FINANCIAL ACCOUNTING RATIOS AS A TOOL FOR THE EVALUATION OF MANAGEMENT OF MILLS COMPANY

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ABSTRACT
This study investigated the financial accounting ratios as a tool for the evaluation of management of Mills Company. To achieve this, a sample of audited financial statement from the selected company was used for the computation of relevant ratios, where analysis and the interpretation of the result becomes possible. An extensive empirical and conceptual literature review were carried out based on the variables of the study. Research question was posed for a guide to the computation of the relevant ratios. The population of the study comprised all registered Mills companies within the areas of the study. The sampling techniques used was a two-stage sampling technique which are purposeful and a simple random sampling technique. Primary data collected were from the audited financial statement of the selected mills company which the data were used for the computation of the major ratios. The analysis and interpretation of financial performance of the mills company were carried out. The study revealed that the financial performance and the returns from investment was encouraging, the efficiency with which inventory, receivables and trade payable were managed was good, the selected company was having a poor liquidity control measures and its debt capacity was high but not excessively high beyond control. The study suggests that financial accounting ratios stands as a powerful tool in forecasting the poor and the good performance of a company. Based on the findings, it was recommended amongst others that business managers of mills company should appreciate the important of frequently subjecting their financial statement to ratio analysis to determine the financial health of the company, users of financial statement are highly advised to use financial ratios to analysis their financial statement of a company for a better financial decision.

Introduction

Shareholders and other stakeholders use financial statements to make informed decisions with regards to the operation of an entity. The financial statement contains a large number of figures, but the figures themselves does not necessarily have much meaning to a user of the financial statement. However, the figures can be analyzed and interpreted by calculating financial ratios. Financial ratios can help the users of the financial statement to assess the financial position of the entity and its financial performance. Barry E. & Jamie E. (2013).

Statement of the Problem

Users of the financial statements needs to know more about the figures stated in the financial statement; a profit-making entity needs to know about its financial performance and the returns that it makes on the capital invested. Its need to know the efficiency with which its manage its receivables, inventory and trade payables. Wish to know whether it would have access to cash readily available to meet obligations to make payment as they all due. Wish to know whether its total of its debts is within control and are not excessive. Investors needs to know whether to continue to hold shares or to sell them.

When all this information needed by these users of financial statement are not provided due to the vast figures in the financial statement, the users would be misled. In order not to put them in a confused side, the figures need to be analyzed and interpreted accordingly to the various users. This brought about the study on the financial accounting ratios as a tool for the evaluation of management account (Mills Company).

The purpose of the study

The major purposes of this study are stated below:

1. To make it known to the profit-making entity its financial performance and the returns that it makes on the capital invested.

2. To enable an entity, know the efficiency with which its managed its receivables, inventory and trade payable.

3. To make a company know whether it would have access to cash when needed to meet obligation to make payment as they are due.

4. To help a company know whether its total debt is within control and are not excessive.

5. To help investors to know whether to continue to invest or to sell their shares.

Research Questions

1. To what extent does financial accounting ratio evaluate the financial performance and the returns the company makes on the capital invested.

2. How does financial accounting ratio evaluate and make it known the efficiency with which a company managed its receivables, inventory and trade payable.

3. To what extent does financial accounting ratio evaluate a company access to cash when needed to meet obligation and to make payment when they are due.

4. How does financial accounting ratio analysis help a company to know whether its total debts are within control and not excessive.

5. To what extent does financial accounting ratio interpret to the investors whether to continue to invest or to sell their shares.

Significance of the study

The significant of this study cannot be overemphasized, as it may be useful to the following group of persons: the investors and potential investors, the lenders, the employees, the suppliers, the customers, the government and government agencies, the general public to mention but a few. The findings and the recommendation of this study may be helpful to the financial statement users so that they would see the needs to evaluate and interprets the vase figures in the financial statement to make meaning to the users.

The scope of the study

The study examined the financial accounting ratio as a tool for the evaluation of management of Mills Company. The sub independent variables are profitability ratio, efficiency ratio, liquidity ratio,

solvency ratio and investors ratios while the dependent variable is management of mills company.

Limitation of the Study

The findings of this study may not be generalized beyond the scope of the study area.

Key Notes of Financial Accounting Ratios

1. **Ratio:** This refers to a mathematical concept that shows the relationship that exist between two or more variables.

2. **Financial Ratio**: This is a mathematical concept that shows the relationship between two or more financial data in a financial statement which may be expressed as a percentage or fraction of other figures in a financial statement.

3. **Financial Accounting**: This refers to the process of recording, classifying, analyzing, summarizing, interpreting and communicating of financial information to the users for effective business decisions.

4. **Evaluation**: This refers to the process of analyzing a company's financial statement for decision making purpose.

5. **Management:** This refers to how businesses organized and direct work flow, operations and employees to meet company goals and objectives.

Conceptual review

The available review related to the topic of this study was reviewed by the researcher and discussed under the following sub-headings.

Profitability ratios and evaluation of management of Mills Company

Since business mainly exist with the primary purpose of creating wealth for their owners, profitability ratios, therefore, provides an insight to the degree of success of achieving these primary objectives. They express profit made or earned in relation to other key figures in the financial statement or to some business resource.

(Prince Casmir Idekwulim, 2022). The following are the common examples of profitability ratios:

i. Return on capital employed (ROCE)

Profit making company should try to make a profit that is large enough in relation to the amount of money or capital invested in the business. This measures the overall performance of a business by comparing the capital employed with the amount generated. For a single company, ROCE is computed as thus:

$$ROCE = \frac{profit\ before\ interest\ and\ tax}{share\ capital\ and\ reserves + long\ term\ debt\ capital\ preference} x\ 100$$

To calculate the ROCE for a group of companies, ROCE should therefore be as profit before interest and tax as a proportion of total capital employed, including the non-controlling interest.

ii. Return on shareholder capital (ROSC)

This measures the return on investment that the shareholders of the company have made. This ratio normally uses the values of the shareholders' investment as shown in the financial statement rather than market value of shares. It is computed as thus:

$$ROCE = \frac{profit\ after\ tax\ and\ preference\ dividend}{share\ capital\ and\ reserves} x\ \frac{100}{1}$$

iii. Gross profit margin: This ratio relates the gross profit of a business to the revenue of the business over the same period. It is computed as thus:

$$Gross\ profit\ margin\ = \frac{gross\ profit}{sales/revenue} x \frac{100}{1}$$

iv. Net Profit margin = This ratio relates the net (PBIT) of the business to the revenue of that business. It measures the operational performance of a business. It is computed as thus:

$$Gross\ profit\ margin\ \ \frac{Gross\ Profit}{Sales/Revenue} X \frac{100}{1}$$

v. The assets turnover ratio: this refers to the ratio of sales to capital employed. It measures the amount of sales achieved during the period for each N1 of investment in assets. It is calculated as:

$$Net\ profit\ margin\ \ \frac{Profit\ before\ interest\ and\ tax}{Sales/Revenue} X \frac{100}{1}$$

vii. Return on total asset: this compares the profit for the period with the total asset employed by the entity during the same period. It is measured as:

$$\boldsymbol{Return\ on\ total\ asset} = \frac{\boldsymbol{Profit\ before\ interest\ and\ tax}}{\boldsymbol{Total\ assets}}\ \boldsymbol{x\ 100}$$

Efficiency or working capital ratios

Working capital or efficiency ratios measures the efficiency with which the entity has managed its receivables, inventory and trade payables. The ratios are usually measured in terms of an average number of days. The working capital ratios are a useful measure of whether the entity has too much or too little invested in working capital. Excessive investment in working capital is indicated by a long cash cycle that appears to be getting even longer. When too much is invested in working capital, the return on capital employed and return on shareholder capital would be lower than they should be. Under investment on working capital is an indication of possible liquidity difficulties. When working capital is low in comparison with the industry average, this might indicate that current assets are beings financed to an excessive extent by current liabilities, particularly trade payables and bank overdraft.

Ratios under this category include:

i. Inventory holding period

ii. Trade receivable collection period

iii. Trade payable payment period

iv. Inventory turnover

v. Trade receivable turnover

vi. Trade payable turnover

i. **Inventory holding period**: this ratio is an estimate of the average time that inventory is held before it is used or sold. It is calculated as thus:

$$Inventory\ Holding\ Period = \frac{Av.Inventory}{Cost\ of\ Sale} X\ 365\ days$$

Note: Average inventory = Opening inventory + closing inventory / 2

However, if opening inventory is not given, closing inventory should be used. Inventory being held in a store before being used or dispatched to the customer can be measured in days, month or week.

ii. **Trade Receivable collection period**: This ratio estimates the time that it takes on average to collect the payment from customers after the sales has been made. It could be described as average credit period allowed to customers. It measures the average number of days, or weeks that it takes an organization to collect money from their customers after selling goods to them

on credit. The shorter the period, the better for the business, but it should not be too short as it may affect the business performance negatively through reduction in turnover. It can be calculated as follows:

Trade receivable collection period = Average trade receivables x 365 days

Credit sales

Note: If the proportion of sales on credit is not available then it will be assumed that all sales were on credit

Average trade receivable = Opening trade receivable + closing trade receivable

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However, if opening trade receivable is not given, then the closing receivable (i.e. SOFP value) should be used as average trade receivables.

iii. **Trade payables payment period**: This ratio measures on the average, how long it takes the business to settle its suppliers after buying goods from them on credit. That is, it measures the average number of days or weeks that the credit suppliers remained unsettled. The longer the period the better for the business but it should not be unreasonably too long. It can be computed as thus:

Trade payables payment period = Average trade payables x 365 days

Credit purchases

Note: If the proportion of purchases on credit is not available, then it will be assumed that all the purchases were on credit.

Average trade payable = Opening trade payable + closing trade payable

2

But if the opening trade payables is not given, then the closing trade payables (i.e. SOFP value) should be used as average trade payables. If opening inventory is not given, then cost of sales should be used as purchases.

However, if opening inventory is available then purchase will be derived as thus:

Purchase = cost of sales + closing inventory – opening inventory

iv. **Inventory Turnover**: This measures how often a business is able to turn its inventory into sales. The higher the number of times, the more efficient the business is in managing inventory. It is measured in times. It is calculated as:

Trade receivable turnover = Cost of sales

Average inventory

v. **Trade Receivables Turnover**: This measures on the average how often the business receives settlement of receivables from its debtors. It measures the rapidity of debt collection. It is measured in times. It is calculated as follows:

Trade receivable turnover = credit sales

Average trade receivables

vi. **Trade payables turnover**: this measures on the average how often the business makes settlement to its creditors. The lower the number of times the better the business but it should not be extremely too low. It can be computed as thus:

Trade payable turnover = Credit purchases

Average trade payables

2.3 Liquidity Ratios and the evaluation of management of Mills Company

Liquidity means having cash or access to cash readily available to meet obligations to make payments as they all due. It is a ratio

used in judging the ability of an enterprise to meet its short-term maturing obligations. Ratios under this category includes

(i) Current ratio (ii) quick ratio or acid test ratio

i. **Current Ratio**: This ratio measures the ability of the business to settle its short-term obligation as at when due using its current assets. That is, the ratio indicates the extent to which assets that will be converted into cash within a year cover claim of short-term payables or creditors. The acceptable norms for current ratio is 2:1, meaning that for a business to be considered liquidity healthy; its current assets should double its current liabilities. It is computed as thus:

current Ratio = Current Assets: 1
Current liabilities

ii. **Quick Ratio or Acid Test Ratio**: This ratio measures the ability of a business to settle its short-term obligations as at when due. Using its liquid or quick assets (i.e. current assets – closing inventory) that is, the ratio shows the extent to which cash and other assets must readily convertible to cash are to meet the demand of short-term creditors or payables. The acceptable norms for quick ratio is 1:1, meaning that for a business to be considered liquidity healthy, its liquid or quick asset. (i.e. current assets less closing inventory) should be equal to its current liabilities. It is calculated as thus:

Acid test ratio or quick ratio = Current Assets – closing inventory; 1

Current liability

iii. **Cash Ratio**: This ratio measures the ability of the business to settle its short-term obligations as at when due using its highly liquid assets (i.e. cash and cash equivalents). A cash ratio of about 0.88 means that the business will be able to settle about 88% of its short-term obligation (current liabilities) as at when due using its cash balance.Cash ratio is calculated as:

Cash Ratio = Cash and cash equivalent: 1
Current liability

Debt ratio or solvency ratio

These ratios are used to assess whether the total debt of the entity are within control and are not excessive. The following ratios are computed under the heading.

i. Gearing ratio (leverage ratios)
ii. Interest cover ratio
iii. Debt/equity ratio

(i) Gearing Ratios – this ratio measures the total long-term debts of a company as a percentage of either

- The equity capital in the company
- The total capital of the company

The equity capital in the company

Debt to equity ratio: this can be computed as:

Long term debt including redeemable preference share x 100
Share capital + reserves
1

Note: A high level of gearing may indicate the following:

- The entity has a high level of debt which means that it might be difficult for the entity to borrow more when it needs to raise new capital.
- High gearing can indicate a risk that the entity will be unable to meet its payment obligations to lenders, when these obligations are due for payment.

The gearing ratio can be used to monitor changes in the amount of debt of a company over time. It can also be used to make comparisons with the gearing levels of other similar companies, to judge whether the company has too much debt or perhaps too little in its capital structure.

ii. **Interest Cover Ratio**: This ratio measures the ability of the company to meet its obligation to pay interest. It measures in times and a cover of about 3 times generally considered safe. It is calculated as thus:

Interest cover = profit before interest and tax / Interest charges in the year

iii. **Debt/Equity Ratios**: This ratio measures the proportion of an entity's asset that is financed with debt. It is calculated as thus:

Debt/Equity Ratio = Long term debt including redeemable pref. shares / Ordinary share capital + Reserves

Investors Ratios

These are ratios concerned with assessing the returns and performance of shares held in a particular business from the perspective of shareholders who are not involved with the management of the business. These ratios are of interest to the investors in shares and bonds and their advisers. They are as follows:

i. Earnings per share (EPS)
ii. Price sharing ratio (P/E Ratio)
iii. Dividend per share (DPS)
iv. Dividend yield
v. Earning yield
vi. Dividend cover
vii. Retention Ratio
viii. Dividend pay-out ratio
ix. Net book value (Net Assets)

i. **Earnings per share (EPS):** EPS is normally viewed as a key measures of an entity's financial performance. It relates the earnings generated by the business and available to ordinary shareholders during a period to the number of ordinary shares in issue. It measures the amount of equity earnings (profit after tax and after preference dividends) attributes to a unit of ordinary shares in issue. The trend in earning per share over time is used to assess the investment potential of a business shares. It is calculated as thus:

Basic EPS = Profit after tax and preference dividend x 100 / Weighted average number of shares in issue during the period

ii. **Price earnings ratio (P/E Ratio):** The price earnings ratio measures how expensive or cheap a share is in relation to its annual earnings. It relates the market value of a business share to its earnings per share. The price earnings ratio reveals the number of times by which the capital value of the business is higher than its current levels of earnings. P/E ratio is a major performance indicator ratio because it measures the level of confidence the market has in the future of the business. The higher the number of times, the greater the confidence. The higher P/E ratio means that investors will pay more to acquire the business shares in the future. It is calculated as thus:

Price earnings ratio = Market value per share(MPS) / Earnings per share (EPS)

iii. **Dividend per share (DPS)**: This measures the amount of current period dividend attributable to a unit of ordinary shares in issue. That is, it shows the actual returns that will be received or was received by ordinary shareholders on a unit of its shares.

Dividend per share (DPS) = Dividend declared or paid / Number of ordinary shares in issue

iv. **Dividend yield ratio**: Dividend yield ratio relates the cash returns from shares to its current market value. That is, it measures the actual returns on ordinary shareholders investments. Dividend yield ratio can help investors to assess the cash return on their investment in a business.

Dividend yield ratio = Dividend per share / x 100

Current market price per share

v. **Earning yield ratio**:This measures the potential returns an ordinary shareholders investment. That is, it measures the amount of return due to the ordinary shareholders and not necessarily their actual returns. If none of the current profit is retained, then earning yield and dividend yield will be the same.

Earning yield ratio = Earnings per share x 100
Current market price per share 1

vi. **Dividend cover ratio**: This ratio measures the number of times that dividend of the current period is covered by the earnings of the same period.

Dividend cover ratio = Earnings per share or
Dividend per share

Profit after tax and preference dividend
Dividend

Methodology

As part of the methodology for this study, efforts were made by the researcher to gather a comprehensive data of the financial statement and income statement of the company where financial accounting ratios were computed from the summarized statements which could stand as a tool for the evaluation of the company. The computed financial ratios from the summarized data collected are shown below.

Profitability ratios

	2018	**2019**	**2020**
1.	Gross profit margin = Gross profit x 100 / Revenue 1		
	47.70%	49.65%	50.81%
2.	Operating profit margin = PBIT x 100 / Rev 1		
	4.62%	25.57%	25.75%
3.	Net profit margin = PAT x 100 / Rev 1		
	16.52%	15.06%	16.04%
4.	ROCE = PBIT x 100 / LTL + Eq 1		
	36.98%	38.74%	45.87%
5.	ROE = PAT x 100 / Equity 1		
	48.71%	40.71%	38.34%

Liquidity Ratios

1.	Current ratio = Current Asset / Current Liabilities		
	1.1	0.66:1	0.46:1
2.	Quick ratio = Current Asset - Inventory / Current Liabilities		
	0.57	0.37	0.25

Solvency Ratio

1.	Gearing ratio = LTL x 100 / LTL + Equity 1		
	49.03%	43.98%	26.30%
2.	Interest cover ratio = PBIT / Net finance cost		
	206times	7times	10times

Efficiency Ratios

1.	Asset turnover = Rev / Tangible asset		
	1.42times	1.27times	1.35times
2.	Inventory holding period = Inventory x 365days / Cost of sales		
	83days	71days	57days
3.	Receivable collection period = Receivables x 365days / Sales		
	11days	29days	20days
4.	Creditors payment period = payables x 365days / Cost of sales		
	117days	117 days	193days

Result

This section deals with the analysis of the data collected from the published financial statement of

the selected Mills Company. The analysis was based on the purpose for which this research work was being carried out. The analysis and results were to:

* Make it known to the company its financial performance and the returns that it's made from the capital invested.
* Enable the company know the efficiency with which it manages its receivables, inventory and payables.
* Make the company know whether it would have access to cash when needed to meet obligation and to make payment as they are due.
* Make the company know whether its total debt is within control and are not excessive.
* Help investors to know whether to continue to invest or to sell their shares. Therefore,

The financial statement of the selected Mills Company was evaluated using financial ratios. The ratios computed were analyzed below.

- The financial performance of the company was encouraging as revenue generated by the company keeps increasing year by year, therefore, resulting to the increment of the gross profit margin from 47.70% in 2018 to 49.65% and 50.8% in 2019 and 2020 respectively. The operating profit also increased from 4.62 in 2018 to 25.59% and 25.75% in 2019 and 2020 respectively. While in 2019, there is a little drop in net profit margin from 16.52% to 15.06% and later increased to 16.4% the decrease in the net profit margin may result from the company not taken adequate cost control measure, indeed, a little cost control measures were put in place which brought a little increase in the net profit margin from 15.06% to 16.04% in 2020.

  The overall business performance of the company was also encouraging for its returns from the capital invested keeps increase from 36.98% in 2018 to 38.74% and 45.37% in 2029 and 2020 respectively. The return from the shareholders' investment decreased from 48.71% in 2018 to 40.71% and 38.34% in 2019 and 2020 respectively.
- The efficiency with which the company managed its inventory, receivables and payables were sensitive and encouraging. This is because the holding period for its inventory decreases year by year this will help the company to escape the holding period expenditures, the collection period from the customers increased from 11 days in 2018 to 29days and later decrease back to 20days in 2020. All payable periods increase, this would help the company enlarge the volume of sales.
- The company was not liquidity healthy; this is because its current asset less closing inventory was not higher or equal to its current liabilities, its acid test ratio keeps decreasing every year, current ratio was normal in 2018 and later decrease in 2019 and 2020. This might cause by the high interest paid by the company for the capital borrowed.
- Though the company has a poor liquidity and high debt but not excessive and can still be controlled if adequate control measures are being put in place by the company.

Conclusions

In this study, an attempt has been made to analyze the financial statement and the income statement of the selected Mills Company using the financial ratio. The financial ratios analysis was found to be useful in forecasting the poor and good performance of the company. It is necessary and advisable for the other companies to use this tool of analysis to forecast their company's performance. A word of caution to the users of this study not to generalized the result to mean the all-Mills Companies as the studied company did not constitute the required percentage that will lead to the generalization of the result.

Recommendations

Based on the findings, the study made the following recommendations.

- Business managers of Mills companies should appreciate the importance of frequently subjecting their financial

statements to ratio analysis to determine the financial health of the company.

- To enable creditors and investors identify and quantify risk while also quantifying the management ability to handle risks, through the use of financial ratios for analysis.
- Users of financial statement are highly advised to use financial ratio to analyze financial statement of a company for a better financial decision.

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