CA BUSINESS SCHOOL
EXECUTIVE DIPLOMA IN BUSINESS AND ACCOUNTING

SEMESTER 2: Interpretation of Financial Statements

Analysis & Interpretation of Financial Statements

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What is Analysis and Interpretation of Financial Statements?

Analysis & interpretation is an analytical mechanism/method in which already reported financial numbers (non financial information) are used to form opinions as to the entity’s past and future performance and position.

Generally, it is ideal to consider audited financial figures/numbers since analysis and/or interpretation alone will not give assurance of the accuracy of such reported numbers.

This is typically associated with, but not restricted to, the calculation and interpretation of accounting ratios. This entails 02 phases in which calculation phase is a mechanical process which leads to interpretation phase where real benefit will enjoy.
Why Analysis and Interpretation is need?

Fundamental purpose of financial statement is to provide useful information to various users including shareholders in order to make their decisions (economic).

Even though the fundamental purpose of financial statement is to provide useful information to users in their decision making, the financial/non-financial data/information contains in these reports are expressed in monetary terms with corresponding figures for the comparative year provided.

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 the absolute values.
Who are the Stakeholders?

Individuals/parties who are interested on entity’s affairs/results and get affected with their decisions; commonly called as “stakeholders”. These stakeholders broadly can 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 stakeholders have different needs and they can be identified as follows;
<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Accounting information need and decision making</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>Information to determine the future profitability of the entity, to assess the future cash flows for dividends and the possibility of capital growth of investment.</td>
</tr>
<tr>
<td>Banks</td>
<td>Information to determine whether entity has the ability to repay a loan along with interests</td>
</tr>
<tr>
<td>Suppliers</td>
<td>Information to determine an entity’s ability to repay debt associated with purchase.</td>
</tr>
<tr>
<td>Employees</td>
<td>Information concerning job security, the potential to pay or awards and bonuses, and promotional opportunities down the track.</td>
</tr>
<tr>
<td>Customers</td>
<td>Information regarding the continuity of the entity and the ability to provide the appropriate goods and services.</td>
</tr>
<tr>
<td>Government authorities</td>
<td>Information to determine the amount of tax that should be paid and any future taxation liabilities or taxation assets.</td>
</tr>
<tr>
<td>Regulatory bodies</td>
<td>Information to determine if the entity is abiding by regulations such as the Companies act and Inland Revenue act.</td>
</tr>
<tr>
<td>Community</td>
<td>Information to determine whether the entity is contributing positively to the general welfare and economic growth of the local community.</td>
</tr>
<tr>
<td>Special interest groups</td>
<td>Information to determine whether the entity has considered environmental, social or industrial aspects during its operations.</td>
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What is the Basis?

Basis for analysis and interpretation of financial statements is **complete set of financial statements** prepared (audited) based on commonly acceptable accounting principles and standards.

Entity must include following key elements as part of its complete sets of financial statements.

- 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
How to conduct?

Conducting a whole analysis 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 core. Do analysis of past – developed basis based on present – do forecast/predict. Ends with plot in to a graph.*

- **Horizontal analysis**
  
  *Analytical skills is key. Identification and determined positive/negative movement is essential. 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;

**Trend**: not possible if reasonable 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, a particular user/stakeholder must compare the current year numbers/values/data with suitable/sound source (benchmark) under any of the techniques discussed in above.

Following are some of commonly applicable benchmarks;

- Previous years’ similar data/figures. (audited)
- Forecasted/budgeted similar data/figures. (evaluate the basis)
- Competitors’ similar data/figures. (Apple to Apple)
- Industry norms.