**EXPLORING THE CONCEPTS OF FINANCIAL STATEMENT ANALYSIS**

**Jebarson J¹ , Navenna M²**

¹B.Com Student, School of Arts, Humanities and Management, Jeppiaar University, Chennai, India.

²Assistant Professor, School of Arts, Humanities and Management, Jeppiaar University, Chennai, India.

**ABSTRACT**

This study's main goal is to analyze, predict, and appraise a company's financial situation and performance in order to inform future choices. Analyzing financial accounts to offer insightful information that helps finance managers make strategic and well-informed corporate decisions is another important goal. A variety of instruments, analytical approaches, and methodologies are used in financial statement analysis to evaluate different facets of a company. In addition to being an essential tool for management and strategic decision-making, it also acts as a diagnostic tool for assessing funding, investment, and operational operations. Many stakeholders, including managers, shareholders, investors, and others curious about the company's financial situation, use this analysis. Financial reports are used by managers to evaluate the company's current state and to tell shareholders about the effectiveness of their investments. Financial statement analysis is essential for prospective investors since it enables them to comprehend the company's present financial situation and make well-informed investment choices. **Key words**: Financial Statement Analysis, Profit and Loss Account, Balance Sheet,Internal Analysis, External Analysis, Vertical Analysis, Horizontal Analysis, Common Size Statement

**1. INTRODUCTION**

Business transactions are systematically recorded, categorized, and summarized as part of the accounting process. Highlighting the company's financial standing and profitability is the aim of the summary stage. The financial statements, which are the process's final output, provide important information on the state and performance of a company's finances. But the real worth of financial statements is found in their efficient analysis and interpretation, not only in their production. Financial statements are instruments for greater understanding rather than a goal unto themselves. Financial statement analysis and interpretation is the act of thoroughly and intelligently examining these statements to reveal the true financial health and performance of an organization.

**Meaning and Definition**

Hampton John claims that financial statements are a rational and consistent collection of data arranged in accordance with accounting standards. Their main objective is to give a comprehensive picture of the financial status of a company. A financial statement might show a series of events over a specified period of time, as in an income statement, or it can show a precise point in time, as in a balance sheet. In essence, these statements provide insightful information to internal and external stakeholders by summarizing the accounting process. In a similar vein, John N. Nyer describes financial statements as "a summary of the accounting of a business enterprise, with the balance sheet reflecting assets, liabilities, and capital as of a specific date, and the income statement presenting the operational results over a particular period." Financial statements usually consist of two important reports:

(A)The Profit and Loss Account or Income Statement

(B) The Position Statement or Balance Sheet

A company organization may additionally create additional financial reports in addition to these core statements for crucial internal uses, such as:

(C) The Owner’s Equity Changes Statement

(D) The Financial Position Changes Statement

**Types of Financial Statement Analysis**

To comprehend a company's financial status throughout a given time period, financial statement analysis is crucial. The study of the links between different financial aspects in a corporation as shown by a single set of statements, as well as the trends of these factors as reflected across a period of statements, constitutes the majority of financial statement analysis, according to Myres. Based on the materials used and the analysis techniques employed, financial statement analysis can be broadly divided into two types.

**2. BASED ON MATERIAL**

Financial statement analysis can be divided into two main categories based on the materials used: internal analysis and external analysis.

* **External Analysis**:

Usually, people or organizations outside the company such as creditors, investors, government organizations, and other financial institutions conduct external analysis. These parties rely on outside analysis to evaluate the company's operational and financial health even though they are not directly involved in the day-to-day operations of the organization. This kind of study offers little insight into the inner workings of the company because it mostly relies on the organization's publicly available financial statements.

* **Internal Analysis:**

Internal analysis uses specific, frequently private financial and operational data and is carried out inside the company. This kind of analysis gives the management a better grasp of the internal workings of the business and aids in assessing the performance of various divisions and units. When it comes to making strategic decisions and creating plans to accomplish the business's overall goals, internal analysis is essential.

1. **Based on Method of Operation**

Financial statement analysis can be roughly classified into two types based on operational methods: vertical analysis and horizontal analysis.

* + - **Horizontal Analysis:**

To find patterns and shifts in financial performance, horizontal analysis compares financial accounts over several years. The current year’s numbers are typically compared to those of a base year, which is typically given a value of 100. This approach makes it easier to comprehend how certain financial components have changed over time. Horizontal analysis is sometimes known as dynamic analysis because of its emphasis on changes throughout time.

* + - **Vertical Analysis:**

The proportional relationships between different items within a single financial statement for a certain period are examined via vertical analysis. Because it concentrates on examining the structure of financial data at a specific moment in time, it is also referred to as static analysis. Every item in the statement is represented as a percentage of a base amount using this manner. All other factors, such earnings and expenses, are shown as a % of sales, for instance, if sales are regarded as 100. This makes it simple to compare and assess the financial structure.

**Parties interested in Financial Statements**

Because more and more stakeholders are interested in a company’s financial success, financial statement analysis has become increasingly important. The following are the main parties with an interest in financial statement analysis:

**Investors:**

The general well-being and prosperity of the company are the top priorities for owners or shareholders. They want to know the company's earning potential as well as its prospects for expansion and profitability in the future.

**Management:**

The enterprise's overall performance and financial status, as well as the performance of its many divisions, are of great importance to management. They may prepare budgets, plan strategically, and assess departmental managers' efficacy with the use of financial statement analysis.

**Trade unions:**

The financial statements are important to workers and labor unions because they use them to bargain with management over pay, benefits, and bonuses. The terms of these agreements are frequently influenced by the company's financial situation.

**Lenders:**

Assessing the company's short- and long-term solvency is of importance to lenders, including debenture holders, loan providers, and leasing firms. They can assess the company's capacity to pay off debt and maintain financial stability with the aid of financial statements.

**Suppliers and trade creditors:**

The solvency of the company, in particular its capacity to fulfill financial commitments and pay off debts when they become due, is of significance to suppliers and other creditors.

**Tax authorities:**

In order to evaluate the company's financial performance and ascertain its tax due, tax authorities examine financial accounts.

**Researchers:**

For the purpose of studying and analyzing business operations, trends, and practices, researchers are interested in financial statements.

**Employees:**

Because it gives them the foundation to demand greater pay and a more positive work environment, employees are interested in learning about the company’s profit development.

**3. OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS**

* To assess the company's profitability or earning potential.
* To evaluate management efficacy and operational efficiency
* To assess the company's long-term and short-term solvency positions.
* To determine the elements influencing shifts in financial position and profitability.
* To use income statements to evaluate the earning potential and effectiveness of different business operations.
* To assess the efficacy of managers in various business contexts.
* To assess several departments' performance over time. should use the balance sheet to evaluate both short-term and long-term solvency.
* To investigate the funding sources and the ways in which available monies are being used. to ascertain the company's earning potential and chances for future expansion.
* To evaluate how fixed assets are used and how they contribute to the company's ability to make money.
* To look into the company’s possibilities for the future.
* To evaluate the operational effectiveness of comparable companies in the same sector.
* To determine the company organization’s growth tendencies.

**4. TOOLS OF ANALYSIS OF FINANCIAL STATEMENTS**

1. **Comparative Statements:** An evaluation of the firm’s position across two or more periods is made possible by these statements, which compare the profitability and financial status of a company over several time periods. The balance sheet and the profit and loss statement are the two main financial statements that are usually subjected to this method. These statements must be prepared using the same accounting rules in order for the data to be genuinely comparable. Any disparities should be noted in a footnote if different principles are used. Trends and the direction of the financial situation and operating performance are shown by comparative figures. Another name for this type of analysis is horizontal analysis.
2. **Common Size Statements:** By representing each item in a financial statement as a percentage of a common basis, these statements show how various items relate to one another. Because the numbers are normalized to a similar foundation, this procedure makes it simple to compare these percentages with those from prior years or other firms. Analysts can evaluate the financial and operational traits of two businesses of varying sizes in the same industry by using common size statements. Common size statements are therefore useful for comparisons inside the same firm over a number of years as well as comparisons across firms for the same year or over a number of years. Another name for this kind of investigation is vertical analysis.
3. **Trend Analysis:** Trend analysis is a method for analyzing a company's financial status and operational outcomes over a number of years. Trend analysis assists in determining percentage changes in specific financial items over time by examining data from prior years. The relationship between each item in various years and the same thing in the base year is shown by the trend %. This approach is useful because it provides a long-term view, which aids in identifying significant shifts in the character of the company. One can determine if a certain ratio is rising, falling, or staying the same by looking for trends in it. Potential problems or indications of good or bad management may be shown by this analysis.
4. **Ratio Analysis:** Ratio analysis draws attention to the important connections between different components in a company’s profit and loss statement and balance sheet. It assesses the relative importance of each component in these financial statements as a method of financial analysis. One can efficiently assess an organization’s operational efficiency, solvency, and profitability by employing ratio analysis.
5. **Cash Flow Analysis:** The actual flow of money into and out of a business is the main subject of cash flow analysis. Cash inflow, also known as positive cash flow, is money coming into the company; cash outflow, also known as negative cash flow, is money going out of the company. Net cash flow is the net difference between inflows and outflows. To demonstrate how money has been collected and spent over an accounting period, a cash flow statement is created, emphasizing the sources of funds as well as the uses for which they were allocated. The explanations for variations in a company's cash position between two balance sheet dates are succinctly summed up in this statement.
6. **Fund Flow Statement:** Robert Anthony claims that a fund flow statement shows where money comes from and how it is used inside a company. It assists in determining the causes of variations in working capital over a certain time frame. Applications of money are transactions that raise working capital, whereas sources of funds are transactions that lower working capital. Also known as the document of Sources and Application of Funds or the Statement of Changes in Financial Position, this document illustrates the flow and modifications in working capital. Because it aims to explain how monies were earned and used, it is frequently referred to informally as the "How Come and Where Gone" Statement.

**5. LIMITATIONS OF FINANCIAL STATEMENTS ANALYSIS**

Although beneficial, the examination of financial statements is subject to certain constraints, as delineated below:

1. Financial Statement Inaccuracy: Any interpretation or analysis based on financial statements that are not created accurately may not be trustworthy
2. Effect of Regulatory Changes: Regular modifications to laws, rules, and controls may have an impact on how financial statements are prepared and, consequently, how they are analyzed.
3. Alternative Accounting Treatments: The effectiveness and comparability of financial analysis may be limited by the existence of different accounting techniques permitted by accounting rules.
4. Analyst Expertise: The proficiency and background of the individuals performing the analysis have a significant impact on it quality. Inaccurate interpretations may result from a lack of experience.
5. Legal Provision Changes: Modifications to the Companies Act or other relevant laws may have an effect on the structure, disclosures, and accuracy of financial statements, which may have an effect on the caliber of analysis

**6. CONCLUSION**

In conclusion, as financial statements offer a clear and thorough picture of a company’s financial performance and health, examining them is an essential first step before making important business decisions. They provide insightful information about solvency, liquidity, profitability, and general financial stability. Stakeholders can evaluate current and historical financial circumstances, identify patterns, and project future performance by looking at the cash flow, balance sheet, and income statement. These statements’ key financial ratios and indicators promote wise and strategic decision-making by assisting in the identification of possible risks and opportunities. In the end, a thorough examination of financial accounts is necessary to fully comprehend a company’s financial situation and make wise, responsible decisions.

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