International Journal of Science and Research (IJSR)
ISSN: 2319-7064
SJIF (2022): 7.942

Ratio Analysis Management Accounting

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Abstract: ***This is most important Ratio analysis is a quantitative procedure of obtaining a look into a firm's functional efficiency, liquidity, revenues, and profitability by analyzing its financial records and statements. Ratio analysis is a very important factor that will help in doing an analysis of the fundamentals of equity. Analysts and investors make use of the methods for ratio analysis to study and evaluate the fiscal wellbeing of businesses by closely examining the historical performance and monetary statements. Comparative data and analysis can give an insight into the performance of the business over a given period of time by comparing it with the industry standards. At the same time, it also measures how well a business racks up against other businesses functioning in the same sector. Accounting is the process of recording financial transactions pertaining to a business. The accounting process includes summarizing, analyzing, and reporting these transactions to oversight agencies, regulators, and tax collection entities. The financial statements used in accounting are a concise summary of financial transactions over an accounting period, summarizing a company's operations, financial position, and cash flows.***

Keywords: Ratio analysis including Current Ratio, Gross Profit Ratio, Inventory Turnover Ratio, Current Assets Ratio, Liquidity Ratio

1. Introduction

Accounting is one of the key functions for almost any business. It may be handled by a bookkeeper or an accountant at a small firm, or by sizable finance departments with dozens of employees at larger companies. The reports generated by various streams of accounting, such as cost accounting and managerial accounting, are invaluable in helping management make informed business decisions. Accounting plays a key role in running a business because it helps you track income and expenditures, ensure statutory compliance, and provide investors, management, and government with quantitative financial information which can be used in making business decisions.

2. Objectives of the Study

- Simplify accounting information.
- Determine liquidity or Short-term solvency and Long-term solvency. Short-term solvency is the ability of the enterprise to meet its short-term financial obligations. Whereas, Long-term solvency is the ability of the enterprise to pay its long-term liabilities of the business.
- Assess the operating efficiency of the business.
- Analyze the profitability of the business.
- Help in comparative analysis, i.e. inter-firm and intra-firm comparisons.

3. Advantages of Ratio Analysis

Ratio analysis plays an important role in analyzing a company's financial performance. Therefore, the advantages of ratio analysis are:

- Useful tools for analysis for Financial Statements
- Simplifies accounting data
- Helpful in assessing the operating efficiency of business
- Useful for forecasting
- Useful in locating the weak areas
- Useful in inter-firm and intra-firm comparison

4. Types of Ratios

[A] Traditional Classification

Traditional Classification has three types of ratios, namely

- Profit and Loss Ratios
- Balance Sheet Ratios
- Composite Ratios

1] Profit and Loss Ratios

When both figures are derived from the statement of Profit and Loss A/c we will call it a Profit and Loss Ratio. It can also be known as Income Statement Ratio or Revenue Statement Ratio. One such example is the Gross Profit ratio, which is the ratio of Gross Profit to Sales or Revenue. As you will notice, both these amounts will be derived from the Profit and Loss A/c. Other examples include Operating ratio, Net Profit ratio, Stock Turnover Ratio etc.

2] Balance Sheet Ratios

Just as above, if both the variables are obtained from the balance sheets, it is known as a balance sheet ratio. When such a ratio expresses the relation between two accounts of the balance sheet, we also call them financial ratios (other than accounting ratios). for example Current ratio that compares current assets to current liabilities, both derived from the balance sheet. Other examples include Quick Ratio, Capital Gearing Ratio, Debt-Equity ratio etc.

3] Composite Ratios

A composite ratio or combined ratio compares two variables from two different accounts. One is taken from the Profit and Loss A/c and the other from the Balance Sheet. For example the ratio of Return on Capital Employed. The profit (return) figure will be obtained from the Income Statement and the Capital Employed is seen in the Balance Sheet. A few other examples are Debtors Turnover Ratio, Creditors Turnover ratio, Earnings Per Share etc

[B] Functional Classification

Then we move onto the functional classification. These help us group the ratios according to the functions they perform

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in our understanding and analysis of financial statements. This is a more accurate and useful classification of ratios, and hence more commonly used as well. The types of ratios according to the functional classification are

1) Liquidity Ratio
2) Leverage Ratios
3) Activity Ratios
4) Profitability Ratios
5) Coverage Ratios

1] Liquidity Ratios
A firm needs to keep some level of liquidity, so stakeholders can be paid when they are due. All assets of the firm cannot be tied up, a firm must look after its short-term liquidity. These ratios help determine such liquidity, so the firm may rectify any problems. The two main liquidity ratios are Current ratio and Quick Ratio (or liquid ratio).

2] Leverage Ratios
These ratios determine the company's ability to pay off its long-term debt. So they show the relationship between the owner's fund and the debt of the company. They actually show the long-term solvency of a firm, whether it has enough assets to pay of all its stakeholders, as well as all debt on the Balance Sheet. This is why they are also called Solvency ratios. Some examples are Debt Ratio, Debt-Equity Ratio, Capital Gearing ratio etc.

3] Activity Ratios
Activity ratios help measure the efficiency of the organization. They help quantify the effectiveness of the utilization of the resources that a company has. They show the relationship between sales and assets of the company. These types of ratios are alternatively known as performance ratios or turnover ratios. Some ratios like Stock Turnover, Debtors turnover, Stock to Working Capital ratio etc measure the performance of a company.

4] Profitability Ratios
These ratios analyze the profits earned by an entity. They compare the profits to revenue or funds employed or assets of an entity. These ratios reflect on the entity's ability to earn reasonable returns with respect to the capital employed. They even check the soundness of the investment policies and decisions. Examples will include Operating Profit ratio, Gross Profit Ratio, Return on Equity Ratio etc.

5] Coverage Ratios
Shows the equation between profit in hand and the claims of outside stakeholders. These are stakeholders that are required by the law to be paid, even in case of liquidation. So these types of ratios ensure that there is enough to cover these payments to such outsiders. Some examples of coverage ratios are Dividend Payout Ratio, Debt Service ratio etc.

5. Scope of the study

- Analyze financial ratios to assess profitability, solvency, working capital management, liquidity, and operating effectiveness.
- Compare current performance with historical conditions using trend analysis.
- Compare with peer companies or industry averages to find out how well companies are performing.
- Determine the purpose of the analysis. The objective identifies the approach, tools, data sources, and format that you use to present the results.
- Collecting data. When you want to examine more comprehensively, for example, valuing the company's stock price, you need data such as economic and industry reports.
- Processing data. The more in-depth analysis may require not only descriptive statistics but also inferential statistics such as regression.
- Interpret statistics. To conclude, you might not only analyze historically but also compare with peer companies or industry averages.

6. Conclusion

The Ratio analysis helps interpret the financial data of a company to understand its true standing. Using ratio analysis, one can determine a company's liquidity, profitability and overall performance. It is also an important tool for investors to understand the worth of a company when investing. So, by understanding ratio analysis and its types, you can assess the company's performance before investing.

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