Financial analysis to identify strengths and weaknesses in business enterprise

A financial analysis assists in identifying the major strengths and weakness of a business enterprise. It indicates whether a firm has enough cash to meet obligations, a reasonable account receivable collection period, an efficient inventory management policy, sufficient plant, property, and equipment, and an adequate capital structure- all of which are necessary if a firm is to achieve the goal of maximizing shareholder wealth. Financial analysis can also be used to assets a firms viability as an ongoing enterprise and to determine whether a satisfactory return is being earned for the risk taken.

Financial analyses are also used by persons other than financial managers. For example, credit managers may examine basic financial ratios of a prospective customer when deciding whether to extend credits credit. Security analysts use financial analysis to help assess the investment worth of different securities. Bankers use the tool of financial analyses when deciding whether to grant loans. Financial ratios have been used successfully to forecast such financial events as impending bankruptcy. Unions refer to financial ratios when evaluating the bargaining positions of certain employers.

FINANCIAL STATEMENT

It is the income statement, the statement of recognized income and expenses and the balance sheet are usually supported by a great deal of additional notes. These notes providing the two main purposes that is they will avoid too much detail being shown on the face of the financial statement and another purpose is they make it easier to provide some supplementary information

TYPES OF ANALYSIS

There are several measuring instruments may be used to evaluate including horizontal, vertical and ratio analysis.

Horizontal analysis is used to evaluate the trend in the financial statements over the years. By using horizontal analysis, it is easy to identify areas that require further attention. It is important to show dollar amount of change and the percentage of change.

While vertical analysis used a significant item on a financial statement as a based value and all other items on the financial statement are compared to it. The vertical analysis also used to disclose the internal structure of the firm.

RATIO ANALYSIS

Financial ratio analysis helps to identify the financial strengths and weakness of a company. It gives meaningful comparisons of firm’s financial data with other firms’. We could use ratio to answer important questions about a firms’ operations.

LIQUIDITY RATIOS

Defined as it its ability to meet debt obligations. That is will the firm have the resources to pay the creditors. If a company has a poor liquidity position, it may be poor credit risk.

1. 0. 1 NET WORKING CAPITAL

Net working capital is a measurement of the operating liquidity available for a company to use in developing and growing its business.

Net working capital = Current assets – Current liabilities

CURRENT RATIO

To measure the ability to meet its current assets.

Current ratio = Current assets

Current liabilities

ACID TEST (QUICK) RATIO

It indicates a firm's liquidity excluding inventories relative to its current liabilities. Inventory and prepaid expenses not included in this ratio.

Current assets – (inventory + prepaid expenses)

Current liabilities

PROFITABILITY RATIOS

It is an indication of firm's financial situation during the year. It shows how effectively the firm is being managed and the company's ability to earn profit and return on investment.

GROSS PROFIT MARGIN

It shows the percentage of each dollar left over after the business has paid for its goods. The higher the gross profit earned, the better it is. The gross profit margin can be calculated as follows:

Gross profit margin = gross profit

Net sales

NET PROFIT MARGIN

It indicates the profitability generated from revenue/ income. Its important to measure of operating performance.

Net profit margin = net profit

Net sales

ASSET UTILIZATION RATIO

It is to determine how effectively a firm is managing its assets. It is necessary to evaluate the activity or liquidity of specific current accounts. It exits to measure the activity of debtors, inventory, and total assets.

FIXED ASSET TURNOEVER

It shows how a firm's used its fixed assets efficiently to generate revenue / income.

Total asset turnover = net sales

Total fixed asset

TOTAL ASSET TURNOVER

Evaluate a company's ability to use it asset efficiently to generate revenue.

Total asset turnover = net sales

Total asset

INVENTORY TURNOVER RATIO

ACCOUNT RECEIVABLE TURNOVER

AVERAGE COLLECTION PERIOD

DEBT MANAGEMENT RATIO

DEBT/ EQUTY RATIO

MARKET VALUE RATIO

This ratio is relates the firm's stock price to its earnings or book value per share. Investors use these ratios to evaluate and monitor the progress of their investments.

EARNING PER SHARE

It indicates the amount of earnings for each common share held. Minus the preferred dividends to determine the amount applicable to common stock.

Earning per share = (net income – preferred dividens)

Total common shares outstanding

PRICE / EARNINGS RATIO

It indicates that the investing public considers the company.

Market price per share

Earnings per share

DIVIDEND RATIO

There are two relevant ratio which are ;

Dividend yields, the percentage of dividends paid to shareholders in relation to the price of the stock.

Dividend yield = dividend per share

Market price per share

Dividend payout, to determine if a company generates a sufficient level of cash flow in order to pay dividends to the investors/ shareholders.

Dividend payout = dividend per share

Earnings per share