FINANCIAL STATEMENT ANALYSIS

Analysis of Financial Statements is a systematic process of analyzing the financial information in the financial statements to understand and take economic decisions.
It is the systematic numerical representation of the relationship of one financial fact with the other to measure the profitability, operational efficiency, solvency and the growth potential of the business.

"In simple words analysis of financial statements is a more comprehensive study of balance sheet and profit and loss account using the tools of analysis to get a proper understanding of profitability and financial position of business."

Objectives or Purposes of Financial Statement Analysis:

- **To measure the Profitability or Earning Capacity of the business** -analysis helps in measuring the profits and earning capacity of business. it helps in judging whether the profits are accurate or not.
- **To measure the Financial Strength of the business** - analysis helps in understanding the financial position of the company. it helps in judging the financial health of the business.
- **To make Comparative Study within the firm (intra – firm) and with other firms (inter - firm)-** analysis helps in comparisons of financial statements.
  There are two types of comparisons-
  - Intra firm- it is the comparison within the business i.e. previous year and current year or from one department to another. it is also known as trend analysis.
  - Inter firm- it is the comparison of one business to another i.e. comparing one company to another. it is known as cross sectional analysis.
- **To judge the Efficiency of Management-** profits and assets of the business helps in judging the efficiency of the business i.e. whether the business is utilizing its resources in an efficient manner or not.
- **To provide Useful Information's to the Managemen**t- analysis helps the management to get useful insight of the business which helps them in taking many managerial decisions.
- **To find out the Capability for payment of interest, dividend etc**.- profitability of the business helps in judging whether the business will be able to pay interest and dividend. analysis helps in judging the capability of the business of payment of interest and dividend.
- **To measure the Short-term and Long-term Solvency of the business**- analysis helps in judging whether the business will be able to pay its short term and long-term dues.

Limitations of Financial Statement Analysis

(i) **Suffer from Limitations of financial statements:** Financial analysis is based on financial Statements, but financial statements themselves suffer from certain limitations, hence the limitations of financial statements are also the limitations of their analysis. For example,
(a) sometimes the information given in financial statements are incomplete and not authentic, (b) financial Statements are based on accounting concepts and conventions. Therefore, unless the basic data given in Financial Statements is reliable, the conclusion since Analysis cannot be reliable.
(ii) **Affected by Window-dressing:** Some firms resort to window-dressing their financial statements to cover up bad financial position on the eve of accounting date. For example, they may not record the purchases made at the end of the year or they may overvalue their closing stock. In such cases, the results obtained by analysis of financial statements will be misleading

(iii) **Different Accounting Policies:** If two firms adopt different accounting policies, the comparison between the two will be unreliable. For example, one firm may provide depreciation on original cost method, whereas the other firm may adopt the written-down value method for providing the depreciation. Similarly, the method of valuation of closing stock may also differ from one firm to another. The results obtained from the comparison of the financial statements of such firms may give misleading picture.

(iv) **Lack of Qualitative Analysis :** Financial statements record only those events and transactions which can be expressed in terms of money. Qualitative aspects of business units are omitted from the books at all as these cannot be expressed in monetary terms. Thus, changes in management, reputation of the business, cordial management-labor relations, firm's ability to develop new products, efficiency of management, satisfaction of firm's customers etc. which have a vital bearing on the profitability of the company are all ignored and omitted from being recorded because all of these are qualitative in nature.

Types of Financial Statement Analysis:

There are two main approaches for the analysis of financial statements.

- **Horizontal Analysis**: In this type of analysis, figure in the financial statements for two or more years are compared and analyzed. It helps in knowing the trends of the business over a period. It is also known as Time series analysis or Dynamic Analysis.
  Comparative statements and cash flow statements **are examples of horizontal analysis.** It is also known as intra firm analysis.
- **Vertical Analysis:** In this type of analysis, figures in the financial statement for a single year are analyzed. It involves the study of relationship between various items of Balance Sheet or statement of Profit & Loss of a single year or period. It is also known as Static Analysis.
  Common size statements and ratio analysis **relating to a particular accounting period are examples of this type of analysis. It is also called inter firm analysis.**

Difference between Horizontal and Vertical Analysis

Horizontal Analysis	Vertical Analysis
Requires financial Statements of two or more accounting periods	Requires Financial Statements of one period
Provides information in both absolute and percentage terms	Provides information in percentage terms
Used for time series Analysis	used for Cross Sectional Analysis

Significance or Importance of Financial Analysis:

The importance of the analysis is for two types of users-

1. **Internal users**- these are the users within the business which require analysis of financial statements. The internal users are-

- ✓ **For Management**: To know the profitability, liquidity and solvency position to measure the effectiveness of its own decisions taken and to take corrective measure in future.
- ✓ **For employees :** employees need analysis to know about the profitability of the business as it is directly related to the salary and bonus they will get.

2. **External users**- these are the users outside the business which require analysis of financial statements. the external users are –

- ✓ **For Investors**: Investors want to know the earning capacity and future growth prospects of the business which helps in assessing the safety of their investment and reasonable return.
- ✓ **For Creditors:** Short-term creditors want to know the liquidity position of the business where as long-term creditors want to know about the solvency position and ability to pay the interest consistently.
- ✓ **For Govt:** To know the profitability position for taking taxation decision and to take decisions about the price regulations.
- ✓ **Tax Authorities** : Tax authorities are interested in financial statements for determining the Tax Liabilities.
  Stock Exchange : The stock exchange members take interest in financial statements
- ✓ for analysis because they provide useful financial information about companies

TOOLS FOR FINANCIAL STATEMENT ANALYSIS

The various tools used for analysis of financial statements are :

Comparative Statement : Financial Statements of two years are compared and changes in absolute terms and in percentage terms are calculated. It is a form of Horizontal Analysis.

Common Size statement : Figures of Financial statements are converted into percentage with respect to some common base. In Common size Income Statement Sales/Revenue from Operations is taken is common base where as in Common size Balance Sheet Total assets or Total Equity and Liabilities are taken as common base.

Ratio Analysis : It is a technique of Study of relationship between various items in the Financial Statements. There are mainly four types of ratios-

1) Liquidity Ratio
2) Solvency Ratio
3) Activity Ratio
4) Profitability Ratio

Cash Flow Statement : It is a statement that shows the inflow and outflow of cash and cash equivalents during a period which helps in finding out the causes of changes in cash position between the two balance sheet dates. It is prepared under accounting standard 3 (AS-3).

Comparative Statements

It is a statement that shows changes in each item of the financial statement in absolute amount and in percentage, taking the amounts of the preceding year as counting period as the base.

Types of Comparative Statements :

1. Comparative Balance Sheet; and
2. Comparative Statement of Profit and Loss.

Comparative Statement is prepared to show:

- ✓ Absolute Data and decrease/increase in absolute Amounts
- ✓ Increase/decrease on absolute data in terms of percentage
- ✓ Comparison expressed in ratios.

Comparative Balance Sheet : It shows the increases and decreases in various items of assets, equity and liabilities in absolute term and in percentage term by taking the corresponding figures in the previous year's balance sheet as a base.

Format for a Comparative Balance Sheet Comparative Balance Sheet of ……… Ltd.

	Rs. Previous Year)	**Rs (Current Year).**	**Absolute Change Rs. (current**	**Percentage Change %**

			year- previous year)	
Particulars				
1. EQUITY AND LIABILITIES (1) Shareholders' funds (a) Share capital (b) Reserves and surplus (2) Non-current Liabilities (a) Long-term borrowings (b) Other Long-term liabilities (c) Long-term provisions (3) Current liabilities (a) Short-term borrowings (b) Trade payables (c) Other Current liabilities (d) Short-term provisions				
Total				
II. ASSETS (1) Non-current assets (a) Fixed assets (b) Non-current investments (c) Long-term loans and advances (2) Current Assets (a) Current investments (b) Inventories (c) Trade receivables (d) Cash and cash equivalents (e) Short term loans and advances (f) Other current assets Total				
Total				

***Percentage change = absolute change/ previous year *100**

*** If CY numbers has decreased, show the absolute change and Percentage change in brackets.**

COMPARATIVE STATEMENT OF PROFIT AND LOSS/COMPARATIVE INCOME STATEMENT

Comparative Income Statement: It shows the increases and decreases in various items of income Statement in absolute amount and in percentage amount by taking the corresponding figures in the previous year's Income Statement as a base.

Format for a Comparative Statement of Profit and Loss Comparative Statement of Profit and Loss

	Rs. (Previous Year)	Rs (Current Year).	Absolute Change Rs. (Current Year (-) Previous Year)	Percentage Change %
Particulars				
I. Revenue from operations II. Other Income				
III. Total Revenue (I+II)				
IV. Expenses : a.Cost of Material consumed b.Purchases of Stock-in-Trade c.Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade d.Employees Benefit Expenses e. Finance Cost f. Depreciation & Amortization Expenses g.Other Expenses				
Total Expenses				
V. Profit before Tax (III-IV) Less : Income Tax				
VII. Profit after Tax				

percentage = absolute change/ previous year*100

*** If CY numbers has decreased, show the absolute change and Percentage change in brackets.**

Common Size Statement

Common Size Financial Statements are the statements in which amounts of the various items of financial statements are converted into percentages to a common base.

Types of Common Size statements :

1. Common Size Balance sheet; and
2. Common Size Statement of Profit and Loss.

Common Size Balance sheet : It is a statement in which every item of assets, equity and liabilities is expressed as a percentage to the total of all assets or to the total of Equity and Liabilities.

Format for a Common Size Balance Sheet :

Common Size Balance Sheet of…………….Ltd as at__________

Particulars	Absolute Amounts	Percentage of Balance Sheet Total

	Rs. (Previous Year)	Rs (Current Year).	Previous Year %	Current Year %
1. EQUITY AND LIABILITIES **(1) Shareholders' funds** (a) Share capital (b) Reserves and surplus **(2) Non-current Liabilities** (a) Long-term borrowings (b) Other Long-term liabilities (c) Long-term provisions **(3) Current liabilities** (a) Short-term borrowings (b) Trade payables (c) Other Current liabilities (d) Short-term provisions				
Total			100	100
II. ASSETS **(1) Non-current assets** (a) Fixed assets (b) Non-current investments (c) Long-term loans and advances **(2) Current Assets** (a) Current investments (b) Inventories (c) Trade receivables (d) Cash and cash equivalents (e) Short term loans and advances (f) Other current assets Total				
Total			100	100

Common Size Income Statement or Statement of Profit and Loss: It is a statement in which every item of Statement of Profit and Loss is expressed as a percentage to the amount of Revenue from Operations.

Format for a Common Size Statement of Profit and Loss:
Common-sized Statement of Profit and Loss for the Year ended_____

Particulars	Absolute Amounts	

			Percentage of Revenue from Operations (Net Sales)	
	Rs. (Previous year)	**Rs (current year).**	**Previous Year %**	**Current Year %**
I Sales (Revenue from Operations) II. Other Income				
III. Total Revenue (I+II)			100	100
IV. Expenses : a.Cost of Material consumed b.Purchases of Stock-in-Trade c.Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade d.Employees Benefit Expenses e. Finance Cost f. Depreciation & Amortization Expenses g. Other Expenses				
Total Expenses				
V. Profit before Tax (III-IV) Less : Income Tax				
VII. Profit after Tax				