

Analysis & Interpretation of Financial Statements

Key: Techniques | Stakeholder Needs | Benchmarks

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What is Analysis and Interpretation of Financial Statements?

Analysis & interpretation is a mechanism/method in which **already reported** numbers/data/information are re-produce in different form in order to form opinions as to the entity's past and future performance and position (health).

Even though the fundamental purpose of financial statement is to provide useful information to users (stakeholders) in their decision making, most of the data/information contains in these reports are **expressed in absolute monetary terms.**

In order to better understand the consequences of an entity's operating, investing and financing decisions, it is **necessary to analyze and interpret the relationships between the numbers in the financial reports rather than relying on such absolute values.** Hence the real need arise for financial statement analysis.

Who are the Stakeholders?

Individuals/group of people/parties who are interested on entity's affairs/results and get affected their routine decisions with such results commonly called as "stakeholders". These stakeholders can broadly be categorized as;

External : *purely external to the entity*

Internal : *totally incorporated with entity's affairs routinely*

Inter-related : *partially incorporated with entity's affairs routinely*

Each of these categories of stakeholders have their different needs which can be separately identified at all times.

Group of Stakeholders with their distinctive needs

Stakeholder Category	Information which is need and respective decision making
Investors/OSHs	Profit at current. Possibility for growth of profit. Cash flows and ability to enhance for dividends and capital gain. Going concern.
Key management	NA. Profit and its trend. Cash flows and its volatility. Recent trend in industry and markets. Emerging risks and mitigating acts. Communication all what matters to all who need.
Financial Institutions	Ability to repay the borrowings with interest. Going concern. NA.
Key suppliers	Cash flows. LT relationship. Changes in ownership. Going concern. Key changes in markets and production.
Employees	Profit at current and its possibility to grow. NA. Changes in internal policies/procedures/structures. Cash flows.
Key customers	Profit. Cash flows. NA. Going concern. LT relationship. Dramatic changes in industry/sector/production.
Government (IRD)	Abiding by laws and ability to pay taxes on time.
Community at large	Main revenue streams. Profitability. Ownership and its key changes. Industry trend in CSR.
Regulatory bodies	Recent structural/ownership changes. Nature of operational activities and its changes. NA. Cash flows. Going concern.
Special interest group	Conformity with general requirements. What intended has delivered.

How to Conduct?

Analyzing financial statements by using accounting ratios is the **most popular and common technique** while following techniques will also be used in order to have better understand.

❑ Trend analysis

Seems to be simple. Care is must. Skills in analyzing and forecasting is key. Do analysis of past – developed basis based on present – do forecast/predict. Usually, ends with plot in to a graph.

❑ Horizontal analysis

Analytical skills is key. Identification and determined positive/negative movement is essential. Usually, no prediction.

❑ Vertical analysis

Determined the base values/data is key. Availability of data/information for the comparison is essential.

What are the Key Shortcomings?

Following are some of the key shortcomings of each of the above techniques when practically used in analysis task.

Trend

- Not possible if prior periods are not available
- Not practical in the industry which highly depend on PEST

Horizontal

- Not practical for the company which doesn't have previous year
- Need technical expertise

Vertical

- Will not be effective in the event of failing to select proper base
- Will not be effective if proper data not available for comparison

What are the Comparative Sources/Benchmarks?

Prior to arrive final decision/conclusion, a particular user/stakeholder **must compare** the current year numbers/values/data/information with suitable/sound source (benchmark) under any of the techniques discussed in above.

Following are some commonly applicable benchmarks;

- Previous years' (immediate preceding) similar data/figures. (audited)
- Forecasted/budgeted similar data/figures. (evaluate the basis)
- Competitors' (most close) similar data/figures. (Apple to Apple)
- Industry norms.