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Ratio Analysis is an Instrument – for Decision Making - A Study

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ABSTRACT

The practice of ratio analysis has been used by financial market participants and managers of firms for almost a century. At the present juncture ratio analysis become very essential for the organization to survive in the market for a longer period. To understand the impact of financial ratio in IT sector the researchers have opted TCS for their study. We have analyzed the accounting information of the company through ratios and construed in such a way that can be easily understood by all.

Keywords: Comparative Analysis, Ratio Analysis, Accounting Information.

Introduction

The two primary objectives of every business are profitability and solvency. Profitability is the ability of a business to make profit, while solvency is the ability of a business to pay debts as they come due. (Hermanson et al, 1992: 824). To take the right decision at the right time executives should know the financial position of the organization. Without which it is not easy to take any type of action for the expansion and augmentation of the organization. Through financial information an executive can take imperative decision as and when they are required. For studying the financial health and having accurate financial information of a business, ratio analysis is being considered as the major tool at present. Bittel et al. (1984:340).observed that one of the effective ways of providing information needed for decision-making is ratio analysis. M_CShane et al. (2000:336) defined decision-making as "a conscious process of making choices among one or more alternatives with the interior of moving toward some desired state of affairs." Therefore, business decisions are those choices exercised by the executives with the well-organized usage of resources. Correct financial information at the appropriate time is of paramount importance for any organization for efficient usage of resources. According to Igben (1999:423), "Accounting or financial ratio is a proportion or fraction or percentage expressing the relationship between one item in a set financial statements and another item in the financial statements. Accounting ratios are the most powerful of all tools used in analyzed and interpreting financial statements". Therefore, ratio analysis involves taking stats of number (or items) out of financial statements and forming ratios with them, to enhance informed judgments and decisions (Lasher, 1997:66).

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Horrigan (1968) reviews the developments of financial ratio analysis in the USA (and briefly in other countries) since the turn of the century. He shows that the current ratio was used in credit decisions since the 1890s, while other ratios, which were compiled by Wall (1919) for a large sample, were used in comparisons of a firm's financial ratios with those of other firms in the same industry and geographical location. Profitability is the ability of a business to make profit, while solvency is the ability of a business to pay debts as they come due. (Hermanson et al, 1992: 824). The achievements of these twin objectives can be done by planning, budgeting, forecasting, control, and decision – making. Accounting is generally used to record the financial position of the firm as well as its operating efficiency .Thus, the American Accounting Association (in Okezie, 2002:1) defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the information". In this regard, Essien (2006:144) observed: Financial statements carry lots of financial Information that are hidden in the figures. The figures in financial statements become more useful when they are related to each other or to some other relevant financial data. Therefore, users of financial information go a further step to establish relationships (or ratios) among selected data in financial statements.

The prevalent use of ratio analysis is manifested in Gibson's 1982 study, and by the sources that publish financial ratio statistics for industries and various firms' sizes in the USA, the UK, and elsewhere. Barnes (1987) opens his review article about financial ratios with the following statement: Financial ratios are used for all kinds of purposes. These include the assessment of the ability of a firm to pay its debt, the evaluation of business and managerial success and even the statutory regulation of a firm's performance. Not surprisingly they become norms and actually affect performance. The traditional textbooks of financial analysis also emphasize the need for a firm to use industry-wide averages as targets (Foulke, 1968), and there is evidence that firms do adjust their financial ratios to such targets' (p.449). Barnes also argues that, implicitly or explicitly, financial ratios are used for predictive purposes where analysts try to predict some event of interest, for example, financial distress, bond ratings, takeover candidates, and risk parameters.

Meaning of Ratio and ratio analysis

A ratio can be defined as the indicated quotient of to mathematical expression and as the relationship between two or more things.

Ratio analysis is a widely used tool of financial analysis. It is defined as the systematic use of ratio to interpret the financial statements so that the strength and weaknesses of a firm as well as its historical performance and current financial condition can be determined. The term ratio refers to the numerical or quantitative relationship between two variables.

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Important of ratio analysis

With the help of ratio analysis conclusion can be drawn regarding several aspects such as financial health, profitability and operational efficiency of the undertaking. Ratio analysis is a fundamental means of examining the health of a company by studying the relationships of key financial variables. A firm's ratios are normally compared to the ratios of other companies in that firm's industry or tracked over time internally in order to see trends. Ratio analysis stands for the process of determining and presenting the relationship of items and group of items in the financial statement. It is a way by which financial stability and health of a concern can be judged. Ratio analysis plays an important role in the financial field of making investment and landing decision by banks, insurance companies etc. and it simplifies the accounting figures and highlights their interrelationship between different segments of the business.

Methodology

To fulfill the objectives of the study and to make a detailed evaluation of financial status, the case study method has been adopted. For the present study ratios and comparative statement analysis are the tools selected. The researcher have collected the data through Primary and secondary method. Researchers have also contacted the concerned officials of the company as and when required. The secondary information is gathered from the the official publications, accounting records, annual reports of TCS, text books, magazines, journals etc. and related website links, published materials.

Objectives

- To study the financial statement of TCS
- To find out the impact of ratio analysis on decision making

Analysis and findings

Table 1: Comparative balance sheet of Tata Consultancy Services

Particulars	Mar '12	Mar '13	Increase or decrease	Percentage of change (%)
Total Share capital	295.72	295.72	0	0.00
Reserves	29,283.51	38,350.01	9,066.50	30.96
Net worth	**29,579.23**	**38,645.73**	**9066.5**	**30.65**
Secured Loans	112.61	209.48	96.87	86.02
Unsecured Loans	3.65	1.52	-2.13	-58.36
Total Debt	**116.26**	**211.00**	**94.74**	**81.49**
Minority Interest	558.77	695.31	136.54	24.44
Total Liabilities	**30,254.26**	**39,552.04**	**9,297.78**	**30.73**
Application Of Funds				
Net Block	**8,662.06**	**9,828.01**	**1,165.95**	**13.46**
Capital Work in Progress	1,446.37	1,895.36	448.99	31.04
Investments	1,350.33	1,897.34	547.01	40.51
Inventories	17.77	21.15	3.38	19.02

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Sundry Debtors	11,520.35	14,076.56	2,556.21	22.19
Cash and Bank Balance	6,003.47	6,769.16	765.69	12.75
Total Current Assets	**17,541.59**	**20,866.87**	**3,325.28**	**18.96**
Loans and Advances	12,394.14	17,779.64	5385.5	43.45
Total CA, Loans & Advances	29,935.73	38,646.51	8,710.78	29.10
Current Liabilities	**6,128.53**	**8,132.80**	**2004.27**	**32.70**
Provisions	5,011.70	4,582.38	-429.32	-8.57
Total CL & Provisions	11,140.23	12,715.18	1574.95	14.14
Net Current Assets	**18,795.50**	**25,931.33**	**7,135.83**	**37.97**
Total Assets	**30,254.26**	**39,552.04**	**9297.78**	**30.73**

Sources: Dion Global Solutions Limited

The table: 1 exhibits an increase in reserves by 30.96% which inter alia reflects that the company is investing the profits back into business. With regard to secured loans results indicates a significant increase of 96.87 % whereas, in case of unsecured loans a negative balance has shown. It can also be observed that there is a significant increase (81.49%) in the total debt but no increase in equity share capital which shows their intention for trading on equity. TCS is a service oriented company, even though there is an increase of 13.46% in fixed asset. With regard to the capital work in progress and investment it seems that there is a significant increase of 31.04 and 40.51per cent respectively. That 18.96% of increase in current assets is a good sign for a company like TCS and that growth is directly attributable to the increase in sundry debtors which reflects a constructive change in company's' credit policy. From the above it can be observed that the increase in company's current liabilities (32.70%) is more in comparison to the increase in current assets (18.96%), with this it can be concluded that the company is adopting a conservative payment policy. The above table also indicates that 8.4% and 37.97% decrease in provision and increased in net current assets respectively. It shows that during the period company's scale of operation is significant.

Table 2: Liquidity and activity ratios

Ratios	Mar '12	Mar '13
Current ratio	2.69	3.00
Quick Ratio	2.66	3.01
Inventory turnover ratio	2751.48	2978.26
Debtors turnover ratio	4.96	4.92

Sources: Compilation of data

The above table indicates that the current ratio is more than 2:1 and the quick ratio is more than 1:1 which shows that the liquidity position of the company is good. Generally current ratio of 2.1 is considered ideal for a concern i.e. current asset should be twice of the current liabilities (Jain and Narang, 2006). The Inventory turnover ratio and Debtors turnover ratio show a marked increase in this year which reveals a quicker operating cycle as well as good credit policy.

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Table 3:Solvency ratios

Ratios	Mar '12	Mar '13
Debt Equity Ratio	0.01	0.01
Fixed Assets Turnover Ratio	5.18	5.73
Total Assets Turnover Ratio	1.83	1.78

Sources: Compilation of data

Table 3 present that the debt equity ratio is less than the 2:1 which a cause of concern for shareholders as the company is not using low cost outsider's fund to acquire fixed assets that could earn a high return. But as the cash position of the company is comparatively better it seems that company may not have any problem in servicing the debt. The company's Fixed Assets, Turnover Ratio, and Total Assets Turnover Ratio are encouraging which proves meticulous use of assets.

Table 4: Profitability ratios

Ratios	Mar '12	Mar '13
Gross Profit Margin (%)	27.64	26.92
Net Profit Margin (%)	21.11	21.68
Return On Capital Employed (%)	46.96	46.67
Operating Profit Margin (%)	29.52	28.63

Sources: Compilation of data

The above table indicates that the profits are more or less steady for these two years. The expenses are reduced as there is a less gap between gross profit and net profit. The return on capital employed is also healthy. It can be concluded that maximization of profit by providing satisfactory services to customers are the main motto of the firm's objective.

Conclusion and findings

The company has shown a progressive approach by increasing its long term debt and investing it in fixed assets. The creditors of the company are enjoying a large margin of protection due to a lower debt equity ratio. The cash position of the company seems to be good. The turnover of inventory and debtors has shown a positive trend which states that the sales policy as well as the collection policy of the company is in order. The company's profitability ratios are increasing by reducing the cost of production & increased sales realization. The firm's capability of assets to generate profits is adequate. The company is very particular with its financial management system and its executives understand the reality of the financial system through which they are taking the appropriate decision at the right time. In this competitive scenario the company is very successfully fulfilling its main objective because of the proper and systematic financial analysis. The traditional textbooks of financial analysis also emphasize the need for a firm to use industry-wide averages as targets (Foulke, 1968), and there is evidence that firms do adjust their financial Ratios to such targets' (p.449). Practical applications of ratio analysis require the comparisons of a firm's financial ratios to some norms, or pre specified benchmarks. Lev (1969) hypothesized that firms attempt to adjust their performance to their industry.

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