RATIO ANALYSIS

CLASSIFIACATION OF RATIOS / ACCOUNTING RATIOS :-

Accounting ratios are classified as follows :

(1) Traditional Classification or classification according to the type financial Statements.

(2) Functional Classification.

(1) TRADITIONAL CLASSIFICATION :-

The ratios are grouped into three categories on the basis of the statements from which the figures are taken for computing the ratios. It is well – known traditional classification and has been so grouped since the advent of ratio analysis. The ratios according to this classification are :

(a) Revenue statement Ratios :-

These are the ratios computed on the basis of items taken from revenue statement i.e. Profit & Loss Account.

e.g.-Net profit ratio is computed by dividing Net Profit by Sales . Here ,both net profit and sales are items appearing in Profit & Loss Account.

(b) Balance Sheet Ratios :-

When two items are taken from the balance sheet.

e.g.-A ratio established relationship between current assets and current liabilities is a balance sheet ratio.

(4) Expenses Ratio (5) Return on capital employed Ratio (6) Return on Shareholders Funds (7) Debt Services Coverage ratio

(c) Leverage Ratios :-

The composition of capital of business and the proportion of owners' capital and capital provided by outsiders are reflected by leverage ratios.

e.g.- Gearing Ratio showing the relationship between the preference capital and ordinary capital is a leverage ratio.

e.g.- (1) Proprietary ratio (2) Debt –Equity Ratio (3) Gearing Ratio (4) Fixed capital – Fixed Assets Ratio.

(d) Activity / Efficiency Ratios :-

These are the ratios showing the effectiveness with which the resources of the business are employed. It signifies the efficiency of the management.

e.g.- Stock Turnover is an activity ratio ,showing the number of times the average stock is turned over during the year.

e.g.- Debtors Ratio , Creditors ratio , Total Assets turnover , Fixed Assets turnover etc.

(4) Formula of operating Profit ratio :

Operating ratio = Cost of goods sold + Operating Expenses* 100 / Net sales

Cost Of Goods Sold = Opening Stock + Net Purchase (Purchase – Purchase Return)
+ Purchase Expenses – Closing Stock

OR

Cost Of Goods Sold = Net Sales(Sales – Sales Return) – Gross Profit

Operating Expenses = Administrative Expense + Interest + Selling Expenses

For Example : Suppose the sales are Rs. 5,00,000; Opening Stock Rs. 76250 ; Purchases RS. 3,12,000; Purchase Expenses Rs. 10,250; Closing Stock Rs. 98,500; Administrative Expenses Rs. 98,000; Interest RS. 12,000 and Selling Expenses Rs. 10,000. The Operating ratio will be computed as under.

Cost Of Goods Sold = Opening Stock + Purchases + Purchases Expenses – Closing Stock.

(4) EARNING PER SHARE :-

(1) This ratio shows the relationship between the After Tax Profit Less Preference Dividend divided by the No. Of Equity Shares.

(2) This ratio measures the profit available to equity shareholders on per share basis.

(3) It is not the actual amount paid paid to shareholders as dividend but is the maximum that can be paid to them.

(4) FORMULA :-

EARNING PER SHARE = After Tax Profit – Pref. Dividend / No. Of Equity Shares

(5) **FOR EXAMPLE :-**

Suppose , if profit after tax is Rs 50,000 , Pref. Dividend is Rs. 4000 and No. Of Equity shares is Rs. 20,000 , the EPS will be calculated as follows :

EPS = 46,000 / 20,000

= Rs. 2.30

(5) Inaccurate base :-

The accounting ratios can never be more correct than the information from which they are computed. If the accounting data is not accurate ,the accounting ratios based on these figures would give misleading results.