LESSON-33
ACCOUNTING RATIOS-2

SUMMARY

Here, we will discuss about the various solvency ratios and profitability ratios. Accounting ratios are calculated from the financial statements to arrive at meaningful conclusions pertaining to liquidity, profitability, and solvency.

SOLVENCY RATIOS

The term 'solvency' refers to the ability of a concern to meet its long term obligations. The long-term liability of a firm is towards debenture holders, financial institutions providing medium and long term loans and other creditors selling goods on credit. These ratios indicate firm's ability to meet the fixed interest and its costs and repayment schedules associated with its long term borrowings.

The following ratios serve the purpose of determining the solvency of the business firm

- Debt equity Ratio

It is also otherwise known as external to internal equity ratio. It is calculated to know the relative claims of outsiders and the owners against the firm's assets.

- Proprietary Ratio

It is also known as equity ratio. This ratio establishes the relationship between shareholders' funds to total assets of the firm. The shareholders' funds is the sum of equity share capital, preference share capital, reserves and surpluses. Out of this amount, accumulated losses should be deducted.

PROFITABILITY RATIOS

These ratios examine the current operating performance and efficiency of the business concern. These ratios are helpful for the management to take remedial measures if there is a declining trend. The important profitability ratios are

- Gross Profit Ratio
- Net Profit Ratio
- Operating Profit Ratio
- Return on Investment Ratio

LIMITATIONS OF ACCOUNTING RATIOS

Accounting ratios are very significant in analysing the financial statements. Through accounting ratios, it will be easy to know the true financial position and financial soundness of a business concern. However, despite the advantages of ratio analysis, it suffers from a number of limitations. The following are the main limitations of accounting ratios

- **Ignorance of Qualitative Aspect :** The ratio analysis is based on quantitativeaspect. It totally ignores qualitative aspect which is sometimes more importantthan quantitative aspect.

Ignorance of Price Level Changes :
Price level changes make the comparison of figures difficult over a period of time. Before any comparison is made, proper adjustments for price level changes must be made.

- **No Single Concept :**

In order to calculate any ratio, different firms may take different concepts for different purposes. Some firms take profit before charging interest and tax or profit before tax but after interest tax. This may lead to different results.

- **Misleading Results if based on Incorrect Accounting Data :**

Ratios are based on accounting data. They can be useful only when they are based on reliable data. If the data are not reliable, the ratio will be unreliable.

- **No Single Standard Ratio for Comparison :**

There is no single standard ratio which is universally accepted and against which a comparison can be made. Standards may differ from Industry to industry.

- **Difficulties in Forecasting :** Ratios are worked out on the basis of past results. As such they do not reflect the present and future position. It may not be desirable to use them for forecasting future events.