# Financial Statement Analysis

Financial statement analysis completes our journey on understanding financial statements. While financial statements provide wealth of information to users reflecting various activities of the organisations, financial statements analysis integrates them and assess whether the business has achieved the goal of maximising the wealth of the shareholders. Financial statements are analysed in several ways depending on the objective of such analysis. Common size analysis, trend analysis and financial ratio analysis are three important methods. The analysis of financial statements consists of a mixture of steps that interrelate and affect each other. It would lead to wrong conclusion and strategy if the analysis were done on piecemeal basis. For instance, higher turnover ratio doesn't mean good for the company since the company might aggressively selling by cutting down the price. Such aggressive selling could influence the collection or increase the bad debts. An integrated analysis would be useful in this context.

The financial health of a firm can be assess how the firm has performed on four important profitability drivers namely Cost Management, Asset Management, Leverage Management and Tax Management. Cost Management and Asset Management together determines the profitability of business at firm level. Asset Turnover Ratios measure how different component of assets are used to generate value. Cost Management presents how costs behaved during the year against revenue. Profitability to shareholders is further affected by leverage management and tax management. Leverage or debt contributes to shareholders if the firm generate a business return (ROCE) greater than cost of debt. The difference accrues to shareholders. Tax management relates to ability of the firm to save tax or defer the tax to future. Financial statements are also analysed to assess the risk associated with the firm. Short-term and long-term solvency are measured using interest coverage ratio, debt service coverage ratio, current ratio and debt to equity ratio. Du Pont Chart framework will useful to place all ratios in one place so that analysis will be easier.

The goal of wealth maximisation is achieved when the firm increases ROE without increasing the financial and business risk. At the firm level, managers need to maximise the return on assets (ROA). This profitability measure is driven by two drivers namely, asset management and cost management. Asset management refers to the ability of the firm to generate maximum revenue for a given level of assets. Cost or profit management refers to ability of the firm in controlling the cost or maximising profit margin. There are two possible strategies that firms can follow to improve cost minimisation or profit maximisation.

Cost leadership requires the company to spend their efforts to reduce the cost and then set competitive price to acquire larger volume or market share. Product differentiation strategy would require the firm to move upward on value chain and get premium price and profit. Companies generally pursue both strategies and develop products for different segments. For instance, Asian Paints (India) Ltd., the company we have analysed in this book, has developed a range of products and services over the years to serve the needs of different segments of market. Managers, who have access to more information, can measure profitability for each product or brand or division or plant or region. The primary purpose of accounting and accounting information system should enable the managers to get such details.

**Optional Readings**

Chapter 5 of the book titled ***Financial Statements and Analysis*** by M S Narasimhan (2016) and published by Cengage Learning, New Delhi, India. The paperback edition of the book is available at www.amazon.co.in E-book at a discounted price of Rupees 299 (equal to USD 5) is available at http://store.ignitorlearning.com/products/ignitor-book-financial-statements-and-analysis