ANALYSIS OF FINANCIAL STATEMENTS

OBJECTIVES

After studying this lesson, you should be able to

- Understand the meaning and types o financial statements.
- Know the objectives, importance, uses of financial statements
- Explain the limitations of financial statements.
- Describe the meaning of financial analysis and different types of analysis.

STRUCTURE

15.1 Introduction

15.2 Objectives of financial statements

15.3 Importance and uses of financial statements

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15.5 Financial statements analysis

15.6 Types of Analysis

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15.8 Objectives of Financial statements analysis

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15.1 INTRODUCTION

You have learnt the reporting of financial performance and financial position of an organisation in the 1st lesson, whereas, in this lesson, you will be knowing the basics of analysis of financial statements, which help you to analyse the statement for having a clear understanding about the factors contributing for the state of affairs either good or bad.

15.1.1 Meaning and types of Financial statements

A financial statement is an organised collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a business firm. It may show the position at a moment of time, as in the case of a balance sheet, or may reveal result of series of activities conducted over a given period of time, as in the case of an Income Statement. Thus the term financial statement generally refers to two basic statements viz., i) the Income Statement, (ii) the Balance Sheet. Of course, a business may also prepare (iii) a Statement of Retained Earnings and (iv) a statement of Changes in Financial Position in addition to the above two statements. The meaning and significance of each of these statements is explained below :

15.1.2 Income Statement

The Income Statement, (also termed as Profit and Loss Account) shows the income and expenses under different heads. The income minus expenditure, indicates the profit made by the firm. Broadly, there are three kinds of expenses. Sales income minus the expenses incurred on operations, gives the operating profit for a given year. The operating profit minus the interest payable gives the 'profit before taxes' (PBT). If from this, taxes are deducted, we derive the 'profit after tax' (PAT). From the PAT, firms pay the dividend on preference shares. The residue, after all these payments, is the 'net profit' available to the equity share holders.

15.1.3 Balance Sheet

The Balance Sheet is a statement of financial position of a business at a specified moment of time. It is a statement of assets and liabilities of a firm or what it owes and what it owns, as on a given date. In a Balance Sheet, the assets and liabilities balances are equal to each other, as this Statement is based on the double entry system of book-keeping.

The important distinction between an Income Statement and a Balance Sheet is that Income Statement is for a period while Balance Sheet is on a particular date. Income Statement is, therefore, a flow report as contrasted with the Balance Sheet which is a static report. However, both are complimentary to each other.

15.2 OBJECTIVES OF FINANCIAL STATEMENTS

The basic objective of financial statements is to furnish information required for decision making. Other objectives are :

(i) to provide reliable financial information about economic resources and obligations of an enterprise.

(ii) to provide reliable information about changes is net resources of an enterprise that result from the activities.

(iii) to provide financial information that assists in estimating the earnings potential of the enterprise.

(iv) to provide other relevant information about changes in the economic resources and obligations, and

(v) to disclose, to the extent possible, other information related to the financial statements relevant to the users of the statements.

15.3 IMPORTANCE AND USES OF FINANCIAL STATEMENTS

Financial Statements assume importance by reporting the financial position and operating results of an enterprise at the end of the accounting period. The impact of business transactions on the financial position and progress of the enterprise is briefly disclosed by these statements. In a nut-shell, financial statements may be described as a comprehensive index of the financial affairs of a concern and are useful in many ways to a variety of people.

Some users of the accounting information have a direct-interest in the firm, while others have an indirect interest. Those, who are directly interested in the financial information, are owners, managers, creditors, investors, employees, customers, and tax authorities. The indirect users of the financial information include, financial analysts, trade associations trade unions etc.

Managers are responsible for the over all performance of the firm. They make several decisions and therefore, need information. Accounting provides relevant information to them. Thus, they have a direct interest in accounting information.

Creditors supply financial resources to the firm. They are interested in the continuing profitable performance of the firm, so that they may regularly receive interest and repayment of the principal sum. They need accounting information to estimate the firms performance and to determine the degree of risk to which they are exposed.

Potential investors, creditors or owners, get an idea about the firms financial strength and performance from its financial reports. They are generally interested in the earnings, dividend, and growth trends of the firm. Usually, they take the services of financial analysts in evaluating the performance of the firm.

Employees and trade unions also make use of the financial information. On the basis of the information revealed in the financial statements, they can bargain on matters relating to salary determination, bonus, fringe benefits, working conditions etc., Thus, financial information is useful to employees and unions, as they get insights into matters affecting their economic and social interests.

Customers may be interested in financial statements of a firm, because a careful study of the financial statements may provide information about the prices being charged by the firm. Government also have an interest in the financial statements for regulatory purposes. The tax department of Government has an interest in determining the taxable income of the firm.

The accounting theory has evolved, over the years, a system of providing information to the various users. It may not be possible for accounting system to serve the needs of all users equally. Sometimes, the interest of users may conflict. In such situations, priority should be given to the interest of owners and creditors. Financial accounting presents general purpose financial information, that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the need of present and potential owners and creditors. Hence, the financial statements are most important and useful for knowing each and every significant aspect of the company and taking for taking useful decisions.

15.4 LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements are the result of the accounting process which involves recording, classifying, and summarising. but the profit/loss figure and financial position as disclosed by Income Statement and Balance Sheet respectively should not be taken to be an exact representation of actual position. The financial statements are based on certain accounting concepts and conventions which can not be said to be fool proof.

The following are the important limitations of financial statements :

(i) The information is historical in nature.

(ii) It is the outcome of accounting concepts and conventions combined with personal judgment.

(iii) The Statements portray the position in monetary terms only. Things which cannot be translated in to monetary terms viz., development of a team of loyal and efficient workers, enlightened management, the reputation and prestige of management cannot be covered.

(iv) While studying financial statements of different units, the size of the units and difference in the accounting procedures adopted by them have to be kept in mind. They may not be reflected in the financial statements, but one has to enquire into them before analysing the statements.

15.5 FINANCIAL STATEMENTS ANALYSIS

In the preceding pages you are exposed to financial statements in greater detail regarding their meaning, objectives, importance and limitations. It was mentioned that financial statements provide, for the reader, understanding of some financial aspects of a firm and also reveal the results of series of activities over a given period of time. The above said functions delivered by financial statements are of primary in nature. By analysing the same information from financial statements one can understand much more important things like, financial strengths and weakness of a firm. The meaning, types, uses and techniques of Financial Statements analysis, or other way called 'financial analysis' are discussed in the following paragraphs.

15.5.1 Meaning of Financial Analysis

'Analysis which is opposite of synthesis, in general means separation of a substance into parts. Specifically, analysis involves breaking/separating a thing into its components, establishing the existing relationships between the key items/components, interpreting the relationship so as to draw meaningful inferences.

Same logic of analysis can be extended to the financial statements also to better explain the financial strengths and weakness of a firm. In such a case, financial statement analysis can be defined as the process of identifying the financial strengths and weaknesses of the firm by properly establishing the relationships between the items of balance sheet and profit and loss account.

A careful examination of the above said definition may necessitate extra elaboration of the following some important points.

Establishment of Proper Relationships

While resorting to analysis, the analyst should be extra cautious to see that relationships are properly established. It means meaningful and significant relationships should only be considered. In establishing the relationships, any financial item can be related to any other one. If that is the case, there is also possibility to emerge meaningless relationships. For example profit figure can be related both to the items viz., investment and also preliminary expenses. The profit to invest relationship is meaningful one and the other may not. Thus, meaningful relationships are important. By eliminating of meaningless and insignificant relationships the analyst can concentrate on meaningful and significant relationships so as to arrive at meaningful conclusions.

Type of relationship to be established

The type of relationship to be investigated depends upon the objective and purpose of evaluation. The purpose of evaluation of financial statements differs among various groups interested in the results reported in the financial statements. For example, short-term creditors are primarily interested in judging the firm's ability to pay its currently-maturing obligations. The relevant information for them is the composition of the short-term (current) assets and short-term (current) liabilities, but not long-term assets and liabilities.

Focus on Key Figures

Although many financial items/figures are available in financial statements, the analysis should focus on key items only. If this is not the case, each small, or unimportant figures also merits for analysis. This leads to emergence of unimportant conclusions. A single item or a group of items may be a key figure for analysis. Generally, capital, net worth, sales, expenses categorised under different heads are some better examples of key figures.

15.5.2 Analysis and Interpretation

A mention of relationship between analysis and interpretation is needed at this juncture. Analysis and interpretation are closely interlinked. They are complimentary to each other. Analysis without interpretation is useless and interpretation without analysis is impossible. But, generally, the term analysis is used to include interpretation as well, since analysis is always aimed at interpretation of the relationships, that are established in the course of analysis. Thus, it can be stated that analysis involves compilation, comparison and study of financial and operative data and interpretation of the same.

15.6 TYPES OF ANALYSIS

Financial statement analysis can be broadly classified in to two groups, based on :

(i) Material used

(ii) Modus operandi

A brief description of the above said methods with their further classification is as follows :

15.6.1 Mat_rial use

The financial analysis can be done on the basis of financial information of a firm. This information can be had either from externally available reports like financial statements or internally available records like books of accounts.

Based upon the information utilised for the analysis, the type of analysis can be decided. Thus, the analysis based on material used can be of two types : (i) External analysis, (ii) Internal analysis.

External Analysis

This type of analysis, is done by utilising information from financial statements, which are available (without much effort) externally to any interested party. This type of analysis is generally undertaken by investors, creditors, lenders, Governmental agencies and labour unions. They do not have access to the internal records of the firm and mainly depend upon published financial statements. Such an analysis cannot be detailed one and as such serves only a limited purpose.

Internal Analysis

This analysis is done by the persons within the organisation. They obviously will have access to the books of accounts and other information related to the business. Such an analysis is done by the executives, employees of the organisation or officers appointed for this purpose by the Government or the courts under powers vested in them. This analysis can be detailed and exhaustive and is done as per the objectives to be achieved through such analysis.

15.6.2 Modus operandi

The other basis on which financial analysis can be viewed is "modus operandi". According to this, financial analysis can also be of two types :

Horizontal analysis

In case of this type of analysis, financial statements for a series of years are collected and analysed. The current years figures are compared with the standard or base year. The analysis statement usually contains figures for two or more years and the changes in each item is shown from the base year in the form of percentages. Such an analysis gives the management considerable insight into levels and areas of strength and weakness. Since this type of analysis is based on the data from year to year rather than as one date, it is also termed as 'Dynamic Analysis'.

Vertical Analysis

In case of this type of analysis, a study is made of quantitative relationship of the various items in the financial statements on a particular date. For example, the ratios of each cost component to sales with reference to a particular period may be calculated. Such an analysis is useful in comparing the performance of several companies in the same group or divisions or departments in the same company. Since this analysis depends on the date for one period, this is not very conducive to a proper analysis of the Company's financial position. It is also called 'static analysis' as it is frequently used for referring to ratios developed on one date or for one accounting period.

It is to be noted that both analysis - Vertical and horizontal - can be done simultaneously also. For example, the Income statement of a company for several years may be given horizontally, where the change in different elements of cost and sales over a number of years may be shown. On the other hand, the percentage of each element of cost to sales may also presented vertically.

15.7 STEPS INVOLVED IN FINANCIAL STATEMENTS ANALYSIS

The analysis of the financial statements require :

(i) To select the information relevant to the decision under consideration from the total information, contained in the financial statements.

(ii) To arrange the information in a way so as to high-light significant relationships.

(iii) To interpret and draw the inferences and conclusions.

15.8 OBJECTIVES OF FINANCIAL STATEMENTS ANALYSIS

The following are some of the important objectives of analysis of financial statements :

1. to estimate the profitability or earning capacity of the enterprise.
2. to gauge the financial position and financial performance of the concern.
3. to determine the measure of efficiency of operations.
4. to decide about the future prospects of the firm.
5. to investigate the future potentiality of the concern.

15.9 IMPORTANCE OF ANALYSIS OF FINANCIAL STATEMENTS

The importance of analysis and interpretation has increased, due to the following uses

1. enables to take decisions on logical and scientific methods, in an intelligible way.
2. decisions can be understood and read by other easily.
3. helps to verify and examine the correctness and accuracy of the decisions.
4. minimises personal experience and intuition in decision-making.

15.10 TECHNIQUES OF FINANCIAL ANALYSIS

A variety of techniques/tools can be used for financial analysis. The most commonly used tools of financial analysis are :

1. Comparative statements analysis
2. Common size statements analysis
3. Trend percentage analysis
4. Ratio analysis
5. Funds flows analysis and Cash flow analysis

These techniques of analysis are discussed and illustrated in the lessons that follows.

15.11 SUMMARY

An organised collection of data according to logical and consistent accounting procedures is known as financial statements. There are the methodical classification of the date given in the financial statements in called as 'analysis' and explaining the meaning and significance of the data so simplified is termed as interpretation.

The financial statements generally refers to income statement, balance sheet, statement of retained earnings, funds flow statement etc. The financial analysis may be external, internal, horizontal, vertical.

The financial analysis helps a layman also to understand the statements easily and take decision wisely. Since, the 'analysis' improves the correctness and accuracy of the decisions, and minimises the personal judgment, more importance is given to the same.

15.12 SELF EXAMINATION QUESTIONS

Short Answer type questions

1. What is the meaning of financial statement ?
2. Explain the method of preparing profit & loss account.
3. Compare and contrast profit and loss account and Balance Sheet.
4. What are the different objectives of financial statements?
5. Briefly explain how financial information is useful to different users of financial statements.

6. List out the limitations of financial statements
7. What is meant by financial analysis?
8. What are the techniques of financial analysis?
9. What are the objectives of financial analysis?

Essay Type questions

10. What is the nature of financial statements? Discuss the objectives and limitations of financial statements.
11. Explain the meaning and importance of financial analysis. List out the different tools of financial analysis.

15.13 GLOSSARY

External analysis an analysis is done by the parties outside the business.

Financial analysis : Methodical classification of the data given in the financial statements.

Financial statements interpretation : Explaining the meaning and significance of the data simplified.

Financial Statements : An organised collection of data according to logical and consistent accounting procedures.

Horizontal Analysis : based on the data from year to year.

Internal analysis : An analysis is done 67 persons, who have access to the books of account and other information related to the business.

Vertical analysis : A study of the quantitative relationship of the various items in the financial statements on a particular date.

15.14 BOOKS FOR FURTHER READINGS

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