Standards for Comparison under Ratio Analysis

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A number of financial tools have come into existence for the analysis of financial statements. Financial statement analysis means a meaningful study of the financial statements, the balance sheet and the profit and loss account, relating to a period of an industry, to ascertain the prevailing state of affairs and reasons therefor. It is not enough to say that firm A is more profitable than firm B; one must also be able to say the causes and factors that are probably responsible for this. The object of the financial statement analysis is of great importance; for example, one's approach to comparison of two firms will be different from the approach of assessing profitability of investment in a firm.

Standards are creatures of experiences, which are modified from time to time to meet changing conditions; they are an ideal or an average or normal results to be attained under certain conditions. Because of the changing nature of standards, constant acquaintance with the conditions under which they are set up is essential so that causes of variations from the standard can be intelligently appreciated. Standard ratios provide a bench – mark against which actual ratios can be compared. The significance of a ratio calculated can be grasped only after it is compared with the ratio. For this purpose four types of standards are employed:-

(a) Absolute standards: - These ratios are determined by the rule of thumb. For example, in the case of current ratio 2:1 is considered to be desirable. This type of standards are those which become generally recognised as being desirable regardless of the company, its type, the time, stage of the business cycles, or the objectives of the analyst. "The absolute standard is the weakest of all, for it suggests the existence of some inherent trait common to all business, which is generally far from the case,"[1]

(b)Historical standards: - These are the past ratios of the company. Present performance can be judged on the basis of past performance and the persons concerned can draw inferences about the improvement or otherwise of the particular aspect. Comparison with historical standards is also known as "Trend Analysis". For this purpose, the trends rather than the actual ratios are important. Hence the behaviour of the ratios over a period is observed. By presenting a picture of operations over an extended time, trend – analysis of ratios becomes a valuable tool for the financial manager. The trend of the ratios indicates whether the concern has been moving in the direction in which it is tending to go, e. g., for measuring the rate of turnover, the ratio may be computed weekly or monthly and the points plotted on a graph to show the trend of the rate of turnover. However, it is not satisfactory from the standard point of view. It can merely compare the present efficiency with the efficiency of the past.

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[1] Howard, Bion B. and Upton, Miller. "Introduction to Business finance", Megrow – Hill Book Company, Inc., New York, 1953, p. 130

Horizontal standards: - These are the average ratios calculated for the entire industry or the ratios of some other firm engaged in the same line, i. e., Inter–Firm Comparison "Comparison can also be made against the achievements of other business where available. It is difficult to be sure that such comparison are on a like for like basis, even if operating in a similar market or industry, partly as to the comparison of profit, but more particularly concerning the scope of the business under comparison."[2] However, the difficulty in using such ratios is that no two firms are similar in size, accounting policies and corporate objectives. So, naturally there will be significant difference between the standard opted and the actual ratio. The ratios calculated for the industry as a whole provide a satisfactory standard to judge and interpret the ratios of the individual firm.

Budgeted standards: - These standards are based on budgeted figures. The actual ratios are compared with budgeted ratios and are, therefore, useful for the internal management as a tool of performance and evaluation and control. The utility even for the internal analyst depends much upon the care with which budgets are drawn up. Sometimes the assumptions made at the time of preparing the budget may go wrong because of abnormal developments. External analysts usually look to historical and / or horizontal standards.

It can be concluded that ratios themselves do not directly answer the important questions about the firm. Instead they simply are relationship that, when compared to a standard of performance, identify difference or variations. Such difference can lead to understanding that brings forth changed performance. "Again as a matter of perspective, remember that the manager uses financial statements mainly to locate problems and issues that need managerial attention. And the alert manager is interested in developing and establishing valuable and realistic standards against which ratios can be measured"[3].

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[2] Hingely, Wilfred, "Finance Management Made Simple", W. H. Allen & Company Ltd., London, 1978, p. 145