Healthcare Accounting, Financial Statement Analysis

Student's Name:

Institution:

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Theorists of capital structure have long argued on both the relative merits of using debt and inquiry in financing the operations of a firm, together with distortions brought about by the use of borrowed money into the investment policies of an organization. Ideally, the optimal capital structure, has been seen as the mix of equity and debt claims that optimize the trade-offs between the tax advantage nature of debt financing and the related increase in the probable costs of financial distress. Similarly, the distortions in investment comprise of problems of under-investment as well as asset substitution. Recently, the focus of these distortions has been widened to include alterative explanations of firm leverage decisions, like market timing hypothesis and pecking order theory.

When evaluating the status of a company, the financial analysts are keen to determine whether the company has access to adequate cash for meeting its financial obligations. This is measured using liquidity ratios. Additionally, the analysis would also want to determine how the company positioned itself after acquiring its capital, the amount used in purchasing assets and in running the business (Barclay, Smith, and Morellec, 2006). Capital is measured using capital structure ratios.

Capital structure ratios compare the debt the debt of a company to its equity. Equity and debt are two methods through which companies get capital. Equity implies money earned or invested while debt implies money borrowed. The financial ratios used to measure capital structure comprise of debt-to-equity ratio or the ratio of fixed assets to long-term liabilities. The debt-to-equity ratio divides the total liabilities of a company by the overall equity owned by stockholders. If the debt ratio is high, the company is said to carry high debts. A debt to equity ratio that nears one demonstrates that there is a balance between debt and equity. The fixed assets to long-term liabilities ratio divides the overall fixed assets by the total of the owned money with a repayment date exceeding a year. This ratio demonstrates the equity percentage possessed by a company in its assets (McLean, 2002).

On the other hand, liquidity ratio analyzes the ability of a company to access money when required. In the event that a company has insufficient access to cash, it loses the opportunities of pursuing investment and may be rated behind in relation to its bills. Liquidity ratios comprises of the inventory turnover and current ratio. The inventory turnover ratio is used for determining the number of times the company sells out its inventory in a given year. Higher ratios mean that the company would receive more cash in exchange for the inventory (McLean, 2002). On the other hand, current ratio is used for comparing the current assets or assets, which can be converted into cash in a given year. If a value above one is obtained, it implies that the company has the capacity its current obligations.

There are various similarities between capital structure ratio and liquidity ratios. Higher values in both capital structure and liquidity ratio imply that the company has a strong financial position. In addition, consistency in ratio values indicates stability in both liquidity ratios and capital structure (McLean, 2002).

There are also distinctions between capital structure ratios and liquidity ratios as they focus on different business aspects. Capital structure ratios are used for measuring, the level of debt a company has and this is compared to the equity amount. On the other hand, liquidity ratio evaluates the cash level of a company, which enables a financial analyst to help in predicting whether the company is bound to face financial predicaments (Nowicki, 2008). The analysts determine the standards of the industry, for the different ratios by determining the ratio for different companies in a given industry. If the ratio of the company varies considerably, from the standard, the analysts should consider keenly the financial position of a company.

The key to profitability is how well a certain company is able to manage and utilize its assets. Some ratios are designed for evaluating the effectiveness of a company to manage its assets. The activities given the main attention are the turnover ratios of some assets. If an asset has a higher turnover, it will require fewer assets for maintaining the activity or revenue. Considering that, companies incur costs of financing its assets with equity or debts, high turnover are more favorable. A company with high activity in the collection of receivables will have low profitability.

Another scenario, where an organization might have an increasing activity ratio but have declining profitability is when there is high number of sales for inventory balance during a reporting period. If a business has a high frequency of selling or turning over its inventory, it would have a lower investment on the inventory. The cost is usually calculated by dividing the cost of goods sold in a given period by the average inventory balance. It is desirable to have a high ratio compared to that of a competitor (Nowicki, 2008). This is because a high ratio indicates comparative strength, which is attributed to superior sales of a company.

References

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