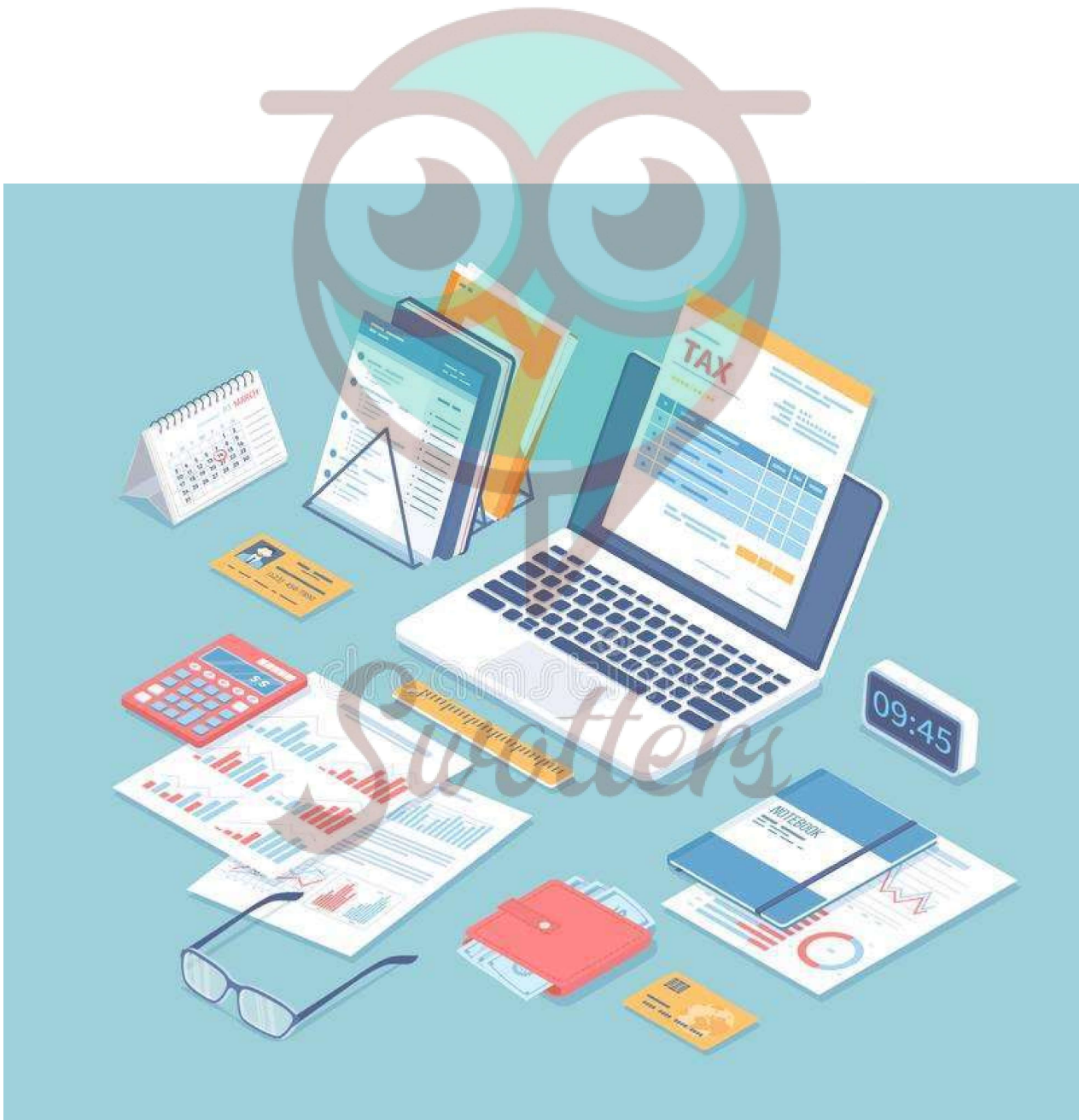


# ACCOUNTANCY



## Important Questions

### Multiple Choice questions-

Question 1. The two basic measures of operational efficiency of a company are

- (a) Inventory Turnover Ratio and Working Capital Turnover Ratio
- (b) Liquid Ratio and Operating Ratio
- (c) Liquid Ratio and Current Ratio
- (d) Gross Profit Margin and Net Profit Margin

Question 2. Acid Test ratio comes under:

- (a) Liquidity ratio
- (b) Solvency ratio
- (c) Profitability ratio
- (d) Activity ratio

Question 3. Current assets are those assets which are convertible into cash within:

- (a) One month
- (b) 6 months
- (c) 12 months
- (d) none of these

Question 4. Which of the following is not considered in the ratio analysis as per guidance notes?

- (a) Fixed Assets
- (b) Share capital
- (c) Other Non-current Assets
- (d) Non-current Assets

Question 5. Which of the following will increase the current ratio where it is 2 : 1 ?

- (a) Payment to creditors
- (b) Conversions of receivables into cash
- (c) Purchase of goods on credit
- (d) Purchase of goods for cash

Question 6. Long term solvency ratio is judged by which of the following ratio?

- (a) Debt equity ratio
- (b) Total assets turnover ratio
- (c) Liquidity ratios
- (d) Operating ratio

Question 7. Which of the following ratios provide solvency position of a business in the long run?

- (a) Liquidity Ratios
- (b) Solvency ratios
- (c) Profitability ratios
- (d) Turnover ratios

Question 8. In debt equity ratio, debt refers to

- (a) Short term debts
- (b) Total debts
- (c) Shareholders' funds
- (d) Long term borrowings and long term debts

Question 9. Which of the following transactions will increase debt equity ratio which is 1 : 2?

- (a) Issue of shares for cash
- (b) Redemption of preference shares
- (c) Redemption of debentures



*Swotters*

(d) Conversion of debentures into shares

Question 10. Interest coverage is equal to

(a) Interest after interest but before tax / interest on debt

(b) Interest before interest and tax / interest on debt

(c) Interest after interest and debt / interest on debt

(d) Interest on debt / Interest before interest and tax

### Very Short Questions-

1. What will be the effect on current ratio if a bills payable is discharged on maturity?
2. Debt Equity Ratio of a company is 1:2. Purchase of a Fixed asset for ₹ 5,00,000 on long term deferred payment basis will increase, decrease or not change the ratio?
3. It is a simple arithmetical expression of relationship between two figures. Name the term.
4. The liquidity of a business firm is measured by its ability to satisfy its long-term obligations as they become due. Name a ratio used for this purpose.
5. X Ltd. has a Debt-Equity Ratio at 3 : 1. According to the management it should be maintained at 1 : 1. What is the choice to do so?
6. How the solvency of a business is assessed by Financial Statement Analysis?
7. What will be operating profit if operating ratio is 88.94?

### Short Questions-

1. What do you mean by Ratio Analysis?
2. What are the various types of ratios?
3. What relationships will be established to study:
  - a. Inventory Turnover
  - b. Trade Receivables Turnover
  - c. Trade Payables Turnover
  - d. Working Capital Turnover
4. The liquidity of a business firm is measured by its ability to satisfy its long-term obligations as they become due. What are the ratios used for this purpose?
5. The average age of inventory is viewed as the average length of time inventory is held by the firm for which explain with reasons.

### Long Questions-



1. What are liquidity ratios? Discuss the importance of current and liquid ratio.
2. How would you study the solvency position of the firm?
3. What are important profitability ratios? How are these worked out?
4. Current liabilities of a company are ₹ 75,000. If current ratio is 4:1 and liquid ratio is 1:1, calculate value of current assets, liquid assets and inventory.
5. Handa Ltd. has inventory of ₹ 20,000. Total liquid assets are ₹ 1, 00,000 and quick ratio is 2:1. Calculate current ratio.

### Assertion Reasons-

1. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.
  - a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
  - b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
  - c. Only Assertion is correct.
  - d. Reason is correct but Assertion is not correct

**Assertion [A]:** While calculating the Current Ratio, Loose Tools and Stores & Spares are not included in the current asset.

**Reason [R]:** Loose Tools and Stores & Spares are not held for sale or conversion into cash.

2. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.
  - a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
  - b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
  - c. Only Assertion is correct
  - d. Reason is correct but Assertion is not correct

**Assertion [A]:** If Current Ratio is 2 : 1. Current maturity of long-term debts i.e. Redemption of debentures in the current year, will increase the Current Ratio.

**Reason [R]:** Current assets will decrease and there is no impact on current liabilities.

### Case Study Questions-

## MCQ Answers-

1. Answer: (a) Inventory Turnover Ratio and Working Capital Turnover Ratio
2. Answer: (a) Liquidity ratio
3. Answer: (c) 12 months
4. Answer: (c) Other Non-current Assets
5. Answer: (a) Payment to creditors
6. Answer: (c) Liquidity ratios
7. Answer: (b) Solvency ratios
8. Answer: (d) Long term borrowings and long term debts
9. Answer: (b) Redemption of preference shares
10. Answer: (b) Interest before interest and tax / interest on debt

## Very Short Answers-

1. Answer: The current ratio will increase
2. Answer: Increased
3. Answer: Ratio
4. Answer: Current Ratio.
5. Answer: To increase the equity or reduce the debt.
6. Answer: With the help of solvency ratios
7. Answer: Operating Profit =  $100 - 88.94 = 11.06$

## Short Answers-

1. It is a quantitative analysis of data present in a financial statement. It shows the relationship between items present in Balance sheet and the Income Statement. It helps in calculating operational efficiency, solvency and determining profitability of a firm. Ratio is a statistical measure which helps in comparing relationship between two or more figures. Analyzing ratio presents vital pieces of information to accounting users about the firm's financial position, performance and viability. It also helps in setting up new policies and framework by the management.
2. **Ratios can be classified into two types:**

**(a) Traditional Classification:** Traditional classification is based on the financial

statements such as Balance Sheet and P & L Account. The ratios are divided on the basis of accounts of financial statements and are as follows:

- i. Income Statement Ratios such as Gross Profit Ratios.
- ii. Balance Sheet Ratios such as Debt Equity Ratio, Current Ratio.
- iii. Composite Ratio: Ratios that contain elements from both Trading and P & L Account.

**(b) Functional Classification:** These ratios are based on the functional need of calculating ratios. These ratio help calculate the solvency, liquidity, profitability and financial performance of a business. Such ratios are:

- i. Liquidity Ratio: Ratios used to determine solvency of short term.
- ii. Solvency Ratio: Ratios used to determine solvency of long term.
- iii. Activity Ratio: Ratios used for determining operating efficiency of the business. These ratios are related to sales and cost of goods sold.
- iv. Probability Ratio: Ratios used to determine financial performance and viability of the firm.

3.

**a. Inventory Turnover Ratio:** This ratio is a relationship between cost of goods sold and the average inventory maintained during a particular time period. It determines the efficiency with which a firm is able to manage its inventory.

$$\text{Inventory / Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses - Closing Stock  
 or, Cost of Goods Sold = Net Sales - Gross Profit

$$\text{Average Stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

**b. Trade Receivables Turnover Ratio:** Debtors turnover ratio is also known as Receivables Turnover Ratio is a measure used to check how quickly a credit sale is converted into cash. It shows efficiency of a business firm in collecting debts from customers.

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivables}}$$

$$\text{Net Credit Sales} = \text{Total Sales} - \text{Cash Sales}$$

$$\text{Average Accounts Receivables} = \frac{(\text{Opening Debtors} + \text{Opening B/R}) + (\text{Closing Debtors} + \text{Closing B/R})}{2}$$

c. **Trade Payables Turnover Ratio:** It is also known as Creditor's turnover ratio or account payable turnover ratio and is a liquidity ratio that measures the average number of times a firm pays its creditors in the course of an accounting period. It is used to measure short term liquidity of the firm.

$$\text{Payable Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Accounts Payable}}$$

$$\text{Net Credit Purchases} = \text{Total Purchases} - \text{Cash Purchases}$$

$$\text{Average Accounts Payable} = \frac{(\text{Opening Creditors} + \text{Opening B/P}) + (\text{Closing Creditors} + \text{Closing B/P})}{2}$$

d. **Working Capital Turnover Ratio:** Working capital turnover ratio is used to measure the efficiency of a company in using its working capital to support the sales. It is a ratio where firms operations are funded and the corresponding revenue generated from business is calculated.

$$\text{Working Capital Turnover Ratio} = \frac{\text{Net Sales}}{\text{Working Capital}}$$

$$\text{Net Sales} = \text{Total Sales} - \text{Sales Return}$$

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

4. A firm's liquidity is measured by its capability to pay long term dues. These dues include principal amount payment on due date and interest payment on regular basis. Long term solvency of a firm can be determined by the following ratios:

a. **Debt-Equity Ratio:** This ratio shows the relationship between owner funds (equity) and borrowed funds (debt). A lower debt-equity ratio provides more security to the people who are lending to the business. It also shows that a company is able to meet long term dues or responsibilities.

$$\text{Debt-Equity Ratio} = \frac{\text{Long-term Debt}}{\text{Equity/ Share holders Fund}}$$

b. **Total Assets to Debt Ratio:** It is based on the relationship between total assets and long term loans. It shows what percentage of company's total assets are financed by creditors. A higher



total assets to debt ratio makes the firm able to meet long term requirements and provides more security to lenders.

$$\text{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long-term Debt}}$$

c. **Interest Coverage Ratio:** This ratio is used to determine the easiness with which a company is able to pay interest on the outstanding debts. It is calculated by dividing earnings before interest and taxes with interest payments. Having a higher interest coverage ratio means that company is able to meet its obligations skilfully.

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Loans}}$$

5. **Inventory Turnover Ratio:** This ratio is a relationship between cost of goods sold and the average inventory maintained during a particular time period. It determines the efficiency with which a firm is able to manage its inventory.

$$\text{Inventory / Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses – Closing Stock  
or, Cost of Goods Sold = Net Sales – Gross Profit

$$\text{Average Stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

$$\text{Average Age of Inventory} = \frac{\text{Days in a year}}{\text{Inventory Turnover Ratio}}$$

It shows the average length for which firm holds the inventory.

## Long Answers-

1. **For determining the short-term solvency of a business liquidity ratios are essential. There are two types of liquidity ratios:**

(a) **Current Ratio:** This ratio deals with the relationship between current assets and liabilities. It is calculated as:

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



Current assets are those assets which can be easily converted into cash whereas Current liabilities are liabilities that need to be paid within that accounting period.

**Importance of Current Ratio:** Current ratio helps in determining a firm's ability to pay off the current liabilities on time. If there is more of current assets as compared to current liabilities, it provides a source of security to the creditors. The ideal ratio is 2:1 (Current Assets: Current Liabilities).

**(b) Liquid Ratio:** It deals with the relationship between liquid assets and current liabilities. This ratio determines if the firm has sufficient funds for paying off the current liabilities on an immediate basis. It can be calculated as:

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

$$\text{Liquids Assets} = \text{Current Assets} - \text{Stock} - \text{Prepaid Expenses}$$

**Importance of Liquid Ratio:** It is helpful in determining if a firm has funds that can be sufficient to pay off liabilities. It does not include stock or prepaid expenses as both these are not easily converted to cash. A ratio of 1:1 is ideal for maintaining the liquid ratio.

2. A firm's solvency position can be best studied with the help of group of ratios called as Solvency Ratios. These ratios measure the financial position of the firm by measuring its ability to pay long term liabilities, these long term liabilities include principal amount payments on due date and interest payments on a regular basis. Following ratios are used to determine long term solvency of a business.

**(a) Debt-Equity Ratio:** This ratio shows the relationship between owner funds (equity) and borrowed funds (debt). A lower debt-equity ratio provides more security to the people who are lending to the business. It also shows that a company is able to meet long term dues or responsibilities.

$$\text{Debt-Equity Ratio} = \frac{\text{Long-term Debt}}{\text{Equity/ Share holders Fund}}$$

**(b) Total Assets to Debt Ratio:** It is based on the relationship between total assets and long term loans. It shows what percentage of company's total assets are financed by creditors. A higher total assets to debt ratio makes the firm able to meet long term requirements and provides more security to lenders.

$$\text{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long-term Debt}}$$

**(c) Interest Coverage Ratio:** This ratio is used to determine the easiness with which a company is able to pay interest on the outstanding debts. It is calculated by dividing earnings before interest and taxes with interest payments. Having a higher interest coverage ratio means that company is able to meet its obligations skilfully.

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Loans}}$$

**(d) Proprietary Ratio:** This ratio shows the relationship between Total Assets and Shareholders fund. It is helpful in revealing the financial position of a business. A higher ratio ensures a greater degree of security for creditors. It is shown as:

$$\text{Proprietary Ratio} = \frac{\text{Shareholders Fund}}{\text{Total Assets}} \text{ or } \frac{\text{Equity}}{\text{Total Assets}}$$

3. Profitability ratios are calculated on the basis of profit earned by a business. This ratio gives a percentage which is used to assess the financial condition of a business:

a. **Return on Assets:** This ratio measures the earning per rupee from assets which are invested in the company. A higher profit ratio is good for the company.

$$\text{Return on Assets} = \text{Net Profit} \div \text{Total Assets}$$

b. **Return on Equity:** This ratio deals with measuring profitability of equity fund that is invested by the company. It also measures how owner's funds are utilized profitably to generate company revenues. A high ratio represents the better position of a company.

$$\text{Return on Equity} = \text{Profit after Tax} \div \text{Net worth}$$

Where Net worth = Equity share capital, and Reserve and Surplus

c. **Earnings per share:** This ratio helps in measuring profitability from an ordinary shareholder's viewpoint. A high ratio represents a well off company.

$$\text{Earnings per share} = \text{Net Profit} \div \text{Total no of shares outstanding}$$

d. **Dividend per share:** This ratio measures the amount of dividend that is distributed by

the company to its shareholders at the end of an accounting period. A high ratio represents that the company is having surplus cash.

Dividend per share = Amount Distributed to Shareholders ÷ No of Shares outstanding

- e. **Price Earnings Ratio:** A profitability ratio that is used by an investor to check for share price of the company which can be undervalued or overvalued. It also indicates an expectation about the company's earning and payback period for the investors.

Price Earnings Ratio = Market Price of Share ÷ Earnings per share

- f. **Return on capital employed:** This ratio is all about the returns earned by the company from the funds invested in the business by its owners. A high ratio is indicative of a better position for the company.

Return on capital employed = Net Operating Profit ÷ Capital Employed × 100

- g. **Gross Profit:** Gross profit ratio or GP ratio is a profitability ratio that deals with the relationship between gross profit and the total net sales revenue. This ratio is used to evaluate the operational performance of the business.

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

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Goods Sold}$$

$$\text{Net Sales} = \text{Total Sales} - \text{Sales Return}$$

$$\text{Cost of Goods Sold} = \text{Opening Stock} + \text{Purchases} + \text{Direct Expenses} - \text{Closing Stock}$$

- h. **Net Profit:** This is a profitability ratio that deals with relationship between net profit after tax and net sales. It is calculated by dividing the net profit (after tax) by net sales.

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

$$\text{or, Net Profit Ratio} = \frac{\text{Profit Before Tax}}{\text{Net Sales}} \times 100$$

$$\text{or, Net Profit Ratio} = \frac{\text{Profit After Tax}}{\text{Net Sales}} \times 100$$

$$\text{Net Sales} = \text{Total Sales} - \text{Sales Return}$$

4. f

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

$$\text{or, } 4 = \frac{\text{Current Assets}}{75,000}$$

$$\text{Or, } 4 \times 75,000 = \text{Current Assets}$$

$$\text{Or, Current Assets} = 3,00,000$$

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Or,

$$1 = \frac{\text{Liquid Assets}}{75,000}$$

$$\text{Liquid Assets} = 75,000$$

$$\text{Inventory} = \text{Current Assets} - \text{Liquid Assets}$$

$$= 3,00,000 - 75,000$$

$$= 2,25,000$$

5.

$$\text{Quick Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

or,

$$2 = \frac{1,00,000}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{or, Current Liabilities} &= \frac{1,00,000}{2} \\ &= 50,000 \end{aligned}$$

Current Assets = Liquid Assets + Inventory

$$= 1,00,000 + 20,000$$

$$= 1,20,000$$

$$\begin{aligned} \text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\ &= \frac{1,20,000}{50,000} \\ &= \frac{2.4}{1} = 2.4 : 1 \end{aligned}$$

### Assertion Reason Answer-

1. (a) Assertion and Reason both are correct and Reason is the correct explanation of assertion.
2. (c) Only Assertion is correct.