Paper Code : **COC 104**

Module Name : **Nature and Component of Financial Statement, Meaning and Need , Traditional and Modern Approaches, Parties interested in Financial Statement Analysis, Trend Analysis-Meaning, Determination , Interpretation, Uses, Merits & Demerits.**

Module Number : **05**

NOTES

Nature and components of Financial Statements

- Financial Statements are the indicators of two significant factors, namely, the profitability and financial soundness of a business enterprise.
- The components of financial statements are nothing but the balance sheet (which presents the financial position of the organization as at a specified date), income statement (which presents the performance of the organization over the specific period) and cash flow statement (which presents the cash flows that arose to the organization at a specific date from operating, investing and financing activities during the period)
- The components of financial statements are the reports which are prepared by the management of the organization or entity to present the financial performance and financial position at a specific date. These are audited by accountant firms so as to give assurance over the reliability of the financial statements.
- The components of financial statements are analyzed by various stakeholders (i.e. employees, inventors, finance providers, management, shareholders, etc.) of the organization. Each stakeholder has a different perspective of analyzing.
- The components help to calculate the ratios (for example current ratio, inventory turnover ratio, quick ratio, interest expense to earnings ratio, etc.). Each of which has potential to gives important insights about the organization

Financial Statement Analysis

Meaning

Analysis of Financial Statements means a systematic and specialised treatment of the information found in financial statements so as to derive useful conclusions on the profitability and solvency of the business entity concerned. This process involves rearranging, comparing and measuring the significance of financial and operating data.

The analysis of financial statements is a process of evaluating the relationship between component parts of financial statements to obtain a better understanding of the firm's position and performance.
It is the process of selection, relation and evaluation.

Need for Financial Statement Analysis

- Analysis of financial statements help the analyst to know the financial information from the financial data contained in the financial statements and to assess the financial health (i.e. strength or weakness) of an enterprise. It also helps to make a forecast for the future which helps in preparation of budgets and estimates.

- It helps to understand the reasons for relative changes—either in profitability or in the financial position as a whole.
- It helps to know both the short-term liquidity position vis-a-vis working capital position, as also the long-term liquidity and solvency position of a firm.
- It highlights the operating efficiency and the present profit-earning capacity of the firm as a whole.
- Analysis of financial statements helps the management in self- evaluation and self-appraisal

Traditional and Modern approach to Financial Statement Analysis

Traditional Approach:

- Traditional approach to financial statement analysis includes the Profit and Loss Account (i.e. Income Statement) and the Balance Sheet.
- Profit and Loss Account or Income Statement helps us to know the result of the operation at the end of the year. The other statement, viz. the Balance Sheet, helps us to understand the financial position as a whole at the end of the financial year
- Traditional approach to financial statement analysis is neither very reliable nor dependable for the purpose of analysis of financial statements. The detailed information relating to financial information is not available from these statements as they do not exhibit the required material information.

Modern Approach to Financial Statement Analysis:

- Modern approach to financial statement analysis includes Cash Flow Statement, Funds Flow Statement, Ratio Analysis, Budgetary Control etc.
- Under Modern approach to financial statement analysis, in addition to the benefits that are available under traditional approach, the other material information viz. liquidity position, solvency position, profitability and management efficiency position can easily be understood accurately
- These statements are proved to be quite reliable and dependable for the purpose of analysis of financial statements.

Parties interested in Financial Statement Analysis

- **Management**

  Analyses of financial statements help Management determine the effectiveness of their policies and decisions. It analyses the financial statements to know short term and long term solvency position, profitability, liquidity position and return on investment from the business. It also helps them make decisions on important issues like efficient capital utilisation, dividend paying capacity, etc.

- **Bankers and Financial Institutions**

  Banks analyse the financial statements of all companies that apply for credit. The purpose is to judge each company's financial health and decide whether to extend credit or not.

- **Trade Creditors**

  Creditors are interested in analyzing the financial statements in order to know the short term liquidity position of an organization. Creditors analyse the financial statements to know whether the organization is able to pay the amount of short term liabilities on the due date.

- **Shareholders and Investors**

  Shareholders and investors are interested in financial statement analysis to know the profitability of the organization. Profitability shows the growth potentiality of an organization and safety of investment of shareholders, investors and lenders. They analyze the financial statement position to determine the ability to pay interest and repayment of principle amount on due date.

- **Employees**

  The employees have a stake in the outcomes of several management decisions. They are interested in the workings of the company as they are primarily interested in their wages, salaries, bonus, etc. They may also be interested in its financial position and performance to assess company expansion possibilities and career development opportunities.

Techniques of Financial Statement Analysis

- **Common size Statement Analysis**
- **Comparative Statement Analysis**
- **Trend Analysis**

Trend percentage Analysis

Trend percentage as a tool of analysis is used when it is required to analyse the trend of data shown in a series of financial statements of several successive years. The trend obtained by such analysis plays significant role in analyzing the financial stature of the enterprise through base years' performance ratio computation. The trend obtained is expressed as percentages.

This not only reveals the trend movement of the financial performance of the enterprise but also highlights the strengths and weaknesses of the enterprise. This trend ratio is computed for every component for many years which not only facilitates comparison but also guides the firm to understand the trend path of the firm.

Method of calculating Trend percentages

- The financial statements of one financial year should be selected as a base statement.
- Every item in the base statement is stated as 100.
- The trend ratios of subsequent years' financial statements should be calculated by applying the following formula

$$= \frac{\textbf{Absolute figure of item in financial statement under study}}{\textbf{Absolute figure of same item in base financial statement}} \times 100$$

Advantages and Disadvantages of Trend Percentages

Advantages -

- Trend percentages indicate the increase or decrease in an accounted item along with the magnitude of change in percentage, which is more effective than absolute data.
- Trend analyses is very useful for comparative analysis of data in order to measure the financial performances of firm over a period of time and which helps the management to take decisions for the future i.e. it helps to predict the future.

Disadvantages-

- The comparability is unfavourably affected when accounts have not been drawn on a consistent basis and when price level is not consistent. It is difficult to follow a consistent accounting principle and policy particularly when the trends of business accounting are constantly changing.
- Analysis of trend percentage is useless at the time of inflation. Trends of data which are taken for comparison will present a misleading result.
- Danger of selecting the base year which may not be representative, normal and typical. It is not so easy to select the base year. Usually, a normal year is taken as the base year. But it is very difficult to select such a base year for the purpose of ascertaining the trend. Otherwise, comparison or trend analyses will be of no value

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