Corporate Financial Reporting & Analysis: Fundamental Principles

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Fundamental Principles of Financial Analysis

Meaning of Fundamental Principles of Analysis:
It means the basic requirements or the prerequisites in order to ensure that purpose of financial analysis is truly and successfully fulfilled.

Important fundamental of Financial Analysis are listed below:

1. Knowledge of Accounting
2. Objective of Analysis
3. Techniques of Analysis
4. Rearrangement/Regrouping of Financial Data
5. Deciding the extent of analysis
6. Consideration of Internal and External Environment
7. Interpretation of Findings/Results
8. Submission of Report
9. Reliability Factor
10. Time Context

Knowledge Accounting

If the financial analyst wants to develop the expertise in financial analysis he/she has to develop the basic knowledge of accounting principles, concepts and conventions, accounting equation, mechanism and the objectives of the preparation of basic accounts such as P/L Account, Balance Sheet, Cash Flow Statement etc.

Objective of Analysis

The analyst must be clear about the objective or purpose of his/her analysis. The analyst may itself be an investor or portfolio manager. The analyst may a mutual fund manager making financial analysis on behalf of the company having its distinctive objectives. So in each case the analyst should know the specific objectives of itself, the objectives of its client or the objectives of its company and make the analysis accordingly.

Techniques of Analysis

The analyst must select appropriate technique/s for the purpose of financial analysis depending on the objective of analysis, the type of data available, software support system available, analysts own understanding of the technique and more importantly simplicity and popularity of techniques. Important techniques available are:

1. Ratio analysis
2. Cash flow and funds flow analysis
3. Common size financial statements
4. Trend analysis
5. Cross sectional analysis

Re-arrangement or re-grouping of Financial Data

Financial analyst must re-arrange the financial data according to the objective of analysis for example if the objective is to know the liquidity of the company then important data to be taken from financial statements are current assets and current liabilities and to be regrouped in the current ratio. Similarly, the objectives may to know about movement of flow of cash in the organization would require cash flow statement data from the financial statements.

Deciding the extent of analysis

The analyst must have clarity about the extent of analysis of available data and analyze the data accordingly. In order to know overall problems in the organization all the financial ratios are important to know. On the other hand if problems are in liquidity then current ratio, quick ratio and cash ratio are important. The problems may be relating to solvency then debt equity or leverage ratios are important.

Consideration of Internal and External Environment

The analyst must be well-acquainted with the internal and external environmental factors such type of competition, technology, business laws governing the organization; attitude of suppliers, lenders, consumer preferences, and internally, the morale of employees, skills, professionalism, ethics and culture the organization. These factors help the analyst to make analysis and interpretation of data more relevant and result oriented.

Interpretation of Findings/Result

The analyst must interpret the results coming after analysis of data in order to make the analysis useful. For example the ratios have been calculated by using various formulas. Now result of these ratios needs an interpretation or comparison in order to know the real problem and taking the remedial steps.

Submission of Report

After the analysis of financial data and a proper interpretation, the analyst needs to submit a concise report which is simple and easily understandable by the users so that proper future course of actions can be decided.

Reliability Factor

In the entire process of financial data analysis, its interpretation and finally submission of the report by the analyst, the reliability factor plays a very crucial role. The reliability factor means that the entire process of analysis and its final report is reliable and acceptable by the user. In order to create high reliability factor, the analyst must be professionally reputed, analysis tools are reliable, the possibility of biasness should be minimum and source of data should be original.

Time context

The delayed final report or outdated data used in the report make the report unimportant for the users. The most updated are required for the analysis. The process of analysis and interpretation and final report must be speedy keeping in mind the time context for users. Not only the historical data of financial important are important but equally important are the changed and prevailing factors internal and external to the organization.

Concluding Remarks

1. Financial analysis is bound by certain principles
2. These principles are helpful for the fulfillment of the objectives the users of financial data.
3. For the analyst knowledge of accounting is required.
4. Specific objectives, techniques and extent of analysis are important.
5. Financial statements data needs a re-arrangement logically.
6. Consideration of internal and external factors creates relevance.
7. In order to make the data useful, they need to be interpreted.
8. The entire analysis with its interpretation need to be submitted to the user.
9. Time context and reliability must be considered in the process of financial data analysis.