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Ratio analysis in financial performance of a company: A review

Sardar Jaswanth Singh
Research scholar, Department of Commerce, Dr. APJ Abdul Kalam University, Arandia Jhalaria, Indore, Madhya Pradesh, India

Abstract
The ratio analysis is a key tool to determine the various external and internal factors of a company influencing the business. It determines the earnings, functional capability and liquidity of a company by comparing the data available in financial statements. The ratio analysis allows shareholders, investors or creditors to know the financial status and performance of a company business. Even ratio analysis is an important tool for the management authorities to resolve various issues in business.

Keywords: ratio analysis, key tool, business, financial statements, shareholders, investors

1. Introduction

Ratio analysis is an approach to evaluate the business of a company through making an emphasis on company's profits, functional efficiency and liquidity by an in-depth comparative study of data obtained from its financial statements. It allows investors, creditors, analysts and shareholders to understand clearly about financial statements of a company. The ratio analysis is a versatile and significant tool which can be used to determine the performance of a business organization (Adedeji, 2014) [1].
If ratio analysis of a company is performed with utmost care by an analyst, it reveals the following outputs.

- departments of company which require special attention
- the potent areas of the business to be improved with proper guidance
- profits, liquidity, solvency and efficiency levels of company
- estimations for future business

The ratio analysis is especially applicable for the following two aspects.

- **Trend line:** It is prepared for a company's multiple financial reports over a period of time (Enyi and Enyi, 2019) [2].
- **Comparison of industry:** It involves computing the similar financial ratios of different companies belonging to the same sector on comparative basis. This study allows us to determine the business performance of a company under study (Alia and Haqueb, 2014) [3].

Types of ratios

There are numerous types of ratios available to analyse the financial statements of a company. But in the following section only those ratios which are genuinely useful for financial performance of a company are discussed.

1. Current ratio: It determines the existing assets of a company to clear the immediate liabilities. The formula to calculate current ratio is given below.

$$\text{Current ratio} = \text{current assets} \div \text{current liabilities}$$

The current ratio analysis allows a company to liquidate current liabilities for the payment pertaining to current assets. In a company, 2:1 ratio of current assets to current liabilities is preferred (Nuhu, 2014) [4].

2. Days sales outstanding: It estimates the capability of company to grant credit to customers and collect back the same in a time frame. The following formula is used to calculate the day sales outstanding.

$$\text{Days sales outstanding} = (\text{Accounts receivable} \div \text{Total credit sales}) \times \text{Number of days}$$

It is useful to check the ability of a company's credit and recovery procedures in giving credit to customers and also ability to recover from them.

3. Debt to equity ratio (D/E): It is the ratio of total liabilities of a company to its equity of shareholders. The formula used for debt to equity ratio is given below (Anuar and Chin, 2016) [5].

$$\text{Debt to equity ratio} = (\text{Long term debt} + \text{Short term debt} + \text{other fixed Payments}) \div \text{Shareholders Equity}$$

The D/E ratio generates an output of financing operations of a company (whether a company is functioning through debts or on owned funds)

4. Dividend payout ratio: It is the ratio of total earnings of a company paid to shareholders in the form of dividends to net earnings (benefits) of the company. It is nothing but, percentage of company's earnings paid to its shareholders in the form of dividends. The formulae to calculate dividend to payout ratio is as follows.

Formula 1
Dividend payout ratio = Annual dividend paid to shareholders per share ÷ Earnings by company per share

Formula 2
Dividend payout ratio = total dividends paid out to

Shareholder ÷ Net earnings of a company
The dividend payout ratio estimates the part of earnings credited in terms of dividends to shareholders. This ratio of a company makes investors to know the amount of money left with company for reinvestment after paying to its shareholders (Manjunatha, 2013) [6].

5. Gross profit ratio: It computes the proportion amount of earnings of a company achieved by selling products or by rendering services before administrative expenditure in added. The formulae used to calculate gross profit ratio are given below.

Formula 1
Gross profit ratio = (Sales of goods – (Direct materials used + Direct labour + Overhead) ÷ Sales

Formula 2
Gross profit ratio = (Sales of goods – Direct materials) ÷ sales

It is employed to study the capability of a company business to design goods that can be sold in a cost-effective mode (Ali and Haqueb, 2014) [3].

6. Inventory turnover: It is the ratio of number of times a company sold to replaced inventory for a given period of time. Inventory turnover data can guide a company business to make better judgement on price, production, marketing and buying new inventory (Rao and Rao, 2009).

7. Net profit ratio: It is the ratio of net profit of a company after payment of tax to net sales. The following is the formula to calculate net profit ratio.

Net profit ratio = Net profit after tax ÷ Net sales

The interrelationship between net profit and net sales can also be represented in percentage. When it is expressed in percentage terms, it is referred to as net profit margin (Husna and Desiyanti, 2016) [8]. The formula to calculate net profit margin is given below.
Net profit margin = (Net profit after paying tax ÷ Net sales of goods) x 100

8. Price earnings ratio: It is the ratio of market value for each share to earnings for each share. To calculate price earnings ratio the following is the formula.

Price earnings ratio = market value per company share ÷ earnings per share

This ratio can be used to estimate the present price of a company's share compared to earnings per share. The higher ratio indicates that an investor is willing to pay more amounts (Dutta *et al.,* 2018) [9].

10. Return on assets: It is the ratio of net profits of a company to total assets of the company. The below formula is used to calculate the return on assets.

Return on assets = net profits of company ÷ total assets of the company

This ratio determines the ability of company management to use its assets to create earnings. Hence, it is regarded as an important measuring tool for investigating the performance of company management (Pandey, 2017) [10].

Conclusion
The ratio analysis is an important tool for the analysis of financial statements. The ratio analysis tool involves various ratios to evaluate the financial status and ability of a company. The financial statements are the only sources to determine the business status of a company. Hence, thorough emphasis on financial statements can be achieved through ratio analysis.

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