CHAPTER : 18

Three characteristics to be evaluated while analyzing financial statement:

1. Liquidity: Liquidity means the availability of liquid assets of the organization. It indicates the ability to pay short term obligations of the business. A short time creditor such as a bank is primarily interested in liquidity. The liquidity of the borrower is extremely important in evaluating the safety of a loan.
2. Probability & solvency: Probability means the capacity to make profit & solvency indicates the ability to meet long term financial obligations. Profitability & solvency indicates the company’s ability to survive over a long period of time. Long term creditors such as bond holders, look to these measures to determine company’s ability to make interest payments. Similarly, share holders assess the likelihood of dividends and the growth potential of the stock through the analysis of profitability & solvency.

Tools for analysis:

1. Horizontal analysis.
2. Vertical analysis.
3. Ratio analysis.

Horizontal analysis: Horizontal analysis is a technic for evaluating a series of financial statement data over a period of time. It is also called a trend analysis. Its’ purpose is to determine the increase or decrease that has taken place. This change may be expressed as either an amount or a percentage. Horizontal analysis is done by following two steps.

Step 1: A base year is selected, and each item amount on the base year statement is assigned a weight of 100 percent.

Step 2: Each item from the statement for the years after base year is expressed as a percentage of its base-year amount. The percentage is determined as:

Current results in relation to base period = (current year amount/base year amount).

Horizontal analysis is used primarily in inter company comparisons. Investors use this analysis tool in order to determine the financial position and to predict the future events of the business.

Vertical analysis: Vertical analysis evaluates financial statement data by expressing each item in a financial statement as a percentage of a base amount. It is also known as common-size analysis. In this case , a common-size percent is measured by taking each individual financial statement amount under analysis and dividing it by its base amount.

In case of balance sheet, the formula for calculating balance sheet percentage is: (each item on balance sheet/total assets).

In case of income statement, the formula for calculating income statement percentage is: (each item on income statement/net sales).

Vertical analysis reveal the relative importance of each item in the financial statement. It is used in both intra & inter company comparisons.

Ratio analysis: Ratio analysis expresses the relationship among selected items of financial statement data. A ratio expresses the mathematical relationship between one quantity or another. The relationship is expressed in terms of either percentage or a simple proportion. Ratios are used to evaluate liquidity, profitability & solvency. Using the ratio, the users can compare the results of different periods of the same firm and forecast the future of the business. The strengths & wicknesses of a firm, as well as its historical performance & current financial condition can be determined through the interpretation of ratios.