



ANALYSIS OF FINANCIAL STATEMENTS AND IDENTIFYING FINANCIAL RISKS

Kulyyeva Oguljeren

Instructor: Lecturer of Oguz han Engineering and Technology University of Turkmenistan
Ashgabat, Turkmenistan

Abdyrahmanova Ayjeren

Instructor: Lecturer of Oguz han Engineering and Technology University of Turkmenistan
Ashgabat, Turkmenistan

Bayramkylychova Gulnaz Toylygylyjovna

Student of Oguz han Engineering and Technology University of Turkmenistan
Ashgabat, Turkmenistan

Meretgeldiyeva Ogulbay Arslanovna

Student of Oguz han Engineering and Technology University of Turkmenistan
Ashgabat, Turkmenistan

Sahedov Davut Yazmyradovich

Student of Oguz han Engineering and Technology University of Turkmenistan
Ashgabat, Turkmenistan

Abstract

The analysis of financial statements is a critical practice for evaluating the financial health of organizations, businesses, and even countries. Through the examination of income statements, balance sheets, and cash flow statements, stakeholders can make informed decisions about the future viability and stability of an entity. Identifying financial risks within these statements allows companies to mitigate potential threats and enhance strategic decision-making. This article discusses the importance of financial statement analysis, the methods used to evaluate them, and the key financial risks that can be identified through such assessments. Furthermore, the article provides insights into how these risks impact business operations and the economy as a whole.

Keywords: financial analysis, financial statements, risk identification, balance sheet, income statement, cash flow, financial ratios, risk management.

1. Introduction

In the contemporary business environment, financial analysis serves as a vital tool for understanding the economic condition of an entity. Financial statements—primarily the balance sheet, income statement, and cash flow statement—offer a snapshot of an organization's financial performance and position over a specific period. These documents help business owners, investors, creditors, and other stakeholders to assess an entity's profitability, liquidity, solvency, and cash flow status.

The process of analyzing these financial statements goes beyond just evaluating figures; it involves identifying potential financial risks that could affect business operations and long-term sustainability. By identifying these risks early, companies can take proactive steps to mitigate them, ensuring better strategic planning and decision-making.

This article explores the fundamental aspects of financial statement analysis, methods of identifying financial risks, and the importance of managing those risks to maintain business stability and growth.

2. Understanding the Key Financial Statements

2.1. The Balance Sheet

The balance sheet is a financial statement that provides a snapshot of an organization's assets, liabilities, and equity at a specific point in time. It is divided into two main sections:

- **Assets:** These include current assets (e.g., cash, receivables) and non-current assets (e.g., property, plant, and equipment).
- **Liabilities:** These include current liabilities (e.g., accounts payable, short-term debts) and non-current liabilities (e.g., long-term loans, bonds).
- **Equity:** Represents the owner's claim after liabilities have been deducted from assets. It reflects retained earnings, paid-in capital, and any other reserves.

The balance sheet follows the fundamental accounting equation:
Assets = Liabilities + Equity.

Analyzing the balance sheet helps in assessing the financial stability and liquidity of an organization, providing insights into how much of its operations are funded by debt versus equity.

2.2. The Income Statement

The income statement, also known as the profit and loss statement, provides information about a company's revenues, expenses, and profits or losses over a specific period. The key components include:

- **Revenues:** Income generated from business activities, such as sales of goods or services.
- **Cost of Goods Sold (COGS):** Direct costs associated with producing goods or services sold.
- **Operating Expenses:** Indirect costs such as salaries, rent, utilities, and marketing.
- **Net Income:** The bottom line—profit or loss after all expenses, taxes, and interest.

Through the income statement, stakeholders can evaluate an entity's profitability, operational efficiency, and cost management.

2.3. The Cash Flow Statement

The cash flow statement outlines the cash inflows and outflows over a period, showing how well an organization generates cash to fund its operations and meet its financial obligations. It is divided into three sections:

- **Operating Activities:** Cash flows from the core business operations.
- **Investing Activities:** Cash flows from buying or selling assets, such as property or investments.
- **Financing Activities:** Cash flows related to borrowing, repaying debt, and issuing or repurchasing equity.

The cash flow statement helps assess a company's liquidity, the ability to generate cash from operations, and its financial health in terms of meeting obligations.

3. Methods of Financial Statement Analysis

3.1. Financial Ratios

Financial ratios are mathematical expressions that compare various financial variables. These ratios help identify trends, uncover potential risks, and benchmark performance against industry standards. Key ratios include:

- **Liquidity Ratios:** Measure a company's ability to cover short-term liabilities with its short-term assets.
 - *Current Ratio* = Current Assets / Current Liabilities.
 - *Quick Ratio* = (Current Assets - Inventory) / Current Liabilities.
- **Profitability Ratios:** Assess a company's ability to generate earnings relative to its revenue, assets, or equity.
 - *Gross Profit Margin* = Gross Profit / Revenue.
 - *Return on Equity (ROE)* = Net Income / Shareholder's Equity.
- **Leverage Ratios:** Evaluate the extent to which a company is using borrowed money.
 - *Debt-to-Equity Ratio* = Total Debt / Total Equity.
 - *Interest Coverage Ratio* = EBIT / Interest Expenses.
- **Efficiency Ratios:** Measure how efficiently a company uses its assets to generate revenue.

- *Asset Turnover Ratio* = Revenue / Total Assets.
- *Inventory Turnover Ratio* = COGS / Average Inventory.

3.2. Trend Analysis

Trend analysis involves comparing financial data over multiple periods to identify patterns, growth trajectories, and potential risk areas. By examining the historical performance of a company, stakeholders can predict future performance and identify emerging risks. For instance, a decline in revenue over several periods may indicate declining market demand or operational inefficiencies.

3.3. Vertical and Horizontal Analysis

- **Vertical Analysis:** Involves expressing each item in the financial statements as a percentage of a base item, such as total assets or total revenue. It helps in understanding the relative proportion of each element.
- **Horizontal Analysis:** Involves comparing financial statements over multiple periods to identify trends, growth patterns, or deteriorating financial conditions.

4. Identifying Financial Risks

4.1. Liquidity Risk

Liquidity risk arises when an organization cannot meet its short-term financial obligations due to insufficient cash or liquid assets. A company with poor liquidity management may struggle to pay off debts, which can negatively affect its credit rating and increase borrowing costs.

Indicators of liquidity risk include low current and quick ratios, persistent negative cash flow from operations, or a growing reliance on short-term debt.

4.2. Credit Risk

Credit risk refers to the likelihood that a business or its customers will fail to meet their financial obligations. Companies that are over-leveraged or have significant amounts of receivables may face increased credit risk, particularly during economic downturns.

Key indicators of credit risk include high debt-to-equity ratios, increasing accounts receivable turnover, and a rising number of overdue accounts.

4.3. Market Risk

Market risk is the possibility of financial losses due to fluctuations in market conditions, such as changes in interest rates, foreign exchange rates, or commodity prices. This type of risk can be especially relevant for businesses engaged in international trade or those heavily reliant on raw materials.

Hedging strategies and diversification of investment portfolios can help mitigate market risks, but constant monitoring of external economic factors is essential.

4.4. Operational Risk

Operational risk refers to the risk of loss due to internal failures such as inefficient processes, inadequate controls, fraud, or human error. Businesses with poor internal systems and governance structures are more vulnerable to operational risks.

Key signs of operational risk include frequent process bottlenecks, high levels of employee turnover, and recurring operational disruptions.

5. Mitigating Financial Risks through Management

Identifying financial risks is only the first step in maintaining financial stability. Risk mitigation strategies involve:

- **Risk Diversification:** Spreading investments across various sectors, geographies, and asset classes to reduce exposure to any single risk factor.
- **Risk Hedging:** Using financial instruments such as derivatives to protect against fluctuations in market conditions.
- **Contingency Planning:** Developing emergency plans to ensure business continuity in case of financial distress, such as securing lines of credit or maintaining a reserve fund.

6. Conclusion

The analysis of financial statements is essential for understanding an organization's financial health and identifying potential risks that could hinder its growth and stability. Through the use of various analytical techniques—such as financial ratios, trend analysis, and vertical/horizontal comparisons—stakeholders can gain valuable insights into the performance of a business. Identifying financial risks early allows businesses to take proactive measures to mitigate these risks, improving their chances of long-term success and financial sustainability. For companies and their managers, understanding the complexities of financial risk and implementing effective strategies to manage it is crucial for navigating today's dynamic and often volatile economic environment.

References

1. Koller, G. (2019). *Financial Statement Analysis: A Practitioner's Guide*. Wiley.
2. White, G. I., Sondhi, A. C., & Fried, D. (2003). *The Analysis and Use of Financial Statements*. Wiley.
3. Investopedia. (2020). *Risk Management and Analysis*. Retrieved from www.investopedia.com
4. CFA Institute. (2018). *Financial Analysis and Risk Management*. Wiley.