



**Financial Literacy 360 Degree
Endeavour for Learners**

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MODULE: 6

Lrn

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DEFINE FINANCIAL RATIOS

Financial ratios are certain financial numerical values related to an organization such as sales, profit, assets etc. These financial values are present in the accounting statement of an organization like balance sheet, income statement and cash flow statement. Financial practitioners calculate various ratios using the said financial data from the statements to analyze the business health, performance and also compare with other competitors or broadly in the sector.

In mathematics ratio is defined as a medium of explaining the interrelation between two numerals. Ratio is computed by dividing one numeral by the other. By means of ratio generally the times by which one numeral is greater than the other or the proportion of one in relation to the other is expressed.

Source: ICWAI Financial Accounting -study material compendium

In a nut shell, by calculating ratios, businesses can compare prior periods and identify the trend whether it is consistent in one direction or has changed.

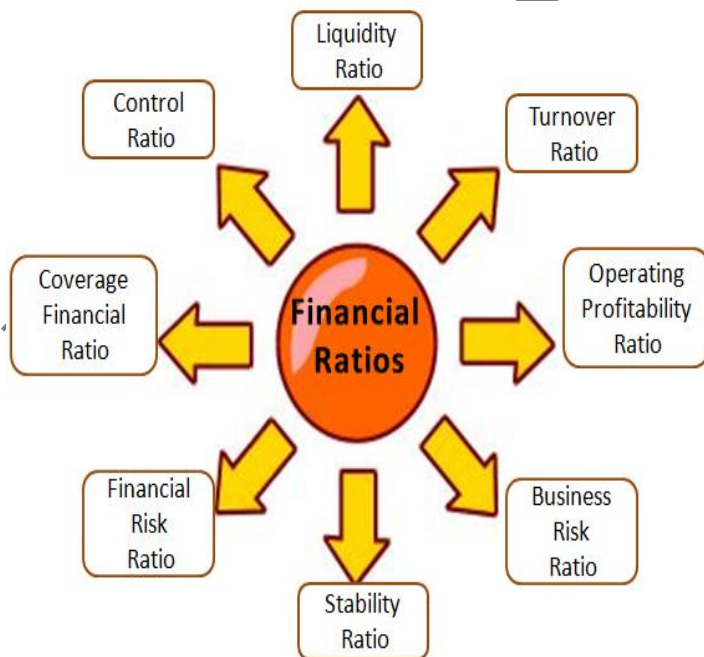
Therefore, ratio analysis of any business will help to take corrective measures that is planning, forecasting and control on expenses/ cost. It is one of the financial communication tools that is useful for internal and external stakeholders:



CLASSIFICATION OF FINANCIAL RATIOS

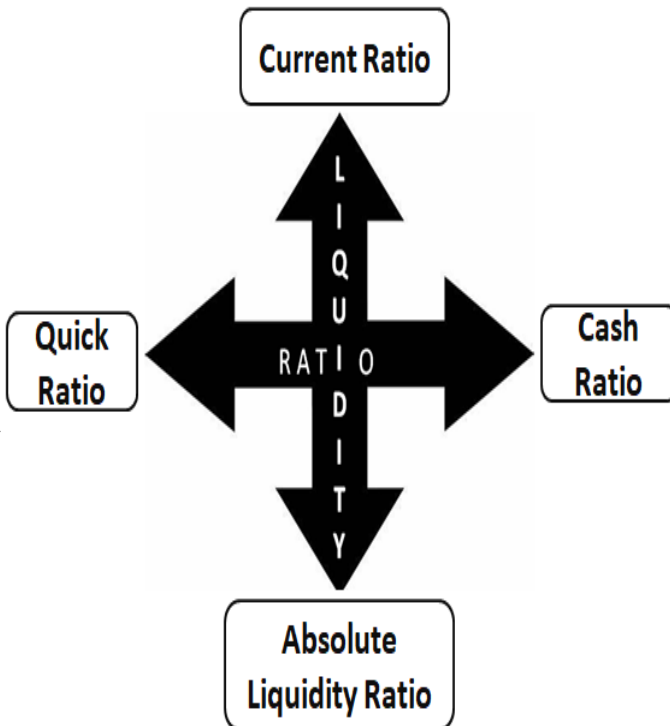
As stated above, ratios are important for both, internal and external stakeholders. For instance, as an investor, you would like to get information about the liquidity, profitability, solvency of the business / organization.

Financial ratios can be classified into eight categories based on their importance:



LIQUIDITY RATIO :

This ratio is used to analyze the business house's ability to pay off the current or short-term obligations without raising external capital. The four common liquidity ratios are shown below:



CURRENT RATIO:

This ratio represents the relationship between current assets and current liabilities. By calculating current ratio, businesses can identify whether its current assets are adequate to meet its current liabilities. You can calculate current ratio by using this formula-

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liability}}$$



Ratio

A comparison of **two** amounts that can be expressed **three** ways.



Equivalent ratios

Ratios that have the **same** value.



Let's see the components of current liabilities and current assets in a balance sheet:

| Current Liabilities | Current Assets |
|---|--|
| Creditors + Bills Payable + Outstanding Expenses + Tax Liability + Bank Overdraft (short-term) Proposed Dividend + Wages | Closing stock + Debtors + Bills Receivable +Prepaid Expenses+ Advances Given + Cash at Bank + Bonds + Commercial papers |

Current ratio is also known as working capital ratio. The result of the current ratio is expressed in percentage.

Example -

A retail store has INR 5cr in current assets and 2cr in current liabilities. Calculate current ratio.

$$\text{Current Ratio} = \frac{5}{2} = 2.5$$

The result concludes that the number of times a business can pay its current obligations with its current assets.

Since current ratio is higher than one in the above example, means store has sufficient money to manage their obligations.

Essentially, 2:1 current ratio is considered an ideal benchmark; meaning per one-rupee current liabilities, current asset of rupees two, (Source -ICAI Intermediate Financial-Accounting) indicates that business can manage its liquidity.

To summarize, higher current ratio indicates better liquidity and enough capacity to pay business liabilities. If it is lower than 1 it indicates the negative performance of business.



QUICK RATIOS :

This ratio is used to identify the liquidity of a business in a short term. Quick ratio includes assets that can be converted to cash in a short period of time to meet current liabilities. It is also known as acid-test ratio because one can easily get quick updates about the present financial status of a business.

Primarily, it includes cash, marketable securities and some account receivables. Inventory and prepaid expenses are not considered in the quick ratio.

Therefore, inventory and current prepaid assets should be subtracted from the total current assets as shown in the formula below:

Quick Ratio =

$$\frac{\textit{(Total Current Assets – Inventory – Prepaid expenses)}}{\textit{Current Liability}}$$

or

$$\text{Quick Ratio} = \frac{(\text{Current Assets} - \text{Inventory})}{\text{Current Liability}}$$

or

$$\text{Quick Ratio} = \frac{\text{Quick assets}}{\text{Current Liability}}$$

Example -

A big retail shop has INR 10cr in current assets and 2cr in inventory and 4cr current liabilities. Calculate quick ratio.

$$\text{Quick Ratio} = \frac{(10-2)}{4} = 2 \text{ times}$$

It indicates that retail shop can easily pay its liabilities in present scenario. It is always used along with current ratio meaning current ratio output is verified or supported by quick ratio.

CASH RATIO:

It is a ratio that measures the liquidity of any business. Essentially, cash ratio is used to compare the cash and cash equivalents with its current liabilities. It is also known as cash coverage ratio.

As per Investopedia- The cash ratio is an indicator of a firm's value under the worst-case scenario. It provides information to creditors and analysts about the value of current assets that can be quickly turn into cash to pay off the immediate liabilities.

You can calculate cash ratio by using the given formula -

$$\text{Cash Ratio} = \frac{\text{Cash \& Cash Equivalents}}{\text{Current Liability}}$$

Example -

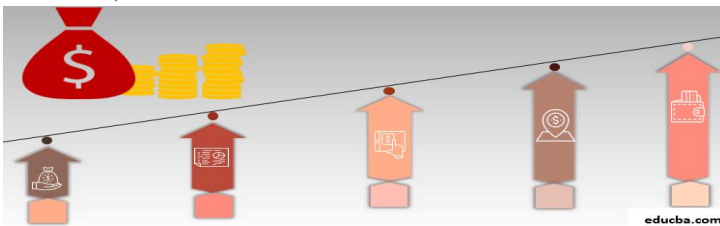
A restaurant owner wants to renovate the restaurant. He has INR 300000 in cash and INR

400000 in cash equivalent. Current liabilities as per the books are INR 800000. Calculate cash ratio.

$$\text{Cash Ratio} = \frac{(300000+400000)}{800000} = 0.87$$

It turns out that because the ratio is lower than 1, the owner will not be able to repay his current liabilities.

If we modify the cash equivalent as INR 600000 (300000+600000), then total cash would be 900000 (900000/800000) therefore the cash ratio would be 1.1. In this case, owner can pay off his current liabilities. However, he has to raise more cash to meet the renovation expenses.



ABSOLUTE LIQUIDITY RATIO:

It is a ratio that measures actual liquidity of a business. Basically, it is one of the indicators that informs about the financial position of a business.

Absolute liquidity ratio is measured by using the given formula -

$$\text{Absolute liquidity ratio} = \frac{(\text{Absolute liquid assets})}{\text{Current Liability}}$$

Absolute liquid assets include cash in hand, cash at bank and market securities.

Current liabilities include short term borrowings, bills payable, short term provisions, outstanding expenses and income received in advance.

Example -

A restaurant provided the following financial figures (in \$) to calculate the Absolute Liquid Ratio:

Absolute Liquid Assets are -

Cash - 5000, Bank - 7000, Marketable securities - 8000, Inventories - 12000, Prepaid expenses - 2000

Current Liabilities are -

Bills payable - 5500, Outstanding expenses - 10000, bank overdraft - 20000

Calculate absolute liquidity ratio.

Absolute liquid assets =

$$5000+7000+8000+12000+2000 = 34000$$

Current Liability =

$$5500+10000+20000 = 35500$$

Hence

$$\text{Absolute liquidity ratio} = \frac{34000}{35500} = 0.95$$

The ratio shows that the status quo of the restaurant is quite satisfactory, as we get absolute ratio 0.95.

CONCLUSION

In short, Liquidity ratio is important to understand the ability of the business to pay its liabilities. Further, the study of these ratios will help to view the obligations and current resources of the business in the near term. If it is negative, business owner can take necessary steps for stabilizing the financial position of the business.



EVALUATE YOUR LEARNING

1. Download the balance sheet of a company from www.moneycontrol.com and calculate the ratios discussed above.

Sources referred:

Finance for Non-finance Managers- by Johan Marx-Sage Pastel Accounting. Fundamentals of Financial Accounting by Patricia Libby, Fred Phillips, Robert Libby. Financial Engineering by John F Marshall and Vipul K Bansal. investopedia.com, balancesheetexample.com businessaccountingbasics.com

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