**Financialstatementanalysis**

The terms‘financial analysis’ also known as analysis and interpretation of financialstatements, refers to the process of determining financial strengths and weaknesses of the firm byestablishing strategic relationship between the items of the balance sheet, profit and loss accountandotheroperativedata.

**Natureoffinancialstatements**

**1. Recordfacts**

The term recorded fact refers to the data taken out from the accounting records.Therecordsaremaintainedonthebasis ofactualcostdata.

**2. Accountingconventions**

Though there are accounting standardslaid down by various accounting bodies,themanagements are free to choose an accounting policy suited to their concerns. Accounting policydifferwithregardtovaluationofinventory, depreciation, research, developmentandsoon.

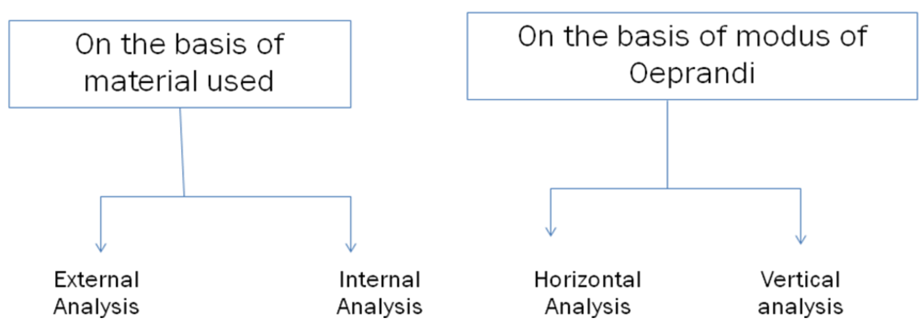
**3. Personaljudgement**

Rateofdepreciationadopted,valuationofinventories,provisionforbad anddoubtful debts.

**ObjectivesofFinancialStatements**

1. Toprovide reliablefinancial information abouteconomic resources and obligations of abusinessfirm.
2. Toprovideotherneededinformationaboutchangesinsucheconomicresourcesandobligations
3. Toprovidereliableinformationaboutchangesinnetresourcesarisingoutofbusinessactivities
4. Todisclose,totheextentpossible,otherinformationrelatedtothefinancialstatementthatis relevanttotheneeds oftheusers.

## METHODS OF FINANCIAL ANALYSIS




i) Onthe basisofMaterialUsed

a) ExternalAnalysis

Thisanalysis isdeonebyoutsiderswhodonothaveaccesstothedetailedinternalaccounting records of the business firm.These outsiders include investors, potential investors,creditors,potentialcreditors,governmentagenciesandthe generalpublic.

**Toolsoffinancialanalysis**

1. Comparativestatements
2. Trendanalysis
3. Common-sizestatements
4. Fundsflowanalysis
5. Cashflowanalysis
6. Ratioanalysis
7. Cost-volumeprofitanalysis

**Ratioanalysis**

A ratio is an expression of the quantitative relationship between tow numbers. Ratioanalysis is the process of determining numerical relationships based on financial statements.It isthe technique of interpretation of financial statements with the help of accounting ratios derivedformsthe balancesheetandtheprofitandloss account.

**USESAND SIGNIFICANCE**

1. **ManagerialusesofRatioanalysis**

a) **Helpsindecisionmaking**

Ratio analysishelpsinmakingdecisionsfromtheinformationprovidedinthesefinancialstatements

b) **Helpsinfinancialforecastingandplanning**

Ratioanalysisisofmuchhelpinfinancialforecastingandplanning.Planning islookingahead andtheratioscalculatedforanumberofyearsworkasa guidefor thefuture.

c) **Helpsincommunicating**

Thefinancialstrengthandweaknessofafirmaarecommunicatedinamorecashandunderstandablemannerbythe useofratios.

d) **Helpsinco-ordination**

Ratios even help in co-ordination which is of utmost importance in effective businessmanagement.Better communication of efficiency and weakness of an enterprise results in betterco-ordinationintheenterprise.

e) **Helpsincontrol**

Ratio analysis even helps in making effective control of the business.Standard ratios canbe based upon proforma financial statements and variance or deviations, if any, can be found bycomparing the actualwiththe standardssoastotake a correctiveactionatthe righttime.

**f) Otheruses**

There are so many other uses of the ratio analysis.It is an essential part of the budgetarycontrolandstandardcosting.Ratiosareofimmenseimportanceintheanalysisandinterpretationoffinancialstatementsastheybringthe strengthorweakness ofafirm.

**2. Utilitytoshareholders/investors**

An investor in the company will like to assess the financial position of the concern where heisgoingtoinvest.Hisinterestwillbethesecurityofhisinvestmentandthenareturn intheformofdividendorinterest.

**3. UtilitytoCreditors**

The creditors or suppliers extent short-term credit to the concern. They are interested toknow whether financial position of the concern warrants their payments ata specified time ornot.

**4. Utilitytoemployees**

Theemployeesarealsointerestinthefinancialpositionoftheconcernespeciallyprofitability.Their wages increases and amount of fringe benefits are related to the volume ofprofitsearnedbytheconcern.

**5. UtilitytoGovernment**

Governmentisinteresttoknow the overall strength of theindustry.Various financialstatements published by industrial units are used to calculate ratios for determining short-term,long-termandoverallfinancialpositionoftheconcerns.

**6. TaxAuditrequirements.**

Section 44 AB was inserted in the Income Tax Act by the Finance Act, 1984.Under thissection every assesse engaged in any business and having turnover or gross receipts excessingRs.40 lakh is required to get the accounts audited by a chartered accountant and submit the taxauditreportbeforethe due dateforfillingthe returnofincome undersection139(I).

**Limitationsofratioanalysis**

**1. Limiteduseofsingleratio**

A single ratio usually does not convey much of a sense.To make a better interpretation anumber of ratios have to be calculated which is likely to confuse the analyst than help him inmakinganymeaningfulconclusion.

2. **Lackofadequatestandard**

Therearenowellaccepted standardsorrulesofthumb for allratioswhichcan beaccepted asnorms.Itrendersinterpretationofthe ratios difficult.

3. **Inherent limitationsofaccounting**

Like financialstatements,ratiosalsosufferfromtheinherentweaknessofaccountingrecordssuchastheirhistoricalnature.Ratiosofthe pastarenotnecessarilytrue indicatorsofthe future.

4. **Changeofaccountingprocedure**

Change in accounting procedure by a firm often makes ratio analysis misleading, e.g. achangeinthevaluationofmethodsofinventories,fromFIFOtoLIFOincreasesthecost ofsalesand reduces considerably the value of closing stocks which makes tock turnover ratio to belucrative andanunfavorablegross profitratio.

5. **Windowdressing**

Financialstatementscaneasilybewindowdressedtopresentabetter pictureofitsfinancialandprofitabilitypositiontooutsiders.

6. **Personalbias**

Ratioareonlymeansoffinancialanalysisandnotanendinitself.Ratioshavetobeinterpretedanddifferentpeoplemayinterpretthesameratioindifferentways.

7. **Uncomparable**

Notonlyindustriesdifferintheirnaturebutalsothefirmsofthesimilarbusinesswidelydifferintheirsizeandaccountingproceduresetc.

8. **Absolutefiguresdistortive**

Ratiosdevoidofabsolutefiguresmayprovedistortiveasratiosanalysisisprimarilyaquantitative analysisandnota qualitativeanalysis.

9. **Pricelevelchanges**

Whilemakingratioanalysis,notconsiderationismadetothechangesinpricelevelsandthismakestheinterpretationofratiosinvalid

10. **Ratiosnosubstitutes**

Ratioanalysisis merelyatooloffinancialstatements. Hence, ratiosbecomeuseless ifseparatedfromthestatementsfromwhichthey arecomputed.

**11.** Absolutefiguresdistortive

**12.** Pricelevelchanges

**13.** Ratiosnosubstitutes