Department of Education
SCHOOLS DIVISION OF CITY OF MEYCAUAYAN
Pag-asa St., Malhacan, City of Meycauayan, Bulacan

Senior High School

12

Activity Sheet in

Fundamentals of Accountancy, Business and Management 2

Financial Analysis Ratio

ABM_FABM12Ig-h-12 & ABM_FABM12Ig-h-14

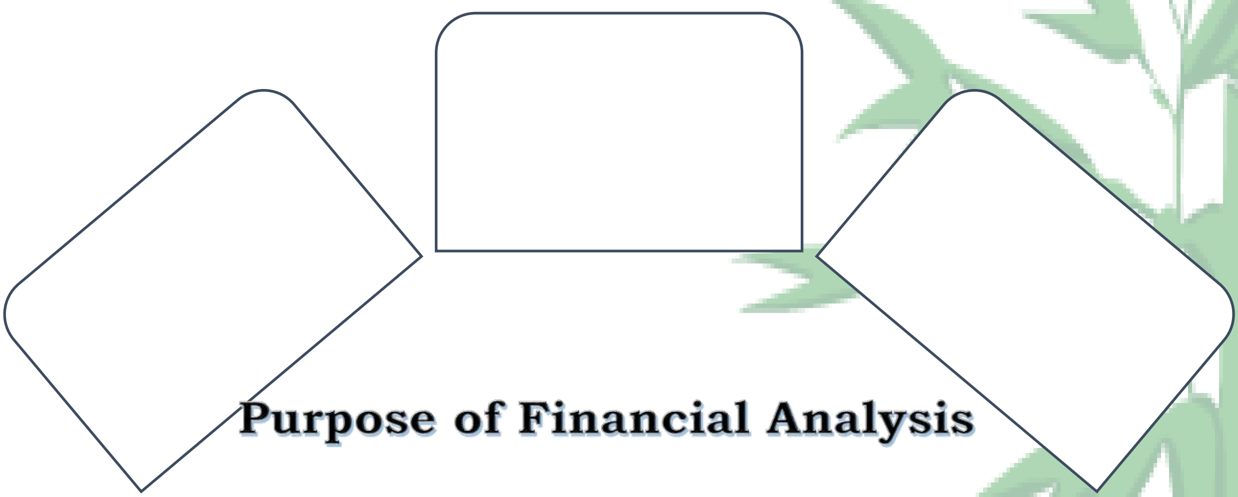
FINANCIAL ANALYSIS-FINANCIAL RATIOS

Let Us Know

In continuation of our lesson about financial analysis, we realized that it is not enough that we prepare a financial statement to make an economic decision. We are oriented to use horizontal and vertical analysis techniques to analyze and understand the financial data reported. In this activity, we will get to know more about financial ratios to acquire better understanding of our business profitability, solvency, liquidity and operating efficiency which is significant for strategic planning, financial and operations management.

Let Us Review

Use the diagram below to enumerate the purpose of financial analysis to the busines organization. Answer the activity on separate sheet of paper.



Let Us Study

In this activity sheet, we will discuss and perform the basic financial statement analysis and look beyond the account values and relate them on firms' structure and performance. We will use ratio so we can have a better understanding how the business entity performs in the prior year and current year of business operation.

A **ratio** is a calculation that show **relationship between two values**. Financial ratio according from the author of Fundamental of Accountancy, Business and Management, is composed of numerator and a denominator that expresses relationship between specific financial data (Salazar 2017). A ratio analysis helps management to measure the performance and its credibility that the company can pay its liabilities before the given maturity date. The ratio can be expressed as a percentage, a rate or proportion It is a powerful tool used by an entity to generate an objective economic decision.

<table>
<tr><th colspan="3">LIQUIDITY RATIOS</th></tr>
<tr><td colspan="3">It is an analysis that measures the company capacity to pay its current maturing or short-term obligation and converting receivables and inventory into cash. This is important to short-term creditors of a company to determine if the borrowing company is in position to pay the borrowed principal and interest when they are already due.</td></tr>
<tr><th></th><th>Definition</th><th>Formula</th></tr>
<tr><td>Working Capital</td><td>Measures a company capability to pay its current liability with its current assets.</td><td>Working Capital =
Current Assets – Current Liabilities</td></tr>
<tr><td>Current Ratio</td><td>Working capital ratio that shows the relationship between current assets and current liabilities. It measures liquidity of company to pay off its current liabilities upon maturity or in timely manner.</td><td>Current Ratio = $\frac{\text{Current Asset}}{\text{Current Liabilities}}$</td></tr>
<tr><td>Quick Ratio</td><td>Also known as quick asset ratio or acid ratio indicator of most readily available current assets to pay off short-term obligations. It is useful in assessing liquidity in the most difficult situation of companies.</td><td>Quick Ratio =
$\frac{\text{Cash +Market Securities +Receivables}}{\text{Current Liabilities}}$
$\frac{\text{Current Assets-Inventories-Prepayments}}{\text{Current Liabilities}}$</td></tr>
<tr><th colspan="3">Efficiency Ratio</th></tr>
</table>

Account Receivable Turnover	• It is a ratio measures the frequency of conversion of Accounts Receivable to cash. • How many times the company was able to collect accounts receivable to its customers. • The higher receivables turnover ratio would be more favorable as they measure efficiency of receivable collection.	**Account Receivable Turnover =** Net Sales ÷Average Account Receivable
Inventory Turnover Ratio	Measures the number of times the company was able to sell its entire inventory to customers during the year. The goal is to have a high inventory turnover.	**Inventory Turnover Ratio =** Cost of Goods Sold÷ Average Inventory
Leverage/ Solvency Ratio		
Measures capability of an entity to pay long term obligation as they fall due. Creditors of the company's long-term notes payable and bond payable will be interested in knowing its solvency status.		
Debt to Equity Ratio	It compares the liabilities of the company with its equity.	**Debt to Equity Ratio=** Total Liabilities ÷ Total Assets

Profitability Ratios		
Primary objective of an investor in investing capital in the business is to earn or gain profit. It is a ratio measure the company's earning power and management's effectiveness in running operations.		
Gross Profit Ratio	It compares the gross margin of a business to the net sales. It measures how profitable a company sells its inventory or merchandise. The higher the ratios indicate that the company is selling the inventory at higher profit percentage.	**Gross Profit Ratio=** Gross Profit ÷ Net Sales

Profit Margin Ratio	It referred also as the return on sales ratio or gross profit ratio. This **measures the amount of net income earned with each peso of sales generated by comparing the net income and net sales of a company**. It also indicates percentage of sales is left over after all expenses are paid by the business.	**Profit Margin Ratio=** Net Income ÷ Net Sales
Return on Assets (ROA)	It is also knowns as Return on total assets. The ratio that **measures the net income produced by total assets during a period by comparing net income to the average total assets.** To compute the average total assets, add the beginning and ending asset as stated in the statement of financial position and divide by two.	**Return on Assets=** Net Income ÷ Average Total Assets
Return on Equity	It interprets how much profit is generated for each peso of ordinary shares equity. It is an indicator of management effectiveness in using equity financing to fund the operations for the needed growth.	**Return on Equity =** Net Profit÷Ordinary Stockholders Equity

Let Us Practice

Read and analyze the given problem below. Write your answer on a separate sheet of paper.

1. Francis Magancia Shop purchased equipment in the last five by securing several loans from banks All these loans are becoming due which decrease the working capital. At the end of the year, Francis had ₱400,000 current assets and ₱200,000 current liabilities. Compute for the working capital of Francis Magancia.

2. Al Quin Tattao Tattoo Company has ₱100,000 bank credit line and a PHP ₱500,000 mortgage on its property. He invested ₱1,500,000. Compute for debt equity ratio of Al Quin Tattao.

3. Cathy's Kitchen spent ₱100,000 on her cake inventory for the year. Ms. Cathy was able to sell her cake inventory for ₱500,000. Unfortunately, a ₱50,000 worth of cakes were returned by customer and refunded. Compute for Ms. Cathy's. gross margin ratio for the year.

Let Us Remember

- The **higher the current ratio** is more favorable **than a lower current ratio**. It shows that the company is more flexible in paying its maturing obligation.
- The **shorter the cash conversion process** of whatever company assets is the **greater impact it has on the ability of the company** to settle its currently maturing obligations in cash and on time.
- **A negative working capital** is considered risky by creditors and investors because it shows the company is not running efficiently and cannot cover its current debt.
- As a rule**, a higher debt to equity ratio indicates that more financing from creditors is used than investor making additional capital.** Debt to equity ratio of **1 mean that investors and creditors have an equal share or claim in the business.**
- **Higher ratios of Accounts Receivable**
  Lower debt equity ratio usually implies a more financially stable business and less risky to creditors and investors.

Changes that affect the working capital	
Current asset increase	Increase in working capital
Current asset decrease	Decrease in working capital
Current Liabilities increase	Decrease in working capital
Current Liabilities decrease	Increase in working capital

- Measurement level of business operation, solvency, liquidity, and profitability.
- Financial statement ratios express the relationship among specific financial data.
- Profitability ratios measure the ability of the company to control costs and generate income from the use of its assets and invested capital.
- Solvency ratio refers to company's capacity to pay their long-term liabilities while liquidity ratio company's capacity to pay their short-term liabilities.

Let Us Appreciate

Research and create an infographic discussing the limitations of financial statements analysis . You can use Canva or power point so that you can create a good lay-out for your infographics.

Rubrics	
Creativity	**40 %**
Substance & Content	**30%**
Lay-out & Design	**20%**
Originality	**10%**
Total	**100 %**

Let Us Practice More

Given below is the comparative Statement of Financial Position & Statement of Comprehensive Income of Miz Na Company for 2017 and 2018. Compute for the following financial ratios. Show your solutions. Write your answer on a separate sheet of paper.

Working Capital
Current Ratio
Quick Ratio
Accounts Receivable Turnover Ratio
Inventory Turnover Ratio
Debt to Equity Ratio
Gross profit ratio
Net Profit margin ratio
Return on Assets

MIZ NA COMPANY		
COMPARATIVE STATEMENT OF FINANCIAL POSITION		
For the Year 2017-2018		
Asset	**2018**	**2017**
Cash	₱350,000.00	₱175,000.00
Accounts Receivable	100,000.00	120,000.00
Marketable Securities	80,000.00	100,000.00
Inventories	100,000.00	75,000.00
Prepaid Expenses	20,000.00	10,000.00
Total Current Assets	**₱650,000.00**	**₱480,000.00**
Total Non-Current Assets	300,000.00	190,000.00
Total Assets	**₱950,000.00**	**₱670,000.00**
Liabilities		
Total Current Liabilities	150,000.00	275,000.00
Total Non -Current Liabilities	175,000.00	200,000.00
Owners Equity		
Total Owners Equity	₱625,000.00	₱195,000.00
Total Liabilities & Owner's Equity	**₱950,000.00**	**₱670,000.00**

MIZ NA COMPANY		
COMPARATIVE STATEMENT OF COMPREHENSIVE INCOME		
For the Year 2017-2018		
	2018	**2017**
Net Sales	₱1,000,000.00	₱650,000.00
Less : Cost of Goods Sold	115,000.00	90,000.00
Gross Profits	**₱885,000.00**	**₱560,000.00**
Less: Operating Expenses	50,000.00	85,000.00
Operating Income	**₱835,000.00**	**₱475,000.00**
Less : Interest Expense	10,000.00	25,000.00
Net Income Before Tax	**₱825,000.00**	**₱450,000.00**
Less: Income Tax	90,000.00	100,000.00
Net Income After Tax	**₱735,000.00**	**₱350,000.00**

Evaluation

I. Identify whether the statement is **True or False**. Write T if the statement is true write F if the statement is false . Write your answer on a separate sheet of paper.

1. _______________ **Financial ratios** are one of the most common tools of managerial decision making.
2. _______________ A business owner can use several methods to check the financial condition of the business and the most used method is **current ratio.**
3. _______________ **Inventory turnover** ratio shows how effectively inventory is being managed and it is computed by comparing cost of goods sold with average inventory for a period.
4. _____________ Financial statements that reflect financial data for two or more periods are often referred to as **comparative statements.**
5. _____________ **Comparability between enterprises** is more difficult to obtain than **comparability within a single enterprise.**
6. _____________Generally, the first concern of financial analyst is a **firm's liquidity.**
7. _____________The **working capital** is the fundamental measurement of a company's liquidity.
8. _____________ The **Return on Asset (ROA)** is a measure of overall asset productivity.
9. _______________ **Return on Equity ratio** interprets how much profit is generated for each peso of ordinary shares equity. It is an indicator of management effectiveness in using equity financing to fund the operations for the needed growth.
10. _______________ **Return on Asset** is the same with **Return on investment** it measures the net income produced by total assets during a period by comparing net income to the average total assets**.**

II. Choose the letter of the correct answer. Write your answer on a separate sheet of paper.

1. Current ratio compares current with __________________.
   a. fixed assets b. current liabilities c. equity capital d. current profit
2. Which ratio analysis how effectively inventory is managed by comparing cost of goods sold with average inventory for a period?
   a. Account receivable turnover ratio
   b. Inventory turnover ratio
   c. Current Ratio
   d. Gross margin ratio

3. Which refers to profitability ratio that measures the ability of a firm to generate profits from its shareholders investments in the company?
   a. Gross profit ratio
   b. Return on equity ratio
   c. Turnover
   d. Solvency

4. What does debt equity ratio analyze?
   a. Liquidity
   b. Profitability
   c. Turnover
   d. Solvency

5. Which are the two main elements of working capital?
   a. asset and liabilities
   b. Equity and Income
   c. Revenues and expenses
   d. interest and taxes

6. Which one is primarily concern in the liquidity of a company?
   a. Government Agency
   b. Security and Exchange Commission
   c. Short-term creditors
   d. Long-term creditors

7. Long-terms creditors are usually interested in evaluating company's_______________.
   a. Liquidity & Solvency
   b. Solvency & marketability
   c. Liquidity &Profitability
   d. Profitability & Solvency
8. Shareholders are most interested in evaluating company's_______________.
   a. Liquidity & Solvency
   b. Profitability & Solvency
   c. Liquidity &Profitability
   d. Solvency & marketability

9. Shareholder is interested in firm's_______________.
   I. pay consistent dividend
   II. appreciate in share price
   III. survive over a long period
   a. I only b. II only c. III only d. I, II and III

10. If average inventory is ₱80,000 and the inventory turnover ratio is 20. How much is the cost of goods sold by the company?
    a. ₱1,600,000
    b. ₱ 4,000
    c. ₱.00025
    d. ₱80,020

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