THE USEFULNESS OF FINANCIAL RATIOS IN PREDICTING COMPANIES FAILURE.

(A CASE STUDY OF FIVE COMPANIES).

A paper submitted to the School of Accountancy, MARA Institute of Technology in partial fulfillment of the requirement for Advanced Diploma in Accountancy.

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PREFACE.

Financial statement analysis was developed at the end of the nineteenth century. Its main purpose at that time was to evaluate the solvency position of prospective borrowers. Shortly afterwards the first efforts were made to design models to predict companies failure.

The ability to predict company failure is important from both the private and social points of view, since failure is obviously an indication of resource misallocation. An early warning signal of probable failure will enable both management and investors to take appropriate steps such as;-

i. Changes in their operating policies

ii. Reorganization of their financial structure

Therefore it will improve both private and social resource allocation.

Financial ratios are usually viewed as indicators of a company deficiencies, such as poor liquidity or low profitability. Note that financial ratios are not intended to provide definite answers. Ratios are therefore symptoms of the company's economic condition intended to guide the analyst in his financial investigation.

CHAPTER 1

1.0 INTRODUCTION

1.1 An Overview Of Ratio Analysis.

What is the basis of knowing whether a company is performing well or otherwise?. Management must constantly evaluate its financial statements to ensure that the business uses its resources effectively. Financial statements alone may not be able to provide all the information needed. A common approach to evaluate company performance is by performing financial ratios analysis.

Financial ratio analysis is the systematic use of ratios to interpret financial statements so that the existing strengths and weaknesses of a company as well as its historical performance and current financial condition can be determined. This can be achieved by using the information from financial statements to obtain a set of indices or percentage values which will form the basic tools for measuring different aspects of a company's activities.