CHAPTER - III

CONCEPTUAL DISCUSSION

1] INTRODUCTION:- Financial statements includes Trading and profit & loss A/C and Balance Sheet, These are prepared and published at the end of accounting year. These are of much interest to a number of different groups. Some of these are 1] Share holders 2] short-term creditors 3] Long-term creditors and 4] Management Share holders want to judge the earning capacity of the company its prospects for future growth and prosperity. Short term creditors want to know the company's ability to meet the debts as and when they fall due. Long-term creditors are interested in knowing the company's ability to pay the interest on the amount borrowed by it and its ability to repay debts on the maturity date. Management realise that financial statements area a report on the company and on their managenial skill and therefore, they analyse these statements as a means self-evaluation and Trading and profit & Loss Account, Balance Sheet prepared at the end of the year do not always convey to the reader the real significance of operating results and financial health of the business. Such financial health of the business. Such financial statements, at the most, present various facts; Whether these facts indicate a good, bad or indifferent managerial performance or whether they point to a probability of future success or failure is for the readers to conclude, and rarely can satisfactory diagnosis be reached in the basis of such information alone. In order to make such statements more meaningful the user resorts to the technique of making special calculation in the form of ratios expressing the relationship of items selected from the income statement and Balance sheet.

II] DEFINATION :

Ratio, broadly speaking, the numerical relationship between two numbers. And hence ratio analysis of statement stand for the process of determining and presenting the relationship of items in the statements. Ratios may be expressed in the following three ways.

A] RATIO :

Specifically the simple division of one number by another e.g. current assets to current liabilities ratio is 2:1.

B] RATE :

The ratio between to numerical facts, usually over of period of time e.g. stock term over is three times a year.

C] PERCENTAGE :

A special type of rate which expresses the relation in hundredth. e.g. gross profit is 25% on sales.

III] LIMITATION :

There are certain limitations of analysis technique and they should be kept in mind while using them in interpreting financial statements.

1] Ratio based on a single set of figures will not have much significance. They become more useful when they are compared with ratios based on past years figures or standard ratios.

2] Ratios are meaning less of detached from the details from which they were derived. It is, therefore, essential that they should be published with related data they are derived from.

3] Ratios are calculated from the data drown from accounting records. Hence it suffers from the inherent weakness of the accounting system itself which is the source of data.

4] Preston of a particular type of ratio is not as sure indicator of bad or good management. It merely conveys certain observations pointing to the probability & matters needing investigation.

It is not wise to assume without further investigation that of condition peculiarly favourable or unfavourable is present.

3:4] CLASSIFICATION OF RATIOS :

According ratios many be classified broadly as follows.

1] Balance sheet Ratios.
2] Revenue Statement Ratios.
3] Balance sheet and Revenue Statement Ratios.

43:4.1 BALANCE SHEET RATIOS :

1] CURRENT RATIO:-

This is also known as working capital ratio, solvency ratio, and 2:1 ratio. This is calculated as under.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets normally include cash in Hand, cash at Bank, Stock, Debtors, Bills Receivable, Prepaid Expenses and Investments which are held for the purpose of immediate, conversion into cash.

Current Liabilities include sundry creditors Bills payable, Bank overdraft, Outstanding and Accrued Expenses, Income Tax Payable.

SIGNIFICANCE :

This signifies the ability of the business to meet its short term obligations and is, therefore, of particular significance to short-term creditors. It is traditionally held that the ratio of current Assets to current liabilities should be 2:1.

2] ACID TEST RATIO:-

This is also known as Quick Assets Ratio and Liquid Ratio, This is calculated as under.

$$\text{Acid Test Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities.}}$$

Quick Assets includes cash, B/R, Debtors after providing for bad and doubtful debts, Temparory Investments and excludes stock & prepaid experience. Quick liabilities include creditors, B/P, Outstanding & Accrued Expanses, Bank Overdraft is not included in current Liabilities. Normally the ratio should be 1:1.

Significance:-

This ratio is the true test of business. It the quick assets exceed or equal to quick Liabilities. It indicates that the financial position of the company is very satisfactory, It is measure of the extent to which the liquid assets are available to meet tne immediate liabilities.

3] PROPRIETORY RATIO OR CAPITAL RATIO:-

This is calculated as under.

$$= \frac{\text{Proprietors Funds}}{\text{Total Assets.}}$$

Proprietors funds comprises share capital (preference & Equity), Reserve & surplus (Losses are to be deducated)

Significance:-

This will indicate the credit strength of the business. Proprietors funds should be higher than the external liabilities. Otherwise the business will be dependent upon the creditors for augmenting its working capital.

4] RATIO OF FIXED ASSETS TO NET TANGIBLE WORTH :

This is obtained all under

$$= \frac{\text{Fixed Assets}}{\text{Proprietors Fund.}}$$

This ratio should be at least 1:1

Significance :

If the fixed Assets exceed the proprietor's funds it indicates that part of the fixed assets owned by outside creditors and it is always a weakness of the business to rely upon creditors.

5] RATIO OF CURRENT ASSETS TO NET TANGIBLE WORTH:

FUNDS

This is calculated as under:-

$$= \frac{\text{External Liabilities}}{\text{proprietors funds.}}$$

Significance:-

If the share holders funds are in excess of the external liabilities, it is indication of the soundness of the financial structure of the business.

7] RESERVES TO CAPITAL RATIO:-

$$= \frac{\text{Reserves}}{\text{Share Capital}}$$

Significance:-

If the ratio of Reserves to Capital is higher then the business can sustain future loss (If occurs) easily.

8] DEBT TO EQUITY RATIO:-

This is calculated as under-

$$= \frac{\text{Outsiders Fund}}{\text{Shareholders Fund.}}$$

On the average debt to equity ratio 1:1 is acceptable.

Significance:-

Theoretically, higher the interests of the proprietor as compared with that of creditor, the sounder would be the financial structure.

9] CAPITAL GEARING RATIO:-

This is established as under:-

$$= \frac{\text{Eq. share Capital All Accumulated Profits}}{\text{Prof. Share capital, Debentures, and Long term Debts bearing Fixed Interests.}}$$

Significance:-

Gearing said to be high if prof. Share capital and Long-term loans is higher than the equity capital & vice versa. If this is high gearing the Equity shareholders will have to suffer for the fixed amount of preference dividend and debenture interest.

3:4:2 REVENUE STATEMENT RATIO :

1 GROSS PROFIT RATIO-

$$= \frac{\text{Gross Profit}}{\text{Net sales}} \times 100$$

This indicates the margin of profit on sales effected. This will reveal the extent to which the business is managed profitably.

2] NET PROFIT RATIO:-

$$= \frac{\text{Net Profit}}{\text{Net sales.}} \times 100$$

This is an effective measure of profitability of a business. This will indicates the company's performance and its sales promotion.

3] EXPENSES RATIO:-

Each item of expenses is compared to net sales and ratios are established such asi] Administration Expenses:-

$$= \frac{\text{Administration Expenses}}{\text{Net sales}} \times 100$$

ii]Distribution Expenses:-

$$= \frac{\text{Distribution Expenses}}{\text{Net sales}} \times 100$$

iii] OPERATING NET PROFIT RATIO-

$$= \frac{\text{Operating Net Profit}}{\text{Sales}} \times 100$$

iv] OPERATING RATIO-

$$\frac{\text{Cost of goods sold + Operating Exp.}}{\text{Net sales.}} \times 100$$

Cost of goods sold= opening stock + purchases Direct Expenses- closing stock.

Operating Exp.-

1] Administrative expenses like rent, Insurance, salaries, directors fees, legal exp. etc.

2] Selling & Dist. Expenses like salaries of salesman, advertising & traveling expenses.

Significance:-

This is a test of efficiency of Management. It is a means of operating efficiency. Normally the ratio should be low.

6] STOCK TURNOVER RATIO (INVENTORY RATIO):-

$$= \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

$$\text{Average stock} = \frac{\text{Op. stock} + \text{closing stock}}{2}$$

Significance:-

This is an indication of the velocity of the movement of the goods during the year. This ratio will reveal the excess stock and accumulation of obsolete or damaged stock. This serves as a check on the control of stock in a business.

3:4:3 BALANCE SHEET AND REVENUE STATEMENT RATIO

1] DEBTORS TURNOVER RATIO-

$$= \frac{\text{Debtors} + \text{B/R}}{\text{Net sales}} \times 365 \text{ (or 360)}$$

This is to find out how many days credit is outstanding by debtors. This indicates the number of days for which accounts remained uncollected.

2] CREDITORS RATIO-

$$= \frac{\text{Average sundry creditors}}{\text{Average purchases per day}}$$

This indicates the number of days purchases outstanding with creditors.

3] NET PROFIT to TOTAL ASSETS

$$= \frac{\text{Net Profit}}{\text{Total Assets.}}$$

This is ascertained to know earning capacity of the total assets. If the ratio is high, there is indication that the total assets are effectively employed in earning the net profit.

4] RETURN ON PROPRIETORS FUNDS:-

$$= \frac{\text{Net profit}}{\text{Shareholders funds.}} \times 100$$

Significance:-

The percentage indicates the actual return on the shareholders investment in the company. It the percentage is high, the shares have a good marketable value and if low the return to the shareholders is very poor.