Chapter: 4

Financial Performance Appraisal
CHAPTER - 4

FINANCIAL PERFORMANCE APPRAISAL

4.1 Concept of Performance
4.2 Concept of “Appraisal”
4.3 Retail Performance and Profitability
4.4 Financial statements
4.5 Performance Appraisal By Financial Statement Analysis
4.6 Objectives of Financial Statement Analysis
4.7 Importance and Usefulness of Performance Appraisal
4.8 Areas of performance appraisal
4.9 Concept of Profitability
4.10 Types of Profit
4.11 Techniques of Financial Statement Analysis
4.12 Technique of ratio analysis
4.13 Balance sheet Ratios
4.14 Profit & loss Account Ratios
CHAPTER - 4
FINANCIAL PERFORMANCE APPRAISAL

4.1 Concept of Performance

The word “performance” connotes an entertainment presented before an audience- the portrayal of a character on the stage. In the context of present study, it covers some other aspects. Erich Kohler defines performance as “a general term applied to a part or to all of the conduct of activities of an organization over a period of time, often with the reference to past or projected costs, efficiency, management responsibility or accountability, or the like”.

In simple words, it is indicative of the quality and the results achieved by management of an enterprise. Further, it reveals how the management has been accomplishing the objectives and the goals which had been set up by the enterprise in comparison with the past performance.

4.2 Concept of “Appraisal”

The word “appraisal” includes the act to examine, to measure, to interpret, to weigh critically and to draw conclusions. Hence, the term appraisal can be defined as a systematic procedure of drawing conclusions.

“Performance appraisal” is a critical process of evaluating the efficiency and effectiveness of an enterprise in performing various operations. As said by Erich A Helfert refers, “The measurement of business performance is more complex and difficult, since it deals with the effectiveness with which capital is employed, the efficiency and profitability of operations”.

The term performance appraisal can be also termed as yardstick for the appraisal of performance of the company of the financial statements of the company. The financial statements are referred to Balance sheet and Profit and Loss account. This statement provides a summarized view of the operations of the firm.

1 New Webster’s Dictionary of the English Language.
Financial appraisal is the technique to evaluate past, current and projected performance of a concern. The dictionary meaning of the performance refers to "achievement". The achievement of target involves the integrated use of human finance and natural resources.

Appraisal may be defined as a critical assessment of various activities in the different areas of an operation of an enterprise. A periodical appraisal of the operations of an organization is essential for financial strength and good profitability just like a periodical check up and examination of human body to assess physical fitness. In case of bad or deteriorating situation it mention the areas whereas improvement is necessary where as in good situation it may suggest the way for further improvement. The assessment of business performance is more complex and difficult since it must deal with effectiveness in which capital is employed, the efficiency and profitability of operations and the value and safety of various claims against the business.

4.3 Retail Performance and Profitability

Retailing is a complex business. The complexity comes not out of the activities involved, but out of detailing an precision involved in implementing each decision.

The profitability of a retailer is based on a judicious use of its three main resources of inventory, space and people. A good management of inventory and efficient consumer response by a retailer would help not only in getting better markups due to right merchandise, but also higher sales at full price and lower markdowns. A higher inventory turnover benefits the customer by providing them merchandise that is fresh and as per their requirements in terms of stock keeping units and items. For the retailer, it translates into higher return on inventory. The return on investments on the store is also to be determined on the basis of square or cubic feet of space. The retailers performance is dependent upon the usage of space which allow shoppers to feel comfortable while shopping. It involves the space of department, stocking, displays, promotions, creating the right ambience and administrative offices. The third major source is people and investments in technology. They play a very crucial role in

delivering the desired experience to the consumer and provide human touch to the consumers. The retailers evaluate their performance in terms of its markdowns, and contribution earned in retail business⁴.

4.4 Financial statements

The term “Financial Statements as used in the modern terms are referred to two statements- the balance sheet and the “Profit and Loss account”. Though the statement of changes in Financial Position and Value Added Statements are also prepared and appended to annual reports. As stated by Guthmann, the Balance sheet is known as “Statement of Financial Position”⁵ and it reveals all the financial position of the firm. The financial statements provide a summarized view of the operation of the firm.

Though the financial statements have the appearance of completeness, exactness and finality. Financial statements are the means to present the operating results and the financial state of the firm.

4.5 Performance Appraisal By Financial Statement Analysis

The term “FSA” refers to the process of determining financial strengths and weakness of the firm by establishing relationship between the items of the Balance sheet and P&L a/c. It is also a process of the total examination of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm. The FSA is basically a study of relationship among various financial facts and figures provided in Financial Statement.⁶ Financial Statement analysis is a process of evaluations of the relationship between components which form a part of a financial statement to obtain a better understanding of a firm’s position and performance.

In the words of Kennedy and Mc Mullen, “The analysis and interpretation of the financial statements result in the presentation of information that will aid in decision

⁴ Ibid pp no 95
making by business managers, Investors and creditors as well as other groups who are interested in financial states and operating results of the firm."7

Performance appraisal consists of applying analytical tools and techniques to financial statements and other relevant data to obtain useful information. The information so obtained would be useful in assessing past performance and current financial positions, which are or result of prior decisions. The objective of performance appraisal is to have a detailed cause and effect study of the effectiveness in the use of resources available in the business enterprise and to evaluate the financial position.

❖ **Features of Financial Statements:-**

1) The two statements are prepared on the basis of generally accepted accounting principles and practices.

2) In the preparation of such financial statements, specific statutory requirements, if any are also followed. For eg:- in case of companies, the requirements of Companies Act, Income Tax Act, statutory requirements, Schedule VI requirements, Accounting Standards etc are to be followed. Many commercial and trade customs are also being followed in the preparation of the financial statements.

3) The financial statements are prepared on the basis of business transactions recorded in the books of accounts only. It means that they are prepared on the basis of accounts only.

4) In addition to the accounting principles, the personal judgment plays an important role in preparation of financial statements. The number of years over which fictitious assets should be written off.

5) Absolute accuracy is not possible in preparation of financial statements as some of the figures are only estimate, e.g. provision for tax liability, provision for doubtful debts etc.

6) In case of joint stock companies, the previous year figures are also shown with the figures for current year.

---

7) Financial statements provide reliable financial information about economic resources and obligation of a business enterprise.

8) Financial statements provide reliable information about changes in net resources.

9) Financial statements provide financial information that assists in estimating the earnings potential of the enterprise.

10) Financial statements also disclose other information that is relevant to statement users.

11) The well framed, designed and audited accounting information about the business activities disclosed by financial statements is more authentic and reliable.

12) The reported financial statements are direct and cheap sources of authentic source of information.

13) The published financial statements information is more reliable and it is directly published by the companies.

14) Corporate financial statements are the source with the most consistently high ranking of importance for various users.

15) In the financial statements of the enterprises having high degree of uncertainty and publishes the data, is a critical factor.

16) Financial statements are prepared for the purpose of presenting a periodical review or report by the management.

4.6 Objectives of FSA:

The basic objective of the analysis of Financial Statement is to understand the information contained in financial statement with a view to know the strength and weakness of the firm to make a forecast about the future and thereby enabling the financial analyst to take different decisions regarding the operation of the firm.

The financial statement analysis includes both analysis and interpretation done on

a) Internal analysis

b) External Analysis

c) Vertical Analysis
External Analysis:-

It is the one which is conducted by an outsider without having any access to the basic accounting record of the firm. These include investor, potential creditors, Government agencies, Credit agencies and the general public. For financial analysis these external parties depend upon almost entirely on financial statements.

Internal Analysis:-

The financial statement analysis is aid to be internal when it is done by people who have access to the books of account and other related information of the firm. This type of financial statement is undertaken for measuring the operational and managerial efficiency at different hierarchy levels of the firm.

Horizontal analysis:-

Horizontal analysis means the comparison of the company for several years. In this a base year is chosen at the beginning point. The analysis is based on the data form year to year rather than on data of any one year.

Vertical analysis:-

It refers to the study of relationship of various items in the financial statements of a year, compared with a standard or a base year subjected from the same year statement. It is also known as static analysis.

4.7 Importance and Usefulness of Performance Appraisal

In any economic society, all stakeholders are interested in varying degrees in all the affairs of business enterprise. The importance and usefulness of the appraisal are as follows:-
• To the management:- Management is responsible for efficiency, current and long term profit from operations so by way of performance appraisal it may help the management in evaluating the plans and policies.

• To the Investors:- Investors are always interested in the current and long term profitability of their equity investment which may be reflected in their growing earnings and dividends. This all is provided to them by way of performance appraisal.

• To the creditors: - Creditors are concerned with the company's ability to meet its financial obligations. They want information regarding the company's ability to repay the loan and its current interest obligation so generally the creditors do appraise the performance of the company before lending money.

• To the Government: - To levy the taxes, estimate future revenues, granting aids, and sanctioning financial assistance and to frame the pricing policy Government appraises the performance.

• To the Society and Others:- Environmental obligations, employment opportunities and social welfare are the important parameters which is to be noted in performance appraisal by the stakeholders.

Financial statement analysis helps in making following useful analysis for the management as well as external users.

1) Inter Firm comparison: - It is a technique of Financial Statement analysis which represents comparative financial features of an enterprise. Under this method, some financial features of an enterprise are selected and then they are put in comparison to another similar enterprise.

2) Intra-Firm Comparison:- it is also known as Time Series Analysis. Under this technique, financial features of an enterprise are depicted and shown over a long period of time. It is a reflection of movement of various financial parameters in the long run.

N.L Hingorani and A.R Ramanathan “Management Accounting”, Sultan Chand & Sons, P No 92.

108
3) Cross sectional cum Time Series Analysis:- Under this technique, financial characteristics of two or more firms are compared for more than one accounting periods. This technique is considered more effective analysis of the financial statement because of presence of both comparative financial features of two or more firms.

4.8 Areas of performance appraisal

Performance appraisal is the critical assessment of various activities performed by a business enterprise in different areas of operations. The important areas are discussed as below.

1) Production: - Production is one of the most important areas of performance. The production data of the company may give an idea as to how the company has performed in the year under review as compared to the past or compared to other companies of the same industry.

2) Profitability: - The second important area of performance is the ability to earn profits. Measurement of profitability is the overall measure of performance. Profit is the motivating force between conducting a business. The importance of appraisal of profitability can be seen from the fact that besides the management and the owners of the company, bankers, financial institutions and creditors even layman also access the performance of the company on the basis of earning profits.

3) Working capital :- It is used for carrying out regular business purchase, raw materials, payment of wages, direct and indirect expenses, carrying on production, investment in stock, credit granted to customers and cash in hand. Appraisal of working capital performance indicates the adequacy of working capital in the enterprise and the efficiency of working capital.\(^9\)

4) Fixed assets:- Fixed assets are tangible assets of a relatively permanent nature that are used in business activities and not intended for sale. Fixed capital is a crucial component of working capital in the enterprise.\(^9\)

---

\(^9\) Lloyd R Amey, "Management Accounting", pp no 62

109
assets are those whose benefits which would be spread over a period of time. Analysis of fixed assets structure, average annual growth of fixed assets, and impact of gross block on sale and operating margin and efficiency of using assets is very important part of appraisal.  

5) Social contribution: - Value added is a basic and broad measure of judging the social contribution of an enterprise. It is a residual of sales after providing the cost of goods and services used in producing those sales. Appraisal of value added statement is also important.

4.9 Concept of Profitability

Profitability is an indication of the operating efficiency in terms of an adequate return on investment and efficient utilization of business enterprises. It also indicates creditworthiness of a concern. Thus profit is a measurement of performance evaluation of a firm form the various quarters by parties associated with the firm.

The prime objective of any business organization is to earn profit. Therefore, every activity of business concern is centered around profit. Moreover, the profit is a prime indicator of measurement of efficiency of management as well as the performance evaluation of a business enterprise. In the present day context the business concern must earn profit for survival growth and expansion. The concept of profitability may defined as the ability of a given investment to earn a return from its use. This ability is also referred as the “earning power” or “operating performance”.

Profitability is a relative term and its measurement which can be achieved by profit and its relation with the other objects by which the profit is affected.

As observed by Sam R Goodman, “Profit is a residual. It is a static historical term more geared to a reporting function than to decision making.” It is essentially an internal measure of new wealth creation.

10 Roger Hermanson “Accounting principles”, Business Publications, pp no 14
Rober Bayer and Donald J Trawicki have observed that “Segment profitability analysis implies segment revenues less segment cost.”  

In the words of F.P Langley, it can be said that “profit is not the surplus of receipts over payments, but the surplus of revenue over expenses.”

### 4.10 Types of Profit

**Accounting Profit:** - In accounting, the word “profit” is used for excess of total revenues over their total cost during a given period of time. The accounting profit is the difference between the current value of sales minus the historic cost of expenses plus the retained capital gains.

**Economic Profit:** - Economic profit is the residue of income after all the contractual and non contractual payments which has been made from the revenue realized during a given period of time. To determine economic profit, a competitive or normal rate of payment is subtracted from the profit for the period as determined by the accounting methods.

**Value Added Concept:** - Value added indicates the net value of wealth created by the manufacturing during a given period. It is a generation of wealth without which an enterprise fails to survive. It is a modern practice in western countries that their annual reports include value added statements. The value added amount is the excess of turnover (or sales revenue) over the cost of goods and services. It is the consideration of income from services, cost of goods bought into materials, the cost of services. Income from services includes reward for services in the form of dividends from it rent, compensation and miscellaneous income etc.

The term “cost of bought on materials” includes the Raw Material, stores, spares and containers consumed plus the purchase of finished goods. The cost of services includes the cost of procuring services like power and fuel, repairs and maintenance of machinery manufacturing and labour charges, laboratory and research expenses etc.

---

Employees cost includes salaries, wages, bonus and gratuity and contribution to Provident Fund and Welfare expenses.

4.11 Techniques of Financial Statement Analysis:-

The analysis and interpretation of Financial Statement is used to determine the financial position and as well as results of operation. A number of techniques or devices are used to study the relationship between data and different statements. The following methods are

1) Comparative financial statements
2) Common size statements
3) Trend Analysis
4) Fund Flow Analysis
5) Cash Flow analysis
6) Cost volume profit
7) Ratio analysis

1) **Comparative financial** statements are two or more Balance sheet or the income statement of a firm are presented simultaneously in columnar form. The financial data for two or more years are placed and presented in adjacent columns and thereby the financial data is provided in order to facilitate periodic comparison.

In comparative financial statements, the Balance sheet and Income statement are presented in condensed form from year to year comparison and to exhibit the magnitude and direction of changes. This kind of comparison would help the management to find out the series of a period which is more significant than the other period and that the accounts are well maintained.

**Comparative Balance sheet**: - The comparative Balance sheet is the study of the trend of the same items, group of items and computed items in two or more Balance sheet on the different dates. The changes in periodic Balance sheet
items reflect the business. The changes can be observed by comparison at the beginning and at the end of the year.\textsuperscript{16}

2) **Common size statement** :- The Common size statement are the statements that represent relationship of different items of a Financial statements with some common item by expressing each item are a percentage of common items. The common size statement are shown as percentages of total assets, total liabilities and total sales.

3) **Trend analysis**:- The financial statement may be analyzed by computing trend or series of information. This method evaluates the direction upward or downward and involves the computation of the percentage relationship that each statement bears to the same item in a base year. A trend analysis indicates the changes which have taken place from time to time in the individual items of assets, liabilities and net worth on the basis of some standard year.

4) **Fund Flow statement**: - In a statement which shows the inflow and outflow of funds during the year, the meaning of the word “Fund” is working capital. The objective of preparing such statement is to show to the management and other interested parties, what funds have come into business and how they have been applied. Fund Flow statement is a dynamic statement showing changes that have taken place during the year.

5) **Cash Flow statement**: - If the management is interested in the changes in cash inflow and outflow in the short run. It is a historical statement which indicates the cash inflows and outflows during the last year and would guide the management in framing policy regarding cash management.

6) **Ratio analysis**: - Ratio method is one of the most important tools of analysis of financial statements. The absolute and unconnected figures of financial statements do not reveal the efficiency of performance and are also

\textsuperscript{16} Ralph D Kennedy and Stewart McMullen, “Financial Statements- Forms, Analysis and Interpretation, 4\textsuperscript{th} Edition, pp no 27
misleading. The importance of the figures will be appreciated if they are related to some other figures therefore they are expressed in form of ratios.

A ratio is the relation between two figures and can be obtained by dividing the former by the latter. A financial ratio indicates the relationship between two sets of financial data and is used for evaluation of performance. Ratio is the most widely used tool. It is a tool which can be expressed in form of percentage, fraction and stated comparison between numbers.

The analysis of financial performance is being done by using the technique of ratio analysis. A ratio is defined as the indicated quotient of two mathematical expressions and the relationship between two or more things. In financial analysis, a ratio is used as a benchmark for evaluating the financial position and performance of a firm.

A ratio is simply one number expressed in terms of another. It is found be dividing one number, the base into other. The percentage is one kind of ratio in which the base is taken as equaling 100 and the quotient expressed as per hundred of the base.17

Ratios are simply means of highlighting in arithmetical terms the relationship between the figures drawn from financial statements.18

### 4.12 Technique of ratio analysis

The technique used for financial analysis is Ratio and this method has the following benefits:

1) The absolute accounting figures reported in the financial statements do not provide a meaningful understanding of the performance and financial position of a firm. An accounting figure conveys meaning when it is related to some other relevant figures.

2) It reflects the quantitative relationship to form a qualitative judgement.

---

18 Basic Business Finance, Hunt, Williams and Donaldson, pp No 138
3) It simplifies the comprehension of financial statements. It gives complete picture about the changes in activity and financial condition of business.

4) It helps in inter firm comparison.

5) The ratios when are compared with the norms and benchmarks of the companies would always provide solution to the problems.

6) It is the tool which provides the analyst with clues and symptoms of underlying conditions.

7) The ratio analysis can disclose relationship which reveals conditions and trends that may not be detected by the inspection of the individual components of the ratio.

8) It can be used as a tool of communication of what has happened to external parties.

9) Ratio helps in the objective of planning in business and can be related with the strengths and weaknesses of the firm.

10) Ratios between various financial and accounting data can be used as managerial tool for providing measurement of performance and for comparison against standards, goals and targets.

11) Any organization is always interrelated with the events of another area or firm. The summary result which is expressed by a ratio on the basis of comparison of two or more relevant data is more reliable.

12) Ratio analysis is the most popular and widely use cross sectional technique of financial statement analysis.

13) Business operations have critical aspects which would be better guided only through ratios.
14) Various ratios are the grass root evaluations of specific area in themselves. The combination of ratios selected for broad strategic activities of the business would lead to total integration which will give correct and comprehensive understanding of the situation in best possible decision making.

15) Management's continuous evaluation of various business activities requires verifying of the quantitative data relating to strategic as well as operational activities. Reference and use of the relevant ratios means continuous reading of the pulse of the business for due control of various activities of the organization.

16) It is an important dimension for sizing up a situation. It is the process of expression of one magnitude in terms of another. In prudent and critical dimensions of a business organization can be calculated to take stock of the situation, which is a reality and it would help in guiding prediction and economic decision making by the top management.

17) The ratio analysis helps in the strategic controllership function in the firm. Strategic planning involves setting down economic goals of the firm, both immediate and long range, considering various means by which goals can be achieved.

18) Careful framing of financial statements and implementation of sound ratio analysis and basic ratio of ROI which covers most of the areas of business activities as a tool of analysis can achieve excellence in financial performance.19

19) For the successful operation and industrial business enterprises, the fundamental, clear and definite understandings of the two sets of figures are positively essential. These are the position statement. Ratio analysis is a very

---

important tool in this context, which allows analysis and understanding of the message conveyed by mathematical figures.\textsuperscript{20}

20) The checking of progress of the company and monitoring of market value and book value of the share of the company and it is possible to predict probable failure and bankruptcy of the business.\textsuperscript{21}

**Ratios Interpretation**

**Table No 5.1 Balance Sheet**

<table>
<thead>
<tr>
<th>Capital + Liabilities or Sources of Funds</th>
<th>Assets or Application of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Share Capital</td>
<td>(6) Fixed Assets</td>
</tr>
<tr>
<td>(2) Resources &amp; Samples</td>
<td>(7) Investments</td>
</tr>
<tr>
<td>(3) Secured Loan</td>
<td>(8) Current Assets,</td>
</tr>
<tr>
<td>(4) Unsecured Loan</td>
<td>(9) Loans &amp; Advances</td>
</tr>
</tbody>
</table>

4.13 Balance sheet Ratios\textsuperscript{22}

(1) **Current Ratio:**

The Current ratio is a measure of the relationship of current assets to current liabilities. Basically it is a test of solvency of a company i.e., short-term financial strength of a company. The company should have adequate working Capital, i.e., short-term funds for carrying out its business operations effectively, because it indicates the ability of the business to meet immediate obligations as well as the capacity to carry out effective operations.


Normally, higher current ratio reflects the strong short-term position; but there is no rule that higher is the better. Therefore, current ratio has to be tested with other two ratios, i.e., Inventory or stock turnover ratio and Debtors Turnover ratio.

(2) **Quick Ratio:** (excluding stock):

This is the relationship between Quick Assets (Cash & Bank + Debtors + BR) and Quick liabilities (Credits + Bills payable + Provisions). This is a mere stringent test of liquidity position of the company. When Debtors + BR constitute more than 50% of current assets, this ratio is used. This is used with Debtors Turnover ratio.

(3) **Quick Ratio (excluding Debtors + BR):**

Again, when stock is more than 50% of current assets, this is used. This must be tested with stock turnover ratio.

(4) **Proprietary Ratio:**

This ratio reflects the capital structure of the company, i.e., how much financing is done through shareholder’s funds. So, this is a relationship between shareholder’s funds/Total Assets (Fixed Assets + Investment + Current Assets, Loans & Advances).

A very high ratio indicates safety of funds for the creditors, but also reflects a state of overcapitalization and inadequate use of external sources of funds which may lower the profit due to tax-shield available due to interest cost; at the same time external funds may be available at cheaper ratio.

Low ratio indicates under-capitalization & excessive use of borrowed funds which may cause a problem when sales are falling; or Gross Profit & Net Profit are declining, or lower fixed Assets turnover ratio.

---

23 Shashi Gupta & Sharma R.K "Financial Management", Theory and Practice, pp no 5.1-5.2
(5) **Stock-Working Capital Ratio:**

This expresses the relationship between stock and working capital (CA - CL). This is used to draw attention to the extent of stocks in the total working capital. It is necessary that working capital should not be locked up in the stocks especially when the stock turnover is low. So, higher the ratio, greater is the weakness of the working capital if the stock is slow-moving or obsoletes.

(6) **Debt/Equity Ratio:**

This ratio looks at the capital structure of the company; how the company has organized finance for doing business. It keeps on changing with overall economic situations, availability of funds from various sources, growth of business, boom or recession, etc. The generally accepted ratio is 2:1, i.e., a company can have debt of Rs. 2 against the equity of Rs.1. It is arrived as (3)+(4)/(1)+(2).

One cannot claim that higher Debt Equity Ratio is good or bad, but it depends on the condition of other ratios i.e if a company has a very high Debt Equity ratio, as 3:1 or 4:1, but at the same time, it has higher Interest Coverage Ratio, i.e. (Sales or Turnover/Interest) then, it has higher Fixed Assets Coverage Ratio, i.e. (Sales/Fixed Assets) and higher Return on Capital Employed, i.e. (Net Profit/(1)+(2)+(3)+4).

Debt Equity ratio has qualitative linkage with such other ratios, for example if there is higher Debt Equity ratio with lower interest coverage ratio, lower fixed assets turnover ratio, and lower Return on Capital Employed, then it all likely the company will be in trouble of sales decline in the coming future.

(7) **Long term Debt-Equity Ratio:**

The ratio reflects the debt structure in relation to equity generated for a longer period of time. The important aspect is effective servicing of the long term debt which can be assessed by Interest coverage, fixed Assets turnover and ROCE. If
both (1) & (2) above mentioned rating is in good combination auth these 3 ratios, then the capital structure is healthy & safer for investment point of view.

(8) **Current Ratio (excluding Debtors):**

This will be linked with Inventory Turnover Ratio. Higher ratio with higher inventory turnover is desired.

(9) **Inventory Turnover Ratio:**

This ratio measures the number of times the stock has been sold in a year (Sales/Average stock on hand) which means the stock has turned say, 10 times in a year. But it is very important to know the average length of time required for one turnover which can be obtained by -

\[
\frac{\text{No.of days}}{\text{Stock turnover rate}}
\]

= No of days of stock turnover

10) **Credit period (Debtors)**

This is also known as “Ratio of Net sales to Gross Receivables”. The main aim of this ratio is to ascertain after how much time the Debtors of the firm make payment. This ratio indicates upto what extent the debts have been collected in time. The higher average collection period will result in the blockage of funds with debtors.

4.14 **Profit & loss Account Ratios**

11) **Gross Profit (Margin) Ratio:**

This ratio is very significant because of competitive nature of industry. It is the relationship between (Gross Profit / Sales). Better ratio indicates efficient sourcing of material & other costs related to client.

---

24 Prasanna Chandra, “Financial Management”, pp No 41
12) **Profit before Interest/Taxes/Depreciation:**

This reflects the inherent capacity of the company to make Cash Profit before financial charges & taxes. This indicates profitability in true sense whether the company carries the ability to generate profit which is operating in nature.

13) **Return on Net Worth:**

This indicates financial reward on owned capital i.e., (Net Profit/ Share Capital + Reserves & Surplus). This reflects whether shareholders earn return on their investment as compared to other opportunities.

14) **Net Profit Ratio:**

This is Net profit as regard to Sales. The final surplus after all expenses is what is important to the owners. Hence higher return is always expected to increase profitability.

15) **EPS:**

Net Profit/Total no. of shares

This reflects what shareholders have earned. Higher EPS ensures better market value of shares in future.

16) **Dividend Payment:**

The dividend in relation to share capital reflects what is distributed to shareholders. This depends on the policy of the company.

17) **Advertisement to Total Cost:**

This reflects how advertisement as expenditure constitutes as a part of the total cost. This has to be read with percentage increase in sales then only, it would show the true picture.

18) **Interest Coverage Ratio** *(Debt service ratio/Fixed charges)*

This ratio is important from lender's point of view and it indicates weather the business can sufficient profits to pay periodically the interest charges on fixed or
long terms or debentures. Here “net income” stands for net income before charging income tax and interest on long term loans and debt service stands for interest on long term debts.

This ratio is computed as

\[
\text{Interest coverage ratio} = \frac{\text{Net Income before interest and tax}}{\text{Periodic Interest on long term debts}}
\]

19) **Retained Earnings to PAT**

This ratio indicates the relationship between profit after tax after payment of dividend and transfer to reserves and the profit after tax without adjustments.

It is an important ratio which shows how much profit the company has retained.

It can be computed by

\[
\text{Retained Earnings to PAT} = \frac{\text{PAT} - T/S \text{ to reserves}}{\text{PAT}} \times 100
\]

20) **Advertisement expenses to total sales**

This reflects the advertisement expenditure related to total sales of the company.

21) **Direct Cost to Total cost**

This ratio indicates the relationship of direct cost in comparison with the total cost. This ratio is important to know the composition of main cost of production, and conversely the margin. It also shows the proportion of other indirect expenses. Higher ratio indicates better situation.

22) **Indirect Cost to Total cost**

It is the composition of indirect cost in relation with the total cost. It includes the costs which are indirect in nature and is not directly related with the production process. Lower ratio indicates better situation.
23) Return on Capital employed

This is the basic ratio of profitability. It is also known as “Net Profit on Capital employed”. It is calculated by establishing the relationship between the total profits earned and the capital employed. It is an indicator of the earning capacity of the capital invested in the business. Capital employed is the total sum of share capital, reserves and balance of profit. Higher ratio indicates favorable situation.

24) Fixed Assets turnover

Fixed Assets Turnover ratio is calculated to determine whether investment decision has been good or bad in the sense of their efficient utilization. A high ratio will show that the concern is over trading on its assets, while a low ratio will include that excessive investment have been made in fixed assets. It may noted that fixed assets are taken at written down value to avoid the effect of depreciation.

25) Debtors turnover

The Debtors Turnover ratio indicates the speed within which the debtors/accounts receivable are being collected. This ratio indicates up to what extent the debts have been collected in time. This ratio is helpful to the money lenders for calculating the average collection period.

26) Book value

The Book value per share indicates that the company has well defined policies in the terms of capital management. It is calculated by the book value of a company divided by the number of shares outstanding.

27) Breakeven point

The break-even point (BEP) is the point at which cost or expenses and revenue are equal: there is no net loss or gain, and one has "broken even". A profit or a loss has not been made, although opportunity costs have been paid, and capital
has received the risk-adjusted, expected return. The breakeven point is also the point on a chart indicating the time when something has broken even, and is a general term for not having gained or lost something in a process.

28) **Margin of safety**

Margin of safety represents the strength of the business. It enables a business to know what is the exact amount has been gained or lost and whether they are over or below the breakeven point.

\[
\text{Margin of safety} = (\text{current output} - \text{breakeven output})
\]

29) **Debtors to working capital**

The term Working capital is also known as "WC", is a financial metric which represents operating liquidity available to a business. It is important to know what are the current assets and current liabilities position of the company and that is reflected through the calculation of debtors to working capital.

30) **Net profit growth rate**

Net profit is equal to the gross profit minus overheads minus interest payable plus/minus one off items for a given time period. Net profit growth rate indicates that weather the profit has shown a substantial increase or decrease in the coming years.

31) **Sales to capital employed**

Sales to capital employed indicate the comparison between sales and the capital employed in the business. It is a ratio which could give some insight into the way a company is utilizing its assets. It shows the company has a tendency of paying good dividends (Dividend Policy).