Module Name:
Module Code:
Student ID:
Student Name:

The globalization of markets, increase in number of multinational organisations, reduction in organisational barriers, increase in number of cross-border trade of services and items and improvement of competitiveness has increased the global financial risk for most of the investors. When it is considered that individual states own national systems of accounting that provide different information to external users, then there is a requirement of creating understandable and compatible sources of information. For investors, the harmonization of reporting standards of organisation can become the effective source (Healy and Palepu, 2012).

According to Han and Chen (2014) organisations provide financial statements that give information related to the financial performance and position. A large number of stakeholders use this information (like investors) in developing decision related to companies by comparing them with each other. Generally, those who are the owners of organisations like shareholders are not the ones that manage it. That is why; the owners of such organisations (along with the stakeholders, like consumers, suppliers and banks) take satisfaction from the assurance that is presented by financial statements, in all terms of materials, the performance and financial position of organisation. In order to take important decisions, investors usually rely on comparing financial statements of different companies. This essay is about critical analysis of use of financial statements in companies, their accuracy and comparison of companies' financial statements.

Discussion

A financial report or financial statement is the record of business position, financial activities, entity or other person. Related financial information is displayed in a structured form and in such form which is easy to interpret. In technical sense, financial statements provide the summary of processes of accounting and give money amounts and tabulation of account titles. Along with it; financial statements does the reporting of financial status or financial position of an individual or business along with the reporting of financial alterations at some given time period or particular time (Richard, 2014). The major objective of financial statement is to do communication with internal and external parties' about information related to financial decisions made within the organisation. The design of financial statements is made for fulfilling the requirement of diverse users, specifically potential and present creditors and owners. Financial statements are mainly caused because of aggregating masses, simplifying and condensing of data which is acquired mainly through financial system. They are majorly the outcome of the accounting system (Lusardi and Mitchell, 2014).

Vogel (2014) stated that the major target of financial statements is to give information related to the financial position, changes and performance in financial position of an organisation that is beneficial to large number of users in making decisions related to the company. Financial statements need to be comparable, reliable, relevant and understandable. Reported expenses, income, equity, liabilities and assets are directly linked with the financial position of an organisation.

The general financial statement of organisation involves the 1) statement of alterations in equity of owner, 2) the retained earnings, 3) cash flow statement 4) income statement, 5) financial statement and the balance sheet. Balance sheet provides the list of all of the liabilities, assets and stakeholders' or owners' equity of a firm as of a particular date. Hence, with the help of income statement accountants depict the moving picture of operations held in a company during a given time period. In income statement a summary of gains, costs, revenues, expenses and in the end net income or net loss incurred by a firm is presented for a given period of time (Brigham and Ehrhardt, 2013). The cash flow statement provides the summary of the cash payments and cash receipts of business related to the financial, investing and operating operations during a particular time period. On the other hand, the income statement reports the financial operations of organisation on accrual basis; the statement of cash flow reports such information on cash basis. Due to the reason that retained earnings depict the earnings of organisation, it was seen that some of the money was distributed or deducted to owners of organisation, the statement of earnings depict the overall earnings of organisation. A statement related to the retained earnings represents the alterations for designed accounting period in retained earnings (Zeff, 2016).

In order to get benefit from financial statements of a company by an analyst, then that kind of information must be provided by financial statements that can be comparable with financial statements of other companies. Different rules and standards of accounting must be consistently implemented by accountants at the time of preparing financial statements.

. An overall set of financial statement involves:

- At the end of time period, a statement related to financial position (balance sheet)
- A statement related to loss or profit and income for some time period (depicted as one statement, or by presenting the loss or profit section in other statement of loss or profit, immediately followed through statement that present income starting with loss or profit)
- A statement of alterations in equity for specific time period
- For specific time period, a statement of cash flows
- Notes consisting of summary of important policies of accounting and some other explanatory notes
- Comparative information as defined through standard (Brochet et al, 2013)

According to Weygandt et al (2015) for the statement, titles should be used by the entities other than the ones being stated. All of the financial statements need to be depicted with same prominence. When accounting policy is applied by the entity or when retrospective restatement is made related to products in financial statements, or when reclassification of products is made in financial statements, it should also depict the financial position at the start of comparative period.

The frameworks of financial reporting usually call for objectivity that is independence from bias. The estimates of accounting are vague, nevertheless, can be impacted by management verdict. Such verdict may include intentional or unintentional management bias for instance as an outcome of motivation to gain required output. The vulnerability of an estimate of an accounting to the management bias enlarges with subjectivity concerned with its making. The latent for intentional management bias and unintentional management bias are deep-rooted in subjective resolutions which are usually needed in producing an estimate of accounting. In order to continue audits, signs of likely management bias recognized at some point in the audit of earlier spans. It affects the risk recognition, planning and evaluation actions of auditor in present span (Hribar et al, 2014).

The extent of subjectivity for instance whether or not an input or supposition is recognizable, affects the level of estimation indecision and hence auditor's risk assessment of material misrepresentation for a specific estimate of accounting. The level of estimation indecision differs depending upon the quality of estimate of accounting, the degree to which the existence of a commonly accepted approach involved in making the estimate of accounting, and assumptions' subjectivity involved in making the estimate of accounting (Daske et al, 2013). Sometimes, estimation indecision linked with the estimate of accounting may be larger in a way that the criteria for recognition in framework of pertinent financial reporting are not fulfilled and it is not possible to make the estimate of accounting.

For a longer period of time, the compliance of the standards of accounting has been the aim of global and local setter of accounting standard. Since 1973, the goal of International Accounting Standards Board, for instance, is to create a distinct set of top quality, comprehensible and International Financial Reporting Standards (IFRS). IFRS was set compulsory by the European Union in 2005 for the solidified financial statements of majority of the European scheduled, or openly traded enterprises. It is decided by the European Council and Parliament to commence EU and IFRS because of the reason that requirements of reporting deployed in Directive were not able to make sure high degree of comparability and transparency of financial statements. Both comparability and transparency of financial statements were taken into account as mandatory for operating the incorporated capital market. The compliance endeavour of European Union was, hence, significantly proposed to gain equivalent financial statements (Schrand and Zechman, 2012).

There are two kinds of comparability that is done in between financial statements of companies. There is a need to make a distinction, nevertheless, between de facto comparability and de jure comparability. Material and formal comparability can be present separately. In European Union for instance, formal comparability prevails for scheduled enterprises since they need to implement the IFRS for their centralized financial statements, however, it is not necessary that there exists material comparability. Various researches already represented that still various options are offered by IFRS and need significant estimates. The commencement of IFRS in European Union and various other nations has, hence, not eradicated the requirement for study regarding comparability of financial statements, in contrast. The commencement of IFRS in European Union does, nevertheless, create a unique chance since it happened for the very first time in past that every enterprise listed in European Union implements same standards (Aebi et al, 2012).

Sauaia (2014) stated that in accounting literature, comparability of financial statements is considered to be an important research topic. Number of articles involves discussing how to measure comparability of financial statements and how to define it. IASB also faces difficulty in describing the comparability of financial statement. To gain comparable financial statements between enterprises, debate exists whether flexibility, harmony or uniformity is ideal procedure. These debates are exhibited in the approaches of measurement which are created to evaluate how equivalent financial statements are sponsor of uniformity and sponsor of flexibility.

With respect to IASB framework, one of qualitative aspects is comparability which makes information given in financial statements valuable to users. It is stated by IASB in the framework that it is required for users to make comparison of the financial statements of an individual with time to recognize styles in its performance and financial position. It is also required for users to make comparison of financial statements of multiple companies to determine their comparative financial position, alterations and performance in financial position. The study is available openly regarding the comparability of financial statements. However, it is concluded by Boards in their joint revelation draft that they are likely to give up such kind of comparability to gain enhanced faithful of relevance representation by commencing new amendments or standards to current standards. Hence by the termination of 'stable platform', amendments are being done on consistent basis by IFRS and various new interpretations and standards were published. These changes of consistent basis endanger comparability eventually while such kind of comparability is seen as enormously significant by the respondents. It is seemed that IASB also stresses on comparability of financial statements of every scheduled enterprise. Such kind of comparability is therefore seen less significant as compared to the comparability of financial statements of those enterprises which are running within same industry (Weil et al, 2013). Moreover, IASB is always struggling to evade needs which are industry explicit, emphasizing on types of transaction instead. It is suggested by the research that possessing same accounting standards is not sufficient to gain comparable financial statements actually. If group of accountants are provided with transactions set from which they are required to make financial statements, certainly, they will not be able to make identical statements, even after implementing IFRS by them. As stated by Ahmed et al (2013) that constant accounting standards can improve comparability exclusively if latent factors influencing the companies are also alike. This actually does not happen. Enterprises in different regions and countries have their own reporting aims, different approach of doing business, and have their own primary political and economic factors.

In accordance with Christensen et al (2013) analysis of financial statement is the interpretation, evaluation and selection of data with the pertinent information for assisting financial and investment decision-making. Along with it; it can also be termed as the procedure to determine financial weaknesses and strengths of the organisation through proper establishment in between the items of loss account and profit and balance sheet (accounting for the website of management). Financial ratio analysis is the major tool used to compare financial statements of different companies. Due of the reason that financial statements are lengthy, it will be strategic and efficient to select the figures that plug them in some of the formulas which are developed with the help of accounting and finance scholars.

Comparability of financial statement in between different organisations is the major problem for analysts because of the reason that they can compare the analysis of financial statements in between different organisations depending on the ratios, but actually it may not paint such perfect picture. The comparison of financial ratios of two organisations can be done to observe that if they are similar then how, but every organisation may aggregate the information different from the other for deriving the accounting statement. This can result into incorrect results derived related to the organisation linked with other organisations present in industry (DeFond et al, 2014).

Different factors point the significance of comparability of financial information across different organisations. In accordance with Securities and Exchange Commission (SEC), when merits of comparability and investments are judged by investors, allocation of capital is supported and then confidence of investors gets nurtured. The benefits of financial statements are underscored. Particularly, according to FASB, lending and investing decisions majorly include evaluation of opportunities, and in case of no information they cannot be made. Analysis of financial statement emphasizes over the significance of comparability across different financial statements in testing the performance of organisation through financial ration (Brüggemann et al, 2013). For example, Christensen et al (2015) stated that ratio out of index give very less information. Despite the significance of comparability, a measurement of comparability is not done and there is less proof over it advantages for users of financial statements.

In contrary to this, Nobes (2014) claimed that in order to assess the importance of specific financial data, experts get involved in financial analysis. It is a process used to determine and evaluate financial ratios. Ratio tells about a relationship that shows performance of activities of a company, like ratio of current assets to current liabilities of a company or ratio of accounts receivable to annual sales. The primary source of measuring ratios is financial statements of a company in which different figures related to assets, liabilities, profits and losses. Ratios help in comparing financial statements of a company with any other company. Ratio analysis assist a person in understanding performance of a company as compared to its competitor and used for tracing performance for some specific time period.

Analysis of the financial ratio is very famous technique of financial analysis for organisations and most importantly for small organisations. Ratio analysis gives business' owners the information related to trend within the organisation; which can be called as time-series analysis or trend analysis; and trends in the industry, known as cross-sectional analysis. Without comparisons, there is no use of financial ratios (Trigueiros and Sam, 2016). Most of the businesses use benchmark organisations for industry analysis. Benchmarking organisations are the ones which are considered as the most important and appropriate and are the ones which are used for making comparisons related to average ratios of industry. Organisations benchmark various divisions of the organisations in opposed to the similar division of benchmark organisations.

Financial ratios can be termed as mathematical comparison of accounts of financial statements or even some categories. These links in between the accounts of financial statement assists management of internal organisation, investors and creditors to interpret that how well business performs its activities. Financial ratios are the most widespread and common tools which are used for the analysis of business financial state. It is easy to interpret ratios and their computation is also easy. It can also be used for the comparison of different organiations in various industries. As a ratio is just a comparison which is dependent on proportions, small and big organisations can use ratios for comparing financial information. Financial ratios do not look over the size of industry or organisation. Ratios can be termed as the computation of performance and financial positions (Yalcin et al, 2012).

Ratios permit the comparison of different organisations, rather small or big, for determining their weaknesses and strengths. The division of financial ratios can be done into seven categories: coverage, investment leverage, market prospect, profitability, efficiency, solvency and liquidity.

In accordance with Baron's Dictionary of Finance and Investment Terms, ratio analysis can be called as the procedure, which is used to assist the process of decision making, dependent on the links in between figures which are depicted in financial statement for the evaluation of risk. This objective is acquired through comparison of outcomes to performance of same organisations across industry. The recent context of global business and globalization, implement short comings over procedures, along with the familiar ones (Davies and Green, 2013). That is why; through normative stand point, organisation to organisation comparability of outcomes is relevant only in case when organisation is the main subject of the ratio analysis of employees. Once the needs are fulfilled, the subject of intra organisation comparability is then extended to some of the choices of accounting policy. For instance, it is stated that IFRS permits the flexibility in accounting opportunities of management. While two of the organisations that use IFRS may record the similar transactions, judgments of management and estimates pertain to matter like provisions, inventory costing, leases, bad debt expenses, equipment and plant, or property may add subjectivity when such results of organisation are compared with the other organisations (Needles et al, 2013).

Conclusion

It can be concluded from the analysis that financial statements are the accounting reports which serve as the major procedures for communicating financial information related to the individual or business entity. These are generally prepared for other parties who are present outside the organisation like investors and banks. In companies International Financial Reporting Standards provide options for formal comparability of financial statements. Investors usually rely on doing comparison between financial statements of different companies in order to take important decisions. In order to compare financial statements, generally ratio analysis is used.

Ratio analysis helps in comparing various aspects of financial statements that help in analyzing performance of companies.

References

Aebi, V., Sabato, G. and Schmid, M., 2012. Risk management, corporate governance, and bank performance in the financial crisis. *Journal of Banking & Finance*, *36*(12), pp.3213-3226.

Ahmed, A.S., Neel, M. and Wang, D., 2013. Does mandatory adoption of IFRS improve accounting quality? Preliminary evidence. *Contemporary Accounting Research*, *30*(4), pp.1344-1372.

Brigham, E.F. and Ehrhardt, M.C., 2013. *Financial management: Theory & practice*. Cengage Learning.

Brochet, F., Jagolinzer, A.D. and Riedl, E.J., 2013. Mandatory IFRS adoption and financial statement comparability. *Contemporary Accounting Research*,*30*(4), pp.1373-1400.

Brüggemann, U., Hitz, J.M. and Sellhorn, T., 2013. Intended and unintended consequences of mandatory IFRS adoption: A review of extant evidence and suggestions for future research. *European Accounting Review*, *22*(1), pp.1-37.

Christensen, H.B., Hail, L. and Leuz, C., 2013. Mandatory IFRS reporting and changes in enforcement. *Journal of Accounting and Economics*, *56*(2), pp.147-177.

Christensen, H.B., Lee, E., Walker, M. and Zeng, C., 2015. Incentives or standards: What determines accounting quality changes around IFRS adoption?. *European Accounting Review*, *24*(1), pp.31-61.

Daske, H., Hail, L., Leuz, C. and Verdi, R., 2013. Adopting a label: Heterogeneity in the economic consequences around IAS/IFRS adoptions.*Journal of Accounting Research*, *51*(3), pp.495-547.

Davies, H. and Green, D., 2013. *Global Financial Regulation: The Essential Guide (Now with a Revised Introduction)*. John Wiley & Sons.

DeFond, M.L., Hung, M., Li, S. and Li, Y., 2014. Does mandatory IFRS adoption affect crash risk?. *The Accounting Review*, *90*(1), pp.265-299.

Han, S. and Chen, R.C., 2014. Using SVM with Financial Statement Analysis for Prediction of Stocks. *Communications of the IIMA*, *7*(4), p.8.

Healy, P.M. and Palepu, K.G., 2012. *Business Analysis Valuation: Using Financial Statements*. Cengage Learning.

Hribar, P., Kravet, T. and Wilson, R., 2014. A new measure of accounting quality. *Review of Accounting Studies*, *19*(1), pp.506-538.

Lusardi, A. and Mitchell, O.S., 2014. The economic importance of financial literacy: Theory and evidence. *Journal of Economic Literature*, *52*(1), pp.5-44.

Needles, B.E., Powers, M. and Crosson, S.V., 2013. *Principles of accounting*. Cengage Learning.

Nobes, C., 2014. *International Classification of Financial Reporting 3e*. Routledge.

Richard, P., 2014. The Role of the Accounting Rate of Return in Financial Statement Analysis. *The Continuing Debate Over Depreciation, Capital and Income (RLE Accounting)*, *67*(2), p.235.

Sauaia, A.C.A., 2014. Evaluation of performance in business games: financial and non financial approaches. *Developments in Business Simulation and Experiential Learning*, *28*.

Schrand, C.M. and Zechman, S.L., 2012. Executive overconfidence and the slippery slope to financial misreporting. *Journal of Accounting and Economics*, *53*(1), pp.311-329.

Trigueiros, D. and Sam, C., 2016. Log-Modulus for Knowledge Discovery in Databases of Financial Reports. *Proc. IMMM*, pp.26-31.

Vogel, H.L., 2014. *Entertainment industry economics: A guide for financial analysis*. Cambridge University Press.

Weil, R.L., Schipper, K. and Francis, J., 2013. *Financial accounting: an introduction to concepts, methods and uses*. Cengage Learning.

Weygandt, J.J., Kimmel, P.D. and Kieso, D.E., 2015. *Financial & Managerial Accounting*. John Wiley & Sons.

Yalcin, N., Bayrakdaroglu, A. and Kahraman, C., 2012. Application of fuzzy multi-criteria decision making methods for financial performance evaluation of Turkish manufacturing industries. *Expert Systems with Applications*, *39*(1), pp.350-364.

Zeff, S.A., 2016. *Forging accounting principles in five countries: A history and an analysis of trends*. Routledge.