About Topic Gateways

Topic Gateways are intended as a refresher or introduction to topics of interest to CIMA members. They include a basic definition, a brief overview and a fuller explanation of practical application. Finally they signpost some further resources for detailed understanding and research.

Topic Gateways are available electronically to CIMA Members only in the CPD Centre on the CIMA website, along with a number of electronic resources.

About the Technical Information Service

CIMA supports its members and students with its Technical Information Service (TIS) for their work and CPD needs.

Our information specialists and accounting specialists work closely together to identify or create authoritative resources to help members resolve their work related information needs. Additionally, our accounting specialists can help CIMA members and students with the interpretation of guidance on financial reporting, financial management and performance management, as defined in the CIMA Official Terminology 2005 edition.

CIMA members and students should sign into My CIMA to access these services and resources.

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**Definition**

‘The objective of financial statements is to provide information… that is useful to a wide range of users in making economic decisions.’

*International Accounting Standards Committee - now the International Accounting Standards Board*

Analysis of financial statement is:

‘The evaluation of a firm’s financial statements in order to assess the firm’s worth and its ability to meet its financial obligations.’

Definitions of each of the ratios described later on this topic gateway can be found in *CIMA Official Terminology*, 2005.

**Context**

In the current syllabus, CIMA students will learn and may be examined on this topic in Paper 8 ‘Financial Analysis’ and at a strategic level in Paper 9 ‘Management accounting financial strategy’. Students may be examined if they take the TOPCIMA case study.

**Related concepts**

The analysis of financial statements is linked to financial analysis and industry or industrial analysis.
Overview

The analysis of financial statements relates to the application of analytical tools and techniques, in particular ratio analysis, to financial statements and other related company data. The purpose is to derive estimates and to make interpretations about these to assist in business and economic decision making.

Analysis of financial statements is used to assess past performance or current position of a business. It can be used to forecast future performance or financial conditions and risks. It is a helpful screening tool in making merger and other investment decisions. Analysis of financial statements is also an evaluation tool for managerial and other business decisions.

In short, it is an important tool in assessing financing, investing and operating activities. (Bernstein and Wild. 2000).

Analysis of financial statements in practice

Analytical framework

Finance professionals need to use their judgement and experience when they interpret the results of financial statement analysis. It is not merely about calculating ratios and applying rules of thumb. The interpretation process is assisted by adopting an analytical framework, with the following main components:

- identification of the user of the analysis
- understanding the nature of the business, industry and organisation
- identification of relevant sources of data for analysis
- numerical analysis of available data
- interpretation of the results of the analysis
- appreciating the limitations of the data and analysis
- communicating and reporting the analysis of the results and recommendations.

Source: Gowthorpe and Robins (2005).
Users of financial statement analysis

Financial statement analysis is used to understand the current financial position of a company and its prospects for the future.

There is a wide range of external user groups that may be interested in an entity’s financial statements, in addition to existing and potential investors. Some of these include existing or potential lenders, suppliers and other creditors, employees, customers, governments and the general public.

Although the various user groups will almost always use general purpose financial reports, their needs will differ. It is important that any analysis and interpretation exercise is tailored to the needs of the particular user.

Understanding the business and industry

In order to interpret the calculations, it is important to understand the relationship between the data and the underlying economic (and other reasons) for the company’s current position. For example, the history, operating characteristics, management composition and attitude to risks of the business will help to explain its current position and future outlook.

Comparisons of the results of the analysis against the industry can be very useful. Therefore it is important to identify industry characteristics and to establish benchmarks against which to compare position and performance.

Identification of data sources

The most obvious source of financial and non-financial information is a company’s annual report. The annual report provides information that is required by law and by accounting standards. The report also usually provides further voluntary disclosures that may be helpful. Other sources of information include:

- interim announcements
- analyst/broker reports
- media announcements
- company web page
- specialist and industry groups
- corporate social responsibility reports.
Numerical analysis of data

Users are primarily interested in two areas:

1. the company’s performance.
2. the company’s current financial position.

Preparers of financial statement analyses in these area will concentrate on the following key areas:

- **performance**: this includes calculating profitability, activity and return on capital ratios, and studying movements in revenue
- **liquidity**: this includes calculating short-term liquidity ratios, analysing working capital and the cash position
- **capital structure and long-term solvency**: a company’s ability to generate future revenues and meet long-term obligations. The effectiveness of the company’s capital structure can also be analysed
- **valuations and investor related**: this area examines a range of ratios to value the company at specific dates in time for investment purposes. It looks at growth potential and the ability to generate future wealth and earnings for investors
- **cash flow**: a company’s cash flow is arguably the most important indicator of the financial health of a company. The three main totals on a cash flow statement (per IAS 7) can be examined: cash flows from operating activities, investing activities, and financing activities. In addition, various ratios can also be calculated.

*Bernstein and Wild (2000).*

In these areas of analysis, a combination of studying movements in absolute numbers and the calculation of ratios is used to understand a company’s performance, its current financial position and prospects for the future. (The further information section of this topic gateway includes resources where you can find more detail on using and interpreting ratios).

**Interpretation of the results**

An analysis should include, but not restrict itself, to the following:

- **Time series analysis.** Determining trends against past years or periods by examining year on year changes. Numbers should be presented both in absolute terms and in percentages.
• Comparing actual versus forecast results can assess the accuracy of forecasts and assist with future planning and can highlight areas for investigation.

• Industrial or cross sectional analysis. Comparing with other companies within the same industry in the same year or to industry averages. By benchmarking a company’s results against its peers, a company can determine if it is above or below average for its industry. It can then work to address weaknesses or to exploit strengths.

Consideration should also be given to the company’s accounting policies and style.

Limitations of analysis

A substantial limitation of financial statements is found in paragraph 13 in the IASB’s Framework for the Preparation of Financial Statements (July 1989):

‘Financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.’

Gowthorpe and Robins (2005)

Other limitations

Timeliness

When analysing financial statements, caution should be exercised and additional information sought regarding post year end events. This is due to the delay between when financial statements are prepared and received (and therefore analysed by users).

Comparability

The usefulness and accuracy of comparisons may become impaired over time. This is due to significant business changes, price inflation and changes in accounting policy and practices over the longer period. Complex businesses, for example, those operating in more than one business sector, may find comparisons with industry averages or with other companies difficult.

International issues

Different tax regimes, legal and regulatory regimes and differences in economic statistics (such as exchange rates and interest rates) must be considered when interpreting results.
Reporting of results

How results are reported will depend on the end user of the information. The content should be tailored to the individual needs of the end user.

Gowthorpe and Robins (2005)

Communicating the results of the analysis

The final step in the analytical framework for financial statement analysis is communicating the results and recommendations to decision makers. A concise and understandable format using simple charts and graphs is an effective way to summarise and illustrate key messages.

Bibliography


Further information

Articles

CIMA members can obtain articles on this topic from the Business Source Corporate database, which can be found in the CIMA Professional Development section of the CIMA website. [www.cimaglobal.com/mycima](http://www.cimaglobal.com/mycima) [Accessed 28 May 2009]


Available from: www.cimaglobal.com/financialmanagement
[Accessed 28 May 2009]


*Statements of cash flows and analysis of ratios (chapter 4)*. Cash Rules, 2003, pp 49-76

**Books**


[Accessed 28 May 2009]


[Accessed 28 May 2009]


[Accessed 28 May 2009]


Higher Education

**Websites**

Biz/ed
This is a website for students and educators in business studies, economics and accounting. It is funded by the Joint Information Systems Committee (JISC). The financial ratio analysis section of this website provides a comprehensive guide to financial ratios. It is illustrated with examples from real business organisations.
Available from: [www.bized.co.uk](http://www.bized.co.uk)
[Accessed 28 May 2009]

Creditguru
Creditguru features corporate credit and risk management solutions. Browsers can also download a free financial statement analysis worksheet with formulas and ratios.
Available from: [www.creditguru.com](http://www.creditguru.com)
[Accessed 28 May 2009]
Investopedia, the Investing Education Site

Owned by Investopedia Inc., Investopedia is the largest financial site on the internet. The site includes free access to over 1,000 articles, 5,000 dictionary entries, and 500 pages of in-depth tutorials on any aspect of finance and investing. These include comprehensive information and learning tools on analysing financial statements.

Available from: www.investopedia.com/university/ratios
[Accessed 28 May 2009]