Exploring the Techniques of Financial Statement Analysis in Business Decision-Making

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ABSTRACT

Financial statements are vital documents that present the overall financial health of a business. Their primary purpose is to provide reliable information for understanding the operational and financial aspects of a firm. Effective preparation and analysis of these statements are as important as financial decision-making itself, as they form the basis for evaluating profitability, liquidity, and long-term stability. Financial statement analysis involves techniques such as comparative analysis, trend analysis, vertical and horizontal analysis, and cash flow examination, which together help managers, investors, and stakeholders assess performance and make informed decisions. This paper explores the various techniques of financial statement analysis and highlights their significance in guiding sound business and financial decisions.

Index Terms: financial statement analysis, techniques, decision-making

I. INTRODUCTION

It may show a position at a moment of time as in the case of a balance-sheet or may reveal a service of activities over a given period of time, as in the case of an income statement.

Income Statement

Income statement is also called as profit and loss account, which reflects the operational position of the firm during a particular period. Normally it consists of one accounting year. It determines the entire operational performance of the concern like total revenue generated and expenses incurred for earning that revenue.

Income statement helps to ascertain the gross profit and net profit of the concern. Gross profit is determined by preparation of trading or manufacturing a/c and net profit is determined by preparation of profit and loss account.

Position Statement

Position statement is also called as balance sheet, which reflects the financial position of the firm at the end of the financial year.

Position statement helps to ascertain and understand the total assets, liabilities and capital of the firm. One can understand the strength and weakness of the concern with the help of the position statement.

Statement of Changes in Owner’s Equity

It is also called as statement of retained earnings. This statement provides information about the changes or position of owner’s equity in the company. How the retained earnings are employed in the business concern. Nowadays, preparation of this statement is not popular and nobody is going to prepare the separate statement of changes in owner’s equity.

Statement of Changes in Financial Position

Income statement and position statement shows only about the position of the finance, hence it can't measure the actual position of the financial statement. Statement of changes in financial position helps to understand the changes in financial position from one period to another period.

Statement of changes in financial position involves two important areas such as fund flow statement which involves the changes in working capital position and cash flow statement which involves the changes in cash position.

II. TYPES OF FINANCIAL STATEMENT ANALYSIS

Analysis of Financial Statement is also necessary to understand the financial positions during a particular period. According to Myres, "Financial statement analysis is largely a study of the relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trend of these factors as shown in a series of statements".

Analysis of financial statement may be broadly classified into two important types on the basis of material used and methods of operations.

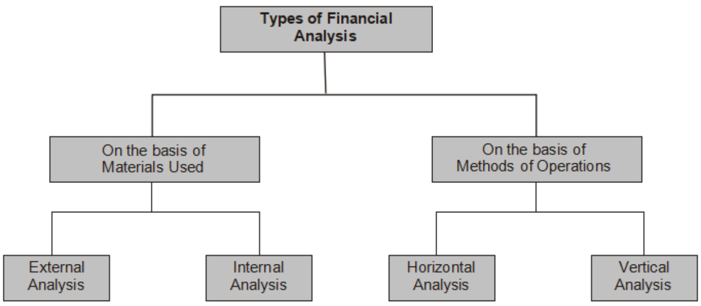

Figure 1: Types of Financial Statement Analysis

1. Based on Material Used

Based on the material used, financial statement analysis may be classified into two major types such as External analysis and internal analysis.

A. External Analysis

Outsiders of the business concern do normally external analyses but they are indirectly involved in the business concern such as investors, creditors, government organizations and other credit agencies. External analysis is very much useful to understand the financial and operational position of the business concern. External analysis mainly depends on the published financial statement of the concern. This analysis provides only limited information about the business concern.

B. Internal Analysis

The company itself does disclose some of the valuable informations to the business concern in this type of analysis. This analysis is used to understand the operational performances of each and every department and unit of the business concern. Internal analysis helps to take decisions regarding achieving the goals of the business concern.

2. Based on Method of Operation

Based on the methods of operation, financial statement analysis may be classified into two major types such as horizontal analysis and vertical analysis.

A. Horizontal Analysis

Under the horizontal analysis, financial statements are compared with several years and based on that, a firm may take decisions. Normally, the current year's figures are compared with the base year (base year is consider as 100) and how the financial information are changed from one year to another. This analysis is also called as dynamic analysis.

B. Vertical Analysis

Under the vertical analysis, financial statements measure the quantities relationship of the various items in the financial statement on a particular period. It is also called as static analysis, because, this analysis helps to determine the relationship with various items appeared in the financial statement. For example, a sale is assumed as 100 and other items are converted into sales figures.

III. TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS

Financial statement analysis is interpreted mainly to determine the financial and operational performance of the business concern. A number of methods or techniques are used to analyse the financial statement of the business concern. The following are the common methods or techniques, which are widely used by the business concern.

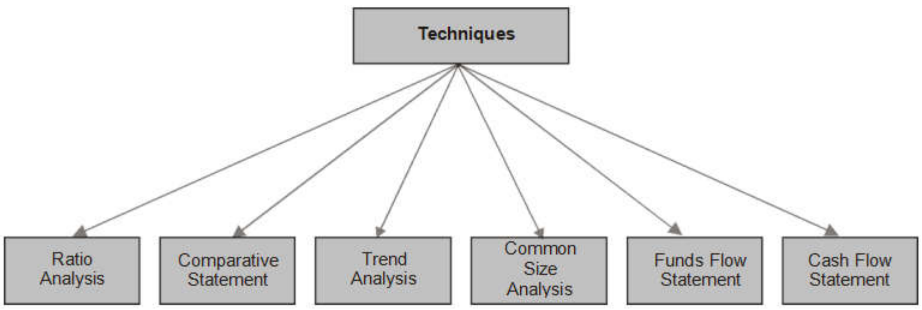

Figure 2: Techniques of Financial Statement Analysis

Comparative Statement Analysis

Comparative statement analysis is an analysis of financial statement at different period of time. This statement helps to understand the comparative position of financial and operational performance at different period of time.

Comparative financial statements again classified into two major parts such as comparative balance sheet analysis and comparative profit and loss account analysis.

Comparative Balance Sheet Analysis

Comparative balance sheet analysis concentrates only the balance sheet of the concern at different period of time. Under this analysis the balance sheets are compared with previous year's figures or one-year balance sheet figures are compared with other years. Comparative balance sheet analysis may be horizontal or vertical basis. This type of analysis helps to understand the real financial position of the concern as well as how the assets, liabilities and capitals are placed during a particular period.

Comparative Profit and Loss Account Analysis

Another comparative financial statement analysis is comparative profit and loss account analysis. Under this analysis, only profit and loss account is taken to compare with previous year's figure or compare within the statement. This analysis helps to understand the operational performance of the business concern in a given period. It may be analyzed on horizontal basis or vertical basis.

Trend Analysis

The financial statements may be analysed by computing trends of series of information. It may be upward or downward directions which involve the percentage relationship of each and every item of the statement with the common value of 100%. Trend analysis helps to understand the trend relationship with various items, which appear in the financial statements. These percentages may also be taken as index number showing relative changes in the financial information resulting with the various period of time. In this analysis, only major items are considered for calculating the trend percentage.

CASH FLOW STATEMENT

Cash flow statement is a statement which shows the sources of cash inflow and uses of cash out-flow of the business concern during a particular period of time. It is the statement, which involves only short-term financial position of the business concern. Cash flow statement provides a summary of operating, investment and financing cash flows and reconciles them with changes in its cash and cash equivalents such as marketable securities. Institute of Chartered Accountants of India issued the Accounting Standard (AS-3) related to the preparation of cash flow statement in 1998.

Difference Between Funds Flow and Cash Flow Statement

Funds Flow Statement	Cash Flow Statement
1. Funds flow statement is the report on the movement of funds or working capital	1. Cash flow statement is the report showing sources and uses of cash.
2. Funds flow statement explains how working capital is raised and used during the particular	2. Cash flow statement explains the inflow and out flow of cash during the particular period.
3. The main objective of fund flow statement is to show the how the resources have been balanced mobilized and used.	3. The main objective of the cash flow statement is to show the causes of changes in cash between two balance sheet dates.
4. Funds flow statement indicates the results of current financial management.	4. Cash flow statement indicates the factors contributing to the reduction of cash balance in spite of increase in profit and vice-versa.
5. In a funds flow statement increase or decrease in working capital is recorded.	5. In a cash flow statement only cash receipt and payments are recorded.
6. In funds flow statement there is no opening and closing balances.	6. Cash flow statement starts with opening cash balance and ends with closing cash balance.

IV. CONCLUSION

The profit maximization objective has, however, been criticized in recent years. It is argued that profit maximization is a consequence of perfect competition, and in the face of imperfect modern markets, it cannot be a legitimate objective of the firm. It is also argued that profit maximization, as a business objective, was developed in the early of 19th century, when the characteristic features of the business structure were self-financing, private property and single entrepreneurship. The only aim of sole proprietor then was to enhance his individual wealth and personal power, which could easily be satisfied by the profit maximization objective. The modern business environment has the features of limited liability and a divorce between management and ownership.

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