

## **Tools of Financial Analysis**

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### **Abstract**

To evaluate the financial condition and performance of a company the financial analyst needs certain yardsticks. The yardstick frequently used is a ratio, or index relating two pieces of financial data to each other.

When comparing changes in the business's ratios from period to period, you can pinpoint improvements in performance or developing problem areas. By comparing the ratios to those in other businesses, you can see possibilities for improvement in key areas.

This paper focus on the main financial ratio calculated for the activity's entities referring to average levels registered for Romanian' entities in comparison with average level registered in Europe and generally, in the world.

## Introduction

The primary goal of financial management is to maximize the stock price's entities but accounting data do influences stock prices and to understand why a company is performing, first of all is necessary to evaluate the information reported by financial statements.

In order to assess how business is doing, one needs more than single numbers extracted from the financial statements. Each number has to be viewed in the context of the whole picture. For example, the income statement may show a net profit of 10,000 Euros. But is this good? If this profit is earned on sales of 50,000 Euros, it may be very good; but if sales of 200,000 Euros are required to produce the net profit of 10,000 Euros, things don't look so great anymore. A 200,000 Euros sales figure may seem impressive, but not if it takes \$2,000,000 in assets to produce those sales.

The true meaning of figures from the financial statements emerges only when they are compared to other figures. Such comparisons are the essence of why **business and financial ratios** have been developed.

The analysis of financial ratios involves two types of comparison.

**First**, the analyst can compare *a present ratio with past and expected future ratios for the same company*. The current ratio for the present year-end could be compared with the current ratio for the preceding year-end. When financial ratios are arrayed on a spreadsheet over a period of years, the analyst can study the composition of change and determine whether there has been an improvement or deterioration in the financial condition and performance over time. Financial ratios also can be computed for projected, or pro forma statements and compared with present and past ratios. In the comparisons over time, it is best to compare not only financial ratios, but also the raw figures.

**The second method of comparison** involves comparing *the ratios of one firm with those of similar or with industry averages* at the same point in time. Such comparison gives insight into the relative financial condition and performance of the firm. Sometimes a company will not fit neatly into an industry category. In such situations, one should try to develop a set, albeit usually small, of peer firms for comparison purposes.

A number of sources, including many trade or business associations and organizations, provide data for comparison purposes. Industry average is published by many companies, trade associations, and governmental agencies. For example, a variety of ratios can be found in the publications of Dun & Bradstreet's, Moody's Manual of Investments and Standard & Poor's Corporation Record.

The analysis must be in relation to the type of business in which the firm is engaged and to the firm itself.

For our purposes, financial ratios can be grouped into five types: **liquidity, debt, profitability, coverage and market value ratios**. No one ratio gives us sufficient information by which to judge the financial condition and performance of the firm. Only when we analyze a group of ratios are we able to make reasonable judgments. We must be sure to take into account any seasonal character of a business.

## **Liquidity Ratios**

Liquidity ratios are used to judge a firm's ability to meet short-term obligations.

From them, much insight can be obtained into the present cash solvency of a company and its ability to remain solvent in the event of adversities. Essentially, we wish to compare short-term obligations with the short-term resources available to meet these obligations.

### **Current ratio**

The ratio most commonly used to appraise the debt exposure represented on the balance sheet is the current ratio. This relationship of current assets to current liabilities is an attempt to show the safety of current debt holders' claims in case of default.

$$\text{Current ratio} = \text{Current assets} / \text{Current liabilities}$$

Presumably, the larger this ratio, the better the position of the debt holders. From the lenders' point of view, a higher ratio would certainly appear to provide a cushion against drastic losses of value in case of business failure. A large excess of current assets over current liabilities seems to help protect claims, should inventories have to be liquidated at a forced sale and should accounts receivable involve sizable collection problems.

Seen from another angle, however, an excessively high current ratio might signal slack management practices. It could indicate idle cash balances, inventory levels that have become excessive when compared to current needs and poor credit management that results in overextended accounts receivable. At the same time, the business might not be making full use of its current borrowing power.

The Rumanians current accounting rules recommends an acceptable level, around 2 (The Romanian accounting rules harmonization at EU norms, 2008).

The possible causes of a *low current ratio* are:

- Current liabilities too high
- Using short-term funds to fund long-term assets

If the firm feel it business's current ratio is too low, it may be able to raise it by:

- Paying some debts.
- Increasing your current assets from loans or other borrowings with a maturity of more than one year.
- Converting non-current assets into current assets.
- Increasing your current assets from new equity contributions.
- Putting profits back into the business

### **Quick ratio (acid test ratio)**

This ratio is an indicator of a company's short-term liquidity. The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets, calculated as follow:

**The quick ratio = Current assets- Inventories /Current liabilities**

The higher the quick ratio, the better the position of the company. Also known as the "acid-test ratio".

This ratio is the same as the current ratio, except that it excludes inventories- presumably the least liquid portion of current assets – from the numerator. The ratio concentrates on cash, marketable securities and receivables in relation to current obligations and thus provide a more penetrating measure of liquidity than does the current ratio. The key concept here is to test collectibles of current liabilities in the case of a real crisis, on the assumption that inventories would have no value at all.

Companies with ratios less than 1 cannot pay their current liabilities and should be looked at with extreme caution. Furthermore, if the acid-test ratio is much lower than the working capital ratio, it means current assets are highly dependent on inventory.

Retail stores are examples of this type of business.

The possible causes of a *low quick ratio* are:

- Current liabilities too high
- Using short-term funds to fund long-term assets
- Stock too high

Solutions could be:

- Move some short-term liabilities to long-term
- Sale' leaseback of some fixed assets
- Reduce stock

**Liquidity of receivables**

When there are suspected imbalances or problems in various components of the current assets, the financial analyst will want to examine these components separately in assessing liquidity. Receivables, for example, may be far from current. To regard all receivables as liquid when in fact a sizable portion may be past due, overstates the liquidity of the firm being analyzed. Receivables are liquid assets only insofar as they can be collected in a reasonable amount of time. For our analysis receivables, we have two basic ratios:

- ❖ The first of which is **the average collection period:**

**The average collection period = (Receivables/Annual credit sales)\* Days in year(365)**

- ❖ The second ratio is **the receivable turnover ratio:**

**The receivable turnover ratio = Annual credit sales/ Receivables**

These two ratios are reciprocals of each other. The number of days in the year, 365, divided by the average collection period, 62 days, gives the receivable turnover ratio, 5.89.

The number of days in the year divided by the turnover ratio gives the average collection period. Thus, either of these two ratios can be employed.

### **Liquidity of Inventories**

We may compute the inventory turnover ratio as an indicator of the liquidity of inventory as follow:

$$\text{The liquidity of inventory} = \text{Cost of goods sold/Average inventory}$$

The average inventory figure used in the denominator typically is an average of beginning and ending inventories for the period.

Generally, the higher the inventory turnover, the more efficient the inventory management of the firm. Sometimes a relatively high inventory turnover ratio may be the result of a too low a level of inventory and frequent stock outs. It might also be the result of too many small orders for inventory replacement. Either of these situations may be more costly to the firm than caring a larger investment in inventory and having a lower turnover ratio. When the inventory turnover ratio is relatively low, it indicates slow-moving inventory or obsolescence of some of the stock.

### **Debt Ratios**

Most companies finance a portion of their assets with liabilities and the remaining portion with equity. A company that finances a relatively large portion of its assets with liabilities is at a greater risk. This is because the liabilities must be repaid and often require regular interest payments. The risk is that a company may not be able to meet required payments. One way to assess the risk associated with a company's use of liabilities is to compute and analyze debt ratio.

Debt proportion analysis is in essence static, and does not take into account the operating dynamics and economic values of the business. The analysis is totally derived from the balance sheet, which in itself is a static snapshot of the financial condition of the business at a single point in time.

Nonetheless, the relative ease with which these ratios are calculated probably accounts for their popularity. Such ratios are useful as indicators of trends, when they are applied over a series of time periods. However, they still don't get at the heart of an analysis of creditworthiness, which involves a company's ability to pay both interest and principal on schedule as contractually agreed upon, what is, to service its debt over time.

In this category, we have three ratios as follows:

#### **Debt-to-equity ratio**

The **debt-to-equity ratio** which is computed by simply dividing the total debt of the firm (including current liabilities) by its shareholders' equity as follow:

$$\text{Debt-to-equity ratio} = \text{Total debt/ Shareholder's equity}$$

When intangible assets are significant, they frequently are deducted from shareholders' equity.

- A ratio greater than one means assets are mainly financed with debt, less than one means equity provides a majority of the financing.
- If the ratio is high (financed more with debt) then the company is in a risky position - especially if interest rates are on the rise.

The ratio of debt to equity varies according to the nature of the business and the volatility of cash flow. An electric utility, with very stable cash flows, usually will have a higher debt ratio than will a machine tool company, whose cash flows are far less stable.

A comparison of the debt ratio for a given company with those of similar firms gives us a general indication of the creditworthiness and financial risk of the firm.

### **Long-term capitalization ratio**

In addition to the ratio of total debt to equity, we may want to compute the following ratio, which deals with only the **long-term capitalization** of the firm:

**The long-term capitalization = Long-term debt/Total capitalization**  
where,

- Total capitalization represents all long-term debt, preferred stock, and shareholders' equity.

This measure tells us the relative importance of long-term debt in capital structure.

### **The debt- to- total assets ratio**

This ratio expresses what proportion of total farm assets is owed to creditors and it is obtained by compares total farm liabilities to the value of total farm assets, after formula below:

**The Debt/Asset Ratio = The debt/Total assets**

The ratio is one measure of the risk exposure of the farm business; thus, is important in evaluating the financial trend of the business.

The goal of many farm business operators is to approach a debt free operation. A continual lowering of this ratio is a trend in that direction. The higher the ratio, the greater the risk exposure of the farm business.

So, it is favorably appreciated a descendent evolution of this indicator and the interval of the financial safety is [0%, 30 %].

In USA, the industry average of this ratio is 40 % (Brigham E. F, 1999).

### **High Debt to total assets ratio:**

- High debt to total assets ratio means more of the firm's assets are financed by debt relative to owners' funds.
- A high ratio requires the commitment of more funds to pay interest and repay principal amount. The failure to meet these requirements may force a company to bankruptcy.
- A company with a very high debt ratio may also find it difficult to attract additional financing.
- Positive aspects of high debt ratio are that existing shareholders can maintain control because using debt avoids the sale of new shares.

### **Low Debt to assets ratio:**

- Generally, lower is better
- Low debt ratio means that the firm is using more of owner's capital and retained earnings to finance its assets.
- It means less risk to creditors.
- Company can borrow additional funds with relative ease.

### **Coverage Ratios**

Borrowing money is one of the most effective things a company can do to build its business. But, of course, borrowing comes with a cost: the interest that is payable month after month, year after year. These interest payments directly affect the company's profitability. For this reason, a company's ability to meet its interest obligations, an aspect of its solvency, is arguably one of the most important factors in the return to shareholders.

There are two types of coverage ratio:

- Time Interests Earned (TIE) ratio
- The Fixed Charge Coverage ratio

#### **Time interests earned (TIE) ratio**

Interest coverage is a financial ratio that provides a quick picture of a company's ability to pay the interest charges on its debt. The 'coverage' aspect of the ratio indicates how many times the interest could be paid from available earnings, thereby providing a sense of the safety margin a company has for paying its interest for any period. A company that sustains earnings well above its interest requirements is in an excellent position to weather possible financial storms. By contrast, a company that barely manages to cover its interest costs may easily fall into bankruptcy if its earnings suffer for even a single month.

#### **The Time Interests Earned (TIE) ratio = EBIT/ Interest charges**

Because interest coverage is a highly variable measure, not only between companies within an industry but between different industries, it is worthwhile to establish some guidelines for setting acceptable levels of interest coverage in particular industries. Obviously, an interest-coverage ratio below 1 is an immediate indication that the company, regardless of its industry, is not generating sufficient cash to cover its interest payments. That said, an

interest-coverage ratio of 1.5 is generally considered the bare minimum level of comfort for any company in any industry.

Beyond these absolute minimums, determining acceptable interest coverage for an industry depends on its nature - or more specifically, the stability or consistency of its earnings.

### **The Fixed Charge Coverage ratio**

This ratio is similar to the times-interest-earned-ratio but it's more inclusive because it's recognizes that many firms lease assets and also must make sinking fund payment.

Leasing is widespread in certain industries, making this ratio preferable to the time-interests-earned-ratio for many purposes.

Fixed charge include interest, annual long-term lease obligations and sinking fund payments, and the fixed charge coverage ratio is defined as follow:

**The Fixed Charge Coverage ratio = (EBIT + Lease payments)/(Interest charges+Lease payment+Sinking fund payment (1-Tax rate))**

### **Profitability Ratios**

We turn now at the viewpoint of the owners of a business. These are the investors to whom management is responsible and accountable. So far, we have not mentioned owners directly, even though it should be quite clear that the management of a business must be fully cognizant of, and responsive to, the owners' viewpoint and expectations in the timing, execution, and appraisal of the results of operations. This is the basis for shareholder value creation, as we've said before. Similarly, management must be alert to the lenders' viewpoint and criteria.

The key interest of the owners of a business, the shareholders in the case of a corporation, is profitability. In this context, profitability means the returns achieved, through the efforts of management, on the funds invested by the owners. The owners are also interested in the disposition of earnings which belong to them, that is, how much is reinvested in the business versus how much is paid out to them as dividends, or, in some cases, through repurchase of outstanding shares. Finally, they are concerned about the effect of business results achieved-and future expectations about results-and the market value of their investment, especially in the case of publicly traded stocks.

Profitability ratios are of two types:

- those showing profitability in relation to sales
- those showing profitability in relation to investment.

Together these ratios indicate the firm's efficiency of operation.



## **Profitability in Relation to Sales**

There are three key profit-margin ratios: gross profit margins, operating profit margins and net profit margins.

### **Gross profit margin**

This ratio tells us the profit of the firm relative to sales after we deduct the cost of producing the goods sold. Your gross profit ratio tells you how much of each sales dollar you can expect to use to cover your operating expenses and profit. In other words, it measures the difference between what it costs to produce a product and what you're selling it for.

The formula for this ratio is:

$$\text{Gross profit margin} = \text{Sales less cost of goods sold} / \text{Sales}$$

There are two key ways to improve your gross profit margin:

- First, it will be increase the prices.
- Second, it will be decrease the costs to produce your goods.

Of course, both are easier said than done. An increase in prices can cause sales to drop. If sales drop too far, you may not generate enough gross profit dollars to cover operating expenses. Price increases require a careful reading of inflation rates, competitive factors and basic supply and demand for the product you are producing.

The second method of increasing gross profit margin is to lower the variable costs to produce your product. This can be accomplished by decreasing material costs or making the product more efficiently. Volume discounts are a good way to reduce material costs. The more material you buy from a supplier, the more likely they are to offer you discounts. Another way to reduce material costs is to find a less costly supplier. However, you might sacrifice quality if the goods purchased are not made as well.

Whether you are starting a manufacturing, wholesaling, retailing or service business, you should always be on the lookout for ways to deliver your product or service more efficiently. However, you also must balance efficiency and quality issues to ensure that they do not get out of balance.

Companies with high gross margins will have a lot of money left over to spend on other business operations, such as research and development or marketing. So be on the lookout for downward trends in the gross margin rate over time. This is a telltale sign of future problems facing the bottom line. When labor and material costs increase rapidly, they are likely to lower gross profit margins - unless, of course, the company can pass these costs onto customers in the form of higher prices.

It's important to remember that gross profit margins can vary drastically from business to business and from industry to industry. For instance, the airline industry has a gross margin of about 5%, while the software industry has a gross margin of about 90%

### **Operating Profit Margin**

By comparing earnings before interest and taxes (EBIT) to sales, operating profit margins show how successful a company's management has been in generating income from the operation of the business:

$$\text{Operating Profit Margin} = \text{EBIT}/\text{Sales}$$

This ratio is a rough measure of the operating leverage a company can achieve in the conduct of the operational part of its business. It indicates how much EBIT is generated per dollar of sales. High operating profits can mean the company has effective control of costs, or that sales are increasing faster than operating costs.

Operating profit also gives investors an opportunity to do profit-margin comparisons between companies that do not issue a separate disclosure of their cost of goods sold figures (which are needed to do gross margin analysis). Operating profit measures how much cash the business throws off, and some consider it a more reliable measure of profitability since it is harder to manipulate with accounting tricks than net earnings. Naturally, because the operating profit-margin accounts for not only costs of materials and labor, but also administration and selling costs, it should be a much smaller figure than the gross margin.

### **Net profit margin**

The net profit margin tells us the relative efficiency of the firm after taking into account all expenses and income taxes, but not extraordinary charges.

The formula for this ratio is:

$$\text{Net profit margin} = \text{Net profit after taxes} / \text{Sales}$$

Margin analysis is a great way to understand the profitability of companies. It tells us how effectively management can wring profits from sales, and how much room a company has to withstand a downturn, fend off competition and make mistakes. But, like all ratios, margin ratios never offer perfect information. They are only as good as the timeliness and accuracy of the financial data that gets fed into them, and analyzing them also depends on a consideration of the company's industry and its position in the business cycle.

Margin ratios highlight companies that are worth further examination. Knowing that a company has a gross margin of 25% or a net profit margin of 5% tells us very little without further information. As with any ratio used on its own, margins tell us a lot, but not the whole story, about a company's prospects.

### **Profitability in Relation to Investment**

With all the ratios that investors toss around, it's easy to get confused. Consider return on equity (ROE) and return on assets (ROA). Because they both measure a kind of return, at first glance, these two metrics seem pretty similar. Both gauge a company's ability to generate earnings from its investments. But they don't exactly represent the same thing. A closer look at these two ratios reveals some key differences. Together, however,

they provide a clearer representation of a company's performance. Here we look at each ratio and what separates them.

- ❖ *Return on assets*, which is of major importance for judging management performance, and
- ❖ *Return on equity*, which serves as the key measure from the owners' viewpoint.

### **Return on Assets**

This number tells you how effective your business has been at putting its assets to work. The ROA is a test of capital utilization - how much profit (before interest and income tax) a business earned on the total capital used to make that profit. The basic formula for return on assets (ROA) is:

$$\text{ROA} = \text{Net profit} / \text{Assets}$$

This is an important ratio for companies deciding whether or not to initiate a new project. The basis of this ratio is that if a company is going to start a project they expect to earn a return on it, ROA is the return they would receive. Simply put, if ROA is above the rate that the company borrows at then the project should be accepted, if not then it is rejected.

To get the most insight out of Return on assets we should look at the number in two different ways:

- Look at the trend in return on assets over time. A falling return on assets could indicate that the company's customers find new products much less valuable than an existing product line or much less valuable than competitor's offerings and aren't willing to pay as much for them. Older products with lower margins could be making up a bigger and bigger part of sales. An older factory simply can't produce the company's products very efficiently anymore. Management can simply be clueless about how to control expenses. A falling return on assets inevitably leads to a declining stock price as investors realize that management is earning less and less profit on the things the business owns.
- Compare a company's return on assets with the ratio at other companies in its industry. Companies with a high return on assets relative to their peers own a very powerful weapon. They are getting more profit out of each dollar of machinery or inventory, for example. That means they have more money to devote to marketing or research and such companies certainly have an easier time attracting investment capital for new factories and new products. Companies with a low return on assets are probably losing ground to competitors. A steadily falling return on assets may be a sign that this company is headed onto history's trash heap.

### **Return on equity or the ROE**

Essentially, ROE reveals how much profit a company generates with the money shareholders have invested in it and it is calculated as follow:

$$\text{ROE} = \text{Net income} / \text{Shareholders' equity}$$

The ROE is useful for comparing the profitability of a company to that of other firms in the same industry.

This index may vary substantially from company to company or from period to period because of the financial structure differences.

The ROE of an enterprise with a rapid growth will constantly decrease even if sales and net gains look very good. This is happening because of the initial sub capitalization of the enterprise.

Obtaining big profit with a company initially low on equity may give the ROE a staggering evolution. A decreasing evolution of the ratio must not be seen as negative - the condition is not to fall below a certain minimum limit that is admitted in the industry. An average ratio on industry for this indicator is 9,2% (Halpern P., 1998)

Also, return on equity ratio, can have a different importance from a shareholder to another, specking about the different interest of a majortar shareholder comparison with minortar shareholder.

Therefore, the majortar shareholder does a long term placement for which he doesn't need an immediately remuneration, so he won't be interested in obtain of dividend, right away. He will want to realize an acceptable level of return on equity ratio, based on the reinvest the profit and also generating a raise of entity value.

Contrarily, the minortar shareholder will be interested in a short-term ratability consist in the value of dividends received for their investment. This level of ratability is evaluated with another group of ratios we will focus later, in this paper. So, the minortar shareholder won't have a special interest for this ratio.

**The Difference between ROA and ROE is All about Liabilities.** The big factor that separates ROE and ROA is financial leverage, or debt. The balance sheet's fundamental equation shows how this is true: assets = liabilities + shareholders' equity. This equation tells us that if a company carried no debt, its shareholders' equity and its total assets would be the same. It follows then that their ROE and ROA would also be the same.

### **Market-Value Ratios**

There are relating the current market price of share of stock to an indicator of the return that might accrue to the investor. This ratios focus on the current market price of stock because that is the amount the buyer would invest. Four market ratios can be used by the analysts and investors as follow:

#### **1. Earning per share Power (EPS)**

It shows how much of the company's profits, after tax, each shareholder owns.

$$\text{EPS} = \text{Net income} / \text{Number of Shares Outstanding}$$

This ratio evaluates profitability strictly from the common stockholders' point of view. This key ratio is used in share valuations.

## **2. Price to Earnings ratio (P/E)**

This ratio measures the relationship between the current market price of the stock and its earnings per share.

$$\text{P/E} = \text{Market Value Per Share/Earnings Per Share}$$

The P/E ratio is used as an indicator of the future performance of the stocks. Analysts use the P/E ratio to predict how the stock price may react to a change in the level of the company's earnings.

In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. An average industry rate, for these indicators is 7 (Halpern P., 1998).

## **3. Market-to-book Ratio (MTBR)**

Simply put, the market value of a firm divided by capital invested.

$$\text{MTBR} = \text{Market Value per Share/Book Equity Value}$$

Market to Book Ratio seeks to show the value of a company, by comparing the book value and market value. Book value is calculated from the companies historical cost, or accounting value, and market value is calculated from its market capitalization. An average industry rate, for this indicators is 0,9 (Halpern P., 1998).

## **4. Dividend Yield Ratio (DYR)**

The indicator measures the earnings of shareholders resulting from investment in enterprise stocks.

$$\text{Dividend Yield Ratio} = \text{Dividend per share/Market Price per Share}$$

Like the P/E ratio, this ratio is a volatile measure because the price of stock may change materially over short period of time, and each change in market price or dividend payment changes the ratios.

For comparison, in the table below, we present the average performance ratios registered for Romania, Europe and world average economy:

**Table 1: The main average performance ratios: Comparison between Romania, Europe and world average.**

Ratios	Romania	Europe	World average
<b>I. Liquidity ratios</b>			
Current Ratio	1,72	1,89	1,79
Quiq Ratio	1,12	1,34	1,17
Debtors' turnover ratio	77,28	90,48	97,71
Inventory Turnover ratio (days)	102,83	96,8	178,1
Total assets Turnover (days)	514,08	323	434,5
<b>II. Debts ratios</b>			
Total debts to total assets	28,51 %	35,59 %	33,24 %
Long Term Debt to Total capital	16,87 %	24,43 %	20,39 %
Equity to total capital	78,16	71,91	76,12
Long term debt to total capitalization	17,75 %	25,35 %	21,12 %
<b>III Profitability ratios</b>			
Gross Profit Margin	30,57 %	23,84 %	24,00 %
Operating profit margin	12,43 %	8,03%	10,67 %
Cost good sold/Sales	59,61 %	70,15 %	68,6 %
Return on Equity	18,11 %	11,96 %	13,81 %
Return on assets	8,86 %	5,38 %	21,73 %
<b>IV Coverage</b>			
Fixed charge coverage ratio	25,41	331,5	1014,3

Source : Parker Philip M. (2006)

For Romania, referring to liquidity ratio, we can observe there is a good liquidity at the global economy level. The solvability ratios are bigger than even the average world level, especially by reason of a good level registered for gross or net profit. There is one except, namely Return on assets, that has small level compare with average world ratio but higher than average Europe ratio. The explanation consists in a higher level of assets compare with the profit that generates it. We can also observe a very small turnover ratio for total assets, with a big level above even the average ratio. The problem is caused by the big level of fix assets and their very small turnover.

As for the solvability ratios, there is a very small debt ratios cause of mistrust for financial organization and also of the small level of their development.

In conclusion, there are no "magic" ratios which somehow encapsulate all that is important to understand about the position of particular company (Walton P, Haller A., Raffournier B, p.494) for minimum **two reasons**:

**First**, the ratios can only be interpreted on a **comparative, basis**. Financial analysis often use four type of standards against which ratio are compared (Short G. Daniel, 1993, Boston, p. 760):

✓ **Comparison of the ratios for the current year with the historical ratios for the same company.** Particular attention is given to the trend of each ratio over time.

✓ **Comparison of the ratios for the current year with ratios of other companies for the same year.** These comparisons include the use of ratios from other similar companies and from industry average.

✓ **Experience of the analyst who has a subjective feel for the right relationship in a given situation.** These subjective judgments of an experienced and competent observer can be more reliable than purely mechanical comparison.

✓ **Comparison of the ratios for the current year with goals and objectives expressed as ratios.** Many companies prepare comprehensive profit plans (the budgets) that incorporate realistic plans for the future. These plan usually incorporated goals for significant ratios, such as profit margin, return on investment, earning per share.

❖ **Second**, the ratios doesn't represent the final point of analyze and doesn't reflect strengths and weaknesses point of a business, only through themselves. A unilateral analyze of an individual ratio could generate wrong conclusions about the activity evaluation. It's impose that financial ratios of a specific business **to be best interpreted as a group**, rather than making judgments on individual ratios. The interpretation of one ratio may be altered by other ratios of the same business.

Also, supplementary, a compute analyze of ratio with **another dates about the entity's management or another entity's economic conditions**, it would be reflect, certainly, the fair value about the entity's activity.

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\*\*\* The Order of Financial Minister no. 1752/2005 that approve The accountant's rules conforms to European Directives, published in M. Of. nr. 1090 din 30.11.2005, Romania modified and completed by OMFP 2374/2007 published in M. O. no.25/14,01.2008.