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Class 12 commerce   Sub. ACT Date 17.01.2021

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Accounting *Ratios*

Meaning of Accounting Ratios

As stated earlier, accounting ratios are an important tool of financial statement analysis. A ratio is a mathematical number calculated as a reference to relationship of two or more numbers and can be expressed as a fraction, proportion, percentage, and a number of times. When the number is calculated by referring to two accounting numbers derived from the financial statements, it is termed as accounting ratio. For example if the gross profit of the business is Rs. 10,000 and the sales are Rs. 1,00,000, it can be said that the gross profit is 10% (10,000/1,00,000) of the sales. This ratio is termed as gross profit ratio. Similarly, inventory turnover ratio may be 6 which implies that inventory turns into sales six times in a year. It needs to be observed that accounting ratios exhibit relationship, if any between accounting numbers extracted from financial statements, they are essentially derived numbers and their efficacy depends a great deal upon the basic numbers from which they are calculated. Hence, if the financial statements contain some errors, the derived numbers in terms of ratio analysis would also present an erroneous scenerio. Further, a ratio must be calculated using numbers which are meaningfully correlated. A ratio calculated by using two unrelated numbers would hardly serve any purpose. For example, the furniture of the business is Rs. 1,00,000 and Purchases are Rs. 3,00,000. The ratio of purchases to furniture is 3 (3,00,000/1,00,000) but it hardly has any relevance. The reason is that there is no relationship between these two aspects.

Objectives of Ratio Analysis

Ratio analysis is indispensable part of interpretation of results revealed by the financial statements. It provides users with crucial financial information and points out the areas which require investigation. Ratio analysis is a technique. Which involves regrouping of data by application of arithmetical relationships, though its interpretation is a complex matter. It requires a fine understanding of the way and the rules used for preparing financial statements. Once done effectively, it provides a wealth of information which helps the analyst:

1. To know the areas of the business which need more attention;

2. To know about the potential areas which can be improved with the effort in the desired direction;

3. To provide a deeper analysis of the profitability, liquidity, solvency and efficiency levels in the business;

4. To provide information for making cross sectional analysis by comparing the performance with the best industry standards;

5. To provide information derived from financial statements useful for making projections and estimates for the future.