Financial Statements Analysis

Meaning: Financial statement 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 able and understandable form.**

Objectives or Purposes of Financial Statement Analysis:

- ✓ To measure the **Profitability or Earning Capacity** of the business.
- ✓ To measure the **Financial Strength** of the business.
- ✓ To make **Comparative Study** within the firm(intra-firm) and with other firms (inter-firm).
- ✓ To judge the **Efficiency of Management.**
- ✓ To provide **Useful Information** to the management.
- ✓ To find out the **Capability for payment of interest, dividend** etc.
- ✓ To measure the **Short-term and Long-term Solvency** of the business.

Limitations of Financial Statement Analysis

- ➢ **Ignores changes in price level**.
- ➢ Affected by the personal ability and **bias** of the analyst.
- ➢ **Lack of qualitative analysis** as only those transaction and events are recorded which can be measured in terms of money.
- ➢ When different accounting policies are followed by the two firms then comparison between their financial statement becomes **unreliable.**
- ➢ Analysis of single year's financial statement have **limited use.**
- ➢ Also **affected by the Window dressing.**

Types of Financial Statement Analysis

There are two main approaches for the analysis of financial statements.
(1) Horizontal Analysis: In this type of analysis, figure in the financial statements for two or more years are compared and analysed. 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.

(2) 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.** Ratio Analysis relating to a particular accounting period are examples of this type of analysis.

Significance or Importance of Financial Analysis:

- ❖ **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 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 Government:** 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.

Tools of Financial Statement Analysis

- **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.
- **Ratio Analysis:** It is a technique of study of relationship between various items in the Financial Statements.
- **Cash Flow Statement:** It is a statement that shows the inflow and outflow of cash and cash equivalents during a particular period which helps in finding out the causes of changes in cash position between the two Balance Sheet dates.

Comparative Financial Statements

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

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

1. 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 of Comparative Balance Sheet of ....Ltd.
as at ----------

Particulars	**Note No.**	**Figures as at the end of previous reporting period**	**Figures as at the end of the current reporting period**	**Absolute Change* (₹)**	**Percentage Change# (₹)**
I. EQUITY AND LIABILITIES					
(1) Shareholders' Funds					
(a) Share capital					
(b) Reserves and surplus					
(2) Non-Current Liabilities					
(a) Long-term Borrowings					
(b) Long-term Provisions					
(3) Current Liabilities					
(a) Short-term Borrowings					
(b) Trade Payables					
(c) Other Current Liabilities					
(d) Short-term Provisions					
Total					
I. ASSETS					
(1) Non-current assets					
(a) Fixed Assets					
(i) Tangible Assets					
(ii) Intangible Assets					
(b) Non-current investment					

(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					

*Absolute Change = Current year figure – Previous year figure
Percentage change = Related absolute change x 100
Related figures of Previous year

2. 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 OF COMPARATIVE STATEMENT OF PROFIT AND LOSS

For the year ended.......

Particulars	**Note No.**	**Figures as at the end of previous reporting period**	**Figures as at the end of the current reporting period**	**Absolute Change* (₹)**	**Percentage Change# (₹)**
I. Revenue from operations II. Other Income					
III. Total Revenue (I+II)					
IV. Expenses: • Cost of Material consumed • Purchases of Stock-in-Trade • Changes in Inventories of Finished Goods, work-in progress and stock-in-trade • Employees Benefit Expenses • Finance Cost • Depreciation & Amortisation Expenses • Other Expenses					
Total Expenses					
V. Profit before Tax (III–IV) VI. Less: Tax					
VII. Profit after Tax (V–VI)					

*Absolute Change = Current year figure – Previous year figure
Percentage change = Related absolute change x 100
Related figures of Previous year

Importance of Comparative Financial Statements

- To make the data simple and more understandable.
- To indicate the trend with respect to the previous year.
- To compare the firm's performance with the performance of other firm in the same business.

Common Size Financial Statements or 100% Statements

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.

1. 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. Total Assets or Total Equity & Liabilities are taken as Common base.

Format of Common Size Balance Sheet of ....Ltd.

as at ----------

Particulars	**Note No.**	**Absolute Amounts**		**Percentage of Total of the Balance Sheet**	
		Figures as at the end of previous reporting period	**Figures as at the end of the current reporting period**	**Figures as at the end of previous reporting period**	**Figures as at the end of the current reporting period**
I. EQUITY AND LIABILITIES					
(1) Shareholders' Funds					
(a) Share capital					
(b) Reserves and surplus					
(2) Non-Current Liabilities					
(a) Long-term Borrowings					
(b) Long-term Provisions					
(3) Current Liabilities					
(a) Short-term Borrowings					
(b) Trade Payables					
(c) Other Current Liabilities					
(d) Short-term Provisions					
Total					
I. ASSETS					
(1) Non-current assets					
(a) Fixed Assets					
(i) Tangible Assets					
(ii) Intangible Assets					
(b) Non-current investment					
(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					

2. Common Size Income Statement or Statement of Profit & 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. Sales /Revenue from operations is taken as base.

Format for a Common Size Statement of Profit and Loss
for the years ended-------------

Particulars	Note No.	Absolute Amounts		Percentage of Total of Revenue from Operations	
		Figures as at the end of previous reporting period	**Figures as at the end of the current reporting period**	**Figures as at the end of previous reporting period**	**Figures as at the end of the current reporting period**
I. Revenue from operations II. Other Income					
III. Total Revenue (I+II)					
IV. Expenses: • Cost of Material consumed • Purchases of Stock-in-Trade • Changes in Inventories of Finished Goods, work-in progress and stock-in-trade • Employees Benefit Expenses • Finance Cost • Depreciation & Amortisation Expenses • Other Expenses					
Total Expenses					
V. Profit before Tax (III-IV) VI. Less: Tax					
VII. Profit after Tax (V-VI)					