FINANCIAL RATIOS ANALYSIS AND COMPANIES' LIQUIDITY EVALUATION

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Abstract

This study used financial ratio analysis to evaluate the companies' liquidity in the primary. One of the SME businesses has been chosen for evaluation based on the study of the data found on their financial statements. Since this statement contains the majority of the pertinent data for this purpose, it has been suggested that this company's cash flow statement be used for this purpose. The numbers showed that liquidity is as important as profit for attracting investors to purchase the company's shares because it provides confidentiality for the company, supporting the hypothesis that financial ratio analysis can help investors choose the company for purchasing their shares. More information has been proposed in this research.

Keywords: Financial Ratio, Liquidity, Financial Performance.

1. Introduction

1.1 Background of the study

Since effective planning and financial management become the keys to running a financially successful small business, lenders and investors rely on financial ratios analysis to make lending and investment decisions (Rashid, 2023). Financial ratios analysis is important for understanding financial statements, identifying movements and developments and measuring the overall business's financial state, particularly in identifying positive and negative financial

trends. Thus, it is important for the investors and shareholders to evaluate the companies' position regarding to liquidity by using financial ratios analysis to know whether having much liquid for a company is crucial or not, because being liquid means controlling obligations, on the other hand means lack of investment (Budur et al., 2023).

Liquidity refers to the ability of a firm to meet short-term financial obligations by converting the short-term assets into cash without incurring any loss. Assets are considered to be high-quality liquid assets if they can be easily and immediately converted into cash at little or no loss of value. Markets are considered to be liquid when those who have assets holdings can sell them at prices that do not involve considerable losses so as to gain the finances they need to fulfill other commitments. Financial performance refers to the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure a firm's overall financial health over a given period. Institutions have various measures of financial performance. However, the common measures of financial performance are the Return on Assets and Return on Equity. Companies try to achieve the conflicting twin objectives of liquidity and improved financial performance by selecting a diversified and balanced asset portfolio within the framework of the regulators. Profitability is improved for banks that hold liquid assets, however, there is a point at which further holding of liquid assets diminishes an institution's profitability or it remains constant. The firms are also expected to hold onto a certain percentage of their liquid assets. Financial managers must therefore strive to achieve a balance between liquidity and profitability. The most suitable liquidity measures are the current ratio, debt ratio and amount of cash reserves. The current ratio measures the firm's ability to meet its current obligations as and when they fall due. A ratio of 2:1 is said to be efficient as it implies that the firm is capable of meeting its obligations as it falls due, hence an indication of better financial performance. The debt ratio represents the proportion of the company's debt-financed assets. The higher the debt ratio, the higher the amount of debt the company employs to finance its assets, hence high financial risk. For such a company, chances of yielding low profits are very optimal. The amount of cash reserves refers to the money a firm or an individual holds in hand to meet short-term and emergency funding needs. The higher the amount of cash reserves, the higher the firm's capability to meet its unplanned emergencies (Akenga, 2017).

1.2 Problem Statement

The problem of the study shows that most of the investors and decision-makers in the world are struggling with the incapability of applying new concepts in evaluating and selecting

available investment choices, such as using analyzing financial ratios as a method to compare the available choices and then select the best choice among them, due to the lack of information in the financial statements of the companies. This might be due to unwillingness to establish all the important information to prevent their competitors from taking advantage from them or to cover their weaknesses.

1.3 Objectives of the Study

The main objective of this study is to evaluate the companies' liquidity by using financial ratio analysis, while the specific objectives can be summarized as follows:

1. Identifying the concept of financial ratio analysis.

2. Identifying the main types of financial ratios.

3. Evaluate the companies' ability to meet short-term obligations and make appropriate investments.

1.4 Research Questions

The study intends to provide an answer to the following question:

1. What is the role of financial ratio analysis in evaluating the company's liquidity?
2. Does liquidity suffice for evaluating a company's financial performance?

1.5 Research Hypothesis

To achieve the objectives of the study, two main hypotheses were formulated:

1. H0: Financial ratio analysis does not significantly evaluate the company's liquidity.

2. H1: Financial ratio analysis plays a significant role in evaluating the company's liquidity.

1.6 Significance of the Study

Analysis of the financial statements is an attempt to assess the efficiency and measure the company's financial position. Hence, the analysis and interpretation of financial statements

play a vital role in measuring the business units' efficiency, profitability, financial stability, and future prospects.

2. Literature Review

2.1 Financial Ratio Analysis

Ratio Analysis is one of the essential tools of financial analysis. It is an important tool in business planning and decision-making as it explores the company's strengths, weaknesses, opportunities, and threats (Budur et al., 2023; Mohammed et al., 2020). Savvy investors use financial ratios to analyze a company's financial performance before investing. Financial ratios reveal how a company is financed, how it uses its resources, its ability to pay its debts, and its ability to generate profit. Ratios provide a glimpse of a company's position at a particular time and are most valuable when compared across time periods and when comparing companies in the same industry. Ratios alone do not give a complete picture of a company's investment potential, but they are a wise place to start the analysis.

Nowadays, the financial analysis of an enterprise is one of the main prerequisites for the successful management of financial resources and, according to several scientists, is one of the most significant elements of financial management (Noori & Rashid, 2017). The efficient operation of a company requires economically well-founded management decision-making, which is based on the analysis of current operating and financing activities. A problem with using ratios as tools is that the extant literature testing their value is limited. For example, there is little evidence that a capital accumulation ratio of 0.7 is better than one of 0.3 or that the protection provided by holding 6 months of assets in liquid investments is worth the tradeoff in expected return. Financial ratios allow for comparisons and, therefore, are intertwined with the process of benchmarking, comparing one's business to that of others or the same company at a different point in time. In many cases, benchmarking involves comparing one company to the best companies in a comparable peer group or the average in that peer group or industry (Rashid, 2020). In the process of benchmarking, investor identifies the best firms in their industry or in another industry where similar processes exist and compares the results and processes of those studied to one's own results and processes on a specific indicator or series of indicators.

For ratios to be valuable and meaningful, they must be:

- Calculated using reliable, accurate financial information.

- Calculated consistently from period to period.

- Used in comparison to internal benchmarks and goals.

- Used in comparison to other companies in your industry.

- Viewed both at a single point in time and as an indication of broad trends and issues over time.

- Carefully interpreted in the proper context, considering many other important factors and indicators involved in assessing performance.

  (Shaban and Zubi, 2014)

2.2 Types of Ratio Analysis

Ratios can be divided into five major categories:

i. Liquidity ratios

Liquidity ratios measure a firm's ability to pay its bills as they come due. Two commonly used liquidity ratios are the current ratio and the quick ratio.

Current Ratio: The current ratio is found by dividing current assets by current liabilities. A ratio of 1 means the business has just enough current assets to pay current liabilities. Ratios above 1 mean a firm has more current assets than current liabilities; ratios below 1 mean more current liabilities than current assets. Investors typically prefer a lower current ratio because it shows that a firm's assets are working to grow the business.

Current Ratio= Current Assets / Current Liabilities

Quick Ratio: The quick ratio, also called the acid test, subtracts inventory from current assets before dividing them by current liabilities. The acid test gives a more accurate view of the firm's short-term liquidity than the current ratio because it removes inventory that the firm may not be able to sell from the equation.

Quick Ratio= Current Assets - Inventory / Current Liabilities

Accounts Receivable Turnover Ratio: It measures the number of times trades receivables turnover during the year. The higher the turnover, the shorter the time between sales and collecting of cash. This ratio tells the investor what are the customer payment habits compared

to firm's payment terms. Accordingly, the firm may need to step up the collection policies or tighten the credit policies. These ratios are only useful if majority of sales are credit sales.

Accounts Receivable Turnover = Net Sales / Average Accounts Receivable

Inventory Turnover Ratio: It measures the number of times inventory turns over into sales during the year or how many days it takes to sell inventory. This is a good indication of production and purchasing efficiency. A high ratio indicates that inventory is selling quickly, and that unused inventory is being stored (or could also mean inventory shortage). If the ratio is low, it suggests overstocking, obsolete inventory or selling issues.

Inventory Turnover = Cost of Sales / Average Inventory

ii. Profitability Ratios

Profitability ratios measure a firm's ability to generate profits. It consists of four main ratios; net profit margin, assets turnover ratio, return on assets and return on equity.

Profit Ratio: Measure of net income produced by each dollar of sales.

Profit ratio = net income / net sales

Assets Turnover Ratio: It measures how efficiently the business generates sales on each dollar of assets. An increasing ratio indicates that the firm is using assets more productively.

Asset Turnover Ratio = Net Income / Average Total Assets

Return on Assets: (ROA) Measure of overall earning power of profitability.

ROA = Net Income / Average Total Assets

Return on Equity: (ROE) Measure of profitability of stockholders' investment.

ROE = Net Income / Average Total Equity

It is important to remember that ROA and ROE ratios are based on accounting book values and not on market values. Thus, it is not appropriate to compare these ratios with market rates of return such as the interest rate on Treasury bonds or the return earned on an investment in a stock (Ahsan, 2013)

iii. Debt or Solvency Ratios

Debt Ratios attempt to measure the firm's use of Financial Leverage and ability to avoid financial distress in the long run. These ratios are also known as Long-Term Solvency Ratios (Rashid & Jaf, 2023).

Debt is called Financial Leverage because the use of debt can improve returns to stockholders in good years and increase their losses in bad years. Debt generally represents a fixed cost of financing to a firm. Thus, if the firm can earn more on assets which are financed with debt than the cost of servicing the debt then these additional earnings will flow through to the stockholders. Moreover, our tax law favors debt as a source of financing since interest expense is tax deductible (B.F Online, 2014).

With the use of debt also comes the possibility of financial distress and bankruptcy. The amount of debt that a firm can utilize is dictated to a great extent by the characteristics of the firm's industry. Firms which are in industries with volatile sales and cash flows cannot utilize debt to the same extent as firms in industries with stable sales and cash flows. Thus, the optimal mix of debt for a firm involves a tradeoff between the benefits of leverage and possibility of financial distress.

Debt to Equity Ratio: Measure of Capital Structure and leverage

Debt to Equity Ratio = Total Liabilities / Total Equity

Debt to Assets Ratio: Measure of assets debt structure

Debt to Assets Ratio = Total Assets / Total Equity

Interest Coverage Ratio: Measure of Creditors' protection from default on interest payment

Interest Coverage Ratio = Income before Income Taxes+ Interest Expenses / Interest Expenses

iv. Cash Flow Adequacy ratios

Cash Flow Yield Ratio: Measure of a company's Ability to generate operating cash flows in relation to net income.

Cash Flow Yield Ratio = Net Cash Flow from Operating Activities / Net Income

Cash Flow to Sales Ratio: Measure of the ability of sales to generate operating cash flow.

Cash Flow to Sales Ratio = Net Cash Flow from Operating Activities / Net Sales

Cash Flow to Assets Ratio: Measure of the ability of assets to generate operating cash flow.

Cash Flow to Assets Ratio = Net Cash Flow from Operating Activities / Average Total Assets

v. Market Value Ratios

Market Value Ratios relate an observable market value, the stock price, to book values obtained from the firm's financial statements.

Price-Earnings Ratio (P/E Ratio): The Price-Earnings Ratio is calculated by dividing the current market price per share of the stock by earnings per share (EPS). (Earnings per share are calculated by dividing net income by the number of shares outstanding.) The P/E Ratio indicates how much investors are willing to pay per dollar of current earnings. As such, high P/E Ratios are associated with growth stocks. (Investors who are willing to pay a high price for a dollar of current earnings obviously expect high earnings in the future.) In this manner, the P/E Ratio also indicates how expensive a particular stock is. This ratio is not meaningful, however, if the firm has very little or negative earnings.

P/E Ratio = Price Per Share / Earnings per Share

Where: Earnings per Share = Net Income / Number of Shares Outstanding

Market-to-Book Ratio: The Market-to-Book Ratio relates the firm's market value per share to its book value per share. Since a firm's book value reflects historical cost accounting, this ratio indicates management's success in creating value for its stockholders. This ratio is used by "value-based investors" to help to identify undervalued stocks.

Market-to-Book Ratio = Price Per Share / Book Value per Share

Where: Book Value per Share = Total Owners' Equity / Number of Shares Outstanding

P/E ratio is a widely used ratio which helps the investors to decide whether to buy shares of a particular company. It is calculated to estimate the appreciation in the market value of equity

shares. The average P/E ratio is normally from 12 to 15 however it depends on market and economic conditions. P/E ratio may also vary among different industries and companies. P/E ratio indicates what amount an investor is paying against every dollar of earnings. A higher P/E ratio indicates that an investor is paying more for each unit of net income. So, P/E ratio between 12 to 15 is acceptable. A higher P/E ratio may not always be a positive indicator because a higher P/E ratio may also result from overpricing of the shares. Similarly, a lower P/E ratio may not always be a negative indicator because it may mean that the share is a sleeper that has been overlooked by the market. Therefore, P/E ratio should be used cautiously. Investment decisions should not be based solely on the P/E ratio. It is better to use it in conjunction with other ratios and measures (ReadyRatio, 2014).

2.3 Empirical Review

Various studies have been carried out to determine the relationship between liquidity and financial performance in different sectors, locally and also internationally, therefore some of the empirical studies are summarized below:

Jamil and Saeed (2007) aimed at evaluating the performances of the banks by identifying the financial ratios and indicators used in the evaluation process and then using them in evaluating the banks within the study. The problem of the research lies in the new economic situation that our country is passing through the existence of many private and state banks. So that needs to evaluate the financial performance of the banks to identify the weakness and lack points to avoid them and identify the positive points to maintain the activity of the bank to gain the best results within the strong contest. The study relied of the hypothesis that using the ratios of liquidity and profitability in the bank performance will eventually lead to discover the points of strength and weakness in the sample bank performance. The study and the indicators showed that the best year was 2002, then the year 2004 in the second class and 2003 in the third. And that was because our country underwent hard events in 2003 including vandalism, looting and bad conditions. Despite all what has been taken place, the bank recovered in 2004.

Dong and Su (2010) concluded that a firm's profitability and liquidity are affected by working capital management. The study used pooled data for the period 2006 to 2008 to assess the companies listed in the Vietnam Stock Exchange. The study focused on the cash conversion cycle to measure working capital management. The study found that the relationship among variables were strongly negative, suggesting that profit is negatively influenced by an increase

in CCC. The study also found that as the debtor's collection period and inventory conversion period decreases, profitability increases.

Bolek and Wolsk (2012) stated that company's liquidity management is connected to working capital, which is determined by decisions made at the level of cash, receivables, inventory, and payables. It can be assumed that the greater the liquidity, the higher the net working capital invested in a company, the higher the level of capital, the greater its cost, and thus the lower the ROE and EVA indicators. In such a case, investors monitoring company performance could interpret high liquidity as a negative signal, entailing a fall in the market prices. On the other hand, the greater the liquidity, the higher the flexibility of the company in terms of production and sales, which could provide additional income for the business. Consequently, investors could also interpret high liquidity as a positive sign, with a subsequent rise in the market prices.

Lyroudi and Bolek (2014) investigated the liquidity of non-financial companies in Poland, as measured by static measures such as the current and quick ratios and the dynamic measure of the cash conversion cycle, since the accurate measurement of liquidity and its consequences for the value of a firm is a major issue for managers and academicians. The results indicated a negative relation between a) the cash conversion cycle and the firm's profitability, b) the size of the company and its liquidity and c) the ineptness of the company and its liquidity. As an inference, all three measures should be used simultaneously by the firm's stakeholders, because they complement each other and they give more insights about the company's performance, helping the firm's stakeholders in making correct and rational decisions regarding the underlying company.

Ehiedu (2014) conducted a study on the impact of Liquidity on Profitability of some selected companies in Nigeria and concluded that 75% of them indicated that current ratio has a significant positive correlation with profitability. The researcher believes that the reason for this positive relationship between current ratio and profitability is simply because idle funds, especially when borrowed, generates profits and less costs in the business. The two companies depicted a negative correlation between Acid test ratio and return on assets respectively. Thus, from the above results, 50% of the companies analyzed indicated a significant negative correlation between current ratio and profitability in this analysis.

Akenga (2017) stated that liquidity refers to the ability of a firm to meet its obligations as and when they fall due. To meet their obligations, firms are expected to hold a certain percentage

of their total finance in cash. However, majority of the institutions especially financial institutions tend to focus only on profit maximization at the expense of liquidity management. It is therefore the role of financial managers to establish effective mechanisms of meeting a firm's obligations and profit maximization. The objective of the study was to establish the effect of current ratio, cash reserves and debt ratio on financial performance of firms listed at the Nairobi Securities Exchange (NSE). Causal research design was adopted. Purposive sampling technique was used to select 30 firms. The data was analyzed using descriptive and inferential statistics, and it was found that current ratio and cash reserves have a significant effect on ROA with a p value of less than 0.05. The debt ratio was found to have no significant effect on ROA as it had a significance level of 0.571.

Alshatti (2015) Conducted research to find out the degree to which effective liquidity management affects profitability in Jordanian commercial banks and how and commercial banks can enhance their liquidity management and profitability positions. Based on the research findings, Alshatti concluded that, liquidity management has effect on profitability as measured by ROE and ROA, where the effect of the investment ratio and quick ratios on the profitability is positive when measured by ROE, and the effect of capital ratio on profitability is positive as measured ROA.

Lee and Lee (2018) investigated the financial ratio of savings banks and the effect of the ratio having influence upon bankruptcy by quantitative empirical analysis of forecast model to give material of better management and objective evidence of management strategy and way of advancement and risk control. Research design, data, and methodology - The author added two growth indexes, three fluidity indexes, five profitability indexes, and four activity indexes CAMEL rating to not only the balance sheets but also the income statement of thirty savings banks that suspended business from 2011 to 2015 and collected fourteen financial ratio indexes. IBMSPSS VER. 21.0 was used. Results - Variables having influence upon bankruptcy forecast models included total asset increase ratio and operating income increase ratio of growth index and sales to account receivable ratio, and tangible equity ratio and liquidity ratio of liquidity ratio. The study selected total asset operating ratio, and earning and expenditure ratio from profitability index, and receivable turnover ratio of activity index. Conclusions - Financial supervising system should be improved, and financial consumers should be protected to develop saving bank and to control risk, and information on financial companies should be strengthened.

Alhilfi (2018) evaluated the NIC company financial health by using financial ratio analysis method, included a three periods analysis for three aspects: profitability, liquidity and solvency. It found from the comparison of the NCI Company's financial ratios of three periods, that there is a remarkable progression in the profitability indicators in 2013 compared with the previous two years; nevertheless, there is an intense regression in its liquidity and solvency indicators. It concluded that the company's profitability increased in 2013, while its liquidity and solvency decreased. Accordingly, the earning power of the business is good presently, but its riskiness is too high.

3. Practical Case

In this chapter several financial indicators will be used to evaluate company's liquidity:

The financial information has been embraced from the financial statements of the SME's companies in KRG\ Sulaimani city.

Years	2017	2018	2019	2020	2021
Current ratio	1.2	1.3	1.1	1.4	1.3

Years	2017	2018	2019	2020	2021
Inventory turnover	44	50	49	52	55

Years	2017	2018	2019	2020	2021
Receivable turnover	67	71	65	69	66

Years	2017	2018	2019	2020	2021
Trade payables turnover	81	88	93	100	99

Years	2017	2018	2019	2020	2021
Quick ratio	0.9	1.2	0.6	1	1.2

Discussion

Because the company may buy its inventory and receive its debtors, and then it has more time to pay its creditors, it can be said that this company's liquidity regarding current ratio, trade payables turnover, receivables turnover, and inventory turnover has not had an obvious liquidity problem. As a result, creditors may be persuaded to extend loans to the business,

thereby strengthening the second theory. It is clear that they will not be able to raise money very soon if they sell any goods; in 2021, they will only be paid after two months. Their trade payables, however, are lengthier than their receivables. The business could be able to get funds this way to make payments. So, investing wisely means having little money. Rashid (2018) did the prior study, which was quite different from this one. They believed that businesses should be profitable and cash-liquid from an investor's perspective to take advantage of market opportunities. However, because they are already operating with significant capital, large corporations do not feel comfortable in this circumstance. As a result, they lack the funds to take advantage of all market chances. Therefore, having this many cash implies a lack of investment, which is extremely typical among big businesses. Because businesses may participate in the company using other assets, in addition to cash, it is not always required to have a lot of cash on hand to take advantage of market opportunities.

4. Conclusion and Suggestions

The company's current ratio indicates that it has not experienced any liquidity issues, but the quick ratio indicates that it has experienced some issues over the last three years (2017, 2018 and 2021). Similarly, they do not have enough cash to cover their liabilities, but even though they have, the corporation is investing its little capital very well. This is a benefit to the company because it will draw in investors who will buy their shares, which will raise the share price and affect the company's worth. Furthermore, because of their dominant market position, creditors might have confidence in them and refrain from banding together to request credit from them, which could eventually resolve whatever issues they had with liquidity. Therefore, it can be advised to any investor that investing in this company or purchasing the company's shares is not going to be bad due to their market position since investors are more likely to be concerned about the company's market position even if the company has liquidity issues because market position can have a significant impact on the share price.

Increased secrecy for the business may be significantly influenced by the company's strong market position (Rashid, 2019). The creditors will extend the time they have to pay their debts since investors want to purchase their shares and regular shareholders want to stay with the business. Strong market position alone, however, is insufficient for the business. According to their quick ratio, they need to solve their liquidity issue, which they encountered in 2017, 2018, and 2021. It is true that they do not have a significant liquidity problem, but to increase their value and draw in more investors in the future, they need not lose sight of their market

confidentiality. However, having a lot of cash in the company might be manipulated by directors for their individual benefits (Rashid, 2023). Therefore, cash has to be balanced in order to avoid the manipulations (Rashid, 2017).

Limitations and Further Research Developments

Despite being a useful tool for assessing a company's liquidity, financial ratio analysis has some drawbacks that should be acknowledged. Five years of comparing one firm to itself may not yield useful information on the company's financial health and fortune. Comparisons could be deceptive because inventories are valued differently each year (Rashid & Fatah 2022). Because they provide numerous issues for additional investigation, ratios should be seen as a beginning point rather than an end. They hardly ever, if ever, respond to inquiries independently. Other sources of data should be included in addition to ratios when analyzing and reaching conclusions regarding the changing within the company itself in their strategy should be evaluated by the analyst (Rashid & Sabir Jaf 2023). Further research can be conducted in this area because, only evaluating company's liquidity by utilizing liquidity ratios analysis have been used in this research. For this reason, evaluating profitability, risk, corporate governance, and corporate social responsibility of companies can be completed regarding to the hypothesis of this research.

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