CHAPTER 1

CONCEPT OF FINANCIAL ANALYSIS
MEANING AND CONCEPT OF FINANCIAL ANALYSIS

Financial analysis refers to an assessment of the viability, stability and profitability of a business, sub-business or project.

It can also be defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account. It is the examination of a business from a variety of perspectives in order to fully understand the greater financial situation and determine how best to strengthen the business and it also looks at many aspects of a business from its profitability and stability to its solvency and liquidity. It is a process of scanning the Financial Statements for evaluating the relationship between the items as disclosed in them.

In other words it can be defined as an analysis which critically examines the relationship between various elements of the Financial Statements with a view to obtain the necessary and effective information from them.

According to John N. Myer, ‘Financial Statement Analysis is largely a study of relationships among the various financial factors in a business, as disclosed by a single set of statements, and study of these factors as shown in a series of statements.’

Financial Statement Analysis involves a systematic and critical examination of the information contained in the Financial Statements with a view to provide effective and more meaningful information to its different users. It is an exceptionally powerful tool for a variety of users of financial statements, each having different objectives in learning about the financial circumstances of the entity.

Financial analysis is an aspect of the overall business finance function that involves examining historical data to gain information about the current and future financial health of a company.

According to Alan S. Donnahoo - "The inability to understand and deal with financial data is a severe handicap in the corporate world"
Financial analysis can be applied in a wide variety of situations to give business managers the information they need to make critical decisions. "In a very real sense, finance is the language of business. Goals are set and performance is measured in financial terms. Plants are built, equipment ordered, and new projects undertaken based on clear investment return criteria. Financial analysis is required in every such case."

Financial statement analysis is an analysis that highlights the important relationship in the financial statements. Financial statement analysis focuses on the evaluation of past performance of the business firm in terms of liquidity, profitability, operational efficiency and growth potentiality. Financial statements analysis includes the method use in assessing and interpreting the result of past performance and current financial position as they relate to particular factors of interest in investment decisions. Therefore financial statement analysis is an important means of assessing past performance and in forecasting and planning future performance.

It is performed by professionals who prepare reports using ratios that make use of information taken from financial statements and other reports. These reports are usually presented to top management as one of their bases in making business decisions, such as:

- **Continuing or discontinuing the business**
- **Making or purchasing certain materials in the manufacture product**
- **Acquire or rent/lease certain machineries and equipment in the production of its goods**
- **Negotiating for a bank loan to increase its working capital and to issue the stocks**
- **Making decisions regarding investing or lending capital**
- **Allowing management to make an informed selection on various alternatives in the conduct of its business**
Elements of a Company Assessed by the financial analysts:

Generally financial analysts assess the following elements:

1. **Profitability** – It is the ability to earn income and sustain growth in both the short- and long-term. A company's degree of profitability is usually based on the income statement, which reports on the company's results of operations.

2. **Solvency** – It is the ability to pay its obligation to creditors and other third parties in the long-term. It is also based on the company's balance sheet, which indicates the financial condition of a business at a given point of time.

3. **Liquidity** – It is the ability to maintain positive cash flow, while satisfying immediate obligations and it is also based on the company's balance sheet, which indicates the financial condition of a business at a given point of time.

4. **Stability** - The firm's ability to remain in business in the long run, without having to sustain significant losses in the conduct of its business.

Assessing a company's stability requires the use of the income statement and the balance sheet, as well as other financial and non-financial indicators.

**Financial Statement Analysis-Users**

- **Creditors**: Anyone who has lent funds to a company is interested in its ability to pay back the debt, and so will focus on various cash flow measures.
- **Investors**: Both current and prospective investors examine financial statements to learn about a company's ability to continue issuing dividends, or to generate cash flow, or to continue growing at its historical rate.
- **Management**: The company controller prepares an ongoing analysis of the company's financial results, particularly in relation to a number of operational metrics that are not seen by outside entities.
- **Regulatory authorities**: If a company is publicly held, its financial statements are examined by the Securities and Exchange Commission to
see if its statements conform to the various accounting standards and the rules of the SEC.

**Objectives**

**Assessment of Past Performance**

Past performance is a good indicator of future performance. Investors or creditors are interested in the trend of past sales; cost of goods sold, operating expenses, net income, cash flows and return on investment. These trends offer a means for judging management's past performance and are possible indicators of future performance.

**Assessment of current position**

Financial statement analysis shows the current position of the firm in terms of the types of assets owned by a business firm and the different liabilities due against the enterprise.

**Prediction of profitability and growth prospects**

Financial statement analysis helps in assessing and predicting the earning prospects and growth rates in earning which are used by investors while comparing investment alternatives and other users in judging earning potential of business enterprise.

**Prediction of bankruptcy and failure**

Financial statement analysis is an important tool in assessing and predicting bankruptcy and probability of business failure.

**Assessment of the operational efficiency**

Financial statement analysis helps to assess the operational efficiency of the management of a company. The actual performance of the firm which are revealed in the financial statements can be compared with some standards set earlier and the deviation of any between standards and actual performance can be used as the indicator of efficiency of the management.

Some other objectives are:
- Provide reliable financial information.
- Provide other needed information about changes in economic resources and obligation.
- Provide reliable information about changes in net resources.
- Provide financial information that assess in estimating the earnings of a business.
- Disclosing other information according to the needs of the users.

Types of Financial Statement Analysis

Financial statement analysis can be performed by employing a number of methods or techniques.

There are two key methods for analyzing financial statements:

1. **Horizontal and vertical analysis:**

   **Horizontal analysis** is the comparison of financial information over a series of reporting periods. Horizontal analysis looks at amounts on the financial statements over the past years. This allows you to see how each item has changed in relationship to the changes in other items. Horizontal analysis is also referred to as trend analysis.

   **Vertical analysis** is the proportional analysis of a financial statement, where each line item on a financial statement is listed as a percentage of another item. Typically, this means that every line item on an income statement is stated as a percentage of gross sales, while every line item on a balance sheet is stated as a percentage of total assets.

   Thus, horizontal analysis is the review of the results of multiple time periods, while vertical analysis is the review of the proportion of accounts to each other within a single period.

2. **Ratio Analysis**

   The **second method** for analyzing financial statements is the use of many kinds of ratios. You use ratios to calculate the relative size of one number in relation to
another. After you calculate a ratio, you can then compare it to the same ratio calculated for a prior period, or that is based on an industry average, to see if the company is performing in accordance with expectations. In a typical financial statement analysis, most ratios will be within expectations, while a small number will flag potential problems that will attract the attention of the reviewer. The methods to be selected for the analysis depend upon the circumstances and the users’ need. The user or the analyst should use appropriate methods to derive required information to fulfill their needs.

**FINANCIAL STATEMENTS USED IN FINANCIAL ANALYSIS**

Financial Statements are divided into three parts named

Income Statement/Profit & loss account

Balance Sheet and

Notes to Financial Statements

**Income Statement**

The Profit & Loss Account reveals financial result in term of Net Profit or Net loss for the period of account year which is normally 12 months.

**Items appearing on Debit side of the Profit & Loss Account:**

The Expenses incurred in a business is divided in two parts. i.e; one is Direct expenses are recorded in trading Account., and another one is indirect expenses, which are recorded on the debit side of profit & loss account.

**Indirect Expenses are grouped under four heads:**

**Selling Expenses:** All expenses relating to sales such as Carriage outwards, travelling expenses, Advertising etc.

**Office Expenses:** Expenses incurred on running an office such as Office Salaries, Rent, Tax, Postage, Stationery etc.,

**Maintenance Expenses:** Maintenance expenses of assets. It includes Repairs and Renewals, Depreciation etc.

**Financial Expenses:** Interest Paid on loan, Discount allowed etc., are few examples for Financial Expenses.
**Item appearing on Credit side of Profit and Loss account:**

Gross Profit is appeared on the credit side of P & L. account. Also other gains and incomes of the business are shown on the credit side. Typical of such gains are items such as Interest received, Rent received, Discounts earned, Commission earned.

**Specimen Format**

**Profit & Loss Account**

(For the year ended 31st March 2012)

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount</th>
<th>Particulars</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Trading A/c</td>
<td></td>
<td>By Trading A/c</td>
<td></td>
</tr>
<tr>
<td>(Gross Loss)</td>
<td></td>
<td>(Gross Profit)</td>
<td></td>
</tr>
<tr>
<td>To Salaries</td>
<td></td>
<td>By Commission earned</td>
<td></td>
</tr>
<tr>
<td>To Rent &amp; Taxes</td>
<td></td>
<td>By Rent received</td>
<td></td>
</tr>
<tr>
<td>To Stationeries</td>
<td></td>
<td>By Interest received</td>
<td></td>
</tr>
<tr>
<td>To Postage expenses</td>
<td></td>
<td>By Discount received</td>
<td></td>
</tr>
<tr>
<td>To Insurance</td>
<td></td>
<td>By Net Loss</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(Capital A/c)</td>
<td></td>
</tr>
<tr>
<td>To Repairs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Trading expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To office expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Bank charges</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Establishment expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Sunder expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Commission</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Discount</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Advertisement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Carriage outwards</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Traveling expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Distribution expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Bad debt provision</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Net Profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(transferred to Capital A/c)</td>
<td></td>
</tr>
</tbody>
</table>
Balance Sheet

The accounting balance sheet is one of the major financial statements used by accountants and business owners. (The other major financial statements are the income statement, statement of cash flows, and statement of stockholders' equity). The balance sheet is also referred to as the statement of financial position.

The balance sheet presents a company's financial position at the end of a specified date. Some describe the balance sheet as a "snapshot" of the company's financial position at a point (a moment or an instant) in time. For example, the amounts reported on a balance sheet dated December 31, 2012 reflect that instant when all the transactions through December 31 have been recorded.

Because the balance sheet informs the reader of a company's financial position as of one moment in time, it allows someone like a creditor to see what a company owns as well as what it owes to other parties as of the date indicated in the heading. This is valuable information to the banker who wants to determine whether or not a company qualifies for additional credit or loans. Others who would be interested in the balance sheet include current investors, potential investors, company management, suppliers, some customers, competitors, government agencies, and labor unions.

We will begin our explanation of the accounting balance sheet with its major components, elements, or major categories:

- Assets
- Liabilities
- Owner's (Stockholders') Equity

Assets

Assets are things that the company owns. They are the resources of the company that have been acquired through transactions, and have future economic value that can be measured and expressed in dollars. Assets also include costs paid in advance that have not yet expired, such as prepaid advertising, prepaid insurance, prepaid legal fees, and prepaid rent.
Classifications of Assets on the Balance Sheet

Accountants usually prepare classified balance sheets. "Classified" means that the balance sheet accounts are presented in distinct groupings, categories, or classifications. The asset classifications and their order of appearance on the balance sheet are:

- Current Assets
- Investments
- Property, Plant, and Equipment
- Intangible Assets
- Other Assets

An outline of a balance sheet using the balance sheet classifications is shown here:

An Example Company Balance Sheet
December 31, 2012

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES &amp; OWNER'S EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Investments</td>
<td>Long-term liabilities</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>Total liabilities</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>Owner’s equity</td>
</tr>
<tr>
<td>Other assets</td>
<td>Total liabilities &amp; owner’s equity</td>
</tr>
<tr>
<td>Total assets</td>
<td></td>
</tr>
</tbody>
</table>

Liabilities

Liabilities are obligations of the company; they are amounts owed to creditors for a past transaction and they usually have the word "payable" in their account title.
Along with owner's equity, liabilities can be thought of as a source of the company's assets. They can also be thought of as a claim against a company's assets.

**Classifications of Liabilities on the Balance Sheet**

Liability and contra liability accounts are usually classified (put into distinct groupings, categories, or classifications) on the balance sheet. The liability classifications and their order of appearance on the balance sheet are:

- **Current Liabilities**
- **Long Term Liabilities**
- **Owner's (Stockholders') Equity**

**Owner's Equity**—along with liabilities—can be thought of as a source of the company's assets. Owner's equity is sometimes referred to as the book value of the company, because owner's equity is equal to the reported asset amounts minus the reported liability amounts.

Owner's equity may also be referred to as the residual of assets minus liabilities. These references make sense if you think of the basic accounting equation:

\[
\text{Assets} = \text{Liabilities} + \text{Owner's Equity}
\]

and just rearrange the terms:

\[
\text{Owner's Equity} = \text{Assets} - \text{Liabilities}
\]

"Owner's Equity" are the words used on the balance sheet when the company is a sole proprietorship. If the company is a corporation, the words Stockholders' Equity are used instead of Owner's Equity.

**Classifications of Owner's Equity on the Balance Sheet**

Owner's equity is generally represented on the balance sheet with two or three accounts (e.g., Mary Smith, Capital; Mary Smith, Drawing; and perhaps Current Year's Net Income). See the sample balance sheet in Part 4. The stockholders' equity section of a corporation's balance sheet is:

- **Paid-in Capital**
- **Retained Earnings**
- **Treasury Stock**
The stockholders' equity section of a corporation's balance sheet is:

![Stockholders' Equity Table]

Notes to Financial Statements

The notes (or footnotes) to the balance sheet and to the other financial statements are considered to be part of the financial statements. The notes inform the readers about such things as significant accounting policies, commitments made by the company, and potential liabilities and potential losses. The notes contain information that is critical to properly understanding and analyzing a company's financial statements.

**Ratio Analysis**

There are several general categories of ratios, each designed to examine a different aspect of a company's performance. The general groups of ratios are:

- **Liquidity ratios:**

  Liquidity refers to a company's ability to pay its current bills and expenses. In other words, liquidity relates to the availability of cash and other assets to cover accounts payable, short-term debt, and other liabilities. All small businesses require a certain degree of liquidity in order to pay their bills on time, though start-up and very young companies are often not very liquid. In mature companies, low levels of liquidity can indicate poor management or a need for additional capital. Of course, any company's liquidity may vary due to seasonality, the timing of sales, and the state of the economy.

  This is the most fundamentally important set of ratios, because they measure the ability of a company to remain in business.
➢ Cash coverage ratio: Shows the amount of cash available to pay interest.
➢ Current ratio: Measures the amount of liquidity available to pay for current liabilities.
➢ Quick ratio: The same as the current ratio, but does not include inventory.
➢ Liquidity index: Measures the amount of time required to convert assets into cash.

Activity ratios: These ratios are a strong indicator of the quality of management, since they reveal how well management is utilizing company resources.

➢ Accounts payable turnover ratio: Measures the speed with which a company pays its suppliers.
➢ Accounts receivable turnover ratio: Measures a company's ability to collect accounts receivable.
➢ Fixed asset turnover ratio: Measures a company's ability to generate sales from a certain base of fixed assets.
➢ Inventory turnover ratio: Measures the amount of inventory needed to support a given level of sales.
➢ Sales to working capital ratio: Shows the amount of working capital required to support a given amount of sales.
➢ Working capital turnover ratio: Measures a company's ability to generate sales from a certain base of working capital.

Leverage ratios:

Leverage refers to the proportion of a company's capital that has been contributed by investors as compared to creditors. In other words, leverage is the extent to which a company has depended upon borrowing to finance its operations. A company that has a high proportion of debt in relation to its equity would be considered highly leveraged. Leverage is an important aspect of financial analysis because it is reviewed closely by both bankers and investors. A high leverage ratio may increase a company's exposure to risk and business downturns, but along with this higher risk also comes the potential for higher returns.
These ratios reveal the extent to which a company is relying upon debt to fund its operations, and its ability to pay back the debt.

- Debt to equity ratio: Shows the extent to which management is willing to fund operations with debt, rather than equity.
- Debt service coverage ratio: Reveals the ability of a company to pay its debt obligations.
- Fixed charge coverage: Shows the ability of a company to pay for its fixed costs.

**Profitability ratios**

Profitability refers to management's performance in using the resources of a business. Many measures of profitability involve calculating the financial return that the company earns on the money that has been invested. As James O. Gill stated in his book Financial Basics of Small Business Success, most entrepreneurs decide to start their own businesses in order to earn a better return on their money than would be available through a bank or other low-risk investments. If profitability measures demonstrate that this is not occurring—particularly once a small business has moved beyond the start-up phase—then the entrepreneur should consider selling the business and reinvesting his or her money elsewhere. However, it is important to note that many factors can influence profitability measures, including changes in price, volume, or expenses, as well the purchase of assets or the borrowing of money.

These ratios measure how well a company performs in generating a profit. Few profitability ratios are as follows:

- Breakeven point: Reveals the sales level at which a company breaks even.
- Contribution margin ratio: Shows the profits left after variable costs are subtracted from sales.
- Gross profit ratio. Shows revenues minus the cost of goods sold, as a proportion of sales.
- Margin of safety: Calculates the amount by which sales must drop before a company reaches its breakeven point.
Net profit ratio: Calculates the amount of profit after taxes and all expenses have been deducted from net sales.

Return on equity: Shows company profit as a percentage of equity.

Return on net assets: Shows company profits as a percentage of fixed assets and working capital.

Return on operating assets: Shows company profit as percentage of assets utilized.

**Limitations of Ratio Analysis**

Financial ratio analysis is useless without comparisons. In doing industry analysis, most business use benchmark companies. Benchmark companies are those considered most accurate and most important and are those used for comparison regarding industry average ratios. Companies even benchmark different divisions of their company against the same division of other benchmark companies.

There are other financial analysis techniques to determine the financial health of their company besides ratio analysis, with one example being common size financial statement analysis. These techniques fill in the gaps left by the limitations of ratio analysis discussed below.

**Benchmark to Industry Leaders' Ratios, Not Industry Averages**

This may be contrary to everything you have ever learned. But, think about it. Do you want high performance for your company? Or do you want average performance? I think all business owners know the answer to that one. We all want high performance. So benchmark your firm's financial ratios to those of high performing firms in your industry and you will shoot for a higher goal. As for a limitation of ratio analysis, the only limitation is if you use average ratios instead of the ratios of high performance firms in your industry.

**Companies' Balance Sheets are Distorted by Inflation**

Ever wonder why you always hear that balance sheets only show historical data? This is why. A balance sheet is a statement of a firm's financial condition at a point in time. So, looking back on a balance sheet, you see historical data.
Inflation may have occurred since that data was gathered and the figures may be distorted. Reported values on balance sheets are often different from "real" values. Inflation affects inventory values and depreciation, profits are affected. If you try to compare balance sheet information from two different time periods and inflation has played a role, then there may be distortion in your ratios.

**Ratio Analysis Just Gives you Numbers, not Causation Factors.**

You can calculate all the ratios you can find from now until doomsday. Unless you try to find the cause of the numbers you come up with, you are playing a useless game. Ratios are meaningless without comparison against trend data or industry data. Ratios are also meaningless unless you take the limitations listed in this article into account.

**Different Divisions May Need Comparison to Different Industry Averages**

Very large companies may be composed of different divisions manufacturing different products or offering different services. To make ratio analysis mean something, different industry averages may need to be used for each different division. The ratio analysis, used in this way, will certainly be more accurate than if you tried to do a ratio analysis for this type of large company.

**Companies Choose Different Accounting Practices**

Different companies may use different methods to value their inventory. If companies are compared that use different inventory valuation methods. The comparisons won't be accurate. Another issue is depreciation. Different companies use different depreciation methods. The use of different depreciation methods affects companies' financial statements differently and won't lead to valid comparisons.

**Companies can use Window Dressing to Manipulate Their Financial Statements**

Ratio analysis is based entirely on the data found in business firms' financial statements. If the financial statements for a company are not quite as good as they
should be and a company would like better numbers to show up in an annual report, the company may use window dressing to manipulate the data in the financial statements. Bear in mind - this is completely against the concept of financial and business ethics and flies in the face of corporate governance. What exactly is window dressing? The company will perform some sort of transaction at the end of its fiscal year that will impact its financial statements and make them look better but is then taken care of as soon as the new fiscal year starts. That is the simplest form of window dressing.

You can see that if ratio analysis is used with knowledge and intelligence and not in a mechanical and unthinking manner (like just cranking out the numbers), it can be a very valuable tool for financial analysis for the business owner. Its limitations have to be keep in mind but they should be more or less intuitive to a savvy business owner.

**Importance of Financial Statement Analysis**

The financial statement analysis is important for different reasons, they are as follows:

**Holding of Share**

Shareholders are the owners of the company. They may have to take decisions whether they have to continue with the holdings of the company's share or sell them out. The financial statement analysis is important as it provides meaningful information to the shareholders in taking such decisions.

**Decisions and Plans**

The management of the company is responsible for taking decisions and formulating plans and policies for the future. They, therefore, always need to evaluate its performance and effectiveness of their action to realize the company's goal in the past. For that purpose, financial statement analysis is important to the company's management.

**Extension of Credit**
The creditors are the providers of loan capital to the company. Therefore they may have to take decisions as to whether they have to extend their loans to the company and demand for higher interest rates. The financial statement analysis provides important information to them for their purpose.

**Investment Decision**

The prospective investors are those who have surplus capital to invest in some profitable opportunities. Therefore, they often have to decide whether to invest their capital in the company's share. The financial statement analysis is important to them because they can obtain useful information for their investment decision making purpose.

**Performance analysis with financial ratios**

Financial ratios are determined by dividing one number by another, and are usually expressed as a percentage. They enable business owners to examine the relationships between seemingly unrelated items and thus gain useful information for decision-making. "They are simple to calculate, easy to use, and provide a wealth of information that cannot be gotten anywhere else," Gill noted. But, he added, "Ratios are aids to judgment and cannot take the place of experience. They will not replace good management, but they will make a good manager better. They help to pinpoint areas that need investigation and assist in developing an operating strategy for the future."

Virtually any financial statistics can be compared using a ratio. In fact, Kristy and Diamond claimed that there are over 150 recognized financial ratios that can be computed in a financial analysis. In reality, however, small business owners and managers only need to be concerned with a small set of ratios in order to identify where improvements are needed. Determining which ratios to compute depends on the type of business, the age of the business, the point in the business cycle, and any specific information sought. For example, if a small business depends on a large number of fixed assets, ratios that measure how efficiently these assets are being used may be the most significant.
Problems with Financial Statement Analysis

While financial statement analysis is an excellent tool, there are several issues to be aware of that can interfere with your interpretation of the analysis results. These issues are:

- **Comparability between periods**: The Company preparing the financial statements may have changed the accounts in which it stores financial information, so that results may differ from period to period. For example, an expense may appear in the cost of goods sold in one period, and in administrative expenses in another period.

- **Comparability between companies**: An analyst frequently compares the financial ratios of different companies in order to see how they match up against each other. However, each company may aggregate financial information differently, so that the results of their ratios are not really comparable. This can lead an analyst to draw incorrect conclusions about the results of a company in comparison to its competitors.

- **Operational information**: Financial analysis only reviews a company's financial information, not its operational information, so you cannot see a variety of key indicators of future performance, such as the size of the order backlog, or changes in warranty claims.

Limitations of Financial Statement Analysis

Although analysis of financial statement is essential to obtain relevant information for making several decisions and formulating corporate plans and policies, it should be carefully performed as it suffers from a number of the following limitations.

**Mislead the user**

The accuracy of financial information largely depends on how accurately financial statements are prepared. If their preparation is wrong, the information obtained from their analysis will also be wrong which may mislead the user in making decisions.
Not useful for planning

Since financial statements are prepared by using historical financial data, therefore, the information derived from such statements may not be effective in corporate planning, if the previous situation does not prevail.

Qualitative aspects

Then financial statement analysis provides only quantitative information about the company’s financial affairs. However, it fails to provide qualitative information such as management labor relation, customer's satisfaction, and management’s skills and so on which are also equally important for decision making.

Comparison not possible

The financial statements are based on historical data. Therefore comparative analysis of financial statements of different years cannot be done as inflation distorts the view presented by the statements of different years.

Wrong judgment

The skills used in the analysis without adequate knowledge of the subject matter may lead to negative direction. Similarly, biased attitude of the analyst may also lead to wrong judgement and conclusion.

The limitations mentioned above about financial statement analysis make it clear that the analysis is a means to an end and not an end to itself. The users and analysts must understand the limitations before analyzing the financial statements of the company. Thus, financial analysis only presents part of the total picture.
BIBLIOGRAPHY

Further Reading:


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