



— THE CONCEPT OF

# FINANCIAL ANALYSIS

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# THE CONCEPT OF FINANCIAL ANALYSIS IN DETAIL

Financial analysis is the assessment of business entities, projects, budgets, and forecasts from a financial perspective by analyzing the data from financial statements. The main purpose is to check the effectiveness of funds employed in the firm by analyzing the efficiency of operations and financing activities using a data-backed approach.

Financial analysis plays a catalyst role in decision making related to investing and financing activities. This interpretation of financial statements helps to understand the characteristics of important operational and financial activities undertaken by the organization.

The process involves financial ratio analysis and interpretation of financial statements. Methodological classification of data for simplification of given financial data represents the analysis part. The explanation of the simplified data and its utility for the organization represents the financial data interpretation part.



# EXTERNAL AND INTERNAL ANALYSIS

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## External Analysis

External analysis can be defined when the parties conducting the analysis are alien to the entity's management. The management of the entity does not have any authority over them and do not take any active part in the process. The investors, shareholders, government agencies, credit agencies are among the external/ outsiders to the organization. The financial analysis conducted by them is called as external analysis. The typical objectives of external analysis are to investigate the liquidity of assets and the ability to generate funds. These observations help in deciding whether it is fruitful to invest in the entity or not. It also helps to make decisions at the time of granting credits and loans to the entity.



# EXTERNAL AND INTERNAL ANALYSIS

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## Internal Analysis

Internal analysis is conducted by the management of the entity through their accounting and finance departments. This type of analysis takes place periodically to ensure that the business functions are in synchronization with the planned goals. The observation helps in deciding whether the business will be able to generate sufficient funds or to make investment decisions related to the purchase or lease of an asset. The conclusions will forecast how much the business can generate as returns on the invested capital.





# THE OBJECTIVE OF THE FINANCIAL ANALYSIS

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The main objective of the whole procedure is to obtain the desired information for the decision-makers about the business entity.

The broad objective of the financial analysis is to determine the profitability potential and financial position of the firm. A comprehensive study of the cause and effect of financial activities and operational activities is undertaken under this process.

Financial statement analysis helps to examine the past performance of the organization under the financial lens. This examination helps to determine the strengths and weaknesses of the company's operations and cash utilization strategies. Moreover, it helps to establish an account for future risks and opportunities for the entity.

However, different parties utilize the analysis of financial statements according to their interests. Financial performance analysis helps potential investors to determine the profit-generating ability of the firm for making an investment decision or portfolio decisions. The debenture holder or loan provider may be more interested in the creditworthiness of the firm. The management of the organization will be more interested in understanding the efficiency and effectiveness of operational activities as well as the financial standing of the firm. Moreover, even the employees and labor unions take financial analysis into consideration to determine the economic stability<sup>[2]</sup> and potential of the enterprise.

# OBJECTIVES OF FINANCIAL ANALYSIS

- Find out the state of financial affairs of the company.
- Evaluation of earning potential of the company.
- Evaluate the value of assets and liabilities of the company.
- To know about the future growth projection of the company.
- To analyze the efficiency of funds employed in the company.
- To know about the operational efficiency of the company.
- To carry on concerned activities or stop them To Make investing and financing decision



# PROCESS OF FINANCIAL ANALYSIS



The first step to begin the financial analysis process is to determine the objective of conducting the same. For example, whether the analysis is taking place for the granting of loans and advances or making an investment in the entity being audited for the financial analysis.

The financial data is analyzed based on the purpose of analysis. The data is analyzed and interpreted to suit the needs of the objective. Drawing a conclusion from interpreted data is the last mile goal of the process.

The financial analysis should not only include the financial statements but also include the notes given with reference to the statements and auditor's report. The report certifies that the statements were audited by following standard accounting procedures. The notes brief about the accounting policies of the company and how they were taken into consideration while preparation of the statements.

# CHARACTERISTICS OF A GOOD FINANCIAL ANALYST

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There are certain qualities that can be used to establish standards for an eligible analyst for conducting financial analysis. These are as follows:

- The person must be aware of the business practices of the entity.
- He understands the nature and applicability of accounting standards taken in practice for the analysis.
- The person must be having knowledge about the business terminology and nature of the business transaction.
- The person must be acquainted with the tools and techniques of financial analysis.





# TYPES OF FINANCIAL ANALYSIS

There are several types of financial analyses that take place as per the requirements of the objective of analysis.

## Vertical Analysis

The vertical analysis is also known as the common size statement. The articles of the income statements are matched with total revenue from sales and then divided to obtain a percentage fraction keeping the amount of sales revenue as the base figure. Similarly, in the Balance Sheet, the items given on each side represented by assets and liabilities are individually compared to total assets and total liabilities in percentage fraction of the base figure.



# Vertical Analysis

Village Shipping Inc. Income Statement Vertical Analysis For the years ending December 31, 2014 and December 31, 2015				
	2014		2015	
Sales	500,000	100.00%	475,000	100.00%
Cost of goods sold	<u>269,000</u>	53.80%	<u>265,000</u>	55.79%
Gross profit	<u><u>231,000</u></u>	46.20%	<u><u>210,000</u></u>	44.21%
Wages	163,000	32.60%	154,000	32.42%
Repairs	4,150	0.83%	5,800	1.22%
Rent	12,000	2.40%	13,000	2.74%
Taxes	17,930	3.59%	16,940	3.57%
Office expenses	587	0.12%	1,023	0.22%
Total expenses	<u>197,667</u>	39.53%	<u>190,763</u>	40.16%
Net Income	<u><u>33,333</u></u>	6.67%	<u><u>19,237</u></u>	4.05%



**Vertical Analysis Formula (Income Statement)** = Income Statement Item / Total Sales \* 100

**Vertical Analysis Formula (Balance Sheet)** = Balance Sheet Item / Total Assets (Liabilities) \* 100



Vertical analysis is helpful in comparing the performance of the company in multiple years as well as with other companies. It is also helpful to understand the structural composition of various heads within the balance sheet and income statements.

## Horizontal Analysis

In the horizontal analysis, we compare financial data from previous years with the targeted year to obtain a pattern of growth for the entity. An analyst observes a trend in the growth of the entity to reach helpful conclusions. This helps to understand growth patterns over the period of time by assessment of changes in different items over the course of time. It helps in long-term planning for the organization.

This process is also known as trend analysis. Absolute comparison and percentage comparisons are the two ways to conduct this type of financial analysis. Here, the value of the item in the initial year acts as a base figure to compare with the value of the same item in the coming years.



# Horizontal Analysis

Income Statement Horizontal Analysis For the years ending December 31, 2014 and December 31, 2015	2014	2015	% Change 2015 from 2014
Sales	500,000	475,000	-5.00%
Cost of goods sold	269,000	265,000	-1.49%
Gross profit	<u>231,000</u>	<u>210,000</u>	-9.09%
Wages	163,000	154,000	-5.52%
Repairs	4,150	5,800	39.76%
Rent	12,000	13,000	8.33%
Taxes	17,930	16,940	-5.52%
Office expenses	587	1,023	14.14%
Total expenses	<u>197,667</u>	<u>190,763</u>	-3.49%
Net Income	<u>33,333</u>	<u>19,237</u>	-42.29%



**Horizontal Analysis formula** = [(Amount in comparison year – Amount in the base year)/Amount in a base year] x 100



# GROWTH RATES ANALYSIS

Analysis of historical data related to profits and growth rates can help to project the future growth possibilities for the entity. It involves collecting data from multiple years with the purpose of finding actionable insights from them.

Growth rate analysis is used to generate data about compounded annualized growth of a certain variable such as earning per share, revenues, dividends, etc.

Growth rates are useful for analysts, stakeholders, and management to do a proper assessment of the company's growth over a period of time. It also helps to make future predictions about the performance of the entity.



## **COMMON EXAMPLES OF GROWTH ANALYSIS**

- Year over year analysis
- Regression analysis
- Bottom-up analysis
- Top-down analysis

**Read Also: In Depth Analysis of Financial Technology Institutions.**



# **PROFITABILITY ANALYSIS**

Profitability analysis is conducted to understand the earning potential of the enterprise. Profitability analysis helps to generate useful insights about the way the company generates its profits from business activities.

This is the analysis of the firm's costs and revenue to determine whether the firm is profitable or not.

# Profitability Ratios

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Sales}} \times 100$$

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Assets}} \times 100$$

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

# Liquidity Analysis

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This type of financial analysis is aimed to find out the potential of the entity to meet its short term liabilities and financial needs of the company. This analysis is important for creditors to gain insights into the financial position of the firm. At the same time, it is important for investors to know about the financial stability of the firm. It also provides an idea of how safe it is to invest in the firm.



## Common Liquidity Ratios

# Liquidity Ratios

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

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

$$\text{Cash Ratio} = \frac{\text{Cash and Cash Equivalent} + \text{Short term Investments}}{\text{Current Liabilities}}$$

# Cash Ratio

Cash ratio Compares the number of short term assets with the number of short term liabilities. The ratio does not include assets that cannot be converted into cash immediately, such as inventory.

**Cash Ratio**= Cash + Cash Equivalents /  
Current Liabilities

# Current Ratio

The current ratio compares the total amount of current assets to the total amount of current liabilities.

**Current Ratio**=Current Asset/ Current Liabilities



# Efficiency Analysis

Efficiency analysis is used to determine the efficiency of the activities employed by the organization. The efficiency analysis looks after how the company uses its assets and liabilities to generate revenue. A well functioning organization will generate more funds from operational profits and will have less dependency on debt funds.

A high-efficiency ratio means the company is using the company is making good use of its assets to generate revenue. On the contrary, if the ratio is low, then it means the company is not making efficient use of its assets to generate revenues.



# Efficiency Ratios

$$\text{Inventory turnover ratio} = \frac{\text{cost of goods sold}}{\text{average inventory}}$$

$$\text{Days' sales in inventory} = \frac{\text{average inventory}}{\text{cost of goods sold} / 365}$$

$$\text{Average collection period} = \frac{\text{average receivables}}{\text{average daily sales}}$$

# COMMON EFFICIENCY RATIOS INCLUDE:

- **Accounts Receivables Turnover** = Revenue/Average Accounts Receivable
- **Inventory Turnover** = Cost of Goods Sold /Average Inventory
- **Accounts Payables Turnover** = Total Purchases/Average Accounts Payables
- **Fixed Asset Turnover** = Sales/Average Fixed Assets
- **Total Assets Turnover** = Sales/Average Total Assets

## Advantages

The process of financial analysis helps to provide useful insights about the entity. These insights contribute to decision making for the internal and external interest holders. The foremost advantage is that it can provide details about the efficiency, profit potential, and financial stability of the company.



# MAJOR ADVANTAGES ARE AS FOLLOWS:

- Help to generate useful data about the company's liquidity, profitability, and financial state
- Helps in decision making related to the purchase or sale of assets
- Helps to understand the operational efficiency of the organization
- Helps in analyzing the strengths and weakness of the entity
- Helps to formulate remedial solutions for the weak spots
- Helps to compare past and presents
- Helps to forecast the future state of the company related to earning capacity operational efficiency, financial performances

# LIMITATIONS OF FINANCIAL ANALYSIS

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The financial analysis process has its own limitations. The analysis of data may be able to provide accurate insights about the past performance of the entity. However, future predictions are always contingent in nature.

One of the major arguments given against the significance of the financial analysis is that they use historical data to reach conclusions that are prone to fluctuations in the future. Another major flaw is that any numerical error in the financial statements can lead to flawed conclusions. Let us study these limitations in detail.



# BASED ON HISTORICAL COST

The conclusions from Financial data interpretation are based on historical costs. The value of assets may change over the passage of time. The value of asset and liabilities are subjected to market factors. Hence, analysis can be misleading and flawed if taking figures from previous years are not adjusted to present values.

## Not Adjusted to Inflation

The values mentioned in the financial statements are not adjusted to inflation. The past year's figures are not adjusted to inflation when comparing the items from previous years to present year values. The items display lower values as they are not adjusted to inflation.

# ANALYST'S BIAS

The financial analysis is conducted by analysts to obtain comparative figures. The figures are then used to make actionable conclusions. Although there are established methods for analysis, there are no standards for drawing a conclusion out of it.

## Time-Based Reporting

The reports concluded from financial statements are derived for a specific period of time. They are used to forecast future events for the same period. However, results that came during a particular period can be influenced by several factors which may or may not period-specific reasons.

# IGNORES INTANGIBLE ASSETS

The financial analysis takes financial statements for drawing conclusions. The financial statements do not include intangible assets of the company. These assets, such as goodwill of the company, play a very significant role in the evaluation of the entity. However, such an important measure of valuation is ignored by the process of financial analysis.

## Comparing of Unequal Factors

The process so the financial analysis is used to compare the performance of the company with other companies. This includes direct competitors and companies from the same sector. However, there are no measures to make exact comparisons as factors that lead to financial statements different from company to company. These factors include accounting practices, valuation, analyst bias, etc.

However, even after so many limitations, they provide a clue to investigate the factors further and make a strategy to counter and foreseeable risk.



**THANK  
YOU**

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Akash Dubey is a Law Graduate and works as an Advisor at Enterslice. He is proficient in Legal and Financial Advisory. His expertise in the skills of Legal and Financial Research is an aid to his strengths as an Advisor.