Analysis of the Limitations of Chinese Enterprises' Financial Statements and Countermeasures

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Abstract. Financial statement analysis bases on financial statements and other information, using special analytical tools and methods to systematically analyze and evaluate the past and present operating results and financial position of an enterprise. It also predicts the future development trend of the enterprise and provides valuable information for decision-making to reduce uncertainty in decision-making. The current financial statements have limitations in the financial statements themselves, including the lack of non-financial information, the lagging nature of the financial statements, accounting policies, optional accounting treatments and subjective estimates by accountants. In terms of financial analysis indicators, some of the solvency indicators and operating capacity indicators have limitations. In terms of financial analysis methods, the comparative analysis method, factor analysis method and trend analysis method all have certain limitations. These limitations are discussed and analyzed in this paper. Suggestions are also made on the financial statements themselves, the indicators to be analyzed in the financial statements and the methods of financial analysis.

Keywords: Financial statement; financial analysis indicators; financial analysis methods ; limitations

1. Introduction

Financial statement analysis is a professional activity in which financial personnel use financial statements as a grip to analyses the business and financial situation of an enterprise over a period of time through certain methods. By analyzing the financial statements, the company is able to put together isolated and boring figures and interpret them in a way that can be understood by non-financial people using special analytical methods. This allows users of the statements, such as shareholders, operators or investors, to have a better understanding of the results of the company's operations in a given accounting period. It also allows managers to have access to a wide range of financial information, such as the current state of cash flow and the profit and loss point of the business, and to plan the future development of the company accordingly. An effective analysis of financial statements requires the analyst to be able to effectively select valid data for the statements, choose the appropriate analysis methods and use professional analytical skills. Therefore, the choice of data, the method of analysis, as well as the quality of the statements, and even the deviation of the analyst's personal preferences, may affect the quality of the analysis of the statements and thus directly influence the business decisions of the enterprise.

2. Significance of financial statement analysis

2.1 Evaluation of current financial position

Balance sheet analysis can divide into asset structure analysis and liability and equity structure analysis. The asset structure analysis allows to calculate the proportion of the company's current assets and non-current assets, respectively, to the total assets. If the company has a high ratio of current assets, it will take up a large amount of capital and reduce the current asset turnover rate, thus affecting the efficiency of the company's capital use. And if the proportion of non-current assets is relatively high, it will reduce the company's profitability, which will affect the future development of the company. By analyzing the debt and equity structure, the ratio of debt and owner's equity to capital

can calculate separately. If the company has lower debt capital and higher equity capital, it can reduce the financial risk of the company, but it will increase the cost of capital of the company and cannot effectively leverage the cost of debt capital.

The income statement can reflect the income of an enterprise for a specific accounting period, such as how much income from the main businesses, how much income from other businesses, etc. It can also reflect the consumption of the enterprise's expenses for a particular accounting period, such as how much is the cost of the main businesses, how much is the selling expenses, financial expenses, management expenses, research and development expenses, etc. Comparing the various figures in the income statement with the historical operations of the enterprise helps users of the accounting statements to understand the results of the enterprise's operations.

Cash flows in the cash flow statement are classified as operating activities, investing activities, and financing activities. The analysis of the cash flow statement is crucial in the study of financial statements. Cash flow is the "blood" of a company and is the source of its motivation [1]. By analyzing cash flow, it is possible to evaluate the quality of a company's profitability and to know where it comes from and what it uses.

2.2 Improving the management level of the enterprise

The analysis of financial statements can help managers understand the current state of business operations and thus identify problems and solve them [2]. The core financial capability of a company includes solvency, operating capability, and profitability. Good solvency helps to improve the profitability of an enterprise, and it consists of the analysis of the current ratio, quick ratio, gearing ratio, etc. Operating capacity can evaluate the liquidity of an enterprise's assets, assess the effectiveness of the enterprise's asset utilization, and understand the problems in the utilization of the enterprise's assets, which includes the analysis of the total asset turnover ratio and inventory turnover ratio. Profitability is a good indicator of management's performance and a guarantee of debt repayment, including gross sales margin and net profit margin. After calculating and analyzing these indicators, managers can compare them with other companies in the same industry and identify any problems in their operations promptly, on time.

2.3 Performing risk control

Business risk refers to the various crises encountered by enterprises in the course of business management. It includes policy risk, market risk, financial risk, legal risk, and team risk. Financial risks can generally find by analyzing financial statements to obtain financial information. For example, the current and quick ratio can reflect whether the liquidity of the enterprise's assets is at risk and whether the short-term solvency is sufficient; the debt ratio can reflect whether the company's financial leverage is reasonable and whether the long-term solvency is adequate. The financial statement analysts provide a basis for financial risk control based on the different risk appetites of managers [3].

3. limitations of the financial statements

3.1 Limitations of the financial statements themselves

3.1.1 Lack of non-financial information

With the development of the economy, the factors affecting the growth of enterprises in the market have become diverse. In addition to the financial information reflected in the financial statements, various information materials in the non-financial form that are directly or indirectly related to the production and operation activities of enterprises, i.e., non-financial information, also have a significant impact on the business management of enterprises. Non-financial information is spatially extensive, and it can not only come from within the enterprise, but also from outside the enterprise. It is also continuous in time, and may relate to past events of the enterprise, as well as present or

future events of the enterprise. A one-sided analysis of financial data can easily lead to companies neglecting long-term development considerations to achieve short-term benefits. It cannot provide managers with effective strategic decisions [4].

3.1.2 Financial statement data with a time lag

The current financial reports mainly comprise annual reports and interim reports. In terms of timing of disclosure, annual reports disclose within four months from the end of each financial year, and interim reports disclose within two months from the end of the first half of each financial year. There is a lag in the timing of disclosure. On the other hand, measuring accounting elements often uses their historical cost rather than fair value. When the value of an asset changes, the current financial report reflects past information, i.e., historical cost information, which is different from the actual value of the asset and has a lag in the accounting information itself. With the rapid development of information technology and the pursuit of high speed and efficiency, the lag of financial accounting reports will become its fatal flaw [5].

3.1.3 Selectivity of accounting policies and accounting treatments and subjective accounting estimates by accountants

The multiple choices of accounting policies and treatments have resulted in a lack of comparability of data in similar statements from different enterprises [6]. The selection of accounting policies includes measuring of the cost of inventories issued, the subsequent measurement of long-term equity investments, the subsequent measurement of investment properties, the recognition of intangible assets, etc. Enterprises can choose different accounting policies according to their circumstances, so even two very similar enterprises may have very other choices of accounting policies, which can lead to a reduction in comparability between enterprises. In terms of subjective accounting estimates by accountants, accountants estimate the relevant items in the accounting statements based on their own experience and actual circumstances, which not only does not guarantee their accuracy, but also has the potential for surplus management. As a result of these two factors, the quality of the financial information provided in the financial statements can be compromised, thus biasing the financial analysis of the business.

3.2 Limitations of financial analysis indicators

3.2.1 Limitations of solvency indicators

3.2.1.1 Current Ratio

The current ratio is the total current assets to total current liabilities. Current assets are consumed or realized in one year or over one operating cycle of more than one year. However, in the current financial statements, accounts receivable and backlogged inventories that have been outstanding for more than one year are still accounted for as current assets and shown on the balance sheet. And the actual value of some non-performing assets is significantly lower than the carrying value due to their poor asset quality. However, such assets not remove from current assets. Companies can whitewash their current ratio and manipulate its size by, for example, instantly increasing current assets or reducing current liabilities [7].

3.2.1.2 Cash Ratio

The cash ratio is the ratio of the sum of cash and cash equivalents to current liabilities, which reflects the actual solvency of the enterprise. However, in practice, it is not possible to require a company to use all of its cash or cash equivalents to service its debts [8]. Cash equivalents, such as treasury bonds that mature or pay off within three months, are not immediately realizable to repay debts and receive certain constraints. If a company has a high level of cash equivalents, this can lead to a situation where it appears to be highly solvent but, in fact has very little cash available.

3.2.1.3 Gearing ratio

The gearing ratio is the percentage of total liabilities over total assets at the end of the period. It is generally used to indicate the ability of a business to meet all of its liabilities. However, this is not reasonable because the denominator of the gearing ratio, i.e., total assets, cannot be used to settle all liabilities. For example, goodwill, intangible assets, etc., are highly uncertain in paying liabilities. Furthermore, for a start-up company, the initial investment is relatively significant, requiring a large amount of capital to build plants, purchase machinery and equipment, install and commission production lines, etc. In this case, the reference value of the gearing ratio diminishes greatly.

3.2.2 Limitations of operating capacity indicators

3.2.2.1 Total Asset Turnover Ratio

The total asset turnover ratio is the ratio of net sales revenue to the average total assets of an enterprise in a certain period, which is an indicator of the ratio between the scale of asset investment and the level of sales. Its numerator represents net sales after discounts and concessions, and is the net income obtained by the enterprise from its business activities. The denominator represents the sum of the various assets, including current assets, long-term equity investments, intangible assets, etc. Total assets, such as income from external investments, are investment gains and losses and cannot form sales revenue, thus leading to inconsistencies in the caliber of the numerator and denominator, which in turn leads to a loss of comparability between the previous and later periods of the indicator and between different enterprises due to differences in the asset structure.

3.2.2.2 Inventory Turnover Ratio

Inventory turnover is the ratio of the cost of goods sold over a certain period to the average inventory balance of an enterprise. It is used to reflect the speed of inventory turnover. The denominator of the inventory turnover ratio, i.e., average inventory, is a comprehensive item, including finished goods, work in progress, materials in transit, and raw materials. The proportion of finished goods, work in progress, materials in transit, and raw materials in the inventory varies from company to company. In addition, the inventory turnover rate is affected by material hoarding and the purchase of large quantities of materials at low prices, which can cause the indicator to drop significantly, but this is a business strategy often used by companies to reduce costs [9]. Therefore, it is not accurate to use the inventory turnover ratio to evaluate a company's ability to operate.

3.3 Limitations of financial analysis methods

3.3.1 Comparative analysis method

Using the comparative analysis method, enterprises in the same industry and with the similar economic businesses need to be selected for comparative analysis, which has more significant limitations [10]. In the application process, even if two enterprises have a high degree of similarity in industry, economic business, and financial situation, the specific case of each enterprise is different, and there are still differences in pricing strategies and market positioning of enterprises. This can lead to the comparability of the comparative analysis method being affected, making the results obtained using the comparative analysis method less credible.

3.3.2 Factor analysis method

When using the factor analysis method, assumptions need to be made. There are multiple choices in several of the main operational aspects of the factor analysis procedure, which can be influenced by the subjective factors of the researcher and are not sufficiently rigorous.

3.3.3 Trend analysis method

When using the trend analysis method, the identical items in the financial statements of two or more accounting periods are analyzed to reveal trends in financial position and results of operations by studying the reasons for the changes and the direction of the changes. However, if there is an

inflection point in the current year's operations, the financial statements of different periods are not comparable.

4. Countermeasures

4.1 Improvement measures for the limitations of the financial statements themselves

First of all, for the long-term interests of enterprises, business decision-makers should pay attention to the changes in non-financial indicators. Whether an enterprise's assets are pledged, the strength of its financing ability, the existence of forms of liabilities and other data in the balance sheet nature descriptions are called non-financial information. The accounting statement information and non-financial information are organically combined to obtain a more accurate enterprise financial situation to carry out enterprise statement analysis, so that the statement analysis can be of high quality and more valuable to use. Secondly, traditional management methods should be improved, and advanced financial accounting management software should be used to improve the speed of data processing. The vast majority of the data required for financial analysis can come from computers or the internet, so it is also possible to use computers directly to collect, collate, calculate, classify and analyze vast amounts of data in a fast and timely manner. Finally, enterprises should also strictly implement the new accounting standards to minimize the occurrence of different accounting treatments and estimates for the same accounting operations, thereby enhancing comparability between enterprises.

4.2 Improvement measures for financial statement analysis indicators

The numerator of the current ratio should exclude uncollected accounts receivable for more than one operating cycle and backlogged inventories and prepayments for the purchase or investment of long-term assets. Then add marketable securities and the excess of the realizable value of inventories over the book value. The numerator of the cash ratio should exclude cash equivalents that are restricted in use and cannot be realized quickly. The gearing ratio should take into account the stage of operation of the business and exclude assets with a high degree of uncertainty in settling debts. The total asset turnover ratio should exclude external investments from the total assets so that the denominator can change to operating assets. To match the numerator and denominator, the numerator in the original formula can change to net operating income. Inventory turnover should be refined to build raw material, work-in-progress, and finished goods turnover indicators to measure the efficiency of inventory turnover in each segment of the enterprise, respectively. It is also essential to look beyond the specific value and to pay attention to the inventory valuation method, and analyze the motivation for the increase or decrease of the company's inventory.

4.3 Improvement measures for financial analysis methods

When using financial analysis ways, various methods should be used in combination. First of all, adhere to the combination of quantitative analysis and qualitative analysis. Modern enterprises often face with complex and changing external environments, which are sometimes difficult to analyze quantitatively, but will have a substantial impact on the financial situation and operating results of the enterprise. Secondly, dynamic analysis and static analysis should combine. The production and operation business and financial activities of an enterprise is an active development process. In contrast, the information, especially the financial statement information, is generally a reflection of the past situation. Two enterprises may have different outputs for the same inputs, so paying attention to the effectiveness of the values and using a combination of dynamic and static analysis to analyze enterprise finance is essential. Finally, it is crucial to combine individual research with comprehensive analysis. The economic operations of an enterprise are not independent of each other; they are mutually constraining and mutually reinforcing. The values of indicators are also relative in nature, and the same value may lead to opposite conclusions in different situations. Financial analysis is therefore carried out in an integrated manner, based on the possible impact of an indicator on other aspects.

5. Conclusion

The analysis of an enterprise's financial statements not only affects the business decisions of the enterprise at the moment, but also has a very far-reaching impact on the future development of the enterprise. Through a comprehensive financial analysis, business operators and investors can gain a better understanding of the internal management of the company, as well as a timely understanding of the risks in the management of the company. This enables improvements to be made to internal management deficiencies, better management of internal oversight, and plays a good role in the development of the enterprise. However, there are still certain shortcomings in the financial statement analysis system of Chinese enterprises, and the analysis results are not accurate enough to guide the business decisions made by enterprises. Therefore, when conducting analysis, it is important to eliminate unfavorable conditions and use scientific methods to conduct analysis. In order to improve the accuracy of financial statement analysis and produce more objective results, companies should improve the accuracy of financial statement analysis in the context of their own production situation and provide reference for the company to formulate business strategies. Financial analysis helps to clarify the internal problems that exist in the development process of an enterprise, which can be solved within a short period of time and has a positive effect on steadily reducing the production and operation risks of the enterprise. Only by combining the future development of the company with finance can higher strategic goals be set. Therefore, enterprises need to improve the financial analysis system to achieve dynamic financial analysis, steadily improve the level of financial analysis, to provide an important scientific basis for enterprise production and management decisions. In conclusion, financial statement analysis is very important for enterprises to become bigger and stronger, and financial statement analysis should be focused on a comprehensive basis to meet the needs of different financial statement users, in order to better serve the enterprise.

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