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Analysis of Financial Statements: The Importance of Financial Indicators in Enterprise

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Abstract

The main purpose of this study is to determine, forecast and evaluate the best of economic conditions and company's performance in the future. The other purpose of this study is to analyze the financial statement and then give information for financial managers to make through decisions about their business. The financial statement applies tools, analytical techniques and required methods for business analysis. It is a diagnostic tool for evaluating financing activities, investment activities and operational activities as well as an assessment tool for management decisions and other business decisions. The analysis of financial statements, respectively the analysis of the financial reports are used by managers, shareholders, investors and all other interested parties regarding the company's state. Managers use financial reports to see the situation in which the company stands and then provide information to shareholders, to see how reasonable are the investments made in the company. To potential investors, the analysis of the financial statements of the company is very important, because, first they want to know the actual state of the company and then decide whether to invest or not.

Keywords: financial analysis, financial reports, decision-making, profitability, liquidity

1. Introduction

There are various number of methods used by accountants and financial analysts to analyze financial state of a company. The purpose of the financial analysis is to provide information to financial managers and analysts to make thorough decisions about their business. Assessing financial position and performance of an enterprise is a skill that every manager needs to have to make the best and right decisions for the company. The analysis of the financial statements is a method of comparing, judging or valuate situation of particular parts of balance sheet, on the basis of which important decisions are made. So, financial analysis is an analysis of balance sheets for the past, present and future of the enterprise. Balance sheet position values separately do not have high analytical significance, but if we compare them to the values of other balance sheet positions then their comparative value increases. Financial analysis is a study of the company's financial statements by analyzing the reports. Report analysis is a tool that easily calculates and interprets reports that are used by investors, creditors, enterprise executives and others.

1.1 Methodology

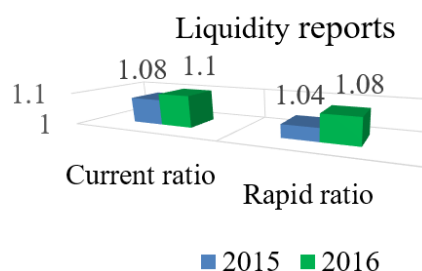
In this research a number of qualitative and quantitative elements have been taken for analysis to determine and analyze the importance of financial indicators in an enterprise. During this study, tools, analytical techniques and adequate methods were used to analyze the financial statement of Company "X". The sources of data used in this research are primary and secondary data. Then, from the data collected, different analyzes were used to come to the results and to reach a conclusion, indicating that inductive methods were used. Apart from analysis and induction, in this research it also used the classification method due to certain criterion data categorization. Also, given the fact that data do not make sense if they are secluded, comparison method was used and the company's financial statements were compared for two consecutive years.

1.2 Hypothesis

H₁ - Company has a good financial statement.

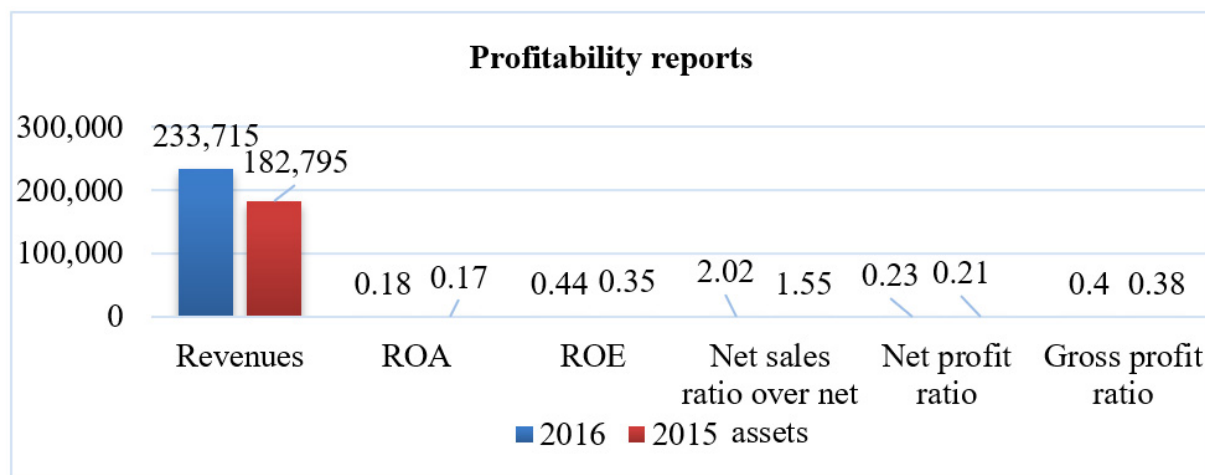
2. Analysis

From analyzing the financial statements of the company, we can conclude its financial condition and how it has operated during the periods for which the analysis is conducted and what are the future trends for that enterprise. By the use of different liquidity indicators we try to anticipate whether companies can meet their short-term liabilities using their available current assets. Liquidity ratios have a great benefit of being relatively accurate regarding their components because on the short-term, there are more realistic data available in the accounting system than for analysing longterm assets and sources. In case of certain fields of activity, the degree of liquidity can differ seasonally. For the calculation, we have analysed data of a manufacturing company in the period of 2016 - 2015.



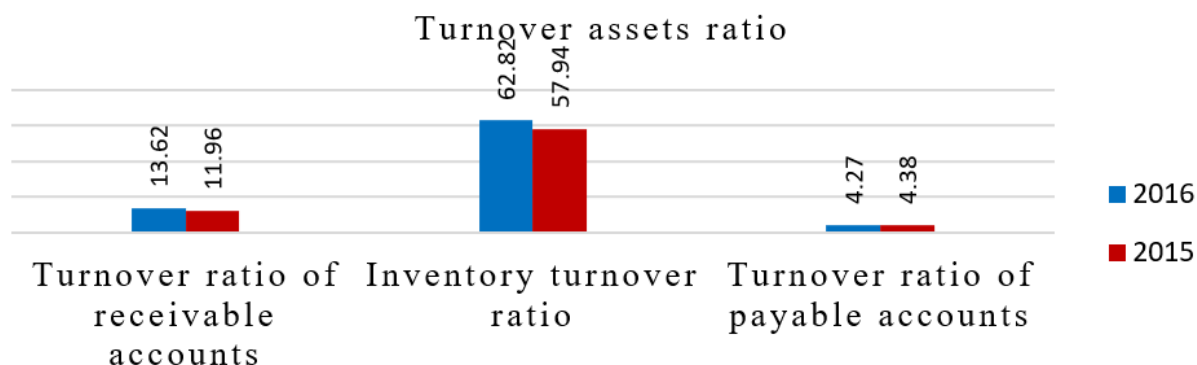
Graphic 1. Summary of liquidity reports

After calculating, analyzing and interpreting the various financial reports of the company, we have come to the conclusion, that the company has a good liquidity statement, because the company has more short-term assets to cover the liabilities short-term, which means that there is more working capital. Because, if these indicators are larger than 1, then it shows that the company has good liquidity status. This means, that this company is able to pay its current liabilities at any time. Also, we know that current assets are also constituted by customer requirements and if it happens that customers do not pay their debts, then the company may become insolvent and this would affect the reputation of the company.



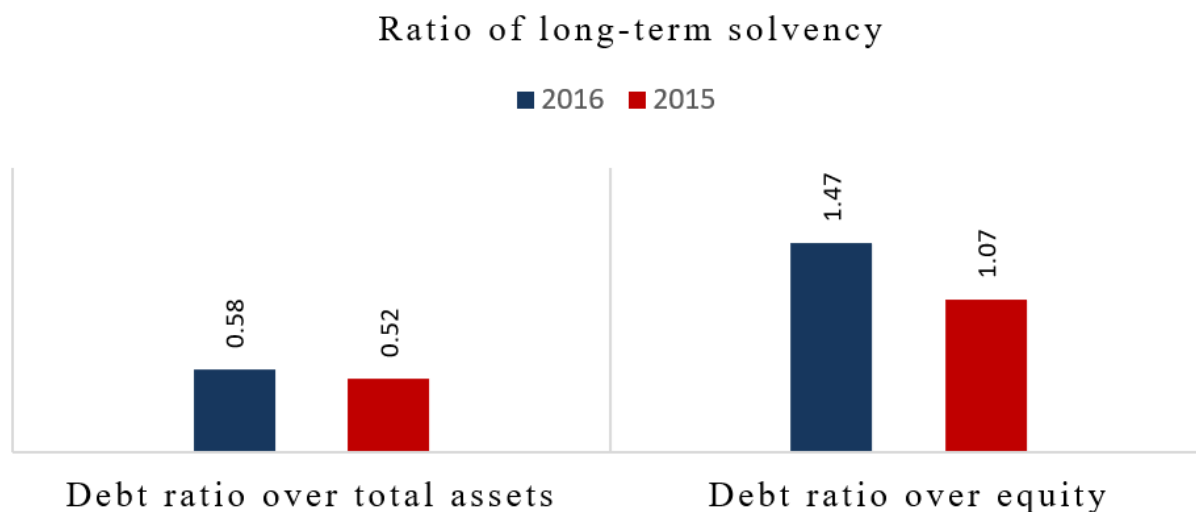
Graphic 2. Summary of revenues and profitability reports

Regarding profitability ratios, there is a better situation in 2016 and it is more effective in using assets to generate revenues, hence, there is a greater turnover this year as well as greater return on capital. This means, that with the revenues increased in 2016, are also increased the performance indicators of the company (net profit ratio, from 0.21 to 0.23 in 2016 and gross profit ratio, from 0.38 to 0.40 in 2016).



Graphic 3. Summary of turnover assets ratio

From turnover assets ratio, we can conclude that the company is more effective in 2016 because in this year it was more likely to collect customer debts (Receivable Accounts, 13.62 times for one year), but it was also more effective in inventory sales (62.82 times for one year), whilst with regard to payable accounts, the company has paid more often the debts to suppliers in 2015 (4.38 times for one year), it is good to pay these debts because the company should not lose these important sources of funding.



Graphic 4. Summary of long-term solvency ratios

Through analysis of financial ratios of long-term solvency, we can conclude that the company is less financed by debts in 2015, because the smaller the value of these coefficients are indicate that the company is less financed by debt.

After calculating, analyzing and interpreting the various financial reports of the company, we have come to the conclusion, that the company has a good financial statement, because the company has a good liquidity statement, is profitable and is effective in inventory sales. And that leads us to the authentication of the third hypothesis, the company has a good financial statement.

3. Financial Statements

According to the Accounting Standards, financial statements are a structured financial presentation and transactions undertaken in an organization. The main financial statements are the means used by the accounting for the purpose of collecting, processing and presenting economic information. The purpose of financial statements is to provide information on the position and financial changes as a very important basis for making managerial decisions (Asllanaj, 2008). The objective of the financial statements is to provide information about the financial situation, financial performance and changes in an entity's financial position that are usable by a wide range of users in making their economic decisions (Lewis, & Pendrill, 2004).

Financial statements and reports arising from their study provide information on:

- Assets
- Liabilities
- Equity
- Income and expenditures and
- Cash Flow

Financial statements reflect the cumulative effects of all of management's past decisions (Helfert, 2001). Financial statements are the business documents that companies use to report the results of their activities to various user groups, which can include managers, investors, creditors, and regulatory agencies. In turn, these parties use the reported information to make a variety of decisions, such as whether to invest in or loan money to the company (Charles, Walter & Thomas, 2012).

The main financial statements are International Accounting Standards (IAS):

- Income and expenditure statements,
- Balance Sheet,
- Cash Flow Statement,
- Statement of Equity Changes,
- Statement of Explanatory Note.

3.1 Income and Expenditure Statements

This statement shows the financial result of a firm over a period of time (monthly, quarterly or annual). It summarizes the incomes and expenditures incurred for the creation of such income.

Income - represents the amount of assets generated through business operations.

Expenditure - represent the amount of assets consumed during the business operation, respectively the flows and obligations occurred during the production of goods and services (Asllanaj, 2008). The difference between income and expenditure represents net income or **net profit**.

Table 1. Income Statement

"X" COMPANY		
	2016	2015
Net Sales	233,715	182,795
Cost of Sales	140,089	112,258
Gross Margin	93,626	70,537
Operating expenses:		
Research and development	8,067	6,041
Selling, general and administrative	14,329	11,993
Operating income	71,230	52,503
Other income/(expense) net	1,285	980
Income before provision for income taxes	72,515	53,483
Provision for income taxes	19,121	13,973
Net income	53,394	39,510

3.2 Balance Sheet

The Balance Sheet reports in a summarized form the balances of the assets, capital and liabilities accounts at the date of its establishment for a specified period of time. The balance sheet denomination comes from the assumption that between the total assets on one side and the total of capital and liabilities on the other hand, there must be a

balanced state. Consequently the total assets in the balance sheet must be equal to the total of liabilities and capital (Asllanaj, 2008).

This equilibrium is expressed through the equation (Xhafa, 2005): Assets = Liabilities + Capital (Equity).

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events (Lewis, & Pendrill, 2004). Capital represents the rights of the owners in the corporate property, so it is a kind of obligation but to the owners. In fact, demands of the owners of the enterprise's assets are equal to the amount of the assets which remains after all the liabilities have been deducted (Asllanaj, 2008).

Table 2. Balance Sheet

"X" COMPANY		
Years	2016	2015
Assets		
Current assets:		
Cash and cash equivalents	21,120	13,844
Short-term marketable securities	20,481	11,233
Accounts receivable	16,849	17,460
Inventories	2,349	2,111
Deferred tax assets	5,546	4,318
Vender non-trade receivable	13,494	9,759
Other current assets	9,539	9,806
Total current assets	89,378	68,531
Long-term marketable securities	164,065	130,162
Property, plant and equipment, net	22,471	20,624
Goodwill	5,116	4,616
Acquired intangible assets, net	3,839	4,142
Other assets	5,556	3,764
Total Assets	290,479	231,839
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payanble	35,490	30,196
Accrued expenses	25,181	18,453
Deferred revenue	8,940	8,491
Commercial paper	8,499	6,308
Current portion of long-term debt	2,500	0
Total current liabilities	80,610	63,448
Deferred revenue, non current	3,624	3,031
Long-term debt	53,463	28,987
Other non-current liabilities	33,427	24,826
Total liabilities	171,124	120,292
Shareholders' equity		
Comon stock	27,416	23,313
Retained earnings	92,284	87,152
Accumulated other comprehensive income	(345)	1,082
Total shareholders' equity	119,355	111,547
Total liabilities and shareholders' equity	290,479	231,839

3.3 Cash Flow Statement

The main purpose of cash flow review is to provide business information about activities that affect cash inflows and outflows during a fiscal period. In other words, the cash flow statement reports the transactions from which the cash is generated and the transactions for which the money is used (Asllanaj, 2008).

Cash flow statement methods (Society of Certified Accountants And Auditors In Kosovo (SCAAK)) (2008):

Direct method - shows cash collection from customers, interest and dividends collected, other cash inflows, money paid to suppliers and employees, paid interests, paid taxes and other operating fees

Indirect method - starts with net income and is adjusted to deferred items, ascertained, non-monetary items such as depreciation and amortization and non-operating items such as profits or losses on the sale of assets.

Money flows and capital movements are divided based on activities (Lewis, & Pendrill, 2004):

- Operational activity
- Investment activity
- Financing activity.

Operational activities - are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

Investment activities – are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities – are activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise.

3.4 Statement of Equity Changes

This statement shows the changes occurred to the size of the owner's equity over a certain period of time from the change of his interests or from the activity of business units, which explains changes in capital and reserves over a year or (Assets – Liabilities = Equity) (Asllanaj, 2008).

4. Main Financial Analysis Indicators

The main indicators of financial analysis are the following ratios (Helfert, 2001):

Liquidity Ratio

Profitability Ratio

Assets turnover ratio

Ratio of long-term solvency (debt)

4.1 The Importance of Liquidity and its Analysis

As it is known, a company's liquidity refers to its ability to settle short-term liabilities when they mature. So liquidity is the ability to convert activities into cash or make money in another way (eg through financing) (Mayo, 2012).

Liquidity analysis through working capital – working capital has been consistently considered as one of the most important and significant indicators in the liquidity analysis of an enterprise. From creditor's point of view, working capital is always from the first indicators to be considered. This is because the creditor always seeks to find and read "safety" in the financial statements. He is interested in liquidity because it "protects" him from an unwanted situation of lack of cash (Shuli & Perri, 2010).

Working capital is calculated as the difference between short-term assets and short-term liabilities

Working capital = short term assets – short term liabilities

2015: Working capital = 68,531 – 63,448 = 5,083

2016: Working capital = 89,378 – 80,610 = 8,768

Liquidity Ratios are

4.1.1 Current Ratio

Shows a direct proportion between short term assets and short term liabilities. Through this, it is measured the ability of a firm to pay short-term liabilities at the maturity date (expiry date of payment) (Mayo, 2012).

$$\text{Current Ratio} = \frac{\text{Short term assets}}{\text{Short term liabilities}}$$

$$2015: \text{Current Ratio} = \frac{68,531}{63,448} = 1.08 \text{ times}$$

$$2016: \text{Current Ratio} = \frac{89,378}{80,610} = 1.10 \text{ times}$$

This ratio shows that the company in 2015, for every 1 euro short-term obligation has 1.08 euro short-term assets to cover them. In 2016 the company has 1.10 euro short-term assets, for every 1 euro short-term obligation. The most liquid is in 2016.

4.1.2 Rapid Ratio

An even more stringent test, although again on a static basis, is the acid test or quick ratio, which is calculated using only a portion of current assets—cash, marketable securities, and accounts receivable—which are then related to current liabilities (Helfert, 2001).

$$\text{Rapid ratio} = \frac{\text{Short term assets} - \text{Stocks}}{\text{Short term liabilities}}$$

$$2015: \text{Rapid ratio} = \frac{68,531 - 2,111}{63,448} = 1.04 \text{ times}$$

$$2016: \text{Rapid ratio} = \frac{89,378 - 2,349}{80,610} = 1.08 \text{ times}$$

This ratio shows that even though the company is deducting stocks as assets that can not be converted into cash very fast, it is still quite liquid and compared to the previous year, in 2016 the company is more liquid, where for every 1 euro short-term liability has 1.08 euros of current assets to cover them.

4.2 Profitability Ratios

The fundamental purpose of every business is to make profit. These reports show how reasonable decisions are that the organization has made for investments. Profitability reports express exactly what the organization wins over its sales, assets or capital (Asllanaj, 2008).

4.2.1 Rate of Return over Total Assets

Shows a direct proportion between net profit and total assets. The return on total assets is a ratio that measures the effectiveness of using total assets to generate net profit (Mayo, 2012).

$$\text{Rate of return over total assets (ROA)} = \frac{\text{Net Profit}}{\text{Total Assets}}$$

$$2015: \text{Rate of return over total assets (ROA)} = \frac{39,510}{231,839} = 0.17 \%$$

$$2016: \text{Rate of return over total assets (ROA)} = \frac{53,394}{290,479} = 0.18 \%$$

From the calculation of this ratio we see that the company has the greatest rate of return on assets in 2016, it is natural that the higher the rate of return is, it is more favorable to the company.

4.2.2 Rate of Return over Share Capital

Measures the profit made from investments of regular shareholders in the company's assets. In other words, the rate of return on share capital is the rate of return from regular (ordinary) shares invested by the owners of the enterprise (Asllanaj, 2008).

$$\text{Rate of return over share of capital (ROE)} = \frac{\text{Net Profit}}{\text{Equity}}$$

$$2015: \text{Rate of return over share of capital (ROE)} = \frac{39,510}{111,547} = 0.35 \%$$

$$2016: \text{Rate on return over share of capital (ROE)} = \frac{53,394}{119,355} = 0.44 \%$$

From the calculation of this ratio we notice that the company has greater return on capital in 2016, it is also important for the company to have this ratio higher than the return on assets, as this indicates that the enterprise is in the successful years of business.

4.2.3 Net Sales Ratio over Net Assets (Equity)

Shows a direct proportion between net sales and net assets. This report measures the profitability of the enterprise on the basis of the efficiency of using net assets in the generation of revenues from sales (Asllanaj, 2008).

$$\text{Net sales ratio over net assets} = \frac{\text{Net Sales}}{\text{Average Net Assets}}$$

$$2015: \text{Net sales ratio over net assets} = \frac{182,795}{123,549 + 111,547/2} = 1.55 \text{ times}$$

$$2016: \text{Net sales ratio over net assets} = \frac{233,715}{119,355 + 111,547/2} = 2.02 \text{ times}$$

From calculation of this ratio we notice that in 2016 the company has exploited assets better and managed to generate more income this year.

4.2.4 Net Profit Ratio

Shows the amount of profit made for each € 1 of sales. In other words, this ratio measures the percentage of each euro of sales that remains after deduction of expenditures, including interest expenditures and tax expenditures.

$$\text{Net profit ratio over net sales} = \frac{\text{Net Profit}}{\text{Net Sales}}$$

$$2015: \text{Net profit ratio over net sales} = \frac{39,510}{182,795} = 0.21 \%$$

$$2016: \text{Net profit ratio over net sales} = \frac{53,394}{233,715} = 0.23 \%$$

From the calculation of this ratio we notice that, from revenues, the company generated higher percentage of profit in 2016 compared to the previous year.

4.2.5 Gross Profit Ratio

Shows the percentage gained from sales after commodities reached the customer (Xhafa, 2005).

$$\text{Gross Net Ratio} = \frac{\text{Gross Net}}{\text{Sales}}$$

$$2015: \text{Gross Net ratio} = \frac{\text{Gross Net}}{\text{Sales}} = \frac{70,537}{182,795} = 0.38 \text{ ose } 38 \%$$

$$2016: \text{Gross Net Ratio} = \frac{\text{Gross Net}}{\text{Sales}} = \frac{93,626}{233,715} = 0.40 \text{ ose } 40 \%$$

This shows that the company in 2016 has a higher gross profit margin than in other years, this report also shows how much the company earns on its products.

4.3 Assets Turnover Ratios

Indicators of assets turnover provide the key information on the efficiency of usage and control of certain aspects of current business assets such as: inventories (reserves), current accounts and credit accounts. The ability to sell inventory of goods and collection of cash from buyers undoubtedly comprises the successful business foundation of any commercial business (Asllanaj, 2008). The main indicators of assets utilization are:

4.3.1 Turnover Ratio of Receivable Accounts

This ratio measures the ability of the entity to collect debts from buyers for sales with due date for payment. So, this ratio shows how many times Receivable Accounts has been converted into cash within a certain period of time (Mustafa, I. (2005).

$$\text{Turnover Ratio of Receivable Accounts} = \frac{\text{Net Sales}}{\text{Average Receivable Accounts}}$$

$$2015: \text{Turnover Ratio of Receivable Accounts} = \frac{182,795}{15,281} = 11.96 \text{ times}$$

$$2016: \text{Turnover Ratio of Receivable Accounts} = \frac{233,715}{17,154} = 13.62 \text{ times}$$

From the calculation of this ratio we notice that the company was most effective in collecting cash from buyers in 2016, doing this 13.62 times during the year, whilst in 2015 it did 11.96 times during the year.

4.3.2 Ratio of Unreceivable Sales Days

This indicator provides information about how many days is the deadline for collecting sales with due date for payment. In other words, through the ratio of unreceivable sales days it is indicated the number of days needed to be collected from receivable accounts (Asllanaj, 2008).

$$\text{Unreceivable sales days} = \frac{365}{\text{Turnover of Receivable Accounts}}$$

$$2015: \text{Unreceivable sales days} = \frac{365}{11.96} = 30.52 \text{ days}$$

$$2016: \text{Unreceivable sales days} = \frac{365}{13.62} = 26.80 \text{ days}$$

From this report we notice that the company has more often received debts from buyers, and this has done every 26.80 days in 2016 whilst in 2015 every 30.52 days.

4.3.3 Inventory (Stocks) Turnover Ratio

This ratio measures the ability of the entity to sell the inventory or the speed of stock sales within a specified period of time. This ratio practically shows how many times a year the firm has sold the average level of its inventory (Asllanaj, 2008).

$$\text{Inventory turnover ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$2015: \text{Inventory turnover ratio} = \frac{112,258}{1,937.5} = 57.94 \text{ times}$$

$$2016: \text{Inventory turnover ratio} = \frac{140,089}{2,230} = 62.82 \text{ times}$$

From the calculation of this report we notice that the company has most frequently sold stocks in 2016, whilst the turnover stocks was 62.82 times during the year.

4.3.4 Inventory (Stocks) Sales Days Ratio

This ratio measures efficiency in inventory management, simply this ratio shows the number of days needed to sell inventory within a year.

$$2012: \text{Inventory sales days ratio} = \frac{365}{\text{Turnover Inventory}}$$

$$2015: \text{Inventory sales days ratio} = \frac{365}{57.94} = 6.29 \text{ days}$$

$$2016: \text{Inventory sales days ratio} = \frac{365}{62.82} = 5.81 \text{ days}$$

Calculating per day, we see that the company has sold stocks every 5.81 days in 2016 and every 6.29 days in 2015.

4.3.5 Turnover Ratio of Payable Accounts

This ratio measures the efficiency of payment management to suppliers, simply this ratio shows the deadline or the period of liabilities towards suppliers. For an ideal firm it would be that the payment period to suppliers to be equal with the period of collection of sales from buyers (Asllanaj, 2008).

Purchases = Cost of goods sold + Inventory at the end – Inventory at first

$$2012: \text{Turnover ratio of payable accounts} = \frac{\text{Purchases on credit}}{\text{Average Payable Accounts}}$$

$$2015: \text{Turnover ratio of payable accounts} = \frac{112,605}{25,685.5} = 4.38 \text{ times}$$

$$2016: \text{Turnover ratio of payable accounts} = \frac{140,327}{32,843} = 4.27 \text{ times}$$

From calculation of this ratio we notice that the company has paid debts to the supplier more often in 2015 with 4.38 times during the year. It is better to pay these debts because the company should not lose these important sources of funding.

4.4 Ratio of Long-Term Solvency

Solvency reports measure the enterprise's ability to pay long-term debts on their maturity date. While liquidity refers to the enterprise's ability to pay short-term debt, solvency means the enterprise's ability to maintain financial stability in meeting long-term liabilities. In the solvency analysis the starting point is the capital structure of an enterprise. The capital structure constitutes share capital and long-term debt capital. Significant component in the capital structure is the financial leverage. Financial leverage represents the amount of debt participation in the financing of the enterprise (Asllanaj, 2008).

4.4.1 Debt Ratio over Total Assets

Measures the ability of an entity to cover long-term liabilities, this indicator is an information for creditors on the security of the given debt return. Practically shows debt participation in an enterprise financing (Shuli & Perri, 2010).

$$\text{Debt ratio over total assets} = \frac{\text{Total debt}}{\text{Total assets}}$$

$$2015: \text{Debt ratio over total assets} = \frac{120,292}{231,839} = 0.52 \text{ or } 52\%$$

$$2016: \text{Debt ratio over total assets} = \frac{171,124}{290,479} = 0.58 \text{ or } 58\%$$

For creditors it is desirable that the debt ratio to be as small as possible and vice versa, for the shareholders it is favorable the debt ratio in the greatest value, under the condition that the profitability of total assets to be higher than the cost of debt capital.

4.4.2 Debt Ratio over Equity

A more refined version of the debt proportion analysis involves the ratio of longterm debt to capitalization (total invested capital). The latter is again defined as the sum of the long-term claims against the business, both debt and owners' equity, but doesn't include short-term (current) liabilities. This total also corresponds to net assets, unless some adjustments were made, such as ignoring deferred taxes (Helfert, 2001).

$$\text{Debt ratio over equity} = \frac{\text{Total debt}}{\text{Share Capital}}$$

$$2015: \text{Debt ratio over equity} = \frac{120,292}{111,547} = 1.07 \text{ or } 107\%$$

$$2016: \text{Debt ratio over equity} = \frac{171,124}{119,355} = 1.43 \text{ or } 147\%$$

When values of this ratio are high, it means that the interest rates to be paid towards creditors will also be higher. Therefore, this report shows the extent of financing the enterprise through debts.

5. Conclusions

The analysis of the financial statements is a very important process, even necessary for making right decisions. Information obtained from financial analysis, together with accounting, are the basis for making decisions, both internally and externally. From the analysis of financial statements, we can ascertain its financial condition and how it has operated during the periods for which the analysis is conducted and what are future trends in that enterprise. These reports are also used to give information to shareholders on how reasonable are investments made in the company because they are interested in making profit from investments made. These reports are also

used by potential investors who first want to know how the company is performing and then decide whether to invest or not.

After calculating, analyzing and interpreting the various financial reports of the company, we have come to the conclusion that in terms of liquidity, the state of the company is better in 2016, because this year the company has more short-term assets to cover short-term liabilities which means that there is more working capital.

Regarding profitability ratios, there is a better situation in 2016 and it is more effective in using assets to generate revenues, hence, there is a greater turnover this year as well as greater return on capital.

From turnover assets ratio can be seen that the company is more effective in 2016 because in this year it was more likely to collect customer debts (Receivable Accounts), but it was also more effective in inventory sales, whilst with regard to payable accounts the company has paid more often the debts to suppliers in 2015, it is good to pay these debts because the company should not lose these important sources of funding

Through analysis of financial ratios of long-term solvency, we see that the company is less financed by debts in 2015, because the smaller the value of these coefficients are indictae that the company is less financed by debt.

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