



## A STUDY ON FINANCIAL STATEMENT ANALYSIS

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**Abstract:** Financial statement analysis, also referred to as financial statement analysis and interpretation, establishes meaningful relationships between elements in financial statements, such as the income statement and statement of position. It is a crucial tool for assessing a company's financial strength and weaknesses, measuring profitability, liquidity, efficiency, and solvency. This article explores the concepts, types, applications, and limitations of financial statement analysis, shedding light on the diverse stakeholders interested in this analysis. This study delves into the realm of financial statement analysis, aiming to comprehensively examine and interpret the financial health of companies. Employing various ratios, percentages, and mathematical relationships, the research conducts a meticulous exploration of profitability, liquidity, management efficiency, and solvency or debt ratios. Drawing on established accounting standards, such as Accounting Standard 3 issued by the Institute of Chartered Accountants of India, the study considers both direct and indirect methods for preparing cash flow statements. In addition, it investigates the Fund Flow Statement, elucidating the sources and applications of funds and their impact on working capital. The research employs a systematic approach to ratio analysis, a powerful tool for assessing a company's strengths and weaknesses. This exploration contributes valuable insights for financial analysts and decision-makers seeking a nuanced understanding of a company's financial standing and performance. Additionally, it delves into tools and techniques employed for a comprehensive understanding of financial statements, providing valuable insights into the interpretation process.

### 1. INTRODUCTION

#### Financial Statement Analysis

Financial statements are not universally tailored to meet the needs of all business stakeholders. The disclosed information may lack completeness from various perspectives, leading stakeholders to draw conclusions for specific purposes. **Financial statements, while informative, are not custom-designed to address the specific needs of every individual involved in a business. Stakeholders may find the information presented incomplete for their own purposes and may lack key details needed to draw their own conclusions. For instance, it's impossible to directly infer a company's true profitability, liquidity, efficiency, or solvency from their financial statements alone. To bridge this information gap, analyzing financial statements in conjunction with other relevant data is essential. This analysis involves comparing various figures and presenting them as percentages or turnover rates to simplify and facilitate interpretation. To glean insights into a company's actual profits, liquidity, efficiency, and solvency, financial statement data must be analysed along with supplementary information. Comparative analysis of different figures, often represented as percentages or turnover rates, facilitates interpretation. For instance, a year-over-year sales increase from Rs. 1,00,000 to Rs. 1,20,000 indicates a 20% growth.**

#### Meaning of Analytics

Analytics involves establishing reliable relationships between different elements in financial statements to draw informed conclusions. Analytics refers to the systematic analysis of data to extract meaningful insights, patterns, and trends that can inform decision-making and drive improvements. It involves the use of statistical methods, mathematical algorithms, and predictive modelling to interpret vast sets of information. By employing various data analysis techniques, analytics helps organizations uncover valuable information, identify correlations, and make informed choices. Whether applied in business, finance, healthcare, or other fields, analytics enables data-driven decision-making, enhances operational efficiency, and provides a strategic advantage in navigating complexities and uncertainties.

### Meaning of Financial Statement Analysis

Financial statement analysis, also known as financial statement analysis and interpretation, encompasses tools and techniques providing relevant information for critical policy decisions. This analysis establishes significant relationships between financial items, particularly in the income statement and statement of position, determining a company's financial strength and weaknesses. It aids in measuring profitability, solvency, efficiency, and stability.

According to Myers, " *Financial statement analysis involves examining the connections among different financial elements within a single statement and exploring the patterns in these elements across multiple statements.*" It involves systematic numerical calculations to measure a company's profitability, liquidity, efficiency, and solvency.

### Parties Interested in Financial Statements

Various stakeholders are keenly interested in financial statement analysis:

1. **Management:** Seeks insights into profitability, liquidity, efficiency, and stability for effective business planning.
2. **Shareholders:** Interested in earning capacity and future growth to assess real profit.
3. **Bondholders:** Concerned with the company's financial condition and ability to meet interest and bond redemption obligations.
4. **Credit Institutions:** Focus on the company's solvency and the safety of borrowed funds.
5. **Creditors:** Interested in both short-term and long-term financial stability, evaluating the company's ability to meet debts and claims.
6. **Employees:** Seek insights into company profits, affecting wages and bonuses tied to productivity and profitability.
7. **Government:** Utilizes financial reports for taxation, regulation, and national economic reports.
8. **Tax Office:** Interested in company profitability for tax collection purposes, particularly sales tax.
9. **Economists and Researchers:** Analyse financial performance for studying growth rates and proposing measures to enhance growth.
10. **Society or Public:** Assess the company's fulfilment of social responsibility through financial reports.
11. **Competitors:** Analyse financial statements to understand company strategies and formulate appropriate policies.

This comprehensive overview provides a foundation for understanding financial statement analysis and its broad relevance to diverse stakeholders.

### II.Objectives of Financial Statement Analysis

Financial statement analysis serves several key objectives:

- **Profitability Assessment:** Determine the company's profitability.
- **Liquidity Position:** Evaluate the liquidity position of the company.
- **Operational Efficiency:** Assess the efficiency of business operations.
- **Solvency Evaluation:** Understand the solvency of the company.
- **Debt to Equity Ratio:** Analyze the debt-to-equity ratio.
- **Accounts Receivable Turnover:** Assess how quickly money is collected from customers.
- **Financial Situation and Progress:** Know the overall financial situation and progress of the company.
- **Competitor Cost and Profitability:** Understand the costs and profitability of competitors.
- **Shareholder Confidence:** Inform shareholders about the safety of investments and the likelihood of receiving regular dividends.
- **Creditor and Bondholder Information:** Provide information to creditors, bondholders, and lenders regarding the security of their investments and the regularity of interest payments.
- **Overall Growth and Progress:** Gain insights into the overall growth and progress of the company.

### Benefits and Utility of Financial Status Analysis

Financial statement analysis yields various utilities, including:

- **Profitability Assessment:** Determine the company's profitability.
- **Willingness to Pay:** Understand the company's ability to meet financial obligations.

- **Operational Efficiency:** Assess the efficiency of business operations.
- **Solvency Evaluation:** Evaluate the solvency of the company.
- **Debt and Equity Relationship:** Understand the relationship between debt and equity.
- **Employee Compensation Guidance:** Provide guidance on employee salary increases and bonus requirements.
- **Creditor Information:** Offer vital information to bankers and lenders for making informed lending decisions.
- **Overall, Company Performance:** Assess the general performance of the company.

Financial statement analysis involves systematic numerical calculations, measuring the profitability, liquidity, operational efficiency, solvency, and growth of a business entity.

### Limitations on the Analysis of Financial Statements

Financial statement analysis has certain limitations:

- **Quality of Financial Statements:** If annual financial statements are inaccurately prepared, the analysis based on them may be unreliable.
- **Regulatory Changes:** Changes in rules, regulations, and government oversight impact financial statement preparation and analysis.
- **Accounting Method Variability:** Alternative accounting methods allowed by standards can affect the analysis.
- **Analyst Expertise:** The expertise and maturity of analysts analyzing financial statements may limit the quality of analysis.
- **Legal Provisions Changes:** Alterations in Company Law provisions can impact the quality of annual accounts analysis.

### III.Types of Financial Analysis

Financial analysis can be classified according to various criteria, including:

#### Based on Material Used

- ❖ **External Analysis:** This type is conducted by external entities utilizing publicly available financial statements to assess a company's financial health and performance.
- ❖ **Internal Analysis:** This category involves analysis performed by individuals who have access to internal company information, providing a more detailed and nuanced examination of the organization's financial status.

#### Based on Mode of Operation

- ❖ **Horizontal Analysis:** This approach involves scrutinizing financial data across multiple years, comparing current-year indicators to those of a chosen base year. This helps identify trends and changes over time.
- ❖ **Vertical Analysis:** This type of analysis examines the quantitative relationships between different financial statements on a specific day, utilizing data from a single fiscal year. It offers insights into the composition and structure of a company's financial position.

### IV.Methods, Tools, or Techniques of Financial Statements

These tools involve analyzing information based on financial statements using percentages or formulas, drawing meaningful conclusions from the data.

#### Methods, Tools or Techniques of Financial Statements

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|---|
| ❖ Comparative Statements                  |
| ❖ Trend Percentages                       |
| ❖ Common-size Statements                  |
| ❖ Statement of changes in Working Capital |
| ❖ Cash-flow Analysis                      |
| ❖ Fund-flow Analysis                      |
| ❖ Ratio Analysis                          |

## Comparative Statements

Comparative statements involve presenting financial statements of recent years in column form to reveal changing trends in business activity. This analysis, known as comparative statement analysis, is crucial for assessing a company's profitability and financial condition. While income statements and balance sheets are typically presented in columns, analyzing only one year's financial statements has limitations, as it fails to reflect the development and nature of changes in the business unit. Comparative statements are valuable for understanding business trends when invoices from different years are examined together. Two methods are commonly used in such comparisons: presenting figures for increases or decreases in income or expenses and expressing each element's numbers as a percentage of the total.

- Financial statements for a single year lack the ability to showcase the evolution and nature of changes within a business unit.
- Absence of a year-on-year comparison in income and expenses, making it challenging to assess the financial performance over time.
- The balance sheet for a specific year does not clearly indicate whether the company's financial position has improved or deteriorated.
- Comparative statements, integrating invoices from different years, prove valuable in discerning changes in business trends.
- Understanding business trends is crucial for effectively utilizing comparative statements, which provide insights into the trajectory of a business unit over time.
- It provides a nuanced perspective by considering the relationship between various financial elements, offering a more thorough understanding of performance and trends over time.

## Trend Percentages

Trend percentages involve calculating the percentage change in financial statements over consecutive years, extending horizontal analysis. The base year's records are compared with corresponding records of other years, expressed as percentages, termed trend percentages. By setting the data of one year as the base year (100), each part of other years is calculated as a percentage of the base year. For instance, if the cash balance in 2020-21, 2021-22, and 2022-23 is Rs. 1,00,000, Rs. 1,50,000, and Rs. 1,75,000, respectively, taking 2020-21 as the base year, the trend analysis shows 100%, 150%, and 175%, indicating a 75% increase in cash balance from 2020-21 to 2022-23.

**Table 2: TREND ANALYSIS from 2021-22 to 2023-24 (Base year 2021-22 (100))**

Particulars	2020- 21	2021-22	2022-23
Cash balance	1,00,000	1,50,000	1,75,000
Trend Analysis (%)	100%	150%	175%

## Common Size Statements

The above methods lack a single basis for comparing all items, leading to the preparation of common size statements. A common size statement is a financial document that expresses each line item as a percentage of a base figure, typically total revenue or total assets. This standardized format facilitates a comprehensive analysis of financial statements, allowing for meaningful comparisons across companies of varying sizes or within the same company over different periods. In a common size statement, every element is proportionally represented, providing a clear snapshot of the relative significance of different components. This financial analysis tool enhances the ability to identify trends, patterns, and areas of concern, aiding in informed decision-making. The advantages of common size statements include:

- **Uniform Comparison:** Enables consistent comparison across companies of different sizes or within the same company over time.
- **Highlighting Trends:** Clearly illustrates trends in the relative proportion of each financial element.
- **Identifying Variances:** Facilitates the identification of significant variances and areas that may require attention.
- **Standardized Analysis:** Simplifies financial analysis and interpretation by presenting data in a standardized and easily comparable format.

## Changes in Working Capital

Working capital, the excess of current assets over short-term liabilities, is crucial for management decisions, as most business transactions impact working capital. The four-column statement of changes in working capital is a popular method, indicating the current year's values of current assets and liabilities, the changes, and the net effect. This method helps determine whether working capital has increased or decreased, providing insights into the liquidity position of the company. Changes in working capital refer to alterations in a company's short-term assets and liabilities over a specific period, reflecting its ability to meet its immediate financial obligations. The working capital equation, which is the difference between current assets and current liabilities, provides insight into a company's liquidity and operational efficiency. Two crucial aspects of changes in working capital are:



- **Cash Flow Implications:** Shifts in working capital directly impact a company's cash flow. An increase in working capital ties up cash, potentially limiting funds available for investment or debt reduction, while a decrease may release cash for strategic initiatives.
- **Operational Efficiency Indicator:** Changes in working capital serve as a key indicator of a company's operational efficiency. A well-managed business strives to optimize its working capital, ensuring that it maintains sufficient liquidity without overcommitting resources, thus contributing to sustainable financial health.

### Cash Flow Statement

A Cash Flow Statement reveals cash inflows and outflows during the past year, determining the cash balance at the year-end. Derived from previous financial statements, this statement aids management in assessing the actual liquidity position and the company's ability to meet liabilities as they arise. This statement serves as a crucial tool for assessing a company's liquidity, financial flexibility, and overall financial health. Three key aspects of cash flow statements are:

- **Operating Activities:** This section reveals the cash generated or used in the core business operations, including receipts from customers and payments to suppliers and employees.
- **Investing Activities:** Reflects cash flows related to the acquisition and disposal of long-term assets, such as property, equipment, and investments, providing insights into a company's strategic investment decisions.
- **Financing Activities:** Highlights cash flows resulting from activities like issuing or repurchasing stock, borrowing, or repaying debt, offering a perspective on a company's capital structure and its ability to meet financial obligations.

### Accounting Standard 3 (AS-3)

Accounting Standard 3 (AS-3), as issued by the *Institute of Chartered Accountants of India*, plays a pivotal role in financial statement analysis by providing guidelines for the preparation of cash flow statements. This standard categorizes cash flows into three main activities – operating, investing, and financing – offering a comprehensive view of a company's cash management. In the context of financial statement analysis:

- **Operating Activities:** AS-3 helps identify cash flows from the core business operations, shedding light on the company's ability to generate cash from its primary activities.
- **Investing Activities:** It assists in analyzing cash flows related to the acquisition or disposal of assets, aiding in understanding the company's investment decisions and strategies.
- **Financing Activities:** By outlining cash flows from financing, AS-3 provides insights into the company's capital structure, its ability to raise funds, and its commitment to meeting financial obligations.
- **Comparative Analysis:** AS-3 enables analysts to compare cash flows over different periods, facilitating trend analysis and the identification of changes in a company's financial performance.
- **Disclosure Standards:** It sets standards for the disclosure of non-cash transactions, ensuring transparency and completeness in financial reporting.

### Methods For Preparing a Cash Flow Statement

The preparation of a cash flow statement involves two primary methods, the Direct Method and the Indirect Method, both offering distinct approaches to presenting the sources and uses of cash within a specific period.

- ❖ **Direct Method:** This approach directly reports cash inflows and outflows from various operating, investing, and financing activities. It provides a straightforward and transparent view of actual cash transactions.
- ❖ **Indirect Method:** In contrast, the Indirect Method starts with net income and adjusts for non-cash items and changes in working capital to derive the net cash provided by operating activities. While it may be more commonly used due to its alignment with accrual accounting, it requires adjustments that can make interpretation more complex.

The choice between these methods often depends on factors such as the availability of detailed cash transaction records and the preference for simplicity versus adherence to accrual accounting principles. Both methods aim to offer stakeholders a comprehensive understanding of a company's cash position and its ability to generate and manage cash flows effectively.

### Fund Flow Statement:

A Funds Flow Statement is a financial document that delineates the sources and applications of funds within a business, providing insights into changes in working capital over a specific period. This statement is instrumental in financial analysis, helping to understand the reasons behind alterations in a company's financial position. Three key aspects of Funds Flow Statement include:

- **Working Capital Changes:** The statement systematically portrays shifts in working capital, identifying whether the changes result from operational activities or financing decisions
- **Sources and Uses of Funds:** It distinctly delineates between the sources, such as depreciation and funds generated from operations, and the uses, such as capital expenditures or debt repayments, offering a comprehensive view of fund movements.
- **Financial Health Indicator:** By illuminating the reasons for fluctuations in working capital, the Funds Flow Statement serves as a critical indicator of a company's financial health, aiding analysts and decision-makers in assessing liquidity and overall financial stability.

### Ratio Analysis:

Ratio analysis is a fundamental technique in financial statement analysis that involves the calculation and interpretation of various financial ratios to assess a company's performance, profitability, liquidity, and overall financial health. This analytical tool provides valuable insights for stakeholders, enabling informed decision-making. In the context of financial statement analysis:

**Profitability Ratios:** Evaluate a company's ability to generate profits relative to its revenue or assets, including measures like net profit margin and return on equity.

**Liquidity Ratios:** Assess a company's short-term financial viability by examining its ability to meet immediate obligations, often measured through the current ratio and quick ratio.

**Management Efficiency Ratios:** Gauge the efficiency of a company's operations and asset utilization, with metrics like inventory turnover and receivables turnover.

**Solvency or Debt Ratios:** Analyse a company's long-term financial stability and its capacity to meet long-term obligations, including debt-to-equity ratio and interest coverage ratio.

**Relationship Analysis:** Offers a comprehensive understanding of the interplay between different financial statement components, providing a holistic view of a company's financial dynamics.

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