Answer on Question#38790 - Math - Other.

How do you analyze and interpret financial statement of a company for reporting on the soundness of its capital structure and solvency?

Explanation:

Analysis of the financial statements provides a framework and one of the most important components in the economic analysis of financial and economic activities of the organization, both internal and external users. The Financial statements accumulate the final results of the company for the accounting period in monetary terms which are indicators of the two main factors: profitability and financial soundness. Analysis of financial statements should answer the questions: does the firm profit for their business activities for the year, whether the firm can meet its obligations and will not lead to the execution of any such liquidation of the company due to lack of resources. Therefore, the information that is given a balance sheet and profit and loss statement contains information about:

- The amount of capital and property company in absolute terms (balance sheet total);
- Capital structure and assets (balance);
- Changes in equity during the reporting period;
- The profit or loss incurred by the company during the reporting period.

Internal analysis of the financial condition of the economic entity is the process of investigating the mechanism of formation, placement and use of capital in order to search for reserves strengthen the financial condition, increase profitability and increasing net worth.

External analysis of financial condition - the process of examining the financial condition of the economic entity for the purpose of prediction of risk capital investment and the level of its profitability.

It should also be noted that the financial statements are prepared by firms based on existing national standards and international standards developed by international economic organizations. International practice has developed certain methods to analyze financial statements, which are based on different absolute and relative standard indicators that allow for not only an analysis of balance sheet items the individual firm, but also a comparative analysis of several companies within the same industry sector or involved in similar activities.

Depending on the objectives of financial statement analysis and interested in its results users are different types of analysis and a different set of indicators - financial factors, namely:

- Absolute figures for discovering statements that allow to draw conclusions about the main sources of raising funds, the directions of their investments, sources of cash flows, the size of the profit, dividend distribution system;

- Comparable percentages (Percentage Changes) to read the statements and identify deviations on major items of financial statements;

- Analysis of the percentage changes in horizontal (Horizontal Percentage Changes), characterizing changes in individual items in the financial statements for the year or a number of years. For example, growth in percent: net sales, cost of sales, gross profit, net profit, operating costs, etc.;

- Analysis of percentage changes in vertical (Vertical Percentage Analyses), assuming the ratio of the various articles in relation to the one selected article. For example, a percentage of sales: Cost of sales, gross profit, operating costs, operating income, net income;

- Trend analysis (trend analysis), characterizing the performance of the company change over the years as compared to the benchmark, to 100. His goal - evaluation of financial managers in the last period and the definition of the forecast their behavior in the future;

- Comparative analysis conducted in order to compare the individual performance of the firm with the performance of competing firms of one industry sector, and about the same size (taking into account the different reporting methods). This analysis can identify competitors strategy and prospects;

- Comparison with the industry average, indicating the stability of the firms in the market. Conducted with regard to the general state of the economic situation changes in the industry and in the economy, in particular, the standard of price , the dynamics of interest rates , raising security raw and other materials;

- Analysis of the indicators through the use of financial ratios (Ratios), the calculation of which is based on the existence of certain relationships between the individual articles reporting. The value of such coefficients determined by the possibility of comparison of the results with existing conventional standard norms - industry averaged coefficients, as well applicable in the country or in a particular firm performance analysis of financial statements.

Financial ratios are used to evaluate the performance of financial managers and accounted for them in management decisions.

As we note earlier one of the indicators characterizing the financial soundness of the company is its solvency, opportunity to cash resources to repay its payment obligations. Solvency assessment on the balance sheet is based on the liquidity characteristics of current assets, which is determined by the time required to convert them into cash. The less time is required for data collection asset strength, the higher the liquidity. It depends on the extent to which the available quantity of means of payment largest short-term debt. To understand the meaning of this indicator, we can specify the following net worth is the absolute measure of solvency. If the value of our assets exceeds our liabilities so we have a positive net worth and our business is solvent. However net worth does not indicate how vulnerable the business is to changing financial conditions. A relative measure of solvency, the debt/asset ratio, indicates the future security of our financial position. The debt/asset ratio is calculated as total liabilities divided by

total assets. This ratio is called the debt-to-total-assets ratio, which measures the dollar amount of a company's assets that are financed by creditors. The higher the percentage of debt-financing the company has, the riskier the company is. This suggests that the interest will be the around the companies that have low debt-to-total-assets ratios. A low debt equity ratio reflects more security to long term creditors. From security point of view, capital structure with less debt and more equity is considered favourable as it reduces the chances of bankruptcy. Evaluating net worth as good or bad also depends on the characteristics of the company. A high ratio, on the other hand, is considered risky as it may put the firm into difficulty in meeting its obligations to outsiders.

Summarizing it should be note downturns in the economy can reduce asset values and put the financial health of the business at risk. Analyze net worth of the company and the debt/asset ratio over time to determine trends in the company solvency position. The entrepreneur who has calculated these measurements for several years can spot positive or negative trends and make appropriate management decisions regarding future of the company.

In today's economy, an important task is the analysis of capital structure. The challenge is to create a structure that will be workable through multiple business cycles. A company needs to have a comprehensive understanding of its financial position before it can determine what its capital structure should look like. Any analysis should therefore include a review of how operating and financial leverage will affect a company ability to make loan payments. Determining an optimal capital structure is also an important issue for entrepreneurs. The optimal capital structure indicates the best debt-to-equity ratio for a company that maximizes its value. The debt ratio compares total liabilities to total assets. Obviously, more of the former means less equity and, therefore, indicates a more leveraged position. In order to engage in a capital structure analysis, it is important to identify all types of debt and equity currently held, project the impact of the current combination on the business operation, and then determine what if any changes should be made in order to strengthen the position of company within a defined period of time. Finance executives should focus on all cash requirements including net working capital and the fixed assets needed to support sales growth and dividends. A thorough weighted average cost of capital analysis is another effective exercise as a company attempts to determine the optimal capital structure.

To determine the extent of possible risk of bankruptcy in connection with leveraged capital structure using indicators (financial soundness). They characterize the degree of financial independence companies from creditors. Indicators of capital structure are:

- Autonomy ratio (concentration of equity).
- Factor to attract debt capital.
- The coverage ratio of non-current assets.
- Interest coverage ratio (protection of creditors).
- The coverage ratio of assets Working capital.

Autonomy ratio (concentration of equity) shows the proportion of equity in total sources of financing. It is the primary and the most extensive assessment , which can be done in an effort to evaluate the risk to the lender .Financial position can be considered stable, if the coefficient of at least 0.5 , in other words, half of the estate formed by own funds. At the same time, a decrease of this ratio indicates a weakening of financial stability. Therefore, the higher the ratio, the banks and lenders look safer financial position of the company.

Factor to attract debt capital shows the share of loans in total sources of financing. The higher the ratio, the more loans from the company and the riskier the situation, which may lead to the eventual failure of the enterprise.

The coverage ratio of non-current assets exceeding the permanent capital of the non-current assets indicates the company's solvency in the long term. Entity's financial position can be considered stable, if the ratio is not less than 1.1. The value of this ratio below 0.8 indicates a deep financial crisis.

Interest coverage ratio (creditor protection) characterizes the degree of protection from creditors for non-payment of interest and the number of times during the year the company earned funds to pay interest on loans. The coefficient above 1.0 indicates that the company enough profits to pay interest on loans, this mean that creditors are protected.

The coverage ratio of assets Working capital shows the proportion of working capital (net working capital) in total funding. The coefficient should be not less than 0.1.

It should be note that rational (optimal) formation Finance Company is the one when the fixed assets acquired through its own funds and long-term borrowings and current - ¼ of its own funds and long-term loans to ¾ - at the expense of short-term loans. A thorough analysis that examines all relevant factors and includes unexpected events is advisable and should occur on a regular basis.

Enterprises operating in a market economy is closely interrelated. When choosing partners, one of the most important criteria for building relationships of economic entities is solvency. Insolvent enterprise neither for suppliers nor for investors, it creates a threat of losing both its own and borrowed resources. Obviously, the solvency of the enterprise can be controlled. The solvency problems of an economic entity involve a plethora of operative and strategic business management.

In this work were considered the key indicators of the financial statements, which play the most important role in assessing financial soundness. In the real economy rating includes many more factors that influence the attractiveness of the company's market.