Accounting: Financial Statements Analysis: Introduction and Definition of Financial Statements

An Introduction

Every business entity prepares financial statements every year. The statements are of two types and those are Trading and Profit and Loss A/c Statement and Balance Sheet. Every Business keeps their statement time to time to know profitability and financial soundness of the business. But those statements alone do not provide any information for decision making. They are just absolute figures and do not make completeness. In order to ascertain decision making regarding different aspects of the business we need to interpret those financial statements. That is called as analysis of financial statements.

Definition

- Financial Statement Analysis – "It refers to the establishing meaningful relationship between various items of the two financial statements"
- Financial Statement Analysis uses different tools and techniques to identify efficiency and performance of an enterprise and future prospects of the business.

Financial Statement Analysis Serves the Following Purposes

- It measures profitability – It compares the profits earned with the capital invested and checks whether the profits earned adequate or not. It also describes the capacity to pay the interest and dividend.
- It assess the growth potential of the business
- It indicates the trend of achievements by comparing previous year statements. It helps in valuing present assets and liabilities and the future prospects of the business can be envisaged.
- It describes the comparative position in relation to other firms of similar kind of activities by comparing sales, expenses, profits and utilization of capital resources.
- It assesses overall financial strength – Sources of funds from both internal and external sources and whether they meet the requirement of the business or not.
- It assess solvency of the firm – ability to meet its short term and long term liabilities.

Parties Interested in Financial Statement Analysis

FSA serves in many ways to different parties based on their requirement. Those parties are –

- **Investors**: They are shareholders or proprietors of the company. Already existing investors uses financial analysis statements whether the entity is working properly or not. New investors look for benefits associated with the firm based on financial statement analysis.

- **Management**: Management prepares budget for the financial year and it considers all the divisions of the business. The preparation is based on financial statement analysis of the previous years.
- **Trade Unions**: They look for better wages and salary negotiations based on financial statement analysis.
- **Lenders**: Lenders give loans to the business entity. To assess their credit worthiness and solvency lenders use financial statement analysis.
- **Suppliers and Trade Creditors**: They look for the ability of the company to meet the debts as and when they fall due.
- **Tax Authorities**: They determine the tax liability of the company basing on FSA.
- **Researchers**: They consider business affairs and practices from FSA.
- **Employees**: They look for the growth of the business that builds a better career for them. Also, they can demand remuneration and other benefits based on FSA.
- **Government and their agencies**: They regulate company activities and make effective regulatory framework and taxation policy for enterprises/industries.
- **Stock Exchange**: They utilize financial statement analysis to provide effective information to the investors in decision making.

Techniques of Financial Statement Analysis

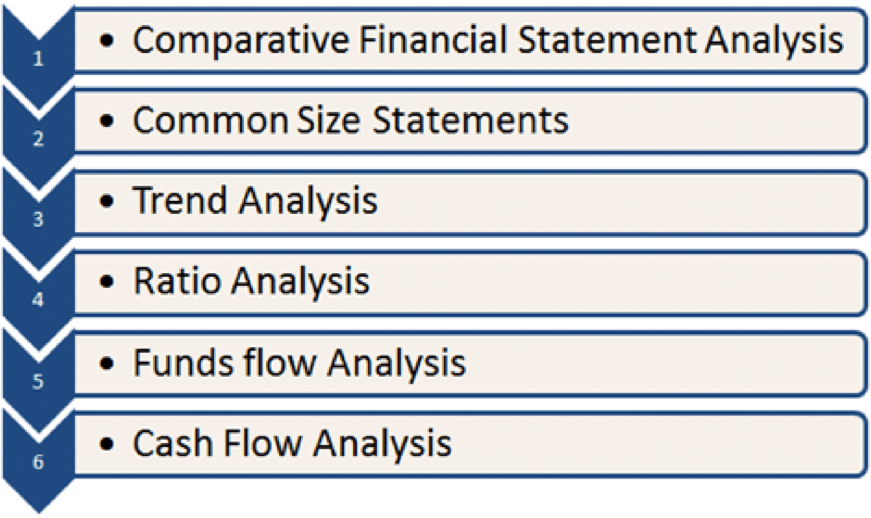
- **Cross-Sectional Analysis**: It is an inter-firm comparison. This analysis compares financial statements of two different companies of the same accounting period to know which one is doing better.

Ex: Company an earned 15% net profit and Company B earned 16% net profit for the accounting year 2016 - 17. Based on this cross-sectional analysis it is clear that company B is doing better.

- **Time Series Analysis**: It is an intra-firm comparison. This analysis compares the financial statements of different years of the same business unit or compares the financial statement of a particular year of different business units.
- **Cross-sectional cum Time Series Analysis**: This is the most effective technique of financial statement analysis. This uses both cross-sectional and time-series techniques.

Tools of Financial Statement Analysis

There are many tools or methods available for financial statements analysis. Some of those important tools including –



Comparative Financial Statement Analysis

It the comparison of the financial statements of the business with the previous year's financial statements. It helps in identifying the weak points and make corrective measures. The financial statements include Balance Sheet and Income statement.