Components of Financial Analysis

The first step toward improving financial literacy is to conduct a financial analysis of your business. A proper analysis consists of five key areas, each containing its own set of data points and ratios.

1. Revenues

Revenues are probably your business's main source of cash. The quantity, quality and timing of revenues can determine long-term success.

- Revenue growth (revenue this period - revenue last period) ÷ revenue last period.

When calculating revenue growth, don't include one-time revenues, which can distort the analysis.

- Revenue concentration (revenue from client ÷ total revenue). If a single customer generates a high percentage of your revenues, you could face financial difficulty if that customer stops buying. No client should represent more than 10 percent of your total revenues.
- Revenue per employee (revenue ÷ average number of employees). This ratio measures your business's productivity. The higher the ratio, the better. Many highly successful companies achieve over one million Dinar in annual revenue per employee

2. Profits:

If you can't produce quality profits consistently, your business may not survive in the long run.

- Gross profit margin (revenues – cost of goods sold) ÷ revenues. A healthy gross profit margin allows you to absorb shocks to revenues or cost of goods sold without losing the ability to pay for ongoing expenses.
- Operating profit margin (revenues – cost of goods sold – operating expenses) ÷ revenues. Operating expenses don't include interest or taxes.

This determines your company's ability to make a profit regardless of how you finance operations (debt or equity). The higher, the better.

- Net profit margin (revenues – cost of goods sold – operating expenses – all other expenses) ÷ revenues. This is what remains for reinvestment into your business and for distribution to owners in the form of dividends

3. Operational Efficiency :

Operational efficiency measures how well you're using the company’s resources. A lack of operational efficiency leads to smaller profits and weaker growth.

- Accounts receivables turnover (net credit sales ÷ average accounts receivable). This measures how efficiently you manage the credit you extend to customers. A higher number means your company is managing credit well; a lower number is a warning sign you should improve how you collect from customers.
- Inventory turnover (cost of goods sold ÷ average inventory). This measures how efficiently you manage inventory. A higher number is a good sign; a lower number means you either aren't selling well or are producing too much for your current level of sales.

4. Capital Efficiency and Solvency

Capital efficiency and solvency are of interest to lenders and investors.

- Return on equity (net income ÷ shareholder’s equity). This represents the return investors are generating from your business.
- Debt to equity (debt ÷ equity). The definitions of debt and equity can vary, but generally this indicates how much leverage you're using to operate. Leverage should not exceed what's reasonable for your business.

5. Liquidity

Liquidity analysis addresses your ability to generate sufficient cash to cover cash expenses. No amount of revenue growth or profits can compensate for poor liquidity.

- Current ratio (current assets ÷ current liabilities). This measures your ability to pay off short-term obligations from cash and other current assets. A value less than 1 means your company doesn't have sufficient liquid resources to do this. A ratio above 2 is best.
- Interest coverage (earnings before interest and taxes ÷ interest expense). This measures your ability to pay interest expense from the cash you generate. A value less than 1.5 is cause for concern to lenders.

Example : The following information abstracted from a company books for the financial year ended 31/12/2019. (Amounts in thousands)
1 - The profit and loss account for the year ended 31/12/2019

particulars	amount
Total revenues (-) Cost of goods sold	2,500,000 (1,500,000)
= Gross Profit	1,000,000
Operating expenses	(450,000)
= Profit before extraordinary items + Net capital gains and losses(100,000 – 130,000) capital gains capital losses	550,000 (30,000)
= Profit before interest and taxes (-) Interest	520,000 (120,000)
= Profit before tax (-) Taxes	400,000 (132,000)
= Net profit after tax	268,000

2 - The Balance sheet as it is in 31/12/2019

amount	Liabilities and Equity	amount	assets
5,000,000	Equity	3,000,000	Fixed Assets
1,200,000	Reserves are not subject to tax	(400,000)	(-) depreciation Accum.
1,500,000	Long-term loans (8%) Current	2,600,000	Net fixed assets
750,000	liabilities Revenue received in	640,000	Prepaid expenses
190,000	advance	3,300,000	Stock
		1,200,000	Accounts receivable
		900,000	Cash
8,640,000	Total	8,640,000	Total

Additional information

- Revenue last period 2,000,000
- Revenue from client 1,500,000
- Average number of employees 1,500

Required: - calculate the following:

1. Revenue growth
2. Revenue concentration
3. Revenue per employee
4. Gross profit margin
5. Operating profit margin
6. Net profit margin
7. Accounts receivable turnover
8. Inventory turnover
9. Rate of return on equity
10. Total Debt to equity Ratio
11. Current ratio
12. Interest coverage

Solution

1. Revenue growth = (revenue this period - revenue last period) ÷ revenue last period

2,500,000 – 2,000,000 ÷ 2,000,000 = 0.25 = 25%

2. Revenue concentration = (revenue from client ÷total revenue)

1,500,000 ÷ 2,500,000 = 0.6 = 60%

3. Revenue per employee = (total revenue ÷ average number of employees)

2,500,000 ÷ 1500 = 1667

4. Gross profit margin = (total revenues – cost of goods sold) ÷ revenues

2,500,000 – 1,500,000 ÷ 2,500,000 = 0.40 = 40%

5. Operating profit margin (total revenues – cost of goods sold – operating expenses) ÷ total revenues.

(2,500,000 – 1,500,000 – 450,000) ÷ 2,500,000 = 0.22 = 22%

6. Net profit margin (revenues – cost of goods sold – operating expenses – all other expenses) ÷ revenues.
(2,500,000 – 1,500,000 – 450,000 –252,000)÷ 2,500,000 = 0.12 = 12%
7. Accounts receivables turnover= (net credit sales ÷ average accounts receivable). 1,000,000 ÷ 1,200,000 = 0.83
8. Inventory turnover = (cost of goods sold ÷ average inventory)
1,500,000 ÷ 3,300,000 = 0.45 = 45%
9. Return on equity = (net income ÷ shareholder's equity)
268,000 ÷ 6,200,000 = 0.043 = 4,3%
10. Debt to equity (debt ÷ equity).
2,440,000 ÷ 6,200,000 = 0.3935= 39.35%
11. Current ratio (current assets ÷ current liabilities).
6,040,000 ÷ 940,000 = 6.425
12. Interest coverage (earnings before interest and taxes ÷ interest expense).
120,000 = 4.333 ÷520,000

Definition of Financial Statements

- The financial statements provide a summary of the accounts of a business enterprise , the balance sheet reflecting the assets , liabilities and capital as on a certain data and the income statements showing the results of operations during a certain period
- “The financial statements are composed of data which are the results of a combination of the following:

(1) Recorded facts concerning the business transactions .

(2) Conventions adopted to facilitate the accounting techniques .

(3) Postulates or assumptions made to , and

(4) Personal judgments used in the application of the conventions and postulates .

Interpretation of Financial Statements

(1)Interpretation of financial statements is the mental process of understanding the terms or the simple elements resulting from the analysis of the compounded financial statements and forming opinions or inferences or conclusions about the various aspect of a business enterprise , such as solvency , profitability , efficiency etc .

(2) Interpretation Financial Statements which follows analysis of financial statements, is an attempt to reach to logical conclusion regarding the position and progress of the business on the basis of analysis .

(3) Interpretation Financial Statements aims to explain the meaning and significance of the data simplified by analysis.

(4) Interpretation of financial statements is the process of drawing inferences or conclusions about the various aspects of business .

(5) Integration Financial Statements aims to explain the meaning and significance of the data simplified by analysis.

Advantages of Analysis of Financial Statements

1) Knowing the Exact Position :

Everybody who is interested in knowing the exact financial position of the concern is benefited by the 'analysis' of financial statement.

Interested party gets the valuable information about the exact facts and figures of the concern by analyzing the financial statements by various methods

2) Decision-making

Every interested party is in a position to assess the exact financial position of the concern when it analyses financial statements of that concern by reliable methods.

such an analysis ultimately helps that party in taking various types of decisions such as investment, sale, purchase etc.

3)Forecasting

After analyzing the financial statements, one is in a position to forecast whether it would be profitable or not to invest in or to deal with the business concern.

Making Financial Decisions on the Basis of Financial Statements

1. The major advantage of financial statement analysis is to provide decision makers information about our a business enterprise decision-making.
2. Financial statements are used by financial institutions, loaning agencies, banks and others to make sound loan or credit decisions.
3. Financial statements helps in predicting the earning prospects and growth rate in earnings which are used by investors while comparing investment alternatives and other users interested in judging the earning potential of business enterprises.
4. Analysis of financial statements is a significant tool in predicting the bankruptcy and failure probability of business enterprises.
5. Financial statement analysis is defined as the process of identifying financial strengths and weaknesses of the firm - by properly establishing relationship between the items of the balance sheet and the profit and loss account