CA BUSINESS SCHOOL
POSTGRADUATE DIPLOMA IN BUSINESS FINANCE AND STRATEGY

SEMESTER 1: Financial Statements Analysis

Introduction to the Course

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Overview

Core aim of this chapter is to discuss fundamentals in financial statement analysis as a preface to the module/syllabus.

It is worthwhile to study the real need of financial statement analysis along with the factors caused it to become essential as well as popular especially in the field of finance/business.

Arguably, this phenomenon/concept has become popular across the business world regardless the nature and/or size of the particular organization. In order to reap the maximum expected benefit, the whole analysis should consider and conduct with the mix of **financial/non-financial** as well as **quantitative/qualitative** information.

Generally, analysis of financial statement is the **mechanical phase (technical skills)** while interpretation of the results shall lead towards **decision making phase (judgmental skills)**.

Analysis of Financial Statements

1. What is analysis of financial statements?

Analysis of Financial Statements is not restricted to but basically a mechanism/method in which **already reported financial numbers are re-produce** in order to form opinions/better understand as to the entity's past and future performance and position (especially financial).

This task is typically associated with the calculation of accounting ratios. The calculation phase is a mechanical process with the real benefit of financial analysis being the interpretative stage.

2. Why analysis of financial statements is need?

Even though the purpose of financial statement is to provide useful information to users/stakeholders in their decision making, the financial data/information in these reports are expressed in monetary terms with corresponding figures for the comparative year(s). Further, information available in these reports **mostly cater the general purpose**.

In order to better understand the consequences of an entity's operating, investing and financing position/situation, it is **essential to analyze the relationships between the numbers in the financial reports rather than relying on the absolute values** appeared on the face of such reports.

Analysis of Financial Statements – Continued

3. Who does need/require?

Individuals/parties who are interested on entity's affairs/results and commonly called as "stakeholders". These stakeholders broadly can be categorized as; external, internal and inter-related.

(will be discussed in detail)

4. How to conduct analysis of financial statements?

Analysis of financial statements by using commonly acceptable accounting ratios is the most popular/common technique used in most circumstance while following techniques will also be used;

- ❑ Trend analysis
- ❑ Horizontal analysis
- ❑ Vertical analysis

(will be discussed in detail)

5. What is the basis?

Main source/basis of conducting analysis of financial statements is general purpose financial statements (must be audited).

Analysis of Financial Statements – Continued

1. What does refer financial statement?

A pool of data/information prepared and presented by an entity (company) in a formal manner to meet the needs of various users/stakeholders who are not in a position to request/claim an entity to prepare financial reports tailored to their particular needs. (general purpose financial statements)

2. Why an entity (company) prepares financial statements?

- Mandatory requirement (regulatory)
- Purpose of statutory income tax (statutory)
- Attract more investors (build confidence)
- Obtain financial facilities from institutions (banks)
- Obtain approval from various statutory bodies (TRC/BOI) & etc.

Analysis of Financial Statements – Continued

3. What are the key aspects represents general purpose financial statements?

According to the accounting standards, financial statements should furnish adequate information about entity's financial position, financial performance and cash flows to a wide range of users in order to make their respective economic decisions.

Hence, financial statements provide information about entity's;

- Net Assets position
- Overall debt position
- Working Capital and Gearing position
- Cash flow position
- Profit or Loss position
- Contribution of & distribution to owners

Analysis of Financial Statements – Continued

In order to provide information about financial performance, financial position and cash flows, a set of financial statements prepared by an entity should comprise with following key elements;

- Income Statement/Statement of comprehensive income
- Statement of financial position
- Statement of changes in equity
- Statement of cash flows
- Notes to the accounts including summary of accounting policies

Analysis of Financial Statements – Continued

1. What are the keys in compiling Financial Statements?

Keys are the basis/fundamentals which are compulsory being adherence in all circumstances.

Following are the key fundamentals/sources;

Accounting Principles (Non regulatory) (now need align with standards)

Accounting Standards (Regulatory)

Companies Act (Regulatory)

CSE/SEC Rules (Regulatory)

Accounting Principles

- **Fair presentation**

Faithful presentation of the effects of transactions, other events and conditions in accordance with the determinants and recognition criteria for assets, liabilities, income & expenses set out in framework/LKASs.

- **Going concern**

Financial statements should prepare on a going concern basis unless management either intends liquidate the entity or to cease trading or has no realistic alternative but to do so.

- **Accrual basis**

Income and expenses should recorded in the particular financial period irrespective whether they paid/received by cash provided those are relevant to such financial period.

- **Offsetting**

An entity shall not offset assets and liabilities and/or income and expenses unless required or permitted by a standard.

Accounting Principles – Continued

- **Frequency of reporting**

An entity shall prepare/present a complete set of financial statements (including comparatives) at least annually.

- **Comparative information**

An entity shall disclose comparative information with respect to the previous period for all amounts reported in the current period's financial statements.

- **Consistency of presentation**

An entity shall retain the consistency of presentation and classification of items in the financial statements from one period to the next.

- **Identification of financial statements**

An entity shall clearly identify the financial statements and distinguish them from other information in the same published document.

Accounting Standards

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), as a member of the International Accounting Standards Committee (IASC) is committed to development and enhancement of accounting standards.

In working towards this mission, IASC develops and issues International Accounting Standards (IAS). IASC believes that the issue of such standards will help to **improve the degree of uniformity** of accounting throughout the world.

As a condition of its membership of IASC, CA Sri Lanka is obliged to support the work of IASC, and specifically to incorporate IAS in Sri Lanka Accounting Standards (SLAS).CA Sri Lanka members are expected to comply with SLAS. Failure to do so may result in CA Sri Lanka inquiring into a member's conduct.

It is impractical to establish accounting standards which universally apply to all situations and circumstances an accountant may encounter. Therefore accountants **should consider SLAS as the basic principles** which they should follow in performing their work.

Accounting Standards – Continued

The Sri Lanka **Accounting and Auditing Standards Act, No. 15 of 1995 which authorizes CA Sri Lanka** to issue SLAS, requires "specified business enterprises" to prepare and present their accounts in compliance with SLAS, with the object of presenting a true and fair view of their financial performance and condition, and requires their auditors to report whether such accounts are so prepared and presented and to specify clearly any deviations there from along with the reasons therefore.

SLAS contain basic principles and essential procedures together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is **necessary to consider the whole text of SLAS including explanatory and other material** contained in SLAS, not just that text which is bold italic black lettered. **SLAS need only be applied to material matters**.

(SLASs will be discussed in detail separately)

Companies Act – No. 07 of 2007

Section	Requirement/Responsibility
148	Duty to keep accounting records
149	Place where accounting records are kept
150	Obligations to prepare financial statements
151	Contents and form of financial statements
152	Obligations to prepare group financial statements
153	Contents and form of group financial statements
166	Obligation to prepare annual report
167	Sending of annual report to shareholders
168	Contents of annual report
169	Failure to send reports
170	Registration of financial statements
171	Balance sheet date

CSE & SEC Rules/Regulations

The Securities and Exchange Commission of Sri Lanka (SEC) was established in pursuance of the Securities and Exchange Commission of Sri Lanka Act, No. 36 of 1987 as amended by Act No. 26 of 1991, Act No. 18 of 2003 and Act no. 47 of 2009.

Vision: "To become the benchmark regulator in South Asia for effective, efficient and proactive capital market regulation"

Mission: "To promote, develop and maintain a capital market that is fair, efficient, orderly and transparent"

Main Objectives

1. The creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner.
2. The protection of the interest of investors.
3. The operation of a Compensation Fund to protect investors from financial loss arising as a result of any licensed stock broker or licensed stock dealer being found incapable of meeting his contractual obligations.
4. The regulation of the securities market and to ensure that professional standards are maintained in such market.