The Growing Significance of Analysing Financial Statements

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Abstract

In order to make wiser financial decisions, financial statement analysis, also known as financial analysis, entails carefully going over and analysing a company's financial accounts. The balance sheet, cash flow statement, statement of retained earnings, and income statement are some of these statements. Financial statement analysis is a process or procedure that uses particular techniques to assess future prospects, an organization's risks, and financial health. It is used by a range of stakeholders, including decision-makers inside the organisation, credit and shareholders, the government, and the general public. These stakeholders all have different interests, and they use various methods to satisfy those interests. Typically, top management is given access to these reports as a whole of their main resources for decision-making. The same is represented in this essay.

Keywords: financial statement analysis, financial analysis, balance sheet, cash flow statement, stakeholders

Introduction

Methods

• **Past Performance -** For the same company, across earlier periods (such as the last five years),

• **Future Performance:** This projection method is the main cause of errors in the financial analysis since previous data can be a poor indicator of future possibilities. It uses historical data along with certain mathematics and statistical approaches, including present and future values.

• **Comparative Performance -** Evaluation of similar businesses. These ratios are derived by dividing one (or more) account balances from the income statement and/or balance sheet by another, as in the following example:

Return on Equity (ROE) = Net Income / Equity

Return on Assets (ROA) = Net Income / Total Assets.

Asset Control Ratios determine how effectively a business can convert its assets into sales.

P/E ratio = stock price / earnings per share

Financial analysis can be done in a variety of ways, including through comparing financial ratios. Theoretically, financial ratios face the following difficulties:

- They don't really say anything about the firm's future prospects. Their perceptions of compared performance necessitate a comparison to earlier periods or businesses of a similar size.
- One ratio has minimal significance. Ratios have at least two reasonable interpretations as indicators. Combining various relevant ratios to create a more complete view of the firm's performance can help to partially solve this issue.
- Year-end values may not be representative due to seasonal variations. As account balances fluctuate from the start to the finish of an accounting period, a ratio's values may become distorted. When possible, use average values for these accounts.
- Financial ratios are less objective then the accounting techniques used. Different ratio numbers can result from changes in accounting practises or decisions.

• Financial evaluation

In percentage analysis, a set of numbers are reduced as a % of a base amount, which is another tool available to financial analysts. One way to express a bunch of items is as a percentage of net income, for instance. Horizontal analysis is when proportionate adjustments to the same figure over a specified time period are expressed as a percentage. Vertical or common-size analysis, which aids in comparability with other companies of various sizes, reduces every item on the statement to a "common size" as a proportion of some base value. As a result, all items on the income statement and balance sheet are divided by sales and total assets, respectively. Comparative analysis is an alternative strategy. This offers a more accurate technique to identify trends. In a comparative analysis, the same data is presented for multiple periods of time side by side for a simple study.

Financial statement analysis instruments and techniques

Financial statements can be analysed using either a horizontal or trend analysis or a vertical analysis. These are described here, along with the benefits and drawbacks of each technique.

Vertical Analysis

Comparing current financial information from a company with previous financial data from the same business over a variety of reporting periods is known as horizontal analysis. It might also be based on ratios computed using the same period's worth of financial data. The basic goal is to compare the figures to historical data in order to determine whether they are high or low, which can be utilised to look into potential causes for concern. For instance, when some costs are high now but were much below budget in prior years, management may be prompted to look into the root of the problem. The cost increase could be the result of changing providers or using better raw materials.

This approach of analysis simply groups the data and arranges it by time frames, such as weeks, months, or years. The data for every time frame can also be displayed as a proportion of the data for the base year, which is the earliest/starting year. Typically, 100% of the total is allocated to the baseline year. Additionally known as dynamic evaluation or trend analysis, this analysis.

Horizontal Analysis

Financial statements for a specific time period are the only ones used for vertical analysis. For a specific time period, usually a year, every item in the financial statement is displayed as the basic figure of a different item in the statement. This analysis typically entails expressing each line item on a profit and loss statement as a number of gross sales and each line item on a balance sheet as a percentage of the firm's total assets. Vertical analysis, which is performed for a single time period, is also known as static analysis.

Trend Evaluation

It is one of the most helpful types of horizontal analysis for comparing financial statements from various years. Any year is chosen to serve as the "base year" when computing trend percentages. The proportion of every item of every year is determined using the assumption that each element of the base year is equal to 100. The trend percentage is useful in identifying if certain elements have increased or decreased.

Financial ratios

Ratio analysis is the study of relationships between different things or a set of objects. A ratio is simply a single number expressed in proportion to another. In order to give meaningful information about liquidity, solvency, profitability, etc., it summarises and simplifies a large amount of accounting data.

Cash flow projections

It displays cash and cash equivalent inflows and outflows during a specific time period and analyses the causes of changes in the cash balance between the two accounting dates. Even though a company makes sizable profits, it may not have enough cash on hand, or it may have plenty of cash even when it experiences a loss. By creating a cash flow statement, it is possible to study and comprehend the causes of these variances.

Financial Statement

The purpose of a fund flow statement is to display changes in the firm's assets, liabilities, and capital between the respective dates of both balance sheets. It identifies the reasons behind variations in an enterprise's working capital over the course of the year. It also reveals the sources from which the business got finances as well as the precise purposes for which those monies were put.

Analyses of breakeven points

The point at which total costs and total sales are exactly equal is known as the breakeven point. There is currently neither a profit nor a loss. It is also known as the "no profit, no loss point."

Important financial accounts and their analysis

The balance sheet, the income statement, and the statement of cash flows are the three primary forms of financial statements. These accounting reports are examined to assist businesses in making economic decisions and to forecast their profitability and cash flow.

Ledger Balance

The balance sheet displays the firm's present financial situation at a specific point in time. The statement of assets and liabilities is another name for it. The balance sheet is organised so that the firm's assets are listed on one side and its debts and shareholders' equity are displayed on the other. The balance of the balance sheet's two sides must be as follows:

Assets = Liabilities + Shareholders' Equity

Following are descriptions of the key things on the balance sheet:

Current Assets

Cash and cash equivalents are considered the firm's current assets. Assets that are easily convertible into cash within a year are these cash equivalents. Marketable securities, inventory, and accounts receivable are examples of current assets.

Long-term Assets

Non-current assets, often known as long-term assets, are fixed assets including real estate, machinery, and other types of property. Every year, a company tracks the depreciation of its fixed, long-term assets. It simply affects the asset's book value rather than being the actual expense of money paid. The accumulated depreciation from previous years is subtracted from the asset's purchase price to arrive at the book value.

Total Assets = Current Assets + Long-Term Assets' Book Value

Current Liabilities

Liabilities that are due in the next year or less are known as the company's current liabilities. These consist of notes payable, accounts payable, and delayed expenses.

Long-Term Liabilities

Financial obligations or payments that are due beyond one year are considered the company's long-term liabilities. These include mortgages that the company must pay back over a longer period of time and capital leases, which the company must pay for in order to use a fixed asset.

Investors' Equity

The term "shareholders' equity" is also used to refer to the company's net worth or "book value of equity." It is the gap between a company's total assets and its entire outstanding obligations. It differs from the stock market capitalisation, or market value of equity, which is determined as follows: multiplied by the current share price by the number of outstanding shares.

Analysis of Balance Sheets

In order to determine some crucial ratios that aid in illuminating the firm's state of health at any given time, the balance sheet is analysed. The following are these metrics:

Total Debt / Total Equity is the debt-to-equity ratio.

Leverage ratio is another name for the debt-to-equity ratio. It measures a company's leverage, also known as gearing, to determine how heavily it depends on debt to fund its operations. This ratio has important ramifications for the company's financial stability as well as the potential return and risk on its stock.

Market-to-Book Ratio is calculated as Market Equity Value / Book Equity Value.

When a firm's characteristics change, the ratio of market to book value is utilised to reflect those changes. Variations in this percentage also reveal the management's potential for growth and any value it adds.

Enterprise Value = Market Value of Equity + Debt - Cash.

The firm's enterprise value reveals the true worth of the company. It depicts the actual value of the company's assets, excluding any cash or cash equivalents, and is unaffected by the debt the company is currently carrying.

Income Statement

An income statement's goal is to summarise a company's earnings and outlays for a given time period. Previously, it was known as a profit and loss account. The income statement has the following general structure and primary components:

sales income- Gross profit = Cost of goods sold (COGS). - Selling, General, and Administrative (SG&A) expenses Earnings before interest, taxes, depreciation, and amortisation (EBITDA) = Research and development (R&D)Earnings (before interest and taxes) before depreciation and amortisationEBT (earnings before taxes) = Interest costsTaxes minus net income

If the net income is positive, it indicates that the business has made an income. If the net income is unfavourable the business lost money.

Determining the total amount of outstanding shares for the corporation allows one to calculate earnings per share as follows:

Earnings per Share = Shares/Net Income Excellent Income statement Analysis

Based on the data in the income statement and balance sheet, the following helpful metrics can be calculated:

Ratios of profitability

1. Net profit margin: This ratio determines the company's profit after all costs, including taxes,

have been subtracted from net sales.

Net Income / Net Sales = Net Profit Margin

2. Return on Equity: This ratio is used to determine how much a firm earns in terms of its total equity.

   Net income divided by the equity's book value equals return on equity.

Ratios of valuation

ratios of price to earnings The P/E ratio

The price to earnings ratio is employed to determine whether a stock's value is in line with the potential level of income it can produce for its shareholders. The stock's overvaluation or undervaluation is evaluated.

(P/E) Market capitalization divided by net income equals share price divided by earnings per share.

The cash flow statement The sources and uses of the money generated by the company are made clear in the report of cash flows. The net income is effectively adjusted in this statement for non-cash costs and any adjustments to net working capital. Additionally, it displays changes in the firm's investment and financing activities' use or receipt of cash. The cash flow statement's primary elements and structure are as follows:

Net income plus depreciation plus adjustments to net working capital equals cash from operating operations.

New debt plus new shares, dividends, and shares repurchased equal cash from financing activities. Capital expenditures minus the proceeds from the sale of long-term assets equals cash from investment activities.

The final result—changes in cash flows—is determined by all three of the aforementioned factors.

Analysis of the Cash Flow Statement

It is helpful to perform a straightforward cash flow statement analysis to see how much cash is accessible to the business for investment without outside funding or money being taken away from activities. As the term implies, a firm can use its free cash flow to pay dividends, settle debts, repurchase shares of stock, and make additional investments to support future growth. The following formula is used to determine the company's free cash flow:

Free Cash Flow is calculated as Net Income + Amortization/Depreciation - Changes in Working Capital - Capital Expenditures. To determine whether the business is generating "quality" income, some analysts additionally examine the cash flow from operating operations. The cash from operational activities must continually exceed the company's net income in order for the business to be performing extraordinarily well.

Additional financial statement details

Complete financial reporting statements also contain the following in addition to the key financial statements:

Review of Operations and Business

The phrase "management discussion and analysis" is another name for a company's and operating review. It acts as an introduction to all full reporting statements, during which the management addresses significant changes in the business sector as well as current events and key information on expansion and future plans.

The company should inform the public of any positive news during its financial and operating review. To demonstrate to the consumers that they genuinely care about communicating freely with them, they have space for further discussion on plans that will improve the company's reputation and handle any unpleasant occurrences that may have happened.

Statement of Shareholders' Equity Changes

Equity analysis is another name for the shareholder equity statement. It offers details on any changes to the company's equity worth over a specific time frame. It makes a comparison between the equity accounts' opening and closing balances. The statement of modification in shareholders' equity includes two different sorts of changes:

Changes brought about by any interactions the corporation has with its shareholders. For instance, issuing bonus shares, paying dividends, buying treasury stock, and so forth.

Modifications are on by variations in the company's total revenue. A revaluation of fixed assets, net income for the time, fair value of investments up for sale, etc. may all be examples of these changes.

Analysis of financial statements is necessary.

Examining both historical and current financial data is the goal of financial statement analysis in order to improve a company's Additional financial statement details

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Any positive news that the company has to share with the public should be done so in the business and operating review. To demonstrate to the consumers that they genuinely care about communicating freely with them, they have space to elaborate on plans that would help improve the company's reputation and handle any unpleasant occurrences that may have happened.

Statement of Shareholders' Equity Changes

Equity analysis is another name for the shareholder equity statement. It offers details on every change in the company's stock worth over a specific time frame. It makes a comparison between the equity accounts' opening and closing balances. The statement of change in shareholders' equity includes two different sorts of changes:

Changes brought about by any interactions the corporation has with its shareholders. For instance, distributing dividends, buying treasury stock, issuing bonus shares, and issuing new shares.

Changes brought about by adjustments to the company's total revenue. Revaluation of fixed assets, net income for the time, fair value of investments up for sale, etc. may all be examples of these changes.

Analysis of financial statements is necessary

In order to assess the success of an organisation and financial condition and to forecast future risks and potential, financial statement analysis looks at both historical and present financial data. Financial statement analysis can reveal important details regarding patterns and connections, the standard of an organization's earnings, and the positives and negatives of its financial condition.

Establishing the analysis's objective(s) is the first step in performing a financial statement analysis. For instance, does the study serve as a foundation for approving credit or creating an investment? The data is gathered from the financial statements and other sources once the analysis's goal has been determined. The analysis's findings are condensed and explained. A report is written, with conclusions, and given to the individual or people for whom the evaluation was done.

To review financial statements, one has to be familiar with business practises, accounting's goals, methods, and constraints, as well as business and accounting jargon. One also needs to be familiar with the instruments of financial statement analysis.

A financial study of a corporation should look at its financial statements, including any notes to those statements, as well as the auditor's report. If the financial records have been examined in conformity with widely recognised auditing standards will be stated in the auditor's report. In compliance with generally accepted accounting standards, the report also states whether the statements depict the company's financial status, operational results, and changes in financial position accurately. The information contained in the financial statements' body is frequently less important than the notes to the financial reports. The notes describe the company's accounting principles and typically give thorough justifications for how those procedures were implemented along with additional information. Analysts frequently compare a company's financial statements with those of other businesses in the same industry, with the sector in which the business operates, and with financial statements from the company's preceding fiscal years.

Comparative financial statements give analysts important details regarding patterns and connections over a period of two or more years. Comparing statements are more important than single-year statements when assessing a company. financial report Additional resources for analysing financial statements include RATIOS. Relationships between various elements on financial statements are established by financial ratios. These categories apply to ratios:

1. **Liquidity ratios:** Determine the company's capacity to settle its debts as they become due.

2. **Activity (or turnover) ratios:** Evaluate the efficiency with which the company uses its resources.

3. **Profitability ratios:** Evaluate management's performance in providing investors with returns on their investments.

4. **Coverage ratios:** Calculate how long-term investors and creditors are protected.

Additional methods that can be employed effectively while examining a company include horizontal and vertical financial statement analysis. In order to reveal changes in items in the accounting records over time, horizontal analysis highlights patterns and creates relationships between things that appear on the exact same row of a comparison statement. To demonstrate the relative relevance of the items and to make comparisons easier, vertical analysis converts items contained in statement columns into percentages of a base figure. Individual components on the income statement, for instance, can be represented as percentages of sales. Assets can be represented on the balance sheet as a proportion of the total assets. Accounts for liabilities and owners' equity can be expressed in reference to the sum of obligations and owners' equity.

The analysis of financial statements has its limitations. The past is represented through statements, which may not always portend the future. Financial statement analysis, however, can offer hints or point to the need for additional research. Financial statements are the result of accounting norms and practises (L1FO or FIFO stock; straight-line or accelerated depreciation), which can occasionally mislead the underlying situation's economic reality or content. Regarding changes in markets, the company's life cycle, technical advancements, rules and regulations, management people, price-level fluctuations, and other crucial analytical concerns, financial statements don't directly address many of these issues.

Financial statement analysis issues

Financial statement analysis is a fantastic tool for assessing a company's past performance and forecasting its prospects for the future, but there are a few issues to be aware of before applying the findings blindly, as they may affect how the results are interpreted. Several of the problems are:

Comparability of Businesses

This presents a significant challenge for analysts since, although it may appear that they can compare financial statement assessments of various organisations based on the ratios employed, this may not be a true representation of the situation. Comparing the financial metrics of two distinct organisations to determine how they stack up against one another is possible, but every business may combine its information in a unique way to create its accounting statements. This could result in inaccurate inferences being made regarding a company's position in comparison to its competitors.

Comparison of Various Periods

The outcomes of the financial statement analysis may change from one period to the next due to changes in the accounts used to hold financial data. The analysis between both of these periods would not be comparable, for instance, if a corporation reports a cost of products sold charge in one period and a selling and distribution expense in another.

Operational information

It is not considered by operational information analysts since only financial data is examined and analysed. The number of backlogged orders, any modifications to licenses or warranty claims made to the company, changes in culture and work environment, as well as other operational information may contain clues that can predict future performance. As a result, analysing financial data may only tell you half the story.

Accounting and financial reporting's limitations

Utilizers of financial statements might improve their financial selections with the help of accounting. When making those selections, it's crucial to be aware of the constraints of financial reporting and accounting. The following are the primary financial reporting and accounting limitations: various accounting procedures

1. Various accounting frameworks and policies

Financial statement preparers can adopt the accounting principles that best reflect the conditions of their companies thanks to accounting standards like IFRS.

Although a certain amount of flexibility is necessary to present accurate information about a specific organisation, the employment of various sets of accounting standards by various companies reduces the level of comparison across financial statements.

Similar issues arise when comparing financial statements from firms operating in different geographical regions that use various accounting standards (such as IFRS and US GAAP). The issue is being solved by the expanding adoption of IFRS and the process of convergence between the top accounting bodies to create a single set of international standards.

2. Accounting projections

When preparing financial statements, accounting mandates the use of approximations when exact numbers cannot be determined. Since estimates rely on management's judgement to determine values to be included in the financial statements, they are inherently subjective and hence imprecise. Estimates can lessen the accuracy of accounting information when they are not supported by unbiased and verifiable data.

3. Use sound judgement.

The application of accounting policies in a way that is compatible with the economic realities of an entity's activities requires the exercise of professional judgement by those who compile financial statements. Differences in how the necessities of accounting standards are interpreted and applied to real-world situations, however, will always be present. Financial statements tend to be more subjective the more judgement is required of them.

4. Reproducibility

The primary method by which users can have faith in financial statements is audit. Despite carrying out the audit in accordance with acceptable standards, some material misstatements in financial statements may still go undetected due to the inherent limitations of the audit because the audit only offers' reasonable' and not complete confidence on the truth and fairness of the financial statements.

Utilising past costs

The most common method for valuing assets is historical cost. Because historical cost fails to take into account how asset prices fluctuate over time, it causes a number of issues for those who utilise financial statements. By reporting assets at levels that may be far lower than their realisable value, this not only diminishes the significance of accounting information but also fails to take into account the opportunity cost of using those assets.

The best way to convey the impact of using historical cost base is with an example.

Some people who create financial statements utilise the method of revaluation to account for assets that are long-term due to the drawbacks of using historical cost. However, it is not frequently employed in practise because of the small market for different assets and the expense of the periodic appraisals required by the revaluation model.

The use of "capital maintenance" in accounting to calculate sustainable profit after accounting for the resources needed to "maintain" operational productivity is an intriguing advance. The development of this accounting base remains in its early stages.

5. Measurement

Only transactions that can be measured in money are taken into account in accounting. As a result, resources and transactions like goodwill and human capital that are difficult to assign a value to are not included in financial statements.

6. Low predictive power

Financial statements give a history of an entity's historical performance. They provide little insight into a company's potential for the future, and as a result, they lack predictive value, which is crucial from the perspective of investors.

7. Fraud and mistakes

Financial statements are prone to fraud and mistakes, which can reduce their overall trustworthiness and dependability as a source of information. Major accounting scandals like the Enron Scandal made intentional tampering of financial accounts with the aim of reaching preset results, commonly known as "window dressing," a regrettable reality in recent history.

8. Cost-benefit tradeoff

The cost of producing accounting data affects how reliable it is. The accuracy of accounting information may occasionally be compromised since it can be more expensive to produce correct information than is anticipated to be beneficial.

Conclusion

The analysis of financial statements has its limits. Statements reflect the past but do not always portend the future. Financial statements, however, can offer hints or point to the need for additional research. Owners of businesses and other interested parties can better understand these crucial variables for decision-making and, ultimately, business survival by using financial statements to analyse the data.

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