



# THEORETICAL FRAMEWORK OF FINANCIAL MANAGEMENT

**CHAPTER NO. 3**

**THEORETICAL FRAMEWORK OF FINANCIAL  
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### **3.1 INTRODUCTION**

Finance holds key position in all business activities. It is considered as life blood of business enterprise. Finance is one of the basic foundations of all kinds of economic activities. The success and survival of any organization depends upon how efficiently it is able to raise funds as and when needed and their proper utilization. In the present chapter an efforts have been made to cover conceptual and theoretical aspects of financial management, funds flow statement and ratio analysis as a tool of financial management.

### **3.2 MEANING OF FINANCIAL MANAGEMENT**

Financial management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. It is the area of business management devoted to judicious use of capital and careful selection of source of capital in order to enable a spending unit to move in a direction of reaching its goals. According to Joseph L. Massie "Financial management is the operational activity of a business that is responsible for obtaining and efficiently utilizing funds necessary for efficient operations"

Thus, financial management is concerned with following aspects:

- a) Raising funds by way of various sources such as share capital, borrowings etc.
- b) Utilization of funds in the form of investments in various types of assets such as fixed assets, current assets etc.
- c) Management of earning which includes appropriation of the profit earned by the organization.

### **3.3 SCOPE OF FINANCIAL MANAGEMENT**

The scope of financial management, as considered by modern approach, can be concerned with the following four types of decisions:

- 1) Investment Decision
- 2) Financing Decision
- 3) Dividend Policy Decision
- 4) Liquidity Decision

These are explained as under:

#### **1) INVESTMENT DECISION**

Investment decision or capital budging involves the decision of allocation of capital or commitment of funds to long term assets that would yield benefits in future. Two important aspects of investment decision are: a) the evaluation of prospective profitability of new investments, and b) the measurement of cut-off rate against that the prospective return of new investments could be compared. The cut-off rate is the required rate of return or the opportunity cost of capital. Future benefits of investments are difficult to measure and cannot be predicted with certainty. Because of uncertain future, investment proposal should, therefore be evaluated in terms of both expected return and risk. Besides the decision to committing funds in new investment proposals, capital budgeting also involves decision of recommitting funds when an asset becomes less productive or non-profitable.

**2) FINANCING DECISION**

Financing decision is the second important function to be performed by the financial manager. It is a decision in respect of when, where, and how to acquire funds to meet the firm's investment needs. The central issue before financial manager is to determine the proportion of equity and debt. The mix of debt and equity is known as firm's capital structure. The financial manager must strive to obtain best financing mix or the optimum capital structure for the firm. The firm's capital structure is considered to be optimum when market value of share is maximized. The use of debt affects the return of shareholders; it may increase the return on equity funds but it always increases the risk. A proper balance will have to be struck between return and risk. When the shareholders' return is maximized with minimum risk, the market value per share will be maximized and the firm's capital structure would be considered optimum. Once the financial manager is able to determine the best combination of debt and equity, he or she must raise the appropriate amount through the best available sources.

**3) DIVIDEND DECISION**

Dividend decision is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and retain the balance. Like debt policy, dividend policy should be determined in terms of its impact on the shareholders' value. The optimum dividend policy is one that maximizes the market value of firm's share. Thus, if shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend pay out ratio. The pay-out ratio is equal to the percentage of

dividend to earnings available to shareholders. The financial manager should also consider the questions of dividend stability, bonus shares and cash dividends in practice.

#### **4) LIQUIDITY DECISION**

It is concern with the investment decision in current assets i.e. working capital management. Investment in current assets affects the firm's profitability, liquidity and risk. A conflict exists between profitability and liquidity while managing current assets. If the firm does not invest sufficient funds in current assets, it may loose the ability to meet the current obligations which are to be met with the help of current assets. It may loose the capacity to carry on the business on a regular and smooth basis. If the company invests too much in the current assets, it may adversely affect the profitability due to the cost of funds blocked in the current assets. Thus, a proper trade-off must be achieved between profitability and liquidity.

Thus, financial decisions directly concern the firm's decision to acquire or dispose off assets and require commitment or recommitment of funds on a continuous basis. Thus in consequence, finance functions may affect the size growth, profitability and risk of firm and ultimately the value of the firm.

### **3.4 OBJECTIVES OF FINANCIAL MANAGEMENT**

Financial management of a firm has to achieve a variety of objectives simultaneously. It is required to serve the interest of different sections of the people namely, shareholders, management, employees, consumers and community as a large. Traditionally, the basic objective of financial

management is to work hard towards maximization of profits. However, according to the modern thinking, financial management should be concern with maximization of wealth, because wealth is an index of the worth of the firm and its maximization is consist with the objective of shareholders wealth maximization (SWM) as discussed follows:

### **1) Profit Maximization:**

According to the traditional view, maximization of profit is the main objective of a business enterprise. Investors purchase shares of the company in hope of getting maximum profits from the company as dividend. It is possible only when company achieve its goal of maximization of profit. Thus traditionally view sates the goal of maximization of profits is the best criterion of the decision making. However it is subject to the following objections:

- 1) Profit in absolute term is not a proper guide to decision making. The precise meaning of the term profit is ambiguous. Does it mean short-or long term profits? Does it refer to profit before or after tax? Total profits or profit per share? Does it mean total operating profit or profit accruing to shareholders?
- 2) It ignores risk. The profits always go hand in hand with risks. The more profitable ventures necessarily involve more amounts of risks. Possibly, owners of a firm would prefer smaller but surer profits to potentially larger but certain stream of benefits.
- 3) The goal of maximization of profits is concerned to be a narrow outlook. When profit maximization becomes the basis of financial decisions, it ignores the interest of the community on the one hand and that of

government, workers and other concerned persons in the enterprise on the other hand.

- 4) Profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money and it values benefits received today and benefits received after a period as the same.

## **2) Wealth Maximization:**

According to experts like Prof. Solomon, Ezra, Van Horne etc. the ultimate objective of financial management should be wealth maximization. It provides unambiguous measure of what should be maximize in making investment and financing decisions on behalf of owners. Wealth maximization means maximizing the net present value of a course of action to shareholders. The net present value is the difference between present value of benefits and present value of cost. A financial action which has positive net present value creates wealth. A financial action resulting in negative net present value should be rejected.

The wealth maximization objective is consistent with the objective of maximizing the owner's economic welfare i.e. their wealth, which is reflected by market value of company's shares. It implies the fundamental principle to maximize the market value of its share in long run in order to work out a normalized market price.

The goal of wealth maximization is supposed to be superior to the goal of profit maximization due to following reasons:



- 1) It uses the concept of future expected cash flows rather than the ambiguous term of profits. As such measurement of benefits in terms of cash flows avoids ambiguity.
- 2) It considers time value of money. It recognizes that the cash flow generated earlier is more valuable than those later. That is why while computing value of total benefits, the future cash flows are discounted at a certain discounting rate.
- 3) It also recognizes the concept of risk, by making adjustment in discounting rate.

### **3.5 FUNDS FLOW ANALYSIS**

The basic financial statements i.e. the Balance Sheet and Profit and Loss Account or Income Statement of business reveals the net effect of various transactions on the operational and financial position of the organization. The Balance Sheet gives a summary of the assets and liabilities of an undertaking at a particular point of time. It reveals the financial status of the organization. The Profit and Loss Account reflects the result of the business operations for a period of time. It contains a summary of expenses incurred and revenues realized in an accounting period. But both these statements fail to explain the changes in assets, liabilities and owners equity. The balance gives static view of sources and uses of finance. But it does not indicate the causes of changes or movement of finances between two periods. The change in owners' equity is partly reflected through the profit and loss account, but besides profits, owners' equity may change due to other factors such as additional investment or withdrawal of profits. Therefore, an additional statement is needed to show the changes in assets,

liabilities and owners equity between two balance sheets. Such a statement is referred as the statement of changes in financial position or funds flow statement.

### **I ] CONCEPT OF “FUNDS” AND “FLOW OF FUNDS”**

In narrow sense, the term “funds” refers to cash resources of the business. In broader sense, it includes all the resources used in the business. It covers all the assets and liabilities. The entire assets side of balance sheet shows the application of funds, whereas the entire liability side shows the sources of funds. But while preparing funds flow statement it is preferred to use the term in the intermediate sense i.e. working capital. The “funds” thus refers to net working capital i.e. the difference between current assets and current liabilities.

Flow of funds means conversion or transfer of economic values from the assets to another, from one equity to another, from one asset to equity or vice versa, or a combination of any of these transfer. Thus the term flow refers to the movement of funds between two balance sheet dates. In the contest of funds flow statement, flow of funds is said to occur where there is a change in the working capital.

### **II ] MEANING OF FUNDS FLOW STATEMENT**

Funds flow statement helps to study changes in the financial position of business enterprises between beginning and end of financial statement data. It a statement which shows the sources from which the funds are obtained and the uses to which they are being put over a period of time. It highlights the changes in financial items of balance sheets prepared at two

different dates. It attempts to report the flow of funds between various assets and equity items during the accounting period. It provides missing link between the balance sheets as the commencement and at the end of accounting period and in the process it reveals the vital changes in the financial structure of an undertaking.

### **III | DEFINITIONS**

1. “A statement of source and applications of funds is a technical device designed to analysis the changes in the financial condition of business between two dates.”

**by Foulk**

2. “ The funds flow statement describes the sources from which additional funds were derived and the uses to which these funds were put .”

**by Robert Anthony**

### **IV | USES AND SIGNIFICANCE OF FUNDS FLOW STATEMENTS**

There are many parties who are interested in the funds flow statements such as shareholders, investors, bankers, creditors and management. Funds flow statement is widely used by the financial analysis, credit rating agencies, and financial managers. It is particularly useful in assessing the growth of the firm, its resulting financial needs and in determining the best way of financing these needs. By making use of projected funds flow statements the management can come to know the adequacy or inadequacy of working capital even in advance.

Funds flow statement helps to plan the intermediate and long term financing of the firm, repayment of long term debts, expansion of business, allocation of resources etc. it helps in analysis of financial operations, allocation of resources, acts as a guide and helps in knowing the overall credit worthiness of a firm.

## **V] LIMITATIONS OF FUNDS DLOW STATEMENTS**

Though funds flow statement is very useful, it has certain limitations:

- 1) Funds flow statement merely rearranges a part of the information contained in financial statements. They do not serve as original evidence of financial status.
- 2) As funds flow statements are prepared from information provided by financial statements, they are essentially historical in nature.
- 3) Changes in cash are important and relevant for financial management than working capital.
- 4) It cannot reveal continuous changes.

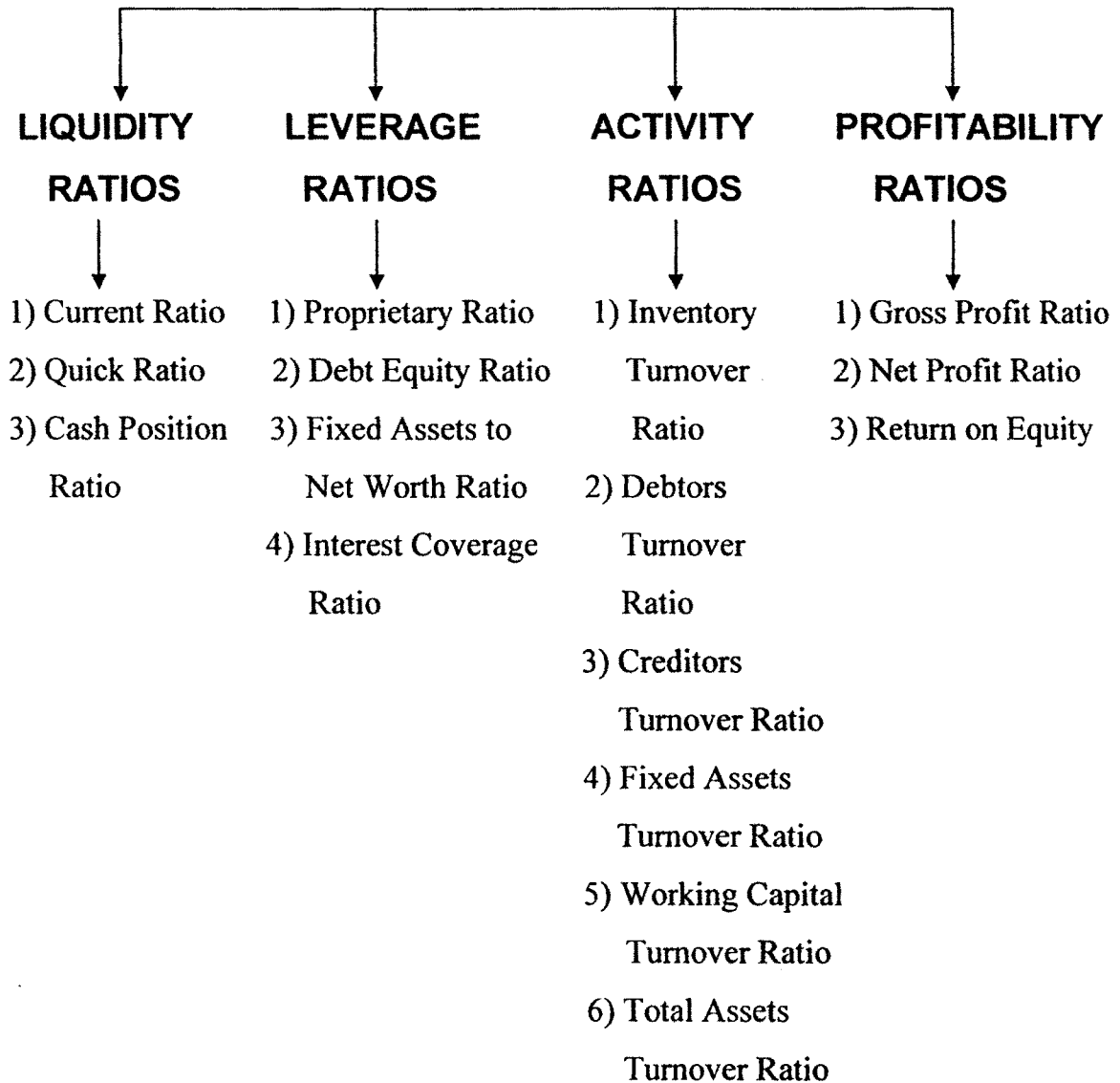
### **3.6 RATIO ANALYSIS**

Ratio Analysis is a powerful tool of financial analysis. The term ratio refers to the relationship expressed in mathematical terms between two individual figures or group of figures connected with each other in some logical manner and are selected from financial statements of the concern. The ratio analysis is based on the fact a single accounting figure by itself may not communicate any meaningful information but when expressed as a relative to some other figure, it may definitely provide some significant information. The relation between two or more accounting figures/groups is called a financial ratio. A financial ratio helps to express the relationship between two accounting figures in such a way that users can draw conclusions about the performance, strengths and weakness of a firm.

#### **CLASSIFICATION OF RATIOS:**

There are various types of ratios. These ratios can be grouped into various classes according to financial activity or function be evaluated. The parties interested in financial analysis are short and long term creditors, owners and management. Short term creditors' main interest is in the liquidity position or short term solvency of the firm. Long term creditors, on the other hand, are more interested in the long term solvency and profitability of the firm. Similarly, owners concentrate on the firm's profitability and financial condition. Management is interested in evaluating every aspect of the firms' performance. They have to protect the interest of all parties and see that the firm grows profitability. In view of the requirement of various interest groups, in the present study the ratios are classified into following important categories:

## CLASSIFICATION OF RATIOS



### A) LIQUIDITY RATIOS

Liquidity means ability of the business to meet its short term obligations, usually a period of one year. Liquidity is a prerequisite for the survival of the firm. The short term creditors of the firm are interested in the short term solvency or liquidity of a firm. But liquidity implies, from the view point of utilization of the funds of the firm, that the funds are ideal or

they earn a very little. A proper balance between two contradictory requirements, that is, liquidity and profitability, is required for efficient financial management. The liquidity ratios measure the ability of a firm to meet its short term obligations and reflect the short term financial strength/solvency of a firm.

The ratios which indicates the liquidity of a firm are: 1) Current Ratio, 2) Quick Ratio and 3) Cash Ratio

### **1) CURRENT RATIO:**

The current ratio is calculated by dividing current assets by current liabilities. Current assets includes cash in hand and at bank, stock, debtors, bills of exchange and those assets which can be converted into cash within a period of one accounting year. Current liabilities mean all obligations maturing within a year. It includes creditors, bills payable, accrued expenses, bank O/D, income tax and long term debt maturing in a year.

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

A current ratio measure the ability of the firm to meet its current liabilities. It indicates the rupee of current assets available for each rupee of current liability. A current ratio of 2:1 has been considered satisfactory. If the ratio is above 2:1, it is considered that the business is highly liquid. If it falls below 2:1, it indicates shortage of working capital. But this is only a conservative outlook about the coverage of current liabilities. Generally the level of current ratio may vary from industry to industry depending on specific industry characteristics. Also firm differs from the industry ratio because of its policy.

**2) QUICK RATIO:**

The quick ratio indicates the relation of quick assets with current liabilities. Quick or liquid assets include all current assets except stock and prepaid expenses. In many lines of business concern whose current assets consist largely of inventory can very easily become technically insolvent, if not actually; within a very short period of time and this is the rationale of the term acid test ratio the name being preferred by some writers. The quick ratio is found out by dividing quick assets by current liabilities.

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

Liquid ratio measures the extent to which liquid resources are immediately available to meet current obligations. This ratio is a better test of financial strength as it gives no consideration to inventory which may be very slow. Generally, a quick ratio of 1:1 is considered to represent a satisfactory current financial condition. It indicates the ability of business to meet its commitment as an when they fall due for payment. When it is below the standard 1:1 in the circumstances when the quick assets do not cover current liabilities, the step should be taken to obtain additional cash.

**3) CASH RATIO:**

The cash ratio measures absolute liquidity of the business. This ratio considers only the absolute liquidity available with the firm. Debtors and bills receivables are generally more liquid than inventories. Yet there may be doubts regarding realization of debts into cash immediately or in time. Hence absolute ratio should also be calculated together with current ratio



and acid test ratio. Absolute liquid assets include cash in hand, cash at bank and marketable securities or temporary investments.

$$\text{Cash Ratio} = \frac{\text{Cash including bank balance}}{\text{Current Liabilities}}$$

The acceptable norms for this ratio is 50% or 0.5:1 or 1:2 i.e. Re 1 worth absolute liquid assets are considered adequate to pay Rs.2 worth current liabilities in time as all creditors are not expected to demand cash at one and the same time. It is also possible realize cash from debtors.

## **B) CAPITAL STRUCTURE/LEVERAGE RATIOS**

The second category of financial ratios is capital structure or leverage ratios. Leverage ratios are computed to determine the extent to which the firm has relied on debts. It shows the proportion of debt and equity in financing the firms' assets. The debt capital is cheaper source of finance but it is a risky one. Leverage ratios help in assessing the risk arising from the use of debt capital.

The leverage ratios throw light on the long term solvency of a firm. There are two aspect of the long term solvency of a firm: i) ability to repay the principal when due and ii) regular payment of the interest. Accordingly, there are two different but mutually dependent and interrelated, types of leverage ratios. First, ratios which are based on the relationship between borrowed funds and owners capital. These ratios are computed from balance sheet and have many variations such as debt-equity ratio, debt-assets ratio, equity-assets ratio and so on. The second types of capital structure ratios, popularly called coverage ratios, are calculated from profit and loss account.

The following leverage ratios are calculated for the unit under study:

**1) DEBT-EQUITY RATIO:**

The debt-equity ratio indicates the proportion of borrowed capital to the net worth. The term debt includes all long term debts such as debentures, term loans etc., where as the term net worth means equity share capital, preference share capital, reserve and surplus. It is calculated as under:

$$\text{Debt-Equity Ratio} = \frac{\text{Debt}}{\text{Net Worth}}$$

The debt-equity ratio is an important tool of financial analysis to appraise the financial structure of the firm. It has important implications from the point of view of the creditors, owners and the firm. The ratio reflects the relative contribution of creditors and owners of business in its financing. Generally 2:1 debt-equity is considered to be satisfactory. A very high ratio is unfavorable from firms' point of view. The debt-equity ratio indicates margin of safety to the creditors against possible losses in the events of liquidation. This ratio is also important for judging the financial policy of the management. An organization having stable profit can afford to operate on a relatively high debt-equity ratio. Too much reliance on external equities may indicate under capitalization where too much reliance on the internal equities may lead to over capitalization.

**2) PROPRIETARY RATIO:**

The ratio of net worth to total assets is called as proprietary ratio. The proprietary ratio is found out by dividing proprietor's fund by total assets. Total asses consist of net fixed assets and current assets (i.e.net worth + Debt + current liabilities.)

$$\text{Proprietary Ratio} = \frac{\text{Proprietors' Funds}}{\text{Total Assets}}$$

This ratio indicates the extent to which the total assets are being financed by the shareholders and by creditors. This ratio is a test of strength of credit worthiness of the concern. The financial analyses are of opinion that the proportion of the net worth to total assets should be 20% - 40%. A high proprietary ratio is however frequently indicative of overcapitalization and an excessive investment in fixed assets in relation to actual needs. A ratio nearing to 100% gives low rate earning per share and consequently a low rate of dividend to shareholders.

A low proprietary ratio on the other hand is a symptom of undercapitalization and as excessive use of creditors fund to finance the business.

### 3) FIXED ASSETS TO NET WORTH RATIO:

This ratio finds out the percentage of net fixed assets financed by the owners. It is calculated by dividing net fixed assets by net worth.

$$\text{Fixed Assets Ratio} = \frac{\text{Net Fixed Assets}}{\text{Net Worth}} \times 100$$

Normally proprietors should provide all the funds required to purchase fixed assets. If the ratio exceeds 100%, it indicates that the company has used borrowed funds for acquiring fixed assets. When amount of proprietors funds exceed the value of fixed assets i.e. when the percentage is less than 100, a part of net working is supplied by the shareholders.

#### **4) INTEREST COVERAGE RATIO:**

This ratio is also known as debt service ratio i.e., the ratio of net profit to fixed interest charges. It is calculated as under:

$$\text{Interest Coverage Ratio} = \frac{\text{N/P before Interest \& Taxes}}{\text{Total Interest Charges on Long Term Debts}}$$

The standard for this ratio is 6 to 7 times. A highest coverage means that the firm can easily meet its interest burden. However, too high ratio may mean that the conservative use of debt is being made by the firm. A low interest ratio on the contrary, may result in financial embarrassment under the same situation and point out that the firm should improve the operating efficiency or repay the debts to improve the coverage.

#### **C) ACTIVITY RATIOS**

Funds of creditors and owners are invested in various assets to generate sales and profits. The better the management of assets, the larger the amount of sales. Activity ratios are employed to evaluate the efficiency with which the firm manages and utilizes its assets. These ratios are also called turnover ratios because they indicate the speed with which assets are being converted or turned over into sales. Activity ratios, thus, involve a relationship between sales and assets. A proper balance between sales and assets generally reflects that assets are managed well. Several activity ratios can be calculated to judge the effectiveness of asset utilization. For the present study following activity ratios are calculated:

**1) INVENTORY TURNOVER RATIO:**

This ratio indicates the efficiency of the firm in producing and selling its products. It is calculated by dividing the cost of goods sold by the average inventory. However, since to an external analyst detailed information about inventory levels and cost of goods sold may not be available, the debtors turnover ratio can be calculated by dividing total sales by closing inventory:

$$\text{Inventory Turnover Ratio} = \frac{\text{Sales}}{\text{Closing Inventory}}$$

The inventory or stock turnover ratio measures how quickly inventory is sold. It is the test of efficient inventory management. In general, a high inventory ratio is better than a low ratio. A high ratio implies good inventory management. However, it may be of underinvestment in, or very low level of inventory. Similarly, a very low inventory turnover ratio is dangerous. It signifies excessive inventory or overinvestment in inventory. Thus a firm should have neither too high nor too inventory turnover.

**2) DEBTORS TURNOVER RATIO AND AVERAGE COLLECTION PERIOD:**

In case firm sells goods on credit, the realization of sales revenue is delayed and receivables are created. The cash is realized from these receivables later on. The speed with which these receivable are collected affects the liquidity position of the firm. The debtors' turnover ratio and average collection period shows how quickly receivables or debtors are converted into cash. These throw light on the collection and credit policies of the firm.

Debtor's turnover ratio is found out by dividing credit sales by average debtors. However, since to an external analyst information about credit sales and opening and closing balances of debtors may not be available, the debtors turnover ratio can be calculated by dividing total sales by the year end balance of debtors:

$$\text{Debtors Turnover Ratio} = \frac{\text{Sales}}{\text{Debtors}}$$

The second type of ratio for measuring the liquidity of a firm's debtors is the average collection period. This is, in fact, interrelated with, and dependent upon, the receivables turnover ratio. It is calculated dividing days in a year i.e. 365 days by the debtor's turnover. Thus,

$$\text{Average collection Period} = \frac{12 \text{ Months}}{\text{Debtors Turnover}}$$

### **3) CREDITORS TURNOVER RATIO AND AVERAGE PAYMENT PERIOD:**

This ratio is calculated on the same lines as receivables turnover ratio is calculated. Creditors turnover ratio indicates the speed with which the payment of credit purchases is made. It is calculated as follows:

$$\text{Creditors Turnover Ratio} = \frac{\text{Credit Purchases}}{\text{Creditors}}$$

An average payment period can be calculated as follows:

$$\text{Average Payment Period} = \frac{12 \text{ Months}}{\text{Creditors Turnover}}$$

A low turnover ratio reflects liberal credit terms granted by suppliers, while a high ratio shows that accounts are to be settled rapidly. The creditors turnover ratio is an important tool of analysis as a firm can reduce its requirement of current assets by relying on suppliers credit.

#### **4) FIXED ASSETS TURNOVER RATIO :**

This ratio helps to know the efficiency of management in using the fixed assets. It is calculated as under

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Fixed Assets}}$$

This ratio is an important measure of the efficiency and profit earning capacity of the business. A high ratio indicates efficiency in utilizing the fixed assets while a low ratio suggest idle capacity and excessive investment in fixed assets. Normally a slandered ratio is taken as five times.

#### **5) WORKING CAPITAL TURNOVER RATIO**

This ratio helps in measuring the efficiency of employment of working capital. It is computed by dividing sales by net current assets. Net working capital is the excess of current assets over current liabilities.

$$\text{Working Capital Turnover Ratio} = \frac{\text{Sales}}{\text{Net Working Capital}}$$

**6) TOTAL ASSETS TURNOVER RATIO:**

Assets are used to generate sales. Therefore, a firm should manage its assets efficiently to maximize sales. The relationship between sales and total assets is called as total assets turnover ratio. This ratio shows the firm's ability in generating sales from all financial resources committed to total assets. Thus,

$$\text{Total Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Total Assets}}$$

Total assets include net fixed and current assets. The ratio indicates the sales generated per rupee of investment in total assets. This ratio indicates the efficiency in use of total assets. Higher ratio indicates that more revenue is generated per rupee of total investment in the assets.

**D) PROFITABILITY RATIOS**

The profitability ratios measure the profitability and operational efficiency of the firm. These ratios reflect the final results of business operations. Profitability ratios can be determined on the basis of either sales or investments. The profitability ratios in relation to sales are a) profit margin (gross and net) ratio b) expenses ratio. Profitability in relation to investments is measured by a) return on assets b) return on capital employed C) return on shareholders equity.

For the present study following profitability ratios have been calculated in order to serve the object:



**1) GROSS PROFIT MARGIN/ RATIO:**

Gross profit margin is also known as gross margin. It is calculated by dividing gross profit by sales. Thus,

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{Net Sales}} \times 100$$

Gross profit is the result of the relation between prices, sales volume and costs. A change in the gross margin can brought about by change in any of those factors, the gross margin represents the limit beyond which fall in sales prices are outside the tolerance limit. A high ratio of gross profit to sales is the sign of good management as it implies that the cost of production of the firm is relatively low. It may also be indicative of a higher sales price without a corresponding increase in the cost of goods sold. A relatively low gross margin is definitely a danger single, warranting a careful and detailed analysis of the factor responsible for it. Therefore a firm should have a reasonable gross profit margin to ensure adequate coverage for operating expenses of the firm and sufficient return to the owners of the business.

**2) NET PROFIT RATIO MARGIN/RATIO:**

It is also known as net margin. This measures the relationship between net profits and sales. Net profit is that proportion of net sales which is remained to the owners or the shareholders after all costs; charges and expenses including income tax have been deducted. It is calculated as follows:

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

The net profit margin is indicative of managements ability to operate business with sufficient success not only to recover from revenues of the period, the cost of merchandise or services, the expenses of operating the business (including depreciation) and the cost of borrowed funds, but also leave a margin of reasonable compensation to the owners for proving their capital at risk. The ratio of net profits to sales essentially the cost price effectiveness of the operation.

A high net profit margin would ensure adequate return to the owners as well as enable a firm to withstand adverse economic condition when selling price is declining, cost of production is rising and demand for product is falling. A low net profit margin has the opposite indications.

### **3) RETURN ON SHAREHOLDERS EQUITY:**

Return on equity measures the profitability of equity funds invested in the firm. This ratio revels how profitability of the owners' fund have been utilized by the firm. The realization of a satisfactory net income is the major objective of a business and the ratio shows the extent to which this objective is being achieved. It is calculated as under:

$$\text{Return on Shareholders Equity} = \frac{\text{Net Profit}}{\text{Shareholders Equity}} \times 100$$

This ratio is of practical importance to prospective investors and shareholders. If the ratio is higher they feel confident and encouraged to invest in the company. The effect of such high ratio will be reflected in the

market price of the shares of the company. It would possible for the company to raise finance from external sources and even through public deposits. A low ratio on the other hand may indicate that the concern is not very successful because of inefficient management, unfavorable general business conditions and over investment in fixed assets.