International Journal of Management, IT & Engineering
Vol. 10 Issue 01, January 2020
ISSN: 2249-0558 Impact Factor: 7.119
Journal Homepage: http://www.ijmra.us, Email: editorijmie@gmail.com
Double-Blind Peer Reviewed Refereed Open Access International Journal - Included in the International Serial Directories Indexed & Listed at: Ulrich's Periodicals Directory ©, U.S.A., Open J-Gate as well as in Cabell's Directories of Publishing Opportunities, U.S.A

Financial Performance Analysis: Critical Analysis on The use of Financial Statements in Assessing the Performance of an Organisation

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Abstract

Financeisconsideredtobethelifebloodofeverybusiness organization. No business enterprise can exist without finance. The owners always eager to know the financial position of the Financial statement i.e. profit and loss account and balance sheet. Finance is one of the most important aspects of business management and includes decision related to the use and acquisition of funds for the enterprise. Finance is a branch of economics considered with providing funds to individuals, business governments. Business enterprises in developing economics are conceived as instruments of economic progress and social change and are expected to reach the commanding heights of economy.Financial statement analysis (or financial analysis) is the process of reviewing and analyzing a company's financial statements to make better economic decisions to earn income in future. These statements include the income statement, balance sheet, statement of cash flows, notes to accounts and a statement of changes in equity (if applicable). Financial statement analysis is a method or process involving specific techniques for evaluating risks, performance, financial health, and future prospects of an organization.

KEYWORDS :Finance, Performance, Ratio Analysis, Liquidity, Profitability

Introduction

Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decision by users of the information. The end products of business transactions are the financial statements comprising primarily the position statement or the balance sheet and the income statement or the profit& loss account. Financial statements are the outcomes of summarizing process of accounting.Finance is considered as life blood of business enterprise. Finance is one of the basic foundations of all kinds of economic activities. The success and survival of any organization depends upon how efficiently it is able to raise funds as and when needed and their proper utilization.It is used by a variety of stakeholders, such as credit and equity investors, the government, the public, and decision-makers within the organization. These stakeholders have different interests and apply a variety of different techniques to meet their needs. For example, equity investors are interested in the long-term earnings power of the organization and perhaps the sustainability and growth of dividend payments. Creditors want to ensure the interest and principal is paid on the organizations debt securities (e.g., bonds) when due. Common methods of financial statement analysis include fundamental analysis, DuPont analysis, horizontal and vertical analysis and the use of financial ratios. Historical information combined with a series of assumptions and adjustments to the financial information may be used to project future performance. The Chartered Financial Analyst designation is available for professional financial analysts.

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Meaning, Significance And Objectives of Financial Analysis

Meaning

The process of reviewing and analyzing a company's financial statements to make better economic decisions is called analysis of financial statements. In other words, the process of determining financial strengths and weaknesses of the entity by establishing the strategic relationship between the items of the balance sheet, profit and loss account, and other financial statements.The term 'analysis' means the simplification of financial data by methodical classification of the data given in the financial statements, 'interpretation' means, 'explaining the meaning and significance of the data so simplified.' However, both' analysis and interpretation' are interlinked and complementary to each other.

Significance of Financial Analysis

Finance Manager

Analysis of financial statements helps the finance manager in:

- Assessing the operational efficiency and managerial effectiveness of the company.
- Analyzing the financial strengths and weaknesses and creditworthiness of the company.
- Analyzing the current position of financial analysis,
- Assessing the types of assets owned by a business enterprise and the liabilities which are due to the enterprise.
- Providing information about the cash position company is holding and how much debt the company has in relation to equity.
- Studying the reasonability of stock and debtors held by the company.

Financial Analysis Helps the Top Management

- To assess whether the resources of the firm are used in the most efficient manner
- Whether the financial condition of the firm is sound
- To determine the success of the company's operations
- Appraising the individual's performance
- evaluating the system of internal control
- To investigate the future prospects of the enterprise.

Trade Payables

Trade payables analyze of financial statements for:

- Appraising the ability of the company to meet its short-term obligations
- Judging the probability of firm's continued ability to meet all its financial obligations in the future.
- Firm's ability to meet claims of creditors over a very short period of time.
- Evaluating the financial position and ability to pay off the concerns.

Lenders

Suppliers of long-term debt are concerned with the firm's long-term solvency and survival. They analyze the firm's financial statements

- To ascertain the profitability of the company over a period of time,
- For determining a company's ability to generate cash, to pay interest and repay the principal amount
- To assess the relationship between various sources of funds (i.e. capital structure relationships)
- To assess financial statements which contain information on past performances and interpret it as a basis for forecasting future rates of return and for assessing risk.
- For determining credit risk, deciding the terms and conditions of a loan if sanctioned, interest rate, and maturity date etc.

Investors

Investors, who have invested their money in the firm's shares, are interested in the firm's earnings and future profitability. Financial statement analysis helps them in predicting the bankruptcy and failure probability of business enterprises. After being aware of the probable failure, investors can take preventive measures to avoid/minimize losses.

Objectives of Financial Analysis

Let us look at some of the main objectives of financial analysis,

1. **Reviewing the performance of a company over the past periods:** To predict the future prospects of the company, past performance is analyzed. Past performance is analyzed by reviewing the trend of past sales, profitability, cash flows, return on investment, debt-equity structure and operating expenses, etc.

2. **Assessing the current position & operational efficiency:** Examining the current profitability & operational efficiency of the enterprise so that the financial health of the company can be determined. For long-term decision making, assets & liabilities of the company are reviewed. Analysis helps in finding out the earning capacity & operating performance of the company.
3. **Predicting growth & profitability prospects:** The top management is concerned with future prospects of the company. Financial analysis helps them in reviewing the investment alternatives for judging the earning potential of the enterprise. With the help of financial statement analysis, assessment and prediction of the bankruptcy and probability of business failure can be done.
4. **Loan Decision by Financial Institutions and Banks:** Financial analysis helps the financial institutions, loan agencies & banks to decide whether a loan can be given to the company or not. It helps them in determining the credit risk, deciding the terms and conditions of a loan if sanctioned, interest rate, maturity date etc.

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Analyzing Financial Statements

The financial statements of a company record important financial data on every aspect of a business's activities. As such they can be evaluated on the basis of past, current, and projected performance.

In general, financial statements are centered aroundgenerally accepted accounting principles (GAAP) in the U.S. These principles require a company to create and maintain three main financial statements: the balance sheet, the income statement, and the cash flow statement. Public companies have stricter standards for financial statement reporting. Public companies must follow GAAP standards which requires accrual accounting.1 Private companies have greater flexibility in their financial statement preparation and also have the option to use either accrual or cash accounting.2

Several techniques are commonly used as part of financial statement analysis. Three of the most important techniques include horizontal analysis, vertical analysis, and ratio analysis. Horizontal analysis compares data horizontally, by analyzing values of line items across two or more years. Vertical analysis looks at the vertical affects line items have on other parts of the business and also the business's proportions. Ratio analysis uses important ratio metrics to calculate statistical relationships.

Financial Statements

As mentioned, there are three main financial statements that every company creates and monitors: the balance sheet, income statement, and cash flow statement. Companies use these financial statements to manage the operations of their business and also to provide reporting transparency to their stakeholders. All three statements are interconnected and create different views of a company's activities and performance.

Balance Sheet

The balance sheet is a report of a company's financial worth in terms of book value. It is broken into three parts to include a company's assets, liabilities, and shareholders' equity. Short-term assets such as cash and accounts receivable can tell a lot about a company's operational efficiency. Liabilities include its expense arrangements and the debt capital it is paying off. Shareholder's equity includes details on equity capital investments and retained earnings from periodic net income. The balance sheet must balance with assets minus liabilities equaling shareholder's equity. The resulting shareholder's equity is considered a company's book value. This value is an important performance metric that increases or decreases with the financial activities of a company.

Income Statement

The income statement breaks down the revenue a company earns against the expenses involved in its business to provide a bottom line, net income profit or loss. The income statement is broken into three parts which help to analyze business efficiency at three different points. It begins with revenue and the direct costs associated with revenue to identify gross profit. It then moves to operating profit which subtracts indirect expenses such as marketing costs, general costs, and depreciation. Finally it ends with net profit which deducts interest and taxes. Basic analysis of the income statement usually involves the calculation of gross profit margin, operating profit margin, and net profit margin which each divide profit by revenue. Profit margin helps to show where company costs are low or high at different points of the operations.

Cash Flow Statement

The cash flow statement provides an overview of the company's cash flows from operating activities, investing activities, and financing activities. Net income is carried over to the cash flow statement where it is included as the top line item for operating activities. Like its title, investing activities include cash flows involved with firmwide investments. The financing activities section includes cash flow from both debt and equity financing. The bottom line shows how much cash a company has available.

Free Cash Flow and Other Valuation Statements

Companies and analysts also use free cash flow statements and other valuation statements to analyze the value of a company. Free cash flow statements arrive at a net present value by discounting the free cash flow a company is estimated to generate over time. Private companies may keep a valuation statement as they progress toward potentially going public.

Key Takeaways

- Financial statement analysis is used by internal and external stakeholders to evaluate business performance and value.
- Financial accounting calls for all companies to create a balance sheet, income statement, and cash flow statement which form the basis for financial statement analysis.
- Horizontal, vertical, and ratio analysis are three techniques analysts use when analyzing financial statements.

Financial Performance

Financial statements are maintained by companies daily and used internally for business management. In general both internal and external stakeholders use the same corporate finance methodologies for maintaining business activities and evaluating overall financial performance.

When doing comprehensive financial statement analysis, analysts typically use multiple years of data to facilitate horizontal analysis. Each financial statement is also analyzed with vertical analysis to understand how different categories of the statement are influencing results. Finally ratio analysis can be used to isolate some performance metrics in each statement and also bring together data points across statements collectively.

Conclusion

In earnings recast is the act of amending and re-releasing a previously released earnings statement, with specified intent.Investors need to understand the ability of the company to generate profit. This, together with its rate of profit growth, relative to the amount of capital deployed and various other financial ratios, forms an important part of their analysis of the value of the company. Analysts may modify ("recast") the financial statements by adjusting the underlying assumptions to aid in this computation. For example, operating leases (treated like a rental transaction) may be recast as capital leases (indicating ownership), adding assets and liabilities to the balance sheet. This affects the financial statement ratios.n earnings recast is the act of amending and re-releasing a previously released earnings statement, with specified intent.Investors need to understand the ability of the company to generate profit. This, together with its rate of profit growth, relative to the amount of capital deployed and various other financial ratios, forms an important part of their analysis of the value of the company. Analysts may modify ("recast") the financial statements by adjusting the underlying assumptions to aid in this computation. For example, operating leases (treated like a rental transaction) may be recast as capital leases (indicating ownership), adding assets and liabilities to the balance sheet. This affects the financial statement ratios.

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