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Accounting Ratios

Advantages of Ratio Analysis

The ratio analysis if properly done improves the user's understanding of the efficiency with which the business is being conducted. The numerical relationships throw light on many latent aspects of the business. If properly analysed, the ratios make us understand various problem areas as well as the bright spots of the business. The knowledge of problem areas help management take care of them in future. The knowledge of areas which are working better helps you improve the situation further. It must be emphasised that ratios are means to an end rather than the end in themselves. Their role is essentially indicative and that of a whistle blower.

There are many advantages derived from the ratio analysis. These are summarised as follows:

1. Helps understand efficacy of decisions: The ratio analysis helps you understand whether the business firm has taken the right kind of operating, investing and financing decisions. It indicates how far they have helped in improving the performance.
2. Simplify complex figures and establish relationships: Ratios help in simplifying the complex accounting figures and bring out their relationships. They help summarise the financial information effectively and assess the managerial efficiency, firm's credit worthiness, earning capacity, etc.
3. Helpful in comparative analysis: The ratios are not be calculated for one year only. When many year figures are kept side by side, they help a great deal in exploring the trends visible in the business. The knowledge of trend helps in making projections about the business which is a very useful feature.
4. Identification of problem areas: Ratios help business in identifying the problem areas as well as the bright areas of the business. Problem areas would need more attention and bright areas will need polishing to have still better results.
5. Enables SWOT analysis: Ratios help a great deal in explaining the changes occurring in the business. The information of change helps the management a great deal in understanding the

current threats and opportunities and allows business to do its own SWOT (Strength- Weakness- Opportunity-Threat) analysis.

6. Various comparisons: Ratios help comparisons with certain bench marks to assess as to whether firm, performance is better or otherwise. For this purpose, the profitability, liquidity, solvency, etc. of a business may be compared: (i) over a number of accounting periods with itself (Intra-firm Comparison/Time Series Analysis), (ii) with other business enterprises (Inter-firm Comparison/Cross-sectional Analysis), and (iii) with standards set for that firm/industry (comparison with standard(or industry) expectations