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शक्तिउत्थानआश्रमलखीसरायबिहार

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Accounting *Ratios*

Illustration 20

Given the following information:

	Rs.
Sales	3,40,000
Cost of Goods Sold	1,20,000
Selling expenses	80,000
Administrative Expenses	40,000

Calculate Gross Profit Ratio and Operation Ratio.

Solution

Gross Profit = Sales – Cost of goods sold
= Rs. 3,40,000 – Rs. 1,20,000
= Rs. 2,20,000

Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}}$ 100

= $\frac{\text{Rs. } 2,20,000}{\text{Rs. } 3,40,000}$ 100

= 64.71%

Operating Expenses = Cost of goods sold + Selling Expenses + Administrative Expenses
= Rs. 1,20,000 + 80,000 + 40,000
= Rs. 2,40,000

Operating Ratio = $\frac{\text{Operating Expenses}}{\text{Net Sales}}$ 100

= $\frac{\text{Rs. } 2,40,000}{\text{Rs. } 3,40,000}$ 100

= 70.58%

5.9.4 Net Profit Ratio

Net Profit Ratio is based on all inclusive concept of profit. It relates sales to net profit after operational as well as non-operational expenses and incomes. It is calculated as under:

Net Profit Ratio = Net profit / Sales × 100

Generally, net profit refers to Profit after Tax (PAT).

Significance: It is a measure of net profit margin in relation to sales. Besides revealing profitability, it is the main variable in computation of Return on Investment. It reflects the overall efficiency of the business, assumes great significance from the point of view of investors.

Illustration 21

Gross profit ratio of a company was 25%. Its credit sales was Rs. 20,00,000 and its cash sales was 10% of the total sales. If the indirect expenses of the company were Rs. 50,000, calculate its net profit ratio.

Solution

Cash sales	=	Rs.20,00,000 × 10/90
	=	Rs.2,22,222
Hence, total sales are	=	Rs.22,22,222.
Gross profit = .25 × 22,22,222	=	Rs. 5,55,555
Net profit	=	Rs.5,55,555 – 50,000
	=	Rs.5,05,555
Net profit ratio	=	Net profit/sales × 100
	=	Rs.5,05,555/Rs.22,22,222 × 100
	=	22.75%.

5.9.5 *Return on Capital Employed or Investment (ROCE or ROI)*

It explains the overall utilisation of funds by a business enterprise. Capital employed means the long-term funds employed in the business and includes shareholders fund, debentures and long-term loans. Alternatively, capital employed may be taken as the total of non-factious assets current liabilities. Profit refers to the Profit before Interest and Tax (PBIT) for computation of this ratio. Thus, it is computed as follows:

Return on Investment (or Capital Employed) = Profit before Interest and Tax/Capital Employed × 100

Significance: It measures return on capital employed in the business. It reveals the efficiency of the business in utilisation of funds entrusted to it by shareholders, debenture-holders and long-term liabilities. For inter-firm comparison, return on capital employed which reveals overall utilisation of fund is considered good measure of profitability. It also helps in assessing whether the firm is earning a higher return on capital employed as compared to the interest rate paid.

5.9.6 *Return on Shareholders' Fund*

This ratio is very important from shareholders' point of view in assessing whether their investment in the firm generates a reasonable return or not. It should be higher than the return on investment otherwise it would imply that company's funds have not been employed profitably.

A better measure of profitability from shareholders point of view is obtained by determining return on total shareholders fund, it is also termed as Return on Net Worth (RONW) and is calculated as under :

$$\text{Return on Shareholders' Fund} = \frac{\text{Profit after Tax}}{\text{Shareholders Fund}}$$

5.9.7 Earnings Per Share

The ratio is defined as -

EPS = Profit available for equity shareholders/ No. of Equity Shares

In this context, earnings refer to profit available for equity shareholders which is worked out as Profit after Tax - Dividend on Preference Shares.

This ratio is very important from equity shareholders point of view and so also for the share price in the stock market. This also helps comparison with other firm's to ascertain its reasonableness and capacity to pay dividend.

5.9.8 Book Value Per Share

This ratio is calculated as -

Book Value per share = Equity shareholders' funds/No. of Equity Shares

Equity shareholder funds refer to Shareholders Funds - Preference Share Capital. This ratio is again very important from equity shareholders point of view as it gives an idea about the value of their holding and affects market price of the shares.

5.9.9 Dividend Payout Ratio

This refers to the proportion of earning that are distributed against the shareholders. It is calculated as -

$$\text{Dividend Payout Ratio} = \frac{\text{Dividend Per Share}}{\text{Earnings Per Share}}$$

This reflects company's dividend policy and growth in owner's equity.

5.9.10 Price Earning Ratio

The ratio is defined as -

P/E Ratio = Market price of a Share/Earnings per Share

For example, if the EPS of company X is Rs. 10 and market price is Rs. 100, the price earning ratio will be 10 (100/10). It reflects investors expectation about the growth in the firm's earnings and reasonableness of the market price of its shares. P/E ratios vary from industy to industry and company to company in the same industry depending upon investors perception of their future.