INTERNATIONAL FINANCIAL STATEMENT ANALYSIS

Financial statement analysis is a part of business analysis. Business analysis is the evaluation of a company's business environment, strategies, financial position, and performance to be able to make decisions with respect to that company. Whether to extend credit to a company or to invest in a company's equity securities are important decisions based on business analysis. Business analysis is conducted using relevant information available about a company. Financial statements are an important source of information for conducting business analysis.

Financial statement analysis consists of the following steps:

i. Accounting analysis;
ii. Financial analysis; and
iii. Prospective analysis.

Accounting analysis

Accounting analysis begins with an evaluation of the extent to which a company's financial statements reflect economic reality. There are three common sources of distortion in financial statements:

i. Accounting standards that are inconsistent with economic reality (a rule that requires all research and development costs to be expensed immediately with no possibility of recognizing an asset is an example).
ii. Estimation errors made by managers in applying accounting standards (the estimation of the cost of pension and other postretirement benefits is an example).
iii. The intentional manipulation of financial statements by managers; often referred to as earnings management (the intentional overstatement of an accrued restructuring charge is an example).

Accounting analysis involves identifying distortions in financial statements and making adjustments to the financial statements where possible. The ability to make adjustments will be determined by whether a company discloses adequate information to allow an adjustment to be made. The extent to which accounting standards induce financial statement distortions will differ from country to country because of differences in national accounting rules. Differences also exist across countries with respect to the amount and type of disclosures required to be provided in financial statements.

Financial Analysis

Financial Analysis involves the use of adjusted financial statement information to conduct:

i. Cash flow analysis: the analysis of how a company generates and uses cash.
ii. Profitability analysis: with a focus on return on invested capital.
iii. Risk analysis: including an evaluation of liquidity and solvency to assess a company's ability to meet its obligations.

Much of financial analysis is conducted through the use of ratios calculated from the financial statements. Financial ratios are compared within a company over time to determine whether the company's ability to generate cash flows, earn a return on invested capital, and so on, is improving or deteriorating. Ratios also are compared across companies operating in the same industry to evaluate companies relative to their peers. The diversity of accounting principles and practices that exists across countries hampers our ability to directly compare companies operating in the same industry but located in different countries.

Prospective Analysis

Prospective Analysis involves combining the results of accounting analysis and financial analysis, along with an analysis of the business environment and company strategy, to forecast future financial statement information, especially cash flows and income. Preparing forecasted future financial statements is a very important part of business analysis because decisions made today about a company are based on forecasts of the company's future prospects.

Reasons to Analyse Foreign Financial Statements

i. Foreign Portfolio Investment
ii. International Mergers and Acquisitions
iii. Making credit decisions about foreign customers.
iv. Evaluating the financial health of foreign suppliers.
v. Benchmarking against global competitors.

Potential Problems in Analysing Foreign Financial Statements

Some of the potential problems that may arise in analysing foreign financial statements include:

i. Data Accessibility
ii. Language
iii. Terminology
iv. Format
v. Extent of Disclosure
vi. Timeliness
vii. Differences in Accounting Principles