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Understand Ranking Rules and Judge Financial Quality

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Abstract

For the current ratio calculation as the mainstream of financial analysis literature and financial analysis textbooks, this paper expounds the ranking rules in financial analysis from five aspects: rules for the arrangement of accounting statement, the ranking of debt items, the ranking of sales receivables, the ranking of purchase payment methods and the ranking of importance of items. The difference between the ratio index and the application of grade rules in judging the financial quality of enterprises is shown through the data. It is important to understand and apply these hierarchical rules if you do not want to get lost in financial analysis.

Keywords

Rules for the Arrangement of Accounting Statement; The Ranking of Debt Items; The Ranking of Sales Receivables; The Ranking of Purchase Payment Methods; The Ranking of Importance of Items.

1. Introduction

Open up the literature and teaching materials of financial analysis, whether it is the four ability analysis framework system or comprehensive performance evaluation, whether it is strategic analysis or life cycle analysis, it is generally inseparable from the calculation of various ratios, such as current ratio, asset liability ratio, turnover period of various assets and funds, various profitability, growth rate of various statement items, proportion of non-performing assets, proportion of interest bearing liabilities Market value to book value ratio, per capita income generation or profit generation, etc. However, no matter which system, the number of indicators contained is limited. The difference only lies in the suitability of indicators selected for different analysis purposes. In fact, there are many hierarchical rules in financial analysis. If you don't understand these hierarchical rules and blindly follow the ratio calculation, you may abandon the basics and go astray, so what are the hierarchical rules in financial analysis? The following will be elaborated from five aspects: the arrangement rules of statements, the level of debt items, the level of sales collection method, the level of purchase payment method and the importance level of items.

2. Statements Arranged According to the Classic Investment Rules of "High Rish and High Return, Low Risk and Low Return"

Balance sheet, income statement, cash flow statement and statement of changes in owner's equity are four familiar statements, which are the concentration of accounting information. Their presentation is placed in the specified format, and these specified formats imply the arrangement rules of statements.

ISSN: 2688-9323

2.1. Arrangement Rules of Balance Sheet

According to the arrangement rules of the balance sheet, the assets on the left are arranged according to liquidity, and the capital sources on the right are arranged according to the length of maturity. If you carefully analyze the essence of this arrangement, in fact, the balance sheet is arranged according to risk and income. The assets on the left, from monetary funds to fixed assets, are less liquid, Fixed assets will not be directly used by enterprises to repay debts because of their slow realization speed or high degree of value damage. Why should enterprises invest in fixed assets? That is because the profitability of assets and the liquidity of assets are opposite. The better the liquidity, the worse the profitability may be. The liquidity of monetary funds is the best, that is, the lowest risk, because it can be used for direct repayment, but the profitability of monetary funds is also the worst, that is, the liquidity of assets and the risk of assets are in the same direction and in the opposite direction. The source of funds on the right, from short-term loans to long-term loans and then to equity, the longer the funds can be used by the enterprise. Logically, the longer the funds are used, the higher the cost should be paid. Therefore, the interest rate of long-term loans is generally higher than that of short-term loans, while equity is permanently used by the enterprise because it will not repay the principal. There is no very clear regulation on the amount and time of dividend payment, Therefore, for the enterprises that raise funds, it is the capital with low risk. Of course, for the shareholders who invest, the risk is high. Because the investors bear the high risk, they will require high remuneration. In the case of investors, it is the remuneration and in the case of enterprises, it is the cost. Therefore, equity funds are the capital with the highest cost in theory. The above balance sheet expressed by risk, income and cost is shown in Table 1.

Table 1. Balance sheet expressed by risk, income and cost

assets	Ranked by liquidity	Liabilities and owner's equity	Arranged according to the length of service time
current assets	Good liquidity, low risk, but low return	liabilities	The use time is short, the risk is high, but the cost is low
Long term assets	Poor liquidity, high risk, but high return	Owner's equity	Long use time, low risk, but high cost

As can be seen from the above table, the essence of the balance sheet is arranged according to the investment Scripture of "high risk, high return, low risk and low return". Therefore, when an enterprise has many long-term assets, the first judgment is that the operation risk of the enterprise is high. Whether the income is high depends on other conditions; When an enterprise has a lot of liabilities, the first judgment is that the financial risk of the enterprise may be high. As for whether the income is high, it also depends on other conditions. This arrangement of the balance sheet should be viewed dialectically, because it requires many conditions to achieve high income. If the risk is not high, it must be high income. However, without taking risks, there is no foundation to achieve high income.

In addition, some assets corresponding to tangible assets such as monetary capital, inventory and fixed assets, such as deferred expenses, goodwill and deferred income tax assets, are considered as virtual assets by many scholars because they do not have liquidity, solvency and investment ability [1,2]. Intangible assets may have investment ability, but their liquidity and solvency are very uncertain, Therefore, the assets of an enterprise can be divided into virtual and real assets. A large number of virtual assets also means that the risk of the enterprise is high.

ISSN: 2688-9323

2.2. Arrangement Rules of Income Statement Items

The income statement is a financial statement that reflects the operating results of an enterprise in a certain accounting period. Generally speaking, revenue and income items will increase profits, such as operating income, other business income, investment income and nonoperating income. However, the quality grade of these income is different from that of profits. Generally, the sustainability of operating income is strong and the grade is high, while the nonoperating income is unsustainable and the grade is low. Therefore, the profit quality of an enterprise can be judged by analyzing the hierarchical structure of profit sources. The essence of Jones model and Roychowdhury model in accounting empirical analysis is to calculate the impact of these unsustainable profit source projects on profits [3].

2.3. Arrangement Rules of Cash Flow Statement Items

Cash flow statement is a financial statement prepared on cash basis. According to the direction of cash flow, it is divided into inflow cash flow and outflow cash flow. According to the activities of the enterprise, it is divided into cash flow from operating activities, cash flow from investment activities and cash flow from financing activities. Generally, the cash flow from operating activities is the most sustainable, the cash flow from financing activities is unsustainable, and the cash flow from investment activities is between the two. Therefore, the cash flow is arranged according to the sustainability of obtaining cash. The level of cash flow statement item shows that if an enterprise's cash inflow mainly depends on the cash inflow from financing activities, it is unsustainable. If an enterprise cannot obtain continuous cash flow, it will eventually break the cash flow and fail to operate.

2.4. Arrangement Rules of Owner’s Equity Items

Paid in capital, capital reserve, surplus reserve and undistributed profit are the four basic items of owner's equity. Undistributed profits can make up for losses, distribute them to shareholders as dividends and increase capital. The surplus reserve is conditionally used to cover losses, distribute to shareholders as dividends and increase capital. Capital reserve cannot make up for losses and cannot be distributed to shareholders as dividends. Only the part of capital premium can be converted into capital. The reduction of paid in capital requires a series of legal procedures. As can be seen from the above, the degrees of freedom of these four projects are different. Undistributed profits are the freest and paid in capital is the least free. In addition, the surplus reserve and undistributed profit belong to the capital source of blood making type, while the paid in capital and capital reserve belong to the capital source of blood transfusion type. The significance of these two types of capital sources to enterprises is different. Generally speaking, the capital source of blood making type is sustainable, while the capital source of blood transfusion type is unsustainable.

From the above, we can see that the essence of high sustainability and high degree of freedom is low risk. In this sense, the four statements are arranged according to risk. Judging from the balance sheet, whether the risk is high and whether the income is high can be read from the other three statements. The information between the four statements is mutually confirmed.

3. Hierarchy of Debt Items

Liabilities refer to the current obligations formed by past transactions or events of the enterprise and expected to cause economic benefits to flow out of the enterprise. Liabilities are divided into current liabilities and long-term liabilities according to their repayment speed or repayment time. According to whether interest should be paid, it is divided into operating liabilities and financial liabilities. Operating liabilities mainly include notes payable, accounts payable, accounts receivable in advance, interest payable, employee remuneration payable, taxes payable, dividends payable, other accounts payable, other current liabilities, etc. because

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there is no fixed interest payment and no fixed maturity date, it can be called flexible liabilities. Financial liabilities generally include short-term loans, long-term loans, bonds payable, long-term accounts payable, and uncurrent liabilities due within one year. Due to the payment of fixed interest and fixed maturity, they can be called rigid liabilities. In fact, there are hierarchical differences between hardness and softness. Financial liabilities have stronger constraints on enterprises and greater flexibility of operating liabilities. Table 2 shows the debt data of the two enterprises. You can see the level of debt.

Table 2. Data of liabilities of a and B white appliance enterprises in 20x1

company	Current ratio	Asset liability ratio	Proportion of short-term loans	Proportion of notes payable	Proportion of accounts payable	Proportion of advance receipts	Proportion of other current liabilities	Proportion of long-term loans	Proportion of bonds payable
A	1.32	66.58%	1.04%	10.16%	14.17%	7.02%	10.58%	13.30%	1.84%
B	1.16	68.91%	8.67%	4.54%	16.07%	6.58%	28.34%	0.00%	0.00%

It can be seen from table 2 that the current ratio of enterprise a is larger than that of enterprise B. traditionally, the current ratio is an indicator of short-term solvency. The smaller the indicator, the higher the risk of debt failure. Therefore, judging from the data in Table 2, the short-term debt repayment risk of enterprise B is higher than that of enterprise a. The asset liability ratio of enterprise B is larger than that of enterprise A. traditionally, the asset liability ratio is an indicator of long-term solvency. The larger the indicator, the higher the financial risk. Therefore, according to the data in Table 2, the long-term solvency risk of enterprise B is higher than that of enterprise a. Therefore, judging from these two ratios, compared with enterprise a, enterprise B has greater financial risk. However, a careful comparison of the ratio of the liabilities of the two enterprises to the total assets will find that the proportion of financial liabilities of enterprise a is higher than that of enterprise B. when comparing various liabilities, the proportion of other current liabilities is higher, especially enterprise B. check the enterprise information to find out that this part is the accrued sales rebate, and later the enterprise uses goods to repay this part of the debt. Therefore, after a detailed comparison of the proportion of various liabilities, it will be concluded that the financial risk of enterprise B is less than that of enterprise a. From the above analysis, we can see that to judge whether the financial risk of an enterprise is high, we need to see the essence of the enterprise's liabilities, rather than relying solely on the calculation of the so-called debt service ratio.

4. Hierarchical Structure of Sales Collection Mothod

There are generally four kinds of sales collection methods: advance receipts, cash, notes receivable and accounts receivable. Theoretically, the order of receipt should be advance receipts, followed by cash, notes receivable and accounts receivable. Behind these four collection methods is the popularity of enterprise products. The more popular products are, the more funds in front of sales collection will be received and the more accounts receivable will be, It shows that the enterprise has more competitors.

There are also four methods of purchase payment: prepayment, cash, notes payable and accounts payable. Theoretically, the order people choose is accounts payable, followed by notes payable, cash and prepayment. The more active accounts payable (not those that cannot be paid), the stronger the negotiation position of the enterprise in the value chain, as shown in Table 3.

Table 3. Sales collection method data of two white appliance enterprises A and B in 20x1

company	Data time	Proportion of monetary capital + proportion of other current assets (note)	Proportion of notes receivable	Proportion of accounts receivable	Proportion of advance receipts
A	Average since listing	8.57%+4.87%=14.44%	6.66%	13.71%	7.81%
	Year 20x1	19.46%+18.88%=38.34%	4.37%	7.07%	7.02%
B	Average since listing	23.26%+0.5%=23.76%	25.24%	4.72%	14.33%
	Year 20x1	46.33%+4.81%=51.14%	15.00%	2.70%	6.58%

Note: most of the other current assets of the two companies are financial products, which can be called monetary funds

Table 4. Purchase payment method data of two white appliance enterprises A and B in 20x1.

company	Data time	Proportion of notes payable	Proportion of accounts payable	Proportion of prepayment
A	Average since listing	8.07%	20.78%	7.15%
	Year 20x1	10.16%	14.17%	0.67%
B	Average since listing	6.29%	29.61%	5.43%
	Year 20x1	4.54%	16.07%	1.73%

Table 3 shows that in terms of sales collection methods, enterprise B has more sales collection funds such as advance receipts and bills receivable than enterprise a. Judging from the collection method, the products of enterprise B may be more popular than those of enterprise A. otherwise, consumers would not be willing to hand over the payment to the enterprise first. In the purchase payment method, enterprise B has more accounts payable, while the lower ranking purchase payment funds such as notes payable and prepayment account for less. Therefore, judging from the purchase payment method, enterprise B has a stronger negotiating position in the value chain than enterprise A. otherwise, the supplier will not hand over the materials to the enterprise without receiving the payment. Both the average value of monetary funds and similar monetary funds since listing and the data of 20x1 (in fact, the monetary funds of enterprise B account for more than that of enterprise A in most years, but they are not listed due to layout reasons). Enterprise B is larger than enterprise A, indicating that enterprise B is more efficient in using the funds of upstream and downstream enterprises.

It is worth mentioning here that when analyzing and calculating the turnover rate of accounts receivable in ratio analysis, after taking into account the notes receivable and advance receipt, assets such as monetary funds are generally not taken into account, because monetary funds are often divided into financial funds [4], but monetary funds are actually a very important collection method and payment method in sales collection. They are the starting point and end point of all activities. Analysts can preliminarily judge the risk and income of enterprises by analyzing the amount of monetary funds and the source of monetary funds.

5. Importance Level of the Project

Materialist dialectics holds that "Among the various contradictions of things or processes, the status and role of various contradictions are unbalanced. At any stage of the development of things, there must be and only one contradiction in the dominant position, which plays the role of regulating or influencing other contradictions. This contradiction is the main contradiction. Other contradictions are nonmain contradictions. It is precisely because there are primary and secondary contradictions that there should be key and unkey points in the methodology of

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thinking about problems and doing things as for the key points, we should be good at grasping the key points and concentrating our efforts to solve the main contradictions. " Everyone is familiar with this passage, but it is often forgotten when it comes to financial analysis, because the ratio index can't read the information of project importance, such as the calculation of asset turnover, which generally calculates accounts receivable turnover, current asset turnover, fixed asset turnover and total asset turnover. There are two defects in the calculation of these ratios. First, the above index takes manufacturing enterprises as the hypothetical calculation object, If the enterprise is not a manufacturing enterprise, the most important assets of the enterprise may not be the assets listed above, but monetary assets (as shown in Table 3, the monetary capital of enterprise B accounted for 51.14% of the total assets in 20XX), or long-term equity investment or other assets. Second, the numerator of these turnover rates is operating income, while the main source of profits of investment-oriented enterprises with equity investment as the main asset may be investment income. It is unfair to calculate the asset turnover rate of such enterprises with operating income as the numerator, as shown in Table 5.

Table 5. Partial report item data of 3 pharmaceutical enterprises (Unit: RMB million)

Report item	Enterprise X	Enterprise Y	Enterprise Z
Proportion of monetary capital	33.98%	6.74%	12.05%
Proportion of notes receivable	15.50%	2.10%	0.93%
Proportion of accounts receivable	4.45%	2.71%	5.24%
Proportion of inventory	31.27%	2.18%	4.44%
Proportion of long-term equity investment	0.00%	68.70%	29.77%
Proportion of fixed assets	6.30%	9.56%	10.58%
Proportion of intangible assets	1.15%	1.37%	11.70%
Proportion of goodwill	0.05%	0.00%	13.66%
Total Assets	27703	21855	61971
business income	24315	2977	18534
income from investment	277	1481	2307
Net profit	3133	1845	3585

It can be seen from the table that enterprise x is a typical production and manufacturing enterprise, y is a typical investment enterprise, and Z is a mixed industry with both manufacturing and investment. At this time, when calculating the turnover rate of assets of different enterprises, the comparability has been greatly reduced. Therefore, the author believes that financial analysis must first start from the purpose of financial analysis to find the important items and important factors affecting the goal. Analysis regardless of key points and grades may be an analysis of sitting in the fog and getting twice the result with half the effort.

6. Concluding Remarks

There is a saying that "laymen watch the excitement while experts watch the doorway". When applied to financial analysis, it is "laymen calculate the ratio and experts see the essence". To master the essence, we must first master the rules. This paper expounds the grade rules in financial analysis from five aspects: the arrangement rules of statements, the grade of debt items, the grade of sales collection method, the grade of purchase payment method and the importance grade of items. If you master these rules and their application, the general direction will not be lost.

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