CHAPTER 2

FINANCIAL STATEMENT 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."

— Finney and Miller

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 (interfirm)
- To judge the **Efficiency of Management**
- To provide **Useful Information's** 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.

Financial Statement Analysis

- Based on basic financial statement which themselves suffer from certain limitations.
- 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.

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.

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 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.