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Chapter 1 : Ratio Analysis: Problems and Solutions | Accounting

Comment on the financial position of the Company i. e., Debt - Equity Ratio, Fixed Assets Ratio, Current Ratio, and Liquidity. Solution: Debt - Equity Ratio = Debt - Equity Ratio / Long - Term Debt.

Uses of ratios When assessing the performance of a business, we will normally use the financial data to make this assessment. Profits are the main yardstick use to assess whether a firm has performed well or poorly. However, profits alone will not tell us too much. Actually, we would probably need to know much more about the firm and the industry it operated in, as well as the prevailing economic and other external factors that affected the firm. Before we even begin to look at how assessment is performed, we should first of all consider how we are going to use the data. We will need some other standard to measure our data against. It would be no use comparing a giant multinational with a small butcher for instance. Comparison of firm operating in the same industry will give us much more meaningful information about how a firm is performing compared with rival competitions. This will be even more meaningful the firms are of similar size measured in either turnover or capital employed. Industry analysis also allows us to see how firms are coping with changes in external factors that affect them in a similar way. For example, analysing how football clubs have coped with the collapse of ITV digital, or how mobile phone companies are coping with the slow take up of third generation phones. Ideally, we could combine the analysis of past performance and industry analysis to see how the industry as a whole has performed over a number of years. This will provide valuable information to see which firms are struggling and which firms are managing to perform well in the circumstances. For example, if profits have been rising over a number of years then this may seem an indicator of good performance. However if other firms have seen profits rise even more quickly, them the good performance would have to be called into question. Variance analysis - comparison with budgeted data Most firms will have expectations for future profits even if they do not produce full budgeted data. It will be useful for firms to compare their own budgeted data performance with the actual performance. Analysis of any variances differences between budgeted data and actual data will provide useful information and allow the firm to investigate why the firm is not performing to the budgeted expectations whether positive or negative. Ratio analysis Assessing the performance of a business requires us to be very clear in actually defining what we are trying to assess. In most cases, profits are seen as the main objective of any firm. However, there are many other areas of a firm that, although not directly affecting profit, will have an indirect affect of the profitability of the firm. To assess the performance of the firm profits alone cannot tell us much information. We need some standard to assess items, such as profits, sales and so on. Ratio analysis is the combination of figures from the financial statements of the firm profit and loss accounts and balance sheets into a format where judgements can be made on the overall performance of the firm. For example, comparing profits to sales, or profits to capital will allow us to see how effective the firm is in generating profits out of sales. Alternatively, comparing profits to capital gives us some idea of profits in relation to the size of the firm. A ratio is simply two or more figures compared with each other to produce an overall result, which is more meaningful than the original figures alone. Ratios require formulas to be memorised. There are a number of different ratios that can be used to assess different areas of the firm. Ratios are therefore grouped according to type, or area. Profitability ratios These ratios focus specifically on the profits of the firm both gross and net profits. The profits are compared with sales, capital to provide some standard for comparison. These ratios in this group are as follows: Return on capital employed Gross profit margin gross profit in relation to sales Net profit margin net profit in relation to sales Mark-up Liquidity Liquidity is a measurement of whether the firm has enough cash available for immediate use. These ratios focus on the ability of the firm to meet day-to-day running requirements. They look at the liquid resources resources easily convertible to cash and compare these with the short-term debts of the firm that will require payment in the next few weeks or months. Many small or new firms find liquidity to be one of their greatest problems. The ratios used to assess liquidity are as follows: Current ratio net current asset ratio Acid test ratio liquid capital ratio Liquidity ratios are sometimes known as solvency ratios Efficiency There are other ratios, which are more likely to be used by internal groups to the firm i. Although these ratios do not look specifically at profits, these ratios will measure the overall financial efficiency of the firm which could eventually affect profits. Common areas to assess are how a firm manages its stockholding, or its debtor and creditor control. Also, how efficient the firm is in controlling expenditure will also be assessed with these ratios. The activity ratios will cover: Stock turnover stockturn Debtor collection period debtor days Creditor collection period creditor days Turnover in relation to fixed assets Turnover in relation to net current assets Overheads in relation to turnover Profitability ratios For most firms, achieving profits are the main goal of the organisation. In limited companies this is even more likely to be the case. This is because the company is owned by shareholders who, expect possibly in the case of private limited companies, have purchased shares with the aim of maximising their returns. The profitability ratios will analyse accounts from the perspective of the size of the profits, and then compare these profits to other figures. For this section we will use the following extracts from the final accounts of Buzz Ltd. Buzz Ltd - extracts from final accounts for year end The ratios and their formulae are as follows: Return on capital employed Have a go at working this out for Buzz and then follow the link below to see how you got on. What do these results tell us? Well, firstly the ratio expresses the profits in relation to the capital and expresses it as a percentage, which is measure of the size of the firm. Therefore, it is meaningful to compare between years and also between other firms as they all relate to the size of the firm. A return on capital employed ROCE should be as high as possible. A negative ROCE would mean that the firm had made a loss. This will depend on the sector in which the firm operates. But the following factors may also need to taken into account: External factors, such as an economic downturn that affects the industry. Remember however, not all firms are affected in the same way by economic downturns and upturns. For example, the takeaway Pizza market was always though to be an industry that would perform better during an economic downturn perhaps because people would resort to takeaways Pizzas rather than restaurant Pizzas. However, in the period of steady economic growth the demand for takeaway pizzas has increased as well which was not expected. Comparable data from other firms. The firms must be in the same industry and should ideally be of a similar size so that meaningful comparisons can be made. It makes sense to consider these ratios together, as they will often be affected in the same way by changes affecting the firm. The formulae for the profit margins are as follows: Have a go at working out the gross and net profit margins for Buzz and then follow the link below to see how you got on. Gross profit margin - what does this tell us? This ratio compares gross profits to the sales revenue. It tells us how much of the sales revenue earned actually consists of gross profits - and therefore, how much consist of costs of goods sold. For Buzz Ltd, in This fell to It certainly does not mean that profits are falling - in fact, although the gross profit margin has fallen, the gross profits in are actually slightly higher than those of Net profit margin - what does this tell us? Similar to the gross profit margin, this ratio compares the net profit to the sales revenue. For Buzz Ltd, the net profit margin falls from This fell by the next year to 5. A falling net profit margin, as with the gross profit margin, doe into mean that net profits have fallen. However, in this case, the net profits have fallen in compared with What do falling profit margins mean? This could be due to one or more of the following: Selling prices have fallen Costs have increased Imagine if the firm reduced its selling price to boost sales volume. This may lead to higher profits. However, the profits on each sale made will be lower due to the lower selling price. This would lead to an overall reduction in the net and gross profit margins - even though profit levels have risen. Possible reasons are as follows Higher cost of materials or higher labour costs in production Lower selling prices - possible due to a promotional campaign or other special offer Increased competition forcing prices down Switch from profit maximisation to sales maximisation i. Supermarkets, however, are very profitable. An antique dealer would not expect sales to be achieved in such as rapid rate. This means that the antique dealer would probably have to charge high selling prices - which mean a higher profit margin - in order to compensate for the slower rate of sales. This means that profits build up at a slower rate, but in bigger steps. Each of these terms refers to the relationship between the selling price of output and the cost of that output. Mark-up refers to the amount of profit added on to the cost of a unit of output in order to set a selling price - normally added on a percentage of the cost Margin refers to the amount of profit in the selling price of a unit of output - normally the percentage of the selling price that is profit Both terms are looking at profits but from different perspectives, so there is bound to be some link between the two measures. Both mark-up and margin are often expressed in percentage terms. What will be the selling price? Have a go at working this out and then follow the link below to see how you got on. The margin refers to the percentage of the selling price that is profit the remaining percentage must therefore be costs. What will be the cost of production? Notice how examples 1 and 2 are actually using the same data. This will mean that we should be able to calculate the mark-up if we already know the margin, or vice versa. If we convert the percentages used into fractions, then we get a clearer idea:

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Chapter 2 : Ratio and Proportion - Aptitude Questions and Answers

Here is a compilation of top thirteen accounting problems on ratio analysis with its relevant solutions. Problem 1: The following is the Balance Sheet of a company as on 31st March.

Problems and Solutions Accounting Article shared by: Here is a compilation of top thirteen accounting problems on ratio analysis with its relevant solutions. The following is the Balance Sheet of a company as on 31st March: From the following Balance Sheet and additional information, you are required to calculate: A company has capital of Rs. What is the return on investment. A high Inventory turnover ratio is better than a low ratio. At the same time, a higher ratio reflects efficient business activities. A low inventory turnover ratio is dangerous. It is an indication of excessive inventory and over investment in inventory. A low ratio may be result of inferior quality goods, stock of un-saleable and absolute goods. A lower ratio reflects dull business and suggests that some steps should be taken to push up sales. Opening Balance of Debtors Rs. Bills Receivable from the buyer of fixed assets, should be excluded. Bad and doubtful debts and their provisions are not deducted from the total debtors in order to avoid the impression that a larger amount of receivables have been collected. A turnover ratio of 8 signifies that debtors get converted into cash 8 times in a year. The average collection period of 1. The average collection period ratio measures the quality of debtors since it indicates the rapidity or slowness of their collectability. The shorter the average collection period, the better the quality of debtors. The higher the Turnover Ratio and the shorter the average collection period, the better the trade credit management and the better the liquidity of debtors. That is, high Turnover Ratio and short collection period imply prompt payment on the part of debtors. On the other hand, low Turnover Ratio and long collection period reflects that payments by debtors are delayed. The Capital of a Company is as follows: The ratios for the firm are: With the following ratios and further information given below, prepare a Trading, Profit and Loss Account and Balance Sheet: Extract from financial accounts of X, Y, Z Ltd.

Chapter 3 : Ratio Analysis Exercise

ANSWERS TO PROBLEM: (note that these are just examples of a good answer) The answer should be focused on using the current and quick ratios. While the current ratio has steadily increased, it is to be noted that the liquidity has not resulted from the most liquid assets as the CEO proposes.

Chapter 4 : Ratio Analysis - Finance (MCQ) Questions and answers

Ratio Analysis - 1 - MCQs with answers 1. When the concept of ratio is defined in respected to the items shown in the financial statements, it is termed as.

Chapter 5 : Financial Ratio Multiple Choice Questions | My Accounting Course

Financial Statement and Ratio Analysis answers to these and other questions. Firm managers use accounting information to help them manage the ï¬• rm. Investors.

Chapter 6 : Revision:A level accounts module 4 - ratio analysis - The Student Room | The Student Room

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Chapter 7 : Ratio Analysis - 1- MCQs with answers

Practice Question: Interpreting Financial StatementsThe summarised financial statements of Renada Limited at 31

October and 31 October

Chapter 8 : Ratios - Grade 5 Maths Questions With Answers

Question Paper, Answers and Financial Analysis Questions, Answers and some of the basic matters they learned in Level 3 such as ratio analysis.

Chapter 9 : Problems and Solutions - Ratio Analysis | Finance Assignment

Ratio Analysis Practical Problems Current ratio, (b) Acid Test Ratio, (c) Stockâ€•Turnover Ratio, (d) Debtors Turnover Ratio, (e) that need to prepare Trading.