RATIO ANALYSIS

(Lecture-1)

SEMESTER – 6

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RATIO – A ratio is the relationship between one value and another. For instance, there is a relationship between current assets and current liabilities, net profit & capital investment.

RATIO ANALYSIS – Ratio analysis is most widely used technique for interpreting and comparing financial reports. It analyses financial data from the firm's P/L A/c & Balance sheet. The figures convey considerable amount of information in terms of their absolute amount. Accounting ratio shows relationship among items in financial statements.

USES – These are used in assessment of profitability ,liquidity, activity and the capital structure of the enterprise.

USERS: It can be classified into two groups:-

- **Internal-** It consist of director, shareholders, partners, managers etc.
- **External-** It consist of Investors, Lenders, Suppliers, Employees, Labour Union, Customers, etc.

OBJECTIVES

- Simplify accounting information.
- Determine liquidity or Short-term solvency and Long-term solvency. Short-term solvency is the ability of the enterprise to meet its short-term financial obligations. Whereas, Long-term solvency is the ability of the enterprise to pay its long-term liabilities of the business.
- Assess the operating efficiency of the business.
- Analyse the profitability of the business.
- Help in comparative analysis, i.e. inter-firm and intra-firm comparisons.

ADVANTAGES

a.) **Forecasting and Planning:** The trend in costs, sales, profits and other facts can be known by computing ratios of relevant accounting figures of last few years. This trend analysis with the help of ratios may be useful for forecasting and planning future business activities.

b.) **Budgeting:** Budget is an estimate of future activities on the basis of past experience. Accounting ratios help to estimate budgeted figures. For example, sales budget may be prepared with the help of analysis of past sales.

c.) **Measurement of Operating Efficiency:** Ratio analysis indicates the degree of efficiency in the management and utilisation of its assets. Different activity ratios indicate the operational efficiency.

In fact, solvency of a firm depends upon the sales revenues generated by utilizing its assets.

d.) **Communication:** Ratios are effective means of communication and play a vital role in informing the position of and progress made by the business concern to the owners or other parties.

e.) **Control of Performance and Cost:**

Ratios may also be used for control of performances of the different divisions or departments of an undertaking as well as control of costs.

f.) **Inter-firm Comparison:** Comparison of performance of two or more firms reveals efficient and inefficient firms, thereby enabling the inefficient firms to adopt suitable measures for improving their efficiency.

The best way of inter-firm comparison is to compare the relevant ratios of the organisation with the average ratios of the industry.

g.) **Indication of Liquidity Position:** Ratio analysis helps to assess the liquidity position i.e., short-term debt paying ability of a firm. Liquidity ratios indicate the ability of the firm to pay and help in credit analysis by banks, creditors and other suppliers of short-term loans.

h.) **Indication of Long-term Solvency Position:** Ratio analysis is also used to assess the long-term debt-paying capacity of a firm. Long-term solvency position of a borrower is a prime concern to the long-term creditors, security analysts and the present and potential owners of a business. It is measured by the leverage/capital structure and profitability ratios which indicate the earning power and operating efficiency.

Ratio analysis shows the strength and weakness of a firm in this respect.

i.) **<u>Indication of Overall Profitability:</u>** The management is always concerned with the overall profitability of the firm. They want to know whether the firm has the ability to meet its short-term as well as long-term obligations to its creditors, to ensure a reasonable return to its owners and secure optimum utilisation of the assets of the firm. This is possible if all the ratios are considered together.

j.) **<u>Signal of Corporate Sickness:</u>** A company is sick when it fails to generate profit on a continuous basis and suffers a severe liquidity crisis. Proper ratio analysis can give signal of corporate sickness in advance so that timely measures can be taken to prevent the occurrence of such sickness.

k.) **Aid to Decision-making:** Ratio analysis helps to take decisions like whether to supply goods on credit to a firm, whether bank loans will be made available etc.

l.) **Simplification of Financial Statements:** Ratio analysis makes it easy to grasp the relationship between various items and helps in understanding the financial statements.

LIMITATIONS :

a.) **Limitations of Financial Statements:** Ratios are calculated from the information recorded in the financial statements. But financial statements suffer from a number of limitations and may, therefore, affect the quality of ratio analysis.

b.) **Historical Information:** Financial statements provide historical information. They do not reflect current conditions. Hence, it is not useful in predicting the future.

c.) **<u>Different Accounting Policies:</u>** Different accounting policies regarding valuation of inventories, charging depreciation etc. make the accounting data and accounting ratios of two firms non-comparable.

d.) **<u>Lack of Standard of Comparison:</u>** No fixed standards can be laid down for ideal ratios. For example, current ratio is said to be ideal if current assets are twice the current liabilities. But this conclusion may not be justifiable in case of those concerns which have adequate arrangements with their bankers for providing funds when they require, it may be perfectly ideal if current assets are equal to or slightly more than current liabilities.

e.) **<u>Quantitative Analysis:</u>** Ratios are tools of quantitative analysis only and qualitative factors are ignored while computing the ratios. For example, a high current ratio may not necessarily mean sound liquid position when current assets include a large inventory consisting of mostly obsolete items.

f.) **<u>Window-Dressing:</u>** The term ‘window-dressing’ means presenting the financial statements in such a way to show a better position than what it actually is. If, for instance, low rate of depreciation is charged, an item of revenue expense is treated as capital expenditure etc. the position of the concern may be made to appear in the balance sheet much better than what it is. Ratios computed from such balance sheet cannot be used for scanning the financial position of the business.

g.) **Changes in Price Level:** Fixed assets show the position statement at cost only. Hence, it does not reflect the changes in price level. Thus, it makes comparison difficult.

h.) **Causal Relationship Must:** Proper care should be taken to study only such figures as have a cause-and-effect relationship; otherwise ratios will only be misleading.

i.) **Ratios Account for one Variable:** Since ratios account for only one variable, they cannot always give correct picture since several other variables such Government policy, economic conditions, availability of resources etc. should be kept in mind while interpreting ratios.

j.) **Seasonal Factors Affect Financial Data:** Proper care must be taken when interpreting accounting ratios calculated for seasonal business. For example, an umbrella company main-tains high inventory during rainy season and for the rest of year its inventory level becomes 25% of the seasonal inventory level. Hence, liquidity ratios and inventory turnover ratio will give biased picture.