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A CONCEPTUAL PAPER ON FINANCIAL STATEMENT ANALYSIS USING RATIOS

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ABSTRACT

An enterprise's operational performance and past financial positions are estimated through the judgmental process of financial statement analysis, with the main goal being to arrive at the most accurate estimations and forecasts for the circumstances of the future. It basically entails gathering and analysing data from financial statements to identify patterns and shed light on a company's strong and weak points. This information can be helpful when making decisions that involve comparing a company's performance over time to that of other companies and to that of other firms. 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. Analysis of financial statements reveals important facts concerning managerial performance and the efficiency of the firm.

1. INTRODUCTION

Financial statement analysis is a comprehensive process of examining and interpreting a company's financial statements to assess its financial health, performance, and potential for growth. This analysis involves studying key financial documents such as the income statement, balance sheet, cash flow statement, and statement of shareholders' equity. The primary objective of financial statement analysis is to gain insights into the company's profitability, liquidity, solvency, efficiency, and overall financial stability. By analyzing trends, calculating financial ratios, comparing with industry benchmarks, and forecasting future performance, stakeholders such as investors, lenders, managers, and analysts can make informed decisions regarding investment, lending, strategic planning, and risk management. Financial statement analysis plays a crucial role in evaluating a company's strengths, weaknesses, opportunities, and threats, ultimately contributing to sound financial decision-making and sustainable business growth.

Parties interested in Financial Statements:

Shareholders and Investors: Financial statements are useful to shareholders and investors in evaluating the company's profitability, growth potential, and overall financial health. They assess the company's stock performance, calculate the possible return on investment, and make investment decisions using this information.

Lenders and Creditors: Financial statements are examined by creditors, including banks and other financial organizations, in order to determine a company's creditworthiness and risk profile. They assess the company's capacity to pay back loans and interest by looking at things like liquidity, solvency, and profitability. The business's creditors are concerned about the company's long- and short-term financial stability. They are interested in learning if the company can pay its obligations and claims.

Board of Directors and Management: Financial statements are used by internal stakeholders, such as the board of directors and business management, to track important financial data, keep tabs on the firm's financial performance, and make strategic choices. Financial statements assist management in determining areas for improvement, allocating resources effectively, and evaluating the success of business strategy.

Financial advisors and analysts: Financial analysts and advisers examine financial statements in order to offer suggestions and insights to companies, investors, and clients. To analyse investment opportunities, determine risk, and offer financial advice, they employ financial ratios, trend analysis, and comparative analysis.

Tax authorities and regulators: Companies must provide financial statements to government agencies, regulatory bodies, and tax authorities for compliance and regulatory purposes. They compute taxes, enforce laws, keep an eye on financial performance, and guarantee openness using this data.In order to collect income tax, tax authorities are curious about the business's profitability. In a similar vein, sales tax authorities are drawn to the company's sales.

Workers and Trade Unions: Financial statements can be useful for unions and employees to evaluate the company's profitability, stability, and capacity to pay salaries, offer benefits, and guarantee jobs. Financial statements may also be relevant in wage, benefit, and working condition disputes. Employees of the company are motivated by the company's success. When profits are high enough, labour unions have a moral right to demand higher salaries. Employees in

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thecompany have an interest in the financial analysis of the company since they receive bonuses based on productivity and profitability.

Rivals and Industry Colleagues: Financial statements are analysed by rivals and industry peers to compare their own performance to that of other businesses operating in the same sector. Financial statements can also be used by them to spot industry trends, rivalry tactics, and possible commercial ventures.

Researchers:

These parties are interested in the business's financial operations in order to assess the enterprise's financial standing, examine its rate of financial growth and compare it to that of other enterprises, and ultimately recommend workable strategies to quicken the pace of expansion.

Public or Society: A company is a part of and grows out of the society in which it operates. It must carry out its societal responsibilities. Through the analysis of financial accounts, the general public is able to learn more about how the company has carried out its social duty.

2. OBJECTIVES OF FINANCIAL STATEMENTS ANALYSIS

Understanding and diagnosing the data of financial accounts is the primary goal of financial statements and assess the company's financial health and profitability. The individual conducting the study and his object determine the purpose of this type of analysis.

The following are the goals of the analysis of financial statements.

1. To ascertain the enterprise's profitability and operational efficiency.
2. To ascertain the commercial enterprise's solvency.
3. To be aware of competitors' prices and profitability
4. To be aware of the company's success and financial situation. .

Advantages of Financial Statement Analysis:

The process of analyzing financial statements aims to quantify profitability, liquidity, efficiency, and the corporate enterprise's solvency. The benefits of financial statement analysis are listed below.

1. To ascertain the company enterprise's profitability.
2. To obtain advice regarding the demands of employees for pay raises and bonuses.
3. To ascertain the commercial enterprise's liquidity.
4. To ascertain the company's solvency.
5. To be aware of the enterprise's debt to equity ratio.
6. To ascertain the commercial enterprise's operational efficiency.
7. To give bankers and other lenders crucial information so they can lend money to businesses.
8. To be aware of the commercial enterprise's entire performance.

Limitations of Financial Statement Analysis:

1. Financial statements may not always give a clear picture of the state of the economy today or in the future because they mostly represent previous financial performance.
2. Analyzing financial statements requires making subjective decisions and interpretations, particularly when comparing them using benchmarks and financial measures.
3. Quantitative information on financial performance, liquidity, solvency, and profitability is the main emphasis of financial statements.
4. Qualitative elements that can have a big impact on a company's performance, like management caliber, brand reputation, market perception, competitive advantages, and industry trends, might be missed by them.

Types of Financial Statement Analysis:

Ratio analysis: Ratio Analysis is the process of computing and examining different financial ratios in order to assess the performance of a business in terms of profitability, liquidity, solvency, and efficiency. The debt-to-equity ratio, return on investment (ROI), earnings per share (EPS), and current ratio are a few examples of ratios.

Trend Analysis: Analzing financial data over time to spot patterns, trends, and shifts in important financial measures is known as trend analysis. It aids analysts in determining if a company's performance is getting better or worse over time.

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Vertical analysis: sometimes referred to as common-size analysis, is expressing each line item on a financial statement as a percentage of the base amount. Every revenue and expense item, for instance, is expressed as a percentage of total revenue on an income statement. This facilitates comparing the various items' respective proportions inside a financial statement.

Horizontal Analysis: Also referred to as trend analysis, horizontal analysis looks for trends and growth rates by comparing financial data over time. It aids analysts in comprehending the course and scope of variations in financial indicators over time, including sales, costs, and net income.

Cash flow Analysis: Analysing cash inflows and outflows within a business over a given time frame is known as cash flow analysis. It facilitates comprehension of a business's capacity to raise capital, pay its debts, and finance its operations and investments.

Comparative Analysis: Comparative analysis is the process of evaluating a company's financial performance and KPIs against those of its rivals or peers in the same industry. It aids in benchmarking and reveals potential areas in which a business is succeeding or underperforming in comparison to its competitors.

Tools for Analyzing Financial Statements:

Financial Ratios: When examining financial statements, financial ratios are an effective tool. They offer a methodical approach to evaluate various facets of an organization's performance, such as profitability, liquidity, solvency, and effectiveness. Among the important financial ratios are: Ratios of profitability (such as net profit margin, return on equity, return on assets, and gross profit margin) Ratios of liquidity (such as the cash, quick, and current ratios) Solvency ratios, such as the debt-to-equity ratio, interest coverage ratio, and debt ratio, Efficiency ratios, such as the ratio of assets to inventory or the ratio of receivables to inventory.

Balance Sheet: The income statement and cash flow statement are closely linked to the balance sheet because the balance sheet at the end of an accounting period depends on data from these statements and balances at the start of the accounting period. The profit and loss statement's net profit (or loss) can be used to calculate the company's equity rise or reduction. At the conclusion of an accounting period, the trade receivables and trade payables shown in the balance sheet are determined by the profit and loss statement and the cash flow statement. The composition of the balances as a result of inter-balance sheet transactions, such as the acquisition of fixed assets, the issuance of shares, and the receipt of a bank loan, is also included in a balance sheet.

Income Statement: The cash flow and balance sheets are intimately related to the profit and loss statement. The balances presented in the balance sheet at the end of the period include the rise or reduction in an entity's net assets resulting from the profit or loss recorded in the income statement. The Balance Sheet displays net profit or loss for the year under shareholders' equity. The cash flow statement includes the profit and loss recognized in the income statement under the heading of cash flows from operation following the adjustment of non-cash transactions.

Cashflow Statement: Because it describes the effects of changes in cash and cash equivalents balances at the start and end of the reporting period in terms of the cash flow impact of changes in the balance sheet's components, such as assets, liabilities, and equity reserves, the cash flow statement and the balance sheet are primarily related. Therefore, the cash flow statement shows the change in cash flow that results from the following:

Change in retained earnings due to net profit or loss recognised in the profit and loss statement (after adjusting non-cash items) and dividend payments;

Change in long-term loans due to receipt or repayment of loans.

Funds Flow Statement: A Funds Flow Statement is an essential tool for financial statement analysis since it provides stakeholders with insight into the cash and fund management practices of a company over a given time period. A Funds Flow Statement can be utilised in the following ways while examining financial statements:

Working Capital Management:

The Funds Flow Statement sheds light on how effectively a business manages its working capital by examining changes in working capital items including inventory, accounts payable, and receivable. Better liquidity may be indicated by a positive change in working capital, whilst possible problems with liquidity may be indicated by a negative change.

Debt and Equity Analysis:

The Funds Flow Statement demonstrates the process of raising money through the issuing of debt or stock as well as the uses of that money. Analysts are able to evaluate the capital structure of the company, its ability to repay debt, and how financing operations affect its overall financial health.

Evaluation of Dividend Payments:

By displaying the monies allocated for dividend payments, the statement aids in the assessment of the company's dividend policy. Analysts can evaluate the sustainability of dividend payments by examining the cash flow from operations and overall financial performance of the company.

Investment and Financing Decisions:

The Funds Flow Statement is a tool used by creditors and investors to help them decide whether to lend money to or invest in a firm. It gives stakeholders a thorough understanding of the business's financial operations and assists in risk assessment.

3. CONCLUSION

Ratio analysis provides a comprehensive assessment of a company's financial health by evaluating key aspects such as liquidity, profitability, efficiency, and solvency. Strong liquidity ratios indicate the company's ability to meet short-term obligations, while robust profitability ratios reflect effective cost management and strong revenue generation. High efficiency ratios suggest optimal use of assets, and favorable solvency ratios demonstrate long-term financial stability. By comparing these ratios against industry standards and historical data, stakeholders can make informed decisions regarding investments, lending, and strategic planning, ensuring a well-rounded view of the company’s operational and financial performance.

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