Ratio Analysis

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Introduction

- It is one of the tools of measuring financial performance of the organization
- It is a comparative analysis between two factors
- Business performance can be measured by the
- use of ratios
- It must be interpreted against some standards
- Apart from the absolute profit figures, the management might find a need of relative data/information about the variables, thus, at this time, ratio analysis assists the management.
- It evaluates the financial conditions and the purpose of a firm through various yardsticks
- This tool is useful for all the various stakeholders of the company like, shareholders, bankers, creditors, lenders, investors, government, etc.

Meaning

- **Ratio analysis** is a quantitative method of gaining insight into a company's liquidity, operational efficiency, and profitability by studying its financial statements such as the balance sheet and income statement.
- Ratio analysis refers to the analysis of various pieces of financial information in the financial statements of a business. They are mainly used by external analysts to determine various aspects of a business, such as its profitability, liquidity, and solvency.
- **Ratio analysis** is used to evaluate relationships among financial statement items. The ratios are used to identify trends over time for one company or to compare two or more companies at one point in time. Financial statement ratio analysis focuses on three key aspects of a business: liquidity, profitability, and solvency.

Definition

Ratio analysis is the process of examining and comparing financial information by calculating meaningful financial statement figure percentages instead of comparing line items from each financial statement.

Analysis using ratios can be done in following ways.

- Analysis of an individual (or) Single Ratio
- Analysis of referring to a Group of Ratio
- Analysis of ratios by Trend
- Analysis by inter-firm comparison

Objectives of Ratio Analysis

- **Measure of Profitability***:* Profit is the ultimate aim of every organization. So if I say that ABC firm earned a profit of 5 lakhs last year, how will you determine if that is a good or bad figure? Context is required to measure profitability, which is provided by ratio analysis. Gross profit ratio, net profit ratio etc provide a measure of the profitability of a firm. The management can use such ratios to find out problem areas and improve upon them.

- **Evaluation of Operational Efficiency***:* Certain ratios highlight the degree of efficiency of a company in the management of its assets and other resources. It is important that assets and financial resources be allocated and used efficiently to avoid unnecessary expenses.

- **Ensure Suitable Liquidity***:* Every firm has to ensure that some of its assets are liquid, in case it requires cash immediately. So the liquidity of a firm is measured by ratios such as Current ratio and Quick Ratio. These help a firm maintain the required level of short-term solvency.

- **Overall Financial Strength***:* There are some ratios that help determine the firm's long-term solvency. They help determine if there is a strain on the assets of a firm. The management will need to quickly rectify the situation to avoid liquidation in the future.

- **Comparison***:* The organizations' ratios must be compared to the industry standards to get a better understanding of its financial health and fiscal position. The management can take corrective action if the standards of the market are not met by the company. The ratios can also be compared to the previous years' ratio's to see the progress of the company. This is known as trend analysis.

Advantages of Ratio Analysis

- **Helps to understand efficacy of decisions**: The ratio analysis helps you to understand whether the business firm has taken the right kind of operating, investing and financing decisions. It indicates how far they have helped in improving the performance.

- **Simplify complex figures and establish relationships**: Ratios help in simplifying the complex accounting figures and bring out their relationships. They help summarise the financial information effectively and assess the managerial efficiency, firm's credit worthiness, earning capacity, etc.

- **Helpful in comparative analysis**: The ratios are not be calculated for one year only. When many year figures are kept side by side, they help a great deal in exploring the trends visible in the business. The knowledge of trend helps in making projections about the business which is a very useful feature.

- **Identification of problem areas**: Ratios help business in identifying the problem areas as well as the bright areas of the business. Problem areas would need more attention and bright areas will need polishing to have still better results.

- **Enables SWOT analysis**: Ratios help a great deal in explaining the changes occurring in the business. The information of change helps the management a great deal in understanding the current threats and opportunities and allows business to do its own SWOT (Strength Weakness-Opportunity-Threat) analysis.

- **Various comparisons**: Ratios help comparisons with certain bench marks to assess as to whether firm's performance is better or otherwise. For this purpose, the profitability, liquidity, solvency, etc. of a business, may be compared:

  (i) over a number of accounting periods with itself (Intra-firm Comparison/Time Series Analysis),

  (ii) with other business enterprises (Inter-firm Comparison/Cross-sectional Analysis) and

  (iii) with standards set for that firm/industry (comparison with standard (or industry expectations).

Limitations of Ratio Analysis

- **Means and not the End**: Ratios are means to an end rather than the end by itself.

- **Lack of ability to resolve problems**: Their role is essentially indicative and of whistle blowing and not providing a solution to the problem.

- **Lack of standardised definitions**: There is a lack of standardised definitions of various concepts used in ratio analysis. For example, there is no standard definition of liquid liabilities. Normally, it includes all current liabilities, but sometimes it refers to current liabilities less bank overdraft.

- **Lack of universally accepted standard levels**: There is no universal yardstick which specifies the level of ideal ratios. There is no standard list of the levels universally acceptable, and, in India, the industry averages are also not available.

- **Ratios based on unrelated figures**: A ratio calculated for unrelated figures would essentially be a meaningless exercise. For example, creditors of Rs. 1,00,000 and furniture of Rs. 1,00,000 represent a ratio of 1:1. But it has no relevance to assess efficiency or solvency.

Types of Ratios

- **Liquidity ratios:** Liquidity ratios measure a company's ability to meet its debt obligations using its current assets. When a company is experiencing financial difficulties and is unable to pay its debts, it can convert its assets into cash and use the money to settle any pending debts with more ease. Some common liquidity ratios include the quick ratio, the cash ratio, and the current ratio. Liquidity ratios are used by banks, creditors, and suppliers to determine if a client has the ability to honor their financial obligations as they come due.

- To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as 'Liquidity Ratios'. These are essentially short-term in nature.

- **Solvency ratios:** Solvency ratios measure a company's long-term financial viability. These ratios compare the debt levels of a company to its assets, equity, or annual earnings. Important solvency ratios include the debt to capital ratio, debt ratio, interest coverage ratio, and equity multiplier. Solvency ratios are mainly used by governments, banks, employees etc.

- Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as 'Solvency Ratios'. These are essentially long-term in nature.

Types of Ratios

- **Profitability Ratios:** Profitability ratios measure a business' ability to earn profits, relative to their associated expenses. Recording a higher profitability ratio than in the previous financial reporting period shows that the business is improving financially. A profitability ratio can also be compared to a similar firm's ratio to determine how profitable the business is relative to its competitors. Some examples of important profitability ratios include the return on equity ratio, return on assets, profit margin, gross margin etc.

- It refers to the analysis of profits in relation to revenue from operations or funds (or assets) employed in the business and the ratios calculated to meet this objective are known as 'Profitability Ratios'

- **Activity (or Turnover) Ratios**: This refers to the ratios that are calculated for measuring the efficiency of operations of business based on effective utilisation of resources. Hence, these are also known as 'Efficiency Ratios'.

- Efficiency ratios measure how well the business is using its assets and liabilities to generate sales and earn profits. They calculate the use of inventory, machinery utilization, turnover of liabilities, as well as the usage of equity. These ratios are important because, when there is an improvement in the efficiency ratios, the business stands to generate more revenues and profits. Some of the important efficiency ratios include the, inventory turnover, payables turnover, working capital turnover, fixed asset turnover, and receivables turnover ratio.

THANK YOU