2.4 RATIO ANALYSIS

Introduction: Absolute figures expressed in monetary terms in financial statements by themselves are meaningless. These figures often do -not convey much meaning unless expressed in relation to other figures. The relationship between two figures, expressed in arithmetical term is called a 'ratio'. In the words of R. N. Anthony "A Ratio is simply one number expressed in terms of-another. It is found by dividing one number in to other." - Ratio can be expressed in the following three ways:

1. **Pure Ratio or Simple Ratio**: It is expressed by the simple division of one number by another. For example, if the current assets of a business are Rs. 2, 00,000 and its current liabilities are Rs. 1, 00,000, the ratio of 'Current assets to current liabilities' will be 2: 1.
2. **Rate' or 'So Many Times':** It is calculated how many times a figure, is in comparison to another figure. For example, if a firm's credit sales during the year are Rs. 2,00,000 and its debtors at the end of the year are Rs. 40,000, its Debtors Turnover Ratio = 2,00,000 / 40,000 = 5 times. It shows that the credit sales are 5 times in comparison to debtors.
3. **Percentage:** In this type, the re1ation between two figures is expressed in hundredth. For example, if a firm's capital is Rs. 10, 00,000 and its profit is Rs. 2, 00,000. The ratio of profit to capital in terms of percentage, is

   $$\frac{2,00,000}{10,00,000} \times 100 = 20\%.$$

2.4.1 Objectives and Advantages or Uses of Ratio Analysis

It helps the reader in giving tongue to mute the mute heaps of figures given in financial statements. The figures then speak of liquidity, solvency, profitability etc. of the business enterprise. Some important objects and advantages of accounting ratios are:

a) **Helpful in Analysis of Financial Statements:** Ratio analysis is an extremely useful device for analyzing the financial statements. It helps the bankers, creditors, investors, shareholders etc. in acquiring enough knowledge about the profitability and financial health of the business.

b) **Simplification of Accounting Data**: Accounting ratio simplifies and summarizes a long array of accounting data and makes them understandable. It discloses the relationship between two such figures which have a cause and effect relationship with each other.

c) **Helpful in Comparative Study:** With the help of ratio analysis comparison of profitability and financial soundness can be made between one firm and another in the same industry. Similarly, comparison of current year figures can also be made with those previous years with the help of ratio analysis.

d) **Helpful in Locating the Weak Spots of the Business**: Current year's ratios are compared with those of the previous years and if some weak spots are located, remedial measures are taken to correct them.

e) **Helpful in Forecasting**: Accounting ratios are very helpful in forecasting and preparing the plans for the future. For example, if sales of a firm during this year are Rs. 10 Lakhs and the average amount of stock kept during the year was Rs. 2 Lakhs, i.e., 20% of sales and if the firm wishes to increase sales in next year to Rs.15 Lakhs, it must be ready to keep a stock of Rs.3, 00,000, i.e., 20% of 15 Lakhs.

f) **Estimate About the Trend of the Business:** If accounting ratios are prepared for a number of years, they will reveal the trend of costs, sales, profits and other important facts-

g) **Fixation of Ideal Standards**: Ratios help us in establishing ideal standards of the different items of the business. By comparing the actual ratios calculated at the end of the year with the ideal ratios, the efficiency of the business can be easily measured.

h) **Effective Control**: Ratio analysis discloses the liquidity, solvency and profitability of the business enterprise. Such information enables management to assess the changes that have taken place over a period of time in the financial activities of the business. It helps them in discharging their managerial functions, e.g., planning, organizing, directing, communicating and controlling more effectively.

i) **Study of Financial Soundness.** Ratio analysis discloses the position of business with different view'-points. It discloses the-position of business with the liquidity point of view, solvency point of view, profitability point of view etc. With the help of such a study we can draw conclusions regarding the financial health of the business enterprise.