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AUTHORS	Katarina Zager Lajos Zager
ARTICLE INFO	Katarina Zager and Lajos Zager (2006). The Role of Financial Information in Decision Making Process. *Innovative Marketing* , *2*(3)
RELEASED ON	Friday, 01 September 2006
JOURNAL	"Innovative Marketing "
FOUNDER	LLC “Consulting Publishing Company “Business Perspectives”

NUMBER OF REFERENCES
0

NUMBER OF FIGURES
0

NUMBER OF TABLES
0

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THE ROLE OF FINANCIAL INFORMATION IN DECISION MAKING PROCESS

Katarina Zager, Lajos Zager

Abstract

One of important assumptions in decision making process and improvement economy is existence of quality information. Significant number of this information comes from accounting information systems and from financial statements. Financial statements have to provide realistic and objective picture of realistic business condition of certain company. In other words, auditing of financial statements is understandable, by which accuracy is ensured. In context of consideration of financial statements as a function of decision making it is important to emphasize that different users must know how to "read" those statements. "Reading" contents of financial statements provide whole number of different instruments and analyses procedures for understanding business. A well-established process of management on the basis of the financial statements and financial information is one of the most significant presumptions of the quality business.

Key words: Accounting process, business quality, financial information, decision making process, financial statements, ratios.

Process of preparing financial information

Decision making process requires information – financial and non-financial information as well. The most important financial information needed in the process of business decision comes from accounting. Therefore, we can say that accounting is a service function to management. It, basically, processes or gathers and studies "raw data" and converts them into suitable information in the process of decision making. The basic characteristics of the accounting are:

- ♦ gathering, processing and presenting accounting (financial) information
- ♦ information considering company's business
- ♦ those directed towards different interested users

Accounting process contains several phases. Basically, it is a process in which input data converts into output information. If we focus our attention on the most significant part of the accounting (bookkeeping), then we can present the data processing through several phases as it is shown in Figure 1.

The first data processing phase consists of collecting data about occurred business events. After data collecting comes the second phase of the accounting process that consists of business event analysis. After that recording in journal and general ledger comes. At the end of accounting period, just before preparing basic financial statements, we need to check data accuracy in the books since we make financial statements on the basis of those data. Therefore we prepare the trial balance. It represents the recapitulation of all ledger accounts and financial transactions. After all records are coordinated and after we find all data accurate, we have the last phase of the accounting process that refers to preparing financial statements. As it has already been pointed out, financial statements have to satisfy interests of different accounting (financial) information users.

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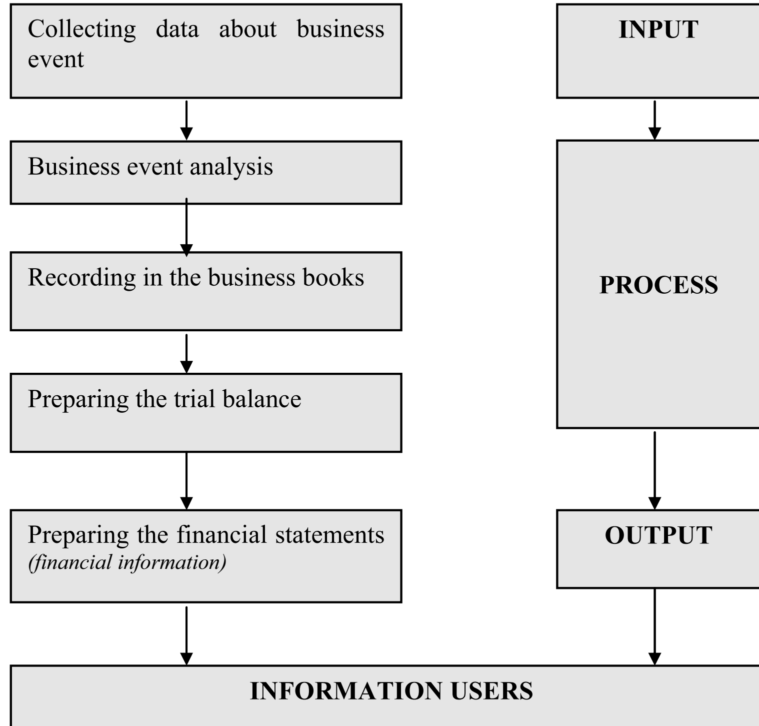

Fig. 1. Accounting process

Accounting process that is shown refers, first of all, to financial accounting whose final products are financial statements. However, from the user's aspects and from the aspects of the scope of business we distinguish the following types of accounting: financial accounting, cost accounting and managerial accounting. We usually say that cost and managerial accounting ensure different information for internal users and financial accounting ensures synthetically and quality information needed for preparing the financial statements for external users. Nevertheless, in the context of measuring the entire business quality, financial accounting is also directed towards internal users.

The most significant financial statements that we should take into account when examining the entire business quality and make decision for the future are (Figure 2):

- balance sheet
- income statement or profit and loss account
- cash flow statement
- changes in owner's equity

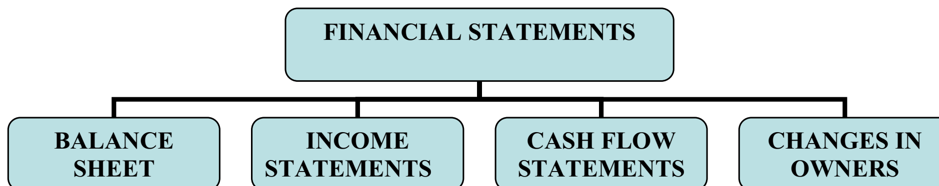

Fig. 2. Financial statements

The balance sheet is the fundamental financial statement that represents company's financial position and is the basis for estimating the security of business. Basic elements of balance sheet are assets, liabilities and owners equity. The structure of assets, liabilities and equity is especially important, together with the correlation and interdependence of assets, liabilities and capital. In the context of business quality, besides security, efficiency of business is also very important. We usually define efficiency of business as an ability of achieving specific goals. Business goals can be different and that means that efficiency of business depends on a set of principles and defined goals. Business profitability is the most often stated goal. If we understand efficiency in this way it is measured by profit and loss account. While balance sheet represents the financial position in a particular moment, income statement (or profit and loss account) represents company's performance for a particular time period. Basic elements of this statement are: revenues, expenses and their difference which can be profit or loss.

It is not unusual that the company according to the profit and loss account has successful business, business with the profit, but at the same time has problems in meeting current liabilities. It is possible because revenues and expenses are accounting categories and many times they can be distinguished from cash receipts and cash expenditure. According to that, while measuring business performance, besides balance sheet and profit and loss account, we need to use cash flow statement and statement of changes in owner's equity as well. The cash flow statement contains the information about cash receipts and cash expenditure as well as about their difference, that is, the cash flow. Statement of changes in owner's equity shows all transaction which refers to profit or loss for a particular time period.

Decision making on the basis of financial information

In order to improve the usage of financial information in the context of the decision making process, we need to analyze financial statements. In that context, we can describe financial statement analysis as the process where we convert data from financial statements into usable information for business quality measurement by different analytical techniques, which is very important in the process of rational management. Therefore, to know the current level of business quality is very significant in the context of future business management, since we try to ensure company's development and existence on the market. Financial statement analysis comes before the management process that is before the process of planning which is the component of the management process. Planning is very important for good management. Good financial plan has to consider all company's strength and weaknesses.

The task of financial statement analysis is to recognize good characteristics of the company so that we could use the most of those advantages, but also to recognize company's weaknesses in order to take corrective actions. Because of that, we can say that management of the company is the most significant user of financial statement analysis.

In the process of financial statements analysis it is possible to use the whole range of different instruments and procedures. First of all, it considers comparative financial statements and the horizontal analysis procedure together with structural financial statements and the vertical analysis procedure. By horizontal analysis which is based on the comparative financial statements we try to examine the tendency and dynamics of changes of particular basic financial statements positions. We estimate business efficiency and security of the company on the basis of observed changes. On the other hand, structural financial statements are the base for vertical analysis which allows insight into financial statement structure. Financial statements structure is very significant in the context of business quality.

By financial statement analysis we get acquainted with the business quality, but the questions of the analysis are not solved by horizontal and vertical analysis procedures of balance sheet, profit and loss account and cash flow statement. In the context of measuring business quality on the basis of financial statements, the most significant are different financial ratios formed from basic financial statements.

Ratios of financial statement analysis and the business decision

Ratio is rational or relative number which means that one economic value is put into relation (it is being divided) with other economic value. Since there is no sense in connecting any two economical values, we can speak about prerequisites of ratio's accuracy. Considering the time dimension, financial ratios can be basically divided into two groups. One group of financial ratios includes company's business within the particular time period (usually a year). This group is based on the data from profit and loss account and cash flow statement. The other group of financial ratios refers to the exactly defined moment which corresponds with the balance sheet date and talks about company's financial position in that moment. Ratios contain concentrated information that is needed for business quality measurement and decision making process as well.

Ratios measure the quality level of particular economic phenomena which are included in financial statements. For example, if we consider relation between revenues and expenses, the lower quality level is expressed by ratio 1, which means that expenses are covered by revenues. When ratio is larger than 1, the quality level is higher since we use less revenues for covering expenses and that trend suggests higher profit. The similar situation occurs when data from balance sheet are put into correlation. For example, in the relation between current assets and current liabilities (current ratio) desirable ratio is 2. However, the current liquidity ratio that is essentially higher or lower than 2 means different business quality level in the context of paying payable liabilities.

We have several ratio types depending on what kind of decisions we want to make or which business quality segment we want to take into account. As a result we distinguish several groups of financial ratios:

1. Liquidity ratios – measure company's capability to pay its payable current liabilities.
2. Leverage ratios – measure how the company is financed from creditors' resources.
3. Activity ratios – measure how efficiently company uses its own resources.
4. Economy ratios – measure relation between revenues and expenses, that is, they show how much revenue is achieved per unit of expenses.
5. Profitability ratios – measure the return of the invested capital and show the highest managerial efficiency.
6. Investibility ratios – measure efficiency of investment in ordinary shares.

Generally, good management includes two criteria: security (liquidity, financial stability and indebt ness) and efficiency (profitability). We ensure our business quality by satisfying those criteria. Accordingly, business security ratios are: liquidity ratios and leverage ratios. Business efficiency ratios are: revenue ratios, profitability ratios and investibility ratios. On the other hand activity ratios can be either security ratios or efficiency ratios. Namely, assets turning ratio on one side affects liquidity and financial stability, but on the other directly affects business profitability. The correlation between ratio groups and quality business basic criteria is presented in Figure 3. As a rule, security and efficiency criteria are, in short term, opposed. However, in long term, efficiency depends on security and vice versa.

When comparing ratios with specific standard values (that are the base of comparison) we get far more precise information. Ratios standard values that are mostly used are:

1. Planned ratio for analysed period.
2. Ratio value changes through specific period in the same company.
3. Ratio value in the similar company that belongs to the same group.
4. The average ratio value of other companies that belongs to the same group.

In modern business terms, besides financial ratios based on balance sheet and profit and loss account, very significant are financial ratios based on cash flow statement. Those ratios are very sig-

nificant during insolvency of the economy when it is very important to take into account the difference between revenues and expenses on one side, and cash flows on the other. Namely, it is well known that the realized profit does not mean that the company has enough money to pay different liabilities; on the other side, loss does not mean that the company does not have any money at all. Therefore, when measuring business quality, we should examine classical ratios, based on balance sheet and profit and loss account, in correlation with cash flow statement and ratios based on cash flow statement. Financial ratios based on cash flow statement are usually divided into four groups:

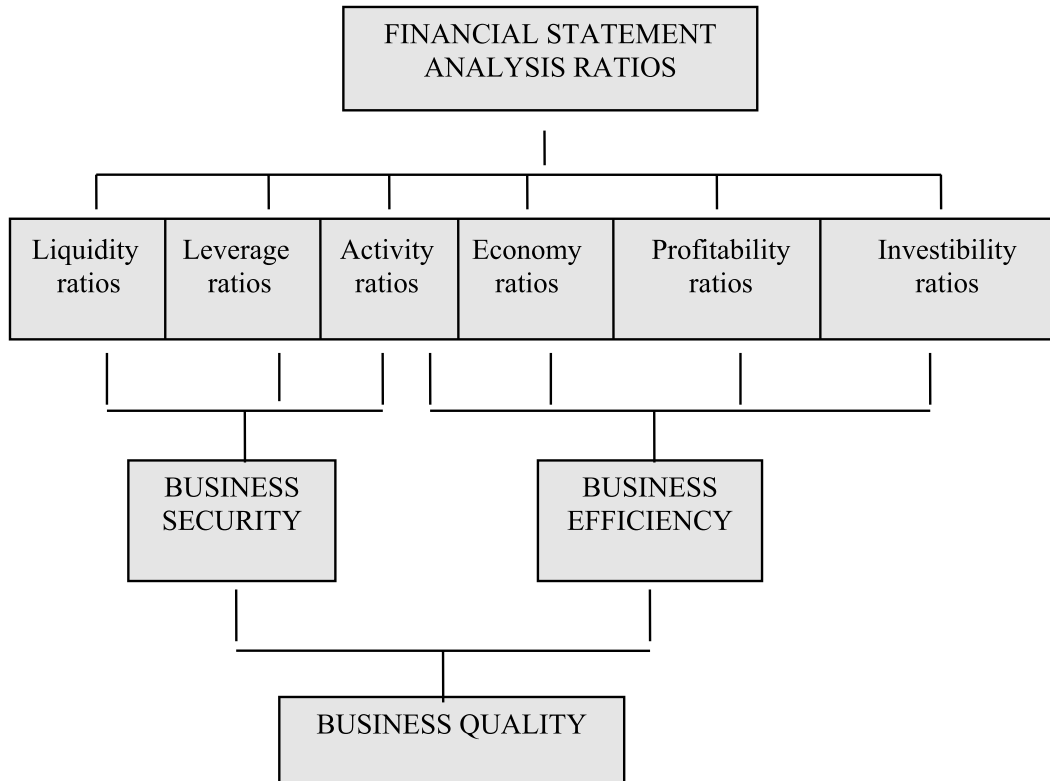

Fig. 3. Correlation between financial statement analysis ratios and basic criterion of good business

1. Assessing solvency and liquidity ratios shows the money coverage of interest, current liabilities, total liabilities and dividends.
2. Quality of income ratios shows the relation between cash receipts from business activities and sales revenues as well as the relation between receipts and profit.
3. Capital expenditure ratios connect different cash flow types and examine the possibility of purchasing capital assets, financing and investing.
4. Cash flow return ratios define cash flow per share, return of the money on total assets, liabilities and equity (basically they speak about profitability).

When combining ratios based on cash flow statements and ratios based on balance sheet, and profit and loss account, we create good presumptions for measuring business quality with the help of financial information.

Conclusion

Accounting information system prepares the whole range of different information for different users. We can measure and examine the business quality of the entire company on the basis of accounting and financial information. In that context we examine true and fair presentation of financial position, business efficiency and cash flow. Successful business is the business operation that results for quite a long period in corresponding level of security and efficiency of business. Security of business is examined, first of all, on the basis of a balance sheet and efficiency on the basis of the profit and loss account. However, for a more complete picture about business quality we need to consider data from other statements, for example, cash flow statement.

The condensed statement of security and efficiency of business is registered by financial ratios. Accordingly, financial ratios can be examined in the context of measuring business quality. Different ratio values define different levels of business quality. By defining the current business quality rate some significant presumptions are made for the development and existence of the company on the market. In that context we can conclude that financial information can be very useful in estimating the current business quality and creating assumption for more successful business in the future.

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