B.Com. IT Part- I

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Subject: Financial Accounting

Unit -4 Analysis of Financial Statements

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Meaning of Analysis of Financial Statements

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'. It is basically a study of relationship among various financial facts and figures as given in a set of financial statements, and the interpretation thereof to gain an insight into the profitability and operational efficiency of the firm to assess its financial health and future prospects.

The term 'financial analysis' includes both 'analysis and interpretation. The term analysis means simplification of financial data by methodical classification given in the financial statements. Interpretation means explaining the meaning and significance of the data. These two are complimentary to each other. Analysis is useless without interpretation, and interpretation without analysis is difficult or even impossible.

Objectives of Analysis of Financial Statements

Analysis of financial statements reveals important facts concerning managerial performance and the efficiency of the firm. Broadly speaking, the objectives of the analysis are to apprehend the information contained in financial statements with a view to know the weaknesses and strengths of the firm and to make a forecast about the future prospects of the firm thereby, enabling the analysts to take decisions regarding the operation of, and further investment in the firm. To be more specific, the analysis is undertaken to serve the following purposes (objectives):

- to assess the current profitability and operational efficiency of the firm as a whole as well as its different departments so as to judge the financial health of the firm.
- to ascertain the relative importance of different components of the financial position of the firm.
- to identify the reasons for change in the profitability/financial position of the firm.
- to judge the ability of the firm to repay its debt and assessing the short-term as well as the long-term liquidity position of the firm.

Through the analysis of financial statements of various firms, an economist can judge the extent of concentration of economic power and pitfalls in the financial policies pursued. The analysis also provides the basis for many governmental actions relating to licensing, controls, fixing of prices, ceiling on profits, dividend freeze, tax subsidy and other concessions to the corporate sector.

Nature of Financial Statements

Financial statements are prepared using facts relating to events, which are recorded chronologically. Thus, we have to first record all these facts in monetary terms. Then, we have to process them using all applicable rules and procedures. Finally, we can now use all this data to generate financial statements.

Based on this understanding, the nature of financial statements depends on the following points:

1. **Recorded facts:** We need to first record facts in monetary form to create the statements. For this, we need to account for figures of accounts like fixed assets, cash, trade receivables, etc.

2. **Accounting conventions:** Accounting Standards prescribe certain conventions applicable in the process of accounting. We have to apply these conventions while preparing these statements. For example, the valuation of inventory at cost price or market price, depending on whichever is lower.

3. **Postulates:** Apart from conventions, even postulates play a big role in the preparation of these statements. Postulates are basically presumptions that we must make in accounting. For example, the going concern postulate presumes a business will exist for a long time. Hence, we have to treat assets on a historical cost basis.

4. **Personal judgments:** Even personal opinions and judgments play a big role in the preparation of these statements. Thus, we have to rely on our own estimates while calculating things like depreciation.

Limitation of Financial Statement:

The limitations of financial statements are those factors that one should be aware of before relying on them to an excessive extent. Having knowledge of these factors can result in a reduction in investing funds in a business, or actions taken to investigate further. Let us discuss them in detail.

1. Based on historical costs:

Financial statements do not disclose the current worth of the company. Initially we record transactions at their cost. The value of assets and liabilities changes over time.

Sometimes items, such as marketable securities, we alter the amount to match changes in their market values, but other items, such as fixed assets, do not change. Thus, the balance sheet could be misleading if we present a large part of the amount which is based on historical costs.

2. Based on Personal judgment:

The value of assets that appears in the statements depends on the standards of the person who deals with it. For example, the method of depreciation, mode of amortization of assets etc, depends on the personal judgment of the accountant.

3. Inflationary effects:

If the situation of inflation the rate is relatively high, the amounts of assets and liabilities in the balance sheet will appear inordinately low, as we cannot adjust it for inflation. This mostly applies to long-term assets.

4. Judgment in respect of various accounting policies:

As we prepare a balance sheet on the basis if going concern concept, where asset valuation does not represent realizable value or replacement value of the asset.

And, we know that the amount that we express through financial statements is not accurate. Further, it depends on the judgment of the management in respect of accounting policies followed.

5. Intangible assets not recorded:

We do not record many intangible assets as assets. Instead, we charge any expenditure made to create an intangible asset as an expense.

This policy underestimates the value of a business, especially one that who spend a large amount to build up a brand image or to develop new products. It is a particular problem for startup companies that who creates intellectual property, but so far who generates minimal sales.

6. Interim reports are produced:

As we know financial statements are interim reports, thus these are not final reports. Therefore, a user can gain an incorrect view of financial results by only looking at one reporting period. We can only compute final gain or loss of the business at the time of termination of business.

7. Not always comparable across companies:

If a company wants to compare the results of its company with different companies, their financial statements are not always comparable, because different companies use different accounting practices.

8. False figures:

The management team of a company may skew the results. This situation arises when there is undue pressure to report excellent results, such as when a bonus plan calls for payouts only if the sales level increases. One might suspect the presence of this issue when the results spike to a level exceeding the industry norm.

9. Lack of non-financial factors:

The financial statements take into consideration only financial factors and they do not address non-financial issues, such as the environmental attentiveness of a company’s operations, or how well it works with the local community.

A business reporting excellent financial results might be a failure in these other areas such as the image of the business, the loyalty of its workers, etc.

10. Figures are distorted:

Financial statements provide information about either historical results or the financial status of a business as of a specific date. The statements do not provide any value in predicting what will happen in the future.

Techniques of Analysis of Financial Statements

The most commonly used techniques of financial analysis are as follows:

1. Comparative Statements:

These are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, balance sheet and statement of profit and loss prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. If this is not the case, the deviation in the use of accounting principles should be mentioned as a footnote. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analysis'.

2. Common Size Statements:

These are the statements which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years. This analysis is also known as 'Vertical analysis'.

3. Trend Analysis:

It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, in which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is detected or the sign of good or poor management is detected.

4. Ratio Analysis:

It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. As a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income and position statements. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.

5. Cash Flow Analysis:

It refers to the analysis of actual movement of cash into and out of an organisation. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been utilised during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarises the causes for the changes in cash position of a business enterprise between dates of two balance sheets.

What is a cost sheet?

A cost sheet is a statement that shows the various components of total cost for a product and shows previous data for comparison. You can deduce the ideal selling price of a product based on the cost sheet.

A cost sheet document can be prepared either by using historical cost or by referring to estimated costs. A historical cost sheet is prepared based on the actual cost incurred for a product. An estimated cost sheet, on the other hand, is prepared based on estimated cost just before the production begins.

Importance and objectives of cost sheet

Cost sheets help with a number of essential business processes:

1. **Determining cost:**
The main objective of the cost sheet is to obtain an accurate product cost. It gives you both the total cost and cost per unit of a product.

2. **Fixing selling price:**
In order to fix the selling price of a product, you need to create a cost sheet so you can see the details of its production cost.

3. **Cost comparison:**
It helps the management compare the current cost of a product with a previous per unit cost for the same product. Comparing the costs helps management take corrective measures if costs have increased.

4. **Cost control:** The cost sheet is an important document for a manufacturing unit, as it helps in controlling production costs. Using an estimated cost sheet aids in monitoring labour, material and overhead costs at each step of production.

5. **Decision-making:**
Some of the most important decisions management makes are based on the cost sheet. Whenever a business needs to produce or buy a component, or quote prices for its goods on a tender, managers refer to the cost sheet.

Types of costs in cost accounting

Costs are broadly classified into four types: fixed cost, variable cost, direct cost, and indirect cost.

1. **Fixed cost:** These are costs that do not change based on the number of items produced. For example, the depreciating value of a building or the price of a piece of equipment.

2. **Variable cost:** These costs are tied to a company's level of production. For example, a bakery spends $10 on labor and $5 on raw materials to produce each cake. The variable cost changes based on the number of cakes the company bakes.

3. **Operating costs:** These are those expenses incurred by an organisation to maintain the product on a day to day basis. Traveling cost, telephone expenses, office supplies are some of things that come under operating costs.

4. **Direct costs:** These costs can be directly associated with production. For example, if a furniture manufacturing company takes five days to produce a couch, then the direct cost of the finished product includes the raw material cost and labor charges for five days.

Format of Cost Sheet

Cost Sheet Format

iEduNote.com
Cost Sheet / Statement of Cost
For the period end ---- ----

Particulars	$	$	$
Operating raw materials			****
Add: Purchases of raw materials		****	
+ Carriage of raw materials		***	
- Return of raw materials		**	
- Discount of raw materials		**	
Raw materials available for use		****	
Less: Closing raw materials		****	
Raw material used in production			****
Direct wages			***
Other Direct Chargeable expense			***
Prime costs			****
Factory overhead			
Factoring supplies inventory (Beginning)	***		
Add: Purchase of Factory supply	***		
Less: Ending supply inventory	***		
Indirect Labor		***	
Factory Insurance		***	
Deprecation factory Building		***	
Factory miscellaneous expense		***	
Factory Insurance		***	
Factory miscellaneous expense		***	
Total manufacturing cost			****
Add: Opening work-in-process			****
Total cost of goods manufactured			****
Less: Closing work-in-process			****
Cost of goods manufactured			****
Add: Opening Finished goods			****
Goods available for sale			****
Less: Closing Finished goods			****
Cost of goods Sold			****
Administration & selling expenses			
Salaries paid to office staff		***	
Office Expense		***	
Office rent		***	
Salesman's salaries and commissions		***	
Advertising expense		***	
Carriage outwards		***	
Sundry expense			***
Total Cost/Cost of Sales			***
Profit/Loss			***
Sales			****