# A STUDY ON WORTH OF FINANCIAL ANALYSIS THROUGH COMPARATIVE STATEMENTS

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## *Abstract*

*The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'. It is mainly a study of relationship among various financial facts and figures given in a set of financial statements, and the interpretation thereof to gain an insight into the effectiveness and operational efficiency of the firm to assess its financial health and future prospects. Comparative analysis is the study of trend of the same items and computed items into financial statements of the business. The term financial performance is very vibrant term. The subject matter of financial performance has been varying very rapidly. The financial statement analysis commonly involves ratio analysis, common size analysis, trend analysis and industry comparative analysis. This permits the valuation analyst to compare the one company to other businesses in the same or similar industry and to ascertain trends affecting the company or the industry over time. By comparing a company's financial statements in different time periods, the valuation expert can assess growth or decline in revenues or expenses, changes in capital structure, or further financial trends. How the subject company compares to the industry will help with the risk calculation and eventually help determine the discount rate and the selection of market multiples. The term financial analysis is known as "analysis and interpretation of financial statements" states the process of determining financial strength and weakness of the firm by establishing strategic relationship between the items of the Balance Sheet, Income Statement and other operative data. Objective of this study is to know the techniques and worth of the financial statement analysis and to highlight the limitations of it.*

***Keywords:*** *Financial Statement, Financial Analysis, Efficiency, Comparative analysis*

## INTRODUCTION

The financial statements of a business or other entity are formal records and financial activities both in the short and long term business or provide an overview of the financial conditions. Analysis and interpretation of financial statements help liquidity situation, long term refinement

Efficiency, financial viability and profitability of a firm. Financial statements are excitedly awaited by investors, bankers and some other concerns. For them, it is the only source of information they are interested in. By studying these statements, they can observe how well or bad the company has performance in the past year. Besides, these statements help them expose the problems faced by the company and identify actions to be taken to safeguard their own interest. In simple words, analysis means "breakup.", just like dismantling. An analyst would analyze the statements, or carry out reverse-engineering process, in order to make deeper sense of business performance.

The drive of financial analysis is to diagnose the information contained in financial statements so as to observe the profitability and financial soundness of the firm. As these statements are used by investors and financial analysts to inspect the firm's performance in order to make investment decisions, they should be prepared very cautiously and contain as much information as possible. The financial statements are generally equipped from the accounting records maintained by the firm. Financial statement's Comparative study is the comparison of the financial statement of the business with the previous years' financial statements and with the performance of other competitive enterprises, so that weaknesses may be identified and remedial measures applied.

Comparative statements can be prepared for both types of financial statements, Balance sheet as well as Income Statement. The comparative Income Statement will present a assessment of operating activities of the business. The comparative balance sheet shows the effect of operations on the assets and liabilities that change in the financial position during the period under concern. The presentation of comparative financial statements boosts the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. While the single balance sheet represents balances of accounts drawn at the end of an accounting period. The comparative balance sheet represent not nearly the balance of accounts drawn on two different dates, but also the degree of their increase or decrease between these two dates.

## OBJECTIVES

The main purpose of this study is to explain the nature and significance of financial analysis. Objectives of this study in this concern are to:

• identify the objectives of financial analysis;

• define the various tools of financial analysis;

• state the advantages of financial analysis;

• state the limitations of financial analysis;

Financial statement analysis is a judgmental process which aims to estimate current and past financial positions and the results of the operation of a business, with primary objective of determining the best possible approximations and predictions about the future conditions. It essentially involves regrouping and analysis of information delivered by financial statements to establish relationships and throw light on the points of strengths and weaknesses of a business enterprise, which can be advantageous in decision-making involving comparison with other firms and with firms' own performance over a time period.

## Significance of Analysis of Financial Statements

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the various items of the balance sheet and the income statement. The nature of analysis will differ depending on the objective of the analyst. Financial analysis is significant to different users in the following ways:

**Finance manager:** Financial analysis emphases on the facts and relationships related to financial strengths and weaknesses, managerial performance, corporate efficiency and creditworthiness of the company. A finance manager must be well-equipped with the different tools of analysis to make rational decisions for the business. The tools for analysis help in reviewing accounting data so as to determine the continuity of the operating policies, investment value of the business, credit ratings and testing the efficacy of operations. The techniques are similarly important in the area of financial control, enabling the finance manager to make constant reviews of the actual financial operations of the firm to analyse the reasons of major deviations, which may help in corrective action wherever indicated.

**Owners:** Business owners need financial information from their operations to determine whether the business is gainful. It helps in making decisions like whether to stay operating the business, whether to improve business strategies or whether to give away on the business altogether.

**Top management:** The importance of financial analysis is not restricted to the finance manager alone. It has a wide scope which includes top management in general and other functional managers. Management of the firm would be interested in each aspect of the financial analysis. It is their complete responsibility to see that the resources of the firm are used most efficiently and financial condition is sound. Financial analysis helps the management in measuring the success of the company's operations, judging the individual's performance and assessing the system of internal control.

**Trade payables:** Trade payables judge not only the ability of the company to meet its short-term obligations, but also appraise the probability of its continued ability to meet all its financial obligations in future through an analysis of financial statements. Trade payables are chiefly interested in the firm's ability to meet their claims over a short period of time. Their analysis will evaluate the firm's liquidity position.

**Lenders:** Providers of long-term debt are concerned with the firm's long term solvency and survival. They analyse the firm's profitability over a period of time, its ability to produce cash, to be able to pay interest and recompense the principal and the relationship between various sources of funds (capital structure relationships). Long-term lenders analyse the historical financial statements to judge its future solvency and profitability.

**Investors:** Investors invest their money in the firm's shares and they are interested about the firm's earnings. They concentrate on the analysis of the firm's present and future profitability. They are also interested in the firm's capital structure to ascertain its effects on firm's earning and risk. They also evaluate the efficiency of the management and decide whether a change is needed or not.

**Government:** Governing and regulating bodies look at financial statement analysis to determine how the economy is performing in general so that they can plan their financial and industrial policies. Tax authorities also analyze a company's statements to calculate the tax burden that the concern has to pay.

**Employees:** Employees want to know if their employment is secure and if there is a possibility of a pay raise. They want to be up-to-date of their company's profitability and stability. Employees may also be interested in knowing the company's financial position to see whether there may be plans for growth and hence, career prospects for them.

**Customers:** Customers need to know about the capability of the company to service its clients into the future. They need to know about the company's constancy of operations is heightened if the customer (i.e. a distributor or procurer of specialized products) is dependent wholly on the company for its supplies.

**General Public:** Anyone in the general public may be interested in using a company's financial statement analysis. They may desire to evaluate the effects of the firm on the environment, or the economy or even the local community. For instance, if the company is running corporate social responsibility programs for improving the community, the public may want to be aware of the future actions of the company.

**Labour unions:** Labour unions analyse the financial statements to judge whether it can presently afford a wage increase and whether it can absorb a wage increase through increased productivity or by raising the prices.

**Others:** The economists, researchers etc. analyse the financial statements to study the present business and economic conditions. The government agencies need it for price regulations, taxation and other alike purposes.

Financial statements Analysis reveals important facts concerning managerial performance and the efficiency of the firm. The objectives of the analysis are to apprehend the information contained in financial statements with the objective to know the weaknesses and strengths of the firm and to make a forecast about the future prospects of the firm thereby, enabling the analysts to take decisions regarding the operation of and further investment in the firm.

Through the analysis of financial statements of an economist can judge the extent of concentration of economic power and pitfalls in the financial policies pursued. The analysis also offers the basis for many governmental actions relating to licensing, controls, fixing of prices, ceiling on profits, dividend freeze, tax subsidy and other concessions to the corporate sector.

## Tools of Analysis of Financial Statements

The most commonly used techniques of financial analysis are as follows:

**Comparative Statements:** These statements present the profitability and financial position of a firm for different periods of time in a comparative form to give an impression about the position of two or more periods. It generally applies to the two important financial statements, namely, balance sheet and income statement prepared in a comparative form. The comparison of financial data will be worth only when same accounting principles are used in preparing these financial statements. Comparative figures stipulate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analysis'.

Firms and companies apply this with regard to two financial statements i.e. Balance Sheet and Statement of profit and loss. Hence, they prepare these financial statements in the comparative form. The firms need to use the same accounting principles to get a better outcome.

### Format of Comparative Statements

| Particulars | 1st Year | 2nd Year | Change [+ or -] | % Change |
|---|---|---|---|---|
| Column | 1 | 2 | 3 | 4 |

**Common Size Statements:** These are the statements which present the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. This calculated percentage can be simply compared with the results of corresponding percentages of the previous year or of the other firms, as the numbers are brought to common base. Such type of statements allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. In this way common size statements are worthwhile in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for a number of years. This analysis is also known as 'Vertical analysis'.

**Format of Common Size Statement**

| **Particulars** | **1st Year** | **Percentage** | **2nd Year** | **Percentage** |
|---|---|---|---|---|
| Column | 1 | 2 | 3 | 4 |

**Trend Analysis:** This analysis is a technique of reviewing the operational results and financial position over a series of years. Trend analysis can be done to observe the percentage changes over time in particular data by using the previous years' data of a business enterprise,. The trend percentage is that percentage relationship, in which each item of different years stand to the same item in the base year. Trend analysis is a vital analysis because, with its long run view, it can point to basic changes in the nature of the business. By looking at a trend in a specific ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is perceived or the sign of good or bad management is detected. It is a technique of studying the operational results and financial position over a number of years.

**Ratio Analysis:** It describes the significant relationship which occurs between various items of an income statement and position statements of a firm. By way of a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income statement and balance sheet of a firm. Through the technique of ratio analysis, it is possible to assess the liquidity, efficiency, solvency and profitability of an enterprise. Ratio analysis is a course of analyzing and studying the company's financial statement and performance. Ratio analysis is a quantitative analysis in which many factors of company financial performance are assessed like solvency ratios, debt management ratios, liquidity, market value ratio, asset management ratio, profitability, etc.

**Cash Flow Analysis:** It states to the study of actual movement of cash into and out of a business. The flow of cash into the business is termed as positive cash flow or cash inflow and the flow of cash out of the firm is termed as negative cash flow or cash outflow. The difference between the inflow and outflow of the cash is called as net cash flow. Under this technique Cash flow statement is prepared to project the mode in which the cash has been received and the cash has been utilized during an accounting year because it displays the sources of cash receipts and the purposes for which payments are made. Thus, it summarises the grounds for the changes in the cash position of a business organisation between dates of two balance sheets.

## PROBLEMS WITH FINANCIAL STATEMENT ANALYSIS

Financial data documents which a company publishes on an annual, biannual, quarterly or monthly basis fall under financial statements. These documents comprise the company's net worth based on assets and liabilities, as well as the company's incomes, expenses and operational budget. Financial planners, administrators, managers, accountants and senior executives may use financial statements to make decisions regarding future arrangements, growth and expansions as well as product launches, but there are disadvantages of using financial analysis. Some of the issues are:

**Comparability between Companies**

It is a big matter for analysts as they can seemingly compare financial statement analyses between different enterprises on the basis of ratios used, but in actuality it may not paint an accurate picture. The financial ratios of two different enterprises may be compared to see how they match up against each other, but each company may combine all their information different from each other in order to draw up their accounting statements. This may lead to inappropriate conclusions drawn about a company in relation to other companies in the industry.

**Comparability between Periods**

The change in financial records where financial information is stored may skew the consequences of the financial statement analysis, from one period to the next period. For instance if a company records an expense as cost of goods sold in one period, while it is noted as a selling and distribution expense in another period, the analysis between those two periods would not be comparable.

**Operational Information**

Analysts do not take into account operational information of an organisation, as only financial information is examined and reviewed. There may be numerous indicators in operational information of a company which may be predictors of future performance. For example, changes in the culture and work environment any changes in licenses or warranty claims submitted to the company, or the number of backlogged orders. Therefore, analysis of financial information may only convey half the story.

**Inflationary effects**

If the raet of inflation is comparatively high, the amounts associated with assets and liabilities in the balance sheet will appear inordinately low, since they are not being adjusted for inflation.

**No predictive value**

The information in the agreed financial statements provides material about either past results or the financial position of a business as of a specific date. The informations in a set of financial statements do not necessarily provide any value in predicting what will happen in the future. For example, a business could report outstanding results in one month, and no sales at all in the succeeding month, because a contract on which it was relying has ended.

**Not a Substitute of Judgement**

Financial statement analysis cannot take place of sound judgement. It is only a means to reach conclusions. Eventually, the judgements are taken by an interested party or analyst on his or her intelligence and expertise.

## CONCLUSION

Financial analysis is a practice in which we review and analyze the financial statements of a company. Financial analysis is significant for making the accurate financial decisions, and for refining the economic health of an organization. Financial statements are prepared mainly for decision-making. They play a leading role-in setting the framework of management decisions. But it is not wrong to say that the information provided in financial statements is not an end itself because no meaningful conclusions can be drawn from these statements alone. The information delivered by the financial statements is of massive use in making decisions through financial analysis.

Financial Statement Analysis is a process of studying and analyzing a company's accounting reports in order to measure its past, present or projected future performance. This process of reviewing the financial statements permits for healthier economic decision making.

Firms are also obligated to provide their financial statements in their annual report that they have to share with their stakeholders. As financial statements are prepared in order to meet the necessities, the next step in the process is to review and analyze them effectively so that future profitability and cash flows can be predicted. Thus, the main purpose of the analysis of financial statements is to utilize information about the past performance of the company in order to foresee how it will fare in the future. Another important purpose of financial statement analysis is to recognize potential problem areas and troubleshoot those. It is rightly said that Financial statement analysis is the process of reviewing and analyzing the financial statements of a company to make better economic decisions to earn income in future. These financial statements include the income statement, balance sheet, statement of cash flows, notes to accounts and a statement of changes in equity. Financial statement analysis is a practice or process involving specific techniques for assessing risks, performance, financial health, and future projections of an organization. It is used by multiple stakeholders such as credit and equity investors, lenders, the government, the public, and decision-makers within the organization. These various stakeholders have diverse interests and apply a variety of different techniques to encounter their needs. For example, equity investors are interested in the long-term earning power of the organization and possibly the sustainability and progression of dividend payments. On the other side Creditors are interested in ensuring the interest and principal is paid on the organizations debt securities when due. The analysis of financial statement is a wonderful tool to gauge the past performance of a company and forecast future performance, but there are numerous issues that one should be aware of before using the financial statement analysis results blindly, as these issues can obstruct with how the results are interpreted.

## RECOMMENDATION

Accounting and financial reporting systems have improved extensively in recent years. Valuable data for benchmarking and industry comparisons is just a mouse click away. If appropriately analyzed, this enriched financial data enables management to make better operating decisions. However, several companies have not improved the processes used to analyze their interim and annual financial statements and reports. The balance sheet and income statement are only the starting point for fruitful financial management. Applying other financial statement analysis methods is a essential step in analyzing the success, failure and progress of any business. Improved financial statement analysis can be helpful in:

- Locating and correcting accounting errors.
- Identifying areas for business improvement.
- Identifying more problem areas and reacting to problems quickly.
- Better understanding the interrelationship of accounts, which in turn will help to devise better solutions to the problems identified.
- Identifying business opportunities.
- Monitoring success or failure of business initiatives.

There must be uniform accounting methods and policies for numeral years. If there are frequent changes, the records of different periods will be different and incomplete. In this case, analysis has no worth and meaning. Proper consideration regarding this is essential. Other than this the purchasing power of money is reduced from one year to succeeding year because of the inflation. It creates problems in comparative study of financial statements of different years. Relevance of the analysis of financial statements can be enhanced by considering inflationary effects.

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