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Analysis of Financial Statements

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Abstract

Financial Statement Analysis is a method of reviewing and analysing a company's accounting reports (financial statements) in order to gauge its past, present or projected future performance. This process of reviewing the financial statements allows for better economic decision making. The main purpose of financial statement analysis is to utilize information about the past performance of the company in order to predict how it will fare in the future. Another important purpose of the analysis of financial statements is to identify potential problem areas and troubleshoot those.

Introduction

Financial analysis is the process of evaluating businesses, projects, budgets, and other finance-related transactions to determine their performance and suitability. Typically, financial analysis is used to analyse whether an entity is stable, solvent, liquid, or profitable enough to warrant a monetary investment.

It is a process of analysing and interpreting financial statements. Analysing means simplifying the data and interpreting means explaining the meaning and significance of data so simplified. Critically examining the accounting information given in the financial statements. Evaluating relationships between the components parts of financial statements to obtain a better understanding of firms positions and performance. It is the outcome of summarizing process of accounting.

Objectives

- To assess the earning capacity and profitability of firm.
- To assess the operational efficiency and managerial effectiveness.
- To make inter-firm comparisons.
- To make forecasts about future prospects of firm.
- To help in decision making and control.
- To guide or determine the dividend action.
- To identify the reason for change in profitability and financial position of the firm.
- To assess the progress of firm over a period of time.

Meaning of Analysis of Financial Statements

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'. It is basically a study of relationship among various financial facts and figures as given in a set of financial statements, and the

interpretation thereof to gain an insight into the profitability and operational efficiency of the firm to assess its financial health and future prospects. The term ‘financial analysis’ includes both ‘analysis’ and ‘interpretation’.

The term analysis means simplification of financial data by methodical classification given in the financial statements. Interpretation means explaining the meaning and significance of the data. These two are complimentary to each other. Analysis is useless without interpretation, and interpretation without analysis is difficult or even impossible.

Potential Financial Statement Users

- ✓ Creditors
- ✓Investors
- ✓ Managers
- ✓ Employees
- ✓ Taxation authorities
- ✓Shareholders

Steps in Financial Analysis

Identify the Industry Economic Characteristics

A financial statement helps in better working of any company. Moreover, looking at these statements the management comes to know about the performance of the company or organization. Knowing about the performance of the company in the form of profits, loss, the solvency of the enterprise, financial strength and more is very essential.

Identify Company’s Investment Strategies

Investors will only invest in a profit-making organization therefore, with the help of financial statements one gets to know about the organization in detail. Moreover, the firm with a good profitability ratio is the one that investors are looking for. More earning per share is also known with the help of a yearly statement which in turn is helpful for the equity investors and other stakeholders. Investment strategies are therefore of utmost importance.

Assess the Quality of the Firm’s Financial Statements

The firm’s accounts and financial statements must abide by the relevant accounting standards. Even for the creditors, a financial analysis is very essential. They are also the investors of the company and they come to know about the solvency ratio of the company through it. Everyone must rely on the financial statements and yearly reports and can come to know whether the company is able to repay back the loans or not.

Prepare the Forecasted Financial Statements

Judging the position of any company is possible with the help of financial analysis. It is although challenging but necessary to make an assumed financial statements. Such statements shall affect both, cash flow statements and also funding. Professionals prepare such statements with the technique of percent of sales approach.

Valuation of the Firm

For deriving the value of the firm there are many approaches. The most ideal amongst the lot is the discounted cash flow methodology. Economic value added is the second most favourable approach.

Different Types of Financial Analysis

1. Internal Analysis

Internal analysis is made by the top management executives with the help of Management Accountant. The finance and accounting department of the business concern have direct approach to all the relevant financial records. Such analysis emphasis on the overall performance of the business concern and assessing the profitability of various activities and operations.

2. External Analysis

Shareholders as investors, banks, financial institutions, material suppliers, government department and tax authorities and the like are doing the external analysis. They are fully depending upon the published financial statements. The objective of analysis is varying from one party to another.

3. Short Term Analysis

The short term analysis of financial statement is primarily concerned with the working capital analysis so that a forecast may be made of the prospects for future earnings, ability to pay interest, debt maturities – both current and long term and probability of a sound dividend policy. A business concern has enough funds in hand to meet its current needs and sufficient borrowing capacity to meet its contingencies. In this aspect, the liquidity position of the business concern is determined through analysing current assets and current liabilities. Hence, ratio analysis is highly useful for short term analysis.

4. Long Term Analysis

There must be a minimum rate of return on investment. It is necessary for the growth and development of the company and to meet the cost of capital. Financial planning is also necessary for the continued success of a company. The fixed assets structure, leverage analysis, ownership pattern of securities and the like are made in the long term analysis.

5. Horizontal Analysis

It is otherwise called as dynamic analysis. When financial statements for a number of years are viewed and analysed, the analysis is called horizontal analysis. The preparation of comparative statements is an example of this type of analysis.

6. Vertical Analysis

It is otherwise called as static analysis. Under this type of analysis, the ratios are calculated from the balance sheet of one year and/or from the profit and loss account of one year. It is used for short term analysis only.

Conclusion

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the various items of the balance sheet and the statement of profit and loss. Financial analysis can be undertaken by management of the firm, or by parties outside the firm, *viz*., owners, trade creditors, lenders, investors, labour unions, analysts and others. The nature of analysis will differ depending on the purpose of the analyst.