FINANCIAL RATIO ANALYSIS: TOOLS USED TO EVALUATE FINANCIAL PERFORMANCE

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All organizations that are established have the intention of achieving their respective objectives. The greatness of an organization can be determined by periodically reviewing its performance. Parties interested in evaluating financial performance, business expansion, and planning for the future should consider the importance of financial statement analysis. Understanding financial ratios and using them to evaluate financial statements can provide valuable insights into the state of a company's finances, as well as the profitability of past investments. The significance of these insights for effective management cannot be overstated, as the financial health and profitability of a company are crucial for its long-term success (Fan & Loang, 2023).

Both internal and external stakeholders examine its financial statements to understand how a company is performing. Examining four crucial financial statements for a corporation; company's annual report, statements of financial position, statement of profit or loss, and cash flow statement are part of the method that attracts the most attention. A financial performance analysis calculates specific financial formulas and ratios provide insight into a company's financial position and performance compared to historical and industry-specific ratios. Financial ratio analysis is one of the best tools of performance evaluation of any company (Oshoke & Sumaina, 2015).

A ratio is a mathematical calculation that refers to the relationship of two or more numbers and is translated into inflection form, percentage, and how many times. When a number is calculated based on two figures taken from the financial statements, it is termed as a financial ratio (Kishori & Sija Mol, 2018). Analysis of financial ratios is the most popular and widely used method because it can be used as a data source for complex mathematical models (Myšková & Hájek, 2017).

This article was written based on a collaborative teaching session that was held during Accounting Global Week 2023, organized by the Faculty of Accountancy, Universiti Teknologi MARA Perlis Branch, in May 2023. Evaluating financial performance using financial ratios is one of the topics in the Introduction to Financial Accounting (ACC117) course for non-accounting students. The first session is conducted by Mrs. Anisa Fitri Sya'bania, who introduces financial statement analysis and types of ratio analysis. The second session is delivered by Mrs. Alfurkaniati, who focuses on the preparation and interpretation of financial ratios and their limitations.

The goals of financial statement analysis include identifying a company's strengths and shortcomings, offering them the tools they need to address any problems, and allowing them the chance to improve their overall financial status in the future. The ratios discussed in this collaborative teaching session have been classified into three categories, namely liquidity, efficiency, and profitability.

1. Liquidity ratios

The term liquidity is basically a technique that is used by an organization to convert its current assets into cash. Whenever a firm or organization needs to meet its financial obligations, it converts its current assets into cash to pay the due liabilities at maturity date (Malik, Awais & Khursheed, 2016). The purpose of these ratios is to gauge a company's capacity to pay short-term debts as they fall due.

i. Current ratio

Formula

Current ratio = <u>Current Assets</u> Current Liabilities

Given the structure of the ratio, with assets on top and liabilities on the bottom, ratios above 1.0 are sought after. A ratio of 1 means that a company can exactly pay off all its current liabilities with its current assets. A ratio of less than 1 (e.g., 0.75) would imply that a company is not able to satisfy its current liabilities.

A ratio greater than 1 (e.g., 2.0) would imply that a company is able to satisfy its current bills. In fact, a ratio of 2.0 means that a company can cover its current liabilities two times over. A ratio of 3.0 would mean they could cover their current liabilities three times over, and so forth (CFI Team, 2023)

ii. Acid test / quick ratio

Formula

Acid-Test Ratio = <u>Current Assets-Inventories – Prepayments</u> Current Liabilities

The acid-test ratio is also known as the quick ratio. It shows the company's ability to immediately cover its present liabilities with its most liquid assets, or assets that can be quickly converted into cash.

The better the ratio result, the more stable the business's finances will be. For instance, a quick ratio of 1.6 means that a company has RM1.60 in liquid assets on hand to cover every RM1 in current liabilities. If a company's quick ratio is less than 1, it might not be able to cover all of its short-term obligations.

2. Efficiency ratios

An efficiency ratio is a metric that enables business leaders to measure how well a company uses its resources. Managers may use these ratios to gain insights into where they can improve operational, asset management and other business practices. Experts sometimes also use the term "activity ratio" instead of efficiency ratio (Luther, 2022). If the company have more assets than that suitable and not many costs that need to be borne, then profit will be produced. On the other hand, if the company may have few assets, there is a possibility that his income will be lost (Baran, 2015).

i. Inventory turnover ratio

Formula

Inventory turnover = $\frac{\text{Cost of goods sold}}{\text{Average inventory}}$

Inventory turnover is a ratio that shows how frequently a business sells and replaces its inventory over a specific time period. The cost of sales is divided by the average inventory to determine inventory turnover. The formula for computing the average inventory is (opening inventory + closing inventory) / 2. High inventory turnover typically indicates a strong state of sales. It shows that the company is selling its goods promptly. A rate of 1 or less indicates excess inventory in the business and a risky cash flow situation.

ii. Average collection period

Formula

Average collection period = <u>Accounts receivable</u> x 365 days Credit Sales

It reflects the period of time a company commits to taking to get money from its debtors or accounts receivable. The shorter the time frame, the better it is for the company's liquidity. The company could not have adequate cash resources to run if debts were not paid on time. For example, when a company's average collection period is 35, it means that it takes that long for its customers to pay their debts. The company's liquidity position improves with a shorter average collection period. If the debts are not paid off in a timely manner, the business won't have the resources to continue operating.

3. Profitability ratios

Profitability ratio analysis is used to measure and evaluate a company's ability to generate revenue relative to its assets, operating costs, and shareholders' equity. Higher ratio results are often more favorable because the company is generating enough revenue, profit, and cash flow (Prabhakar, & Japee, 2023).

i. Gross profit margin

Formula

Gross Profit Margin = <u>Gross profit</u> x 100% Sales It is frequently expressed as a percentage of net sales for the gross profit. Net sales less the cost of goods sold represent a company's gross profit. The gross profit margin displays the amount of profit made by a company before deducting its administrative, distribution, finance, and other operational costs. This profit is made after paying off the cost of the products sold.

A higher ratio is preferable. For instance, if the estimated gross profit ratio is 30%, that implies that for every RM100 in sales, RM70 would be allocated to the cost of products sold, and the leftover RM30 would be kept and may be applied to the settlement of operational costs.

ii. Net profit margin

Formula

Net Profit Margin = = $\frac{\text{Net profit}}{\text{Sales}} \times 100\%$

The amount of net profit an organization generates from sales revenue is measured as its net profit margin. Investors can use this information to determine how effectively a business is managing its operating and overhead costs by seeing how much of each revenue source is kept by the company after all expenses have been paid.

The cost of goods sold, operating costs, and other costs should be subtracted from the net sales to get the net profit. The ratio is calculated by dividing the outcome by net sales and multiplying the result by 100 to get the percentage. If the net profit of 20% shows that at every RM100 sales, the company earns a net profit of RM20 after deducting all the operating and non-operating expenses

A high financial state is indicated by a positive net profit margin. A high profit margin is frequently a sign of effective operation management, minimal costs, and effective pricing techniques. While a low net profit margin indicates a subpar pricing strategy and an ineffective cost structure. The net profit of the organization decreases will bring bad effects for the company (Pancha & Tagariya, 2016).

iii. Return on investment (ROI)

Formula

ROI = <u>Net profit</u> x 100% Total assets – Total current liabilities

Or

ROI = Net income x 100%Investment

Return on investment (ROI) is a financial ratio used to calculate the benefit an investor will receive in relation to their investment cost. It is most commonly measured as net income divided by the original capital cost of the investment. The higher the ratio, the greater the benefit earned (Vipond, 2023). If a return on assets of 25% means that for every RM100 invested in assets, the company made RM25.The better a corporation uses its assets to make money, the greater its return on asset.

Nevertheless, there is a limitation to the use of financial ratio analysis. The analysis of financial ratio is quantitative rather than qualitative. It, therefore, does not address certain factors that may play a major role in determining a company's prospects. For example, it cannot analyze the quality of their management. As a result, even though financial ratio analysis is incredibly important, it only provides quantitative information (Horsfall, 2023).

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