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# PRACTICE QUESTIONS

# RATIO ANALYSIS

Q.1) _____________ is a process of determining and interpreting relationships between the items of financial statements to provide a meaningful understanding of the performance and financial position of an enterprise.

[a] Accounting process

[b] Ratio analysis

[c] Financial statement analysis

[d] Preparation of final accounts

[e] Cash flow analysis

Answer: Option B

Ratio analysis is a quantitative method of gaining insight into a company's liquidity, operational efficiency, and profitability by studying its financial statements such as the balance sheet and income statement. Ratio analysis is a cornerstone of fundamental equity analysis.

Q.2) Which of the following is not an objective of ratio analysis?

[a] It is useful in analysis of financial statement.

[b] It is useful in inter-firm and intra-firm comparison.

[c] It gives elaborate details about the financial health of the organization.

[d] It is useful for forecasting.

[e] It simplifies accounting data.

Answer: Option C

Accounting ratio simplifies, summarises, and systematizes accounting data to make them understandable. Its main contribution lies in communicating precisely the interrelationships which exist between the elements of financial statements. In the words of Biramn and Dribin, "Financial Ratios are useful because they summarise briefly the results of detailed and complicated computation".

Q.3) How are accounting ratios beneficial for making inter firm and intra firm comparisons?

1. It makes comparison of the firm with that of other firms easy.

2. It absolutely helps in predicting future course of action to be taken by firm.

3. It helps in locating the weak areas of the firm.

[a] 1 and 2 only

[b] 2 and 3 only

[c] 1 and 3 only

[d] 1, 2 and 3 only

[e] 1 only

Answer: Option C

Statement given in point number 2 is extreme. Yes, it is true that accounting ratios assist in locating the weak areas of the business even though the overall performance may be good. The management can then pay attention to the weaknesses and take remedial action but we cannot say that it absolutely helps in predicting future course of action to be taken by firm.

Q.4) Current ratio is calculated by dividing current assets by current liabilities. Which of the following is not an example of current liabilities?

[a] Accrued interest

[b] Income tax

[c] Short-term borrowings

[d] Marketable securities

[e] Payroll taxes

Answer: Option D

Current Assets: Assets that can be convertible into cash within one year or with in operating cycle of the business. Example: Cash, Receivables, Inventory, Short term loans, Short-term deposits, Advance to vendors, prepaid expenses, etc.

Current Liabilities: Debts or obligations that are need to be paid within one year or less. Example: Sundry creditors, Short-term borrowings, Advance from customers, Accrued Expenses, Bills discounted/purchased.

Q.5) Calculate Quick Ratio from the given data:

Inventories = 80000, Working Capital = 240000, Current Assets = 400000

[a] 1:1

[b] 2:1

[c] 2.5:1

[d] 3:1

[e] 1.5:1

Answer: Option B

Liquid/ Quick Ratio = Quick Assets/ Current Liabilities = 320000/160000 = 2:1.

Working Capital = Current Assets – Current Liabilities

Current Liabilities = Current Assets – Working Capital

400000 – 240000 = 1,60,000

Liquid/Quick Assets = Current Assets – Inventories

400000 – 80000 = 320000

Q.6) Assume that Debt-Equity Ratio of the company is 2:1 and it declared the final dividend. What will be the impact of declaring final dividend by the company on debt-equity ratio?

[a] Decrease

[b] Increase

[c] No effect

[d] First increase then decrease

[e] First decrease then increase

Answer: Option B

Upon the declaration of dividend by the company the profits to the extent of dividend declared become a current debt and hence shareholders' funds are decreased and Current Liabilities are increased by the amount of dividend declared. So, here in this question, shareholders' funds have decreased by the amount of profits appropriated for dividend but Long-term debts remain unchanged. Therefore, there will be an increase in debt to equity ratio.

Q.7) Anuj Ltd. has a term-loan of Rs. 10,00,000. Interest on the loan for the year is Rs. 1,25,000 and its Profit before Interest and Tax is Rs. 5,00,000. Calculate Interest Coverage Ratio.

[a] 0.25

[b] 4

[c] 0.4

[d] 3

[e] 2

Answer: Option B

Interest Coverage Ratio = Profit before Interest and Tax/ Interest on Long-term debt

5,00,000/1,25,000 = 4

Q.8) Debt Service Coverage Ratio measures company's ability to service its current debts by comparing its __________ with its debt obligation.

[a] Net operating income

[b] Net income

[c] Net profit

[d] Net financial income

[e] Net Sales

Answer: Option A

It measures a company's ability to service its current debts by comparing its net operating income with its total debt service obligations. In other words, this ratio compares a company's available cash with its current interest, principal, and sinking fund obligations.

The debt service coverage ratio is important to both creditors and investors, but creditors most often analyze it. Since this ratio measures a firm's ability to make its current debt obligations, current and future creditors are particularly interested in it.

$$\boxed{\text{Debt Service Coverage Ratio} = \frac{\text{Earnings available for debt services}}{\text{Interest + Installments}}}$$

Q.9) Identify the correct statement from the following:

[a] Operating ratio establishes relationship between operating costs and net cost.

[b] Operating cost includes direct cost of goods sold, administrative, selling and distribution expenses, discounts, and bad debts.

[c] Operating cost excludes expenses which have no relation with production or sales and interest on working capital loans.

[d] Operating ratio is computed by dividing revenue from operations by operating cost.

[e] Operating ratio and Operating Profit Ratio are supplementary to each other.

Answer: Option B

Operating ratio establishes relationship between operating costs and net sales.

Operating cost includes "direct cost of goods sold, administrative, selling and distribution expenses, interest on working capital loans, discounts, bad debts".

It <u>excludes incomes and expenses, which have no relation with production or sales.</u> For example, "interest and dividend received on investment, interest on loans and debentures, profit or loss on sale of fixed assets".

It is computed by dividing operating cost by Revenue from Operations, i.e., Net Sales and is expressed as a percentage.

Operating Ratio = Operating Cost/ Revenue from Operations (Net Sales) * 100

It is to be noted that Operating Profit Ratio and Operating Ratio are COMPLEMENTARY to each other and thus, if one of the two ratios is deducted from 100, another ratio is obtained.

Q.10) Identify the correct formula from the following:

1. Earning per share = Net profit available to equity shareholders/ Number of equity shares outstanding

2. Dividend per share = Total Dividend paid to equity shareholders / Number of equity shares outstanding

3. Dividend pay-out Ratio = Earning per share/ Dividend per equity share

[a] 1 only

[b] 3 only

[c] 1 and 2 only

[d] 1, 2 and 3

[e] 2 only

Answer: Option C

Dividend per share (DPS): Dividend per share ratio indicates the amount of profit distributed to equity shareholders per share.

Dividend pay-out ratio = Dividend per equity share (DPS)/ Earning per share (EPS)

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