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Name = Sohela

Batch = 332

Business Ad. Assignment

⇒ CSS-2009 (B.ad)

Q. What is ratio analysis? List four ratios and explain what they are used for? Discuss various benefits and drawbacks of ratio analysis? (5+5+10)

Ans.

⇒ **Ratio Analysis:**

Ratio analysis is a financial analysis technique used to evaluate the performance, Financial Health, and efficiency of a Company by examining the relationships between different financial variables. It involves comparing and interpreting various ratios calculated from the Company's financial statements such as the Balance Sheet and Income statement

⇒ Ratios are mathematical calculations that provide insights into different aspects of Company's operations, Profitability, Liquidity.

and Solvency. They help in understanding the Company's strengths, weaknesses, and trends over time.

⇒ Some commonly used ratios in ratio analysis include:

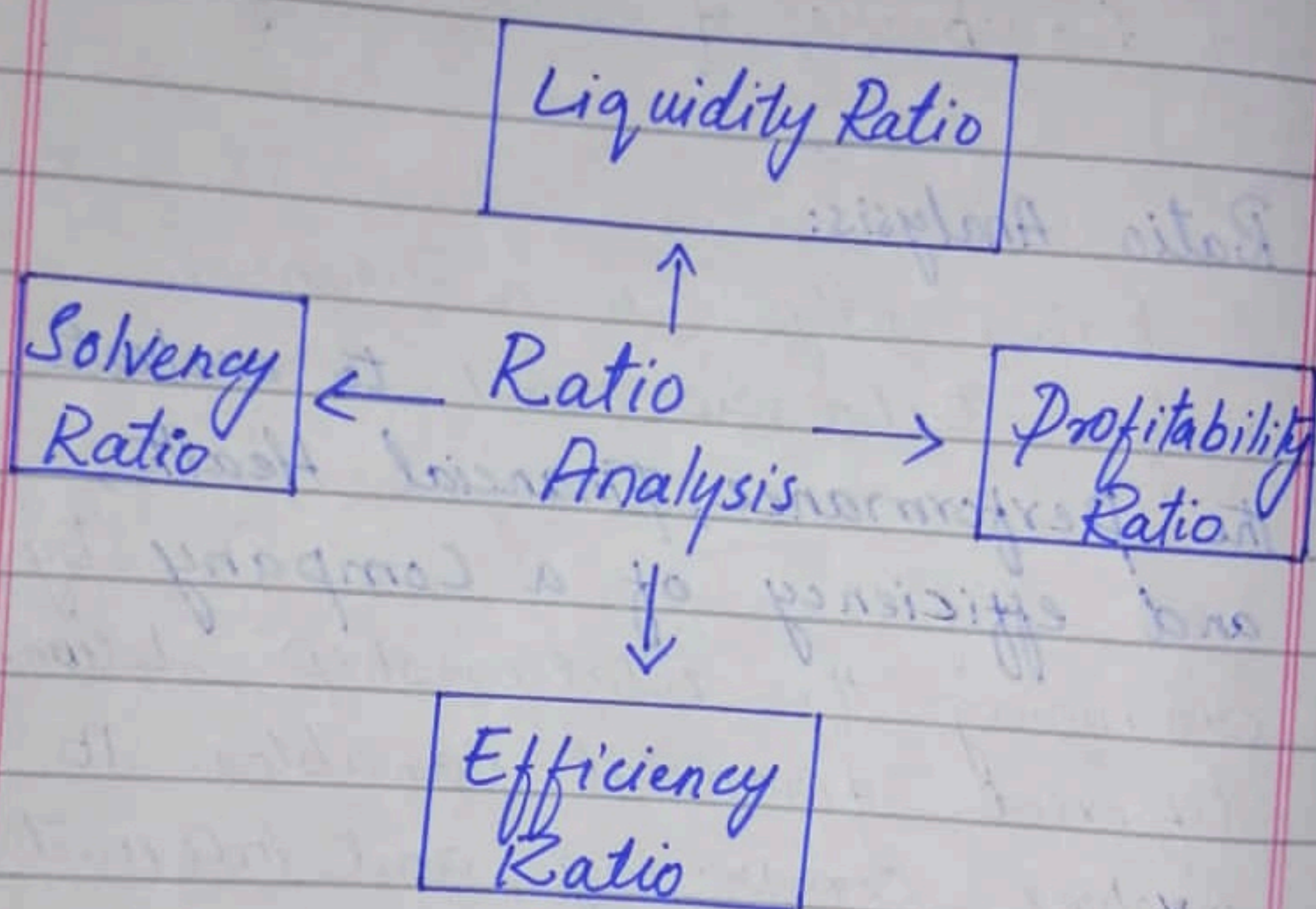

Figure: Ratio Analysis and its types.

(1) Liquidity Ratio:

Liquidity Ratio assess a Company's ability to meet its short-term obligations. It means that liquidity ratio indicates whether a Company has enough cash or assets that

can be easily converted into cash to pay its bills and debts in the near future.

Example includes: The current ratio and the Quick ratio

(2) <u>Profitability Ratio:</u>

Profitability ratio measures the company's ability to generate Profits and Returns. It helps assessing the company's overall profitability and efficiency in utilizing its resources.

→ In simple terms, Profitability ratios help answer questions like "How well is the Company making money?" and "How much profit is it generating from its sales?"

Example: Here are a few common Profitability Ratios

(1) Gross Profit Margin
(2) Net profit Margin
(3) Return on Assets (ROA)
(4) Return on Equity (ROE)

3. Solvency Ratio:

Solvency ratios are financial ratios that provide insights into a company's long-term financial stability and its ability to meet its long-term debt obligations.

It tells "Can the company pay off its long-term debts?" and "Does the company have enough assets to cover its long-term obligations?"

Example includes;

(1) Debt-to-Equity Ratio
(2) Interest Coverage Ratio

4. Efficiency Ratio:

Company's operational efficiency and its ability to utilize its resources effectively to generate sales and manage its assets.

It helps assess the company's efficiency in utilizing its resources to generate profits and improve overall performance.

Efficiency ratio tells us "How well is the company using its resources?" and "Is the company managing its assets and operations efficiently?"

Example: Here are two common efficiency ratios:

(1) Inventory Turnover Ratio
(2) Accounts Receivable Turnover Ratio

⇒ **Advantages of Ratio Analysis:**

Ratio analysis offers several benefits that can help individuals and organizations make informed financial decisions. They are as follows:

(1) **Performance Evaluation:**

Ratio analysis allows to assess a company's performance over time. For example, by comparing the gross profit margin ratio of a company in different years, one can determine if the company is becoming more or

less efficient in generating profits from its sales. If the ratio increases over time, it indicates improved performance.

2. **Financial Health Assessment:**
Ratios provide insights into a company's financial health and stability. For instance, the current ratio can help determine if a company has enough current assets (such as cash and inventory) to cover its current liabilities (such as short-term debts and payments). If the current ratio is higher than 1, it suggests that the company is in better position to meet its short-term obligations.

3. **Benchmarking:**
Ratios can be compared with industry averages or competitors' ratios to benchmark a company's performance. For Example, if the company's Return on Investment (ROI) is higher than the industry average,

it indicates a competitive advantage.

4. **Decision Making:**

Ratio analysis provides valuable information for decision making.
Example: Investors can use ratios to evaluate investment opportunities. A Higher ROE ratio can indicate a company's ability to generate higher returns for shareholders, making it an attractive investment.

5, **Early Warning Signs:**

Ratio analysis can act as early warning signs of potential financial problems.
For example, a decreasing Profit margin ratio over several periods may indicate a decline in Profitability, signalling the need for further investigation and Corrective actions.

Moreover, Ratio Analysis also helps in Financial Planning, Communication, and Transparency by Providing a Standardized Framework

between management, investors, and creditors.

=> Drawbacks of Ratio Analysis:

While Ratio Analysis offers several benefits, it also has some limitations and disadvantages that should be considered. They are as follows:

(1) **Simplification of Complex Financial Information:**

Ratios provide simplified representation of financial data. This simplification may overlook important nuances and complexities in underlying financial statements, potentially leading to incomplete or inaccurate assessments.

(2) **Lack of Context:**

Ratios need to be interpreted in the context of industry norms, company-specific factors, and economic conditions. Failing to consider these factors may result in misleading interpretations

or inappropriate comparisons.

(3) **Reliance on Historical Data:**

Ratio Analysis primarily relies on historical financial data, which may not accurately reflect future performance or changes in market conditions. Economic shifts, industry trends, or changes in company strategy may render historical ratios less relevant.

(4) **Limited Comparability:**

Comparing ratios across companies or industries may be challenging due to variations in accounting methods, business models, and reporting practices. These differences can hinder meaningful comparisons and make benchmarking less reliable.

(5) **Lack of Standardization:**

While some ratios have industry standards or benchmarks, there is no universally standardized set of Ratios. Different analysts or stake-holders may use different ratios or formulas, leading to inconsistencies

in interpretation and decision making.

Additionally, Ratio Analysis has limited scope of capturing the full picture of Company's operational efficiency, management quality, or competitive advantages. It should be used in conjunction with other Qualitative and Quantitative factors for a comprehensive evaluation.

⇒ **Conclusion:**

In Conclusion, Ratio analysis helps evaluate a company's financial performance and health, but it has limitations and should be used alongside other information for a complete understanding and decision-making.