# St. Lawrence High School

A Jesuit Christian Minority Institution

Study Material 5

Sub: ACCOUNTANCY Class 12

Chapter: Unit 5: Analysis of Financial Statements Date: 30/01/2021

Topic: Accounting Ratios 1

**Meaning of Ratio**

A ratio is the relationship between one value and another. It is an expression of mathematical relationship between one quantity and another. The calculation of ratio is an important technique for analyzing and understanding profit and loss accounts and balance sheets.

**Meaning of Ratio Analysis**

Ratio Analysis is the most widely used technique for interpreting and comparing financial reports. It analyses financial data from the firm's profit and loss account and balance sheet convey a considerable amount of information in terms of their absolute amounts. But relationship between one figure and another can be more useful. Accounting Ratios shows the relationship among items in financial statements. These are used in the assessment of profitability, liquidity, activity and the capital structure of the enterprise.

**Objectives of Ratio Analysis**

1. To allow comparison to be made which assist in predicting the future.

2. To investigate the reasons for the changes.

3. To construct a simple explanation of a complicated financial statement by its expression in one figure.

4. To provide indicators of a firm's past performance in terms of its operational activity and profitability; and near present financial condition.

5. To see what information users can get from the accounting system output.

**Advantages of Ratio Analysis**

1. It is used as an aid to simplify the comprehension of financial statements of an organization.

2. It is used as an aid to analysis and interpretation of financial statements.

3. It provides data for inter-firm comparison in regard to operating performance and financial results.

4. It can be used for comparing the working results of the different divisions of the same organization.

5. Accounting Ratios based on past performance is helpful in predicting the future performance of the different division and the business as a whole.

6. It can help the management in planning and forecasting and provides clues on trends and future problems.

7. Without going into much details, the position of the business can be ascertained at a glance by the use of accounting ratio.

8. Accounting reports can be strengthened by the use of accounting ratio.

9. It can be used for making investment decision.

## Limitation of Ratio Analysis

1. Financial Statements suffer from number of limitations. When the ratios are constructed from those financial statements, ratios suffer from the inherent weakness of the accounting system itself.

2. By using ratios, forecasts of a future business may not prove correct. This is because, ratios are all based on past happening and not future probabilities. They are subject to change in the future.

3. Accounting Ratios are simply clues. They do not indicate the causes of difference. Therefore, they are not considered as basis for immediate conclusion.

4. The accounting ratios change with the change in the operating results which give misleading information.

5. Ratios are not free from individual bias, because accounting is man-made. Two identical business units with the same level of operation and investment may show highly incomparable financial results.

6. There is lack of proper standards for ideal ratios. There are many rules of thumb, since it is not possible to establish well accepted absolute standards.

7. While constructing accounting ratios, arithmetic window dressing is possible by concealing vital facts and presenting the financial statements in such a fashion as to show the business in a better position than it actually is.

## Standards of Comparison

There are broadly three bases of comparison for ratios calculated from financial statements.

1. Past Periods.

2. Planned performance

3. Industry ratio.

**Users of Ratios**

There are two groups according to users such as internal group and external group as follows:

1. Internal Group

Directors

Shareholders

Partners

Managers

2. External Group

Investors

Lenders

Suppliers

Employees

Labour Union

Customers

**Classification of Ratio**

Ratio

| Liquidity Ratio | Solvency Ratio | Activity Ratio | Profitability Ratio |
|---|---|---|---|
| 1. Current Ratio<br>2. Quick or Liquid Ratio | 1. Debt-Equity Ratio<br>2. Total Assets to Debt Ratio<br>3. Proprietary Ratio<br>4. Interest Coverage Ratio | 1. Inventory Turnover Ratio<br>2. Trade Receivable /Debtor Turnover Ratio<br>3. Trade Payable/ Creditor Turnover Ratio<br>4. Working Capital Turnover Ratio | 1. Gross Profit ratio<br>2. Net Profit Ratio<br>3. Operating Ratio<br>4. Operating Profit Ratio |

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