Financial Statement and Ratio Analysis for Business Decisions

Posted on September 22, 2018

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Executive Summary

This paper is in the form of an essay that enlists the ratio and financial statement analysis of companies. Ratio analysis is important for a company to analyze its strengths and weaknesses from the past and future. Moreover, the financial statements of companies are also discussed in the essay, which helps in making financial decisions for the company. Limitations and advantages are also discussed in the study, which explains the need and challenges to be kept in line by companies.

Ratio Analysis:

Ratio analysis is a form of analysis that is used to get a rapid indication of a company's financial performance in various key areas. These ratios are further divided into solvency ratios, profitability ratios, liquidity ratios, efficiency ratios, coverage ratios, and market prospect ratios (Al-Nimer & Sleihat, 2015). These ratios are also further divided into subcategories, which help in making assumptions about the financial condition of a company in the present and in the future. For companies, ratio analysis is selected as the first step for making assumptions only, and it is not effective in the long term. It can also help the company compare its financial performance with that of the industry and its competitors. These ratios give an overview to the directors of the company, where the company has done well, and where improvement is needed.

Data included in the ratio analysis is usually taken from the historical financial resources of the company, which makes it easy for the management to get assumptions from it and improve in the area that is not doing well.

Liquidity ratios help a company calculate its ability to pay short-term debts, which come from the quick or current assets. Companies use liquidity ratios to examine the concerns that indicate the positioning of cash flows (Al-Nimer & Sleihat, 2015). This type of ratio is calculated internally or externally based on the type of organization. It is usually in a comparison, which includes the previous statements and the current operations of the company. Ultimately, it helps make assumptions that the company was performing better in the past or present (Al-Nimer & Sleihat, 2015). A higher liquidity ratio indicates that a firm has more capability to cover its short-term outstanding debts.

Externally, companies compare themselves with their competitors in an industry. Based on the results, companies try to make strategic decisions comparing their competitors. Liquidity ratios can be measured from the current ratio, working capital ratio, and quick ratio.

The solvency ratio helps a company to measure whether the firm's cash flow is good enough to cover its short and long-term liabilities. The solvency ratio compares the liability levels with the equity, assets, and earnings of a company to measure whether the company can pay off its short and long-term debts or not (Al-Nimer & Sleihat, 2015). A lower solvency ratio indicates that the company has enough cash flow to cover its debt obligations. The solvency ratio can be measured using the debt-to-equity ratio, debt-to-asset ratio, and interest coverage ratio. Instead of calculating the income of a company, the solvency ratio measures the cash flow of a company, which gives an overview to the management of how much cash flow they have and what they will earn after paying their long/short-term debts (Al-Nimer & Sleihat, 2015).

Profitability ratios tell a company how well they can gain profit from the operations. It helps a company to analyze how much they can gain from the operations of the company, compared to the expenses incurred over a certain period of time (Saleem & Rehman, 2011). profitability ratio can be measured using Return on Assets (ROA) and profit margin ratio. A good profitability ratio must be higher, which shows that the company is earning more than the expenses incurred by the company. This ratio also compares with the competitors' earnings to analyze where the company lies compared to the competitors of the industry (Saleem & Rehman, 2011). A lower ratio will ultimately mean that the firm does not earn so well and needs to make adjustments in its operations.

The efficiency ratio helps a company to measure how well they utilize their assets and liabilities to increase sales and profit margin. It analyzes a firm's short-term or current performance by managing its assets and liabilities. A lower efficiency ratio indicates that the company has fewer costs applied to its assets and liabilities, and the company is selling much more than that. The efficiency ratio can be measured using A/R turnover, sales to inventory, sales to net working capital, accounts payable to sales, and stock turnover ratio (Saleem & Rehman, 2011).

Then, there are coverage ratios, which tell the ability of a company to pay its interest in the market and other financial implications. Using coverage ratios in the financial report can tell about the level of the company's commitment to paying the interest, which is mandatory for the company (Siddiqui et al., 2016). However, a higher coverage ratio is meant to be beneficial in terms of paying loans and interest to their lenders. Looking into the company's financial statements, one can identify how much interest is payable at a given time. Coverage ratios include Interest coverage ratio (the ability of a company to pay interest expense on its debt), debt service coverage ratio (the ability of a company to pay its entire liability), and asset coverage ratio (the ability of a company to pay off its debt service in terms of the balance sheet).

The market prospect ratio is used to measure the amount/of cash that a company expects to receive from its investments. It can be a dividend yield, shares in a corporation, stocks acquired by a

company, and the stock price. Simply, it helps to examine what a company will get from its investment. It gives the directors an idea of how much the stock price will be in the future based on the current investments. A higher market prospect ratio means that the company will get higher returns from its investments in the future (Siddiqui et al., 2016).

All these ratios serve the same purpose for the company. It depends upon the company to choose which ratio they want to use in given circumstances. Using ratio analysis in a company helps them to identify their financial position, that is where our company is standing as compared to the competitors. It also helps in making investment decisions in the future and analyzing how much the company should invest and what it will get in the future. Doing a ratio analysis helps a company to make an evaluation of the accounting figures, which can deviate from each financial term (Siddiqui et al., 2016). It also helps in making efficient operational analyses of whether the company is making positive operations or not. The values of these ratios (higher or lower) help to make assumptions about the future of the company. Most importantly, it helps forecast the company's entire growth and the ability to respond to external factors in the market (Siddiqui et al., 2016). By forecasting, a lot of errors regarding the company's financial statements are eliminated.

Financial Statement Analysis:

Financial statement analysis is a procedure of analyzing and evaluating a firm's balance sheet or profit and loss statements. This analysis is done to review the financial health of a company and, in return, make more effective decisions for the company (Grant, 2016). These analyses record the company's data to make a company more beneficial to their stakeholders, shareholders, managers, and investors.

Implementing financial statement analysis helps a company to establish trends by comparing the ratios in different time periods of the company. What was the company doing in the past, and what is it doing in the present? The analysis, as a result, helps to measure the profits, liquidity, and cash flow of the company (Grant, 2016). Financial statements include a balance sheet, income statement, and cash flow statement. The balance sheet is a detail of a company's assets, liabilities, and shareholders equity. The total assets and total liabilities (including shareholders' equity) should be equal in amount, otherwise it means the company is not managing its operation in terms of assets and liabilities.

The income statement gives an overview of the company's sales and ends up showing the company's net income. It gives values of gross profit, net profit, and operating profit to do analysis in the future (Wahlen, Baginski & Bradshaw, 2014). The cash flow statement gives an overview of a company's cash flow in terms of its operating, investing, and financing activities throughout the year. The values provide the description of what the company has been investing in its operations, finances, and investments.

There are always some limitations to using this analysis, which can be vital in decision-making for the company. Researchers might take values from previous statements that are not current values and make assumptions about them, which can lead to disruptive results (Wahlen, Baginski & Bradshaw, 2014). Keeping in mind the sales of the company, the same issue can occur there as well, and the sales area always fluctuates in the company. Most importantly, it gives a budget outline to the company for its future, including what it has on hand and what can be utilized from it (Bruce-Twum & Mensah, 2015). Making forecasting on the financial reports will ultimately help the company to be more productive and operational in the practical environment. Along with these analyses, it also helps a company to create opportunities for improvement in the area that is not of great interest to the company.

Conclusion

Relating to real-life scenarios, this analysis can be beneficial for the banking, logistics, and commercial sectors. Multinational firms can also gain a lot of advantages in their processes as this analysis can make a huge impact on the internal and external aspects of the company. Companies should use these ratios and financial statements on an annual or semi-annual basis to make sure that their operations and financials are in line, and if there is any need for improvement, it should be catered on time.

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