CBSE Class –XII Accountancy
Revision Notes
Chapter 2 Part – B
Financial statement analysis

Financial Statements analysis is a systematic process of studying the relationship among the various financial factors contained in the financial statements to have a better understanding of the working and the financial position of a business.

“**Financial analysis consists in separating facts according to some definite plan, arranging them in groups according to certain circumstances and then presenting them in a convenient and easily read and understandable form.”**

-Finney and Miller

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 postion 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-

1) intra firm- it is the comparison within the business ie previous year and current year or from one department to another. it is also known as trend analysis.

2) inter firm- it is the comparison of one business to another ie 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 ie whether the business is utilising its resources in an efficient manner or not.

To provide **Useful Information's to** the Management- analysis helps the management to get useful insight of the business which helps them in taking many managerical 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 paymnet 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.

Limitation of Financial Statement Analysis

Based on basic financial statement which themselves suffer from certain limitations- financial accounting has certain disadvantages itself which becomes the limitation of its analysis for example financial accounting records only historical cost which becomes the limitation of its analysis.

Ignores changes in price level.- financial accounting analysis does not take in to consideration the current changes in the prices in the economy.

Affected by the personal ability and bias of the analyst.- since analysis is done by the accountant he or she applies their on personal judgement while using the tools of analysis which affect the analysis.

Lack of qualitative analysis as only those transaction and events are recorded which can be measured in terms of money.- only those transactions in financial statements can be analysed which can be measured in money.

When different accounting policies are followed by the two firms then comparison between their financial statement becomes unreliable.- since accounting is dependent upon personal judgement of the accountant sometimes different policies adopted by accountant makes it difficult to compare the financial statements

Analysis of single year's financial statement have limited use- single year financial statements are of limited use as they cannot be used for inter firm and intra firm comparisons.

Also affected by the Window dressing- if the values of different assets and liabilities are not shown at fair value the analysis will not give a fair picture of the business.

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 of time. It is also known as Time series analysis or Dynamic Analysis. Comparative statements and cash flow statements are example 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 analysed. 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.

Significance or Importance of Financial Analysis: the importance of the analysis is for two users-

i) 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.

For Employees: To know the progress of the company for assessing bonus, possible increase in wages and to ensure stability of their jobs.

For Customers: To know about the continuance of the business in future.