Chapter Review

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There are three major financial statements used by the various stakeholders to analyze the performance of any company. A balance sheet shows the position of a company at a given point in time, more specifically on a given date. It includes current assets that are supposed to benefit the company for less than a year and fixed assets which are supposed to benefit the company for more than a year and these assets are financed by the liabilities and owner’s equity. The income statement shows the results of operations undertaken by the company in the form of the net profit which is calculated by deducting all the expenses from the revenues and incomes. The expense is either direct or indirect in nature depending upon whether these are related to sales directly or not. The direct expenses are recorded as the cost of goods sold while indirect expenses are recorded as administrative or selling expenses. A statement of cash flows is made in order to assess the various activities affecting the cash position of the company. It includes operating, investing and financing activities.

 The financial analysis serves many purposes for a company including the identification of weaknesses and strengths. There can be a common size analysis that includes a comparison of one company to the other on the basis of percentages. The other form of analysis is done with the data of the same company but over a period of time also called a cross-sectional analysis.

 Certain sets of ratios are used to analyze the financial statements of a company which is meant for different purposes. Any stakeholder who is interested in studying the profitability of any company will use the profitability ratios e.g. net profit margin. A good example can be a probable investor who wants to invest in the company. A creditor will be more interested in the liquidity ratios e.g. current ratio that shows the ability of a firm to pay its short term liabilities as they become due. These creditors will also be interested in the financing ratios e.g. debt ratio.