FINANCIAL STATEMENTS ANALYSIS AND INTERPRETATION

Meaning of Financial Analysis

Financial analysis is a process which involves reclassification and summarization of information through the establishment of ratios and trends. Analysis of financial statement refers to the examination of the statements for the purpose of acquiring additional information regarding the activities of the business. The users of the financial information often find analysis desirable for the interpretation of the firm's activities.

Financial statement analysis can be referred as a process of understanding the risk and profitability of a company by analyzing reported financial info, especially annual and quarterly reports. Putting another way, financial statement analysis is a study about accounting ratios among various items included in the balance sheet. These ratios include asset utilization ratios, profitability ratios, leverage ratios, liquidity ratios, and valuation ratios. Moreover, financial statement analysis is a quantifying method for determining the past, current, and prospective performance of a company.

Financial analysis is certain procedures and methods applied to determine the past, present and also the future status and performance of business with the aim to compare how the business performed in the past, how it performs now and use such data for forecasting purposes, making decisions about the business performance, manage it and control.

The overall objective of financial statement analysis is the examination of a firm's financial position and returns in relation to risk. This must be done with a view to forecasting the firm's future prospective.

We know business is mainly concerned with the financial activities. In order to ascertain the financial status of the business every enterprise prepares certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. But the information as is provided in the financial statements is not adequately helpful in drawing a meaningful conclusion. Thus, an effective analysis and interpretation of financial statements is required.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn. By financial statements we mean two statements:

(i) Profit and loss Account or Income Statement
(ii) Balance Sheet or Position Statement

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These are prepared at the end of a given period of time. They are the indicators of profitability and financial soundness of the business concern. The term financial analysis is also known as analysis and interpretation of financial statements. It refers to the establishing meaningful relationship between various items of the two financial statements i.e. Income statement and position statement. It determines financial strength and weaknesses of the firm.

To summarize, financial statement analysis is concerned with analyzing the balance sheet and the income statement of a business to interpret the business and financial ratios of a business for financial representations, business evaluation, in addition to financial forecasting.

Objectives/Purposes of Financial Analysis

While learning how to perform a financial statement analysis, it is important to understand the purpose of financial analysis.

The purpose of a financial analysis varies with the company conducting the analysis and the users of financial analysis data. During a financial analysis, the relation between the various elements of financial statements is established and also compared with the other information obtained about the business. This is a very important tool and is used by the investors, creditors and the management in determining the future prospects as well as the plans regarding the company. This is also used to identify the areas that need improvement and also solve any type of financial and operational problem. The prime aim of a financial analysis is to analyze the current financial status and performance of the company, so that it will be possible to judge on the future performance of the business.

The purpose of financial analysis usually differs depending on the users of this data. For example, creditors are concerned with the solvency and liquidity because they are the ones who purchase bonds and debt securities of the company. Therefore they want top know the company's ability to pay off the debts and interest. The investors (investing in the company's stock) are mainly concerned with the profitability of the company. They wish to know what returns they are going to earn in the form of dividends and a higher stock value.

Analysis of financial statements is an attempt to assess the efficiency and performance of an enterprise. Thus, the analysis and interpretation of financial statements is very essential to measure the efficiency, profitability, financial soundness and future prospects of the business units. Financial analysis serves the following purposes:

1. **Measuring the profitability**

The main objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.

2. **Indicating the trend of Achievements**

Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profits and net profit etc. can be ascertained. Value of assets and liabilities can be compared and the future prospects of the business can be envisaged.

3. **Assessing the growth potential of the business**

The trend and other analysis of the business provide sufficient information indicating the growth potential of the business.

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4. **Comparative position in relation to other firms**

The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilizing capital, etc.

5. **Assess overall financial strength**

The purpose of financial analysis is to assess the financial strength of the business. It also helps in taking decisions, whether funds required for the purchase of new machines and equipments are provided from internal sources of the business or not if yes, then how much and also to assess how much funds have been received from external sources.

6. **Assess solvency of the firm**

The different tools of an analysis tell us whether the firm has sufficient funds to meet its short term and long term liabilities or not.

Advantages of Financial Statements Analysis

The various advantages of financial statement analysis are:

1. Financial statements analysis helps the government agencies to analyze the taxation due to the company.
2. Any company can analyze its own performance through financial statements analysis over any period of time.
3. The investors get enough idea to decide about the investments of their funds in the specific company.
4. The most important benefit if financial statement analysis is that it provides an idea to the investors about deciding on investing their funds in a particular company.
5. Another advantage of financial statement analysis is that regulatory authorities like IASB (International Accounting Standards Board) can ensure the company following the required accounting standards.
6. Financial statement analysis is helpful to the government agencies in analyzing the taxation owed to the firm.
7. Above all, the company is able to analyze its own performance over a specific time period.

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Disadvantages/Limitations of Financial Statements Analysis

Although analysis of financial statements is essential to obtain the relevant information for making several decisions and formulating corporate plans and policies, it should be carefully performed as it suffers from the following limitations:

1. **Mislead the user**

The accuracy of financial information largely depends on how accurately financial statements are prepared. If their preparation is wrong, the information obtained from their analysis will also be wrong which may mislead the user in making decisions.

2. **Not useful for planning**

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Since financial statements are prepared by using historical financial data, therefore, the information derived from such statements may not be effective in corporate planning, if the previous situation does not prevail.

3. **Qualitative aspects**

Then financial statement analysis provides only quantitative information about the company's financial affairs. However, it fails to provide qualitative information such as management labour relation, customer's satisfaction, and management's skills and so on which are also equally important for decision making.

4. **Comparison not possible**

The financial statements are based on historical data. Therefore comparative analysis of financial statements of different years can not be done as inflation distorts the view presented by the statements of different years.

5. **Wrong Judgment**

The skills used in the analysis without adequate knowledge of the subject matter may lead to negative direction. Similarly, biased attitude of the analyst may also lead to wrong judgement and conclusion.

6. **No strong financial future**

Strong financial statement analysis does not necessarily mean that the organization has a strong financial future. Financial statement analysis might look good, but there may be other factors that can cause an organization to collapse.

The limitations mentioned above about financial statement analysis make it clear that the analysis is a means to an end and not an end to itself. The users and analysts must understand the limitations before analyzing the financial statements of the company.

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Tools/Techniques/Methods of Financial Analysis

A number of tools or methods or devices are used to study the relationship between financial statements. However, the following are the important tools which are commonly used for analyzing and interpreting financial statements:

- Comparative Financial Statements/Horizontal Analysis
- Common-size Statements/Vertical Analysis/Cross-Sectional Analysis
- Trend Analysis
- Ratio Analysis
- Funds Flow Analysis
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Cash Flow Analysis

1. Comparative Financial Statements/Horizontal Analysis:

In brief, comparative study of financial statements is the comparison of the financial statements of the business with the previous year's financial statements. It enables identification of weak points and applying corrective measures. Practically, two financial statements are prepared in comparative form for analysis purposes. They are as follows:

a) Comparative Balance Sheet
b) Comparative Income statement

a) Comparative Balance Sheet

The comparative balance sheet shows the different assets and liabilities of the firm on different dates to make comparison of balances from one date to another. The comparative balance sheet has two columns for the data of original balance sheets. A third column is used to show change (increase/decrease) in figures. The fourth column may be added for giving percentages of increase or decrease. While interpreting comparative Balance sheet, the interpreter is expected to study the following aspects:

(i) Current financial position and Liquidity position
(ii) Long-term financial position
(iii) Profitability of the concern

(i) For studying current financial position or liquidity position of a concern one should examine the working capital in both the years. Working capital is the excess of current assets over current liabilities.

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(ii) For studying the long-term financial position of the concern, one should examine the changes in fixed assets, long-term liabilities and capital.

(iii) The next aspect to be studied in a comparative balance sheet is the profitability of the concern. The study of increase or decrease in profit will help the interpreter to observe whether the profitability has improved or not.

After studying various assets and liabilities, an opinion should be formed about the financial position of the concern.

b) Comparative Income Statement

The income statement provides the results of the operations of a business. This statement traditionally is known as trading and profit and loss account. The important components of income statement are net sales, cost of goods sold, selling expenses, office expenses etc. The figures of the above components are matched with their corresponding figures of previous years individually and changes are noted. The comparative income statement gives an idea of the progress of a business over a period of time. The changes in money value and percentage can be determined to analyze the profitability of the business. Like comparative balance sheet, income statement also has four columns. The first two columns are shown figures of various items for two years. Third and fourth columns are used to show increase or decrease in figures in absolute amount and percentages respectively.

The analysis and interpretation of income statement will involve the following:

- The increase or decrease in sales should be compared with the increase or decrease in cost of goods sold.
- To study the operating profits.

- The increase or decrease in net profit is calculated that will give an idea about the overall profitability of the concern.

2. Common-size Statements/Vertical Analysis/Cross-Sectional Analysis:

The common size statements (Balance Sheet and Income Statement) are shown in analytical percentages.
The figures of these statements are shown as percentages of total assets, total liabilities and total sales. In the balance sheet, the total assets are taken as 100 and different assets are expressed as a percentage of the total. Similarly, various liabilities are taken as a part of total liabilities. Practically, two financial statements are prepared in common-size form for analysis purposes. They are as follows:

a) Common-size Balance Sheet
b) Common-size Income statement

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a) Common size balance sheet

It is a statement in which the balance sheet items are expressed as a percentage of total assets and total liabilities. The assets are expressed as a percentage of the total assets and the liabilities are expressed as a percentage of total liabilities. It is prepared in the following ways:

i) The total assets or liabilities are taken as 100.
ii) The individual assets are expressed as a percentage of the total assets i.e.100. Similarly, different liabilities are calculated as a percentage of total liabilities.

For example, if total assets are Rs10,00,0