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THE ROLE OF FINANCIAL STATEMENTS IN UNDERSTANDING A COMPANY'S FINANCIAL POSITION AND PREPARING AND ANALYZING SUCH STATEMENTS

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ABSTRACT

This research paper examines the preparation and analysis of financial statements as well as the crucial role they play in comprehending a company's financial position. For stakeholders to evaluate a company's performance, make wise decisions, and assess its financial health, financial statements are essential tools. The balance sheet, income statement, and statement of cash flows are just a few of the different parts of financial statements that are investigated in this essay along with their significance in providing important financial data. The process of creating financial statements is also covered, emphasizing the value of abiding by accounting principles andstandards for truthful and accurate reporting. The research paper also examines the analytical methods, such as ratio analysis, trend analysis, and benchmarking, that are used to interpret financial statements. The importance of these analytical tools in assessing a company's liquidity, solvency, profitability, and operational effectiveness is emphasized. The study acknowledges the significant contribution financial statements make to decision-making, transparency, accountability, and stakeholder confidence. In conclusion, this research paper emphasizes the significance of financial statements as a tool for understanding a company's financial position as well as the significance of effectively preparing and analyzing them to gain insightful informationfor decision-making and performance evaluation.

Keywords: balance sheet, income statement, statement of cash flows, stakeholders, financial position.

Introduction

If we break the term financial statement analysis, we get three individual terms including Financial which means money related, Statement which implies records and the last word analysis which conveys study or interpretation. The process of critical evaluation of the financial

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information contained in the financial records of a company for decision-making purposes about the financial position/status of the firm is known as financial statement analysis. It consists primarily of an analysis of the relationships between different financial data points as presented in a set of financial statements, as well as their interpretation to gain an understanding of the firm's profitability and operational productivity and to evaluate the firm's financial condition and its possible future. Ratio financial analysis and quantitative analysis are the two types of analysis on which the concept of financial analysis is based. In general, analysis entails identifying a situation's strengths and weaknesses.

Financial statements act as a crucial component in assessing the financial status, operational efficiency and cash flow of a company. On interpreting the financial statements of a company, the strengths and the weaknesses of a company can be easily figured out which can help a company do better. They act as the main channel for communicating financial information to various parties, such as creditors, employees, government workers, investors, and the public. Here are a few main arguments supporting the significance of financial statements:

1. Decision Making

Financial statements provide significant information to both the stakeholders and the internal members of the organization which could help them in making a crucial decision. Investors decide their investment in a company by interpreting its financial statements to get their profitability and prospects. Owners assess their financial records to determine whether the company is giving profits, do they need to improve their business strategies or if the business should shut down completely. Creditors make their decisions after assessing the company's financial statements by gaining enough confidence in the company as to whether the company will be able to repay its debt or not. The employees also are assured of their income through a positive financial record.

2. Accountability and Transparency

Financial statements encourage accountability and transparency within organizations. They aid in proving adherence to legal and regulatory requirements, such as tax laws and accounting standards. To maintain transparency and fulfill their reporting responsibilities to stock exchanges, securities regulators, and shareholders, publicly traded companies must provide financial statements. For instance, Hindustan Unilever Pvt. Ltd. Is a public company that maintains its transparency by making all its financial statements available to all which helps them to gain confidence from their stakeholders and henceforth, increases its stockholders.

3. Stakeholder Confidence

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By providing trustworthy information about the company's financial health, financial statements help stakeholders develop a sense of trust and confidence. A company's credibility is increased by accurate and transparent financial reporting, which attracts potential investors, lenders, and business partners. The capacity of the company to generate returns, manage risks, and fulfil commitments can be evaluated by stakeholders.

4. Compliance and Governance

By ensuring adherence to accounting standards and laws, financial statements support corporate governance. They serve as a foundation for evaluations of internal and external controls and promote transparency, integrity, and moral conduct within organizations. Maintaining the trust of stakeholders and preventing legal and reputational risks depend on accurate financial reporting.

In conclusion, financial statements are a crucial tool for compliance, transparency, stakeholder confidence, performance evaluation, and decision-making. They give stakeholders a thorough understanding of a company's financial position and performance, enabling them to assess the company's financial health and prospects.

Types of Financial Statement Analysis

1. Internal Analysis

Internal Analysis is conducted by the management of the company to determine the financial status and the efficiency of the business operations of an organisation. They management include people who have access to all the financial information of the company.

2. External Analysis

External Analysis on the other hand, is conducted by the external stakeholders, those who do not have access to the actual financial information of the company and have to depend on the published reports. This type of analysis is made by investors, credit agencies, research scholars and the government.

3. Horizontal/Dynamic Analysis

Horizontal Analysis is carried out by taking into consideration the financial data for two or more than two years. It is done to compare the financial position for several years against the chosen base year. It is useful for long-term analysis. For example, Comparative Financial Statements.

4. Vertical/Static Analysis

Vertical Analysis is carried out taking into consideration the financial information of only one

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year. It is useful in comparing the financial position of different companies in the same product line or department of an enterprise.

The role of Financial statements in understanding the financial position of a company

Balance Sheet

The balance sheet provides insight on the company's financial position by determining its profitability, solvency, and liquidity. It takes into consideration the company's financial information such as its assets, liabilities, and shareholder's equity. The balance sheet adheres to the simple equation of Assets = Liabilities+ Shareholder's equity. Risk is determined by balance sheets. This financial statement lists all assets and liabilities of a company. A business will be able to determine in an efficient way whether it has taken on too much debt, whether the liquidity of its assets is inadequate, or whether it has enough cash on hand to cover immediate needs. Balance sheets can also be used to raise money. For a company to be approved for a business loan, a lender typically requires a balance sheet. A balance sheet is typically required when a business seeks private equity funding from investors. In both situations, the outside party seeks to determine a company's financial stability, creditworthiness, and ability to pay off short-term debts.

There are two types of balance sheets that act as tools for financial analysis namely, Comparative Balance Sheets and Common Size Balance Sheets.

A comparative balance sheet is a tool used to compare a company's balance sheet at various times, typically over several reporting periods. It allows for year-to-year or period-to-period comparisons by presenting the company's financial position at the end of each period in a side-by-side format.

The common-size balance sheet is a technique used to analyse the composition and relative proportions of different items on the balance sheet. It displays the percentage of total assets for each line item. It makes it simpler to compare and identify trends over time or across different companies by expressing all items as a percentage of the total.

Income Statement

An overview of a company's financial performance for a given time is given by the income statement. It displays the company's income, expenses, and net profit or loss. Stakeholders can evaluate the profitability, effectiveness, and revenue-generating capabilities of the company by examining the income statement. They can assess the company's ability to make consistent profits, spot patterns in revenue and spending, and comprehend the effects of different variables

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on its net income. Like Balance sheet, the income statement is also of two types, Comparative Income Statement and Common Size Income Statement.

The comparative income statement compares the company's revenues, costs, gains, and losses over several periods, usually presented side by side.

Statement of Cash Flows

As balance sheet and income statement fail to give precise information about the cash coming in or cash going out during an accounting period, statement of cash flow is prepared. Transaction of cash and cash equivalent in a business is very common activity but to maintain a systematic record, these cash transactions are recorded in the cash flow statement. It records cash on hand, balance with bank, marketable securities and short-term investment. It divides cash flows into three categories: financing, investing, and operating. Stakeholders can learn about the company's cash-generating capacity, cash management procedures, and cash flow sustainability by examining the statement of cash flows. They can assess whether the business is producing enough cash from its operations, making investments in useful assets, and effectively managing its financing activities.

Preparation of Financial Statements

Accounting Principles for Preparation

Generally Accepted Accounting Principles (GAAP)

GAAP stands for Generally Accepted Accounting Principles. Financial statement preparation and presentation are governed by accounting principles and standards. GAAP seeks to guarantee regularity and comparability in financial reporting among various organisations. It includes a few pronouncements, including the Statements of Financial Accounting Concepts (SFAC), the Financial Accounting Standards (FAS), and the Accounting Standards Codification (ASC).

International Financial Reporting Standards (IFRS)

International Accounting Standards Board (IASB) developed and maintains a set of accounting standards known as International Financial Reporting Standards (IFRS). It has gained widespread acceptance outside of the United States with the aim of achieving financial reporting that is transparent and comparable around the world. Companies listed on stock exchanges worldwide, including those in the European Union, use IFRS.

Accrual Concept

Both GAAP and IFRS state that the transactions for the financial statements are to be recorded

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when they occur rather than recording them when the cash is paid or received. Accrual accounting matches revenues with related expenses to provide a more accurate representation of a company's financial performance and position.

Going Concern

Going Concern states that the preparation of financial statements is based on the assumption that the business will carry on with its operations for the foreseeable future. The measurement and presentation of assets, liabilities, revenues, and expenses are guided by this assumption.

Historical Cost Principle

According to this principle, the assets should be recorded at their purchase rate (the price at which they were purchased) which is also called the original price. The historical cost principle offers an accurate and impartial basis for measurement, despite the fact that the market value of assets may fluctuate over time.

Preparation of Balance Sheet

The balance sheet consists of 3 main components including Assets, liabilities, and shareholder's equity. The balance sheet is prepared according to the equation

LIABILITIES + SHAREHOLDER'S EQUITY = ASSESTS

1. Assets

An asset is anything that a company owns that has a quantifiable value and can be dissolved and converted to cash. They are the company's goods and resources.

Current assets and non-current assets are two types of assets.

- Current Assets

Cash and cash equivalents, prepaid expenses, inventory, marketable securities, and accounts receivable are examples of current assets, or short-term assets, that a company expects to convert into cash within a year.

- Non-current Assets

Non-current assets are investments that a company does not expect to convert into cash in the near future, such as land, equipment, patents, trademarks, and intellectual property.

2. Liabilities

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A liability is anything owed to a debtor by a company or organisation. rent and utility payments, debt payments, money owed to suppliers, taxes, or bonds payable are some examples of liabilities.

Liabilities, like assets, can be divided into two types: current liabilities and non-current liabilities.

- Current Liabilities

Accounts payable and other accrued expenses are examples of current or short-term liabilities that are typically due within one year.

- Non-current Liabilities

Non-current or long-term liabilities are those that a business does not expect to repay within a year. They are typically long-term obligations such as leases, payable bonds, or loans.

3. Shareholders' Equity

Shareholders' equity is a company's net worth that reflects the amount of money that would be left over if all assets were sold, and all liabilities were paid. The equity of shareholders, whether private or public, belongs to the shareholders.

Similarly, to how assets must equal liabilities plus shareholders' equity, shareholders' equity can be represented by the following equation: **Shareholder equity equals assets minus liabilities.**

Preparation of Income Statement

To prepare an income statement, also known as a profit and loss statement or P&L statement, you'll need to gather information about your revenue and expenses.

- **Revenue/Sales** – At the top of the statement, every firm's sale and service revenue are shown.
- **Cost of Goods Sold (COGS)** – It is a line-item that sums up the direct costs related to goods sold to make revenue. If the company is a service business, COGS is also known as the cost of sales.
- **Gross Profit –** It is determined by subtracting the cost of goods sold from sales revenue.
- **Marketing, Promotion, and Advertising Expenses –** Most organizations have expenses associated with selling products and services. Marketing, promotion, and advertising are

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often classified in the same cost.

- **Depreciation & Amortization Expense** – These are non-cash charges. A fewexamples are depreciation charges on plant, property, and equipment (PP&E).
- **Interest** – It is divided into interest income and interest expense line in the income statement.

Preparation of Cash Flow Statement

A cash flow statement has the following main components:

Cash from Operating Activities

Cash from Investing activities

Cash From Financing activities

a. Operating Activities

Any use or source of money derived from a business's operations is included in operating activities. They change the reported items from the income statement's accrual basis accounting to cash accounting. Operational cash typically reflects changes in cash, accounts receivable, inventory, and accounts payable. The operational activities could consist of:

Cash receipt from sale of products and services

Income tax payments

Payments to suppliers of goods and services required for production

Rent payment

Salary payment

Other operating expenses

Purchase or sale of long-term assets does not come under operating activities in the cash flow statement.

b. Investing Activities

Investing activities are inclusive of any use or source of cash generated from a business' investments. They report purchase and sale of long-term investments including plant, property,

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and equipment. Sale or purchase of assets, paid loan, received loans, or any merger or acquisition related payments are part of investing activities. Changes in assets, equipment, or investments are reflected in invested cash.

C. Financing Activities

Financing activities are inclusive of any use of cash paid to a business' shareholders or any source of cash generated from a business' investors or banks. They report issue and repurchase of the bonds and stocks owned by the business and its dividends payment. Payment made on dividends, stock repurchases, and loans are part of financing activities. Example of changes in financing cash are reflected in financed cash as "cash in" when capital is raised and "cash out" when dividends are paid.

Analysing Financial Statements

Analysing balance sheet

To identify developments and potential areas of concern, a balance sheet analysis includes comparing the current year's numbers to earlier periods and benchmarking against competitors. The balance sheet provides a snapshot of a company's assets, liabilities, and shareholders' equity.

1. Assets: Assets represent what a company owns and include current assets (such as cash, accounts receivable, and inventory) and non-current assets (such as property, plant, and equipment).

- Liquidity: Review the composition of current assets to assess the company's liquidity and ability to meet short-term obligations. Calculate the current ratio (current assets dividedby current liabilities) to evaluate liquidity further.
- Asset quality: Examine the composition and valuation of non-current assets. Analyse the depreciation and impairment policies, as well as any significant changes in asset values.

2. Liabilities: Liabilities represent what a company owes and include current liabilities (such as accounts payable and short-term debt) and non-current liabilities (such as long-term debt and deferred taxes).

- Debt levels: Evaluate the company's debt load by comparing total liabilities to shareholders' equity. Calculate the debt-to-equity ratio (total liabilities divided by shareholders' equity) to assess the company's leverage.

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- Debt maturity: Assess the maturity profile of the company's debt to determine any upcoming obligations. Evaluate the proportion of short-term debt to total debt and consider the company's ability to refinance or meet these obligations.

3. Shareholders' Equity: Shareholders' equity represents the residual interest in the assets after deducting liabilities. It includes common stock, retained earnings, and additional paid-in capital.

- Capital structure: Analyse the proportion of equity financing compared to debt financing.
- Assess the company's ability to generate returns for shareholders.
- Retained earnings: Evaluate the trend in retained earnings over time to assess the company's profitability and dividend-paying capacity.

4. Financial ratios: Utilize various financial ratios to gain insights into the company's financial health and performance. Examples include:

- Return on assets (ROA): Net income divided by total assets. It measures the company'sability to generate profit from its assets.
- Return on equity (ROE): Net income divided by shareholders' equity. It indicates the return generated for shareholders' invested capital.
- Debt ratio: Total debt divided by total assets. It measures the proportion of assets financed by debt.
- Working capital ratio: Current assets divided by current liabilities. It assesses the company's ability to cover short-term obligations.
- Quick ratio: (Current assets minus inventory) divided by current liabilities. It measures the company's ability to meet short-term obligations without relying on inventory.

Analysing Income Statement

Analysing an income statement should involve comparing the current year's figures to previous periods and benchmarking against industry peers to identify trends and potential areas ofconcern.

1. Revenue: Revenue represents the total income generated from the company's primary operations. It includes sales revenue, service revenue, and other sources of income. • Revenue growth: Compare the current year's revenue to previous periods to assess the company's growth rate. Analyse the factors contributing to the revenue growth ordecline.

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- Revenue sources: Evaluate the composition of revenue sources and their relative importance. Identify any significant changes in revenue streams.

2. Expenses: Expenses include the costs incurred in generating revenue and running the business. They can be categorized into various types, such as cost of goods sold, operating expenses, and financial expenses.

- Gross profit margin: Calculate the gross profit margin (gross profit divided by revenue) to evaluate the company's ability to generate profit after accounting for direct costs. Compare it to previous periods and industry benchmarks.
- Operating expenses: Analyse the trend and composition of operating expenses (such as salaries, marketing expenses, and rent). Evaluate their proportion to revenue and identify any cost-saving opportunities.
- Operating profit margin: Calculate the operating profit margin (operating profit divided by revenue) to assess the company's profitability from core operations.

3. Gains and Losses: Gains and losses represent non-operating income and expenses,such as investment gains, asset sales, or one-time charges.

- Non-operating items: Evaluate the significance and nature of gains and losses.

Determine if they are recurring or one-time events and assess their impact on overall profitability.

4. Net Income: Net income, also known as net profit or net earnings, represents the company's bottom line after deducting all expenses and taxes.

- Net profit margin: Calculate the net profit margin (net income divided by revenue) to assess the company's overall profitability. Compare it to previous periods and industry benchmarks.
- Earnings per share (EPS): Divide the net income by the weighted average number of shares outstanding to calculate EPS. It indicates the company's profitability on a per share basis.

5. Financial ratios: Utilize financial ratios derived from the income statement to gain insights into the company's financial health and performance. Examples include: •Return on sales (ROS): Net income divided by revenue. It measures the company's ability to generate profit from each dollar of revenue.

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- Operating profit margin: Operating profit divided by revenue. It indicates the profitability of core operations.
- Expense ratios: Calculate various expense ratios (such as cost of goods sold as a percentage of revenue or operating expenses as a percentage of revenue) to evaluate cost management and efficiency.

Analysing Cash Flow Statement

The cash flow statement provides insights into a company's cash position, operating activities, investing activities, and financing activities.

1. Operating Activities: Operating activities represent the cash flows directly related to a company's primary operations, including cash received from customers and cash paid for expenses.

- Operating cash flow: Analyse the net cash provided by operating activities to assess the company's ability to generate cash from its core operations. Compare it to previous periods to identify trends.
- Operating cash flow margin: Divide the operating cash flow by revenue to evaluate the proportion of cash generated from each dollar of sales.
- Quality of earnings: Evaluate the composition of operating cash flows and assess if theyare sustainable and of good quality. Look for consistency and stability in operating cash flows.
- Investing Activities: Investing activities represent cash flows related to the purchase or sale of long-term assets, such as property, plant, and equipment, as well as investments.
- Capital expenditures: Analyse cash outflows for purchases of property, plant, and equipment. Assess if the company is investing in its long-term growth and maintaining its assets.
- Asset acquisitions and divestitures: Evaluate cash flows from acquiring or selling assets, including investments in other companies. Assess the strategic rationale and impact on cash position.

2. Financing Activities: Financing activities represent cash flows related to raising capital and repaying debts, such as issuing or repurchasing stock, borrowing or repaying loans, and paying dividends.

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- Debt financing: Analyse cash flows from borrowing or repaying loans. Assess the company's ability to manage its debt obligations and potential refinancing risks.

- Equity financing: Evaluate cash flows from issuing or repurchasing stock. Assess the impact on shareholders' equity and the dilution or enhancement of ownership. • Dividends: Analyse cash flows related to dividend payments. Assess the company's dividend policy and its impact on cash flows and retained earnings.

- Cash Flow Ratios: Utilize financial ratios derived from the cash flow statement to gain insights into the company's liquidity and cash management. Examples include: • Operating cash flow ratio: Divide operating cash flow by current liabilities to assess the company's ability to cover short-term obligations with cash generated from operations. • Free cash flow: Calculate free cash flow by subtracting capital expenditures from operating cash flow. It represents the cash available for debt reduction, dividends, or investments.

- Cash conversion cycle: Assess the efficiency of the company's cash conversion cycle, which includes the average time it takes to convert inventory into sales and collect receivables.

Conclusion

In conclusion, this research paper has examined the significant role of financial statements in understanding a company's financial position and the process of preparing and analysing such statements. Financial statements, including the balance sheet, income statement, and cash flow statement, provide crucial information about a company's financial performance, liquidity, and overall health.

The balance sheet helps stakeholders understand the company's assets, liabilities, and equity, providing insights into its financial stability and solvency. It allows for the evaluation of the company's capital structure and its ability to meet its financial obligations.

The income statement summarises a company's revenues, costs, profits, and losses so that stakeholders can evaluate its profitability and operational effectiveness. Investors and managers can find trends in the income statement, compare performance over time, and come to wise decisions.

The cash flow statement details the company's cash inflows and outflows, providing information about its liquidity and its capacity to produce and manage cash. Stakeholders can evaluate the company's cash position and cash flow management by highlighting the sources and uses of

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cash, such as operating, investing, and financing activities.

These financial statements are crucial tools for various stakeholders, including investors, creditors, analysts, and managers, in making informed decisions and evaluating the financial health of a company. They serve as a basis for financial analysis, ratio calculation, and benchmarking against industry peers and competitors.

Overall, understanding financial statements and the process of preparing and analysing them is essential for gaining insights into a company's financial position, making informed decisions, and evaluating its performance. Continued research and analysis in this area are critical for improving financial reporting practices and enhancing stakeholders' ability to assess the financial health and prospects of companies.

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