SECTION 5: RATIO ANALYSIS

LEARNING OBJECTIVES

→ Ratio
→ Accounting Ratio
→ Ratio Analysis
→ Importance or Utility or Advantages of Ratio Analysis
→ Limitations of Ratio Analysis
→ Classification of Accounting Ratio
→ A Brief Discussion on Different Accounting Ratios:
→ Solved Problems
→ Exercise

Ratio:

A ratio is an expression of quantitative relationship between two figures. In other words ratio denotes proportion of one in relation to other. For example in a partnership firm suppose partner A will get Rs 60 and partner B will get Rs 40 out of total profit of Rs 100. This means profit sharing ratio is 3:2.

Accounting Ratio:

Accounting ratio is the quantitative and qualitative relationship between any two accounting figure expressed in different ways such as times, months, days, percentage, proportion etc.

According to **J.Batty,** accounting ratio, "is used to describe significant relationships which exist between figures shown on a Balance Sheet, in a Profit and Loss Account, in a Budgetary Control System or in any other part of the accounting organization."

Ratio Analysis:

In business different analysis is required for judging strength and weaknesses in different areas with the help of ratios. For this purpose, different financial statement is prepared like Fund Flow Statement, Cash Flow Statement, Balance Sheet, Profit and Loss A/c etc. Ratio analysis is made on the basis of different financial information expressed in financial statements. On the basis of ratio analysis, different valuable decision is taken by the management.

Importance or Utility or Advantages of Ratio Analysis

Ratio analysis is a very important technique of analyzing financial strength and weaknesses of an organization. The importance or advantages of ratio analysis is given below:

(i) **Analytical Ability:** The financial ability of an organization can be judged through ratio analysis. Solvency, profitability, liquidity etc can be analyzed with the help of ratios. Weakness can be sorted out and remedial measures can be taken.

(ii) **Inter-firm Comparison:** With the help of ratio inter-firm comparison under the same management or with the competitors can be judged. Solvency, liquidity, profitability, efficiency etc can be compared within the same industry or with the outsiders.

(iii) **Measurement of Long Term Solvency Position:** With the help of ratio analysis, an analysist may determine the long term debt paying capacity of a firm. Those who are long term investor of the firm say Creditors, Debenture holders, Bank etc can take the decision wisely whether to invest in the firm or not.

(iv) **Measurement of Profitability:** Ratio analysis helps to determine the earning capacity or profitability of a firm. Moreover, trends or variation in profitability over the years can also be judged with the help of ratio analysis.

(v) **Measurement of Liquidity Position:** The liquidity position of a firm can also be determined help of ratio analysis. Here liquidity means short term debt repayment capacity. With the help of liquid ratio etc creditors, financial institutions etc can take decision regarding granting of short term cred..

(vi) **Assist in Decision Making:** Overall efficiency of an organization can be judged with the help of ratio analysis. Management can take valuable decision on the basis of computed ratios.

(vii) **Managerial Efficiency regarding Utilization of Assets:** With the help of ratio analysis the managerial efficiency regarding utilization of different assets can be determined.

(viii) **Assist in Controlling:** Ratio analysis is a very useful tool for controlling the financial activities of a firm. For this purpose different expense ratios are calculated for different years and help the top management aware to control the specific areas.

Limitations of Ratio Analysis

Though ratio analysis gives different benefits to an organization and also to the different outside users still this is not free from limitations. The limitations of ratio analysis are discussed below:

(i) **Only based on comparison:** Only calculating a single ratio can not give a meaningful analysis unless it is compared with other ratio also. For example, calculating current ratio itself can not give any concrete findings regarding solvency of a firm unless some other ratio like quick or absolute quick ratios are analysis together to give some conclusion. Hence comparison is only one of the technique for finding some result but other test also have influence to give some conclusions which is absent in ratio analysis.

(ii) **Post Mortem Examination:** Ratio analysis is made on the basis of some past financial statements i.e. this analysis is purely historical and has no ability to predict the future. Moreover, ratio analysis only helps the management to find out trends of a particular item but can not prove it.

(iii) **Uniform accounting principles:** Inter-firm comparison through ratio analysis can not give a real picture regarding strength and weaknesses unless there are uniform accounting principles maintained by the other firms under the same group or by the competing firm. For example one firm follow cost price of stock valuation and another firm follow cost or market price whichever is lower. Definitely stock turnover ratio will give misleading result.

(iv) **Problem in fixing of standards**: One of the tools of ratio analysis is to compare the actual result with the standards. But in reality fixing of standard is a very tough task for the analyst and this standard may also vary from industry to industry. The standard ratio once decided for the industry is not rigid and may change over time. Hence fixing of standards for all the ratios is really a very hard task for different situation.

(v) **Limitations of financial statements**: Financial statements are the sources of calculating ratios. But financial statement has its many limitations. Ratios calculated on the basis of these statements gives misleading result unless some adjustment is made.

(vi) **Personal Influence**: Interpreter must have a sound knowledge and analytical ability for calculating ratios. Often it is seen, the interpreter apply his personal influence while determining ratios for different purposes. This may give a misleading result and valueless for the firm.

(vii) **Only quantitative measurement**: Ratios are calculated on the basis of two numerical figures and hence quantitative and not qualitative. Only quantitative analysis may give misleading results in different matters. For example, a high current ratio indicates the favorable loan repayment capacity of the firm but it may happen the ratio is high due to huge accumulation of inventory in the current asset. Hence even if current ratio is high that only gives quantitative prove but not qualitative.

Classification of Accounting Ratios:

Ratio may be classified in different ways such as importance wise, user wise, source wise, function wise etc. Firms may analyze ratios as per their requirements. The function wise classification of ratios is given below.

(i) **Profitability Ratios:** Those who are interested parties to the business such as shareholders, owners, creditors, employees, management, government etc want to know the profitability of the firm. The financial analyst will select the following ratios for judging the profitability position.