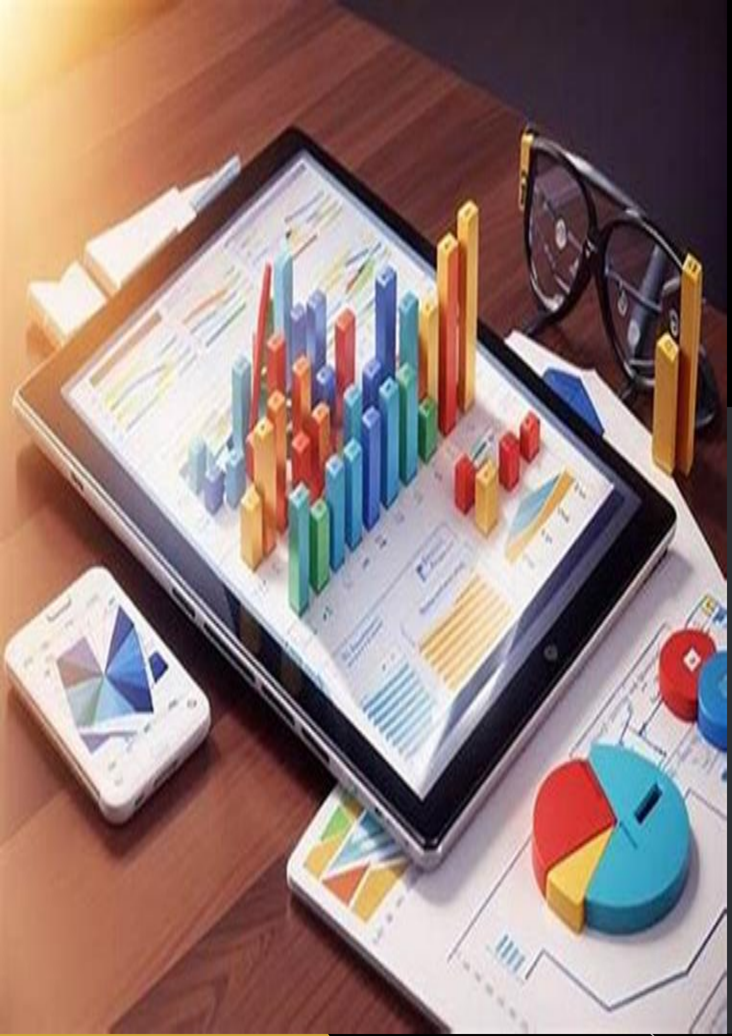


# Chapter 2

# Financial Analysis as an Approach to Decision-Making in Financial Institutions

# First: The nature and importance of financial analysis.

**1- The concept of financial analysis:** Refers to a set of technical and financial studies conducted for accounting data in order to analyse the information and clarify its significance and focus on the facts that are hidden behind these numbers. It helps in assessing the past, as it contributes to exploring the future, diagnosing problems and identifying steps to solve these problems.

## First: The nature and importance of financial analysis.

**2- Purposes of financial analysis:** The importance of financial analysis is to provide many advantages, the most important of which are:

- ❑ Evaluating the entity's financial position in a given financial period.
- ❑ Evaluating the results of the business through profitability indicators.

# First: The nature and importance of financial analysis.

- ❑ **Judging the suitability of financial and operating policies.**
- ❑ **Evaluating the efficiency and effectiveness of management performance.**

# First: The nature and importance of financial analysis.

- **Evaluating the credit situation through analysing the company's debt.**
- **Enhancing the control over the financial policies adopted by the company for each of the investment centres, cost, revenue, and profitability.**

# First: The nature and importance of financial analysis.

**3- Factors supporting financial analysis:** Financial analysis depends on a number of factors, the most important of which are:

- ❑ The analyst's Objective and point of view.
- ❑ The degree of interest of the analyst in the company and the need for in-depth analysis
- ❑ The data available to the analyst in terms of quantity and quality.

## First: The nature and importance of financial analysis.

### 4- Steps to analyze the financial statements:

The financial statements are analyzed through three main steps that can be addressed as follows:

**4/1 – Classification.**

**4/2- Comparison.**

**4/3- Reasoning.**

## Second: The basic rules that must be considered in financial analysis.

**There are several rules to consider when performing a financial analysis that relate to the meaning of numbers, data, and relationships that are extracted:**

- **The extent of the reliability of the numbers in the income statement and balance sheet accounts in terms of the values shown therein.**

## Second: The basic rules that must be considered in financial analysis.

- **Mechanisms of processing the intangible assets, specifically the goodwill.**
- **The percentages of changes must be interpreted carefully.**

## Second: The basic rules that must be considered in financial analysis.

- The comparisons must be for long periods. Comparisons through long periods of time are better than the results of comparisons from one year to another, because they are often greater and more important than comparing two successive periods, because the data for a long period of time can indicate the existence of trends in numbers.

## Second: The basic rules that must be considered in financial analysis.

- The net income from the non-recurring elements must be settled by excluding them from the income.
- The need to use the net income before deduction of interest and taxes if the purpose is to measure the efficiency of operation at the level of operational processes, as the manager at the level of operation is responsible for how to use the assets efficiently in operational processes, but it may not be responsible for how to acquire these assets.

## Second: The basic rules that must be considered in financial analysis.

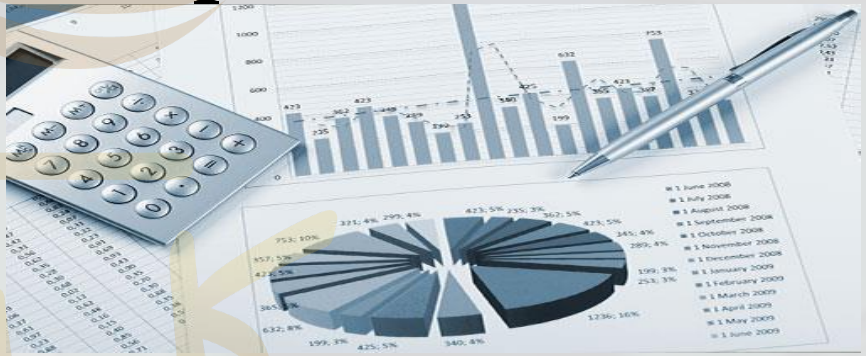
- Investment in securities: the returns on these investments must be excluded from the net income if the investments are excluded from the assets side.
- Fixed assets: In the case of exclusion or addition to fixed assets during the year, it is preferable to use the average assets during the year when determining rates of return.

# Activity No. (1)

- **Activity nature:** **Discussion.**
- **Activity Time:** **10 minutes.**
- **Task:** **Discuss the purposes of financial analysis and identify the steps of it.**

## Third: Financial Analysis Inputs (necessary information needed for analysis):

There are many basic information that must be available to the person who performs the financial analysis before conducting the analysis process, extracting results and submitting recommendations and proposals. The most important of this information is the following:



## Third: Financial Analysis Inputs (necessary information needed for analysis):

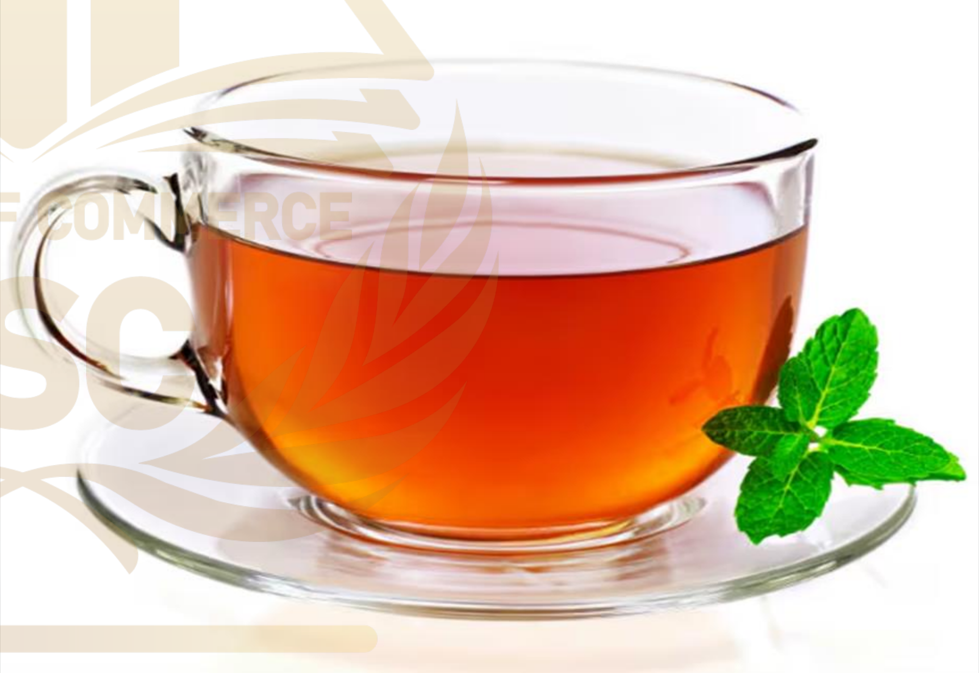
1-The necessity of studying the methods used by the company in applying accounting principles in terms of how depreciation and provisions are calculated and evaluating the inventory.

2-Knowing the details of the different items in each of the balance sheet and the statement of business results during the period under study.

3-Reviewing the report company’s board of directors, the report of the auditor, and any observations it may contain.

# 5 minute break.....

**Tea Break**



## Fourth: Financial analysis methods for financial reports:

**1-The essence of the financial analysis of accounting reports:** The financial analysis is interested in studying and analysing the trends of the items of the financial statements and reports, determining the relative importance of each of them, and extracting the ratios and indicators that are used in evaluating the financial and economic performance according to the objective methods used by the financial analyst.

# Fourth: Financial analysis methods for financial reports:

**2- Financial analysis methods:** There are three main methods of financial analysis for the items of financial statements and reports (horizontal analysis, vertical analysis, financial ratios). It is worth noting that there is almost agreement on the need to use the two methods of horizontal and vertical analysis at the same time to maximize the benefit from the analysis process. The following is a detailed view of each of these methods:

# Fourth: Financial analysis methods for financial reports:

**Methods for Financial Reports**

- Horizontal analysis
- Vertical analysis
- Financial ratios

# Fourth: Financial analysis methods for financial reports:

**2/1- Horizontal Analysis:** is one of the important financial analysis methods that are concerned with determining both the amount and the percentage of change that occurred in the items of the financial statements during successive periods (at least two periods). **This method** helps the financial analyst to identify the extent of improvement or deterioration in the performance of the company over a certain period.

# Fourth: Financial analysis methods for financial reports:

**Horizontal analysis,** also called **trend analysis**, is a technique for evaluating a series of financial statement data over a period of time.

- Purpose is to determine **the increase or decrease** that has taken place.
- **Commonly applied** to the balance sheet, income statement, and statement of retained earnings.

# Fourth: Financial analysis methods for financial reports:

| Description | 2019 | 2020 | Horizontal Analysis | |
|---|---|---|---|---|
| | | | Value of change | Percentage of change |
| Net income | 150,000 | 225,000 | 75,000 | 50% |

**The percentage of change (increase) has been determined according to the following equation:**

$$\text{Percentage of increase} = \frac{\text{The recent value} - \text{the base year value}}{\text{The base year value}}$$

$$50\% = \frac{225{,}000 - 150{,}000}{150{,}000}$$

## Example No. 1

The following is the income statement as well as the financial position statement for 2023 and 2024 for one of the industrial companies in Sadat City:

**1- Income Statement:**

| Description. | 2023 | 2024 |
|---|---|---|
| Revenue. | 37,500 | 45,000 |
| (-) Sales cost. | 22,000 | 25,000 |
| Gross profit. | 15,500 | 20,000 |
| + Other revenue. | 19,500 | 16,800 |
| (-) Other expenses. | 15,000 | 13,400 |
| Net income. | 20,000 | 23,400 |

## Example No. 1

# 2- Balance Sheet:

| Description. | 2023 | 2024 |
|---|---|---|
| Fixed assets : | | |
| Machines. | 164,000 | 150,000 |
| Cars. | 136,000 | 145,000 |
| Total fixed assets. | 300,000 | 295,000 |
| Current Assets: | | |
| Debtors. | 72,000 | 70,000 |
| Bank. | 93,000 | 95,000 |
| Total current assets. | 165,000 | 165,000 |
| Total assets | 465,000 | 460,000 |
| Liabilities: | | |
| Notes payable. | 58,000 | 55,000 |
| Creditors | 45,700 | 48,000 |
| Loans | 76,300 | 88,200 |
| Total liabilities | 180,000 | 191,200 |
| Owners Equity. | 285,000 | 268,800 |
| Liabilities and equity | 465,000 | 460,000 |

# Example No. 1

**Required:** **Determine the changes that occurred in the items of financial statements during the year 2020, using horizontal financial analysis?**

# Activity No. (2)

- **Activity nature:** Discussion.
- **Activity Time:** 10 minutes.
- **Task:** Discuss the example and write the answer.

## Example No. 1

**1- Analysis of income statement items:** **The horizontal analysis is concerned with determining the amount and percentage of change as shown in the following table:**

- **The percentage of change (increase) in sales has been determined as follows:**

$$= \frac{45000 - 37500}{37500} \times 100 = 20\ \%.$$

## Example No. 1

**Thus for the rest items included in the income statement.**

| Description. | 2023 | 2024 | Change | % |
|---|---|---|---|---|
| Revenue. | 37,500 | 45,000 | 7,500 | 20% |
| (-) Sales cost. | 22,000 | 25,000 | 3,000 | 13,6% |
| Gross profit. | 15,500 | 20,000 | 4,500 | 29% |
| + Other revenue. | 19,500 | 16,800 | (2700) | (13,8) |
| - Other expenses. | 15,000 | 13,400 | (1600) | (10,7) |
| Net income. | 20,000 | 23,400 | 3400 | 17% |

# Example No. 1

| Description. | 2023 | 2024 | Change | % |
|---|---|---|---|---|
| Fixed assets : | | | | |
| Machines. | 164,000 | 150,000 | (14,000) | (8,5)% |
| Cars. | 136,000 | 145,000 | 9,000 | 6,6% |
| Total fixed assets. | 300,000 | 295,000 | (5,000) | (1,7)% |
| Current Assets: | | | | |
| Debtors. | 72,000 | 70,000 | (2,000) | (2,8)% |
| Bank. | 93,000 | 95,000 | 2,000 | 2,2% |
| Total current asset. | 165,000 | 165,000 | -- | -- |
| **Total assets** | **465,000** | **460,000** | **(5,000)** | **(1,08)%** |
| Liabilities: | | | | |
| Notes payable. | 58,000 | 55,000 | (3,000) | (5,2)% |
| Creditors | 45,700 | 48,000 | 2,300 | 5,04% |
| Loans | 76,300 | 88,200 | 11,900 | 15,6% |
| Total liabilities | 180,000 | 191,200 | 11,200 | 6,2% |
| Owners Equity. | 285,000 | 268,800 | (16,200) | (5,7)% |
| **Liabilities & equity** | **465,000** | **460,000** | **(5,000)** | **(1,08)%** |

# 2/2- Vertical Analysis Method:

**Vertical analysis means "analysis of financial statements to determine the reciprocal relationship between each item listed in this list, whether at the level of each group separately and / or at the overall level of the list. This analysis is concerned with determining all percentage of change (the relative importance of the item or what is known as relative weight).**

## 2/2- Vertical Analysis Method:

**Vertical analysis,** also called common-size analysis, is a technique that expresses each financial statement item as a percent of a base amount.

- On an **income statement**, we might say that selling expenses are 16% of **net sales( 100 % ).**
- Vertical analysis is commonly applied to the balance sheet and the income statement.

# Example No. 2

You have the following data available on the results of Sadat's business in Tala for the period ending on 31/12/2023.

| Description. | 2023 |
| --- | --- |
| Revenue. | 100,000 |
| (-) Sales cost. | 63,500 |
| Gross profit. | 36,500 |
| (-) Other expenses: | |
| Marketing expenses. | 5,500 |
| Administrative expenses | 11,000 |
| Net income after tax. | 20,000 |

# Example No. 2

**Then the vertical financial analysis method is applied to the income statement items by comparing the value of each item of the income statement with the value of sales as (100%) achieved by the company in the fiscal year, as follows:**

# Example No. 2

| Description. | Vertical analysis | |
|---|---|---|
| | value | % |
| Revenue. | 100,000 | 100% |
| (-) Sales cost. | 63,500 | 63,5% |
| Gross profit. | 36,500 | 36,5% |
| (-) Other expenses: | | |
| Marketing expenses. | 5,500 | 5,5% |
| Administrative expenses | 11,000 | 11% |
| Net income after tax. | 20,000 | 20% |

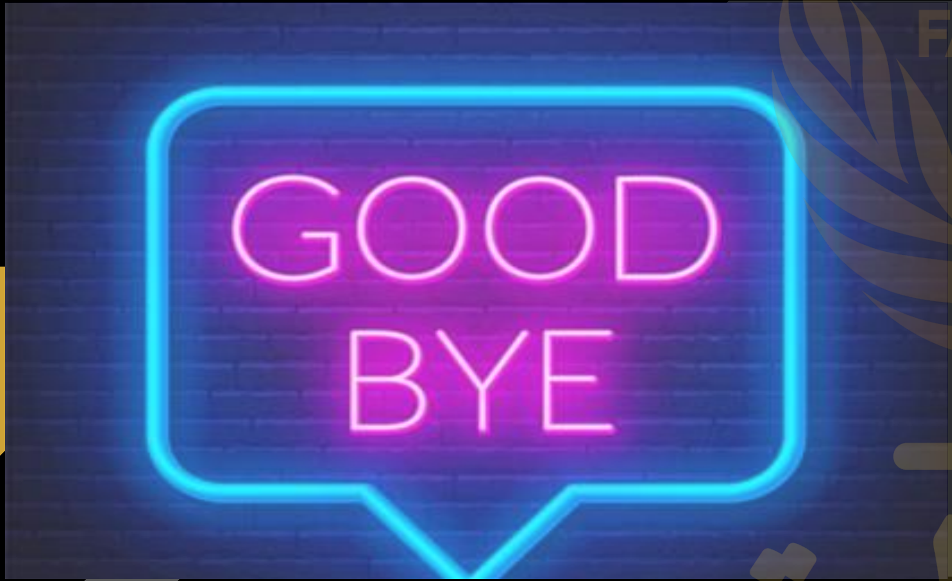
# Example No. 2

**The relative importance or relative weight of each item was determined by the following formula:**

$$\text{Percentage} = \frac{\text{Item value}}{\text{Sales (base)}} \times 100 = xx\ \%$$

$$\text{Sales cost} = \frac{63{,}500}{100{,}000} \times 100 = 63{,}5\ \%$$

# The Next Lecture




Con… Chapter 2

**Financial Analysis as an Approach to Decision-Making in Financial Institutions**