

Financial Ratio Analysis: Decision Usefulness for Potential Shareholders' Benefit

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Abstract

The certainty of the reliance on the use of financial ratio analysis in making investment decisions by potential investors still remained a mystery. This has to do with the choice of ratios to select when making investment decisions. Many shareholders in Nigeria are uneducated or illiterate, and due to their ignorance, they cannot use ratio analysis in evaluating firms for investment decisions. Thus, this paper explores the concept of financial ratio analysis in terms of the decision usefulness of financial ratios. The paper suggests that the relevant financial information needed for the purposes of making investment decision can be sourced through the use of financial ratio analysis. Therefore, management must ensure that disclosure of comprehensive financial ratios form part of financial statement prepared for the overall appraisal of firms.

Keywords: Financial ratio analysis, decision usefulness, shareholders, firms.

1.0 Introduction

In a competitive market where there is free entry and free exit of investments, stockholders require the use of financial ratios to evaluate the value of firms for investment purposes. Study established the insufficiencies of the disclosed financial ratios in satisfying the information needs of the shareholders (Ho, Aripin, & Tower, 2012). To enable investors make significant investment decisions, the use of financial ratio analysis is required. The appraisal of investment opportunities is of utmost significance owing to the need for maximizing returns on investment. Corporate firms seek capital funds which are to be made available by the investors having been able to evaluate the firm value through painstaking analysis of the financial reports (Mankiw, 2007).

To enable the production of goods and services for the growth of an economy, basic knowledge of ratio analysis by investors is required for wealth maximization. The nation's productive capital comes from the aggregate savings within an economy. The efficient allocation of capital resources from the potential shareholders to the corporate entities is needed for stimulating the development of an economy. However, to enable

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this mechanism, potential investors require accounting information from business firms to decide where to invest their capital for optimum yield.

The information needs of potential investors can be sourced through the use of financial ratio analysis (Amran, & Aripin, 2015). If the financial information from the disclosed financial reports cannot satisfy the information needs of the investors, then they might make the wrong economic decisions. It will adversely affect their investments if the usefulness of financial ratio analysis is not considered as a means of sourcing for additional information about stock returns (Kheradyar, Ibrahim, & Nor, 2011).

Decision-making is the process of selecting one alternative among many substitutes (Miller, 1994). The decision maker must have precise, accurate, reliable and relevant information to define the problems, generate alternatives and ultimately make a choice (O'reilly, Chatman, & Anderson, 1987). According to Rowe and Boulgarides (1983) the process depends on the circumstances in which a decision is made, the decision maker's way of perceiving and understanding signals, what the decision maker values or judges as important.

Martinsons and Davison (2007) claimed that two of the most significant influences on decision-making are values and cognitive perception. Both depends on how a decision maker will interpret and respond to a stimulus and sets of conditions. In the context of this paper, decision-making is highlighted in terms of information obtained by the potential investors in their decision-making processes with respect to financial ratio analysis. More importantly, understanding the usefulness of disclosed financial ratios in the annual reports based on the suggestion of previous studies makes the study necessary (Aripin, Ho, & Tower, 2014).

Financial ratio is a widely-used tool of financial analysis, the use of financial ratios to interpret financial statements provides a quick indication of a firm's performance and financial position to different users of the financial statement (Abdul-Baki, Uthman, & Sanni, 2014). In the light of the above, this paper theoretically assesses the usefulness of financial ratios analysis to the potential investors and to understand the current state of affair as to the usefulness of ratio analysis.

Financial reports of Nigerian firms have been found to be deficient over time (Wallace, 1988; Adeyemi, 2006; Nzekwe, 2009; Raph, 2015) in the sense that they lacks vital information that will enable potential investors make informed decisions. A study conducted by the World Bank (2006) states that disclosure practices by Nigerian firms are insufficient for investment decisions. Other scholars' remarks are similar to that of World Bank in the sense that they all found the Nigerian corporate reporting practices to be deficient (Adekunle & Asaolu, 2013; Umoren, 2009; Ofoegbu & Okoye, 2006; Okike, 2000). This paper conceptually assesses the extent to which financial ratios analysis can be used by potential shareholders to source for vital information for decision making.

2.0 Decision Usefulness: An Overview

The wisdom behind the use of financial ratios is to guide users to make good and effective decision which is expected under normal circumstances in order to have a multiplier effect on the economy at large (Maidoki, 2013). The objective of financial statements is to convey information about the true financial performance or position as well as the capability of an entity (Piotroski, 2000). There are different users of accounting information generated through ratio analysis; each of the categories have their unique demand in terms of their information need. For instance, potential shareholders are interested in ascertaining the earnings that will emanate from the financial resources they will commit to finance their organizations.

Employees, on the other hand, are strongly interested in being adequately compensated for the services they rendered. Governments are interested in the reports to ensure that a just and fair resources allocation is achieved and for tax purposes. Moreover, members of the public are in need of information to understand the operational performance of the businesses located in their domain, particularly their responsibilities to stakeholders (Dandago & Hassan, 2013). In other words, the public are solely interested in information from financial ratios which will guide them in appreciating the economic and social impact of the firm's activities.

In a market economy, the potential holders of stocks need to make significant decisions concerning investment opportunities. However, for decisions concerning investment to take place, investors need accounting information to take advantage of investment opportunities that would result in value creations. Financial data generated through financial ratio analysis conducted on annual financial statements will assist both potential and existing investors in order to decide when to procure, dispose or hold their shares. If the financial information disclosed in the annual reports is not sufficient, then wrong investment decisions becomes inevitable if the process of financial ratio analysis cannot be employed by the potential investors.

Accounting information, right from the inception, was made to protect the shareholders and the creditors. According to Akmal, Syed and Shaikh (2012), the world accounting standards setters, IASB and FASB, tilted and conferred excessive significance on the concept of decision usefulness to lenders and stockholders. Thus, Statement of Financial Accounting Concepts (SFAC) No. 1, provides the objectives of financial reporting as to present information to potential investors and creditors and other users in making rational investment decision.

Generally, it was alleged that the general purpose financial reports do not meet the comprehensive needs of the potential investors which necessitate the promotion of the single-person theory by different scholars over time. For example, scholars such as William (2009), Godfrey, Hodgson, Holmes and Tarca (2006) and McCartney (2004) proposed the adoption of single person theory in the preparation of annual report. This is based on the need to provide comprehensive accounting information to investors

and capital providers. They resolved to prepare general-purpose financial reports by corporate bodies in the literature of accounting emanated in US in the 1950s vis-à-vis decision usefulness theory (Zeff, 2012).

Financial ratios analysis can offer the comprehensive information needs of the investors in response to the single person theory of accounting as proposed by scholars as against the normally produced multiple purposes financial accounting annual reports. In other words, financial ratio analysis is intended to meet the specific needs of all potential investors who require additional comprehensive accounting data (Brearey, 2013; Barth and Landsman, 2010).

The single-person decision usefulness theory is aimed at satisfying the accounting information needs of potential investors. This will enable the optimal utilization of all the means of providing relevant, reliable and timely accounting information capable of ensuring the best investment decisions. It emphasizes that if theoretically, comprehensive financial statements cannot be provided, then specifically comprehensive accounting data that can aid investment decision should be provided through financial ratio analysis. However, it should be understood that tailoring financial ratios to the needs of each of the users could be easier than striving to satisfy the needs of all the users at the same time.

The down fall of giant companies like Xerox (2000), Enron (2001), Parmalat in (2003) at the international level as well as the Cadbury saga, Societe Generale Bank, Savannah Bank, Intercontinental Banks, Afribank in Nigeria still lingers in the mind of potential investors. The collapse of these corporate bodies occurred after being certified with a clean health by auditors. Potential investors are slightly cynical on trusting the contents of financial statements in spite of being certified by auditors (Ekwe, 2013). The loss of confidence on the quality of financial reports in Nigeria has made auditing to be seen as a window dressing profession. Prior to this period, the profession has always been perceived as a credible and noble profession (Adeyemi and Uadiale, 2011; Salehi, 2007).

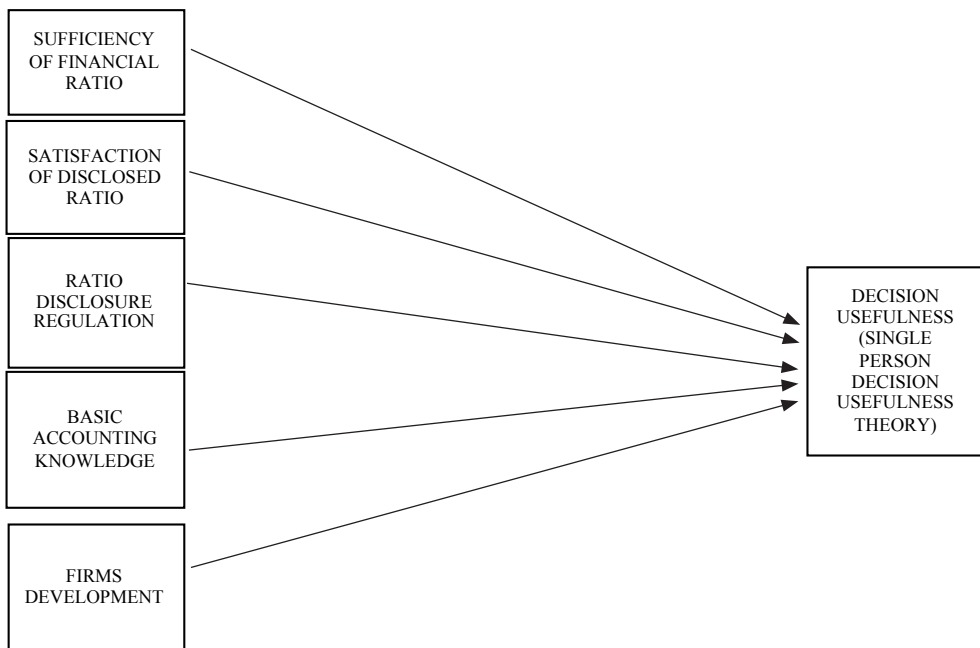
Moreover, accounting technologies as presented in the annual financial reports seems too technical for the knowledgeable let alone the layman. Majority hardly comprehend the contents of financial statement and as such investment decision becomes difficult (Norman, 2010), knowledge of accounting data is not only significant to investors but to other users ((Norman, 2006). Normally, accounting information reveals the investment opportunities in a firm which could be sourced from financial reports duly certified by external auditors (Oladipupo and Izedonmi; 2013).

The relevance placed on the information content in financial reports has been lost over time, even in advanced nations such as USA and UK (Parera & Thrikawala, 2012; Oyerinde, 2009; Ball & Brown 1968 and Guthrie, 2007). Due to the evident failure of annual financial reports to satisfy the information needs of investors, there is an urgent

need for satisfying the investment needs of potential investors through financial ratio analysis.

Financial ratio is a widely-used tool of financial analysis. The use of financial ratios to interpret financial statements provides a quick indication of a firm’s performance and financial position (Abdul-Baki, Uthman, & Sanni, 2014). In the light of the above, this paper conceptually evaluates the usefulness of financial ratio to the shareholders. In addition, it provides conceptual understanding of current state of affairs as to the usefulness of financial ratio analysis in stimulating investments drive of potential investors. More so, the study evaluates the extent to which financial ratios analysis can be used by the investors for investment decision making purposes to accelerate the growth of the economy.

Conceptual Framework of Decision Usefulness of Financial Ratio Analysis



3.0 Underpinnings Theories

This paper is guided by two theories – the single-person decision usefulness theory. This was developed on the basis that; if a comprehensive single purpose financial report cannot be guaranteed, then a singular comprehensive specific accounting information should be made available. This will stimulate the investment decisions drives of potential investors based on the emphasis of Statement of Financial Accounting Concepts (SFAC, No. 1).

The agency theory, on the other hand, established the inherent relationship between potential investors and the firm's management. The utmost concern of this theory is to mitigate potential problems that can occur in agency relationships due to managerial shenanigan as a result of the possession of insider corporate information. This theory presupposes that the complete disclosure of corporate value to the potential investors through disclosed financial ratios to enable rational investment decision.

4.0 Conclusion

It can be realized from the paper that financial ratios analysis is still the best way that accounting information can fully be communicated to potential investors in order to inspire the best investment decisions. However, the general purpose financial statement lacks clear information on the performance of corporate firms which the investors need to make investment decisions. For the shareholders to make the best use of the financial statement as a guide for making investment decision there is need for single purpose financial ratio disclosure through financial ratio analysis.

The paper conceptually shows that sufficiency of disclosed financial ratios and satisfactions derived from them are required for decision making. In addition, regulations mandating the disclosure of financial ratios and acquiring basic knowledge of the understanding of disclosed ratios are important. Moreover, other theoretical information on firms' level of development are one of the basic requirements that will catapult the investment drive of investors. In a nutshell, full disclosure of all relevant corporate financial ratios are needed for useful decision making.

5.0 Recommendation and Further Research

Based on the foregoing, the paper recommends that in order to make financial ratios more meaningful, there is need to consider these antecedent variables as itemised in the conceptual framework. This will ensure adequate disclosures on performance rather than mere window dressing for the use of both potential and existing shareholders. Furthermore, this paper proposed the adoption of fundamental analysis as a panacea for determining the corporate value of business entity for the purpose of taking investment decision.

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