UNIT VI: FINANCIAL STATEMENTS ANALYSIS

Accounting is a service activity. One of its function is communication of information at a specific interval, usually at the year and by the financial statements. In accounting, financial statements are the means of conveying to management, owners and interested outsiders a concise picture of profitability and financial position of the business. The preparation of financial statements is not the first step in the accounting process but they are the end products of accounting process which give a concise accounting information of the accounting period after the accounting period is over. All financial transactions are recorded first in subsidiary books and subsequently they are posted to relevant ledger accounts. The balances of ledger accounts at the end of the year are ultimately presented through financial statements. These statements are called final accounts because they are prepared after the accounting period is over and they give final picture of the financial transactions of an accounting period.

Meaning of Financial Statements:
Financial statements at least refer to the three statements which are prepared by the business concern at the end of the year. They are i) *income statement or statement of profit and loss* which is prepared by the business concern in order to know the profit earned and the lost sustained during the specified period; ii) *position statement or balance sheet* which is prepared by the business concern on a particular date in order to know its financial position. iii) *cash flow statement*, It gives the various items of inflow and outflow of cash flow from operating investing and financing activities.
Smith and Ashburne define Financial statements as "the end product of financial accounting is a set of financial statements, that purports to reveal the financial position of the enterprise the results of its recent activities, and analysis of what has been done with earnings."

From this definition it is clear that financial statements are the outcome of preparing financial accounts and these statements reveal financial position and profitability of the concern and the utilization of retained earnings.

There are two types financial statements:

- Profit and loss account/ Income statement
- Balance sheet/ Position statement

Profit and Loss account: It is a financial statement prepared for the purpose of ascertaining the benefits of a firm. It is prepared by transferring the balance of all nominal account balances representing the incomes and expenses. A portion of the fixed assets held real account ledger balances is also transferred in the form of depreciation full stops expenses incurred in the past shown as real account ledger balance is like preliminary expenses, discount on issue of securities et cetera are also written off over the years to profit and loss account by way of amortization. In addition, any previous years mistake rectified adjustment account and transferred to the profit and loss account.

Traditionally, in the horizontal format, this contained too many items rendering analysis a bit difficult. Therefore, they are prepared as income statements in the vertical formats with main headings and the details of expenses under each heading given as schedules separately as part of the income statement. The income statement is prepared in such a way to facilitate analysis through classification of expenses on the basis of behavior like fixed expenses and variable expenses and also on functional basis like manufacturing overheads, office and administration overheads, selling and distribution overheads etc.

Proforma of Income Statement

Income statement for the year ended…

Particulars	Rs.
Sales	xxx
(-) Variable Overheads:	xx
Cost of Materials Consumed	xx
Wages	xx
Contribution	xxx
(-) Fixed Overheads:	xx
Manufacturing Overheads	xx
Office & Administration Overheads	xx
Selling & Distribution Overheads	xx
Earnings Before Interest, Tax, Depreciation & Amortization [EBITDA]	xx
(-) Depreciation & Amortization	xx
(-) Preliminary Expenses	xx
Earnings Before Interest, Tax [EBIT]/ OPERATING PROFIT	xxx

Balance Sheet: All the balances of real accounts and personal accounts are transferred to a statement called balance sheet. If they have credit balances, they are transferred to the left-hand side called 'liabilities side'. All the debit balances are transferred to the right-hand side called 'asset side'. This was traditionally called the horizontal format. Like profit and loss account, this contained too many items to make proper financial analysis. A vertical format is followed where by the details of the ledger balances are given by way of notes and only the heading of sources of funds and application of funds are given in the vertical format one below another.

Proforma of Balance Sheet [vertical format]

XYZ LTD

Balance Sheet as on ….

Equities and Liabilities	Rs.
Shareholder's Funds:	
Capital	xxx
Reserves & Surplus	xxx
(Reserves + P&L a/c)	xxx
Non-Current Liabilities	xxx
Current Liabilities	xxx
Total	
ASSETS	
Non-Current Assets:	
Fixed Assets	xxx
Non-Current Investments/Assets	xxx
Current Assets	xxx
Total	

Analysis of financial statements:

Meaning:

Analysis is the process of critically examining in detail accounting information given in the financial statements. For the purpose of analysis, individual items are studied, their interrelationships with other related figures established, the data is sometimes rearranged to have better understanding of the information with the help of different techniques for tools for the purpose. Analyzing financial statements is a process of evaluating relationship between component parts of financial statements to obtain a better understanding of firm's position and performance.

In the words of Myer, "financial statement analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trend of these factors are shown in a series of statements". For this purpose, financial statements are classified methodically, analyzed and compared with the figures of previous years or other similar firms.

Objectives or uses of financial analysis:

- The present and future earning capacity of profitability of the firm,
- The operational efficiency of the concern as a whole and of its various parts or departments,
- The short-term and long-term solvency of the concern for the benefit of the debenture holders and trade creditors,
- The comparative study in regard to one firm with another firm for one department with another department,
- The possibility of developments in the future by making forecasts and preparing budgets,
- The financial stability of a business concern,
- The real meaning and significance of financial data, and
- The long-term liquidity of its funds.

Techniques (tools or methods) of analysis of financial statements:
Following techniques can be used in connection with analysis and interpretation of financial statements:

1. Comparative financial statements
2. Common size statements
3. Trend percentages analysis
4. Funds flow statement
5. Net working capital analysis
6. Cash flow statement
7. Ratio analysis