# Unit 3: Financial Statement Analysis

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**3.0 Aims and Objectives**

This unit aims at presenting the term financial statements, importance, objectives, uses, financial analysis meaning, importance and techniques of financial analysis.

After going through this unit, you shall be able to:

* understand the financial statements
* list the users of financial statements
* explain the terms analysis and interpretation
* identify the techniques of financial analysis.

**3.1 Financial statements**

In financial accounting, you have learned the process of preparation of financial statements. Financial statements are the end products of accounting system. The two basic financial statements are required to be prepared for the purpose of external reporting are balance sheet and income statement. For internal purposes of planning, decision making and control much more information is contained in Balance sheet and Income statement.

* + 1. **Balance Sheet:**

This is one of the important financial statements. It indicates the financial position of an accounting entity at a particular, specified movement of time. It is valid only for a single day, the very next day it will become obsolete. It contains the information about the resources, obligations of a business entity and the owners interest at a specified point of time.

* + 1. **Income statement:**

This report has greatest importance to the users of financial statements. It is a performance report recording the changes in income expenses, profit and losses as a result of business operations during the year between two balance sheet dates. The income statement is valid for the whole year.

**3.2 Importance of financial statements**

Financial statements are the index of the financial affairs of a company. To the owners of the company, they reveal its progress as evidence by earnings and current financial condition; to the prospective investors they serve as mirror reflecting potential investment opportunity; to the creditors they reflect the credit worthiness; labor unions are able to know the fair sharing of bonus; the economist can judge the extent to which the current economic environment has effecting its business activity; to the government the financial statements offer a basis of taxation, control of costs, prices and profits and; to the management they reveal the efficiency with which business affairs are conducted.

**3.3 Users of financial statements**

The following are interested in financial statements

1. ***Owners:*** The owners of a business unit has primary concern in operational and financial results of the company. They wanted to know how safe their investment is and how effectively it is being used. They expect periodical reports from the directors who are the custodians of their money.
2. ***Managers:*** The managers are entrusted with the financial resources contributed by the owners and other suppliers of funds for effective utilization. In their pursuit to take the company to the destination of wealth maximization and maximization of economic welfare of winners, the managers take several decisions. If their decisions are to be right and timely, they require relevant financial information.
3. ***Creditors:*** The money suppliers are known as the creditors. They are interested in short-run periodical payment i.e., payment of interest and in long-run to get back their money. It may include the trade credits also. Thus, financial statements are highly useful.
4. ***Prospective Investors:*** Depending upon the financial performance, their financial soundness and professional way managing the business activities may retain the interest of existing stock holders and attract the potential. Prospective stock holder, who has the inclination to invest their surplus or savings. The only basis for them to estimate the financial position is company’s financial information i.e., income statement and balance sheet.
5. ***Employees and Trade Unions:*** The financial statements are used by the employees working in the company. It will help them to understand the earning capacity of the firm and the amount spent on welfare, bonus fringe benefits, working conditions etc. The trade unions will have better bargaining edge, when it has full information about the financial date.
6. ***Consumers:*** The customers are also interested in the financial statements of a company. Since, they are the one who is going to bear the cost of goods or services provided by a company. A realistic appraisal of the firm activities through financial statements would enable them to know whether they are over priced or exploited by being charged unduly high rates/prices.
7. ***Government:*** It may be seen all over the world today that the governments as the custodians of general public have assumed a dynamic role in shaping the economic activities to take their own course in the hands of a few, self-interested capitalists, the governments have started planning, regulating and controlling the economic affairs of the country in a systematic way. All these efforts to be fruitful require information about the economic activities of individual organizations. The financial statements of individual companies serve as a source of information on the basis of tax levies, granting subsidies or loans, imposing controls, fixing prices, offering protection or even nationalization, taking over managements etc. the government uses the financial statements of the business unit as a source.

**3.4 Financial analysis meaning and importance**

Financial statement analysis is a process of synthesis of summarization of financial statements and operative data (presented in financial statements) with a view to getting an insight into the operative activities of a business concern. It is a technique of investigating the financial positions and progress of the unit. By establishing some relationship between balance sheet and income statement, analysis attempts to reveal the meaning and importance of various items contained in the financial statements. An analysis of financial statements gives a detailed account of business operations and their impact on the financial health of the company.

For the purpose of financial analysis, we have to re-organize and re-arrange the data contained in financial statements. The data may be grouped and re-grouped on the basis of resemblances and affinities into categories of a few principal elements. These categories are clearly defined so that their computations can be readily made. Through such classification and re-classification the financial statements will be recast and presented in a condensed form. The changed arrangement of items will be different form the original financial statements.

The analysis of financial data i.e., classification of the data into groups and sub-groups and establishment of relationships among then, is followed by interpretation. The term interpretation means explaining the meaning and significance of data. So simplified. It involves drawing inferences from the analyzed data about the different aspects of the operational and financial results of the business and its financial health.

Analysis and interpretation are closely inter linked. They are complementary 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 date and preparation, study and interpretation of the same.

**3.5 Objective of financial analysis**

The main objective of financial analysis is to reveal the fact and relationships among the managerial expectations and the efficiency of the business unit. The financial strengths and weaknesses, its credit worthiness can also be known through such an analysis. The safety of funds invested in the firm, the adequacy or otherwise of its earnings, the ability to meet its obligations etc. can also be examined through an analysis of their financial statements.

Of course, the financial analysis reveals only what has happened in the past. But, we can predict future basing on past.

The management of the business unit is concerned, analysis can be used as a means of self-evaluation. Through analysis the banker can assess the liquidity positions of the client firm and a creditor can determine the credit worthiness. Analysis of financial statements helps an investor in knowing the safety of his funds and the possible returns on the same. The bond holders can know whether the income generated by the firm would provide sufficient margin to pay interest as well as principal on maturity. Through an analysis of financial statements of firms, an economists can gauge the extent of concentration of economic power and lapses in the financial policies perused. The employees and trade unions can know how the firm stands in relation to labor and its welfare. The analysis provides a basis to the government relating to licensing controls, price fixation, ceiling of profits, dividend freeze, tax subsidy and other concessions.

**3.6 Types of analysis**

The financial analysis can be broadly divided into two

1. external analysis and
2. internal analysis.

***External Analysis:*** This kind of analysis will be undertaken by the outsiders of the business unit. These outsiders include investors, creditors, money suppliers, government and labor unions. They do not have the access to the records of the company and depend on the published financial statements and other information which the company furnishes.

***Internal Analysis:*** This analysis is done by persons within the organization. They will have the access of data i.e., the records of accounting and other information related to the business. They include executives or employees of the organization.

#### Check Your Progress –1

1. What is analysis of financial statements?

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1. Analysis which is done by the persons within the organization is called.

**………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………**

1. Name the financial statements.

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1. List the users of financial statements.

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**3.7 Techniques of financial analysis**

In the process of financial analysis various tools are employed. The most prominent amongst them are listed as below:

1. Comparative statements
2. Common size statements
3. Trend Analysis
4. Ratio Analysis
5. Fund flow and cash flow analysis

***Comparative Statements:*** Comparative statements are prepared to provide time perspective to the consideration of various elements of operations and financial position of the business embodied in the statement. Here, the figures for two or more periods are placed side by side to facilitate comparison. In addition to absolute figures the ratios constructed from the financial statements are also presented in the form of comparative statements. Both, balance sheet and income statement are presented in the form of comparative statements.

***Common Size Statements:*** Under this technique the individual items of income statement and balance sheet are expressed as percentages in relation to some common base. In income statement, sales are usually taken as hundred and all items are expressed as percentage of sales. Similarly, in balance sheet the total of assets or liabilities treated equivalent to hundred and all individual assets or liabilities are expressed as percentage of this total.

***Trend Analysis:*** It is highly helpful in making a comparative study of the financial statements for several years. The calculation of trend percentages involves the calculation of percentage relationship that each item bears to the same item in the base year. Any year may be taken as base year. Usually, the first year will be taken as the base year. Any intervening year may also be taken as the base year. Each item of the base year is taken as 100 and on that basis the percentage for each of the item of each of the years are calculated. These percentages can also be taken as the index numbers showing the relative changes in the financial data over a period of time.

***Ratio Analysis:*** Ratio analysis is a tool which establishes a numerical relationship of between two figures normally expressed in terms of percentage. This has been discussed in detail in the next unit.

***Fund flow and Cash flow Analysis:*** The changes that have taken place in the financial position of a firm between two dates of balance sheets can be ascertained by preparing the fund flow statement which contains the sources and uses of financial resources. This is a valuable aid to finance manager, creditors and owners in evaluating the uses of funds by a firm and in determining how these uses are financed. This statement also helps to assess the growth of the firm and its resulting financial needs to decide the best way to finance those needs.

Cash flow statement summaries the causes of changes in cash position between two dates of two balance sheets. It indicates the sources and uses of cash. This statement is similar to statement prepared on working capital basis, except that it focuses attention on cash instead of working capital.

**3.8 Summary**

The term ‘Financial Statements’ include balance sheet and income statement. The former one reflects on the financial soundness of a business unit as on a particular date, the later one provides the profit/loss made during a particular year. There are various people interested in financial statements like owners, manages, creditors, consumers, government, employees etc.

Financial analysis is a process evaluating the soundness of a business unit from the print of view of all parties interested in the affairs of the business. Different people may use different tools to suit their individual purposed.

**3.9 Answers to check Your Progress**

1. I. Analysis is a process of summarization of financial statements with a view to getting an insight into the operative activities of a business unit.

II. Internal analysis

III. Balance sheet and income statement are the financial statements.

IV. Owners, managers, creditors, government, employees, trade unions etc.

**3.10 Model examination questions**

1. State the objectives of financial statements.
2. Distinguish between balance sheet and income statement.
3. Who are the users of financial statements?
4. What is meant by financial analysis?
5. Differentiate between analysis and interpretation.
6. List out the techniques of financial analysis.