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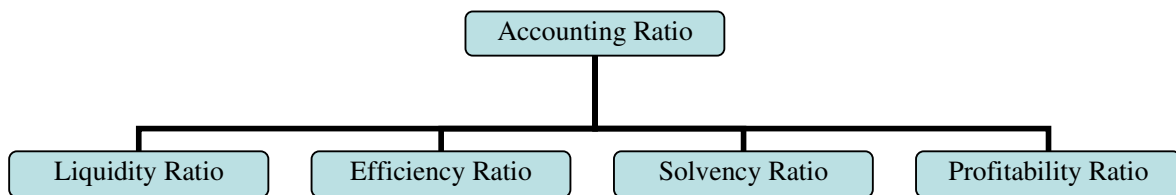
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Liquidity and Solvency Ratio

**Module - 18
Liquidity and Solvency Ratio**



Liquidity Ratios

The ratios that are used to test the liquidity position of a firm are called liquidity ratios. Liquidity refers to the ability of a firm in settling its current liabilities as and when they become due. It is also known as short-term solvency.

- 1) Current Ratio
- 2) Quick Ratio
- 3) Super -quick Ratio

(1) Current Ratio = 2:1

Current ratio establishes relationship between current assets and current liabilities. Current assets are those assets that can be converted into cash say within a year. And, current liabilities are those liabilities that should be settled within a short period say one year.

Current ratio = Current Assets / Current Liabilities

Current Ratio = Current assets: Current liabilities
(Current Ratio of 2: 1 is considered ideal)

Current ratio is also known as working capital ratio as the excess of current assets over current liabilities is called working capital.

Current Assets	Current Liabilities
1) Cash in hand/ Cash at bank	1) Outstanding expenses (accrued expenses)
2) Marketable securities	2) Bills Payable
3) Temporary investments	3) Sundry creditors
4) Bills Receivable	4) Short-term loans and advances
5) Sundry Debtors	5) Income -tax Payable
6) Inventories (Stocks)	6) Dividends Payable
7) Short -term loans and advances	7) Income Received in advance
8) Outstanding incomes / (accrued incomes)	8) Bank overdraft.
9) Prepaid expenses.	

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Bank overdraft should be excluded from current liabilities when it is a permanent or long-term arrangement with the bank.

Illustration: 1

Calculate current ratio from the following:

	Rs.		Rs.
Sundry debtors	1,00,000	Outstanding salaries	20,000
Bills receivable	80,000	Prepaid expenses	2,000
Stock	50,000	Marketable securities	20,000
Sundry creditors	80,000	Bank Overdraft	30,000
Bills Payable	40,000	Cash in hand and at bank	1,00,000

Solution:

Current ratio = Current Assets/Current Liabilities

$$= 3, 52,000/1, 70,000$$

$$= 2.70 \text{ Or } 207\% \text{ or } 2.07:1$$

Current Assets = 1, 00,000 + 80,000 + 50,000 + 2,000 + 20,000 + 1, 00,000
= Rs. 3, 52,000

Current Liabilities = 80,000 + 40,000 + 20,000 + 30,000
= Rs. 1, 70,000
= 2.07 or 207% or 2.07:1

Interpretation of Current Ratio

As it is stated earlier, no interpretation is possible without analysis and analysis becomes useless without interpretation. Therefore, in ratio analysis, interpretation is of great importance and in interpreting a ratio standard norm or rule of thumb is of great use. In the case of current ratio, the standard norm or rule of thumb is 2:1. It means that let the total amount of current assets be twice of the total amount of current liabilities. When a firm's current ratio is 2 or more it means that its liquidity position is considered to be sound or good.

(2) Quick Ratio = 1:1

Quick Ratio or Liquid Ratio or Acid Test Ratio Quick ratio is a more rigorous test of liquidity than the current ratio. Quick ratio establishes relationship between quick assets and current liabilities. Quick assets are those assets which could be easily and quickly converted into cash within a short period without loss of value.

Quick ratio = Quick Assets/Quick Liabilities

$$QA = CA - (\text{Stock} + \text{Prepaid Expense})$$

$$QL = CL - \text{Bank Overdrafts}$$

(A Quick Ratio of 1:1 is considered satisfactory)

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Illustration: 2

From the following figures, calculate quick ratio:

Short-term investments	50,000
Sundry Debtors	80,000
Stock	1,00,000
Bills Receivable	60,000
Sundry Creditors	50,000
Bills Payable	30,000
Bank overdraft	40,000
Prepaid expenses	10,000
Outstanding expenses	10,000
Cash in hand and at bank	60,000
Short-term loan (cr.)	70,000

Solution:

Quick ratio = Quick Assets/Quick Liabilities

Quick assets = Current assets except or Minus stock and prepaid expenses
Quick assets
= Rs. 50,000 + 80,000 + 60,000 + 60,000 = Rs. 2, 50,000

Quick Liabilities = Current liabilities - Bank overdrafts
= Rs. 2, 00,000 - Rs. 40,000
= Rs. 1, 60,000

\therefore **Quick Ratio** = Rs.2, 50,000 / Rs.1, 60,000
=1.56

Note: Bank overdraft is not included in quick liabilities since it is made as a permanent arrangement with the bank in general.

Interpretation of Quick Ratio

In general, a high liquid ratio (quick ratio) indicates that the firm is so sound as regards its liquidity is concerned whereas a low liquid/quick ratio indicates that the firm's liquidity position is not good.

(3) Super Quick Ratio or Absolute Liquid Ratio = 0.5:1

It is true that debtors, bills receivables are more liquid than stock. Nevertheless, there may be doubts regarding their realization into cash immediately or in time. Hence, some authorities are of the opinion that super quick ratio (Absolute Quick

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Ratio) should also be calculated along with the earlier two ratios namely current ratio and quick ratio so as to establish relationship between super quick assets and current liabilities.

Super quick ratio establishes the relationship between super quick assets and current liabilities.

Super quick assets are cash in hand, cash at bank and marketable securities or temporary investments. As the name implies, marketable securities or temporary investments or investment in Govt. securities are encashable very quickly. Therefore, Marketable securities are included under super quick assets.

A Super Quick Ratio of 0.5:1 is satisfactory

Illustration: 3

From the given below accounting figures, calculate super quick ratio:

	Rs.		Rs.
Cash in hand	50,000	Sundry creditors	2,80,000
Cash at bank	1,00,000	Bills payable	40,000
Marketable securities	2,00,000	Outstanding expenses	20,000
Sundry debtors	1,20,000	Short term Loan (cr.)	80,000
Bills receivables	80,000	Accrued income	10,000
Stock	1,50,000	Bank overdraft	1,20,000
Prepaid expenses	20,000		

Solution:

Super Quick Ratio or Absolute Liquid Ratio = Absolute Liquid Assets/Current Liabilities

Super Quick Assets = Rs. 50,000 + 1, 00,000 + 2, 00,000
= Rs. 3, 50,000

Current Liabilities = Rs. 2, 80,000 + 40,000 + 20,000 + 80,000 + 1, 20,000
= Rs. 5, 40,000

∴ Super Quick Ratio = 3, 50,000/5, 40,000
= 0.65 or 65% or .65:1

Absolute liquid ratio and super quick ratio is also known as cash ratio.

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Liquidity and Solvency Ratio

	Liquidity Ratios	Formula	Standard Norm
1.	Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	2.1 or 200%
2.	Quick Ratio	$\frac{\text{Quick Assets}}{\text{Quick Liabilities}}$	1:1 or 100%
3.	Super Quick Ratio	$\frac{\text{Absolute Liquid Assets}}{\text{Current Liabilities}}$	0.5:1 or 50%

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Illustration: 4

The following is the Balance Sheet of New Bath Limited for the year ending 31st Dec 2009.

Liabilities		Assets	
Equity share capital	5,00,000	Fixed assets	10,00,000
Preference share	1,00,000	Investments	3,00,000
Capital	4,00,000	Current assets :	
Reserves & Surplus	7,00,000	Cash	50,000
Debentures		Debtors	1,50,000
Current liabilities	60,000	Marketable securities	2,00,000
Sundry creditors	1,00,000	Stock	3,00,000
Bills payable	10,000		
O/S expenses	1,30,000		
Bank overdraft			
	20,00,000		20,00,000

From the above balance sheet, ascertain: (a) Current ratio (b) Quick ratio (c) Absolute liquid ratio Comment on these ratios.

Solution:

(a) **Current ratio = Current Assets/Current Liabilities**
 $= \frac{7,00,000}{3,00,000}$
 $= 2.33:1$

	Rs.
Current assets:	
Cash	50,000
Debtors	1,50,000
M. Securities	2,00,000
Stock	3,00,000
	7,00,000

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	Rs.
Current liabilities:	
S. Creditors	60,000
Bills Payable	1,00,000
O/S Expenses	10,000
Bank Overdraft	1,30,000
	3,00,000

(b) Quick or Acid Test ratio = Quick or Liquid Assets/Quick Liability
 = 4, 00,000/1, 70,000
 =2.35/1

Quick Assets = Current Assets - Stock
 = 7, 00,000 - 3, 00,000
 = Rs.4, 00,000

Quick Liability = Current Liability - Bank Overdraft
 =3, 00,000 - 1, 30,000
 =Rs.1, 70,000

(c) Absolute Liquid ratio = Absolute Liquid Assets / Current Liabilities
 = 2, 50,000 / 3, 00,000
 = 0.83:1

Absolute liquid assets:	Rs.
Cash	50,000
Marketable Securities	2,00,000
	2,50,000

Illustration 5:

The working capital position of ABC Co. Ltd stands as under on 31.12.99

Current Liabilities	Rs	Current Assets	Rs.
Sundry Creditors	4,50,000	Cash	1,00,000
Bank Overdraft	2,50,000	Debtors	5,00,000
		Stock	4,50,000
		Bills Receivable	50,000
	7,00,000		7,00,000

- (i) Calculate current ratio and quick ratio from the above information.
- (ii) Calculate the revised current ratio assuming that Bank overdraft of Rs.1,00,000 is discharged during the year



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Liquidity and Solvency Ratio

Illustration 6:

Following is the Balance Sheet of Raj Oil Mills Limited as at March 31, 2016.

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
	8,97,000
II. Assets	
1. Non-current Assets	
a) Fixed assets	7,53,000
Tangible assets	
2. Current Assets	
a) Inventories	55,800
b) Trade Receivables	28,800
c) Cash and cash equivalents	59,400
	8,97,000

Calculate Current Ratio.

Illustration 7:

Current Ratio is 3.5:1. Working Capital is Rs 90,000. Calculate the amount of Current Assets and Current Liabilities.

Solution:

Current Ratio = Current Assets/Current Liabilities

3.5/1 = Current Assets/Current Liabilities

Current Assets = 3.5 Current Liabilities (1)

Working Capital = Current Assets - Current Liabilities

90000 = Current Assets - Current Liabilities

90000 = 3.5 Current Liabilities - Current Liabilities (from 1)

2.5 Current Liabilities = 90000

Current Liabilities = 90000/2.5= 36000

Current Assets = 3.5 Current Liabilities
= 3.5 x 36000= 126000

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Illustration 8:

Current liabilities of a company are Rs 75,000. If current ratio is 4:1 and liquid ratio is 1:1, calculate value of current assets, liquid assets and inventory.

Solution:

Current Ratio = Current Assets/Current Liabilities

$$4 = \text{Current Assets}/75000$$

$$\text{Current Assets} = 75000 \times 4 = 300000$$

Liquid Ratio = Liquid Assets/Current Liabilities

$$1 = \text{Liquid Assets}/75000$$

$$\text{Liquid Assets} = 75000 \quad \text{Inventory} = \text{Current Assets} - \text{Liquid Assets} = 300000 - 75000 = 225000$$

Illustration 9:

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

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

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Solvency Ratios IOS

A solvency ratio assesses a company's ability to pay off its long-term debts. It shows how much of the company's assets are financed by debt, and whether its earnings are sufficient to cover interest payments. Common solvency ratios include the debt-to-assets ratio, interest coverage ratio, equity ratio, and the debt-to-equity (D/E) ratio. Lenders and investors review these ratios to estimate the likelihood that a company will default on its debt. While both solvency and liquidity ratios measure a firm's financial health, solvency ratios have a long-term focus, assessing the ability to meet obligations that go beyond one year.

Key Solvency Ratios and Their Formulas

Ratio	Formula	Explanation
Debt-to-Assets Ratio	Total Debt / Total Assets	Measures proportion of assets funded by debt
Interest Coverage Ratio	Earnings before Interest & Taxes (EBIT) / Interest Expense	Shows how many times earnings can cover interest payments
Equity Ratio	Shareholder Equity / Total Assets	Measures proportion of equity financing
Debt-to-Equity (D/E) Ratio	Total Debt / Total Equity	Compares funds from creditors to those from owners

Solvency Ratios vs. Liquidity Ratios

Aspect	Solvency Ratios	Liquidity Ratios
Focus	Long-term debt repayment	Short-term (within a year) obligations
Examples	Debt-to-assets, D/E, Interest coverage	Current ratio, quick ratio
Key Use	Lender/investor assessment of stability	Ensuring cash flow for daily operations

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1. Debt to Asset Ratio

The Debt to Asset Ratio measures the proportion of a company's assets that are financed by debt. It indicates the level of indebtedness and financial leverage.

Formula

$$\text{Debt to Asset Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

Interpretation

- A higher ratio indicates a higher level of debt financing and potential financial risk.
- A lower ratio indicates a lower level of debt financing and potentially more financial stability.

Example

If a company has a Debt to Asset Ratio of 0.4, it means that 40% of its assets are financed by debt.

Illustration 1:

A company has the following information:

Particulars	Amount (\$)
Total Assets	25,00,000
Long-term Borrowings	8,00,000
Short-term Borrowings	4,00,000
Trade Payables	2,00,000

Calculate the Debt to Asset Ratio.

Solution:

$$\begin{aligned} \text{Total Debt} &= \text{Long-term Borrowings} + \text{Short-term Borrowings} \\ &= 800,000 + 400,000 \\ &= 1,200,000 \end{aligned}$$

Note that Trade Payables are not considered as debt for this ratio.

$$\begin{aligned} \text{Debt to Asset Ratio} &= \frac{\text{Total Debt}}{\text{Total Assets}} \\ &= \frac{1,200,000}{2,500,000} \\ &= 0.48 \end{aligned}$$

This means 48% of the company's assets are financed by debt.



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Liquidity and Solvency Ratio

Illustration 2:

A company has the following information:

Particulars	Amount (\$)
Fixed Assets	18,00,000
Current Assets	12,00,000
Long-term Borrowings	9,00,000
Short-term Borrowings	5,00,000
Trade Payables	3,00,000
Other Current Liabilities	1,00,000
Provisions	50,000

Calculate the Debt to Asset Ratio.

Solution

Total Assets = Fixed Assets + Current Assets

$$= 1,800,000 + 1,200,000$$

$$= 3,000,000$$

Total Debt = Long-term Borrowings + Short-term Borrowings

$$= 900,000 + 500,000$$

$$= 1,400,000$$

Note that Trade Payables, Other Current Liabilities, and Provisions are not considered as debt for this ratio.

Debt to Asset Ratio = Total Debt / Total Assets

$$= 1,400,000 / 3,000,000$$

$$= 0.47$$

This means 47% of the company's assets are financed by debt.

Question 1

A company has the following information:

Particulars	Amount (\$)
Total Assets	40,00,000
Long-term Borrowings	15,00,000
Short-term Borrowings	8,00,000
Trade Payables	4,00,000

Calculate the Debt to Asset Ratio.

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Liquidity and Solvency Ratio

Question 2

A company has the following information:

Particulars	Amount (\$)
Fixed Assets	25,00,000
Current Assets	15,00,000
Long-term Borrowings	12,00,000
Short-term Borrowings	6,00,000
Other Current Liabilities	2,00,000

Calculate the Debt to Asset Ratio.

2. Debt to Equity Ratio

The Debt to Equity Ratio measures the proportion of a company's debt financing compared to its equity financing. It indicates the level of financial leverage and potential financial risk.

Formula

Debt to Equity Ratio = Total Debt / Total Equity

Interpretation

- A higher ratio indicates a higher level of debt financing and potential financial risk.
- A lower ratio indicates a lower level of debt financing and potentially more financial stability.

Implications

- Helps investors and creditors assess the company's financial risk and leverage.
- Indicates the company's ability to meet its debt obligations.
- Influences the company's cost of capital and borrowing capacity.

Question

A company has the following balance sheet information:

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Particulars	Amount (\$)
Equity Share Capital	15,00,000
Reserves and Surplus	5,00,000
Preference Share Capital	3,00,000
Long-term Borrowings	8,00,000
Short-term Borrowings	4,00,000
Trade Payables	2,00,000

Calculate the Debt Equity Ratio.

Solution

$$\begin{aligned} \text{Total Equity} &= \text{Equity Share Capital} + \text{Preference Share Capital} + \text{Reserves and Surplus} \\ &= 1,500,000 + 300,000 + 500,000 \\ &= 2,300,000 \end{aligned}$$

$$\begin{aligned} \text{Total Debt} &= \text{Long-term Borrowings} + \text{Short-term Borrowings} \\ &= 800,000 + 400,000 \\ &= 1,200,000 \end{aligned}$$

Note that Trade Payables are not considered as debt for this ratio.

$$\begin{aligned} \text{Debt Equity Ratio} &= \text{Total Debt} / \text{Total Equity} \\ &= 1,200,000 / 2,300,000 \\ &= 0.52: 1 \end{aligned}$$

This means the company's debt is 0.52 times its equity.

For the Debt Equity Ratio, debt typically refers to interest-bearing liabilities, such as long-term borrowings and short-term borrowings. Trade payables are not interest-bearing and are therefore excluded from the debt calculation.

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Liquidity and Solvency Ratio

Question

A company has the following balance sheet information:

Particulars	Amount (\$)
Equity Share Capital	20,00,000
Reserves and Surplus	8,00,000
Preference Share Capital	4,00,000
Long-term Borrowings	12,00,000
Short-term Borrowings	6,00,000
Trade Payables	3,00,000
Other Current Liabilities	1,00,000
Provisions	50,000

Calculate the Debt Equity Ratio.

Solution

Total Equity = Equity Share Capital + Preference Share Capital + Reserves and Surplus

$$= 2,000,000 + 400,000 + 800,000$$

$$= 3,200,000$$

Total Debt = Long-term Borrowings + Short-term Borrowings

$$= 1,200,000 + 600,000$$

$$= 1,800,000$$

Note that Trade Payables, Other Current Liabilities, and Provisions are not considered as debt for this ratio.

Debt Equity Ratio = Total Debt / Total Equity

$$= 1,800,000 / 3,200,000$$

$$= 0.56: 1$$

This means the company's debt is 0.56 times its equity.

Question 1

A company has the following information:

Particulars	Amount (\$)
Equity Share Capital	30,00,000
Reserves and Surplus	10,00,000
Long-term Borrowings	18,00,000
Short-term Borrowings	9,00,000

Calculate the Debt to Equity Ratio.

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Question 2

A company has the following information:

Particulars	Amount (\$)
Equity Share Capital	25,00,000
Preference Share Capital	5,00,000
Reserves and Surplus	8,00,000
Long-term Borrowings	20,00,000
Short-term Borrowings	10,00,000

Calculate the Debt to Equity Ratio.

3. Interest Coverage Ratio

The Interest Coverage Ratio (ICR) measures a company's ability to pay interest on its debt.

Formula

$$\text{ICR} = \text{EBIT (Earnings before Interest and Taxes)} / \text{Interest Expenses}$$

Interpretation

- A higher ratio indicates a company's ability to meet its interest payments.
- A lower ratio suggests potential difficulty in meeting interest payments.

Implication

The Interest Coverage Ratio assesses a company's:

1. Debt servicing capacity
2. Financial health
3. Creditworthiness

Question

A company has the following information:

Particulars	Amount (\$)
Revenue	5,00,000
Cost of Goods Sold	2,00,000
Operating Expenses	1,00,000
Interest Expenses	30,000
Taxes	20,000

Calculate the Interest Coverage Ratio.

Solution

$$\begin{aligned} \text{EBIT} &= \text{Revenue} - \text{Cost of Goods Sold} - \text{Operating Expenses} \\ &= 500,000 - 200,000 - 100,000 \end{aligned}$$

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Liquidity and Solvency Ratio

= 200,000

Interest Coverage Ratio = EBIT / Interest Expenses
= 200,000 / 30,000
= 6.67

This means the company's EBIT is 6.67 times its interest expenses, indicating a comfortable position to meet interest payments.

Question

A company has the following information:

Particulars	Amount (\$)
Revenue	7,50,000
Cost of Goods Sold	3,00,000
Operating Expenses	1,50,000
Interest Expenses	45,000

Calculate the Interest Coverage Ratio.

Solution

EBIT = Revenue - Cost of Goods Sold - Operating Expenses
= 750,000 - 300,000 - 150,000
= 300,000

Interest Coverage Ratio = EBIT / Interest Expenses
= 300,000 / 45,000
= 6.67

This means the company's EBIT is 6.67 times its interest expenses, indicating a comfortable position to meet interest payments.

Question 1

A company has the following information:

Particulars	Amount (\$)
Revenue	10,00,000
Cost of Goods Sold	4,00,000
Operating Expenses	2,00,000
Interest Expenses	50,000

Calculate the Interest Coverage Ratio.

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Question 2

A company has the following information:

Particulars	Amount (\$)
Net Profit	1,50,000
Interest Expenses	30,000
Taxes	50,000

Calculate the Interest Coverage Ratio.

4. Equity Ratio

The Equity Ratio, also known as the Equity-to-Asset Ratio, measures the proportion of a company's total assets financed by shareholders' equity.

Formula

$$\text{Equity Ratio} = \frac{\text{Total Shareholders' Equity}}{\text{Total Assets}}$$

Interpretation

- A higher ratio indicates a larger portion of assets is financed by equity, suggesting lower debt levels and potentially greater financial stability.
- A lower ratio suggests a larger portion of assets is financed by debt, potentially increasing financial risk.

Implication

The Equity Ratio assesses a company's:

1. Capital structure
2. Debt reliance
3. Financial leverage
4. Risk profile

It helps investors, lenders, and analysts evaluate a company's financial health and stability.

Question

A company has the following information:

Particulars	Amount (\$)
Equity Share Capital	6,00,000
Reserves and Surplus	3,00,000
Preference Share Capital	1,00,000
Long-term Debt	5,00,000
Short-term Debt	3,00,000
Fixed Assets	12,00,000
Current Assets	7,00,000
Investments	1,00,000

Calculate the Equity Ratio.



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Solution

Total Shareholders' Equity = Equity Share Capital + Reserves and Surplus + Preference Share Capital
 = 600,000 + 300,000 + 100,000
 = 1,000,000

Total Assets = Fixed Assets + Current Assets + Investments
 = 1,200,000 + 700,000 + 100,000
 = 2,000,000

Equity Ratio = Total Shareholders' Equity / Total Assets
 = 1,000,000 / 2,000,000
 = 0.5 or 50%

This means 50% of the company's total assets are financed by shareholders' equity.

Question 1

A company has the following information:

Particulars	Amount (\$)
Shareholders' Equity	12,00,000
Long-term Debt	6,00,000
Short-term Debt	4,00,000
Fixed Assets	15,00,000
Current Assets	8,00,000

Calculate the Equity Ratio.

Question 2

A company has the following information:

Particulars	Amount (\$)
Equity Share Capital	8,00,000
Reserves and Surplus	4,00,000
Long-term Debt	7,00,000
Fixed Assets	18,00,000
Current Assets	6,00,000
Investments	2,00,000

Calculate the Equity Ratio.

