

Unit IV

Meaning, Objectives, Advantages and Limitations of Ratio

Analysis:

Once the financial statements of an organization are prepared they then need to be analyzed. One such tool to analyze and assess the financial situation of a firm is Ratio Analysis. It allows the stakeholder to make better sense of the accounts and better understand the current fiscal scenario of an entity. Let us take an in-detail look at ratio analysis.

Meaning of Ratio Analysis

Now, we have previously learned what ratios are. They are a comparison of two numbers with respect to each other. Similarly, in finance, ratios are a correlation between two numbers, or rather two accounts. So two numbers derived from the financial statement are compared to give us a more clear understanding of them. This is an accounting ratio.

Let us take an example. The income for the year from operations is let us say 1,00,000/- for a given year. The Purchases and other direct expenses cost around 75,000/-. So the Gross Profit for the year is 25,000/-. Now it can be said that the Gross Profit is 25% of the Operations Revenue. We calculate this as

$$\text{G.P. Ratio} = \frac{\text{G.P.}}{\text{Sales/Revenue}} \times 100$$

$$\text{G.P. Ratio} = \frac{25,000}{1,00,000} \times 100$$

$$\text{G.P. Ratio} = 25\%$$

One factor to be kept in mind is that ratio analysis is used only to compare numbers that make sense and give us a better understanding of the financial statement. Comparing random financial accounts should be avoided.

Objectives of Ratio Analysis

Interpreting the financial statements and other financial data is essential for all stakeholders of an entity. Ratio Analysis hence becomes a vital tool for financial analysis and financial management. Let us take a look at some objectives that ratio analysis fulfills.

1] 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 Ratios, Net Profit Ratio, Expense ratio etc provide a measure of profitability of a firm. The management can use such ratios to find out problem areas and improve upon them.

2] 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. Turnover Ratios and Efficiency Ratios will point out any mismanagement of assets.

3] 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.

4] 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 or if the firm is over-leveraged. The management will need to quickly rectify the situation to avoid liquidation in the future. Examples of such ratios are Debt-Equity Ratio, Leverage ratios etc.

5] 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

When employed correctly, ratio analysis throws light on many problems of the firm and also highlights some positives. Ratios are essentially whistleblowers, they draw the managements attention towards issues needing attention. Let us take a look at some advantages of ratio analysis.

- Ratio analysis will help validate or disprove the *financing, investment and operating decisions* of the firm. They summarize the financial statement into comparative figures, thus helping the management to compare and evaluate the financial position of the firm and the results of their decisions.
- It *simplifies complex accounting statements* and financial data into simple ratios of operating efficiency, financial efficiency, solvency, long-term positions etc.
- Ratio analysis help identify problem areas and bring the attention of the management to such areas. Some of the information is lost in the complex accounting statements, and ratios will help *pinpoint such problems*.
- Allows the company to conduct *comparisons with other firms, industry standards, intra-firm comparisons* etc. This will help the organization better understand its fiscal position in the economy.

Limitations of Ratio Analysis

While ratios are very important tools of financial analysis, they d have some limitations, such as

- The firm can make some year-end changes to their financial statements, to improve their ratios. Then the ratios end up being nothing but *window dressing*.
- Ratios *ignore the price level changes due to inflation*. Many ratios are calculated using historical costs, and they overlook the changes in price level between the periods. This does not reflect the correct financial situation.
- Accounting ratios completely *ignore the qualitative aspects of the firm*. They only take into consideration the monetary aspects (quantitative)
- There are *no standard definitions* of the ratios. So firms may be using different formulas for the ratios. One such example is Current Ratio, where some firms take into consideration all current liabilities but others ignore bank overdrafts from current liabilities while calculating current ratio
- And finally, accounting ratios *do not resolve any financial problems* of the company. They are a means to the end, not the actual solution.

Solved Example for You

Q: When many year figures are kept side by side, they help a great deal in exploring the _____ visible in the business.

- a. Trends
- b. System

c. Difference

d. None of the above

Ans: The correct option is A. Ratio analysis can be used to compare information taken from financial statements to gain a general understanding of the results, financial positions, and cash flow of a business. Ratio analysis is useful in exploring trends of the business.