

Analysis of Financial Statements

Meaning

Financial statements (Income Statement + Balance Sheet) are summarised reports of a company's results and financial position.

Financial Statement Analysis = critical ~~guess~~ evaluation of this information to understand and decide about the firm's operations.

Analysis = simplification of data by methodical classification.

Interpretation = explaining meaning & significance of the data.

Both are complimentary - one is useless without the other.

Two Bases of Comparison

1. Cross-sectional - compare with other firms (inter-firm).
2. Time series - compare a firm's own performance over years (intra-firm).

Aim : estimate past & present position and predict the future condition of the firm.

Significance - Who Uses It

Nature of analysis differs with the purpose of the analyst.

- ① Finance Manager: rational decisions, financial control, reviews deviations.
- ② Top Management: measures success, appraises performance, internal control.
- ③ Trade Payables: judge short-term ability to pay - liquidity position.
- ④ Lenders: long-term solvency, ability to pay interest & principal.
- ⑤ Investors: present & future profitability, capital structure, risk.
- ⑥ Labour Unions: can the firm afford a wage increase?
- ⑦ Others: economists, govt. for price regulation, taxation, research.

Objectives

- assess profitability & operating efficiency
- find relative importance of components
- identify reasons for change in position
- judge ability to repay debt (liquidity)

Tools of Analysis

① Comparative Statements:

show profit/position for 2 or ^{*} more periods side by side. Also = HORIZONTAL analysis.

② Common Size Statements:

each item shown as a % of a common base (brings sizes to a common base). Also = VERTICAL analysis (good for ~~intra~~ inter-firm).

③ Trend Analysis: studies results

over a series of years vs a base year %.

④ Ratio Analysis: relationship between

items of B/S and Statement of P & L.

⑤ Cash Flow Analysis: actual movement

of cash in (inflow) and out (outflow).

Net cash flow = inflow - outflow.

This chapter covers the first three tools;

ratio & cash flow are separate chapters.

Footnote any change in accounting policy.

Comparative Statements

Columns for current year, previous year and the change - in absolute and relative terms.

Steps

1. List absolute figures of 2 periods.
2. Absolute change = Year2 - Year1 ;
mark increase (+) or decrease (-).
3. Percentage change :

$$\% = \text{Abs change} / \text{Yr1} \times 100 \quad \begin{array}{l} = \text{1st yr} \\ \leftarrow \text{base} \end{array}$$

Illustration

BCR Co. Ltd. - Comparative Statement of Profit & Loss (Rs.) :

Rev. from ops 60,00,000 → 75,00,000

$$\text{Abs } +15,00,000 ; \quad \% = 15/60 \times 100 = 25\%$$

Other incomes 1,50,000 → 1,20,000

$$\text{Abs } (30,000) ; \quad \% = (20\%) \quad *$$

Total Revenue 61,50,000 → 76,20,000

$$\text{Abs } +14,70,000 ; \quad \% = 23.90\%$$

Profit before tax 17,50,000 → 25,60,000

$$\text{Abs } +8,10,000 ; \quad \% = 46.29\%$$

Common Size Statements

Every item is expressed as a percentage of a common base item.

$$\% = \text{Item} / \text{Base} \times 100$$

base
← common

Base for P & L = Revenue from operations

Base for Balance Sheet = Total Assets

(or Total of Equity & Liabilities).

Illustration

Common Size Income Statement (2015-16) :

Rev. from ops 25,00,000 = 100% (base)

Cost of goods sold 12,00,000 = ~~48~~ 48%

Gross Profit 13,00,000 = 52%

Operating exp. 1,20,000 = 4.80%

Operating Income 11,80,000 = 47.20% *

Non-operating exp. 15,000 = 0.60%

Profit 11,65,000 = 46.60%

Use : compares 2 firms of different sizes in the same industry on a common base.

Cost of goods sold % rose → margin fell ; a warning sign for the analyst.

Trend Analysis

Studies operational results over a series of years. Each year is shown as a percentage of the same item in the BASE year.

$$\text{Trend \%} = \text{Item} / \text{Base yr} \times 100 \quad \begin{matrix} = 100 \\ \leftarrow \text{base} \end{matrix}$$

Base year is taken as 100. Shows whether an item is rising, falling or constant - points to basic changes in the business.

Limitations of Financial Analysis

1. Ignores price level (inflation) changes.
2. Misleading if accounting ~~policy~~ method changes are not known.
3. Only a study of the company's reports.
4. Considers monetary items only ; non-monetary aspects are ignored.
5. Based on accounting concepts - may not reflect the current position.

Quick Recall

Horizontal = Comparative ; Vertical =

Common Size + Ratios. Both aid decisions.