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A CONCEPTUAL PAPER ON FINANCIAL STATEMENT ANALYSIS

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ABSTRACT

The main purpose of this study is to determine, forecast and evaluate the best of economic conditions and company's performance in the future. The other purpose of this study is to analyse the financial statement and then give information for financial managers to make through decisions about their business. The financial statement applies tools, analytical techniques and required methods for business analysis. It is a diagnostic tool for evaluating financing activities, investment activities and operational activities as well as an assessment tool for management decisions and other business decisions. The analysis of financial statements, respectively the analysis of the financial reports is used by managers, shareholders, investors and all other interested parties regarding the company's state. Managers use financial reports to see the situation in which the company stands and then provide information to shareholders, to see how reasonable are the investments made in the company. To potential investors, the analysis of the financial statements of the company is very important, because, first they want to know the actual state of the company and then decide whether to invest or not.

Key Words: Financial Statement Analysis

1. INTRODUCTION

Accounting process involves recording, classifying and summarising of various business transactions. In the process of summarising, efforts are made to clarify the profitability and financial position of the enterprise. Financial Statements are the outcome of this process which provides various information related to profitability and financial position of the business. The significance of financial statements lies not in their preparation but in their analysis and interpretation. The fact is that financial statements are not an end in themselves but they are means only. Something more is required to find out real truth and for this purpose these statements are intelligently scrutinised, which is called analysis and interpretation of financial statements.

Meaning and Definition

According to Hamptors John, the financial statement is an organized collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of financial aspects of a business firm. It may show a position at a moment of time as in the case of a balance-sheet or may reveal a service of activities over a given period of time, as in the case of an income statement. Financial statements are the summary of the accounting process, which, provides useful information to both internal and external parties. John N. Nyer also defines it "Financial Statements provide a summary of the accounting of a business enterprise, the balance-sheet reflecting the assets, liabilities and capital as on a certain data and the Income Statements showing the results of operations during a certain period" Financial statements generally consist of two important statements:

(A) The income statement or profit and loss account.

(B) Balance sheet or the position statement.

A part from that, the business concern also prepares some of the other parts of statements, which are very useful to the internal purpose such as:

(C) Statement of changes in owner's equity.

(D) Statement of changes in financial position.

Types of Financial Statement Analysis

Analysis of Financial Statement is also necessary to understand the financial positions during a particular period. According to Myres, "Financial statement analysis is largely a study of the relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trend of these factors as shown in a series of statements". Analysis of financial statement may be broadly classified into two important types on the basis of material used and methods of operations.

2. BASED ON MATERIAL

Used Based on the material used, financial statement analysis may be classified into two major types such as External analysis and internal analysis.

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A. External Analysis:

Outsiders of the business concern do normally external analyses but they are indirectly involved in the business concern such as investors, creditors, government organizations and other credit agencies. External analysis is very much useful to understand the financial and operational position of the business concern. External analysis mainly depends on the published financial statement of the concern. This analysis provides only limited information about the business concern.

B. Internal Analysis:

The company itself does disclose some of the valuable information to the business concern in this type of analysis. This analysis is used to understand the operational performances of each and every department and unit of the business concern. Internal analysis helps to take decisions regarding achieving the goals of the business concern.

1. Based on Method of Operation

Based on the methods of operation, financial statement analysis may be classified into two major types such as horizontal analysis and vertical analysis.

A. Horizontal Analysis:

Under the horizontal analysis, financial statements are compared with several years and based on that, a firm may take decisions. Normally, the current year's figures are compared with the base year (base year is consider as 100) and how the financial information is changed from one year to another. This analysis is also called as dynamic analysis.

B. Vertical Analysis:

Under the vertical analysis, financial statements measure the quantities relationship of the various items in the financial statement on a particular period. It is also called as static analysis, because, this analysis helps to determine the relationship with various items appeared in the financial statement. For example, A sale is assumed as 100 and other items are converted into sales figures.

Parties interested in Financial Statements

Analysis of financial statements has become very significant due to widespread interest of various parties in the financial results of a business unit. The various parties interested in the analysis of financial statements are:

Investors:

Shareholders or proprietors of the business are interested in the wellbeing of the business. They like to know the earning capacity of the business and its prospects of future growth.

Management:

The management is interested in the financial position and performance of the enterprise as a whole and of its various divisions. It helps them in preparing budgets and assessing the performance of various departmental heads.

Trade unions:

They are interested in financial statements for negotiating the wages or salaries or bonus agreement with the management.

Lenders:

Lenders to the business-like debenture holders, suppliers of loans and lease are interested to know short term as well as long term solvency position of the entity.

Suppliers and trade creditors:

The suppliers and other creditors are interested to know about the solvency of the business i.e. the ability of the company to meet the debts as and when they fall due.

Tax authorities:

Tax authorities are interested in financial statements for determining the tax liability.

Researchers:

They are interested in financial statements in undertaking research work in business affairs and practices.

Employees:

They are interested to know the growth of profit. As a result of which they can demand better remuneration and congenial working environment.

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3. OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS

- To assess the earning capacity or profitability of the firm.
- To assess the operational efficiency and managerial effectiveness.
- To assess the short term as well as long term solvency position of the firm.
- To identify the reasons for change in profitability and financial position of the firm.
- To examine the earning capacity and efficiency of various business activities with the help of income statements.
- To measure the managerial efficiency under various business situations.
- To estimate the performance evaluation of different departments over a period of time.
- To measure short term and long-term solvency position of the business organization with the help of Balance Sheet.
- To examine the source of finance and way of utilizing the available finance.
- To determine earning capacity and future prospects of the business concern.
- To identify the way of utilizing fixed assets and the role of fixed assets on maintaining the earning capacity of the business concern.
- To investigate the future potential of the business concern.
- To compare operational efficiency of similar concerns engaged in the same industry.
- To identify the growth trend of the business organization

4. TOOLS OF ANALYSIS OF FINANCIAL STATEMENTS

1) **Comparative Statements:** These are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, balance sheet and statement of profit and loss prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. If this is not the case, the deviation in the use of accounting principles should be mentioned as a footnote. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analyses.
2) **Common Size Statements:** These are the statements which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years. This analysis is also known as 'Vertical analyses.
3) **Trend Analysis:** It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, in which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is detected or the sign of good or poor management is detected.
4) **Ratio Analysis:** It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. As a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income and position statements. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.
5) **Cash Flow Analysis:** It refers to the analysis of actual movement of cash into and out of an organisation. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been utilised during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarises the causes for the changes in cash position of a business enterprise between dates of two balance sheets.
6) **Fund Flow Statement:** According to Robert Anthony, "Fund flow statement shows the sources and application of funds." Fund flow statement detects the reasons of changes in working capital during a period of time. If a

transaction increases the working capital, it is treated as application of funds. If a transaction decreases the working capital, it is treated as sources of funds. This statement shows changes in the working capital. It is also known as 'Statement of Sources and Application of Funds' or 'Statement of Changes in Financial Statement'. Sometimes, it is called as 'How come and were gone statement.

5. LIMITATIONS OF FINANCIAL STATEMENTS ANALYSIS

Analysis of financial statements also has some limitations as stated below.

1. If the financial statements are not prepared with accuracy, the interpretation based on such analysis cannot be reliable.

2. Changing government rules, regulations and controls affect the preparation of financial statements. It will also affect the analysis of financial statements.

3. Limitations of alternative accounting treatments inbuilt and permitted by the accounting standards also affect the analysis of financial statements.

4. Efficiency and maturity of professionals analysing financial statements could also become a limitation of analysis.

5. Changes in provisions of The Companies Act also have an effect on quality of financial statements analysis.

6. CONCLUSION

In conclusion, reviewing financial statements before making important decisions is important because these documents offer a comprehensive snapshot of a company's fiscal health and performance. Financial statements provide vital insights into its profitability, liquidity, solvency, and overall stability. By analysing income statements, balance sheets, and cash flow statements, stakeholders can study the company's past and current financial standings, identify trends, and predict future trajectories. Key financial metrics and ratios derived from these statements, decision-makers can identify potential risks and opportunities, enabling them to make well-informed choices. A thorough examination of financial statements is fundamental step in understanding the financial health and stability of a business, contributing to more informed and prudent decision-making.

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