Financially analyse a company

Business, Company

" It is meaningless to financially analyse a company without understanding the context andenvironmentin which it operates". Discuss to what extent you agree with this statement. Introduction Financial analysis is the use of financial statements to analyze a company's financial position and performance, and to assess future financial performance. 1 Therefore, it is a subjective and complex task.

To effectively accomplish this task we should adopt interdisciplinary perspective. This includes understanding the context and environment in which a company operates. So, this essay is tending to discuss the understanding of context and environment in which to interpret thefinancial statement, and examine it is an important and essential part of financial analysis.

To examine this discussion, this essay is divided into four main parts: the first part illustrates the important role of the context and environment in which a company operates through a discussion of MicroStrategy case ; the second part examines some interpretation problems arising from ratio analysis, and consequently argues the acontextual financial analysis is inherently limited; the third part specifically considers the foreign environment; finally, the fourth part draws a conclusion about this discussion.

In March 2000, MicroStrategy (MSTR), a worldwide software company, announced that it was revising its financial results. Sales would be lowered by roughly 25 percent, from $205 million to about $150 million; and profits would be adjusted from 15 cent a share gain to a 43 cent a share loss. The

reaction was swift. MSTR's stock plunged $63. But just two weeks before, its common stock touched $333, up nearly 46-fold in a year. Huge sums ofmoneywere lost by investors who based their investment decisions on misleading reported numbers.

While many in the business press blamed the problems on aggressive accounting practice, we should question where those investors who bought MSTR shares at $333 went wrong. In 12 months, the stock had multiplied nearly 46 times. Was it conceivable that this business could be worth 46 times more in one year? Undoubtedly, the answer was " no". However, the investors were willing to pay airy sums based on tools like price-to-sale, or price-to-earnings, which could not determine values.

Ultimately, the analyst community should exercise increased care in its assessment of a firm's prospects. This suggests an analysis fully incorporates all explicit projections and uncovers any implicit assumptions. A better analysis may be accompanied by outside scrutiny and attestation of the processes used by analysts in developing their reports and forecasts, i. e. a successful of financial analysis comes from the combination of the context and environment in which a company operates and its accounting figures. As what Stickney states:

" effective analysis of a set of financial statement requires an understanding of (1) the economic characteristics and current conditions of a firm's business; (2) the particular strategies the firm selects to compete in each of these businesses; and (3)the accounting principles and procedures underlying the firm's financial statements. " 3 Part 2. 1: Ratio analysis There

are different principle tools of financial analysis. One of them is ratio analysis, which is based on the externally available financial data from corporations, 4 and used to assess how various line items in a firm's financial statement related to one another.

In ratio analysis, the analyst can compare ratios for a firm over several years (a time-series comparison) examining the effectives of a firm's strategy over time, compare ratios for the firm and other firms in the industry (cross-sectional comparison) to some absolute benchmark. Because of simple and convenient, it is one of the most popular and widely used tools. Interpretation problems in ratio analysis While computation of a ratio is a simple operation, its interpretation is more complex.

The usefulness of ratios depends on our skilful application and interpretation of them, and consequently there are some problems arising from the using of ratio analysis. Firstly, Ratio might be interpreted in isolation, and might not be considered in the context of the company's other ratios. Example (1), company A maintains a current ratio (current assets divided y current liabilities) well below 1. 00, which if viewed by itself could signify a solvency problem. However, the company's strong earning power and cash flows provide adequate cash to meet the company's need.

Therefore, to more meaningful, a ratio must refer to an economically important relation. Secondly, the analysts could ignore the factors can affect the effectiveness of ratios. It must be recognized that a substantial amount of important information is not included in a company's financial statements. These events involving such things as industry changes, management

changes, competitors' actions, technological developments, government actions, and union activities are often critical to a company's successful operation, and so on.

Without considering these events, the accounting data is unreliable. Consequently, the ratios based on those unreliable data will lack insight. This point is illustrated in MicroStrategycase studyin Part 1. So, to successfully predict of corporate performance we must assess the unrecorded events potentially influencing future ratios. Thirdly, the analysts might choose misleading ratios caused by the difficult problem of achieving comparability among firms in a given industry.

Achieving comparability among firms requires that the analyst (1) identifies basic differences existing in their accounting principles and procedures, and (2) adjusts the balances to achieve comparability. 7 Basic differences in accounting usually involve a variety of areas, which include some such as (1) Inventory valuation (FIFO, LIFO, average cost); (2) Depreciation methods, particularly the use of straight-line versus accelerated depreciation. (3)Capitalization versus expense of certain costs, particularly costs involved in developing natural resources, etc.. 8

The use of these different alternatives can make a significant difference in the ratios computed. For example, in the brewing industry, company B noted that if it had used average cost for inventory valuation instead of LIFO, inventories would have increased. Such an increase would have a substantive impact on the current ratio. Several studies have analyzed the impact of different accounting methods on financial statement analysis. The

average investor may find it difficult to grasp all these differences, but investors must be aware of the potential pitfalls if they are to be able to make the proper adjustments.