

Accounting Ratio

Objectives of Ratio Analysis in Simple Terms

Ratio analysis is a tool used to make sense of the numbers in financial statements. By using ratios, you can uncover important details about a company's financial health. Here are the key objectives of ratio analysis explained simply:

- 1. Identify Focus Areas:** Ratio analysis helps you spot parts of the business that may need more attention or improvement. It highlights areas that might not be performing well and could benefit from further investigation.
- 2. Spot Improvement Opportunities:** By analyzing ratios, you can find areas with potential for improvement. This allows businesses to take steps to enhance their performance in specific areas.
- 3. Analyze Financial Health:** Ratio analysis provides a deeper understanding of how profitable, liquid (able to meet short-term obligations), solvent (able to meet long-term obligations), and efficient a business is. This helps in assessing the overall financial health of the company.
- 4. Compare with Industry Standards:** Ratios allow you to compare a company's performance with the best in the industry. This cross-sectional analysis helps you see where the company stands compared to others in the same field.
- 5. Plan for the Future:** The information gained from ratio analysis is useful for making forecasts and estimates. It helps in planning for the future by predicting how the company might perform based on its current financial situation.

Types of Financial Ratio

Here's a brief explanation of each type of financial ratio:

1. Liquidity Ratios:

- **Purpose:** Measure a business's ability to pay off its short-term obligations.
- **Example:** The Current Ratio compares current assets to current liabilities, showing whether the company can cover its short-term debts with its available assets.

2. Solvency Ratios:

- **Purpose:** Assess a company's ability to meet long-term obligations and ensure long-term financial stability.
- **Example:** The Debt-to-Equity Ratio compares total debt to shareholders' equity, indicating how much of the company is financed by debt versus owned by shareholders.

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3. Activity (or Turnover) Ratios:

- **Purpose:** Evaluate how efficiently a business uses its resources to generate sales or revenue.
- **Example:** The Inventory Turnover Ratio shows how quickly inventory is sold and replaced, indicating the efficiency of inventory management.

4. Profitability Ratios:

- **Purpose:** Analyze a company's ability to generate profit from its operations and resources.
- **Example:** The Net Profit Margin Ratio shows how much profit is made for every rupee of sales, indicating overall profitability.

Type of Ratio	Ratio Name	Formula	Purpose
Liquidity Ratios	Current Ratio	Current Assets / Current Liabilities	Measures the ability to cover short-term obligations
	Quick Ratio	(Current Assets - Inventory) / Current Liabilities	Measures immediate liquidity without relying on inventory
	Cash Ratio	Cash and Cash Equivalents / Current Liabilities	Measures liquidity using only cash and cash equivalents
Solvency Ratios	Debt-to-Equity Ratio	Total Debt / Shareholders' Equity	Assesses financial leverage and risk
	Interest Coverage Ratio	EBIT / Interest Expense	Measures the ability to cover interest payments
	Debt Ratio	Total Debt / Total Assets	Indicates the proportion of assets financed by debt
Activity (Turnover) Ratios	Inventory Turnover Ratio	Cost of Goods Sold / Average Inventory	Evaluates inventory management efficiency
	Receivables Turnover Ratio	Net Credit Sales / Average Accounts Receivable	Measures how efficiently receivables are collected
	Asset Turnover Ratio	Net Sales / Average Total Assets	Assesses overall asset efficiency
Profitability Ratios	Net Profit Margin	Net Profit / Revenue	Indicates profitability as a percentage of revenue
	Return on Assets (ROA)	Net Income / Average Total Assets	Measures efficiency in using assets to generate profit
	Return on Equity (ROE)	Net Income / Shareholders' Equity	Indicates the return generated on shareholders' equity

