VIDYA BHAWAN BALIKA VIDYA PITH

शक्तिउत्थानआश्रमलखीसरायबिहार

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Accounting *Ratios H.W*

Question 4:

The current ratio provides a better measure of overall liquidity only when a firm's inventory cannot easily be converted into cash. If inventory is liquid, the quick ratio is a preferred measure of overall liquidity. Explain.

ANSWER:

Current Ratio- It explains the relationship between current assets and current liabilities. It is calculated as:

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

Currents Assets are those assets that are easily converted into cash within a short period of time like cash in hand, cash at bank, marketable securities, debtors, stock, bills receivables, prepaid expenses. etc.

Current Liabilities are those liabilities that are to be repaid within a year like bank overdraft, bills payables, Short-term creditors, provision for tax, outstanding expenses etc.

Liquid Ratio- It explains the relationship between liquid assets and current liabilities. It indicates whether a firm has sufficient funds to pay its current liabilities immediately. It is calculated as:

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

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

Generally, Current Ratio is preferable for such type of business where the stock or the inventories cannot easily be converted into cash like heavy machinery manufacturing companies, locomotive companies, etc. This is because, the heavy stocks like machinery, heavy tools etc. cannot be easily sold off. But on the other hand, the businesses where the stock can be easily realised or sold off regard Liquid Ratio to be more suitable measure to reveal their liquidity position. For example, the inventories of a service sector company is very liquid as there are no stock kept for sale, so they prefer Liquid Ratio as a measure of overall liquidity***.***

Moreover, sometimes companies prefer to resort to Liquid Ratio instead of Current Ratio, if the prices of the stock held are prone to fluctuate. This is because if the prices of the inventories fluctuate more, then this may affect their liquidity position of the business and may reduce (or overcast) the Current Ratio. Consequently, they prefer Liquid Ratio as it excludes inventories and stocks.

Thirdly, if the stock forms the major portion of a company's current assets, then they would prefer Current Ratio and not Liquid Ratio. This is because their current assets mostly consist of stock. The Liquid Ratio of such company will be very low as liquid assets exclude stock. This will reduce their Liquid Ratio and may create a bad image for the creditors. In such a case, Current Ratio provides better measure of overall liquidity.

Question 1:

Following is the Balance Sheet of Raj Oil Mills Limited as at March 31, 2017. Calculate Current Ratio.

Particulars	(Rs)
I. Equity and Liabilities:	
1. Shareholders' funds	
a) Share capital	7,90,000
b) Reserves and surplus	35,000
2. Current Liabilities	
a) Trade Payables	72,000
Total	**8,97,000**
II. Assets	
1. Non-current Assets	
a) Fixed assets	
Tangible assets	7,53,000
2. Current Assets	
a) Inventories	55,800
b) Trade Receivables	28,800
c) Cash and cash equivalents	59,400

Total	**8,97,000**

ANSWER:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$
$$= \frac{1,44,000}{72,000}$$
$$= 2:1$$

Current Assets = Inventories +Trade Receivables + Cash
= 55,800 + 28,800 + 59,400
= Rs 1,44,000
Current Liabilities = Trade Payables = Rs 72,000

Question 2:

Following is the Balance Sheet of Title Machine Ltd. as at March 31, 2017.

Particulars	**Amount Rs.**
I. Equity and Liabilities	
1. Shareholders' funds	
a) Share capital	24,00,000
b) Reserves and surplus	6,00,000
2. Non-current liabilities	
a) Long-term borrowings	9,00,000
3. Current liabilities	
a) Short-term borrowings	6,00,000
b) Trade payables	23,40,000
c) Short-term provisions	60,000
Total	**69,00,000**

II. Assets	
1. Non-current Assets	
a) Fixed assets	
Tangible assets	45,00,000
2. Current Assets	
a) Inventories	12,00,000
b) Trade receivables	9,00,000
c) Cash and cash equivalents	2,28,000
d) Short-term loans and advances	72,000
Total	**69,00,000**

Calculate Current Ratio and Liquid Ratio.

ANSWER:

1. Current Ratio

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

$$= \frac{24,00,000}{30,00,000}$$

$$= 0.8:1$$

Current Assets = Inventories +Trade Receivables + Cash + Short term Loans and Advances
= 12,00,000 + 9,00,000 + 2,28,000 + 72,000
= Rs 24,00,000

Current Liabilities = Trade Payables + Short-term Borrowings + Short-term Provisions
= 23,40,000 + 6,00,000 + 60,000
= Rs 30,00,000

2. Quick Ratio

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

$$= \frac{12,00,000}{30,00,000}$$

$$= 0.4:1$$

Quick Assets = Trade Receivables + Cash + Short term Loans and Advances
= 9,00,000 + 2,28,000 + 72,000
= Rs 12,00,000