APPROACHES TO FINANCIAL STATEMENT ANALYSIS

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ABSTRACT: *Financial statement analysis represents a fundamental instrument for evaluating performance, financial position, and future prospects. The increasing complexity of financial reporting, driven by globalization, regulatory changes, and the growing availability of data, has led to the supplementation of traditional analytical techniques with more advanced and integrated approaches. This paper provides a review of the main approaches to financial statement analysis, including horizontal and vertical analysis, ratio analysis, cash flow analysis, integrated approaches of the financial statement and market-oriented approaches. The purpose of the paper is to provide a clearer understanding of their applicability in different decision-making contexts, because the financial statement analysis has become a central component of accounting and financial research, as well as professional practice.*

KEY WORDS: *financial statement analysis, accounting information, ratio analysis, cash flow analysis, financial performance, horizontal analysis, vertical analysis.*

JEL CLASSIFICATION: *M41, G30, M21.*

1. INTRODUCTION

Financial statements are the primary source of information for assessing the financial performance, position, and viability of business entities. Investors, creditors, managers, and regulators rely on financial reporting to support economic decision-making, risk assessment, and resource allocation. However, the informational value of financial statements depends not only on the quality of accounting standards and disclosures but also on the analytical approaches employed to interpret reported figures. Consequently, financial statement analysis has become a central component of accounting and financial research, as well as professional practice.

Traditionally, financial statement analysis has been based on techniques such as horizontal analysis, vertical analysis, and ratio analysis, which aim to evaluate trends, structural relationships, and relative performance indicators. While these methods remain widely used due to their simplicity and interpretability, they are

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subject to several limitations, including sensitivity to accounting policies, limited predictive capacity, and reduced comparability across firms and industries. In response to these shortcomings, the literature has progressively incorporated additional approaches, such as cash flow analysis, market-based measures, value-based performance indicators, and predictive models of financial distress.

Financial statements "are the output of an accounting period and in the same time became an input of the financial analysis and the decision-making process" (Monea, 2012).

The integration of non-financial information, sustainability indicators, and data-driven techniques reflects an evolving understanding of firm value and performance. As a result, financial statement analysis involves a multidimensional assessment of financial and economic outcomes.

2. TRADITIONAL ANALYTICAL TECHNIQUES TO FINANCIAL STATEMENT ANALYSIS

The main key techniques for analyzing financial statement considered traditional approaches are: horizontal analysis (trend analysis) and vertical analysis (common-size financial statement). These two "key techniques are widely recognized as baseline tools for identifying changes in growth, cost structure, and balance-sheet composition over time and across firms" (Fraser & Ormiston, 2015). "Their primary role is diagnostic, as they provide an initial analytical framework that supports more detailed investigation by highlighting areas were variations in performance, risk exposure, or accounting practices may exist" (Penman, 2013).

Horizontal analysis examines the evolution of financial statement items across multiple reporting periods, typically through absolute (amount) and percentage changes relative to a base year. This method enables analysts to identify trends, growth patterns, and structural shifts in revenues, expenses, assets, and liabilities (Palepu et al., 2020). Prior research emphasizes that horizontal analysis is particularly useful for assessing operational dynamics and financial stability over time. However, its interpretive power may be limited by inflation, economic cycles, transactions, or changes in accounting standards and policies, which can distort observed trends if not properly adjusted for contextual factors (Penman, 2013).

Amount change = Amount (value) from current year - Amount (value) from previous year (1)

$$\text{Percentage change} = \frac{Amount\ change}{Amount\ from\ previous\ year} \text{x}100\ \% \quad (2)$$

Table 1. Empirical example of Horizontal analysis - the changes in accounts over time

Accounts from Income Statement	Previous Year	Current Year	Amount Change	Percentage Change (%)
Revenues	215,000	230,500	15,500	7.21%
Cost of goods sold	130,300	140,050	9,750	7.48%
Gross profit	84,700	90,450	5,750	6.78%

In this short basic example, we see the changes in those 3 elements from Income Statement: Revenues, Cost of goods sold and Gross profit. The changes occurred in the amount of revenues and cost of goods sold are reflected also in the evolution of the gross profit. The horizontal analysis reveals the absolute and percent changes of all items considered.

Vertical analysis, also known as common-size analysis, focuses on the internal structure of financial statements by expressing each item from the financial statement as a percent of a base amount. Vertical analysis is commonly applied to the Balance Sheet and the Income Statement. These means that every line item on an income statement or balance sheet is stated as a percentage:

- The base amount in the vertical analysis of a Balance Sheet is - Total Assets
- The base amount in the vertical analysis of an Income Statement is - Revenue

This approach enhances comparability across firms of different sizes and facilitates cross-sectional analysis of cost structures, capital allocation, and financing decisions (White, et al., 2002). The literature highlights the usefulness of vertical analysis in identifying efficiency patterns and deviations from industry norms, particularly in comparative studies. Nevertheless, researchers caution that relative proportions may obscure absolute performance changes and may be influenced by differences in business models or industry characteristics (Fraser & Ormiston, 2016).

Table 2. Empirical example of Vertical analysis

Specification	Previous Year	Current Year	Previous Year (%)	Current Year (%)
Noncurrent assets:	55000	65000	45.83%	48.15%
Tangible assets	40000	45000	33.33%	33.33%
Intangible assets	15000	20000	12.50%	14.82%
Financial assets	0	0	0.00%	0.00%
Current Assets	65000	70000	54.17%	51.85%
Inventory	30000	35000	25.00%	25.92%
Accounts receivable	25000	20000	20.84%	14.82%
Cash	10000	15000	8.33%	11.11%
Total assets	**120000**	**135000**	**100.0%**	**100.0%**

Overall, the literature converges on the view that horizontal and vertical analysis should be applied jointly, as they offer complementary perspectives on financial performance. While horizontal analysis captures temporal dynamics, vertical analysis highlights structural relationships within financial statements. Together, these methods provide an essential preliminary assessment that informs and enhances subsequent application of ratio analysis, cash flow evaluation, and predictive modeling techniques (Palepu, et al., 2020).

Ratio analysis. In the relevant academic literature, it is widely acknowledged that, in analyzing an entity's financial position, one of the most extensively used methods is ratio analysis. A ratio expresses the relationship between two indicators with specific informational relevance that are interdependent. This relationship may be expressed as a coefficient (a numerical value), as a percentage, or in terms of a number

of days (duration). Ratio analysis allows for comparative studies over time and enables an objective assessment of the financial position and performance of different entities.

Furthermore, by considering the average ratios of the industries to which the analyzed entities belong, spatial comparisons can also be conducted. Thus, even if an entity's internal performance over time appears satisfactory, it may prove to be only mediocre when compared with sectoral ratios established by specialized bodies that indicate superior competitive performance.

The variables used in constructing these indicators are derived either from annual financial statements (balance sheet, income statement, explanatory notes) or from other operational or statistical records.

Table 3. Ratio categories and their informational content

General categories of ratios	The analytical purpose of the ratios
Liquidity ratios	➢ Assess the firm's ability to meet short-term obligations as they come due.
Solvency ratios	➢ Evaluate the firm's capacity to meet long-term obligations and maintain financial stability over time.
Profitability ratios	➢ Measure the firm's ability to generate profit, reflecting overall performance and operational effectiveness.
Activity ratios	➢ Indicate how efficiently management utilizes assets to generate revenue or earnings, reflecting operational efficiency.
Market value ratios	➢ Assess the firm's value from the perspective of shareholders, often reflecting market expectations and performance.

Liquidity ratios. Liquidity reflects the entity's ability to cover its current liabilities from current assets, the entity's ability to meet short-term obligations, and reflects the ability to quickly convert current assets into cash. An entity is considered "liquid" when the resources generated by its current operations during a financial year provide it with sufficient cash to meet its short-term obligations.

Table 4. The informational content of liquidity ratios

Ratio	Formula	Purpose/objective/goal
Current Ratio	$\frac{Current\ Assets}{Current\ Liabilities}$	Measures the firm's ability to meet short-term obligations using current assets (short-term liquidity).
Acid Test Ratio	$\frac{CurrentAssets-Inventory}{Current\ Liabilities}$ or $\frac{Cash + Accounts\ Receivable + Cash\ equivalents}{Current\ Liabilities}$	Assesses the firm's capacity to pay current liabilities without relying on inventory sales, providing a more conservative liquidity measure.
Cash Ratio	$\frac{Cash}{Current\ Liabilities}$	Measures the firm's immediate liquidity and ability to cover short-term obligations using only the most liquid assets.
Working Capital	Current Assets – Current Liabilities	Provides a basic measure of the firm's short-term financial health and

		operational efficiency.

Solvency ratios. Solvency represents the entity's ability to pay all its obligations, including meeting medium- and long-term maturities, and depends on the size of its debts and the cost of borrowing. The entity's solvency must be assessed both in terms of its assets and its financial results as reflected in the profit and loss account.

Table 5. The informational content of solvency ratios

Ratio	Formula	Purpose/objective/goal
Debt Ratio (Solvency ratio)	$\frac{Total\ Liabilities}{Total\ Assets}$	Measures the company's financial stability by showing what portion of assets is financed by debt. A higher ratio = higher financial risk.
Debt to Equity	$\frac{Total\ Liabilities}{Total\ Equity}$	Compares debt financing versus equity financing. Indicates how leveraged a company is and the level of risk to owners and creditors.
Interest Coverage ratio Time interest earned	$\frac{EBIT}{Total\ Interest}$	Measures the firm's ability to pay interest from operating income. Higher ratios indicate greater safety for lenders.
Equity Ratio	$\frac{Total\ Equity}{Total\ Assets}$	Shows how well a company can cover its interest payments on a pretax basis. Often used interchangeably with Interest Coverage.

Profitability ratios. In the case of profitability, the main question is how much profit is enough. An important grouping of ratios, profitability ratios are financial metrics that determine a business' ability to generate earnings and effective employment of resources. If a profitability ratio has a higher value relative to a competitor's ratio or the same ratio from the previous period, it is indicative that the company is doing well.

Table 6. The informational content of profitability ratios

Ratio	Formula	Purpose/objective/goal
Gross Profit Margin	$\frac{Gross\ Profit}{Revenue}$ x 100	Measures the proportion of sales revenue remaining after covering the cost of goods sold, reflecting production and pricing efficiency.
Net Profit Margin	$\frac{Net\ Income}{Revenue}$ x 100	Indicates the firm's overall profitability after deducting all operating and non-operating expenses, including taxes and interest.
Operating Profit Margin	$\frac{Operating\ Profit}{Revenue}$ x 100	Evaluates the profitability of core business operations, excluding the effects of financing, taxes, and extraordinary items.
Return on Assets	$\frac{Net\ Income}{Total\ Assets} \times 100$	Measures how effectively a firm utilizes its assets to generate earnings.
Return on Equity	$\frac{Net\ Income}{Total\ Equity} \times 100$	Assesses the rate of return earned on shareholders' investments.

Activity ratios assess how effectively a firm manages its assets and enable financial statement users to evaluate the level of output generated by those assets. Measures of speed and time are central to asset management ratios, as they reflect how quickly assets are converted into sales or cash flows (Monea, 2010). Accordingly, these ratios are most informative when compared against relevant benchmarks, such as historical firm performance or industry standards and averages (Monea, 2019).

Table 7. The informational content of activity ratios

Ratio	Formula	Purpose/objective/goal
Total Assets Turnover	$\frac{Turnover}{Total\ Assets}$	Measures how efficiently management uses total assets to generate sales.
Total Assets Turnover in days	$\frac{Total\ Assets}{Turnover} \times 365$	Indicates the average number of days required to generate sales from total assets.
Long term Assets Turnover (non-current)	$\frac{Turnover}{Long\ term\ Assets}$	Evaluates how effectively long-term assets are utilized to generate sales.
Long term Assets Turnover in days	$\frac{Long\ term\ Assets}{Turnover} \times 365$	Measures the average time required to generate sales from non-current assets.
Current Assets Turnover	$\frac{Turnover}{CurrentAssets}$	Assesses how efficiently current assets are employed to generate sales.
Current Assets Turnover in days	$\frac{CurrentAssets}{Turnover} \times 365$	Indicates the average time required to convert current assets into sales.
Inventory Turnover	$\frac{Turnover}{Average\ Inventory}$ $\frac{Cost\ of\ Goods\ Sold}{Average\ Inventory}$	Measures the effectiveness of inventory management, indicating how frequently inventory is sold and replaced.
Inventory Period Days Inventory Outstanding	$\frac{Average\ Inventory}{Turnover} \times 365$ $\frac{Average\ Inventory}{Cost\ of\ Goods\ Sold} \times 365$	Indicates the average number of days inventory is held before being sold.
Receivables Turnover	$\frac{Annual\ CreditSales}{Accounts\ Receivable}$	Measures how quickly the firm collects amounts owed by customers.
Average Collection Period;	$\frac{Accounts\ Receivable}{Annual\ Credit\ Sales} \times 365$	Indicates the average number of days required to collect receivables.
Accounts Payable Turnover	$\frac{Cost\ of\ Goods\ Sold}{Accounts\ Payable}$	Indicates how often the firm pays its suppliers during the accounting period.
Days Payable Outstanding	$\frac{Accounts\ Payable}{Cost\ of\ Goods\ Sold} \times 365$	Measures the average number of days the firm takes to pay its suppliers.
Working Capital Turnover	$\frac{Turnover}{Working\ Capital}$	Assesses how efficiently working capital is used to generate sales.

Market value ratios. Market value ratios reflect how the capital market evaluates a firm's financial performance, growth prospects, and risk profile by relating accounting information to the company's market price. These ratios provide insight into shareholder value creation and investors' expectations regarding future earnings and dividend potential.

Table 8. The informational content of activity ratios

Ratio	Formula	Purpose/objective/goal
Earnings per Share	$\frac{Net\ Income - Preferred\ Dividends}{Shares\ Outstanding}$	Indicates the portion of earnings attributable to each ordinary share, reflecting profitability available to shareholders.
Dividend Yield	$\frac{Annual\ Dividends\ per\ Share}{Price\ per\ Share}$	Measures the return to investors in the form of dividends, relative to the market price of the share.
Price Earnings Ratio	$\frac{Market\ price\ per\ Share}{Earnings\ per\ Share}$	Reflects investors' expectations of future growth and profitability, indicating how much investors are willing to pay for one unit of current earnings.

Cash Flow Analysis The assessment of a company's financial position, the achievement of financial equilibrium, and the implications for corporate performance require an analysis of cash flows. The analysis of corporate decisions within a value creation approach is based on cash flows. The maintenance and development of the company require the identification of the main cash flows (inflows and outflows), the accurate assessment of their magnitude, their sources and uses, and the way they are managed.

Cash flow analysis focuses on evaluating a firm's ability to generate and manage cash and cash equivalents through its operating, investing, and financing activities. Unlike accrual-based measures, cash flow analysis provides insight into the actual liquidity position of a firm and its capacity to meet short-term obligations, service debt, and finance future growth.

Cash Flow Statement - provides a summary of company's operating, investments and financing activities, and their impact on cash flows during the period (accounting period). A company can make a profit, as reported in income statement, and still not have enough cash available to meet its obligations. So, the primary purpose of a statement of cash flows is to provide information about the cash receipt and cash payments of a company during a period. The statement of cash flows reports the cash flows effects from operations, investing and financing

By examining the *statement of cash flows*, analysts assess the sustainability and quality of earnings, identify potential liquidity constraints, and evaluate the firm's financial flexibility. Operating cash flows are particularly important, as they indicate whether a company's core activities generate sufficient cash to support ongoing operations without excessive reliance on external financing.

Financial ratios used in cash flow analysis contribute to a more comprehensive understanding of financial performance, risk exposure, and long-term value creation.

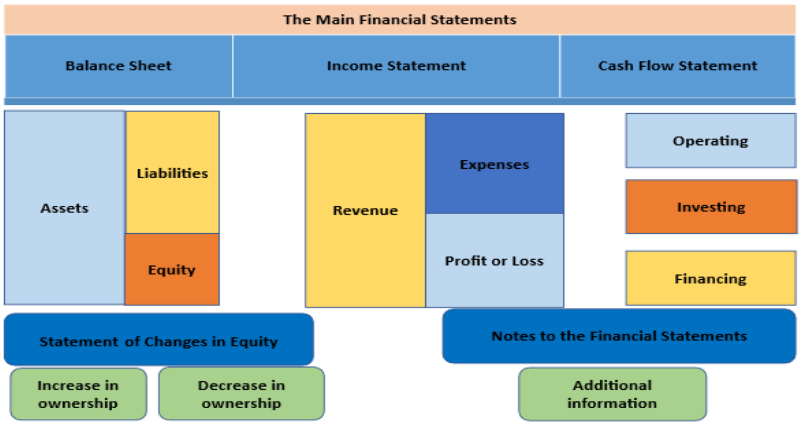
Table 9. Financial ratios used in cash flow analysis

Ratio	The analytical purpose of the ratios
Operating Cash Flow Ratio	➢ Measures the firm's ability to cover short-term obligations from operating cash flows, indicating liquidity strength.
Cash Flow to Total Debt	➢ Assesses the firm's capacity to service total debt using internally generated cash, reflecting solvency and credit risk.
Cash Flow Margin	➢ Indicates the quality of sales revenue, showing the proportion of sales converted into operating cash.
Cash Flow Return on Assets	➢ Measures how effectively the firm's assets generate operating cash flows.
Cash Flow Return on Equity	➢ Assesses the cash-based return to shareholders, complementing accrual-based ROE.

In advanced financial statement analysis, cash flow analysis is often integrated with ratio analysis and profitability measures to enhance the reliability of conclusions.

3. INTEGRATED APPROACHES TO FINANCIAL STATEMENT ANALYSIS

An integrated approach looks at the income statement, balance sheet, and cash flow statement together, rather than in isolation. The goal is to understand performance, risk, and value creation as one connected system. This integrated understanding provides the foundation for ratio analysis, where relationships among income, assets, equity, and cash flows are quantified to assess profitability, efficiency, liquidity, and risk.



Source: adapted from Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/

Figure 1. Integrated View of the Main Financial Statements

Each financial statement answers a distinct question, yet all describe the same underlying business from complementary perspectives. The *income statement* explains how profit was generated over a period by matching revenues with expenses. The *balance sheet* provides a snapshot of the firm's financial position at a specific point in time, showing the resources it controls and the claims against those resources. The *cash flow statement* tracks the actual inflows and outflows of cash, revealing how operating, investing, and financing activities affect liquidity.

An integrated approach to financial statement analysis involves assessing whether these narratives are consistent with one another. When profitability, financial position, and cash movements tell a coherent story, confidence in the firm's reported performance increases; when they diverge, further investigation is warranted.

Integrated analysis often incorporates trend analysis, benchmarking, cash flow analysis, and value-based measures, allowing analysts to capture both short-term financial conditions and long-term value creation potential. Advanced methodologies may further employ multivariate techniques, financial modeling, and predictive analytics to improve the assessment of risk, performance sustainability, and future financial outcomes

Overall, advanced and integrated approaches strengthen financial statement analysis by reducing information asymmetry and supporting more informed economic decisions. By linking accounting data with strategic context and market expectations, these approaches provide a more comprehensive and reliable basis for evaluating corporate financial health in an increasingly complex and dynamic business environment.

Related work examines ESG performance and disclosure trends as a growing dimension of firm assessment, reinforcing the idea that financial statement analysis is expanding toward multi-capital and sustainability-informed evaluation.

Environmental, Social, and Governance (ESG) performance and disclosure have emerged as an increasingly important dimension of firm assessment, reflecting a broader evolution in financial statement analysis toward a multi-capital, sustainability-informed framework. Corporate Finance Institute (CFI) explains ESG as a framework that helps investors and analysts assess non-financial risks and opportunities that may materially affect a firm's long-term performance, risk profile, and value creation. ESG factors complement traditional financial analysis by incorporating sustainability, ethical behavior, and governance quality into firm evaluation (Petcu et al., 2023).

Typical ESG factors comprise a wide and heterogeneous set of themes (Boffo & Patalano, 2020):

- Environmental: climate impact, energy use, emissions, resource management (environmental factors address the firm's interaction with natural resources and ecological systems);
- Social: labor practices, human rights, customer relations, community engagement (social factors relate to the management of relationships with employees, customers, and communities);

- Governance: board structure, executive compensation, shareholder rights, transparency (governance factors concern the structures and processes that guide corporate decision-making, accountability, and control).

Together, these dimensions provide a comprehensive framework for evaluating corporate sustainability, ethical conduct, and long-term economic viability beyond traditional financial indicators.

As regulatory requirements, investor expectations, and stakeholder scrutiny intensify, the integration of ESG indicators into financial analysis enhances the ability to evaluate corporate resilience, strategic sustainability, and the durability of economic returns. Consequently, contemporary financial statement analysis is progressively expanding from a purely financial perspective to a more comprehensive assessment that incorporates both financial and non-financial value drivers.

4. CONCLUSIONS

Financial statement analysis remains a fundamental tool for evaluating a firm's financial position, performance, and prospects. This article has examined the principal approaches to financial statement analysis, emphasizing the complementary roles of liquidity, solvency, profitability, activity, and market value analyses in forming a comprehensive assessment of corporate financial health. Each approach offers distinct yet interconnected insights, highlighting the importance of interpreting financial indicators within a broader analytical framework rather than in isolation.

The main aspects of the approach to analyzing financial statement are focused on the following areas:

- Financial statement provides useful information regarding the financial position and performance of a company, the success of its operations, the policies and strategies of managerial team;
- Information provided by the financial statement analysis are useful to a wide range of users, helping in the decision-making process: owners, investors, managers, creditors, government regulators;
- Financial statement analysis can be performed over a series of reporting periods in a structured way using ratio analysis, horizontal analysis, and vertical analysis
- Financial ratios analysis is a useful technique, ratios indicate trends but are more valuable on a comparative base, than they are interpreted in individual circumstances;
- As an entrepreneur, you will want to review your balance sheet monthly to keep a handle on your company's assets, liabilities and shareholders' equity;
- As an entrepreneur, a regularly updated income statement will allow you to track the performance of your business over time;
- The financial decisions have an impact on the numbers in your financial statements, which show the health and stability of your company

The findings underscore that the effectiveness of financial statement analysis depends not only on the selection of appropriate ratios and methods but also on their contextual interpretation, including comparisons across time, against industry

benchmarks, and within prevailing economic conditions. No single analytical approach is sufficient on its own; instead, a multidimensional perspective enhances the reliability of conclusions drawn by investors, managers, creditors, and other stakeholders.

Integrated approaches to financial statement analysis extend beyond traditional ratio analysis by combining financial indicators with strategic, market-based, and forward-looking information. These approaches emphasize the interdependence of financial statements, integrating liquidity, solvency, profitability, activity, and market value measures into a unified analytical framework that enhances interpretative depth and decision relevance.

In conclusion, approaches to financial statement analysis continue to play a critical role in supporting informed decision-making and reducing information asymmetry. Future research may extend this framework by integrating non-financial indicators, sustainability metrics, and advanced analytical techniques, thereby strengthening the explanatory and predictive power of financial statement analysis in an increasingly complex business environment.

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