A Conceptual Research on Financial Statement Analysis

DR. IDRISH ALLAD
Asst. Professor of Accountancy
Smt. T. J. Patel Commerce College, Nadiad-387 001.

Abstract:
The term financial statements analysis is also known as analysis and interpretation of financial statements. It establishes meaningful relationship between various items of the two financial statements especially income statement and position statement. It determines financial strength and weaknesses of the business. Analysis of financial statements is helpful to measure the profitability, liquidity, efficiency and solvency of an enterprise. All stakeholders have an interest in the analysis of financial statements. The main objective of financial statements analysis is to understand and diagnose the information of financial statements and to determine the profitability and financial strengths of the business. The paper focuses on concept, types, utilities and limitations of financial statements analysis. It also throws light on various parties interested in the analysis of financial statements. Finally, it presents tools and techniques for analysis of financial statements. This research paper will helpful to understand the throw knowledge of analysis and interpretation through analysis of financial statements.

1.Financial statements analysis: Concept and Meaning

Financial statements are not prepared to satisfy the requirements of all stakeholders related to the business enterprise. Information published in financial statements may not be sufficient from the view point of all stakeholders. Different stakeholders are interested in arriving at conclusions for their own purposes based on information included in the financial statements. For such conclusions, the information may not be readily available from financial statements. For example, we cannot know directly the real profitability, liquidity, efficiency and solvency of the business from the financial statements. For this purpose, information contains in financial statements is to be analyzed based on the figures of financial statements and other related supplementary information.

For the purpose of analysis, different information and figures have to be compared and such information can be obtained in the form of percentage or rate of turnover. Thus, conclusions can be drawn based on different financial figures given in the financial statements is known as interpretation. For example, sales during the last year were Rs. 1,00,000 and the sales during the current year are Rs. 1,20,000. It can be said that the sales during the current year has gone up by Rs. 20,000 as compared to the last year. In other words, as compared to last year, sales have gone up by 20% during the current year.

1.1 Meaning of Analysis

Analysis means establishing a meaningful relationship between various items of the two financial statements in such a way that a conclusion can be drawn.

1.2 Meaning of Financial Statements Analysis

Financial statements analysis is the collective name for the tools and techniques that are intended to provide relevant information for making important policy decisions.

The term financial statements analysis is also known as analysis and interpretation of financial statements. It establishes meaningful relationship between various items of the two financial statements especially income statement and position statement. It determines financial strength and weaknesses of the business. Analysis of financial statements is helpful to measure the profitability, liquidity, efficiency and solvency of an enterprise.

1.3 In the words of Myers
"Financial statements analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements and study of the trends of these factors as shown in a series of statements."

Thus, financial statements analysis is the systematic numerical calculation of the relationship between one fact with other to measure the profitability, liquidity, efficiency and solvency of the business.

2. Parties Interested in Financial Statements
Every person concerned with the state of affairs of the business has an interest in the financial statements of the business. The following parties have an interest in the analysis of financial statements.

- **Management:** The management wants to know the profitability, liquidity, efficiency and soundness of the business, so that strengths and weaknesses of the business may be identified and effective business plans may be formulated.
- **Shareholders:** Shareholders are interested to know the earning capacity of the business and its future growth. Shareholders are not directly involved in the day to day working of the company but they want to know the real profitability with the help of the financial statements.
- **Debenture-holders:** Debenture-holders are interested to know whether the financial position of the business is sound or not. They are also interested to know whether the company is able to pay the interest as well as to redeem the debentures on maturity date.
- **Credit Institutions:** Credit institutions and banks want to know the solvency of the business. They also want to know whether the money given as loan is safe or not.
- **Creditors:** Creditors of the business are interested in the short-term and long-term financial soundness of the business. They want to know the ability of the business to meet the debts and claims.
- **Workers:** Workers of the business are interested in the profit of the business. In case of sufficient profit, labour unions have moral justification to demand for higher wages. Workers in the business are paid bonus on the basis of productivity and profitability, so they have an interest in the financial analysis of the business.
- **Government:** Various government agencies study profitability and turnover ratios for the purpose of taxation, regulation and nationalization. Financial statements also help government in compiling national accounts.
- **Taxation Authorities:** Tax authorities are interested to know the profitability of the business, so that income tax can be collected. Similarly, sales tax authorities are interested in the sales of the business.
- **Economist and Researchers:** These parties are interested in the financial activities of the business, so that they may study the financial health of the business enterprise, study the rate of financial growth and compare it with other business enterprises and finally, suggest effective measures to increase the growth rate.
- **Society or Public:** Company emerges and develops in the society and it is the part of the society. It has to fulfill its obligations towards the society. With the help of financial statements analysis, the society or public gets information regarding to the manner and method by which the company has fulfilled its social responsibility.
- **Competitors:** Competitors are interested in knowing the strategies of an enterprise by financial statement analysis, so that they can also formulate the appropriate policies.

3. Objectives of Financial Statements Analysis

The main objective of financial statements analysis is to understand and diagnose the information of financial statements and to determine the profitability and financial strengths of the business. The purpose of such analysis depends upon the person interested in analysis and his object. The main objectives of financial statements analysis are as under.

1. To know the profitability of the business enterprise.
2. To know the liquid position of the business enterprise.
3. To know operating efficiency of the business enterprise.
4. To know the solvency of the business enterprise.
5. To know the proportion of debt to equity.
6. To know how quickly money is collected from customers.
7. To know the financial position and progress of the business.
8. To know the cost and profitability of competitors.
9. Shareholders can know whether their investments are safe or not and whether regular and increasing dividend will be received on capital or not.
10. Financial statements analysis is also useful for debenture holders, bankers and other lenders to know about safety of money and regular interest on investments.
11. To know the overall growth and progress of the business.

4.Utilities, or Advantages of Financial Statements Analysis

Analysis of financial statements is an attempt to measure profitability, liquidity, efficiency and solvency of the business enterprise. Following are utilities of financial statements analysis.

1. To know the profitability of the business enterprise.
2. To know liquidity of the business enterprise.
3. To know operating efficiency of the business enterprise.
4. To know solvency of the business enterprise.
5. To know the proportion of debt to equity enterprise.
6. To get guidance about demand of workers for increase in wages and bonus.
7. To provide important information to bankers and other lenders for lending money to business enterprise.
8. To know about the overall performance of the business enterprise.

Thus, analysis of financial statements is the systematic numerical calculation of the relationship between one fact with the other to measure the profitability, liquidity, operating efficiency, solvency and the growth of the business unit.

5.Limitations of Financial Statements Analysis

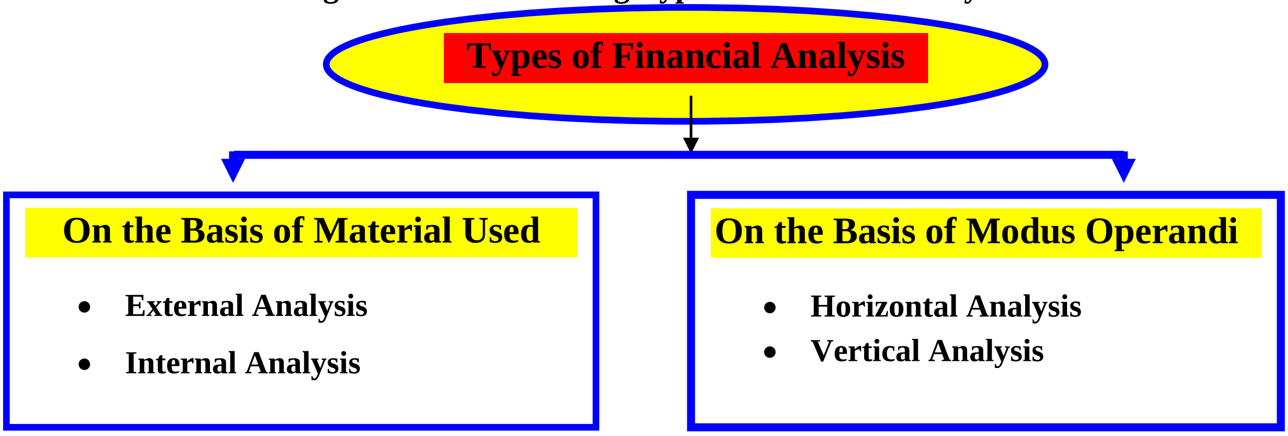
Analysis of financial statements also has some limitations as stated below.

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 analyzing 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.Types of Financial Analysis

Financial analysis can be classified into different categories as under.

Figure 1: Chart showing Types of Financial Analysis



Source: Designed by Researcher

6.1 On the Basis of Material Used

6.1.1 External Analysis

Analysis done by outsiders (i.e. investors, credit agencies, government agencies and other creditors) who cannot get the internal records of the company is called as external analysis. This analysis is made on the basis of published financial statements, reports and information so that, it becomes useful for limited purposes. Now days, the position of these analysts has improved due to increase governmental control over companies.

6.1.2 Internal Analysis

This type of analysis is undertaken by those persons, who are able to access the books of accounts and other information of the company. This analysis is done by the executives and employees of the company or by the officers appointed by the government for this purpose or by the court under powers vested in them. This type of analysis is object-oriented. It is useful to know the strengths and weaknesses of the business and it is also suggests suitable measures for future growth.

6.2 On the Basis of Modus Operandi

6.2.1 Horizontal Analysis

In this type of analysis, financial statements for a number of years are studied and analysed. The current year's figures are compared with the standard or base year. It includes figures for two or more years and the changes are presented relating to each item from the base year in the form of percentage. Such analysis provides the strengths and weaknesses of the business enterprise. It is also known as 'Dynamic Analysis'.

6.2.2 Vertical Analysis

In vertical analysis, study is made for quantitative relationship of the various items of financial statements on a particular date. It is useful to compare the performance of several companies in the same industry or various departments in the same company. It is also useful to analyze the financial position of the business. This analysis is also known as 'Static Analysis' because it is based on data for one accounting period.

Table 1: Methods, Tools or Techniques of Financial Statements
Comparative Statements
Trend Percentages
Common-size Statements
Statement of changes in Working Capital
Cash-flow Analysis
Fund-flow Analysis
Ratio Analysis

7. Methods, Tools or Techniques of Financial Statements

Analysis of information based on financial statements with the help of percentages or formula and arriving at conclusions based on such analysis is known as financial statements analysis. Following are different methods or tools of financial statements.

7.1 Comparative Statements

When financial statements of past few years are presented in columnar form, they provide the trend of changes in business enterprise. The method of presenting financial statements in columnar form and of determining the trend of profitability and financial position of the business is known as Comparative Statements Analysis. Generally, Profit & Loss Account and Balance-Sheet are prepared in columnar form. However, an individual cannot get any idea about profitability and financial position by analyzing only one year's financial statements, because they have following limitations.

- Financial statements of a single year do not present the trend and nature of changes taking place in business unit.
- It does not provide the comparison of incomes and expenditures of current year with last year.
- Balance-Sheet of a single year does not provide whether the financial position of a company is improved or not.

By presenting the figures of different years together, an individual can know about the change of trend in a business unit. Comparative statement is useful to know the trend of the business. For such type of comparison, following two methods are used.

1. By presenting figures of increase or decrease in incomes or expenditures. For example, comparative Profit & Loss Account presents increase or decrease in incomes.
2. By presenting figures of each element as percentage of total amount. For example, Percentage of Net Profit based on Sales of current year may be compared with the previous year.

7.2 Trend Percentages

Trend percentage includes calculation of percentage changes in financial statements items for a number of successive years. It is an extension of horizontal analysis to many years. The items of one year which may be called base year, are compared with similar items of other years in the form of percentages are called as trend percentages. The figures of one year are taken as base year. Every item of this base year is taken as 100. Figures of each item in other year are divided by an item of the base year and calculate percentage of each item. For example, the cash balances in a firm of 2012-13, 2013-14 and 2014-15 are Rs. 1,00,000, Rs. 1,50,000 and Rs. 1,75,000 respectively. If we consider 2012-13 as base year, then its cash balance of Rs. 1,00,000 is treated as 100. Following statement shows trend percentage from 2012-13 to 2014-15.

Table 2: TREND ANALYSIS from 2012-13 to 2014-15 (Base year 2012-13 (100)

Particulars	2012-'13	2013-'14	2014-'15
Cash balance	1,00,000	1,50,000	1,75,000
Trend Analysis (%)	100%	150%	175%

The trend percentages indicate that during 2014-15 cash balance is 175% as compare to 2012-13, a rise of 75%. Trend percentages help in identifying certain basic changes in the nature of the business over a period of time. Therefore, many large scale companies disclose a summary of operating results for five or more years.

7.3 Common-size Statements

The above methods do not provide any common base with which all items of each statement can be compared. For this purpose, common-size statements are prepared. In common-size statement, all items are compared with one common item, which is significant. These statements are prepared to know percentage of each asset to total assets and percentage of each element of expense as total sales. Such statements are also known as '100 percentage statements'. While analyzing Balance-Sheet, each asset as a percentage of total assets and each liability as a percentage of total liabilities are calculated. For example, in Balance-Sheet total assets may be taken as 100 and all other items in this statement are calculated as percentage of total assets. Similarly, while analyzing Profit and Loss Account, each item of expense and income is calculated as percentage of total sales.

Common-size statements are also useful to compare the financial position of two companies. For example, in our company, Cash is 10% of total assets and the same is 15% in case of other company. It means that the liquid position of other company is better.

Common-size statements are also useful to know how much difference is there and where the difference lies.

7.4 Statements of Changes in Working Capital

The excess of current assets over current liabilities is known as working capital. The amount of working capital is very useful to the management, because most of the transactions of the business affect the working capital. There are various methods to show the changes in working capital. Generally, most popular method is used to prepare a statement of changes in working capital with four columns. In the first column, the value of current assets and liabilities of the current year are mentioned, while in the second column, the value of current assets and liabilities of the previous year are mentioned. In the third and fourth columns increase or decrease in the working capital are mentioned. The net effect of the changes of current assets and liabilities is shown at the end of the statement, which indicates whether the working capital has increased or decreased. It is also very useful to determine the liquid position of the company.

7.5 Cash Flow Statement

A statement showing Inflow and Outflow of Cash during the last year and as a result the balance of cash at the end of the year is known as 'Cash Flow Statement'. It is prepared on the basis of historical financial statements. This statement helps management to know the actual liquid position or position of cash on hand and also to know whether the business is able to get enough cash to meet the liabilities as and when they arise.

7.5.1 Accounting Standard 3

The Institute of Chartered Accountants of India has issued Accounting Standard-3 for the preparation of cash flow statement. As per AS-3, cash flow statement is divided in to the following three activities.

1. Cash flow from Operating Activities. For example, operating profit.
2. Cash flow from Investment Activities. For example, purchase or sale of fixed assets.
3. Cash flow from Financial Activities. For example, issue of shares, redemption of redeemable preference shares.

The cash balance in the beginning and at the end to be shown in cash flow statement which includes both cash and cash equivalent. Here, cash equivalent means short term, highly liquid investments, which are readily convertible into cash and which are subject to little risk of changes in value.
There are two methods to prepare cash flow statement as under.

- **Direct Method:** Here, cash flow is shown from sources of cash inflows and cash outflows.
- **Indirect Method:** Here, cash flow is calculated by making necessary adjustments in net profit.

According to amendment of The Companies Act, it has been made compulsory for all companies to implement all accounting standards issued by this institute. Therefore, now a day's, all companies issuing their annual financial statements include a cash flow statement in their reports.

7.5.2 Fund Flow Statement

7.5.2.1 Fund

In narrow sense, fund is synonyms with cash but in broader sense, fund means working capital. i.e. excess of current assets over current liabilities.

Formula

Fund = Working capital = Current Assets – Current Liabilities.

Flow: It means change in the working capital from one time period to another.

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 where gone statement."

7.5.3 Ratio Analysis

Ratio is the mathematical and logical relationship between two or more quantities (components) of financial statements. It is the technique of analysis and interpretation of financial statements. To evaluate the financial position of the business, the financial analyst needs a certain yardstick, which is provided by ratio analysis. Ratio can be calculated in the form of percentage, proportion, number of times or number of days. Ratios can be classified in to four financial indicators like profitability ratios, liquidity ratios, management efficiency ratios and solvency or leverage ratios.

Ratio analysis establishes a relationship between two or more components of financial statements. Two companies have earned the same amount of profit in a particular year, but it is not possible to ascertain which of them is more profitable unless the profit is related to sales or total assets, Ratio analysis helps to establish relationships between financial statements items for further investigation. It is a powerful tool and technique to know the real strengths and weaknesses of a business enterprise.

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