1. **Details of Module and its structure**

Module Detail	
Subject Name	**Accountancy**
Course Name	**Accountancy 04 (Class XII, Semester - 2)**
Module Name/Title	**Analysis of Financial Statement Analysis**
Module Id	**Leac_20401**
Pre-requisites	**Basic knowledge of of Financial Statements**
Objectives	**After going through this lesson, the learners will be able to understand:** • Meaning of Financial Statement Analysis, Feature, Objective, Importance, etc.
Keywords	Financial Analysis,

2. **Development Team**

Role	**Name**	**Affiliation**
National Coordinator	**Dr. Amarendra Bahera**	**Joint-Director,CIET, NCERT**
Course Coordinator	**Dr. Rejaul Bharbhuiya**	**CIET - NCERT**
Course Co-Coordinator	**Dr. Nidhi Gusain**	**CIET - NCERT**
Subject Matter Expert (SME)/ Presenter	**CA. Sanjay Mutreja**	**Faculty Member, ICAI.**

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1. Meaning of Financial Analysis

Financial statements present mass and complex data in monetary terms but does not reveal anything about the Liquidity, Solvency and Profitability of the business. In financial analysis, the data given in financial statements is classified into groups and then with the help of some formulas, methods and comparisons of various groups with each other, management is able to see the strong and weak points of a business, and after ANALYSING (Methodical Classification) of the above exercise, take some decisions (Corrective Actions).
For example, if Current assets are in one group and Current liabilities are in another group, then the comparison between these two groups will provide fruitful & useful information. Similarly, short term liabilities versus long term liabilities will provide some deeper insights and help in taking some important decisions.

Plain Figures do not speak much about themselves. But when analysis and comparison of these figures are made, it does wonders & helps the interested reader by giving a voice to these mute silent figures and the magic begins.

So, Financial statement analysis is a study of relationships among the various financial figures of business, as disclosed in financial statements and a study of the trends, comparisons, etc. of these figures & getting some useful insights for decision making.

2. Features of financial statement analysis are:

1) Present the complex data contained in financial statements in simple & understandable form.
2) Classify the items of financial statements in rational groups.
3) Make comparisons between various rational groups to draw suitable conclusions.
4) Study the Trend of Movements between related groups.

3. Methods of Financial Analysis

Two types of analysis are:

(1) Horizontal Analysis

(2) Vertical Analysis

(1) Horizontal Analysis:

Under this type of analysis, Financial statements for a number of years are reviewed and analyzed. Figures for two, three or more years are placed side-by-side to facilitate comparison. Such an analysis besides showing the Increase or Decrease in these items in absolute figures also show it in percentage form also. So, this kind of analysis involves making comparisons and establishing relationship among related items of an enterprise for a number of years.

Examples can be like Sales, cost of production, Gross Profits, Net Profits, etc. are compared for number of years of a business, then the areas of strength and weakness of the enterprise can be tracked and smart business decisions can be taken. Besides, the trend of the business can be known and Forecast for the future can be made. This type of analysis is also called 'Dynamic Analysis'.

(2) Vertical Analysis:

Under this type of analysis, Financial statements for a single year is reviewed and analyzed with the help of Quantitative expressions (Ratios). We study quantitative relationship among various items of Balance Sheet or Profit & Loss Statement for a particular period. The total of the financial statements is taken as equivalent to 100 and then All items in the financial statement are expressed as a percentage to total. Such an analysis is termed as 'Common Size Statements'.

The common Size statement can be of two types:

1. Common Size Profit & Loss Statement which will show each element of Cost as a percentage of sales which helps in analyzing the costs and operating results of the year.

2. Common size Balance Sheet where various Assets can be expressed as percentage of total Assets and similarly various Liabilities can be expressed as percentage of total Liabilities.

Vertical analysis (Common size statements) has Multi-purpose usefulness. These are very useful in comparing the performance of Inter company or Intra company or various companies under the same group or various departments in the same company.

But, Vertical analysis is not useful for analysis of the Company's financial position (Balance sheet) because it is the data of a single period and there are no comparisons.

As compared, the Horizontal analysis is more useful because it brings out more clearly the nature and trends of current changes affecting the enterprise as it deals with a series of periods which is more significant than the data for a single period.

4. Objectives of Financial Analysis

(1) **Measuring Earning Capacity or Profitability:** The objective of a business is to earn good returns on the money invested in it and maintaining a sound financial position. Financial analysis helps in ascertaining whether adequate profits are being earned or not on the capital invested in the business, whether these profits are increasing or decreasing over the years and other relevant matters. Financial statements of a 2-5 years are taken into account to understand the changes in profits over the years which helps in ascertaining the future profitability or earning capacity of the business.

(2) **Measuring the Solvency**: Financial analysis helps in giving answers to the Questions like whether the business is in a position to pay its short-term as well as long-term liabilities in time. For example, Debt Equity Ratio decides whether the business has the ability to repay the long term liabilities in time & Current ratio / Quick ratio decide whether the business enterprise has ample liquid funds to meet its short term liabilities.

(3) **Measuring the Financial Strength and Potential of Business:** The main purpose of financial analysis is to assess the financial potential of the business and providing answers to the questions, Like:

   a. Funds required for the Expansion will be available from internal resources of the business or not?
   b. Funds required for Repayment of Liabilities will be available from internal resources of the business or not?
   c. Funds required for the purchase of New Assets like Machinery and Equipment, Land & Building will be available from internal resources of the business or not?

d. Based on the current situation of the business & market conditions, can funds be raised from external sources?
e. And many other Decisions.

(4) **Comparative Study with other Firms:** Financial analysis helps the management in making a comparative study of the profitability of various firms engaged in same business line. These comparison helps the management to study the position of their firm in comparison to other firms in respect of sales, expenses, profitability and working capital etc.

(5) **Identifying Trend of the Business:** When data is compared for two or more years of an Enterprise, they indicate the direction in which a business is moving. Suppose, Sales are increasing along with an increase in profit margins, it is a good indication of growth trend of the business. These analysis helps in ascertaining whether the business is making progress

(6) **Forecasting and Budgeting for Future:** Future forecast, Planning & making Budgets for future, are all dependent on Analysis of the Trends and Comparative studies.

(7) **Judging the Efficiency of Management:** One of the main purpose of Financial Analysis is to judge the efficiency of the financial policies adopted by the management, whether they are proper or not, are they giving desired results or a change is needed. If the actual results are on the basis of expectation of the management, it's fine, the policies of the management may be said to be proper and efficient otherwise go for change.

(8) **Provide Useful Information to the Management for corrective measures:** Financial analysis helps in finding out the shortcomings of the business, so that the management can take remedial measures to remove those shortcomings.

(9) **Ability to Pay Interest and Dividend:** Financial Analysis helps to assess whether the business will be having sufficient profits to pay the interest and dividend to the Lenders and Investors in future Timely. For example- Analysis of Interest coverage ratio will indicates the number of times the business is earnings profit as compared to interest.

5. Usefulness of Financial Analysis:

(1) **Investment Decisions:** Analysis of financial statements helps an investor to know whether the firm is performing as per his expectations as regards to payment of dividend, appreciation in the value of investments made by him (Share prices) and safety of his investment. He can then take decision about whether to continue his investment in the firm or not.

(2) **Financing Decisions:** Making a decision whether to go for Equity financing or Debt financing for the Business can also be taken by Analyzing the financial statements of that company.

(3). **Dividend Decisions:** Such analysis is useful in deciding about how much portion of the profit is to be distributed as dividend and how much to retain.

(4). **For Estimating Trend of the Business:** Analysis of financial statements for a number of years reveals the trend of costs, sales, profits etc. It helps in assessing the future growth potential of the firm.

(5). **Credit Decisions:** Making a decision whether to grant or extend credit to the Business can be done by Analysing the financial statements of that company.

(6) **Other Managerial Decisions: As** Analysis of financial statements throws light on the Liquidity, Solvency and Profitability of the business, it helps in locating the Strong & Weak spots of the business and in return this information enables the management to take various other important decisions.

6. Significance of Financial Analysis

Various parties are interested in the financial statements of a company due to various reasons. Different users of financial statements using the same statement but for a different purpose. Example, Shareholder / Owner more interested in the profitability whereas Creditor would be more interested in the liquidity, i.e., whether the firm will be able to pay its current liabilities. Similarly, Long term loan providers interested in short term (Interest) and Solvency (Repayment of Debt).

Therefore, the significance of the financial analysis may be studied from various point of view:

(1) **Management:**

Management more interested in the Solvency, Profitability and three important financial decisions (Investment, Financing & Dividend). They just want to make sure that the business is earning sufficient profits & it must be in a solvent position to pay the debts as and when they fall due. They are interested not only in the current year's profit but also in the capacity of the business to earn more profits in future so as to Finance their Future Projects mostly from Internal sources.

By comparing the financial statements of their business with the financial statements of others or with the Previous year's help them to evaluate the effectiveness of their own policies and decisions, adopting new policies and procedures, if change is required.

(2) **Investors:**

Investors and shareholders of the business are interested in the long term solvency of the business enterprise and therefore, they are more interested in the earning capacity of the business and its future growth prospects and prosperity. Analysis of financial statements helps them in assessing the capacity of the business to pay returns (dividends) at a higher rate and also the Safety of their Investments.

(3) **Creditors:**

There are two types of creditors (i) Short-term & (ii) Long –term.

(i) Short-term creditors want to know whether the company will have sufficient current assets and cash to pay their debts or not. Liquidity Ratios (Current ratio and quick ratio) help them in assessing this.

(ii) Long-term creditors are interested in

(a) Whether the company will be able to pay the interest consistently (Short term), and

(b) Whether the company will be able to pay their debts when they fall due (Long term).

On the basis of interest coverage ratio, they can ascertain whether the company will be able to pay the interest regularly (Short term) or not and on the basis of debt-equity ratio they can ascertain whether the company will be able to pay their debts on maturity (Long term).

(4) **Government:**

On the basis of analysis of financial statements, which industry is progressing on the desired lines and which industry needs the financial help. Government can take a decision to reduce the Taxes or give Subsidies in those industries where the profit margins are low in comparison to the cost of production or which are essential for Infrastructure & Economy or Country as a whole. Reverse, if the profit margins are very high, Government can increase the Taxes or enforce price control.

(5) **Financial Institutions:**

Financial institutions such as Banks, Insurance companies, etc. are interested in the profit earning capacity of the business and its Long-term Solvency. They want to assess about the present position of the business & also its likely position in future. Analysis helps them.

(6) **Employees:**

Employees are also interested in profitability of the business enterprises so that they can ascertain as to how much bonus and increase in their wages will be possible from the profits of the company. Analysis helps the trade unions in negotiating wages agreements.

(7) **Taxation Authorities:**

Analysis of the financial statements of a company helps them to know whether these statements have been prepared in accordance with the legal provisions and the figures of Cost of production, Sales, Expenses and Profits are correct for the purpose of assessment of Various taxes (GST, Income- Tax).

(8) **Researchers:**

Analysis of financial statements help a Researcher who is conducting research in respect of the profitability, efficiency, financial soundness and future growth potential of that company.

(9) **Other Parties:**

Some other parties may also be interested in the analysis of financial statements of a company from their own point of view, like Potential investors, Economists, Trade associations, Consumer organizations etc.

7. Limitations of Financial Analysis

Although Financial analysis helps to make an assessment of the Earning capacity and Financial Soundness of an enterprise but it has its own limitations. These limitations should be kept in mind while using the information provided by the financial analysis.

(1) **Shortcomings of Financial Statements:**

Financial analysis is based on financial statements & they themselves suffer from certain limitations. So, the limitations of financial statements become the limitations of their Analysis.

Like for example (i) Information given in financial statements are sometime based on Estimates like Provision for Bad debt, etc. (ii) Financial Statements are based on Accounting concepts and Policies, which are different for different enterprises. As such, their utility decreases due to the shortcomings of financial statements.

(2) **Window-dressing leading to misleading:**

Window-dressing of financial statements means to cover up bad financial position. For example, not recording some expenses at the end of Accounting year, not recording the purchases made at the end of the year or overvalue their closing stock, etc. to show more Profits. It makes the Financial Statements misleading, so the results obtained by Analysis of financial statements will also be mis-leading.

(3) **Do not Reflect Price Level Changes:**

Figures given in financial statements do not show the effect of changes in price level. So, comparison of past year figures with current year figures give misleading conclusions. For example, Rs. 100/- of 1990 is not equal to Rs. 100/- of 2020. It means if in 1990, we get 10 kg. Atta for 100/- we cannot get the same Quantity in 2020. As such, sufficient adjustments must be made for changes in price level before making the analysis.

(4) **Different Accounting Policies:** Different accounting policies adopted by two different business makes the comparison between the two unreliable. Example, one business adopting Depreciation policy of Original cost method, whereas the other business adopting the written-down value method for providing the depreciation. The results obtained from the comparison of the financial statements of such firms will be different & it may give misleading picture.

(5) **Personal Bias of the Analyst: Mute & Silent** Figures do not speak by themselves, hence, no conclusion can be drawn from SINGLE figure. Analysis of these figures are affected to a great extent by the personal ability and knowledge of the analyst. Like for example, if there are two formula given for calculating a particular ratio, in which one analyst is considering the Profits **after taxes**, whereas, the other one is considering the Profits **before taxes**, Results are bound to differ. Similarly, the term ‘Debt’ may mean only the ‘Long term Funds’ for one analyst, whereas the other analyst may take the ‘Short Term and Long Term Debts’ Both. Share holder Funds is another example on this point.

(6) **Difficulty in Forecasting:** Financial statements are a record of past events. Analysis of past information may not be of much use in the fast changing and developing modern business

environment for future forecasting as continuous changes take place in the Demand of the product, Policies adopted by the firm, etc. Proper estimates based on the analysis of historical facts cannot be made for future.

(7) **No Qualitative Analysis:** As we know, Financial statements record only those events and transactions which can be expressed in terms of money, so Qualitative aspects are altogether omitted from the books as these cannot be expressed in monetary terms. So, Qualitative changes in management, Cordial Staff- Management relations, Ability to develop new products, Efficiency of management, Goodwill of firm, etc. which are important & vital on the profitability of the company are Ignored from being recorded because all these are not Money.

It is clear from the above mentioned limitations that the results obtained from analysis of financial statements must be kept in mind while taking decisions based on the results obtained from such analysis & should not be taken as the true indicators of the strength and weaknesses of the concern. The results obtained from analysis must be read carefully and cautiously.