ACCOUNTANCY THEORY NOTES

CBSE – GRADE 12

CHAPTER – V
FINANCIAL STATEMENT ANALYSIS

SHORT NOTES

1. Financial Statement Analysis 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.

2.Types of Financial Statement Analysis
(i)External analysis
(ii)Internal analysis
(iii)Horizontal analysis
(iv)Vertical analysis
(v)Long-term analysis
(vi)Short-term analysis

3.Process of Financial Statement Analysis
(i)Rearrangement of data
(ii)Comparison
(iii)Analysis
(iv)Interpretation

4. Importance or Objectives of Financial Statement Analysis
(i)Judging the operational efficiency of the business.
(ii)Measuring the profitability.
(iii)Measuring short-term and long-term financial position.
(iv)Indicating the trend of achievements.
(v)Assessing the growth potential of the business.
(vi)Inter-firm comparison

5.Uses or Advantages of Financial Statement Analysis
(i)Security analysis
(ii)Credit analysis
(iii) Debt analysis
(iv) Dividend decision
(v) General business analysis

6. Limitations of Financial Statement Analysis
(i) Financial statement analysis ignore qualitative aspects like quality of management, labour force and public relations.
(ii) Suffering from the limitations of financial statements, which are as follows:
(a)Financial statements are historical in nature.
(b)Financial statements do not show price level changes hence, affect the analysis also.
(c)The results obtained by analysis of financial statements may be misleading due to window dressing.
(d)Financial statements are affected by the personal ability and bias of the analyst.

7.Parties Interested in Financial Statement Analysis and their Areas of Interest

Parties	Areas of Interest
1. Shareholders or Investors or Owners	(i) Profitability (ii) Financial position (iii) Future prospects of business
2. Management	(i) Short-term and long-term solvency (ii) Liability of the concern (iii) Profitability in relation to turnover and investments
3. Suppliers or Creditors	(i) Financial position (ii) Profitability (iii) Short-term solvency or liquidity position
4. Bankers and Lenders	(i) Financial position (ii) Profitability (iii) Long-term and short-term solvency
5. Employees and Trade Union	(i) Profitability (ii) Financial position of the concern
6. Government and Agencies	(i) Profitability (ii) Financial position (iii) Growth
7. Researchers	(i) Profitability (ii) Financial position (iii) Growth (iv) Future prospects

SHORT HINTS

- Analysis of Financial statement is the systematic process of identifying the financial strength and weaknesses of the firm by establishing the relationship between the items of the Balance Sheet and income statement.
- The information available from the Analysis, serves the interest of different sections like Management, shareholders, workers, creditors, government, Potential Investors, Economist and Researchers and Stock Exchange.
- Financial analysis can be External Analysis and Internal Analysis, Horizontal analysis and Vertical Analysis.
- ***External Analysis:*** when analysis is made on the basis of Published statements, reports and information then this is known as External analysis.
- ***Internal Analysis:*** This analysis is based upon the information available to the business only.
- ***Horizontal Analysis:*** This analysis is based on the financial statements of different years of the same business unit or financial statements of a particular year of different business units.
- ***Vertical Analysis:*** According to this analysis financial statement of the same period or different items of the same financial statements are compared.
- Comparative statements, Common Size statements, Trend Analysis, Ratio Analysis, Fund Flow Statement, Cash flow statement are the Tools of financial statement analysis.

Comparative Statements: it helps in ascertaining change in the items of income statement and Position Statement of different years in terms of figures and percentage.

- ***Common Size Statements:*** In common size statements every item of the statement is presented in the form of percentage of its important heading i.e Net Sales(in case of Common Size income Statement) and Total of Assests and Liabilities(in case of Common Size Balance Sheets)

BOARD EXAM QUESTIONS

1.State any one limitation of financial statement analysis.(Delhi 2014,2013,2010; All India 2014,2014(C), 2013,2010)
Ans. Qualitative aspect is ignored Qualitative aspects like quality of management, quality of labour force, public relations are ignored while carrying out the analysis of financial statements, as financial statements are confined to monetary matters only.

2.State any one objective of financial statement analysis. (All India 2013; Delhi 2013,2010)
Ans. Inter-firm comparison With the help of financial statement analysis inter-firm comparison become easy. It helps in assessing own performance as well as that of others.

3.State one advantage of financial statements analysis. (Delhi, 2013)
Ans. Financial statement analysis helps the management to judge the overall as well as segmentwise operational efficiency of the business.

4.Explain how financial statements analysis ignores qualitative elements. (All India 2013)
Or
State how qualitative aspects are ignored in financial statements analysis. (Delhi 2011C)
Ans. Financial statements analysis ignore qualitative elements as it is confined to the monetary matters only because quality cannot be measured in monetary terms.

5.State the significance of analysis of financial statements to 'top management'.(All India 2012)
Ans. Financial statement analysis enables the 'top management' to evaluate the overall efficiency of the business. It provides adequate information for planning, budgeting and controlling the affairs of the business.

6.State the significance of analysis of financial statements to 'lenders'? (Delhi 2012)
Ans. Lenders can judge long-term and short-term solvency of the business or its ability to repay debts and interest through analysis of financial statements.

7.How is the financial statements analysis useful to finance manager? (All India 2011)
Ans. Financial statements analysis is useful to finance manager for taking financial decisions for the business. It provides adequate information for financial planning.

8.State the interest of tax authorities in the analysis of financial statements.(All India 2011; HOTS)
Ans. Tax authorities are interested to analyse the financial statements to know about the revenue of business firm and for the collection of various types of taxes.

9.How is 'window dressing' a limitation of financial statements analysis? (All India 2010)

Ans. 'Window dressing' refers to displaying the rosy picture of an enterprise through financial statements. Sometimes material information is concealed in financial statements due to 'window dressing'.

10.How the solvency of a business is assessed by financial statements analysis?(Delhi 2010)

Ans. The solvency of a business is assessed by financial statements analysis through long-term and short-term solvency ratios.

11. Which item is assumed to be 100 while preparing common size statement of profit and loss? (Compartment 2014)

Ans. Revenue from operations are assumed to be 100 while preparing common size statement of profit and loss.

12. Name any two tools of analysis of financial statements. (Compartment 2014)

Ans. Two tools of analysis of financial statements are:
(i) Ratio analysis (ii) Cash flow statement

13. What is meant by a common size statements? (Delhi 2011)

The statement wherein figures reported are converted into percentage to some common base are known are common size statements. Each percentage shows the relation of the individual item to its respective total. In common size income statement, net sales figure is assumed to be 100 and all other figures of expenses are expressed as a percentage of sales. In common size balance sheet, the total of assets or liabilities is assumed to be 100 and figures are expressed as a percentage of the total.