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ROLE OF RATIOS IN BUSINESS ORGANIZATIONS: AN OVERVIEW

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ABSTRACT

Mathematics, which deals with numbers and their operations. It reveals hidden patterns that help us to understand the world. Mathematics is used in commerce also. Business organizations use mathematics in terms of ratios in accounting to analyses the financial statements by using "Ratio analysis".

Ratio analysis helps the management in decision making and to compare the financial results of various competitors. This paper gives an overview of ratios and importance in business organizations.

Keywords: Ratios, Ratio Analysis, Decision Making, Financial Statement Analysis, Financial Ratios.

Role of Ratios in Business Organization

The term ratio refers to the mathematical relationship between any two inter-related variables. It establishes a relationship between two items expressed in quantitative form. It may be expressed in a simple fraction, integer, and decimal. A ratio is calculated by dividing one item by another item.

Ratios are quantitative tools that are used to analyze sets of financial information. Every business organization analyses its financial performance through "Ratio analysis". It is considered as a powerful tool for financial statement analysis.

Ratio analysis is a quantitative analysis of information which contains in a company's financial statements. It is based on balance sheet, income statement, and cash inflow. It is used to evaluate a financial performance of a Business Organization.

Description of Role of Ratios in a Business Organization

Ratios in accounting in terms of Ratio analysis is providing great help in making comparative study with other competitors. It is by means of ratio analysis that the current performance and as well as the profitability in trends.

Ratios are an effectual means of communication and informing about financial soundness made by the business concerned to owners, creditors, investors and others. There is no end to the number of ratios which can be calculated. So the ratios are to be calculated selectively and judiciously.

A number of possible ratios like Liquidity ratios, Profitability ratios can be used to make decision making in Business organizations and to compare the profits with their competitors.

Financial ratios show the financial capacity of the Business organization.

a. Current ratio = current assets/current liabilities.
b. Quick ratio = quick assets/quick liabilities.
c. Absolute liquid ratio = absolute liquid assets/ quick liabilities

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(Current assets are cash, debtors, bills receivables, stock, short term investments, prepaid expenses. Current liabilities are creditors, bills payables, and bank overdraft. Quick assets are cash, debtors, bills receivables & short term investments. Absolute liquid assets are cash, bank balance and market securities.)

Profitability ratios indicate the profit earning capacity of business organizations.

a. Gross profit ratio = Gross profit/Net sales.
b. Net profit ratio= Net profit/ Net sales.

(Gross profit = sales + closing stock – (Opening stock + purchases + direct expenses) and Net profit = Gross profit – All business organization's expenses).

Ratios:

Any ratio as it is, it is meaningless. It must be compared with some standard unit to arrive a logical conclusion. The four most common standards are (a) absolute (b) relative (c) historical and (d) budgeted.

Absolute standards are those which become generally recognized as being desirable regardless of the company, the time and the state of business cycle. Relative standards are a company compared with the other company. Historical standards involve comparing a company's past performance as a standard unit and budgeted standards are arrived after preparing the budgets.

Interfirm comparison involves comparing the ratios of a firm with those others in the same line of business or for the industry as a whole. It reflects the firm's performance in relation to its competitors by financial statement analysis.

Test of liquidity: the liquidity ratios are used to test the short term solvency or liquid position of the business. The important ratios in test of liquidity are current ratio, quick ratio and absolute liquid ratio.

There is an ideal ratio for each liquidity ratio that is current ratio 2:1; quick ratio 1:1; absolute liquid ratio is 1:2.

If the business organization is having cash 100000, stock 50000, bills receivables 50000, accounting payables 50000, creditors 50000 then

Current ratio =200000/100000=2:1

If the current ratio is equivalent to ideal ratio then it is in good position, higher than ideal ratio indicates that the business organization has excess cash. Less than ideal ratio indicates there is a liquid issue. By using this ratio organizations can take a decision either they have to maintain the same liquid position or increase or decrease.

Quick ratio=150000/100000=1.5:1

Absolute quick ratio = 100000/100000 =1:1

If the quick ratio and absolute quick ratios are equivalent to ideal ratio then the organization is sufficiently meet the short-term liabilities, higher than the ideal ratio indicates that the business organization is financially in secure position, less than ideal ratio indicates that the organization is struggling in sales and to pay bills. By using this ratio business organizations can take a decision either they has to maintain the same position or increase the financial position or not.

If the business organization earns gross profit 25000, net profit 50000 and sales were 100000 then

Gross profit ratio = 25000/100000 =0. 25: 1.

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Net profit ratio = 50000/100000 =0.5:1.

These profit ratios indicates the profit earning capacity of the business organizations. By using these ratios business organizations will take a decision either they have to maintain the same level of profits or it should be increase and it can be compare with the past year's profits, then organizations able to know either the profit level is increased or decreased, according to the situation business organizations with increase the sales.

Conclusion

Ratios of ratio analysis are the application of ratios in productive and optimum way with the aim of understands relationships that exist amongst different variables. Ratios play a vital role in business organizations to take decisions.

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