CHAPTER ONE: INTRODUCTION TO FINANCIAL ANALYSIS

Learning Outcome

At the end of this topic, the learner should be able

a) Define financial analysis and Financial statement analysis

b) Identify users of financial statements and their needs

c) Describe the Features of Financial Analysis

d) Determine the Purpose of Analysis of financial statements

e) Outline the Procedure of Financial Statement Analysis

f) Appreciate the importance of Financial Statement Analysis:

1.1 Introduction

Financial statement analysis is the process through which users of financial information manipulate the presented financial reports for the purpose of extracting information necessary in decision making. Ordinarily financial information is presented to stake holders in a standardized manner in line with the recommended reporting standards. This information is meant for a big group of users and as such may not be able to focus on the needs of specific categories of users. For this reason further analysis may be necessary to be able to bring out specific aspects of the financial reports necessary for decision making.

In order to make rational decisions in keeping with objectives of the firm the stakeholders especially the managers must have at their disposal certain analytical tools. These tools of financial analysis are important as they give a feedback as to the contents of the financial statements. These tools are also used by outside suppliers of capital, creditors, investors and by the firm itself. The firm uses financial analysis not only for internal controls but also for a better understanding of what capital suppliers seeks in the way of financial conditions and performance of it.

c) Ratios may not be useful in comparing between companies where the companies are significantly different in size, and internal structure

d) Differences in determination of variables making up the ratios

Yard Stick Used In Ratio Analysis

1. Past performance of the company

The company's past performance (past ratio) is used to measure or gauge the company's performance and in particular the change in performance whether good (favorable), better, same or even worse than the past. Such comparison is then used to interpret the company's performance bearing in mind the factors that influenced the present and past performances.

2. Average industry ratios

These are useful as they indicate the average performance of various companies in a given industry i.e. it gives the minimum performance of a number of companies in a given industry. These ratios are useful in so far as to enable the analyst to make a reasonable comparison of the company's performance vis-à-vis other companies in the same industry. However, for this yardstick to be useful the term average should include those companies which are not extremely. I.e. very strong and very weak companies – which should be excluded to arrive at industry average figures.

3. Ratio of successful companies

Useful if the company can get figures of competitors who are leading in the market so as to enable it to gauge its performance against better performance. However this information is difficult to obtain and sometimes it calls for private investigators e.g. Private Eyes Ltd.

this capital will remain constant during the forecasting period.

3. The relationship between balance sheet item and sales i.e balance sheet items as % of sales will be maintained during forecasting period.
4. The after tax, profit on sale or net profit margin will be achieved and shall remain constant during the forecasting period.

Illustration

The following is the balance sheet of XYZ Ltd as at 31st December 2002:

	Sh." 000"
Net fixed asset	300
Current assets	100
	400

Financed by: