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# Adequacy of financial statement and information for investors decision on the Nigerian stock exchange

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**ABSTRACT**

This study focuses on the efficiency of financial indicators to influence the decisions of investors. It investigates the effect of information content of financial statements on shareholders' investment decisions. The study is vital as it portrays the extent to which shareholders of firms listed on the Nigerian Stock Exchanged (NSE) are influenced by the contents of published accounts in their investment decisions. The annual financial reports provided by the accounting system, is considered the main source for information for decision-makers especially the investors. Therefore, the validity and accuracy of the decisions depend on the understanding, reliability and proper analysis of financial statements. In order to determine the relationship between information contents of financial statements and shareholders' investment decisions, some of the key contents of financial statement were used to derive the proxy variables used in the study, namely profitability, dividend per share, earnings per share, leverage, and liquidity; while shareholders' investment decisions is represented by change in number of shares. Data for the study were obtained from the published annual financial report of the selected firms. Regression model was employed to establish the relationship between the variables. The findings generally indicate that though shareholders in the Nigerian capital market do not rely much on financial statements as a major determining factor for their investment decisions, still the financial analysis factors constitute the main tool in attracting investment. It was observed that other factors or variables outside firms' annual reports such as regularity and amount of dividend payment and what is in-vogue or everybody is doing (herding) affect market price of shares and are vital to shareholders' investment decisions. The study recommends proper awareness creation by the appropriate agencies to enhance shareholders' understanding of the relevance of published accounts to enable them to know the financial states of the companies (banks) of their interest before making investment decisions. Besides, shareholders should seek the advice of financial analysts so as to be properly guided in their investment decisions.



## Introduction

A financial analysis assists in identifying the major strengths and weaknesses of a business enterprise. It indicates whether a firm has enough cash to meet obligations; a reasonable accounts receivable collection period; an efficient inventory management policy; sufficient plant, property, and equipment; and an adequate capital structure (Moyer, McGuigan, Kretlow, 2005). The economic climate calls for investors to apply vigorous financial analysis as they evaluate business performance, weigh potential investments, and assess global competition. In response, strategic financial analysis for business evaluation focuses on the frameworks required to monitor performance, forecast capital utilization, value strategic assets, and review restructuring opportunities.

Investment is putting money into an asset with the expectation of capital appreciation, dividend or interest earnings. Financially, investment is the purchase of an asset or item with the hope that it will generate income or appreciate in the future and be sold at the higher price. (Wikipedia, 2014) Making big investment decisions means that, we must allocate substantial amounts of major resources of people, time, technology, intellectual capital, and money. A high quality decision process requires that our choices are précised and the consequences are understood and well explored.

Ratio analysis is one of the main financial indicators extracted from financial statement analysis that is used to obtain a quick indication of a firm's financial performance in several key areas. Ratio Analysis as a tool possesses several important features. The data, which are provided by financial statements, are readily available. The computation of ratios facilitates the comparison of firms which differ in size. Ratios can be used to compare a firm's financial performance with industry averages. In addition, ratios can be used in a form of trend analysis to identify areas where performance has improved or deteriorated over time.

The purpose of financial statement is to provide reliable information about the financial position, performance and relevant changes in financial position of a company or business. Listed companies use financial statements as one of the major medium of communication with their equity shareholders and public at large (Cheng and Yang, 2003; Sloan, 1996; Hribar and Collins, 2002). When these financial

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statements are released, they can have large impacts on the business and on the investors of the company. Therefore, it is critical for the companies to ensure that the information the statements present is correct.

Financial statements can have a drastic effect on the stock price of a company. Many investors look at the financial statements when making investment decisions. If information is presented in a financial statement that is better or worse than expected, it can send the stock price up or down. Investors often use financial ratios based on information from the financial statements to make assumptions. Because of this, the financial statements can have a serious effect on the investors of a business.

Financial statements can also have an impact on how easy it is for a business to get financing. If a company is trying to take out a business loan, the lender will typically want to look at the financial statements of that company. If the information on the financial statements is not flattering, it may negatively impact the ability of the company to borrow money. Lenders usually, only want to invest in companies that have good financial numbers.

Financial statements also have impact on new investors. When a company issues new shares of stock, it will most likely distribute financial statements to potential investors. The potential investors will examine the financial statements to determine if they want to put money into the company. Low earnings numbers could negatively impact the number of investors willing to put money into the company. In some cases, financial statements can even affect other businesses. For example, a leading company in a particular industry releasing financial statements can influence that industry as a whole. Bad numbers by a leading company can sometimes lead to a negative outlook on other companies. This may drive down the stock prices on other companies in the same industry or sector of the market.

Statement of Accounting Standards (SAS )2 provides that financial statements consist of:
Balance Sheet, Profit and Loss Account or Income Statement, the Notes to the Accounts, Statement of Sources and Application of Funds, Value Added Statements and Historical Financial Summary. These elements of financial statement provides information about the resources, obligation and the performance of the company in a clear, simple and understandable manner. Shareholders of a company, both existing and potential, will want to know how effectively the directors are performing their stewardship function.

They will use the financial statement as a base for decisions to dispose of some or all of their shares, or to buy some. Investment decisions depend on expectations of the benefits of the investment, which in turn depend on expectations of future growth and product demand. Expectations of future growth are based on information that includes earnings per share, dividends per share, leverage, and liquidity. Thus, the financial statements are considered very important to shareholders.

Some authors have however argued that in developing economies, shareholders of corporate firms do not seem to pay particular attention to financial statements in their investment decisions but rather on other extraneous variables such as the frequency and regularity of dividend payment and market price per share (Ugwunba, 2010).

Shareholders are said to be quite keen with respect to the regularity of their (cash) dividend and, therefore, would usually react if there is an outright omission of dividend payment, or an announcement of dividend cut. To this effect, companies whose focus is to maximize shareholders wealth see the knowledge of how dividend change relates to the value of the company as a very important issue.

In making investment decisions, investors should take into considerations the following points; first, what is the scale of the investment which the company can afford? Second, how long will it take before the investment starts to yield returns, and at what rate? Third, how long will it take to payback the investment? The answer to these questions will take place only after the investors take the right investment decision, which means the right investment place where he is going to invest his money. The right investment place is the core of our research paper, which depends on ratio analysis performed by financial analyst or the investor himself.

Financial analysis is helpful in assessing corporate excellence, judging credit worthiness, forecasting bond ratings, predicting bankruptcy and assessing market risk. The financial analysis can be performed by analysts who work for the firm or by outsiders like investors, creditors, lenders, suppliers, customers, security analysts, academics, researchers, environmental protection organizations, government and other regulatory bodies, special interest lobbying groups and so on. So the financial analysis, which aims at measuring the performance of the organization is intended for both (a) for internal use by management and (b) for external use by external parties.

Table 1.1 list the parties who are interested in the financial statement analysis, their focus of interests and purposes of analysis; and the nature of the information that they need for taking their decisions. Shareholders and potential investors use the analysis for investment decision purposes; lenders, and suppliers have an interest to know whether the company can pay back the amount they lend or supply; customers are interested in the company’s ability to sustain so that their warranty, guarantee and quality of products is ensured; employees are interested in knowing the position o f the company so that their salary, retirement benefits, and other incentives and benefits are not in jeopardy; the security analysts focus on knowing

**Purpose of financial ratio analysis**

Tools of financial analysis function as keys to measure performance, creditworthiness, investment returns and effects of financial performance pre and post mergers and acquisitions.

1) Performance analysis - this analysis is important for internal users of a company's management. They use financial information available in the financial statements and financial data to make analysis for control, planning and performance evaluation purposes. Ratios include turnover rates, investments, inventory and turnover of net working capital and assets (Matar, 2003).

2) Credit analysis - this analysis seeks to identify potential risks or dangers faced by lenders in their relationships with borrowers. Short and long-term credits are assessed to obtain information on a unit's ability to meet the debt and benefit payment when due, financial policies, the effects on the capital structure of the unit, the objectivity of evaluating assets provided as collateral and debt/bankruptcy risk if the unit went into liquidation or financial distress (Saeed, 1982). Useful indicators in this analysis are short-term liquidity indicators,

financial leverage indicators or long-time solvency and long and short term cash flow.

3) Investment analysis - this analysis is important for investors (current and potential shareholders) who are interested in current and future company's resources and their ability to continue, investment growth rates, market risks and the efficiency of unit management in terms of financial policies and exploitation of economic resources (Matar, 2003). Quantitative indicators are useful in this analysis such as profitability ratios, market risk and other indicators.

4) Mergers and acquisition analysis – this serves to evaluate a unit's business performance intending to merge with or purchase other business units. It is based on an appropriate method, followed by the merging company to pay for shares of the merged companies (subsidiaries) and explore the potential effects of the merger at pre and post merger/acquisition (Qyasa, 2006).

**Table 1.1 Target Audience for Financial Statement Analysis**

| (S.No. | Interested Parties | Purpose for which information is Required | Type of information Required |
|---|---|---|---|
| 1 | Shareholders and Potential investors | (a) Investment focus: For Investment decisions i.e. which Shares to buy, retain or sell? At which time should such transactions be made?<br>(b) Stewardship focus: How does management Use resources under its control? Is the capacity fully utilised. | Risk, return, dividend yield liquidity and so on. The share holders want to predict the timing, amounts & uncertainties of future cash flows of the firm. Sustainability of cash flows earnings, etc. |
| 2 | Lenders and Suppliers | (a)Do they get back their money in time?<br>(b)What are the prospects of the firm? | Short-term and long-term liquidity and profitability. |
| 3 | Customers | Customers have a vested interest in monitoring the financial viability of firms with which they have long term relationships e.g. guarantees, warrantees, deferred benefits, etc. | Profitability, Liquidity, Efficiency with which resources are put to use. |
| 4 | Security analysts | They help shareholders, investors, lenders and auditors. The focus of their attention varies depending upon the needs of their clients. | Risk, return, sustainability of cash flows, efficient management of resources, etc. |
| 5. | Government/other regulatory bodies | Revenue raising "{direct and indirect taxes), government contract (cost plus information), regulatory intervention (whether to provide a loan guarantee to a financially distressed firm), equitable resource allocation, etc. | All such information that may help In ascertaining and maintaining good health of the capital market and the economy through good corporate governance. |
| 6 | Employees | Employees have a vested interest in the continued and profitable operations of the firm.<br>In the long-term, they are interested in pension, stock option, payment of retirement benefits, etc.<br>In the short term, their focus of attention would be bonus, incentive schemes, etc. | Production, profits, liquidity, solvency, and stability. |
| 7 | Management Managers need financial statement information | For financial, investment, dividend and operating decision. They also need to estimate the linkages between compensation (or incentives schemes)and financial statement variables such as earnings per share, cash flows per share, etc. | Information for capital structure planning, investment decisions, dividend decision, etc. |

Source: Babatosh Banerjee (2005), Financial Policy and Management Accounting, Prentice Hail: www.ccsenet.org/ijbm International Journal of Business and Management Vol. 8, No. 4; 2013

Based on the above definitions, researchers arrive at the following conclusions. Firstly, published financial statement is the basis of financial analysis activities. Analysts set off doing the analysis after accountants finished their work, so we must understand the foundations and components of these financial statements before we analyze it. Secondly, beneficiaries and financial analysts must be able to use analysis tools study these financial statements and find relationships between elements of these financial statements to get to the financial value of the project at a certain date. They must be able to provide and decipher internal and external information about their performance, profitability and ability to continue in the future.

Practitioners and Academics identify two approaches of financial analysis: Qualitative - traditional and Quantitative-modern methods. In a quantitative method, financial analysts use financial ratios for the purpose of analysis and judgment on a company's activities (Alsayah and Ameri, 2007). They use a comparative analysis that is a complement to the traditional method, to compare between current and previous data or with standard or industry indicators (Hayali, 2004). Modern method (quantitative) helps to achieve more accurate results. It is time and cost savings approach for analysts as the work can be computerized. Matar (2003) highlights the importance of qualitative approach in financial analysis. The author argued that evaluating the numbers on the published financial statements alone are not adequate to arrive at conclusions because quantitative data are not the only outcome of accounting policies that determine the type and nature of the accounting principles and methods. Financial analysts must extend their range of study from examining the quantitative data to qualitative explanations of the published data. This includes specific features of unit profitability and financial position.

**Study Problem**

Provided a financial statement in authentic devoid of window dressing and earnings management, it should be a reliable source of vital information for investment decisions. Ratio analysis is an important technique of financial statement analysis. Ratios are useful for interpreting and understanding the financial position of a company. Investors, management, bankers and creditors use the ratio to analyze and judging the company's efficiency, locating the strength and weakness of the company's operations. Although financial ratios are used to analyze the company's past financial performance, they can also be used to forecast its future trends of performance. As a result, investors can predict the company's performance over the coming years and then facilitates comparison to make the suitable investment decisions However, the advent Erron-Mobil case in America and Cadbury in UK has cast doubt on total reliability of financial statement and its ratios for watertight convincing investment decisions. Sudden fall of some banks in Nigeria lately (e.g. Oceanic Bank Plc and Intercontinental Bank Plc) is a case in point, where the financial statements for upward of five years were not revealing any serious problems and their share performance on the Nigerian Stock Exchange were good, only for The Central Bank of Nigeria to come out late with some revealing woeful facts and figures about their performance that sent them off the market and off the street with many investors bearing the scar.

**Study Objectives**

The main objective of the study is to evaluate reliability of ratio analysis in investment decision making by applying ratio analysis to determine the strengths and weaknesses of the organization.

Specifically, the study seeks to:

(1) Investigate the effect of the relevant contents of financial statements of companies listed on the Nigerian Stock Exchange.

(2) Determine the extent to which shareholders' base their investment decisions on the financial statements of the companies of their choice.

In assessing the significance of various financial data for effective investment decision, investors engage in financial analysis of financial statements. This involves process of determining and evaluating financial ratios among others.

**Literature Review**

Ratio Analysis is one of the basic tools of financial analysis. It is an important tool in business planning and decision making as it explores the strengths, weaknesses, opportunities and threats facing the company (Akintoye, 2004). Smart investors use financial ratios to analyze a company's financial performance before making an investment. Financial ratios reveal how a company is financed, how it uses its resources, its ability to pay its debts and its ability to generate profit. Ratios provide a glimpse of a company's position at a particular time, and are most useful when compared across time periods and when comparing companies in the same industry. Ratios alone do not give a complete picture of a company's investment potential, but they are a wise place to start the analysis (Young, 2014).

Nowadays, the financial analysis of an enterprise is one of the main prerequisites for successful management of financial resources, and, according to several scientists, is one of the most significant elements of financial management. The efficient operation of a company requires economically well-founded management decision making, which is based on the analysis of current operating and financing activities ( Zelgave ,2012).

According to Osama and Al-Zubi (2015), for ratios to be useful and meaningful, they must be calculated using reliable, accurate financial statement information and this must be done consistently from period to period for proper monitoring for meaningful : (a) comparison to internal benchmarks and goals, (b) comparison to other companies in your industry, (c) viewed both at a single point in time and as an indication of broad trends and issues over time and (d) carefully interpreted in the proper context, considering there are many other important factors and indicators involved in assessing performance.

Ratios can be divided into five major categories:

a) Liquidity ratios
b) Profitability Ratios
c) Debt or Solvency Ratios
d) Cash Flow Adequacy ratios
e) Market Value ratios

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

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

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

Short-term liquidity than the current ratio because it removes inventory that the firm may not be able to sell from the equation.

**Quick Ratio**= $\frac{\text{Current Assets -Inventory}}{\text{Current Liabilities}}$

**Accounts Receivable Turnover Ratio**

It measures the number of times trade receivables turnover during the year. The higher the turnover, the shorter the time between sales and collecting of cash. This ratio tells the investor what are the customer payment habits compared to firm's payment terms. Accordingly the firm may need to step up the collection policies or tighten the credit policies. These ratios are only useful if majority of sales are credit sales

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

**Inventory Turnover Ratio**

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

**Inventory Turnover =** $\frac{\text{Cost of Sales}}{\text{Average Inventory}}$

b- Profitability and Activity Ratios Profitability ratios measure a firm's ability to generate profits. It consist four main ratios; net profit margin, assets turnover ratio, return on assets and return on equity. Activity ratios are also known as efficiency ratios. These ratios measure how efficiently the firm is using its resources like turnover o f working capital and turnover of fixed assets etc. (Gupta, R.K. 1990).

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

**Profit ratio** = $\frac{\text{Net Income}}{\text{Net Sales}}$

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

**Asset Turnover Ratio =** $\frac{\text{Net Income}}{\text{Average Total Assets}}$

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

**ROA**= $\frac{\text{Net Income}}{\text{Average Total Assets}}$

**Return on Equity:** (ROE) Measure of profitability of stock holders' investment.

**ROE**= $\frac{\text{Net Income}}{\text{Average Total Equity}}$

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

**C- Debt Ratios**

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

Debt is called Financial Leverage because the use of debt can improve returns to stockholders in good years and increase their losses in bad years. Debt generally represents a fixed cost of financing to a firm. Thus, if the firm can earn more on assets which are financed with debt than the cost of servicing the debt then these additional earnings will flow through to the stockholders. Moreover, our tax law favors debt as a source of financing since interest expense is tax deductible (Akintoye, 2004).

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

**Debt to Equity Ratio**

Measure of Capital Structure and leverage

**Debt to Equity Ratio** = $\frac{\text{Total Liabilities}}{\text{Total Equity}}$

**Debt to Assets Ratio:**

Measure of assets debt structure

**Debt to Assets Ratio** = $\frac{\text{Total Assets}}{\text{Total Equity}}$

**Interest Coverage Ratio**: Measure of Creditors' protection from default on interest payment before Income Taxes+ Interest Expenses

**Interest Coverage Ratio** = $\frac{\text{Income}}{\text{Interest Expenses}}$

**D- Cash Flow Adequacy Ratios**

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

**CashFlowYieldRatio**=$\frac{\text{NetCashFlowfromOperatingActivities}}{\text{Net Income}}$

**Cash Flow to Sales Ratio**

Measure of the ability of sales to generate operating cash flow

**CashFlowtoSalesRatio**=$\frac{\text{NetCashFlowfromOperating ctivities}}{\text{Net Sales}}$

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

**CashFlowtoAssetsRatio**=$\frac{\text{NetCashFlowfromOperatingActivis}}{\text{AverageTotal Assets}}$

**E- Market Value Ratios**

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

**Price-Earnings Ratio (P/E Ratio)**

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

$$\textbf{P/E Ratio} = \frac{\text{Price Per Share}}{\text{Earnings per Share}}$$

$$\text{Where: Earnings per Share} = \frac{\text{Net Income}}{\text{Number of Shares Outstanding}}$$

**Market-to-Book Ratio**

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

$$\textbf{Market-to-Book Ratio} = \frac{\text{Price Per Share}}{\text{Book Value per Share}}$$

$$\text{Where: Book Value per Share} = \frac{\text{Total Owners' Equity}}{\text{Number of Shares Outstanding}}$$

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

Summary, Conclusion and Recommendation

This study investigated the impact and usefulness of information content of financial statements on shareholders' investment decisions. The study is vital as it portrays the extent to which shareholders of firms listed on the Nigerian Stock Exchanged (NSE) are influenced by the contents of published accounts in their investment decisions.

According to Data Analysis the study had concluded the following:

a. The use of financial indicators has a significant positive effect on investment taken by investors.

b. Financial indicators represented in ratio analysis plays a vital role in a business forecasting and figuring out the strength, weaknesses, and opportunities of a business enterprise.

c. High significance to individual ratios doesn't always result in a good decision. Sometimes higher profitability may be accompanied with low liquidity.

However, results of the study show that: investors are more concerned about returns – dividend, with a little or no understanding of how it came about or the underlying financial statement. To them companies with higher profitability attract more shareholders. Investors show less interest in companies' Earnings per Share while making their investment decisions in the Nigerian Stock market, Shareholders are after their own return on their investment in the company, and not how the management of the company settles its obligation to creditors and lenders.

Finally the extent which information content of financial statement affects shareholders' investment decision is low; that is if they understand it and its underlying fundamentals at all implying that there are other factors that have stronger impression on investment decisions by shareholders.

According to the study conclusions the researcher recommends the following:

a. Financial indicators should be used wisely after complete check of the past history of the company, and through auditing check of the financial cycle.

b. Other tools than financial indicators has significant effect on decision making which should be taken into consideration.

c. Financial indicators will not say why something is going wrong, or what to do about a particular situation, they only pinpoint area of the problem.

d. Management policies and action could lead to high profit readings but comparison of such company with another could be misleading.

e. Investor who are not conversant with stock market games, should use financial expert or unit trust or investment funds at least to start with or investment clubs for the safety of their capital

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