

CHAPTER

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Financial Statement Analysis

MEANING OF FINANCIAL STATEMENT ANALYSIS

Analysis of Financial Statements is a systematic process of analysing the financial information in the financial statements to understand and make decisions regarding the operations of the enterprise.

TOOLS OR TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS

Comparative Statements

Comparative Statements or Comparative Financial Statements mean a comparative study of individual items or components of financial statements, *i.e.*, Balance Sheet and Statement of Profit & Loss of two or more years of the enterprise itself.

Common-size Statements

Common-size Statements or Common-size Financial Statements mean statements in which individual items of financial statements of two or more years are placed side by side and thereafter converted into percentage taking a common base. Common base normally taken is *Total Assets or Total of Equity and Liabilities*, in the case of Common-size Balance Sheet and *Revenue from Operations*, in the case of Common-size Statement of Profit & Loss.

Ratio Analysis

Ratio is an arithmetical expression of relationship between two related or interdependent components of financial statements of an accounting period.

Cash Flow Statement

Cash Flow Statement is a statement showing flow of Cash and Cash Equivalents during the accounting period, classified under Operating Activities, Investing Activities and Financing Activities.

TYPES OF FINANCIAL STATEMENT ANALYSIS

External Analysis**Internal Analysis**

External analysis is carried out by outsiders such as creditors, bankers, debentureholders and government agencies. Internal analysis is meant for management.

Horizontal (or Dynamic) Analysis

Vertical (or Static) Analysis

Dynamic or Horizontal Analysis is a time series analysis. Static or Vertical Analysis is carried out at one particular point of time, generally when the accounts are closed.

Intra-firm Comparison and Inter-firm Comparison

Intra-firm Comparison: A comparison of financial variables of an enterprise over a period of time is known as **Intra-firm Comparison**. It is also called **Time Series Analysis** or **Trend Analysis**. It analyses the performance of a business over a number of years and shows trend of financial factors.

Inter-firm Comparison: A comparison of two or more enterprises or firms is known as **Inter-firm Comparison**. It analyses and compares financial variables of two or more enterprises or firms to determine their competitive position. When single set of statements of two firms is compared, it is known as **Cross-sectional Analysis**.

PROCESS OF FINANCIAL STATEMENT ANALYSIS

Rearrangement of Financial Statements

Comparison

Analysis

Interpretation

PURPOSES (OBJECTIVES) AND SIGNIFICANCE OF FINANCIAL ANALYSIS

Assessing the Earning Capacity or Profitability

Assessing the Managerial Efficiency

Assessing the Short-term and Long-term Solvency of the Enterprise

Inter-firm Comparison

Forecasting and Preparing Budgets

Explainable and Understandable

USES OF FINANCIAL ANALYSIS

Security Analysis

Credit Analysis

Debt Analysis

Dividend Decision

General Business Analysis

PARTIES INTERESTED IN FINANCIAL ANALYSIS

Management
Employees and Trade Unions
Shareholders or Owners or Investors
Potential Investors
Suppliers or Creditors
Bankers and Lenders
Researchers
Tax Authorities
Customers

LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS

Historical Analysis
Ignores Price Level Changes
Qualitative Aspect Ignored
Suffers from the Limitations of Financial Statements
Not Free from Personal Bias
Variation in Accounting Practices
Window Dressing
Identifies Symptoms

CHAPTER SUMMARY

- **Analysis of Financial Statements** is a systematic process of identifying the financial strengths and weaknesses of a firm by properly establishing relationships between the items of the Balance Sheet and Statement of Profit & Loss.
- **Tools or Techniques of Financial Statement Analysis**
 1. Comparative Statements
 2. Common-size Statements
 3. Ratio Analysis
 4. Cash Flow Statement
- **Types of Financial Statement Analysis**
 1. External Analysis
 2. Internal Analysis
 3. Horizontal or Dynamic Analysis
 4. Vertical or Static Analysis

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- **Purposes or Objectives of Financial Analysis**

1. To assess an enterprise's operating efficiency and profitability.
2. To assess financial stability of an enterprise.
3. To assess an enterprise's short-term and long-term solvency.
4. To compare intra-firm position, inter-firm position and pattern position within the industry.
5. To assess the future prospects of an enterprise.

- **Uses of Financial Analysis**

1. Security Analysis
2. Credit Analysis
3. Debt Analysis
4. Dividend Decision
5. General Business Analysis

- **Parties Interested in Financial Statements Analysis**

1. Management
2. Employees and Trade Unions
3. Shareholders or Owners or Investors
4. Potential Investors
5. Suppliers or Creditors
6. Bankers and Lenders
7. Researchers
8. Tax Authorities
9. Customers

- **Limitations of Analysis of Financial Statements**

1. Historical Analysis.
2. Ignores the price-level changes.
3. Qualitative Aspect is ignored.
4. Limitations of Financial Statements are also the limitations of Financial Statement Analysis.
5. Not free from bias.
6. Financial analysis identifies the symptoms but does not arrive at the diagnosis.
7. Variation in Accounting Practices.
8. Window Dressing.