Dimension and importance of ratio analysis through financial statements as a reliable basis for future of business entities

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***Abstract*- Today's needs for precise planning and decision making are very crucial.**

Therefore, the application of the analysis is inevitable.

The application of the analysis will first examine and explain the results presented in the financial statements.

Hence, we will see the data which will confirm the financial strength of the business entity which has been the subject of analysis. Namely, for the realization of the effects achieved with building business plans, are used ratio indicators which are the centre and also the derive source for developing ideas.

It follows that the applied analysis with ratio indicators tends to give us a reference how and where to direct ourselves in creating business policy, and to enable us to access the results of operations.

Despite these conclusions we can say that the results obtained through the financial statements would be even better perceived through individual observations by ratio analysis.

The theory shows that the analytical indicators represent implicit part in the analysis of financial statements.

From here, we will rightly say that the analytical and applied indicators represent a focus in management and economic performance.

Keywords: ratio analysis, financial statements, analytical indicators, management, economic performance, dimension.

I. Application of Analytical Procedures

Data accounting has a key role in determining the company's value and specificity.

Today, almost all companies are recognizing the quality of work and the evaluation of results provided by using a special ratio analysis.

Everyday, we make ratio of the various prices of the products which we buy.

In business, making ratio before taking any decision is inevitable.

Namely, we need to do the first step, and it is a ratio analysis, that should be used in financial analysis, to get a quick indication of the firm's performance and to identify the areas that need to be explored further.

These indicators result from the balance sheet and income statement, as well as other types of reports from the set of financial statements prepared for the fiscal year. Different ratio coefficients provide a variety of benefits. Their assessment allows us to see how the business entity is running. In fact, in anticipation of the events we have more factors that condition the expected results.

Therefore, in practice, we must know as many indicators as possible which will give us a foundation for further comparison of these results with the results of other similar or the same companies.

II. Ratio Analysis – Financial Statements

If we consider an investment, we need to have the money, time and reliable basis. To have a reliable basis we need to calculate certain ratio indicators. What we need is to know the revenue, costs and capital. We also need the type of information that will be used in ratio analysis. Inn this paper we give several examples of ratio indicators of current liquidity, profitability and efficiency.

III. Liquidity Analysis Ratios

Current Ratio

It should be emphasized that the current liquidity is closely dependent on the availability of current assets. Current ratio measures the ability of a company to repay its short-term debts and meet the unexpected cash needs. Quite logically, because current assets such as qualities during continuous work are represented in money that will later be converted into cash payment. The base for determining the current liquidity ratio is the amount of current capital. The current ratio is calculated by dividing current assets by current liabilities.

Current Ratio (Current liquidity ratio) will be obtained from the following relation:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{2.450.000}{850.000} = 2.8$$

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = \frac{900.000}{850.000} = 1.05$$

Quick Assets = Current Assets – Inventories

IV. Effective Liquidity Ratio

Effective Ratio

Effective liquidity ratio is a measure of how many times receivables are traded; a business entity transformed its funds during the year.

As the most sensitive position in the calculation of this analytical account indicator are: receivables and these are accounted differentiated: country receivables and advances to customers abroad.

Therefore, the calculation of the effective liquidity ratio practice can be quantified according to the origin of such claims: the country's trade receivables and trade receivables from abroad.

$$\text{Effective Ratio (Turnover of trade receivables at home and abroad)} = \frac{\text{Amount of total sales}}{\text{Average balance of accounts: Receivables from customers in the country and abroad}} = \frac{6.370.000}{980.000} = 6.5$$

Appropriate for the overall effective liquidity ratio, however, in practice, indicators for effective liquidity should be calculated and separately by origin of sale (realization), that is realized in the domestic and foreign market, and also according to the nature of the requirements of the customers in the country and abroad.

V. Profitability Analysis Ratios

Profit Margin

This ratio is used to consider the operational efficiency of the business entity.

Namely, according to the data given in the final report of profit or loss, marginal profit is determined when the operating income in the amount of € 3.000.000, is divided by the amount of sales of 34.000.000 euros.

It is calculated by dividing net income by net sales.

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Sales}} = \frac{3.000.000}{34.000.000} = 8.82$$

VI. Return on Assets (ROA)

Furthermore, this ratio is necessary and together with the return on assets ratio (ROA) is considered an overall measure of profitability. ROA indicator is calculated directly from the financial statements. It measures how much net income was generated for each €1 of assets the company has. ROA is a combination of the profit margin ratio and the asset turnover ratio. It can be calculated separately by dividing net income by average total assets or by multiplying the profit margin ratio times the asset turnover ratio.

$$\text{Return of Assets (ROA)} = \frac{\text{Net Income}}{\text{Average Total Assets}} = \frac{140.000}{1.200.000} = 11.6$$

Thus higher values of return on assets show that business is more profitable. This ratio should be only used to compare companies in the same industry. The reason for this is that companies in some industries are most asset-insensitive i.e. they need expensive plant and equipment to generate income compared to others. Their ROA will naturally be lower than the ROA of companies which are low asset-insensitive. An increasing trend of ROA indicates that the profitability of the company is improving. Conversely, a decreasing trend means that profitability is deteriorating.

VII. Return on Equity (ROE)

Today, for the business entities one of the most important profitability ratios is return on equity (ROE). This indicator is calculated directly from the financial statements. Return on equity reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. Shareholder equity is equal to total assets minus total liabilities.

$$\text{Return of Equity (ROE)} = \frac{\text{Net Income}}{\text{Average Stockholders Equity}} = \frac{140.000}{720.000} = 19.4$$

ROE is more than a measure of profit; it's a measure of efficiency. A rising ROE suggests that a company is increasing its ability to generate profit without needing as much capital. Actually, it indicates how well a company's management is deploying the shareholders' capital. In other words, the higher the ROE the better. Decreasing ROE is usually a problem.

VIII. Conclusion

A. *Advantages*

Using accounting data is a base that will allow us to calculate the performance of other companies, and in our company, to calculate more ratios (growth trend, increasing efficiency, some increases that give us parcelled data on which we may put theses and plans).

B. *Calculation of Data*

Ratio analysis calculates comparative advantages by obtaining data from the financial statements (balance sheet and income statement).

C. *Limitations*

Ratio analysis is a necessity, but in its application there are certain limitations.

The calculation of ratio coefficients calculated is made in order to find more precise information, but the reliability is not 100%.

All formulas and equations should be comparable to others that are based on industry standards.

D. *Internal Usage for Ratio Analysis*

Ratio analysis used by managers for measuring the overall health of a company or business unit.

These coefficients can be calculated and checked, and then measured again for the past years to determine whether there is opportunity for growth. Companies also use the information for comparison.

E. *Making Company-Level Comparisons Using Ratio Analysis*

The external use of ratio analysis is widespread. Although these procedures do not tell the whole truth, but without some significant deviations from industry standards they can normally predict growth and decline.

Financial analysts and individual investors use calculations to determine the ground state of the business.

At the very end, we can conclude that any financial indicator itself is not a good basis for assessing the financial performance of the company**.**

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