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FINANCIAL ANALYSIS OF FINANCIAL STATEMENTS

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Abstract: This article provides the transaction analysis model to include operating activities financial statements of companies, as well as information on how to conduct financial statements and its financial elements, and conclusions and proposals on this. In addition to this, significant financial analysis issues based on international standarts

Key words: financial analysis, financial statement, IFRS, financial reporting, financial elements, financial ecosystem, financial markets

The long-term objective for any business is to turn cash into more cash. If a company is to stay in business, this excess cash must be generated from operations (that is, from the activities for which the business was established), not from borrowing money or selling long-lived assets. Companies acquire inventory and the services of employees and sell inventory or services to customers. The operating (cash-to-cash) cycle begins when a company receives goods to sell, pays for them, and sells to customers (or, in the case of a service company, has employees work to provide services to customers); it ends when customers pay cash to the company. The length of time for completion of the operating cycle depends on the nature of the business.

The complete transaction analysis model includes all five elements: assets, liabilities, stockholders' equity, revenues, and expenses. Recall that the Retained Earnings account is the accumulation of all past revenues and expenses minus any income distributed to stockholders as dividends (that is, earnings not retained in the business). When net income is positive, Retained Earnings increases; a net loss decreases Retained Earnings. Now let's talk carefully to remember how the model is constructed and to understand the impact of operating activities on both the balance sheet and income statement:

• All accounts can increase or decrease, although revenues and expenses tend to increase throughout a period. For accounts on the left side of the accounting equation, the increase symbol + is written on the left side of the T-account. For accounts on the right side of the accounting equation, the increase symbol + is written on the right side of the T-account, except for expenses, which increase on the left side of the T-account. That is because, as expenses increase, they have an opposite effect on net income, the Retained Earnings account (which increases on the credit side), and thus Stockholders' Equity.

• Debits (dr) are written on the left of each T-account and credits (cr) are written on the right.

• Every transaction affects at least two accounts.

• When a revenue or expense is recorded, either an asset or a liability will be affected as well:

• Revenues increase stockholders' equity through the account Retained Earnings and therefore have credit balances (the positive side of Retained Earnings). Recording revenue requires either increasing an asset (such as Accounts Receivable when selling goods on account to customers) or decreasing a liability (such as Unearned Revenue that was recorded in the past when cash was received from customers before being earned).

• Expenses decrease stockholders' equity through Retained Earnings. As expenses increase, they have the opposite effect on net income, which affects Retained Earnings. Therefore, they have debit balances (opposite of the positive credit side in Retained Earnings). That is, to increase an expense, you debit it, thereby decreasing net income and Retained Earnings. Recording an expense requires either decreasing an asset (such as Supplies when used) or increasing a liability (such as Wages Payable when money is owed to employees).

• When revenues exceed expenses, the company reports net income, increasing Retained Earnings and stockholders' equity. However, when expenses exceed revenues, a net loss results that decreases Retained Earnings and thus stockholders' equity.

Financial statements created under cash basis accounting normally postpone or accelerate recognition of revenues and expenses long before or after goods and services are produced and delivered (when cash is received or paid). They also do not necessarily reflect all assets or liabilities of a company on a particular date. For these reasons, cash basis financial statements are not very useful to external decision makers. Therefore, generally accepted accounting principles require accrual basis accounting for financial reporting. In accrual basis accounting, revenues and expenses are recognized when the transaction that causes them occurs, not necessarily when cash is received or paid. That is, revenues are recognized when they are earned and expenses when they are incurred to generate revenues.

Net profit margin ratio measures the profit generated per dollar of sales (operating revenues). A high ratio as compared to competitors or over time suggests that a company is generating revenues and/or controlling expenses more effectively. The ratio is computed as follows:

Net Profit Margin Ratio = Net Income/ Net Sales (or Operating Revenues)

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