CHAPTER 1

Financial Statement Analysis

MEANING OF KEY TERMS USED IN THE CHAPTER

1. Analysis of Financial Statements

It is a systematic process of establishing, interpreting and analysing the quantitative relationship between the items, *i.e.*, components of financial statements to assess liquidity, solvency, profitability and efficiency of the enterprise.

2. Comparative Financial Statements

Comparative Financial Statements are statements prepared to compare items, *i.e.*, components of:

- Financial Statements of an enterprise for two or more successive accounting periods, or
- Financial Statements of different enterprises for the same accounting period.

It is prepared separately for Balance Sheet and Statement of Profit and Loss.

3. Common-size Statements

Common-size Financial Statements are those statements in which reported amounts (figures) are converted to a common base. In the case of Common-size Statement of Profit and Loss, common base is Revenue from Operations, *i.e.*, Net Sales while in Common-size Balance Sheet, it is the total Assets or total of Equity and Liabilities.

4. Cash Flow Statement

Cash Flow Statement shows inflow or outflow of Cash and Cash Equivalents during a specific period.

5. Ratio Analysis

Analysis of financial statements on the basis of accounting ratios is known as **Ratio Analysis**.

6. Internal Analysis

It is conducted by those persons (management) who have access to the books of account to analyse the financial performance and position of the enterprise.

7. External Analysis

It is conducted by those persons who do not have access to the books of account to analyse the financial performance and position of the enterprise.

8. Horizontal (or Dynamic) Analysis

It is an analysis conducted to review and analyse financial statements of a number of years and, therefore, are based on financial data taken from those years.

9. Vertical (or Static) Analysis

It is an analysis conducted to review and analyse the financial statements of one accounting year only.

SUMMARY OF THE CHAPTER

- **Analysis of Financial Statements** is a systematic process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the Balance Sheet and Statement of Profit and Loss.

- **Tools or Techniques of Financial Statement Analysis**
  1. Comparative Financial Statements
  2. Common-size Financial Statements
  3. Cash Flow Statement
  4. Ratio Analysis.

- **Types of Financial Statement Analysis**
  1. External Analysis
  2. Internal Analysis
  3. Horizontal Analysis
  4. Vertical Analysis.

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

- **Parties Interested in Financial Statement 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. Government,
  9. Tax Authorities,
  10. Customers.

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