

Objective and Tools for Financial Statement Analysis

Financial statement analysis is all about understanding a company's financial health by examining its financial documents, like the balance sheet and profit & loss statement.

Here's a simple breakdown of why we analyze financial statements:

1. Check How Well the Company is Doing:

- We look at whether the company is making money and how efficiently it's running. This helps us see if the business is healthy overall.

2. Understand What the Company Owns and Owes:

- By analyzing the financial statements, we can see what the company owns (like cash and equipment) and what it owes (like loans). This helps us figure out how strong the company's financial position is.

3. Find Out Why Profits are Changing:

- If the company's profits go up or down, analysis helps us understand why this is happening. Knowing the reasons can help the company improve in the future.

4. See If the Company Can Pay Its Debts:

- We also check if the company can pay back its loans and other debts, both in the short term (like paying bills) and in the long term (like repaying big loans).

5. Help Make Economic Decisions:

- Governments and economists use financial analysis to decide on rules, like setting prices or offering tax benefits, to ensure companies are fair and competitive.

Tools of Analysis of Financial Statements

1. Comparative Statements:

- **What It Is:** These statements compare the financial position and profitability of a firm over different periods.

- **Why It's Useful:** By looking at figures from different periods side by side, you can see trends and changes. For example, you can compare the sales revenue of the current year with the previous year to see if the company is growing or shrinking.

- **Also Known As:** Horizontal Analysis.

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Company ABC Comparative Balance Sheet		
Particulars	2020 (Amount)	2022 (Amount)
ASSETS		
Current assets		
Cash and cash equivalents	\$3,000	\$8,000
Short-term investments	\$17,000	\$14,000
Account receivable-net	\$36,000	\$30,000
Inventory	\$25,000	\$36,000
Supplies	\$38,000	\$10,000
Total current assets	\$89,000	\$98,000
Property, plants & equipments	\$249,000	\$340,000
Other assets including intangible assets	\$300,000	\$500,000
Total assets	\$668,000	\$938,000
LIABILITIES		
Current liabilities	\$177,000	202,250
Long-term liabilities	\$141,000	208,250
Total liabilities	\$318,000	\$410,500
STOCKHOLDERS EQUITY	\$350,000	\$527,500
Total liabilities and stockholder's equity	\$668,000	\$938,000

2. Trend Analysis:

- **What It Is:** This technique studies the changes in financial data over a series of years. It shows how specific items in the financial statements have increased or decreased over time.
- **Why It's Useful:** Trend analysis helps you identify long-term patterns in the company's performance, which can indicate whether the company is improving, declining, or remaining stable.
- **Example:** If sales have been increasing by 10% every year, this trend might suggest that the company is expanding.

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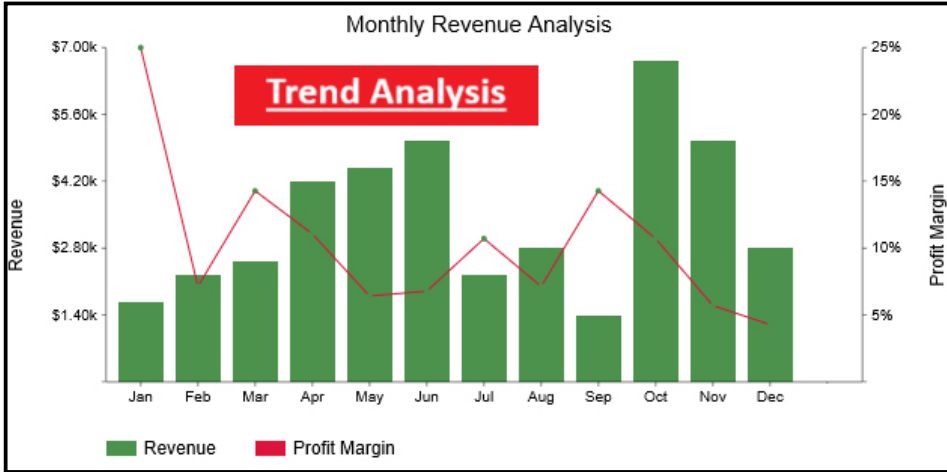
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3. Ratio Analysis:

- **What It Is:** Ratio analysis involves calculating the relationships between different items in the financial statements. Common ratios include profit margins, return on assets, and debt-to-equity ratios.
- **Why It's Useful:** Ratios help assess a company's profitability, efficiency, and financial health. For example, a high debt-to-equity ratio might indicate that a company is heavily reliant on borrowing.
- **Example:** A profit margin ratio compares the net profit to sales, showing how much profit is made for each rupee of sales.

Liquidity Ratio:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Profitability Ratio:

$$\text{Net Margin} = \frac{\text{Net Income}}{\text{Sales}}$$

Liquidity Ratio:

$$\text{Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Total Assets}}$$

Solvency Ratio:

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$