

A STUDY ON FINANCIAL STATEMENT ANALYSIS

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ABSTRACT

Understanding financial statements is key to fundamental stock analysis and overall investment research. Financial statements provide an account of a company's past performance, a picture of its current financial strength and a glimpse into the future potential of a firm.

This is the first in a new AAII Journal series on financial statement analysis. The goal is to enhance your ability to make a sound judgment about a company's financial strength and future prospects by showing you the benefits of using financial statements in your personal investment research.

Given the varied financial knowledge of our readers, I will address many topics that some may find very basic. However, to build a strong understanding of advanced topics, you need a solid foundation. As we progress through this series, I expect to touch on more advanced topics when explaining how I personally use financial statements to analyze a firm. In this introductory article, I explain the major components of each financial statement and why they matter in security analysis.

I. INTRODUCTION

1.1 Objective

To understand the information contained in financial statements with a view to know the strength or weaknesses of the firm and to make forecast about the future prospects of the firm and thereby enabling the financial analyst to take different decisions regarding the operations of the firm.

1.2 Ratio Analysis

Fundamental Analysis has a very broad scope. One aspect looks at the general (qualitative) factors of a company. The other side considers tangible and measurable factors (quantitative). This means crunching and analyzing numbers from the financial statements. If used in conjunction with other methods, quantitative analysis can produce excellent results.

1.3 Meaning of Ratio

A ratio is one figure express in terms of another figure. It is a mathematical yardstick that measures the relationship two figures, which are related to each other and mutually interdependent. Ratio is express by dividing one figure by the other related figure. Thus a ratio is an expression relating one number to another. It is simply the quotient of two numbers. It can be expressed as a fraction or as a decimal or as a pure ratio or in absolute figures as " so many times". As accounting ratio is an expression relating two figures or accounts or two sets of account heads or group contain in the financial statements.

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1.4 Meaning of Ratio Analysis

Ratio analysis is the method or process by which the relationship of items or group of items in the financial statement are computed, determined and presented.

Ratio analysis is an attempt to derive quantitative measure or guides concerning the financial health and profitability of business enterprises. Ratio analysis can be used both in trend and static analysis. There are several ratios at the disposal of an analyst but their group of ratio he would prefer depends on the purpose and the objective of analysis.

1.5 Objective of Ratios

Ratio is worked out to analyze the following aspects of business organization-

- A) Solvency-
- 1) Long term
- 2) Short term
- 3) Immediate
- B) Stability
- C) Profitability
- D) Operational efficiency
- E) Credit standing
- F) Structural analysis
- G) Effective utilization of resources
- H) Leverage or external financing

II. FORMS OF RATIO

Since a ratio is a mathematical relationship between two or more variables / accounting figures, such relationship can be expressed in different ways as follows –

A] As a pure ratio:

For example the equity share capital of a company is Rs. 20,00,000 & the preference share capital is Rs. 5,00,000, the ratio of equity share capital to preference share capital is 20,00,000: 5,00,000 or simply 4:1.

B] As a rate of times:

In the above case the equity share capital may also be described as 4 times that of preference share capital. Similarly, the cash sales of a firm are

Rs. 12,00,000 & credit sales are Rs. 30,00,000. so the ratio of credit sales to cash sales can be described as 2.5 [30,00,000/12,00,000] or simply by saying that the credit sales are 2.5 times that of cash sales.

C] As a percentage:

In such a case, one item may be expressed as a percentage of some other item. For example, net sales of the firm are Rs.50,00,000 & the amount of the gross profit is Rs. 10,00,000, then the gross profit may be described as 20% of sales [10,00,000/50,00,000]

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III. STEPS IN RATIO ANALYSIS

The ratio analysis requires two steps as follows:

1] Calculation of ratio

2] Comparing the ratio with some predetermined standards. The standard ratio may be the past ratio of the same firm or industry's average ratio or a projected ratio or the ratio of the most successful firm in the industry. In interpreting the ratio of a particular firm, the analyst cannot reach any fruitful conclusion unless the calculated ratio is compared with some predetermined standard. The importance of a correct standard is oblivious as the conclusion is going to be based on the standard itself.

IV. TYPES OF COMPARISONS

The ratio can be compared in three different ways –

1] Cross section analysis:

One of the way of comparing the ratio or ratios of the firm is to compare them with the ratio or ratios of some other selected firm in the same industry at the same point of time. So it involves the comparison of two or more firm's financial ratio at the same point of time. The cross section analysis helps the analyst to find out as to how a particular firm has performed in relation to its competitors. The firms performance may be compared with the performance of the leader in the industry in order to uncover the major operational inefficiencies. The cross section analysis is easy to be undertaken as most of the data required for this may be available in financial statement of the firm.

2] Time series analysis:

The analysis is called Time series analysis when the performance of a firm is evaluated over a period of time. By comparing the present performance of a firm with the performance of the same firm over the last few years, an assessment can be made about the trend in progress of the firm, about the direction of progress of the firm. Time series analysis helps to the firm to assess whether the firm is approaching the long-term goals or not. The Time series analysis looks for (1) important trends in financial performance (2) shift in trend over the years (3) significant deviation if any from the other set of data\

3] Combined analysis:

If the cross section & time analysis, both are combined together to study the behavior & pattern of ratio, then meaningful & comprehensive evaluation of the performance of the firm can definitely be made. A trend of ratio of a firm compared with the trend of the ratio of the standard firm can give good results. For example, the ratio of operating expenses to net sales for firm may be higher than the industry average however, over the years it has been declining for the firm, whereas the industry average has not shown any significant changes.

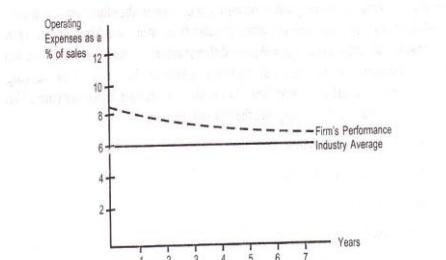


Figure 2.1 : Combined Analysis of Cross-section and Time series.

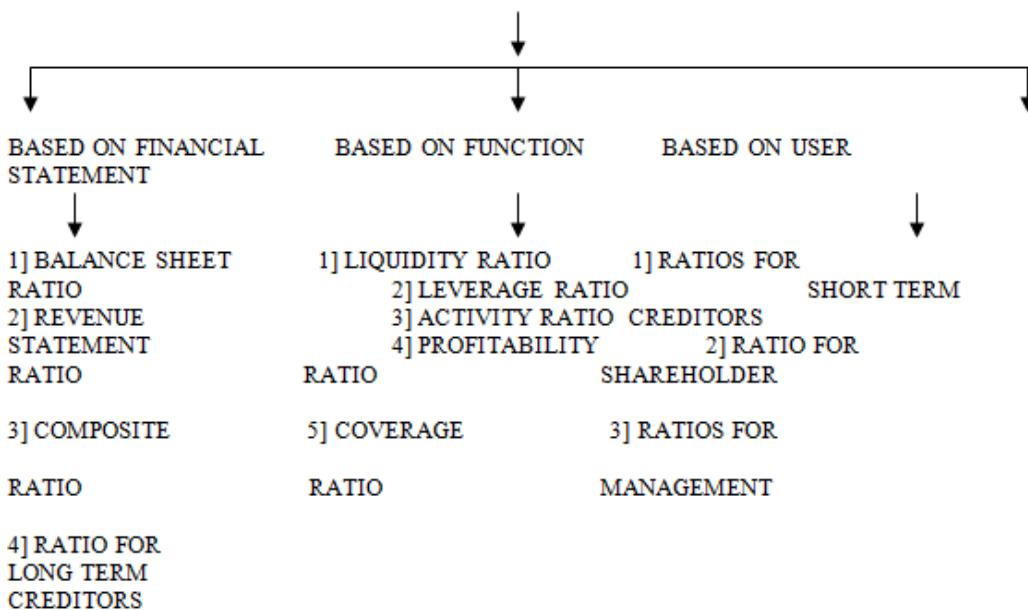
The combined analysis as depicted in the above diagram, which clearly shows that the ratio of the firm is above the industry average, but it is decreasing over the years & is approaching the industry average.

V. PRE-REQUISITES TO RATIO ANALYSIS

In order to use the ratio analysis as device to make purposeful conclusions, there are certain pre-requisites, which must be taken care of. It may be noted that these prerequisites are not conditions for calculations for meaningful conclusions. The accounting figures are inactive in them & can be used for any ratio but meaningful & correct interpretation & conclusion can be arrived at only if the following points are well considered.

- 1) The dates of different financial statements from where data is taken must be same.
- 2) If possible, only audited financial statements should be considered, otherwise there must be sufficient evidence that the data is correct.
- 3) Accounting policies followed by different firms must be same in case of cross section analysis otherwise the results of the ratio analysis would be distorted.

CLASSIFICATION OF RATIO



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- 4) One ratio may not throw light on any performance of the firm. Therefore, a group of ratios must be preferred. This will be conducive to counter checks.
- 5) Last but not least, the analyst must find out that the two figures being used to calculate a ratio must be related to each other, otherwise there is no purpose of calculating a ratio.

VI. BASED ON FINANCIAL STATEMENT

Accounting ratios express the relationship between figures taken from financial statements. Figures may be taken from Balance Sheet , P& P A/C, or both. One-way of classification of ratios is based upon the sources from which are taken.

1] Balance sheet ratio:

If the ratios are based on the figures of balance sheet, they are called Balance Sheet Ratios. E.g. ratio of current assets to current liabilities or ratio of debt to equity. While calculating these ratios, there is no need to refer to the Revenue statement. These ratios study the relationship between the assets & the liabilities, of the concern. These ratio help to judge the liquidity, solvency & capital structure of the concern. Balance sheet ratios are Current ratio, Liquid ratio, and Proprietary ratio, Capital gearing ratio, Debt equity ratio, and Stock working capital ratio.

2] Revenue ratio:

Ratio based on the figures from the revenue statement is called revenue statement ratios. These ratio study the relationship between the profitability & the sales of the concern. Revenue ratios are Gross profit ratio, Operating ratio, Expense ratio, Net profit ratio, Net operating profit ratio, Stock turnover ratio.

3] Composite ratio:

These ratios indicate the relationship between two items, of which one is found in the balance sheet & other in revenue statement.

There are two types of composite ratios-

- a) Some composite ratios study the relationship between the profits & the investments of the concern. E.g. return on capital employed, return on proprietors fund, return on equity capital etc.
- b) Other composite ratios e.g. debtors turnover ratios, creditors turnover ratios, dividend payout ratios, & debt service ratios

VII. BASED ON FUNCTION

Accounting ratios can also be classified according to their functions in to liquidity ratios, leverage ratios, activity ratios, profitability ratios & turnover ratios.

1] Liquidity ratios:

It shows the relationship between the current assets & current liabilities of the concern e.g. liquid ratios & current ratios.

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2] Leverage ratios:

It shows the relationship between proprietors funds & debts used in financing the assets of the concern e.g. capital gearing ratios, debt equity ratios, & Proprietary ratios.

3] Activity ratios:

It shows relationship between the sales & the assets. It is also known as Turnover ratios & productivity ratios e.g. stock turnover ratios, debtors turnover ratios.

4] Profitability ratios:

- It shows the relationship between profits & sales e.g. operating ratios, gross profit ratios, operating net profit ratios, expenses ratios
- It shows the relationship between profit & investment e.g. return on investment, return on equity capital.

5] Coverage ratios:

It shows the relationship between the profit on the one hand & the claims of the outsiders to be paid out of such profit e.g. dividend payout ratios & debt service ratios.

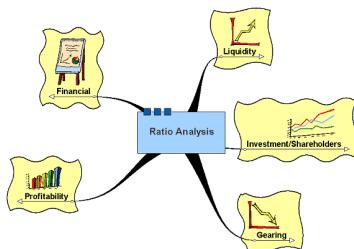
VII. BASED ON USER

1] Ratios for short-term creditors:

Current ratios, liquid ratios, stock working capital ratios

2] Ratios for the shareholders:

Return on proprietors fund, return on equity capital



3] Ratios for management:

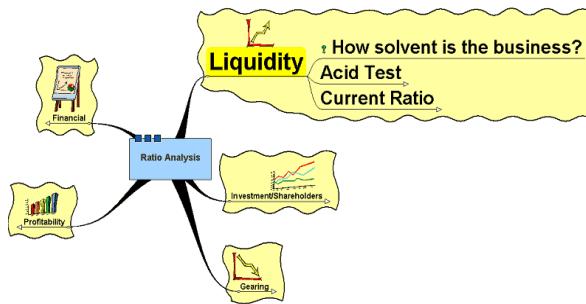
Return on capital employed, turnover ratios, operating ratios, expenses ratios

4] Ratios for long-term creditors:

Debt equity ratios, return on capital employed, proprietor ratios.

LIQUIDITY RATIO

Liquidity refers to the ability of a firm to meet its short-term (usually up to 1 year) obligations. The ratios, which indicate the liquidity of a company, are Current ratio, Quick/Acid-Test ratio, and Cash ratio. These ratios are discussed below



CURRENT RATIO

Meaning:

This ratio compares the current assets with the current liabilities. It is also known as ‘working capital ratio’ or ‘solvency ratio’. It is expressed in the form of pure ratio.

E.g. 2:1

Formula:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The current assets of a firm represents those assets which can be, in the ordinary course of business, converted into cash within a short period time, normally not exceeding one year. The current liabilities defined as liabilities which are short term maturing obligations to be met, as originally contemplated, within a year.

LIQUID RATIO:

Meaning:

Liquid ratio is also known as acid test ratio or quick ratio. Liquid ratio compare the quick assets with the quick liabilities. It is expressed in the form of pure ratio. E.g. 1:1.

The term quick assets refer to current assets, which can be converted into, cash immediately or at a short notice without diminution of value.

Formula:

$$\text{Liquid ratio} = \frac{\text{Quick assets}}{\text{Quick liabilities}}$$

Quick Ratio (QR) is the ratio between quick current assets (QA) and CL. QA refers to those current assets that can be converted into cash immediately without any value strength. QA includes cash and bank balances, short-term marketable securities, and sundry debtors. Inventory and prepaid expenses are excluded since these cannot be turned into cash as and when required.

CASH RATIO

Meaning:

This is also called as super quick ratio. This ratio considers only the absolute liquidity available with the firm.

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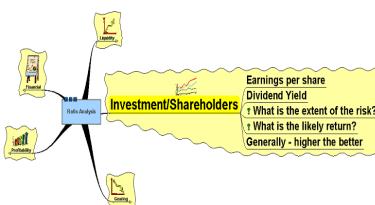
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Formula:

$$\text{Cash ratio} = \frac{\text{Cash} + \text{Bank} + \text{Marketable securities}}{\text{Total current liabilities}}$$

Since cash and bank balances and short term marketable securities are the most liquid assets of a firm, financial analysts look at the cash ratio. If the super liquid assets are too much in relation to the current liabilities then it may affect the profitability of the firm.

INVESTMENT / SHAREHOLDER



EARNING PER SHARE:-

Meaning:

Earnings per Share are calculated to find out overall profitability of the organization. An earnings per Share represents earning of the company whether or not dividends are declared. If there is only one class of shares, the earning per share are determined by dividing net profit by the number of equity shares. EPS measures the profits available to the equity shareholders on each share held.

Formula:

$$\text{Earning per share} = \frac{\text{NPAT}}{\text{Number of equity share}}$$

The higher EPS will attract more investors to acquire shares in the company as it indicates that the business is more profitable enough to pay the dividends in time. But remember not all profit earned is going to be distributed as dividends the company also retains some profits for the business

DIVIDEND PER SHARE:-

Meaning:

DPS shows how much is paid as dividend to the shareholders on each share held.

Formula:

$$\text{Dividend per Share} = \frac{\text{Dividend Paid to Ordinary Shareholders}}{\text{Number of Ordinary Shares}}$$

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DIVIDEND PAYOUT RATIO:-

Meaning:

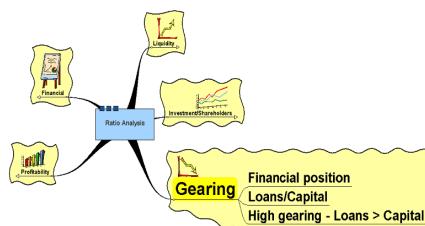
Dividend Pay-out Ratio shows the relationship between the dividend paid to equity shareholders out of the profit available to the equity shareholders.

Formula:

$$\text{Dividend Pay out ratio} = \frac{\text{Dividend per share}}{\text{Earning per share}} * 100$$

D/P ratio shows the percentage share of net profits after taxes and after preference dividend has been paid to the preference equity holders.

GEARING



CAPITAL GEARING RATIO:-

Meaning:

Gearing means the process of increasing the equity shareholders return through the use of debt. Equity shareholders earn more when the rate of the return on total capital is more than the rate of interest on debts. This is also known as leverage or trading on equity. The Capital-gearing ratio shows the relationship between two types of capital viz: - equity capital & preference capital & long term borrowings. It is expressed as a pure ratio.

Formula:

$$\text{Capital gearing ratio} = \frac{\text{Preference capital} + \text{secured loan}}{\text{Equity capital} + \text{reserve} + \text{surplus}}$$

Capital gearing ratio indicates the proportion of debt & equity in the financing of assets of a concern.

PROFITABILITY

These ratios help measure the profitability of a firm. A firm, which generates a substantial amount of profits per rupee of sales, can comfortably meet its operating expenses and provide more returns to its shareholders. The relationship between profit and sales is measured by profitability ratios. There are two types of profitability ratios: Gross Profit Margin and Net Profit Margin.

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GROSS PROFIT RATIO:-

Meaning:



This ratio measures the relationship between gross profit and sales. It is defined as the excess of the net sales over cost of goods sold or excess of revenue over cost. This ratio shows the profit that remains after the manufacturing costs have been met. It measures the efficiency of production as well as pricing. This ratio helps to judge how efficient the concern is I managing its production, purchase, selling & inventory, how good its control is over the direct cost, how productive the concern , how much amount is left to meet other expenses & earn net profit.

Formula:

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Netsales}} * 100$$

NET PROFIT RATIO:-

Meaning:

Net Profit ratio indicates the relationship between the net profit & the sales it is usually expressed in the form of a percentage.

Formula:

$$\text{Net profit ratio} = \frac{\text{NPAT}}{\text{Net sales}} * 100$$

This ratio shows the net earnings (to be distributed to both equity and preference shareholders) as a percentage of net sales. It measures the overall efficiency of production, administration, selling, financing, pricing and tax management. Jointly considered, the gross and net profit margin ratios provide an understanding of the cost and profit structure of a firm.

RETURN ON CAPITAL EMPLOYED:-

Meaning:

The profitability of the firm can also be analyzed from the point of view of the total funds employed in the firm. The term fund employed or the capital employed refers to the total long-term source of funds. It means that the capital employed comprises of shareholder funds plus long-term debts. Alternatively it can also be defined as fixed assets plus net working capital.

Capital employed refers to the long-term funds invested by the creditors and the owners of a firm. It is the sum of long-term liabilities and owner's equity. ROCE indicates the efficiency with which the long-term funds of a firm are utilized.

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Formula:

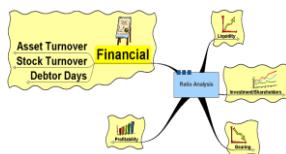
$$\text{Return on capital employed} = \frac{\text{NPAT}}{\text{Capital employed}} * 100$$

FINANCIAL

These ratios determine how quickly certain current assets can be converted into cash. They are also called efficiency ratios or asset utilization ratios as they measure the efficiency of a firm in managing assets. These ratios are based on the relationship between the level of activity represented by sales or cost of goods sold and levels of investment in various assets. The important turnover ratios are debtors turnover ratio, average collection period, inventory/stock turnover ratio, fixed assets turnover ratio, and total assets turnover ratio. These are described below:

DEBTORS TURNOVER RATIO (DTO)

Meaning:



DTO is calculated by dividing the net credit sales by average debtors outstanding during the year. It measures the liquidity of a firm's debts. Net credit sales are the gross credit sales minus returns, if any, from customers. Average debtors are the average of debtors at the beginning and at the end of the year. This ratio shows how rapidly debts are collected. The higher the DTO, the better it is for the organization.

Formula:

$$\text{Debtors turnover ratio} = \frac{\text{Credit sales}}{\text{Average debtors}}$$

INVENTORY OR STOCK TURNOVER RATIO (ITR)

Meaning:

ITR refers to the number of times the inventory is sold and replaced during the accounting period.

Formula:

$$\text{Stock Turnover Ratio} = \frac{\text{COGS}}{\text{Average stock}}$$

ITR reflects the efficiency of inventory management. The higher the ratio, the more efficient is the management of inventories, and vice versa. However, a high inventory turnover may also result from a low level of inventory, which may lead to frequent stock outs and loss of sales and customer goodwill. For calculating ITR, the average of

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inventories at the beginning and the end of the year is taken. In general, averages may be used when a flow figure (in this case, cost of goods sold) is related to a stock figure (inventories).

FIXED ASSETS TURNOVER (FAT)

The FAT ratio measures the net sales per rupee of investment in fixed assets.

Formula:

$$\frac{\text{Net sales}}{\text{Fixed assets turnover}} =$$

$$\frac{\text{Net fixed assets}}{\text{}}$$

This ratio measures the efficiency with which fixed assets are employed. A high ratio indicates a high degree of efficiency in asset utilization while a low ratio reflects an inefficient use of assets. However, this ratio should be used with caution because when the fixed assets of a firm are old and substantially depreciated, the fixed assets turnover ratio tends to be high (because the denominator of the ratio is very low).

PROPRIETORS RATIO:

Meaning:

Proprietary ratio is a test of financial & credit strength of the business. It relates shareholders fund to total assets. This ratio determines the long term or ultimate solvency of the company.

In other words, Proprietary ratio determines as to what extent the owner's interest & expectations are fulfilled from the total investment made in the business operation.

Proprietary ratio compares the proprietor fund with total liabilities. It is usually expressed in the form of percentage. Total assets also know it as net worth.

Formula:

$$\frac{\text{Proprietary fund}}{\text{Proprietary ratio}} = \frac{\text{Total fund}}{\text{Shareholders fund}}$$

$$\text{Proprietary ratio} = \frac{\text{Shareholders fund}}{\text{Fixed assets + current liabilities}}$$

STOCK WORKING CAPITAL RATIO:

Meaning:

This ratio shows the relationship between the closing stock & the working capital. It helps to judge the quantum of inventories in relation to the working capital of the business. The purpose of this ratio is to show the extent to which working capital is blocked in inventories. The ratio highlights the predominance of stocks in the current financial position of the company. It is expressed as a percentage.

Formula:

$$\frac{\text{Stock}}{\text{Stock working capital ratio}} = \frac{\text{Working capital}}{\text{}}$$

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Working Capital

Stock working capital ratio is a liquidity ratio. It indicates the composition & quality of the working capital. This ratio also helps to study the solvency of a concern. It is a qualitative test of solvency. It shows the extent of funds blocked in stock. If investment in stock is higher it means that the amount of liquid assets is lower.

DEBT EQUITY RATIO:

MEANING:

This ratio compares the long-term debts with shareholders fund. The relationship between borrowed funds & owners capital is a popular measure of the long term financial solvency of a firm. This relationship is shown by debt equity ratio. Alternatively, this ratio indicates the relative proportion of debt & equity in financing the assets of the firm. It is usually expressed as a pure ratio. E.g. 2:1

Formula:

$$\frac{\text{Total long-term debt}}{\text{Total shareholders fund}}$$

Debt equity ratio =

$$\frac{\text{Total long-term debt}}{\text{Total shareholders fund}}$$

Debt equity ratio is also called as leverage ratio. Leverage means the process of the increasing the equity shareholders return through the use of debt. Leverage is also known as ‘gearing’ or ‘trading on equity’. Debt equity ratio shows the margin of safety for long-term creditors & the balance between debt & equity.

RETURN ON PROPRIETOR FUND:

Meaning:

Return on proprietors fund is also known as ‘return on proprietors equity’ or ‘return on shareholders investment’ or ‘investment ratio’. This ratio indicates the relationship between net profit earned & total proprietors funds. Return on proprietors fund is a profitability ratio, which the relationship between profit & investment by the proprietors in the concern. Its purpose is to measure the rate of return on the total fund made available by the owners. This ratio helps to judge how efficient the concern is in managing the owner’s fund at disposal. This ratio is of practical importance to prospective investors & shareholders.

Formula:

$$\frac{\text{NPAT}}{\text{Proprietors fund}}$$

Return on proprietors fund = $\frac{\text{NPAT}}{\text{Proprietors fund}} * 100$

CREDITORS TURNOVER RATIO:

It is same as debtors turnover ratio. It shows the speed at which payments are made to the supplier for purchase made from them. It is a relation between net credit purchase and average creditors

$$\frac{\text{Net credit purchase}}{\text{Average creditors}}$$

Credit turnover ratio =

$$\frac{\text{Net credit purchase}}{\text{Average creditors}}$$

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Months in a year

Average age of accounts payable =

Credit turnover ratio

Both the ratios indicate promptness in payment of creditor purchases. Higher creditors turnover ratio or a lower credit period enjoyed signifies that the creditors are being paid promptly. It enhances credit worthiness of the company. A very low ratio indicates that the company is not taking full benefit of the credit period allowed by the creditors.

MPORTANCE OF RATIO ANALYSIS:

As a tool of financial management, ratios are of crucial significance. The importance of ratio analysis lies in the fact that it presents facts on a comparative basis & enables the drawing of inference regarding the performance of a firm. Ratio analysis is relevant in assessing the performance of a firm in respect of the following aspects:

- 1] Liquidity position,
- 2] Long-term solvency,
- 3] Operating efficiency,
- 4] Overall profitability,
- 5] Inter firm comparison
- 6] Trend analysis.

1] LIQUIDITY POSITION: -

With the help of Ratio analysis conclusion can be drawn regarding the liquidity position of a firm. The liquidity position of a firm would be satisfactory if it is able to meet its current obligation when they become due. A firm can be said to have the ability to meet its short-term liabilities if it has sufficient liquid funds to pay the interest on its short maturing debt usually within a year as well as to repay the principal. This ability is reflected in the liquidity ratio of a firm. The liquidity ratio are particularly useful in credit analysis by bank & other suppliers of short term loans.

2] LONG TERM SOLVENCY: -

Ratio analysis is equally useful for assessing the long-term financial viability of a firm. This respect of the financial position of a borrower is of concern to the long-term creditors, security analyst & the present & potential owners of a business. The long-term solvency is measured by the leverage/ capital structure & profitability ratio. Ratio analysis s that focus on earning power & operating efficiency.

3] OPERATING EFFICIENCY:

Yet another dimension of the useful of the ratio analysis, relevant from the viewpoint of management, is that it throws light on the degree of efficiency in management & utilization of its assets. The various activity ratios measures this kind of operational efficiency. In fact, the solvency of a firm is, in the ultimate analysis, dependent upon the sales revenues generated by the use of its assets- total as well as its components.

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4] OVERALL PROFITABILITY:

Unlike the outside parties, which are interested in one aspect of the financial position of a firm, the management is constantly concerned about overall profitability of the enterprise. That is, they are concerned about the ability of the firm to meet its short term as well as long term obligations to its creditors, to ensure a reasonable return to its owners & secure optimum utilization of the assets of the firm. This is possible if an integrated view is taken & all the ratios are considered together.

5] INTER – FIRM COMPARISON:

Ratio analysis not only throws light on the financial position of firm but also serves as a stepping-stone to remedial measures. This is made possible due to inter firm comparison & comparison with the industry averages. A single figure of a particular ratio is meaningless unless it is related to some standard or norm.

6] TREND ANALYSIS:

Finally, ratio analysis enables a firm to take the time dimension into account. In other words, whether the financial position of a firm is improving or deteriorating over the years. This is made possible by the use of trend analysis. The significance of the trend analysis of ratio lies in the fact that the analysts can know the direction of movement, that is, whether the movement is favorable or unfavorable.

IX. ADVANTAGES OF RATIO ANALYSIS

Financial ratios are essentially concerned with the identification of significant accounting data relationships, which give the decision-maker insights into the financial performance of a company. The advantages of ratio analysis can be summarized as follows:

- Ratios facilitate conducting trend analysis, which is important for decision making and forecasting.
- Ratio analysis helps in the assessment of the liquidity, operating efficiency, profitability and solvency of a firm.
- Ratio analysis provides a basis for both intra-firm as well as inter-firm comparisons.
- The comparison of actual ratios with base year ratios or standard ratios helps the management analyze the financial performance of the firm.

LIMITATIONS OF RATIO ANALYSIS

Ratio analysis has its limitations. These limitations are described below:

1] Information problems

- Ratios require quantitative information for analysis but it is not decisive about analytical output .
- The figures in a set of accounts are likely to be at least several months out of date, and so might not give a proper indication of the company's current financial position.
- Where historical cost convention is used, asset valuations in the balance sheet could be misleading. Ratios based on this information will not be very useful for decision-making.

2] Comparison of performance over time

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- When comparing performance over time, there is need to consider the changes in price. The movement in performance should be in line with the changes in price.
- When comparing performance over time, there is need to consider the changes in technology. The movement in performance should be in line with the changes in technology.
- Changes in accounting policy may affect the comparison of results between different accounting years as misleading.

PURPOSE OF RATIO ANALYSIS:

1] To identify aspects of a business's performance to aid decision making

2] Quantitative process – may need to be supplemented by qualitative

Factors to get a complete picture.

3] 5 main areas:-

- **Liquidity** – the ability of the firm to pay its way
- **Investment/shareholders** – information to enable decisions to be made on the extent of the risk and the earning potential of a business investment
- **Gearing** – information on the relationship between the exposure of the business to loans as opposed to share capital
- **Profitability** – how effective the firm is at generating profits given sales and or its capital assets
- **Financial** – the rate at which the company sells its stock and the efficiency with which it uses its assets

X. CONCLUSION

Financial analysis determines a company's health and stability, providing an understanding of how the company conducts its business. But it is important to know that financial statement analysis has its limitations as well. Different accounting methods adopted by different firms' changes the visible health and profit levels for either better or worse. Different analysts may get different results from the same information. Hence, we must conclude that financial statement analysis is only one of the tools (although a major one) while taking an investment decision.