PDF - FINANCIAL RATIOS AS AN AID TO MANAGEMENT DECISION MAKING - researchcub.info

## 1.1 FINANICAL STATEMENT ANALYSIS

Financial statement analysis consists of applying analyst tools and techniques to financial statement and other relevant data to obtain to useful information. This information is shown as significant relationship between data and trends in those data assessing the company's past performance and current position. The information shows the results or consequence of prior management decision. In addition, the information is used to make prediction that may have a direct effect on decision made by many users of financial statement.

Business entities may have objects and goals. However, the two primary objectives of every business are solvency and profitability, solvency is the ability to pay debts as the become due, profit ability is the ability to generate income unless a business can produce satisfactory income and pay its debts is they become due, other objective a business may have will never be realized simply because the business will not survive.

The financial statement that reflects a company solvency is the balance sheet the financial statement reflecting the company's profitability is the income statement. The balance sheet, sometimes called the statement of financial position lists the company assets and liabilities and stockholders equity as of a specific moment in time. It captures the financial position of a company at a particular point in time.

The income statement, sometimes called an earning statement, reports the profitability of a business organization for a statement period of time profitability is measured for period of time, by comparing the revenues generated with the expenses incurred to produce these revenues.

Present company investors and potential company to earn profits its profitability. These investors wish to predict future dividends and changes in the market price of the company common stock.

Since both dividends and price changes are likely to be influenced by earnings, investors may seek to predict earning. The company's past earning record is the logical starting point in predicting future earning.

Sometime, outside parties are interest in predicting a company's solvency rather than its profitability short – term solvency is affected. By the liquidity of the company. Liquidity is the state of possessing liquid assets such as cash and other assets that will soon be converted into cash.

Several types of analysis can be performed on a company financial statement.

All these analyses rely on comparison or relation hips of data because comparison enhance the utility, or practical value of accounting information for instance knowing that a company's net income last year was #100,000 is not very useful information. Some usefulness is added when it is known that the prior year's net income was #25,000. And even more useful information is gained if the amounts of sales and assets of the company are known. Such comparison or relationship may be expressed as:

- Absolute increases and decreases for an item from one period to the other
- Percentage increase and decreases for an item one period to the other
- Trend percentages
- Percentage or single items to an aggregate total
- Ratios

## 1.2 RATIO ANALYSIS

A ratio is the relationship between two amount that result from dividng one by the other. The ratio of 1, 00 to 500 would be 1,000 / 500 = 2, sometimes expressed as 2:1. This means that the first number is twice as large as the second.

Financial ratios become relevant fro decision – making only when compared with some standard. Each analyst must decide upon to gauge the performance of the company being analyzed. Some common bases for establishing standard are considered below:

**Company history**

Horizontal analysis has been defined as comparing financial statement and trend analysis were presented as application of horizontal analysis. Each of the financial ratios may be computed for a number of years and then compared to form an opinion about whether the company's performance is getting better or worse. If management inefficiency seems to be the only plausible explanation, the analyst may expect continued problem that could lead to a decision or reject a credit application or not to invest in stock of the corporation.

**External standard**

Ratios information about other companies is often used as a yardstick against which to examine data on industry, norms, average ratios, and credit rating from credit agencies such as dun and Bradstreet or by consulting statistics available investment service publication such as annual statement studies published by Robert Murnks association.

Care must be taken in deciding whether ratios are to e used as standard of comparison. Many companies are so diversified that 4 is difficult to identify one particular industry in which they operate. A current ratio or inventory turnover ratio for such conglomerate would be meaningless for comparing with those statistics of another firm operating in only one industry.

The difference in accounting methods employed in generating financial information may also influence the comparability of ratios and other statistic among the different principles that firms may employ are different inventory techniques, depreciation methods;

- estimates of useful lives
- Method of accounting for income, taxes
- Revenue recognition procedures

In other words logical relationship exist between certain accounts or items in a company financial statement these accounts may appear on the same statement or they may appear on two different statement. The dollar amount of the related accounts or item at set up in fractions form and called ratios. The se ratios can be broadly classified as:

- Liquidity ratios
- Equity, or long – term solvency, ratios
- Profitably tests
- Market test

**Liquidity ratios**

These are used to indicate a company's short term debt – paying ability. Thus, these ratios are designed to show interested parties the company's capacity to meet maturing current liabilities. They are sub divided into current ratio and acid test or quick ratio.

## FINANCIAL RATIOS AS AN AID TO MANAGEMENT DECISION MAKING