RATIO ANALYSIS AS A CORPORATE PERFORMANCE MEASURING TOOL

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ABSTRACT

The paper examined the importance of ratio analysis to corporate entities by showing its contributions in the performance of companies. The effectiveness of ratio analysis was also examined. Secondary data were used for the analysis. The data were extracted from the financial statements of Zenith Bank Plc within the range of twelve (12) years (2000 -2011). The following ratios were calculated for the company and were used for the analysis: Total Debt Ratio, Return on Equity Ratio, Cash Ratio, Earnings per Share ratio and Dividend per share ratio. Simple percentage increments were also estimated on each of the indices mentioned in a tabulated form. It was found out that the use of ratio analysis by the firm has really assisted it in making meaningful comparison and taking appropriate decisions for improvement. Hence ratio analysis has served as a veritable tool for measuring the company's performance.

Keywords: Cash Ratio, Performance, Liquidity, Financial Statement, Leverage.

INTRODUCTION

In today's business world, no company can be considered good for investment either on the short term or long term unless it has good current financial position which can be shown through financial statements. Financial statements prepared by companies are meant to provide its users with reliable information about a company's performance and financial position (Pandey, 2005). The three basic financial statements that are of great significance to users of financial information are the Balance Sheet, the Profit and Loss account and the Cash flow Statement.

However, despite the appropriate presentation of the various financial statements by corporations with their appealing and attractive information in form of monetary value, many of the corporations still wind up after a short time period. Many are always at the verge or brink of collapse before being resuscitated.

The problem of such companies might not be unconnected with the inability of the stakeholders to evaluate and assess the viability of the organizations. This has led many investors to groan in pains as a result of investing their funds in companies that are not viable and also putting some would –be investors in dilemma about whether to invest or not.

To avert the problem mentioned, there is the need for accounting information users to assess the organizations' performances in terms of their values to them. For the users to appreciate significant changes and relationships in the accounting information, the monetary values reported in the financial statements are frequently converted into percentages or ratios by the statements users which enable them to make decisions that require an assessment or analytical study of the present operations, future prospect and probable outcome of decisions which could be made.

Therefore, the paper is out to find out how ratio analysis can help the management and other investors in assessing the performance of companies and also find out how appropriate is the ratio analysis in measuring corporate performance.

THEORETICAL FRAMEWORK

The Concept of Ratio Analysis

Ratio analysis through financial statements means different things to different people. Trade creditors, for example, are primarily interested in the liquidity of the firm. Their claims are short –term and ability of the firm to pay the relevant claims which can best be adjudged by an analysis of its liquidity.

The claims of the owners of the firm on the other hand are long –term. Therefore, the analysis of the capital structure of the firm, the company's profitability over time and projections of future profitability can best be analysed through the use of ratio analysis.

In general term, Financial ratio is said to be the relationship between two accounting figures expressed mathematically (Wood and Sangster 2002). It reflects a quantitative relationship which in turn helps to form a qualitativejudgment by the management of the firm or by parties outside the firm (Akinsulire, 2006)

According to Pandey (2004), ratio is defined as the indicated quotient of two mathematical expressions and as the relationship between account figures expressed in mathematical form.

Solomon (2004), defines ratio as the percentage or decimal that shows the relationship of one number to another. According to him, ratios are useful decision making tools because they conveniently summarize information in a form that is more easily understood, interpreted and compared. He opined that though ratio has no meaning in itself, it is the first step in assessing an entity financially, because it removes some of the mystery surrounding the financial statements and makes it easier to pin point items which would be interesting to investigate further.

Also, Wood and Sangster (2002), opined that without ratios, financial statements would be largely uninformative to all. But with ratios, financial statements can be interpreted and usefully applied to satisfy the needs of the reader. Financial ratio is of great importance due to the fact that it is used to compare performance from year to year which assists in predicting the future. Analysis can be undertaken to aid decision making by different groups of users of financial statements and this is because analysis of financial statement attempts to supply information in respect of the entity for which the statements are prepared (Inanga and Ajayi, 2001).

COMPARATIVE STANDARDS OF RATIOS

According to Pandey (2004), a single ratio in itself does not indicate favourable or unfavourable condition. Hence, it should be compared with some standards through the following:

i. **Time Series Analysis: -**This is done by comparing the present ratios of a firm with its past ratios when evaluating its performance. This gives an indication of the direction of change and reflects whether the firm's financial performance has improved, deteriorated or remained constant over time. However, the analyst should not just determine the change, but more importantly, he or she should understand why ratios have changed.
ii. **Cross – Sectional Analysis: -**This is done by comparing a firm's ratios with some selected firms' ratios in the same industry at the same point in time. This kind of a comparison indicates the relative financial position and performance of the firm.(Horne and Wachowicz, 1993).
iii. **Industry Analysis:-** In determining the financial condition and performance of a firm, its ratios are compared with average ratios of the industry of which the firm is a member. This type of analysis helps to ascertain the financial standing and capability of the firm in comparison with other firms in the industry. However, average ratios for the industry might be difficult to get in some cases and where they are available, they cover both strong and weak firms in the industry which may even differ in their accounting policies and practices.
iv. **Proforma Analysis:-**This analysis concerns the use of future ratios as the standard of comparison. Here, future ratios are developed from the projected or proforma financial statements. The comparison of current or past ratios with future ratios shows the firm's relative strengths and weakness in the past and the future. And if the future ratios indicate weak financial position, corrective actions can be initiated.

CLASSIFICATIONS OF FINANCIAL RATIOS

There are various classifications of financial ratios. One classification is the one that seeks to classify them according to familiarities of what each ratio measures. Another classification is based on what they are devised to measure, while some authors like Wood and Sangster (2002) classified them according to various users and information analysed.

However, the differences in the various classifications do not mean disagreement between various schools of thought or among scholars but only represent the ideological opinion of the author on how best to meaningfully classify them for easy analysis and understanding,

Therefore, as identified by Pandey(2004), Gitman (2000), Obamuyi(1999) and Ayodele (2002), ratios are generally classified into four without really having any identified difference from those classifications of Wood and Sangster (2002).

The classifications are:

i. Liquidity or Solvency Ratios: - These ratios are used to indicate the ability of the company to meet its financial obligations as they fall due. According to Pandey (2004), analysis of liquidity needs the preparation of cash budgets and cash fund flow statements; but liquidity ratios, by establishing a relationship between cash and other current assets to current obligations, provide a quick measure of liquidity. Examples of liquidity ratios are; current ratio, quick ratio, cash ratio, interval measure and net working capital ratio.

ii. Leverage Ratios (Capital Structure Ratios):- These ratios measure the degree of protection for long term creditors and investors. It involves the use of assets invested by common stockholders as collateral for debt financing in an attempt to earn a higher return for the common stockholders. Hence it is concerned with strategic rather than the operational level of corporate decision making (Horne and Wachowicz, 1993). Examples are; Debt Ratio, Debt –Equity ratio, Interest Cover, Capital Employed to Net Worth ratio, etc.
iii. Activity or Efficiency Ratios: These are ratios that measure the extent to which company's resources and assets have been efficiently managed. They indicate the speed at which assets are being converted into sales. Examples of Activity ratios are; inventory turnover, debtors' turnover, collection period, assets turnover, working capital turnover, and capital employed turnover.
iv. Profitability ratios: - These ratios measure the operating efficiency of a company. They assess and indicate the profitability of a given company. According to Pandey (2004), besides the management of the company, creditors want to get interest and repayment of principal regularly. Also owners want a required rate of return on their investments. This is possible only when the company earns enough profit. Examples of these are: Gross profit margin, Net Profit margin, Return on Equity etc.

USERS OF ACCOUNTING RATIOS

According to Olowe (1997), users of financial ratio vary and it depends on which aspect of information or area of usefulness they are interested in. The users are:

i. Management – They are interested in all aspects of financial information, as their aim is to ensure overall financial success of the company.
ii. Investors – They are mostly concerned with company's earnings and their focus is on the company's present and future profitability. Investors are both existing and potential ones who want to know how effectively and efficiently the Directors are performing their stewardship functions.

iii. Employees – This group of people are interested in the long term stability of the firm which their jobs depend on and also on the company's ability to meet their wage demands.
iv. Creditors – They are concerned with profitability, liquidity, growth and leverage positions of the company. This group of people are interested in the ability of the company to repay back its principal sum and interest owed to them as at when due.
v. Government – The government is interested in the profit of the business or company in order to ascertain the tax ability of the company.
vi. Competitors- They are interested in the comparative performance of the company so that they can make appropriate decisions.
vii. Financial Analyst and Advisers – This group of users need information on the profitability or efficiency of the company to advise potential investors on where they can have adequate returns on their investment.

LIMITATIONS OF RATIO ANALYSIS

Though the ratios analysis is a widely used technique to evaluate the financial position and performance of a business, Pandey (2004), observed some limitations of ratio analysis as encompassing difficulty in deciding on the proper basis of comparison and ratios not being an indicator of future since they are generally calculated from past financial statements. According to him, other limitations include, the differences in the definitions of items in the financial statements which usually make ratios interpretations difficult; different situations confronting different companies which may not allow proper comparison, price level changes and inability of ratios to take care of short term changes.

However, a lot of importance has been attached to financial ratios, both in the literature and in the professional world, for assessing the financial health of a firm. Ratio analysis has been adjudged to be a very useful tool to raise relevant questions on a number of managerial issues and to provide clues to investigate those issues in detail.

METHODOLOGY

Sample size and Data Collection Method

Zenith Bank Plc was selected purposively for the study because it is one of the biggest banks in the Nigerian banking industry with consistent operations. The financial statements of the company covered 12 years (i.e 2000 -2011) of operation where information which allow the calculation of ratios such as current ratio, net profit margin, stock turnover, debt ratio and earnings per share are used.

PRESENTATION AND ANALYSIS OF DATA

The secondary data extracted from Zenith Bank, Plc financial statements were presented in tabular form and analysed through simple percentages and ratios.

DEFINITION OF FORMULAE

The formulae for the used ratios are as shown below

i. Dividend per Share (DPS) = $\frac{\text{Total Dividend}}{\text{No of ordinary shares outstanding}}$

ii. Cash Ratio = $\frac{\text{Cash + Cash Equivalent}}{\text{Current Liabilities}}$

iii. Return on Equity = $\frac{\text{PAT}}{\text{Networth}}$

iv. Debt Ratio = $\frac{\text{Total debt}}{\text{Total Assets}}$

v. Earnings per share (EPS) $\frac{\text{PAT}}{\text{No. of shares}}$

Table 1.Financial Ratios of Zenith Bank Plc between 2000 -2011

Year	Dividend per share	Percent Increment	Cash Ratio	Percent Increment	Return on Equity	Percent Equity	Debt Ratio	Percent increment	Earnings Per Share	Percent Increment
2000	50k	-	1.02	-	0.34	-	0.88	-	322k	-
2001	50k	0	1.35	32.35	0.36	5.88	0.89	1.14	236k	-26.71
2002	90k	80.00	1.29	-4.44	0.38	5.56	0.90	1.12	341k	44.49
2003	70k	-22.22	1.25	-3.10	0.35	-7.89	0.89	-1.11	375k	9.97
2004	35k	-50.00	0.93	-25.60	0.33	-5.71	0.92	3.37	168k	-55.20
2005	36k	2.86	0.77	-17.20	0.18	-45.45	0.89	-3.26	136k	-19.05
2006	110k	205.56	0.92	19.48	0.12	-33.33	0.84	-5.62	191k	40.44
2007	189k	71.82	0.99	7.61	0.16	33.33	0.87	3.57	189k	1.05
2008	345k	82.54	0.95	-4.04	0.14	-12.5	0.80	-8.05	345k	82.54
2009	73k	-78.84	0.56	-41.05	0.06	-57.14	0.80	0	73k	-78.84
2010	106k	45.21	0.62	10.71	0.10	66.67	0.81	1.25	106k	45.21
2011	118k	11.32	0.61	-1.61	0.10	0	0.83	2.47	118k	11.32

Source: (i) Author's Computation, 2015

(ii) Zenith Bank Plc Annual Reports (2000 -2011)

FINDINGS FROM THE ANALYSIS

From the analysis above, Zenith bank showed a very good liquidity status within the period 2000-2003analysed as the cash ratio was above 1.0 in each year. This shows that the company had enough cash holding in relation to its current liabilities with the four years but the cash holding was insufficient between 2004 -2011

Earnings per share and dividend per share are of good standing and impressive. The analysis showed that the firm is profitable on a per – share basis and shareholders had been well compensated.

Return on Equity (ROE) showed a decline from 2005 to the last year (2011) of the analysis. This means that the profit generated by owners' investment was declining compared to what it was before year 2005. However, there was a 66.67% increase in the year 2010 over the value of 2009. This performance might not be unconnected with the low value of ROE recorded in the immediate previous year. This asserts further, that ratio analysis can help to plan ahead after learning from past mistakes or inefficiency.

The total debt ratio analysis shows that the company had been solvent generally. The data showed further that the percentage increament had been on decline, meaning that the value of debt used is declining compared to the overall capital structure of the firm.

Generally from the data, it can be deduced that the firm in question performed best in the year 2002 in all the indices used. The company did not perform to the expectation in year 2005 and performed worst in 2009 as shown in the analysed data.

CONCLUSION

The discussion and analysis so far showed that ratio analysis is a very good tool for comparative purpose and can be used to plan ahead after studying the past estimates of calculated ratios. The study showed further that the users of ratio information cut across nearly all the social strata of man, namely, investors, management, shareholders, creditors, employees, firm owners, society, researchers etc.

The ratios calculated with their percentage increaments showed that with the help of ratio, improvement can be made on previous or past inefficiency. This can induce the management and owners of firms to sit up. Hence, ratio analysis can be described as a veritable tool for measuring corporations performance. Therefore, it should be considered by every user of accounting information before making any meaningful decision.

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