FYBCOM (Semester- II)

Subject: Ad. Acc III (UB02DCOM71)

Unit 4: Accounting Ratio

What Is an Accounting Ratio?

Accounting ratios, an important sub-set of financial ratios, are a group of metrics used to measure the efficiency and profitability of a company based on its financial reports. They provide a way of expressing the relationship between one accounting data point to another and are the basis of ratio analysis.

An accounting ratio compares two line items in a company's financial statements, namely made up of its income statement, balance sheet, and cash flow statement. These ratios can be used to evaluate a company's fundamentals and provide information about the performance of the company over the last quarter or fiscal year.

Analyzing accounting ratios is an important step in determining the financial health of a company. It can often point out areas that are bringing the profitability of a company down and therefore need improvement. The efficacy of new management plans, new products, and changes in operational procedures, can all be determined by analyzing accounting ratios.

Accounting ratios also work as an important tool in company comparison within an industry, for both the company itself and investors. A company can see how it stacks up against its peers and investors can use accounting ratios to determine which company is the better option.

A thorough accounting analysis can be a complex task, but calculating accounting ratios is a simple process of dividing two line items found on a financial statement, that provide a quick form of clear analysis to a business owner or investor.

What are the Different Types of Accounting Ratios?

Ratios are classified into two types namely traditional classification and functional classification. The traditional classification is based on the financial statement to which the determinants belong. Based on the traditional classification, ratios are classified as:

1. **Statement of Profit and Loss Ratios:**

A ratio of two variables from the profit and loss statements is termed the statement of profit and loss ratio. For example, the ratio of gross profit to revenue generated from business operations is referred to as the gross profit ratio. It is calculated using both the figures derived from the profit and loss statement.

2. Balance Sheet Ratios:

If both the variables of the ratios are from the balance sheet, then it is classified as the balance sheet ratios. For example, the ratio of current assets to current liabilities is termed the current ratio. It is calculated using both the figures derived from the balance sheet.

3. Composite Ratios:

If the ratios are calculated using one variable from the financial statement and another variable from the balance sheet, then it is termed composite ratios. For example, the ratio of credit revenue from business operations to trade receivables is termed the trade receivable turnover ratio. It is calculated using one variable from the profit and loss statement (credit revenue from business operations) and another variable (trade receivables) from the balance sheet statement.

On the Basis of Functional Classification, Ratios Are Classified as:

1. **Liquidity Ratios:** To meet business commitments, the business needs liquid funds. The ability of a business to pay the due amount to stakeholders as to when it is due is known as liquidity; the ratios calculated to measure it are known as liquidity ratios. The liquidity ratios are short-term in nature. They are calculated to measure the short-term solvency of the business i.e. the firm's ability to meet its current obligations. The most common type of liquidity ratios are:

- **Current Ratio**
- **Quick or Liquid Ratio**

2. **Solvency Ratio:** The business solvency is determined by its ability to meet its contractual obligations towards stakeholders, specifically towards external stakeholders, and the ratios calculated to measure the business solvency positions are known as the solvency ratio. The solvency ratios are long-term in nature. The most common type of solvency ratio for calculating the business solvency are:

- Debt-Equity Ratio
- Debt to Capital Employed Ratio
- Proprietary ratio
- Total Asset to Debt Ratio
- Interest Coverage Ratio

3. **Activity or Turnover Ratio**: These are the ratios that are calculated for measuring the efficiency of business operations based on the effective utilization of resources. Hence, these are also termed efficiency ratios. A higher turnover ratio means better utilization of assets and signifies improved business efficiency and profitability. The most important types of activity ratios are:

- Activity Turnover Ratio

- Trade Receivable Turnover Ratio
- Trade Payable Turnover Ratio
- Net Asset or Capital Employed Turnover Ratio
- Fixed Asset Turnover Ratio, and
- Working Capital Turnover Ratio

4. **Profitability Ratios:** Profitability ratios are referred to as analysis of business profits in relation to the revenue generated from the business operations (or funds) or assets used in the business and the ratios calculated to meet its objectives are termed as profitability ratios. The most common types of profitability ratios that are used to analyze the profitability of the business are:

- Gross Profit Ratio
- Operating Ratio
- Operating Profit Ratio
- Net Profit Ratio
- Return on Investment (ROI) or Return on Capital Employed (ROCE)
- Return on Net Worth (RONW)
- Earnings Per Share
- Book Value Per Share
- Dividend Payout Ratio
- Price Earning Ratio

Advantages of Ratio Analysis

1. 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.

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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.

8. Indication of Long-term Solvency Position:

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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.

9. Indication of Overall Profitability:

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.

10. Signal of Corporate Sickness:

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.

11. 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.

12. Simplification of Financial Statements:

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Ratio analysis makes it easy to grasp the relationship between various items and helps in understanding the financial statements.

Limitations of Ratio Analysis:

The technique of ratio analysis is a very useful device for making a study of the financial health of a firm. But it has some limitations which must not be lost sight of before undertaking such analysis.

Some of these limitations are:

1. 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.

2. Historical Information:

Financial statements provide historical information. They do not reflect current conditions. Hence, it is not useful in predicting the future.

3. Different Accounting Policies:

Different accounting policies regarding valuation of inventories, charging depreciation etc. make the accounting data and accounting ratios of two firms non-comparable.

4. Lack of Standard of Comparison:

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.

5. Quantitative Analysis:

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.

6. Window-Dressing:

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.

7. 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.

8. 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.

9. 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.

10. Seasonal Factors Affect Financial Data:

Proper care must be taken when interpreting accounting ratios calculated for seasonal business. For example, an umbrella company maintains 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.