

Financial statement and Financial Analysis - An overview

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ARTICLE DETAILS

Article History

Published Online: 24 May 2018

Keywords

Financial Information, investors, creditors, owner of firm

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ABSTRACT

Financial Information is the basis for financial planning, analysis and decision-making. It is also useful to different users who are either directly or indirectly interested in firm. Owners of firm, managers, creditors, investors, employees and tax authorities are direct users, whereas, financial analyst, researchers and trade organization are indirect users. A firm communicates financial information to these users through financial statements and report. Financial statements contain summarized information of the firm's financial affairs organized systematically.

Therefore in the present descriptive paper, the author has tried to present theoretical concepts of financial statement, financial analysis and relationship between financial analysis.

1. Concept of Financial Statement:

Financial statements are the end products of the financial accounting process. These statements are nothing but the presentation of financial information about the firm in concise and capsule form. The financial information is that, information which relates to financial position at a moment in time and results of a series of activities over a period of time. Thus, financial statements refer to the statements that show the financial position and results of business activities at the end of the accounting period. These statements reveal the gross and net profits of the business carried on during a certain period and the financial position at the end of that period. To have a clear understanding of the meanings of financial statements, the few definitions of financial statements are given as under:

Meyer Philip E. says that "Accounting has identified wealth and performance as phenomena for which measurement and communication are warranted. Wealth is measured by direct attention to an entity's owners' equity and performance is measured by focusing on the effect of an entity's operating transactions on its owners' equity. The medium through which such information is communicated is known as Financial Statement".

John N. Nyerdefines it, "Financial statements provide a summary of the accounting of a business enterprise, the balance-sheet reflecting the assets, liabilities and capital as on a certain data and the income statement showing the results of operations during a certain period".

According to Monga J.R., "The financial statement are the end products of the accounting process starting from the communicated of business transactions expressed in money values".

2. Objectives of Financial Statement:

Financial statements serve as horoscopes of a business as they enable readers to measure financial position of the concern. Such statements contain sufficient valuable

information about various aspects of business that can be useful for business decisions.

The prime objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. Therefore, every firm prepares the following financial statements:

- 2.1 Balance-sheet
- 2.2 Income Statements
- 2.3 Statements of Retained Earnings
- 2.4 Statements of Sources and use of Funds
- 2.5 Supplementary Statements

3. Nature of Financial Statement

Financial statements are prepared for the purpose of presenting a periodical review or report on the progress made by the firm to the management. These statements deal with the status of investments in the business and the results achieved during the period under review. The American Institute of Certified Public Accountants States that "Financial statements reflect a combination of recorded facts, accounting conventions and personal judgments and conventions applied affect them materially". Therefore, the data exhibited in these financial statements are the result of the combined effect of

- 3.1 Recorded Facts
- 3.2 Accounting Conventions
- 3.3 Personal Judgment

4. Limitations of Financial Statement

Financial statements have the appearance of completeness, exactness and finality. However these statements have certain limitations which are as follows:

- Information given by financial statements is historical in nature. The recorded value of assets of the date of balance-sheet does not reflect the value of assets in future when the business is liquidated.

- Financial statements do not depict facts which cannot be expressed in terms of money, because many factors which affect materially financial condition and operating results cannot be expressed in monetary terms.
- Financial statements are prepared on the basis of certain accounting and conventional procedures developed by the accounting profession through many years of experience; the financial position as disclosed by these statements may not always be realistic.
- The net income shown in the income statement is not absolute but relative dependent as it on particular conventional procedures used in its accounting by the enterprise.
- Profit and loss account and balance-sheet reflect rupee value of transaction of different dates and the value of rupee is quite fluctuating, as such conclusions drawn on the basis of financial statements may prove to be misleading.

5. Concepts of Financial Analysis

“Analysis of financial statements is the systematic numerical calculation of the relationship between one fact the other to measure the profitability, operational efficiency and growth potential of the business”. The analysis of such statements provides valuable information for managerial decision. Thus, the analysis of financial statements is basically a study of the relationship among various financial fact and figures as given in a set these statements. The basic financial statement i.e. balance-sheet and income statements, contain a whole lot of historical data. The complex figures, as given in these financial statements, are broken into simple and valuable elements and significant relationships are established between the elements of the same statements or different financial statements with the help of various techniques of financial analysis.

In the word of Metcaff and Titard, “Analysis of the financial statements is a process of evaluating the relationship between component parts of financial statements to obtain a better understanding of a firm’s position and performance”.

6. Significance of Financial Analysis

The analysis of financial data highlights upon the significant facts and relationships concerning various aspects of financial life of business entity. So, every person who has interest in business entity likes to take decisions based on analyzed financial statements. The following factors enhance the significance of the analysis and interpretation of financial statements:

6.1 Disclosure of Facts: With the help of financial analysis, all facts relating to liquidity, position, financing of fixed assets, credit policy and quantum of working capital, solvency and valuation of assets are made available. Thus, as a result of analysis, all undisclosed facts come to light for the benefits of all concerned parties.

6.2 Effective Planning and Control: The analysis of financial statements provides adequate information for

planning and controlling the affairs of the business. Future forecasts can easily be made by analyzing the past data with help of information. The management can take corrective actions by drawing interfaces about routine activities.

6.3 Measures operational Efficiency: The management and the owners are interested in knowing about the operational efficiency of different activities of the concern. This can be judge by calculating different activity and profitability ratios.

6.4 Comparative study: With the help of financial analysis, business information and facts can be presented comparatively. Such presentation is made either in the form of last few years, showing position of the business or comparison of operating activities with other business engaged in the same industry. Thus, financial analysis is helpful in the comparative study of business efficiency.

7. Limitations of Financial Analysis

Financial analysis has certain limitations which are as follows:

- Financial statements suffer from variety of weakness. Such as assets are disclosed in the balance-sheet as historical cost which is different from current cost. Financial statements suffer from these weakness, hence the analysis based upon these statements cannot be said to be always reliable.
- Accounting is not an exact science, so it does not comprise universally accepted terminology. Different meanings are assigned to a particular term. Depreciation is provided by different methods and interest is changed at varied rates. In this way, there are a lot of changes of manipulation. As a result, financial analysis may be proved to be defective.
- Financial analysis is the quantitative measurement of the performance of the firm. It does not disclose the skill, technical know-how and the efficiency of its employees and managers. It means that analysis of financial statements measures only the financial performance of the business. It completely ignores human aspect.
- The results disclosed by financial statements may be misleading, if the price level changes are not taken into consideration. The gross profit ratio may improve with the increase in prices, whereas, actual efficiency may not improve. If prices of commodities differ, the ratio of two year will not be meaningful for comparison. Changes in price affect cost of production, sales and values of assets; thereby comparability of ratios suffers.
- Financial analysis shows the trend of the affairs of business. It may spot symptoms of financial weakness and operational inefficiency which cannot be accepted. A final decision in this regard

will require further investigation and thorough diagnosis.

8. Relationship between Financial Statement and Financial Analysis

Financial statements are only the mean providing general information regarding operational result and financial position of a business firm. These statements merely contain financial data about business events which do not reveal any significant conclusions such as efficiency of the management, strength and weakness of the firm, index of future progress etc. Therefore, their meaning and significance cannot be known till their users do not analysis and interpreter them for their specific purpose. Financial analysis is a multipurpose and multidimensional technique which involves a systematic and careful examination of information contained in the financial statements for a certain period. The use of this technique is art which requires pertinent knowledge, experience and intuition for its development.

Financial analysis refers to the progress of the critical examination of the financial information contained in the financial statements in order to understand and make decision regarding the operations of the firm. The financial analysis is basically a study of the relationship among various financial facts and figure as given in a set of financial statements. The basic financial statements contain a whole of lot of historical data. The complex figures as given in these financial statements are deselected/ broken up into simple and valuables elements and significant relationship are established between the elements of the same statement or different financial statements. This process of dissection, establishing relationship and interpretation thereof to understand the working and financial position of a firm is called the financial analysis.

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