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A STUDY OF RATIO ANALYSIS AS A TECHNIQUE OF FINANCIAL PERFORMANCE EVALUATION

PARVESH KUMAR GOYAL
Assistant Professor, Department of Commerce,
Dayanand Post Graduate College, Hisar

ABSTRACT

In today's financial world, financial performance is significant for various stakeholders, be the management, lenders, owners and investors. Measurement of Financial performance is crucial for taking financial decisions. Hence, it is of the paramount importance for taking financial decisions effectively. The annual financial reports provided by the accounting system, is considered the main source for information for decision-makers especially the investors. Therefore, the validity and accuracy of the decisions depend on the proper analysis of financial statements. Despite, the fact that there are other factors affecting investment decisions, such as, economic, political and social considerations, but still the financial analysis factors constitute the main tool in attracting investment. The objective of this paper is to identify the role of ratio analysis indicators in investors' decisions.

Keywords: *Business, Decisions, Financial Statements, Ratio Analysis, Financial Performance.*

INTRODUCTION

Every business has two primary objectives: profitability and solvency. Profitability is the ability of a business to make profit, while solvency is the ability of a business to pay debts as they come due. To take the right decision at the right time executives should know the financial position of the organization, without which it is not easy to take any type of action for the

expansion and growth of the organization. Through financial information an executive can take imperative decision as and when they are required. For studying the financial health and having accurate financial information of a business, ratio analysis is being considered as the major tool at present.

Decision-making may be defined as "a conscious process of making choices among one or more alternatives with the interior of moving toward some desired state of affairs." Therefore, business decisions are those choices exercised by the executives with the well-organized usage of resources. Correct financial information at the appropriate time is of paramount importance for any organization for efficient usage of resources.

Ratio analysis is a significant technique for financial analysis. It indicates relation of two mathematical expressions and the relationship between two or more things. Financial ratio is a ratio of selected values on an enterprise's financial statement. There are many standard ratios used to evaluate the overall financial condition of a corporation or other organization. Financial ratios are used by managers within a firm, by current and potential stockholders of a firm, and by a firm‘s creditor. Financial analysts use financial ratios to compare the strengths and weaknesses in various companies.

Making big investment decisions means that, we must allocate substantial amounts of major resources of people, time, technology, intellectual capital, and money. A high quality decision process requires that our choices are accurate and the consequences are understood and well explored. Investment decisions could be made on the basis of cost-benefit analysis. Cost benefit analysis, is an economic analysis tool that has the potential to help investors to make decisions. It enables investors to assess the alternative options available by comparing the benefits and costs of each option. Through this process it is expected investors will able to decide which option will generate the highest net benefits. Also it will also help them to achieve economic efficiency in the essence that it improves allocation of scarce resources (Campbell & Brown 2005).

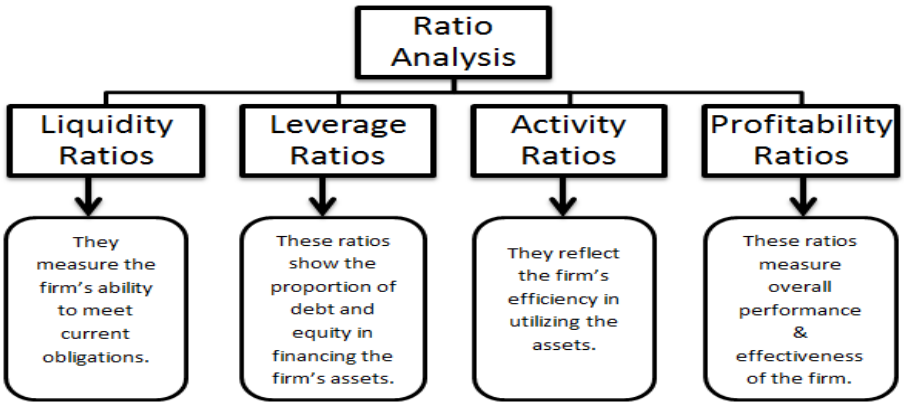
RATIO ANALYSIS: A BRIEF OVERVIEW

The term ratio refers to the numerical or quantitative relationship between two variables. According to Igben (1999:423) "Accounting or financial ratio is a proportion or fraction or percentage expressing the relationship between one item in a set financial statements and another item in the financial statements. Accounting ratios are the most powerful of all tools

used in analyzed and interpreting financial statements". Ratio analysis is a widely used tool in financial analysis. It is defined as the systematic use of ratios to interpret the financial statements so that the strength and weaknesses of a firm as well as its historical performance and current financial condition can be determined. Therefore, ratio analysis involves taking stats of number (or items) out of financial statements and forming ratios with them, to enhance informed judgments and decisions.

Ratios can be divided into four major categories:

- Liquidity ratios
- Leverage Ratios or Solvency Ratios or Capital Structure Ratios
- Activity or Turnover Ratios or Working Capital Ratios
- Profitability Ratios



Liquidity Ratios

S. No.	RATIOS	FORMULAS
1	Current Ratio	Current Assets/Current Liabilities
2	Quick Ratio	Liquid Assets/Current Liabilities
3	Absolute Liquid Ratio	Absolute Liquid Assets/Current Liabilities

Profitability Ratios

S. No.	RATIOS	FORMULAS
1	Gross Profit Ratio	Gross Profit/Net Sales X 100
2	Operating Cost Ratio	Operating Cost/Net Sales X 100
3	Operating Profit ratio	Operating Profit/Net Sales X 100
4	Net Profit Ratio	Operating Profit/Net Sales X 100
5	Return on Investment Ratio	Net Profit After Interest And Taxes/ Shareholders Funds or Investments X 100
6	Return on Capital Employed Ratio	Net Profit after Taxes/ Gross Capital Employed X 100
7	Earnings Per Share Ratio	Net Profit After Tax & Preference Dividend /No of Equity Shares
8	Dividend Pay Out Ratio	Dividend Per Equity Share/Earning Per Equity Share X 100
9	Earning Per Equity Share	Net Profit after Tax & Preference Dividend / No. of Equity Share
10	Dividend Yield Ratio	Dividend Per Share/ Market Value Per Share X 100
11	Price Earnings Ratio	Market Price Per Share Equity Share/ Earning Per Share X 100
12	Net Profit to Net Worth Ratio	Net Profit after Taxes / Shareholders Net Worth X 100

Working Capital Ratios

S. No.	RATIOS	FORMULAS
1	Inventory Ratio	Net Sales / Inventory
2	Debtors Turnover Ratio	Total Sales / Account Receivables
3	Debt Collection Ratio	Receivables x Months or days in a year / Net Credit Sales for the year
4	Creditors Turnover Ratio	Net Credit Purchases / Average Accounts Payable
5	Average Payment Period	Average Trade Creditors / Net Credit Purchases X 100
6	Working Capital Turnover Ratio	Net Sales / Working Capital
7	Fixed Assets Turnover Ratio	Cost of goods Sold / Total Fixed Assets
8	Capital Turnover Ratio	Cost of Sales / Capital Employed

Capital Structure Ratios

S. No.	RATIOS	FORMULAS
1	Debt Equity Ratio	Total Long Term Debts / Shareholders Fund
2	Proprietary Ratio	Shareholders Fund/ Total Assets
3	Capital Gearing ratio	Equity Share Capital / Fixed Interest Bearing Funds
4	Debt Service Ratio	Net profit Before Interest & Taxes / Fixed Interest Charges

LITERATURE REVIEW

According to Drake (2010), financial statement analysis is the selection, evaluation, and interpretation of financial data, along with other pertinent information, to assist in investment and financial decision-making. Moreover, it is also the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account (accounting for management website).

Analysis of financial statement assists in identifying the major strengths and weaknesses of a business enterprise. It indicates whether a firm has enough cash to meet obligations; a reasonable accounts receivable collection period; an efficient inventory management policy; sufficient plant, property, and equipment; and an adequate capital structure (Moyer, McGuigan, Kretlow, 2005)

The economic climate calls for investors to apply financial analysis as they evaluate business performance, weigh potential investments, and assess global competition. Investment is putting money into an asset with the expectation of capital appreciation, dividend or interest earnings. Financially, investment is the purchase of an asset or item with the hope that it will generate income or appreciate in the future and be sold at the higher price (Wikipedia, 2014).

Ratio Analysis is one of the basic tools of financial analysis. It is an important tool in business planning and decision making as it explores the strengths, weaknesses, opportunities and threats facing the company.

Smart investors use financial ratios to analyze a company's financial performance before making an investment. Financial ratios reveal how a company is financed, how it uses its resources, its ability to pay its debts and its ability to generate profit. Ratios provide a glimpse of a company's position at a particular time, and are most useful when compared across time periods and when comparing companies in the same industry. Ratios alone do not give a complete picture of a company's investment potential, but they are a wise place to start the analysis (Young, 2014).

Financial ratios allow for comparisons and, therefore, are knotted with the process of benchmarking, comparing one's business to that of others or of the same company at a different point in time. In many cases, benchmarking involves comparisons of one company to the best companies in a comparable peer group or the average in that peer group or industry. In the process of benchmarking, investor identifies the best firms in their industry, or in another industry where similar processes exist, and compares the results and processes of those studied to one's own results and processes on a specific indicator or series of indicators (Boundless, 2014).

RATIO ANALYSIS AS A TOOL FOR MEASURING FINANCIAL PERFORMANCE

Evaluation of financial performance has a big importance in world of economy and it is what the studies of accounting and administration focus greatly on. The financial reports which are prepared in the company is considered as an important tool to evaluate the financial performance where analyzing these reports helps in identifying the company’s points of weakness and strength and work on the weakness to find solutions. The financial ratio is the most common method used to analyze the financial reports and has an accurate evaluation to treat the points of weakness, effectively and efficiently. The financial ratios do not add new information but it is helpful in explaining the relation between the variables to come up with results

Ratio analysis is one of the main financial indicators extracted from financial statement analysis that is used to obtain a quick indication of a firm's financial performance in several key areas. Ratio Analysis as a tool possesses several important features. The data, which are provided by financial statements, are readily available. The computation of ratios facilitates the

comparison of firms which differ in size. Ratios can be used to compare a firm's financial performance with industry averages. In addition, ratios can be used in a form of trend analysis to identify areas where performance has improved or deteriorated over time.

Financial ratio analysis helps us to understand how profitable a business is, if it has enough money to pay debts and we can even tell whether its shareholders could be happy or not. Financial ratios allow for comparisons:

- between companies
- between industries
- between different time periods for one company
- between a single company and its industry average

With the help of ratio analysis conclusion can be drawn regarding several aspects such as financial health, profitability and operational efficiency of the undertaking. Ratio analysis is a fundamental means of examining the health of a company by studying the relationships of key financial variables. A firm's ratios are normally compared to the ratios of other companies in that firm's industry or tracked over time internally in order to see trends. Ratio analysis stands for the process of determining and presenting the relationship of items and group of items in the financial statement. It is a way by which financial stability and health of a concern can be judged. Ratio analysis plays an important role in the financial field of making investment and landing decision by banks, insurance companies etc. and it simplifies the accounting figures and highlights their interrelationship between different segments of the business.

To evaluate the performance of one firm, its current ratios will be compared with its past ratios. When financial ratios over a period of time are compared, it is called time series or trend analysis. It gives an indication of changes and reflects whether the firm‘s financial performance has improved or deteriorated or remained the same over that period of time. It is not the simply changes that has to be determined, but more importantly it must be recognized that why those ratios have changed. Because those changes might be result of changes in the accounting polices without material change in the firm‘s performances.

Another method is to compare ratios of one firm with another firm in the same industry at the same point in time. This comparison is known as the cross sectional analysis. It might be more useful to select some competitors which have similar operations and compare their ratios with the firm‘s. This comparison shows the relative financial position and performance of the firm. Since it is so easy to find the financial statements of similar firms through publications, this type of analysis can be performed so easily. To determine the financial condition and

performance of a firm, its ratios may be compared with average ratios of the industry to which the firm belongs. This method is known as the industry analysis that helps to ascertain the financial standing and capability of the firm in the industry to which it belongs. Industry ratios are important standards in view of the fact that each industry has its own characteristics, which influence the financial and operating relationships.

But there are certain practical difficulties for this method. First finding average ratios for the industries is such a headache and difficult. Second, industries include companies of weak and strong so the averages include them also. Sometimes spread may be so wide that the average may be little utility. Third, the average may be meaningless and the comparison not possible if the firms with in the same industry widely differ in their accounting policies and practices. However if it can be standardized and extremely strong and extremely weak firms be eliminated then the industry ratios will be very useful.

Ratio analysis helps the financial manager to identify problems before they become a crisis. These problems may be life threatening to the company (such as realizing that the company will not be able to pay its bills in the upcoming months) or simple planning issues (such as identifying that company's the equipment is aging and that funds need to be set aside to replace this equipment in the next few years).

Performance evaluation of a company is usually related to how well a company can use it assets, share holder equity and liability, revenue and expenses. Financial ratio analysis is one of the best tools of performance evaluation of any company. In order to determine the financial position of the pharmaceutical company and to make a judgment of how well the pharmaceutical company efficiency, its operation and management and how well the company has been able to utilize its assets and earn profit.

For ratios to be useful and meaningful, they must be:

- Calculated using reliable, accurate financial information
- Calculated consistently from period to period
- Used in comparison to internal benchmarks and goals
- Used in comparison to other companies in concerned industry
- Viewed both at a single point in time and as an indication of broad trends and issues over time
- Carefully interpreted in the proper context, considering there are many other important factors and indicators involved in assessing performance.

CONCLUSIONS

From the above discussion the following conclusions may be drawn:

- The use of financial indicators has a significant positive effect on investment taken by investors.
- Financial indicators represented in ratio analysis plays a vital role in a business planning process and figuring out the strength, weaknesses, and opportunities of a business enterprise.
- High significance to individual ratios doesn't always result in a good decision. Sometimes higher profitability may be accompanied with low liquidity.

RECOMMENDATIONS

- Financial indicators should be used wisely after complete check of the past history of the company, and through auditing check of the financial cycle.
- Other tools than financial indicators has significant effect on decision making which should be taken into consideration.
- Financial indicators will not say why something is going wrong and what to do about a particular situation; they only pinpoint where the problem is.
- Management policies and action could lead to high profit readings; comparison of such company with another could be misleading.

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